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Via Electronic Mail and Expedited Courier

John E.B. Pinney
Acting General Counsel
Office of General Counsel
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, KY 40602-0615

RE: *Comments of Louisville Gas and Electric Company and Kentucky Utilities Company on Proposed Changes to Commission Regulation 807 KAR 5:056*

Dear Mr. Pinney:

Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU") (collectively, the "Companies") respectfully submit these comments to the Kentucky Public Service Commission (the "Commission") concerning proposed revisions to 807 KAR 5:056, which prescribes the operation of the fuel adjustment clauses of electric utilities in Kentucky.

Background

Kentucky electric utilities have long utilized tariff provisions to pass through changes in the cost of fuel to their customers. The tariffs of Louisville Gas and Electric Company and Kentucky Utilities Company have contained fuel adjustment clauses or similar mechanisms since at least the 1940s.[1] In 1978, after extensive review and discussion, the Public Service

[1] In Cases No. 98-426, *Application of Louisville Gas and Electric Company for Approval of an Alternative Method of Regulation of its Rates and Service* (Ky. PSC filed Oct. 12, 1998), and No. 98-474, *Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of its Rates and Service* (Ky. PSC filed Oct. 12, 1998),

Commission promulgated an administrative regulation establishing uniform standards for the contents and operation of such tariff provisions. This regulation, which is currently codified at 807 KAR 5:056, was last amended in 1982. The present version of the regulation has successfully governed the operation of electric utility fuel adjustment clauses for more than 37 years.

Fuel adjustment clauses are very important to the financial viability of the Commonwealth's electric utilities because fuel costs represent a significant portion of an electric utility's costs. In 2018, for example, approximately 29 percent of every dollar that KU billed its Kentucky jurisdictional retail customers for electric service was for fuel costs. In the same year, approximately 26 percent of every dollar LG&E billed to its retail customers was for fuel costs. Fuel adjustment clauses ensure a full and timely recovery of fuel costs. By permitting an electric utility to promptly pass through increases in its fuel costs, fuel adjustment clauses reduce regulatory lag and avoid the need for frequent and costly rate proceedings.

Fuel adjustment clauses also benefit electric utility ratepayers by allowing for the prompt reduction in rates when an electric utility's fuel costs decrease. It was primarily through the operation of fuel adjustments clauses that ratepayers received the benefits of the significant decline in fuel prices that occurred in the late 1980s and 1990s. Today fuel adjustment clauses continue to ensure that ratepayers receive any savings that result from reductions in fuel prices. For example, in eleven months of 2018, KU's retail customers received

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the Companies proposed an alternative method of regulation which included the elimination of the fuel adjustment clause. The PSC permitted the proposed tariffs that implemented the alternative method of regulation to take effect subject to review, but subsequently denied the Companies' proposals and ordered the reinstatement of their FACs. Between July 2, 1999 and March 1, 2000, the Companies had no fuel adjustment clause in their tariffs.

a credit on their monthly bills through the fuel adjustment clause. LG&E's retail customers received a credit on their monthly bills as a result of the fuel adjustment clause for eight months in the same period.

Evaluation of the Reasonableness of Fuel Procurement Contracts

Kentucky imposes excise taxes on coal and natural resource severances. For coal, the tax is 4.5 percent of the gross value of coal severed, processed or both with a minimum tax of 50 cents per ton of severed coal.[2] Other states from which the Companies purchase coal impose similar taxes. Some coal producing states assess no such taxes. Section 3(5) of the proposed amendment requires the Commission, when evaluating the reasonableness of an electric utility's fuel procurement activities, to remove from the contract price or bid the Kentucky severance tax assessed on the coal that a contract vendor supplies or potential vendor offers to provide.

