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May 5, 2016

VIA HAND DELIVERY

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**PUBLIC SERVICE
COMMISSION**

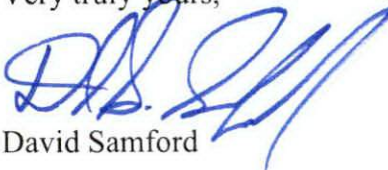
Executive Director
Kentucky Public Service Commission
P.O. Box 615
211 Sower Boulevard
Frankfort, KY 40602

Re: PSC Case No. 2016-00002

Dear Executive Director:

Please find enclosed for filing with the Commission in the above-referenced case an original and ten copies of the Brief of East Kentucky Power Cooperative, Inc. Please return a file-stamped copy of the Brief to my office.

Very truly yours,



David Samford

Enclosures

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MAY 05 2016

PUBLIC SERVICE
COMMISSION

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

AN EXAMINATION OF THE APPLICATION)	
OF THE FUEL ADJUSTMENT CLAUSE OF)	
EAST KENTUCKY POWER COOPERATIVE,)	CASE NO. 2016-00002
INC. FROM MAY 1, 2015 THROUGH)	
OCTOBER 31, 2015)	

**BRIEF OF
EAST KENTUCKY POWER COOPERATIVE, INC.**

Comes now East Kentucky Power Cooperative, Inc. (“EKPC”), by counsel, pursuant to the direction of the Commission as given at the hearing held in this matter on April 7, 2016, and for its Brief in the above-captioned fuel adjustment clause (“FAC”) proceeding, respectfully states as follows:

I. Introduction

This case presents the question of how “the avoided variable cost of the utility’s highest cost generating unit available to serve native load the during the FAC expense month” should be calculated. If the Commission determines that the method EKPC has historically used to arrive at this component of the FAC is unreasonable, then it will very likely have the effect of expanding the scope of what are referred to in FAC parlance as “non-economy energy purchases.” This would have the corresponding effect of increasing the amount of energy purchases that must be excluded from cost recovery under the FAC.¹

¹ See e.g. EKPC’s Response to Commission Staff’s Third Information Request, Response No. 5.

Thus, once again, EKPC is confronted with the possibility that the Commission will re-interpret the FAC regulation set forth in 807 KAR 5:056 and accompanying precedent in such a manner as to further reduce the usefulness and benefit of the FAC to jurisdictional utilities in Kentucky.² However, EKPC is at a greater disadvantage in this proceeding than in prior proceedings because it has even less certainty as to what the Commission's likely re-interpretation of the FAC regulation might be. EKPC is therefore in the difficult position of having to essentially prove the reasonableness of its current method for applying the FAC without fully understanding what alternative methodologies the Commission may be considering and, more importantly, without having any understanding of the rationale to support such alternative methodologies. Reinterpreting the FAC, particularly if undertaken retroactively, would be arbitrary, capricious, unlawful, unreasonable and a violation of due process. EKPC respectfully requests that the Commission find that EKPC's current methodology for applying the FAC remains reasonable.

II. Background

EKPC is an electric generation and transmission cooperative that provides electricity to approximately 525,000 retail customers. EKPC is owned by sixteen Members, all of whom are distribution cooperatives. EKPC owns four active electric generation stations: (1) the John Sherman Cooper Generating Station ("Cooper Station") near Burnside, Kentucky; (2) the H. L. Spurlock Generating Station near Maysville, Kentucky; (3) the J. K. Smith Generating Station ("Smith Station") near Trapp, Kentucky; and (4) the Bluegrass Generating Station ("Bluegrass

² See e.g. *In the Matter of an Examination of the Fuel Adjustment Clause of East Kentucky Power Cooperative*, Final Order, Case No. 2004-00430 (Ky. P.S.C., March 21, 2005) (modifying the definition of "non-economy energy purchases"); *In the Matter of an Examination of the Application of the Fuel Adjustment Clause of East Kentucky Power Cooperative, Inc. from November 1, 2013 Through April 30, 2014*, Order, Case No. 2014-00226 (Ky. P.S.C. July 10, 2015) (limiting "economic dispatch basis" to the security-constrained dispatch of EKPC's generation assets as a stand-alone utility without regard to EKPC's participation in the more economically efficient PJM Day-Ahead and Real-Time Energy Markets).

