COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION OF THE FUEL ADJUSTMENT CLAUSE REGULATION 807 KAR 5:056	)))	ADMINISTRATIVE CASE NO. 309

O R D E R

On September 3, 1986, the Commission instituted an investigation of the fuel adjustment clause ("FAC") regulation (807 KAR 5:056). The scope of the investigation was to determine whether, due to changed circumstances, the FAC should be modified or eliminated and, if changes were needed, to develop a proposed regulation. Comments were solicited from the parties and a public hearing was held January 13, 1987.

Based on the filed comments and the hearing record, the Commission issued an Order on September 21, 1988 setting forth the following findings:

1. The Commission's objectives in establishing the standard FAC in 1978 had been met.

2. The Commission's objectives and standards for the FAC were as stated in the Commission's September 3, 1986 Order and are being met by the present FAC.

3. A FAC is an appropriate part of the regulatory framework under current conditions.

4. The FAC regulation should be revised to incorporate a partial passthrough and to allow for billing of FAC over- and under-recoveries.

5. All other proposed modifications of the FAC regulation should be denied.

6. A draft regulation, attached to the September 21, 1988 Order as an appendix, incorporates the proposed revisions to the FAC regulation.

7. The parties should be invited to submit comments on the draft regulation.

Comments were filed by Big Rivers Electric Corporation ("Big Rivers"), the Attorney General of the Commonwealth of Kentucky ("AG"), East Kentucky Power Cooperative, Inc. ("EKPC"), Kentucky Power Company ("Kentucky Power"), Kentucky Utilities Company ("KU"), and Louisville Gas and Electric Company ("LG&E").

Each took the opportunity to reiterate its previously stated positions. In general, none of the commentators disputed the Commission's findings that: its objectives in establishing the FAC in 1978 have been met; its objectives and standards are as stated in its September 3, 1986 and September 21, 1988 Orders; a FAC is appropriate under current conditions; and all other proposed modifications of the FAC regulation should be denied. The comments took issue with: 1.) the Commission's findings that the FAC regulation should be revised to incorporate a partial passthrough incentive and to allow for billing of FAC over- and under-recoveries; and 2.) the draft regulation incorporating revisions to the FAC regulation.

The intent of a partial passthrough is to establish additional financial incentives to supplement those included in the current FAC regulation. In drafting the proposed regulation, the Commission decided that the percentage of passthrough should be set at 90 percent of deviations from fuel cost to balance the benefits of additional financial incentive against the greater administrative costs and uncertainties.[1] To further protect utilities and ratepayers from large gains or losses resulting from extreme fluctuations in fuel costs, the Commission provided a cap of 3 percent of total fuel costs on fuel cost deviations absorbed or retained during each 6-month review period.[2]

FAC Regulation

All comments, except those of the AG, supported the FAC regulation currently in effect. LG&E recognized the Commission's attempt to "strike a balance between its objective of encouraging utilities to keep their fuel cost as low as practicable and the need for providing utilities with an orderly rate-making mechanism for reflecting increases or decreases in fuel costs, which cannot always be directly controlled or influenced by utilities"[3] but opined that the current FAC has always worked well. Big Rivers reaffirmed its position that the FAC, in its present form with 100 percent passthrough, has served consumers and utilities well and

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1 Administrative Case No. 309, Order dated September 21, 1988, page 21.

2 Id.

3 LG&E Comments filed October 24, 1988, page 2.

should be retained.[4] KU and EKPC stated that the current FAC should remain unchanged as it has met the Commission's established criteria, is precise and understandable, provides for proper review and monitoring, and is equitable to both customers and utilities.[5] KU also criticized the proposed regulation as being deficient because it failed to satisfy the criteria of being fair in billing costs to cost-causers, administratively workable and efficient, and providing for fair regulation of both distribution and generation utilities.