The proposed provision appears to violate the Dormant Commerce Clause. The U.S. Constitution grants to Congress the authority "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[3] The U.S. Supreme Court has found a negative implication in this grant of authority that prohibits a state from in "any form or under any guise, directly burden[ing] the prosecution of interstate business . . . when the avowed purpose of the obstruction, as well as its necessary tendency, is to suppress or mitigate the consequences of competition between the states."[4] "The modern law of what has come to be called the Dormant Commerce Clause is driven by concern about 'economic protectionism that

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2 KRS 143.020.
3 U.S. Constitution, Art. I, § 8, cl. 3.
4 *Baldwin v. G. A. F. Seelig, Inc.*, 294 U.S. 511, 522 (1935).

is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.'"[5]

Whether a law or regulation is discriminatory depends upon whether it is intended or brings about "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter."[6] If so, it is considered *per se* invalid unless the proponent of the regulation or law demonstrates a legitimate, non-protectionist purpose for the discrimination and shows that the purpose cannot be adequately served in a different, non-discriminatory way.[7] If not discriminatory on its face, the challenged provision is valid, unless the challenger can show that, although seemingly non-discriminatory, the provision nevertheless burdens interstate commerce in a way or to a degree that is clearly out of proportion to the provision's valid local benefits.[8]

The effect of the proposed amendment is to favor Kentucky-mined coal. For example, if the all-in price of a ton of coal produced in Kentucky is $40.00, and the all-in price of a ton of coal produced in Indiana, for the same quality of coal, is $38.25, the Companies would currently select the lower price Indiana coal. However, under the proposed amendment, the Commission must ignore the portion of the $40.00 attributable to Kentucky's 4.5 percent severance tax, thereby rendering the Kentucky coal the lower cost than the Indiana coal for purposes of evaluating the reasonableness of a utility's fuel costs. The purpose of the proposed amendment is "to incentivize Kentucky utilities to purchase Kentucky coal . . . [and is] an attempt to remove

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5 *Dep't of Revenue v. Davis*, 553 U.S. 328, 337-38 (2008).
6 *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 338 (2007), (quoting *Oregon Waste Sys., Inc. v. Dep't of Environmental Quality of Ore.*, 511 U.S. 93, 99 (1994)).
7 *Jamgotchian v. Kentucky Horse Racing Comm'n*, 488 S.W.3d 594, 604 (Ky. 2016).
8 *Id.* at 604-05 (quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970)).

from [a utility's] consideration the increase in the cost of Kentucky coal as a result of the Kentucky coal severance tax."[9]

The Commission has not identified a legitimate, non-protectionist purpose for the discriminatory treatment the proposed amendment requires. Indeed the Commission's explanation demonstrates the discriminatory intent of the proposed amendment. The Commission has also failed to explain how the promotion of the Kentucky coal industry is within its statutory mandate to regulate utility rates and services and to establish "fair, just and reasonable rates."

Under the holding in *Wyoming v. Oklahoma*, 502 U.S. 437 (1992) a serious legal question exists concerning the constitutionality of the proposed amendment. [10] The proposed amendment is likely to attract legal challenges by disappointed vendors. Such challenges to preferences for in-state coal generally have been successful. [11] The legal challenges will place

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[9] Cases No. 2019-00004 and No. 2019-00005, Video Transcript, 04/16/2019 at 9:53:38 – 9:54:33. It also was stated that this proposal was made at the request of some members of the Kentucky House of Representatives.

[10] In *Wyoming v. Oklahoma*, 502 U.S. 437 (1992), Wyoming sought a declaration that an Oklahoma statute requiring coal-fired electric utilities to burn a mixture containing at least 10 percent of Oklahoma-mined coal violated the Dormant Commerce Clause. The United States Supreme Court agreed, holding that the law "reserves a segment of the Oklahoma coal market for Oklahoma-mined coal, to the exclusion of coal mined in other States. Such a preference for coal from domestic sources cannot be characterized as anything other than protectionist and discriminatory, for the Act purports to exclude coal mined in other States based solely on its origin." *Id.* at 454.