Station”) near LaGrange, Kentucky. Altogether, EKPC currently has 3,009 megawatts (MWs) of wintertime net electric generating capacity in its fleet.

The Commission initiated the current six month review case on February 5, 2016. EKPC filed responses to information requests propounded by Commission Staff on February 19, 2016. EKPC received the Commission Staff’s second set of information requests on March 1, 2016 and the Commission’s third set of information requests on March 18, 2016. EKPC tendered responses on March 11, 2016 and March 28, 2016, respectively. The Commission held a hearing on April 7, 2016, which resulted in several post-hearing information requests. EKPC tendered responses on April 21, 2016. With the filing of this Brief, the case is ripe for adjudication.

III. Argument

A. Overview of the FAC Regulation and Applicable Precedent

The purpose for having a fuel adjustment rate mechanism in a utility’s tariff is well-established in Commission precedent. An FAC tariff is:

... a means for [an electric] utility to recover from its customers its current fuel expense through an automatic rate adjustment without the necessity for a full regulatory rate proceeding. This rate may increase or decrease from one billing cycle to the next depending on whether the utility’s cost of fuel increased or decreased in the same period. The rate provides for a straight pass-through of fuel costs, with no allowance for a profit to the utility.³

In Kentucky, each electric utility has an FAC tariff that conforms to certain regulatory prescriptions that have been set forth in regulations promulgated by the Commission. The current iteration of the Commission’s FAC regulation, 807 KAR 5:056, became effective on April 7,

³ *In the Matter of 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*, Order, Case No. 2004-00430 (Ky. P.S.C. Feb. 7, 2005) (quoting *In the Matter of Kentucky Power Company*, Order, Case No. 6877, p. 2 (Ky. P.S.C. Dec. 15, 1977)).

1982.⁴ The preamble to the regulation states that, “Fuel adjustment clauses which are not in conformity with the principles set out below are not in the public interest and may result in suspension of those parts of such rate schedules.”⁵

In accordance with the Filed Rate Doctrine (KRS 278.160) and the FAC regulation, EKPC prepared and tendered a proposed FAC tariff that the Commission accepted. Though EKPC’s FAC tariff has been revised from time to time over the intervening decades, its current tariff became effective on June 1, 2011, and, for purposes of this proceeding, substantially mirrors the definition of “Fuel Cost” set forth in 807 KAR 5:056, Section 1(3), stating in relevant part:

Fuel cost (F) shall be the most recent actual monthly cost of:

- (a) Fossil fuel consumed in the utility’s own plants, and the utility’s share of fossil fuel and nuclear fuel consumed in jointly owned or leased plants, plus the cost of fuel which would have been used in plants suffering forced generation and/or transmission outages, but less the costs of fuel related to substitute generation, plus
- (b) The actual identifiable fossil and nuclear fuel costs associated with energy purchased for reasons other than identified in paragraph (c) below, but excluding the cost of fuel related to purchases to substitute the forced outages, plus
- (c) The 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 outages, also such kinds of energy being purchased by the buy to substitute for its own higher cost energy; and less
- (d) The cost of fossil fuel recovered through inter-system sales including the fuel costs related to economy energy sales and other energy sold on an economic dispatch basis.

⁴ See 8 Ky.R. 822.

⁵ 807 KAR 5:056, Section 1.

(e) All fuel costs shall be based on weighted average inventory costing.⁶

Any textual differences in the Commission's FAC regulation and EKPC's FAC tariff are immaterial for purposes of the questions posed in this proceeding. Thus, any analysis of EKPC's tariff and the FAC regulation should consistently lead to the same result.

