COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC INVESTIGATION OF THE FUEL ADJUSTMENT CLAUSE REGULATION 807 KAR 5:056, PURCHASED POWER COSTS, AND RELATED COST RECOVERY MECHANISMS	)))))	**CASE NO. 2022-00190**

RESPONSE OF KENTUCKY UTILITIES COMPANY AND LOUISVILLE GAS AND ELECTRIC COMPANY TO THE COMMISSION'S ORDER OF NOVEMBER 2, 2022

Pursuant to the Public Service Commission's Order of November 2, 2022, Kentucky Utilities Company and Louisville Gas and Electric Company submit their comments to the issues and questions raised therein.

Dated: December 2, 2022

Respectfully submitted,

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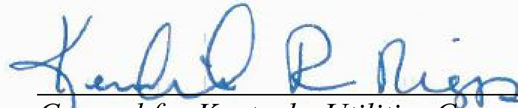
CERTIFICATE OF SERVICE

In accordance with 807 KAR 5:001, Section 8, and the Commission's Order of July 22, 2021 in Case No. 2020-00085, I certify that this document, including exhibits thereto, was submitted electronically to the Public Service Commission on December 2, 2022 and that there are currently no parties that the Public Service Commission has excused from participation by electronic means in this proceeding.



Counsel for Kentucky Utilities Company and Louisville Gas and Electric Company

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807 KAR 5:056, PURCHASED POWER COSTS,	)	**CASE NO. 2022-00190**
AND RELATED COST RECOVERY	)	
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COMMENTS OF
KENTUCKY UTILITIES COMPANY AND
LOUISVILLE GAS AND ELECTRIC COMPANY

FILED: December 2, 2022

Introduction

The current Uniform Fuel Adjustment Clause ("UFAC") Regulation treats Kentucky generating utilities and their ratepayers in a fair and equitable manner and has significantly reduced the effects of fuel cost volatility for utilities and their ratepayers. It allows electric utilities to recover the reasonable cost of fuel in times of rapid fluctuations without first undergoing extensive and successive rate case proceedings while ensuring that ratepayers promptly receive the benefits of falling fuel costs in declining fuel markets.

Electric utilities have been permitted to use automatic adjustment clauses to reflect variations in the price of fuel since 1917.[1] Fuel adjustment clauses ("FACs") began appearing in the rate schedules of electric utilities in Kentucky in the 1950s. They attracted public attention in the 1970s when the price of coal dramatically increased. As a result of that earlier period of volatile fuel costs, the Commission initiated proceedings that lead to the promulgation of 807 KAR 5:056, the UFAC Regulation.

The Public Service Commission ("Commission") has described a fuel adjustment clause ("FAC") as

> a means for the 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 passthrough of fuel costs, with no allowances for profit to the utility.[2]

Under the UFAC Regulation, an FAC is a neutral ratemaking mechanism that benefits both utilities and their ratepayers and offers substantial protections to each. Increased fuel costs compared to the amount in base rates are passed directly through the FAC to customers to ensure that the utility recovers its reasonable fuel costs. Conversely, if a utility's fuel costs decrease compared to the amount in base rates, the decreased costs are passed through the FAC to the utility's customers in the form of a credit.

Ratepayers benefit from an FAC in two ways. First, by reducing the frequency for expensive rate proceedings and reducing the utility's cost to attract capital, an FAC lowers the utility's overall revenue requirements and thus rates for service. Second, it ensures that ratepayers receive the benefits of incremental decreases in fuel costs in declining fuel markets by promptly distributing these lower costs through to ratepayers. The FAC protects ratepayers by ensuring that an electric utility does not gain from lower fuel costs in a declining fuel market where higher fuel costs are reflected in base rates but merely recovers its reasonable actual fuel costs.

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[1] R.S. Trigg, *Escalator Clauses in Public Utility Rate Schedules*, 106 U. Pa L. Rev. 964 (1957).