[11] *See Alliance for Clean Coal v. Bayh,* 72 F.3d 556 (7th Cir. 1995) (The Court found that Indiana's Environmental Compliance Plans Act violated the commerce clause because it discriminated against interstate commerce based upon geographic origin. The clear intent of the statute, which permitted utilities to submit plans showing compliance with federal legislation to the Commission if they could show continued or increased use of Indiana coal, was to benefit the state's coal industry); *General Motors Corp. v. Indianapolis Power & Light Co.*, 654 N.E.2d 752 (Ind. Ct. App. 1995) (The Court found an Indiana Code coal provision, which allowed the Commission to add the value of any "qualified pollution control property" to the value of the utility's property for ratemaking purposes if the facility used Indiana coal as a primary fuel source, to be an unconstitutional interference with interstate commerce); *Alliance for Clean Coal v. Miller*, 44 F.3d 591 (7th Cir. 1995) (The Court held the Illinois Coal Act violated the United States Commerce Clause because it required Illinois utilities to install scrubbers for pollution control and to continue to use coal from Illinois, rather than purchase coal from an interstate source), affirming *Alliance for Clean Coal v. Craig*, 840 F.Supp. 554 (E.D. Il. 1993) (The Court held that the Illinois Coal Act discriminated in favor of the Illinois coal industry because it required public utilities to consider the use of Illinois

the recovery of a significant cost of service for the Companies at risk, increasing their cost of raising capital and threatening their credit ratings.

Proposed Amendment Places Companies at risk of fuel cost disallowances in other jurisdictions. The proposed amendment subjects the Companies to conflicting regulatory regimes and a greater risk that they will not recover their actual fuel costs. The Companies sell power on the wholesale market. KU has retail operations in Virginia. The Federal Energy Regulatory Commission ("FERC") and the Virginia State Corporation Commission ("VSCC") regulate these sales and apply least cost principles to determine the reasonableness of the Companies' fuel costs. Neither regulatory commission is likely to adopt the proposed amendment's fuel cost evaluation methodology that ignores a cost element for coal purchased in Kentucky and may result in the purchase of a more expensive source of fuel. In those instances where the proposed amendment's methodology favors the purchase of higher cost coal over comparable lower-cost sources, the FERC and the VSCC regulators are likely to consider such purchases as unreasonable and to disallow that portion of the Companies' fuel costs that resulted from the Companies' failure to purchase the lower cost source. The Companies' purchase of Kentucky coal that has a lower evaluated price, but a higher actual price, will place the Companies at risk of fuel disallowances by the regulatory commissions of other jurisdictions. Disallowance of fuel costs in any jurisdiction would adversely affect the Companies' financial health and increase the cost of raising capital to invest in facilities to serve customers.

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coal and declared that the Act was unconstitutional under the Commerce Clause of the United States Constitution).

Operational concerns: Additional Information. The proposed regulation will require the utilities to develop, maintain and provide more complex fuel cost information to the Commission to demonstrate the reasonableness of their fuel procurement decisions than that currently required and provided under the traditional least-cost, most reasonable analysis that the Commission presently uses. At a minimum, electric utilities will need to require coal vendors to identify the portion of the bid price related to Kentucky severance tax. Given that the information is only in the possession of the coal vendors, the process is subject to potential manipulation through the submission of aggressive statements regarding the portion of the bid price related to Kentucky severance tax, further distorting the price of the purchased fuel.

Further complicating the process is that, as written, the proposed amendment applies to all forms of fuel sources, not merely coal. Therefore, electric utilities that use natural gas or oil must also identify the origin of those fuels and whether any of those fuels were subject to the Kentucky severance tax.