The FAC regulation authorizes the recovery of "[t]he net energy cost of energy purchases...when such energy is purchased on an economic dispatch basis."⁷ The term "economic dispatch basis" is not defined in the regulation and has been the subject of several Commission Orders. In Case No. 2000-00496-B, the Commission held that clarification of the phrases "economy energy purchases" and "non-economy energy purchases" was necessary "in recognition of the recent changes in the wholesale energy market."⁸ The Commission went on to define the term "economy energy purchase" as a purchase that an electric utility makes "to serve native load, that displaces its higher cost of generation, and that [has] an energy cost less than the avoidable variable generation cost of the utility's highest cost generation unit available to serve native load during the FAC expense month."⁹ A "non-economy energy purchase" was conversely defined as an energy purchase that an electric utility makes "to serve native load that [has] an energy cost greater than the avoidable variable generation cost of the utility's highest cost generation unit

⁶ EKPC Tariff P.S.C. No. 34, First Revised Sheet No. 2 (June 1, 2011).

⁷ See 807 KAR 5:056 Section 1(3)(c).

⁸ *In the Matter of An Examination of the Application of the Fuel Adjustment Clause of East Kentucky Power Cooperative, Inc. from May 1, 2001 to October 31, 2001*, Order, Case No. 2000-00496-B (Ky. P.S.C. May 2, 2002). Disappointingly, the Commission exercised its discretion to not update its interpretation of these terms in light of the even more significant developments in the wholesale energy market occasioned by the creation of the Day Ahead and Real Time Energy Markets created by PJM. EKPC continues to believe that the Commission's interpretive policy is outdated and should be reconsidered in light of subsequent events. To reiterate, the FAC should be implemented in such a way that utilities are fully compensated for costs incurred using reasonable economic dispatch methodologies regardless of whether any particular plant is running or not.

⁹ *Id.*, p. 4.

available to serve native load during the FAC expense month.”¹⁰ Thus, whether a given energy purchase is characterized as an economy energy purchase or a non-economy energy purchase depends upon whether the cost of that energy is greater or less than “the avoidable variable generation cost of the utility’s highest cost generation unit available to serve native load during the FAC expense month.”

Calculating the avoided variable generation cost of a utility’s highest cost unit available for dispatch requires one to take the heat rate (expressed as mmBtu/kWh) of the highest cost generation unit that is available and multiply it by a fuel price.¹¹ A generation asset’s heat rate will vary significantly based upon the physical characteristics of the unit, however, which prohibits the easy application of any “one size fits all” interpretation of when a particular unit is “available” for FAC purposes. Likewise, the cost of fuel is a dynamic variable that changes from day to day and from product to product. EKPC is unaware of any statute, regulation or Commission Order defining the operating heat rate at which a specific generation unit becomes “available” for FAC purposes. Likewise, there is no known authority to determine or mandate the calculation of the fuel cost variable. Finally, EKPC is unaware of any authority to mandate that the method for calculating these variable components must be uniform across all jurisdictional utilities.

¹⁰ *Id.* Ironically, these definitions were never intended to assume the precedential value they have come to occupy. These definitions were originally set forth in a Settlement Agreement resolving three disputed FAC cases involving Kentucky Utilities Company and Louisville Gas & Electric Company. Section 4.10 of the Settlement Agreement, which the Commission approved and adopted to bring the cases to a conclusion, expressly provided that, “Nothing in this Settlement Agreement is intended to be, nor shall it be construed as a general regulatory change.” *See e.g.* Case No. 1994-00461-A, Order, Appendix A (Ky. P.S.C. May 17, 2002). It is also important to note that the Commission’s definition of “non-economy energy purchase” was also subsequently changed to include energy purchases both greater and less than the avoided variable cost of a utility’s highest cost generation unit available to serve native load. *See In the Matter of 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*, Rehearing Order, Case No. 2004-00430, p. 6 (Ky. P.S.C, Mar. 21, 2005).

¹¹ *See* EKPC’s Response to Commission Staff’s Third Information Request, Response No. 3a. A generation unit’s “heat rate” is a measure of the unit’s efficiency and is expressed in Btu’s/KWh. As heat rate increases the efficiency of the unit gets worse. Likewise, as heat rate decreases the unit’s efficiency improves.