[2] *In the Matter of: Kentucky Power Company, East Kentucky Power Cooperative, Louisville Gas and Electric Company, Kentucky Utilities Company, Big Rivers Electric Corporation*, Case No. 6877 (Ky. PSC Dec. 15, 1977) at 2.

A utility benefits from an FAC by the timely recovery of fuel costs without the regulatory lag associated with base rate cases. Generally, any increased fuel cost is recovered within two months of being incurred, subject to extensive retrospective reviews and possible disallowance. This timely recovery of increased fuel costs reduces the utility's financial risk and, therefore, lowers the utility's cost to borrow funds and attract capital.

The UFAC Regulation has achieved the Commission's original objective of minimizing the economic burden on ratepayers and utilities caused by fluctuating fuel costs. As shown in Figures 1 and 2 below, the FAC monthly charges of Kentucky Utilities Company ("KU") and Louisville Gas and Electric Company ("LG&E") (collectively, "the Companies") for the past ten years have frequently been credits, thus reducing the customers' total monthly bills and allowing customers to enjoy the savings resulting from lower fuel costs. In 89 of the 127 months shown below, the monthly fuel charge for KU customers was a credit. For LG&E customers, their fuel charge was a credit in 59 of those months. On a combined basis, the FAC charge was a credit nearly 60 percent of the time during this ten-year period.

Figure 1

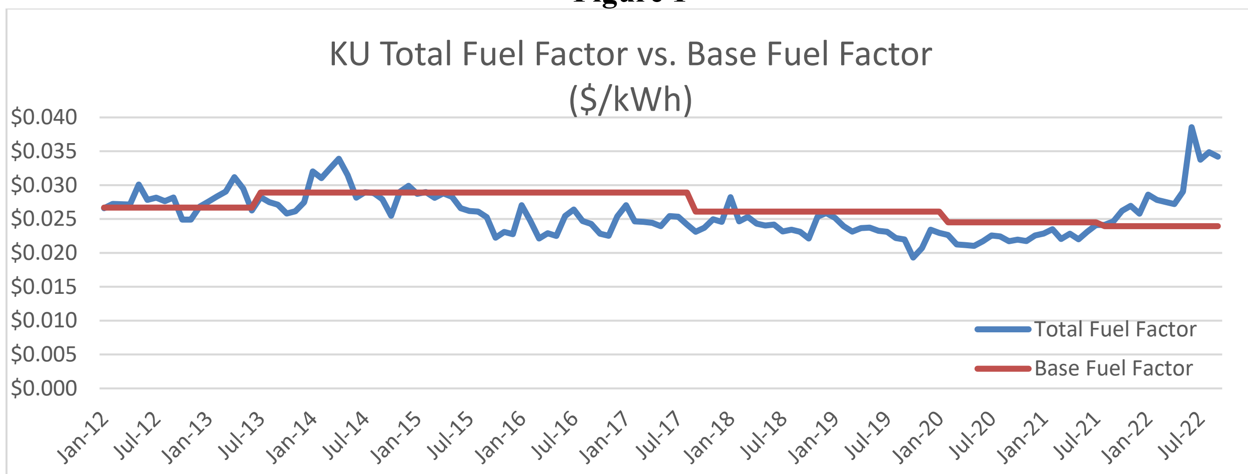
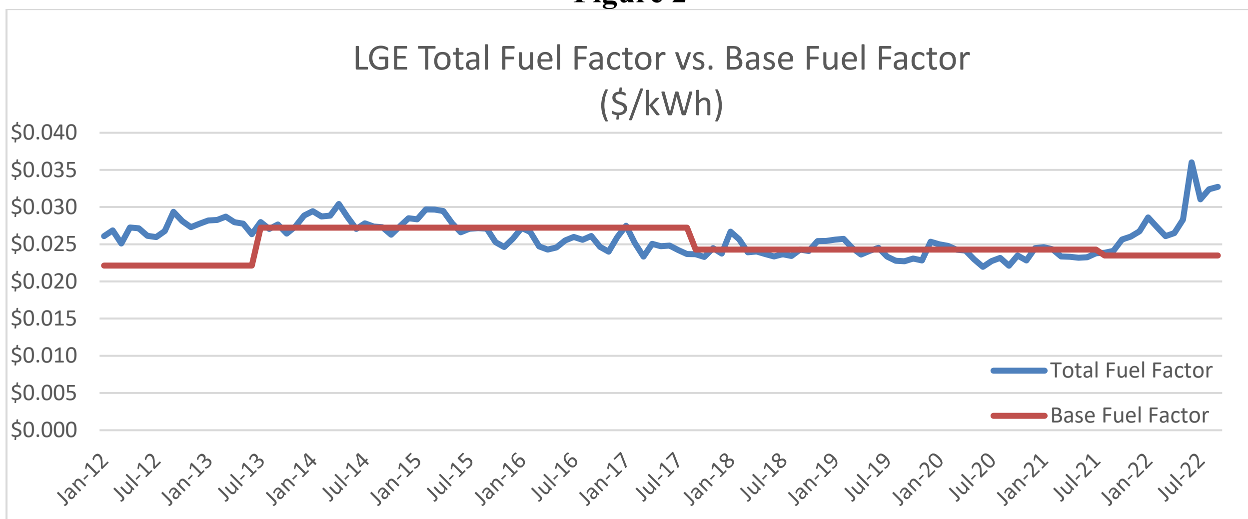