The AG did not propose to modify the Commission's draft regulation. Rather, the AG supported the Commission's efforts and characterized them as a "significant first step in providing true incentives that encourage electric utilities to control fuel costs."[6] To provide even greater incentives, the AG asked for reconsideration of its initial recommendation that FAC passthroughs be limited from 50 percent to 75 percent deviations from base rates.[7]

Incentives and Risk

Substantial incentives for efficient management of fuel costs already exist according to Big Rivers.[8] "Current fuel clause

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4 Big Rivers Comments filed October 17, 1988, page 1.

5 KU Comments filed October 21, 1988, page 4; and EKPC Comments filed October 21, 1988, page 1.

6 AG Comments filed October 21, 1988, page 1.

7 Id., page 2.

8 Big Rivers Comments filed October 17, 1988, page 1.

operation has not proved that such incentives have been lacking," stated KU.[9] EKPC pointed out that "high standards of fuel procurement and generating station efficiency have been a priority of EKPC management philosophy, aside from any considerations or advantages to be gained in the FAC."[10] EKPC and Big Rivers contend that absorbing 10 percent of allowable fuel cost would not serve as an incentive to reduce costs but would merely reduce revenue and margins, thus requiring more rate increases than under present regulations.[11] LG&E acknowledged that the proposed incentive could actually encourage a utility to secure fuel of lower quality and cost resulting in higher operation and maintenance expenses.[12]

KU does not believe the partial passthrough to be an incentive to the utility but rather a risk for its customers and investors.[13] When fuel costs are declining, the customers are penalized by not receiving the full passthrough of the cost savings. When fuel costs are rising, the investors are penalized by the utility's inability to fully recover a cost which the Commission has acknowledged to be not completely under the utility's control.

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9 KU Comments filed October 21, 1988, page 4.

10 EKPC Comments filed October 21, 1988, page 1.

11 EKPC Comments filed October 21, 1988, page 1; and Big Rivers Comments filed October 17, 1988, page 2.

12 LG&E Comments filed October 24, 1988, page 3.

13 KU Comments filed October 21, 1988, page 1.

LG&E acknowledged that the partial passthrough created an incentive to the company but does not believe the benefits equal the risks as compared to the current FAC regulation.[14] LG&E believes the proposed regulation would work to inhibit its ability to recover its fuel costs and to earn a fair and reasonable rate of return.[15] LG&E fears its investors' perception of this greater risk could result in an increase in its cost of capital.[16]

Establishment of Base Fuel Cost

The proposed regulation places undue significance on the selection of the fuel clause base according to KU.[17] Kentucky Power found that establishing the base rate would be critical as this is where the 90 percent is determined and if a base rate is not carefully established by the Commission, a "regulatory" difference between base and actual fuel cost could arise which would be harmful to either the company or its customers.[18] Kentucky Power expressed concern that absent full recovery, a strong incentive would exist to achieve price stability by entering firm coal contracts of at least one year rather than taking full advantage of the spot market to minimize overall cost.[19]

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14 LG&E Comments filed October 24, 1988, page 3.

15 Id., page 5.

16 LG&E Comments filed October 24, 1988, page 5.

17 KU Comments filed October 21, 1988, page 2.

18 Kentucky Power Comments filed October 21, 1988, page 2.

19 Id., page 4.

In requesting clarification as to how the base fuel cost would be established, LG&E predicted that fuel clause hearings could become very argumentative with expert testimony if the methodology is not explicitly stated in the regulation.[20] LG&E, KU, and Kentucky Power shared the opinion that the current biennial review of the base fuel cost would be too infrequent under the proposed passthrough.[21] As KU stated, "selection of the base upon biennial review is a judgment call attempting to replicate a typical month that has no direct correlation with the procurement of coal and/or power plant operations."[22]

Three Percent Cap

The validity, effectiveness, and equity of the proposed 3 percent cap were all questioned by utilities. Kentucky Power applied the proposed partial passthrough to its FAC data for a 10-year period and found it would never have triggered the cap.[23] Citing this example, Kentucky Power claimed that the cap would provide little protection to the utilities or ratepayers. In fact, Kentucky Power maintained that it would have had to realize

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20 LG&E Comments filed October 24, 1988, page 5.