Operational concerns: Effect on Unit Dispatch. The proposed amendment does not address how the required exclusion of Kentucky severance tax will affect the Commission's evaluation of an electric utility's dispatch of its generation units. Currently the Companies dispatch their units based upon cost of generation. The fuel costs are the major determinant of this cost. The proposed amendment requires the Commission to ignore the effects of Kentucky severance tax on the cost of the fuel when evaluating fuel procurement decisions. Will the Commission evaluate the reasonableness of the Companies' dispatch of their generation units based upon the actual cost of fuel or upon the evaluated cost (which excludes Kentucky

severance tax)? If evaluated cost is used, there is a strong risk that generation will not be dispatched in the order of least cost to highest cost, thereby increasing the cost to customers and prejudicing wholesale power sales. If actual cost is used, the Companies will be required to maintain two different sets of records regarding fuel costs.

Assuming that the Commission permits electric utilities to dispatch their generation units based upon actual cost, the proposed methodology is likely to result in two unintended consequences. First, by requiring the purchase of higher cost coal, it will likely result in less coal being consumed as coal-fired units will be less cost competitive with natural gas-fired units, and thus, they will be dispatched after natural gas-fired generation units. Second, by increasing the cost of electricity generated by coal-fired generation units, it is likely to make Kentucky generated electricity less competitive in the off-system sales market and result in a reduction of off-system sales and the margins associated with off-system sales. A reduction in off-system sales margins means that native load customers will receive a lower credit through the OSS adjustment clause.

Retroactive Application of the Evaluation Standard. The proposed amendment requires that the Commission apply the new evaluation standard three months after the effective date of the amendment. It makes no provision for contracts that have been entered prior to the effective date of the regulation and that may have been entered without any knowledge or notice of the proposed amendment. A significant portion of the Companies' near and intermediate term fossil fuel requirements are under contract. Applying the proposed evaluation methodology to existing contracts is akin to changing the rules in the middle of a

game. The retroactive application of the evaluation standard to existing contracts penalizes electric utilities that executed contracts under the current evaluation methodology and that cannot unilaterally terminate those contracts.

Moreover, retroactive application of an administrative regulation is legally prohibited.[12] If the amendment is adopted, application of the proposed evaluation methodology should be limited to fuel procurement contracts and decisions made after the effective date of the amendment going forward.

Revisions in Adjustment Factor

In its amendment, the Commission proposes to revise the adjustment factor formula in Section 1(1) to substitute the term "cost" for "expense." These terms are not synonymous. "Cost" generally "means the amount of money actually paid for property or services,"[13] and includes either expenses or assets, while an expense is a cost that has expired or was necessary to earn revenues. The distinction is important. The Federal Energy Regulatory Commission's fuel adjustment clause regulation, upon which 807 KAR 5:056 was originally modelled, expressly refers to "expense" in its formula. The proposed substitution of "cost" for "expense" in the definition of F(b) and F(m) suggests a broader inclusion of items such as asset costs. The Companies recommend that the proposed substitution be withdrawn and "expense" continue to be used in Section 1(1) to define F(b) and F(m).

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[12] *Kerr v. Ky. State Bd. of Registration for Prof'l Eng'rs & Land Surveyors*, 797 S.W.2d 714 (Ky. Ct. App. 1990); *Sullivan Univ. Sys. v. Commonwealth*, No. 2011-CA-000853-MR, 2012 Ky. App. Unpub. LEXIS 1042 (Ct. App. Aug. 24, 2012). *See also* KRS 446.080(3); *Kentucky Industrial Utility Customers, Inc. vs. Kentucky Utilities Co., 983 S.W2nd 493, 500* (Ky. 1998).

[13] 18 CFR Part 101 Definitions 9 ("Cost means the amount of money actually paid for property or services. ...")

Revisions in the Definition of Fuel Costs (F)

Section 1(3) of the current regulation states:

> 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 outage, all such kinds of energy being purchased by the buyer to substitute for its own higher cost energy;

The Commission proposes to amend Section 1(3)(c) so that the phrase "irrespective of the designation assigned to such transaction" will modify "energy purchases" rather than "capacity or demand charges." The proposed amendment will significantly modify the meaning of the section. In its current form, the Section prohibits the inclusion of capacity or demand charges in the cost of fuel and their recovery through an electric utility's fuel adjustment clause. The proposed amendment may be interpreted as permitting the Commission to consider individual components of energy purchases for recovery as a cost of fuel and potentially limiting the recovery of economy energy purchases to only identifiable fossil fuel costs associated with the energy purchase.