There are obviously good reasons for not mandating such points when subjective judgments are called for. For instance, there are many occasions where a utility will do well to make natural gas purchases on the spot market as opposed to locking in long term purchase contracts where the natural gas may or may not be consumed. At other times, a firm contract may be the preferable fuel supply option. Likewise, an investment in a generation facility that makes it more operationally flexible is beneficial and likely to enhance the unit's capacity factor, but the investment is diminished if the unit's "availability" for FAC purposes is arbitrarily set at a level incompatible with the unit's unique operational characteristics. The Commission has never resorted to mandating the precise level of load that make a unit "available," nor has it ever mandated the precise valuation of natural gas to be used in the FAC's avoided generation cost equation. The hesitation to take such actions over the past fourteen years is itself an indication that a new reinterpretation of the FAC regulation that further restricts the scope of the cost recovery mechanism, particularly without an identified basis for doing so, is unnecessary and, very likely, counterproductive.

In the course of this proceeding, Commission Staff's information requests and questions at the hearing imply that the Commission may be considering the adoption of a single, uniform methodology for calculating the avoidable variable generation cost of EKPC's highest cost generation unit available to serve native load during an FAC expense month. The Commission's questions to EKPC and other utilities have involved scenarios where: 1) the heat rate is calculated at a generation asset's: a) minimum load; b) maximum load; or c) average of minimum and maximum load; and 2) the fuel cost is calculated at: a) the highest natural gas price paid during a month; b) the actual natural gas price at the time the highest cost generation unit is dispatched; or c) the average observed natural gas price for the applicable FAC expense month. Other

combinations and permutations may also be under consideration. This case therefore appears to present questions of first impression.

B. EKPC's Current Methodology for Determining "the Avoidable Variable Generation Cost of the Utility's Highest Cost Generation Unit Available to Serve Native Load During the FAC Expense Month" is Reasonable.

In calculating its avoided variable generation cost, EKPC uses the heat rate for the minimum load level of its Smith Station 1, 2 and 3 Units.¹² These units are identical and will rank as the highest cost units in EKPC's fleet except in periods of very low natural gas prices, which have not occurred.¹³ As explained by EKPC, when calculating the avoidable generation cost of these Smith Units, EKPC takes into account fuel costs, variable operations and maintenance costs, start-up costs and environmental costs in order to ascertain and compare the all-in cost of starting the applicable Smith Unit with an available energy purchase.¹⁴ While it is axiomatic that a generation unit cannot safely or efficiently operate below its minimum load level,¹⁵ it is not at all unusual for PJM to call upon the Smith 1, 2 and 3 Units to operate at or near their minimum load levels to satisfy economic dispatch or reliability criteria.¹⁶ One or more of these units were available for dispatch during each month of the six-month period under review in this proceeding.¹⁷ As for the fuel cost component, EKPC utilizes the highest actual price that it has paid for natural gas during the applicable FAC expense month.¹⁸ EKPC's natural gas purchases are generally

¹² See EKPC's Response to Commission Staff's Second Information Request, Response No. 2.

¹³ See *id.*

¹⁴ See EKPC's Response to Commission Staff's Third Information Request, Response No. 3a.

¹⁵ See *id.*

¹⁶ See *id.*, Response 3i.

¹⁷ See *id.*, Response 3j.

¹⁸ See *id.*, Response 3d.

made on the spot market, but other products are available. Because the cost of fuel is the greatest variable cost incurred by a utility, generally speaking, any regulatory interpretation that restricts fuel cost recovery will likely force the hand of EKPC and other utilities in fuel procurement decisions.

EKPC has used this methodology for calculating the avoided generation cost of its highest cost generation unit available for dispatch to serve native load during each FAC expense month since 2013 without any question or comment from the Commission. Indeed, it is a well-established course of conduct which has never been challenged or objected to as unreasonable over multiple review periods. The Commission's focus upon whether the Smith Station Units were dispatched in any given month is irrelevant.¹⁹ The only question that matters under the prevailing interpretation of "economy energy purchase" is whether any of these units was "available" to be dispatched. Likewise, the Commission's Order in Case No. 2004-00430 makes it clear that the analytical horizon for determining whether a given energy purchase is excluded from the FAC is the "FAC expense month," not the "FAC expense day" or "FAC expense month average." Importantly, there is nothing about EKPC's methodology for calculating the avoided variable cost of the Smith 1, 2 and 3 Units that contradicts either 807 KAR 5:056 Section 1(3)(c) or any Commission guidance construing that regulation. There is no identified basis in the record for making a finding that EKPC's methodology is unfair, unjust or unreasonable.