21 LG&E Comments filed October 24, 1988, page 5; KU Comments filed October 21, 1988, page 2; and Kentucky Power Comments filed October 21, 1988, page 2.

22 KU Comments filed October 21, 1988, page 2.

23 Kentucky Power Comments filed October 21, 1988, page 5.

a 30 percent change in fuel cost to trigger the protection of the 3 percent cap.[24] EKPC found the theory of providing protection against extreme fluctuations to be good but found a basic inequity in the methodology.[25] This inequity, which adversely impacts the utility, arises because it requires a longer time and more pronounced cost fluctuation to trigger increases while rate decreases would be required more frequently.[26] LG&E also found a disparity between the utility's risks of under-recovery and opportunities for over-recovery.[27] LG&E's costs would have to rise 42.86 percent before the 3 percent threshold would be exceeded and LG&E entitled to increase its rates. However, a 23.07 percent decrease in costs would exceed the 3 percent threshold and result in a rate decrease.

Over/Under Recovery Provision

According to KU, there is nothing intuitively wrong with requiring generating utilities to initiate monthly over- and under-recovery of fuel costs as is currently required for distribution utilities.[28] However, KU argued that implementation would be complicated and based on KU's historical operation, would

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24 Id.

25 EKPC Comments filed October 21, 1988, page 2.

26 Id.

27 LG&E Comments filed October 24, 1988, page 5.

28 KU Comments filed October 21, 1988, page 2.

have no material significance.[29] LG&E was also concerned with implementation and requested the Commission to explain the provision in detail.[30] Big Rivers and EKPC both supported the provision.[31] Like KU, EKPC stated that its operating statistics over the long term show that over- and under-recoveries balance out.[32]

SUMMARY

The Commission, having considered the evidence of record and being otherwise sufficiently advised, finds that it must reconsider the decision set forth in its Order dated September 21, 1988. The Commission has reviewed the record extensively and has measured the current FAC against the six objectives set forth in the Order of September 21, 1988. After due consideration, the Commission finds that the current FAC meets these objectives and requires no modification at this time. While this represents a change from the decision of September 21, 1988, the Commission finds that such change and the resulting continuation of the current FAC is preferable to implementing a partial passthrough.

A partial passthrough FAC was originally favored by the Commission because it would establish additional financial

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29 Id.

30 LG&E Comments filed October 24, 1988, page 13.

31 Big Rivers Comments filed October 17, 1988, page 2; and EKPC Comments filed October 21, 1988, page 2.

32 EKPC Comments filed October 21, 1988, page 2.

incentives to supplement those in the current FAC. However, the additional incentives are likely to produce unwanted and undesirable results, including higher administrative costs and inefficiencies such as more frequent rate cases, extensive reviews of base fuel rates at least annually, and the likelihood of expenses for consultants to review the base fuel rates in FAC cases. A partial passthrough could also provide incentives for utilities to stabilize costs through long-term contracts at the expense of lower cost spot-market purchases and to set base rates as high as possible to minimize the chances of fuel cost under-recovery. Since the base rate would be so critical in a partial passthrough FAC, the attention focused on its establishment could result in the utilities, as well as the Commission and intervenors, losing sight of the real issues of fuel procurement and fuel cost management.

The Commission further finds that the current FAC includes effective incentives for the efficient management of fuel costs. These incentives are provided primarily through the Commission's review and oversight which will continue and be strengthened within the present FAC framework. In addition, the current FAC is administratively workable and efficient for both the utilities and the Commission. The current FAC provides information necessary to adequately monitor fuel costs and such monitoring can lead to in-depth investigation of fuel costs and fuel-related issues, as

evidenced by Case No. 9631.[33] Furthermore, the potential results of a partial passthrough--more frequent general rate cases and FAC cases which take on the complexity and length of general rate cases--would not result in a more workable or more efficient FAC. Hence, the FAC regulation should not be revised to include a partial passthrough.