This result would be inconsistent with the Commission's longstanding precedent supporting economy energy purchases, contrary to current wholesale power market practices which do not provide cost support for energy sales, and would severely discourage the purchase of economy energy under economic circumstances, thereby increasing the cost of fuel expense.

Public Hearings in Review Proceedings

The Companies support the proposed revisions that provide the Commission with discretion in determining whether a hearing should be held in a six-month or two-year formal review proceeding. While a public hearing in a formal review proceeding may be necessary to develop the record of the proceeding and to address issues that remain unresolved after discovery, past proceedings have shown that a public hearing is not necessary in all instances and that mandating a hearing in all instances may result in an unproductive use of the resources of the Commission and the parties to the proceeding. Please note that, unlike Section 3(5), Section 3(3) does not set forth a standard for determining when a hearing should be held for six-month review proceedings. The standard set forth in Section 3(5) is also appropriate for making such determinations.

Deviation Provision

The proposed amendment fails to contain a provision to permit the Commission to authorize deviations from the regulation for good cause. Such deviation provisions are found in most provisions of Title 807. The Commission should consider the addition of such provision to afford greater flexibility in addressing unusual or unique circumstances for good cause where the application of the regulation might otherwise produce unreasonable or uneconomic results.

Public Disclosure and Inspection of Fuel Contracts

The Commission should consider the deletion of Section 2(5) from the proposed regulation and limit public disclosure and inspection of fuel procurement documents such as coal purchase contracts and transportation contracts. These contracts contain provisions that are difficult to negotiate and whose disclosure has placed Kentucky electric utilities at a serious

competitive disadvantage in negotiating similar provisions with other potential suppliers. The past disclosure of these documents has deprived electric utilities of the strategy and opportunity of bargaining for the most favorable mix of terms and conditions.

Request for Hearing

KU and LG&E request the Commission hold the hearing scheduled for May 30, 2019 at 9:00 a.m. KU and LG&E intend to attend the hearing, present a witness, offer comment on the proposed revisions to 807 KAR 5:056 and answer any questions about their position expressed in this letter. They further request that a video transcript be taken of this hearing.

Summary

For the last 37 years, the current version of 807 KAR 5:056 functioned very well. It has ensured that Kentucky electric utilities obtain timely recovery of their reasonable fuel costs and that Kentucky ratepayers paid reasonable fuel costs. During this period, Kentucky ratepayers have been subject to some of the lowest electric rates in the United States. In reviewing this regulation, the Commission should carefully consider whether the proposed revisions will enhance the regulation's operation and allow it to continue these achievements.

While the proposed amendment to 807 KAR 5:056 contains several improvements, its requirement that the Commission ignore Kentucky severance tax in its assessment of an electric utility's fuel procurement decisions represents a serious legal risk to achieve a dangerous departure from longstanding least-cost principles that will result in significant adverse effects for Kentucky's ratepayers and Kentucky's economy. This provision effectively requires Kentucky electric utilities to use higher cost fuel sources if they are to recover the full cost of fuel through their rates. As a direct consequence, Kentucky ratepayers will pay more for their electric service

than they otherwise would. The higher cost of electric service will make Kentucky manufacturing businesses less competitive with their out-of-state and foreign competitors and make Kentucky a less attractive place for businesses and industries to locate.

The proposed amendment may not withstand the likely legal challenges to it. The public would be better served if those means are used and Section 3(5) of the proposed amendment is revised to eliminate the provision regarding Kentucky severance taxes.

In summary, the Companies greatly appreciate the Commission's efforts to update 807 KAR 5:056 and the opportunity to submit comments on those efforts. They respectfully urge the Commission to carefully consider their comments.

Yours very truly,

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