¹⁹ See *In the Matter of an Examination of the Application of the Fuel Adjustment Clause of Duke Energy Kentucky, Inc. from November 1, 2013 Through April 30, 2014*, Order, Case No. 2014-00229 (Ky. P.S.C. January 30, 2015) ("The phrase 'highest cost generating unit available to be dispatched' means that the highest-cost unit is available to be dispatched, but is not required to have been dispatched in order to be considered the highest-cost unit.").

C. Excluding Energy Costs Under a Different Methodology in this Review Period is both Unreasonable and Unlawful.

A significant amount of information requests and questions at the April 7, 2016 hearing suggest that the Commission may be considering adopting an alternative methodology for calculating EKPC's avoided generation costs that would result in additional exclusions of energy purchases. Questions posed to other jurisdictional utilities suggest that the Commission might even be considering a uniform methodology that would be applicable to all such utilities. EKPC does not believe that such a result is necessary or advisable. While interpreting the FAC regulation may involve mixed questions of law and administrative policy, the "one size fits all" approach is untenable, unreasonable, inconsistent with Commission precedent and, quite likely, unlawful.

1. The Commission Has Never Hesitated to Treat Utilities Uniquely Based Upon Unique Circumstances.

No two utilities have the exact same tariffs and the Courts and the Commission have often noted that an element of subjectivity plays into the question of what is reasonable.²⁰ In ratemaking, it is the result that is to be scrutinized and not necessarily the method of arriving at that result; substance matters over form. This elementary principle of regulatory practice is clearly and vividly displayed in the fact that the Commission has allowed Kentucky Power Company to utilize a price proxy, to simulate its ownership of a combustion turbine similar to the Smith Units, when calculating its avoided generation costs for FAC purposes.²¹

²⁰ See *National-Southwire Aluminum Co. v. Big Rivers Electric Corp.*, 785 S.W.2d 503, 513 (Ky. App. 1990) ("[The Commission] has many appropriate rate-making methodologies available to it, and it must have some discretion in choosing the best one for each situation. Again, we must look more to whether the result is fair, just and reasonable rather than at the particular methodology used to reach the result.") (citation omitted); see also *Kentucky Indus. Utility Customers, Inc. v. Kentucky Utilities Company*, 983 S.W.2d 493, 498 (Ky. 1998) ("[T]he Commission has discretion in working out the balance of interest necessarily involved and that it is not the method, but the result, which must be reasonable.") (citing *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591 (1944)).

²¹ See *In the Matter of an Examination by the Public Service Commission of the Application of the Fuel Adjustments Clause of American Electric Power Company from May 1, 2001 to October 31, 2001*, Order, Case No. 2000-00495-B (Ky. P.S.C. Oct. 3, 2002).

Common sense and precedent such as the Kentucky Power proxy authorization clearly establish that it would be unreasonable to assume that each of the jurisdictional electric generation utilities should be facsimiles of one another. Each utility has its own service area with distinctive characteristics. Each utility has its own generation fleet, rendered unique by differing fuel supplies, capacity sizes, geographic location, vintages, appurtenant transmission resources and – most importantly for the purposes of this proceeding – operational limitations. The Commission must take into account the options and limitations of each utility when considering whether to impose a uniform methodology for calculating the avoided generation cost arising from the utility’s highest cost generation unit available for dispatch to serve native load.