The Commission reaffirms its previous finding that a provision for billing over- and under-recoveries should be incorporated into the calculation of the monthly FAC factor for the electric generating utilities. A provision for billing over- and under-recoveries has been in effect for the electric distribution utilities since May 1981. The implementation of a similar provision for electric generating utilities does not necessitate a revision of the FAC regulation. Attached as Appendix A is a revised format for the monthly FAC report which includes over- and under-recoveries. All parties are invited to submit comments on the new format within 15 days of the date of this Order.

IT IS THEREFORE ORDERED that:

1. The Commission's Order of September 21, 1988 be and it hereby is modified to eliminate the draft revisions to the FAC incorporating a partial passthrough incentive and a provision for billing FAC over- and under-recoveries.

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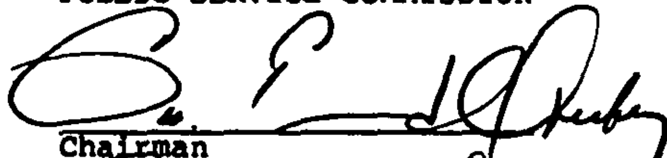
[33] Case No. 9631, An Investigation Into the Fuel Procurement Practices of Kentucky Utilities Company.

2. Parties shall file comments on the FAC report format as revised to allow for billing of FAC over- or under-recoveries, attached hereto and incorporated herein as Appendix A, within 25 days of the date of this Order.

Done at Frankfort, Kentucky, this 18th day of December, 1989.

PUBLIC SERVICE COMMISSION



Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN ADMINISTRATIVE CASE NO. 309 DATED

Company: ______________________________

FUEL ADJUSTMENT CLAUSE SCHEDULE

Month Ended: ______________________________

Fuel Fm (Fuel Cost Schedule) / Sales Sm (Sales Schedule) = ____________ =(+)

Fuel (Fb) / Sales (Sb) (-)

(+) ____________
($/KWH)

Effective Date for Billing: ______________________________

Submitted By: ______________________________
(Signature)

Title: ______________________________

Date Submitted: ______________________________

Company: ______________________________

FUEL COST SCHEDULE

Month Ended: ______________________________

A. Company Generation		
Coal Burned	(+)	
Oil Burned	(+)	
Gas Burned	(+)	
Fuel (jointly owned plant)	(+)	
Fuel (assigned cost during F.O.)	(+)	
Fuel (substitute for F.O.)	(-)	
Sub Total		________
B. Purchases		
Net Energy Cost-Economy Purchases	(+)	
Identifiable Fuel Cost - Other Purchases	(+)	
Identifiable Fuel Cost (substitute for F.O.)	(-)	
Sub Total		________
C. Inter-System Sales		
Fuel Costs		________
D. Over or (Under) Recovery from Page 4		________
Total Fuel Cost (A + B - C - D)		________

Company: ______________________________

SALES SCHEDULE

Month Ended: ______________________________

A. Generation (Net)	(+)	
Purchases Including Interchange In	(+)	
Sub-Total		________
B. Pumped Storage Energy	(+)	
Inter-System Sales Including Interchange Out	(+)	
Systems Losses	(+)	
Sub-Total		________
Total Sales (A - B)		________

Company: ______________________________

(OVER) OR UNDER RECOVERY SCHEDULE

1. Last FAC Rate Billed ____________
2. KWH Billed at Above Rate ____________
3. FAC Revenue/(Refund) (L1 x L2) ____________
4. KWH Used to Determine Last FAC Rate ____________
5. FAC Revenue/(Refund) to be Derived (L1 x L4) ____________
6. Over or (Under) Recovery (L3 - L5) ____________