For instance, it is well known that the heat rate of a particular generation unit will generally decrease as its generation level increases.²² However, it is unrealistic and inconsistent with good utility practice to require a utility to assume that a unit operates at maximum generation levels for FAC purposes. Generation units are frequently required to operate below their maximum load for a variety of reasons. Sometimes, the overall system load is insufficient to require their maximum output. Other times, economic dispatch principles may limit a unit’s ability to run at full capacity. On other occasions, transmission constraints will limit the ability of a unit to operate fully. In addition, stringent environmental rules often mandate that a given unit must operate at a level below what is possible,²³ as do original equipment manufacturer guidelines.²⁴ For the most part, these operational limitations are well beyond the control of the utility that owns the asset. The Commission should therefore be extremely hesitant to adopt any new interpretation of the FAC

²² See EKPC Response to Commission Staff’s Third Information Request, Response No. 5.

²³ See Hearing Video Record (“HVR”), 09:58:00 (April 7, 2016).

²⁴ See *id.*

that causes EKPC (or any other utility) to sacrifice the ability to timely recover *bona fide* energy purchase costs through the FAC, especially when there is no clear and compelling reason to do so stated in the administrative record. Here, no such reason exists and to adopt a new interpretation without EKPC having an opportunity to challenge it would amount to a violation of due process.²⁵

2. The Commission Cannot Engage in Retroactive Ratemaking

If the Commission were to once again narrow the parameters for establishing the variables used to calculate the avoided variable cost of EKPC's highest cost generation asset available to serve native load during an FAC expense month in the current proceeding, it would amount to unlawful retroactive ratemaking. This is not a situation wherein the Commission could determine that EKPC has somehow mathematically mis-applied its established method for calculating the avoided generation cost. Instead, in order to exclude such costs, the Commission would have to find and hold that EKPC's established practice for calculating the avoided generation cost is itself unreasonable or unlawful. That determination, however, can only be applied prospectively.²⁶ Indeed, when the present definitions of "economy energy purchase" and "non-economy energy purchase" were adopted, it was done prospectively.²⁷ While the Commission may feel compelled to further clarify the definitions for "economy energy purchase" and "non-economy energy purchase" it laid down in Case No. 2000-00496-B, it would be unfair, unjust, unreasonable and unlawful to apply such a clarification retroactively.

²⁵ See *Kentucky American Water Co. v. Com. ex rel. Cowan*, 847 S.W.2d 737, 741 (Ky. 1993) (Under due process, litigants are entitled to know what evidence is being considered and are entitled to an opportunity to test, explain and/or refute that evidence) (citing *Utility Regulatory Commission v. Kentucky Water Service, Inc.*, 642 S.W.2d 591 (Ky. App. 1982); *Ohio Bell Tel. Co. v. Public Utility Comm'n of Ohio*, 301 U.S. 292 (1937)).

²⁶ See *Boone County Sand and Gravel Co., Inc. v. Owen Rural Elec. Co-op. Corp.*, 779 S.W.2d 224, 225-26 (Ky. App. 1989); *City Of Russellville v. Public Service Comm'n*, Slip. Op., 2005 WL 385077, *4 (Ky. App. 2005).

²⁷ Case No. 1994-00461-A; Case No. 1994-00461-B; Case No. 1994-00461-C (Ky. P.S.C, May 17, 2002).

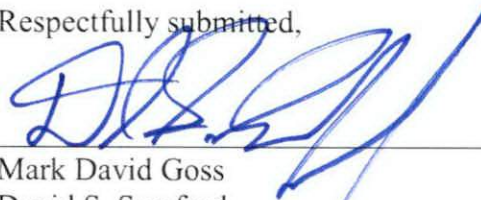
IV. Conclusion

EKPC has used the same methodology for calculating the components of the avoided generation cost formula for several years without question or concern. It would be inequitable, unreasonable, unjust and unlawful to force EKPC to adopt an alternative methodology that divorces the practice of calculating its avoided generation cost from the actual operation of its generation fleet. Doing so with retroactive application would be especially egregious.

WHEREFORE, on the basis of the foregoing, EKPC respectfully requests that the Commission neither impose a new "one size fits all" approach for calculating its avoided generation cost nor impose an alternative methodology from that which it currently employs.

Done this 5th day May, 2016.

Respectfully submitted,



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