Figure 2



In late 2021, coal and natural gas costs began to increase and continued to increase in 2022 due to increases in market gas prices, an increased need to make spot purchases of gas to operate simple cycle combustion turbines, and higher market coal prices. The Companies' capacity mix, i.e., 63% coal, 36% natural gas and 1% renewables, however, does reflect their actual energy mix. For 2021, the Companies' actual energy mix was 84% coal, 15% natural gas and 1% renewable energy. Thus, as shown in Figure 3 and Figure 4 below, the higher gas costs were partially mitigated by the dominant use of coal for electric generation.

Figure 3

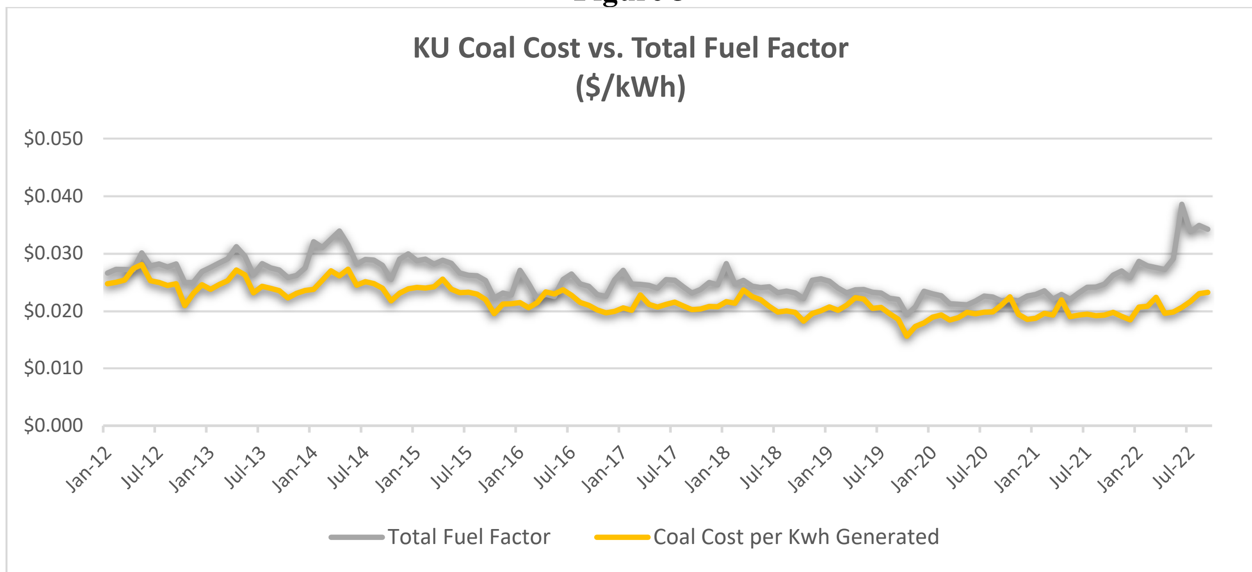
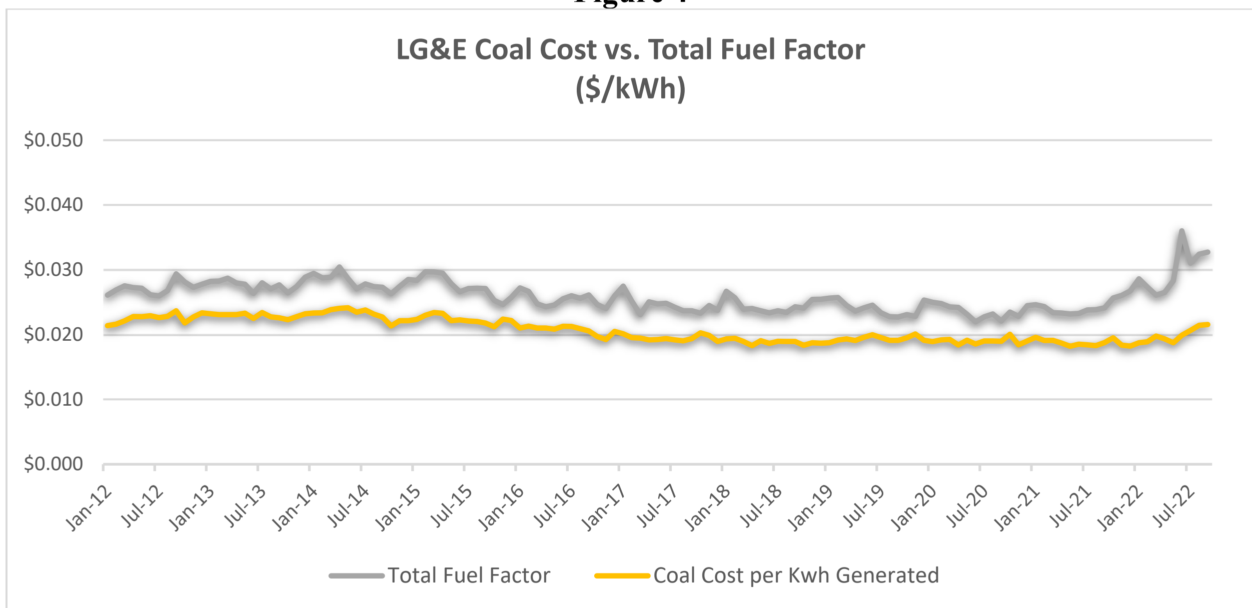


Figure 4



Based upon the Companies' experience with the UFAC Regulation, the UFAC Regulation and the mechanics of the fuel cost recovery calculations have performed well, have accomplished their intended purposes, and do not require modification.

Question 1: What changes to the FAC regulation, if any, could reduce the monthly volatility of the FAC?

The present UFAC Regulation contains a provision to reduce the monthly volatility of the FAC charge. 807 KAR 5:056, Section 1(3) requires that fuel costs be "based on weighted average inventory costing," which effectively smooths out coal price fluctuations that occur over time.

While this provision reduces the volatility of FAC charges, sound business practices and strategies are the critical factor in the reduction or mitigation of large swings in fuel costs. The Companies have long been concerned with fuel cost volatility and its effects on their customers and have adopted business practices and strategies that have proven successful in reducing such volatility. As a result, the Companies' FAC charges have remained relatively stable.

The Companies continue to rely upon coal-fired plants as their major generation source but have expanded and diversified their generation fleets to allow for the greater use of natural gas when such use is reasonable and economical. The Companies operate their coal-fired units and Cane Run 7 (the Companies' natural gas fired combined-cycle unit) together to meet the Companies' annual base load. The Companies can and have adjusted the generation mix to take advantage of changes in fuel prices to ensure the most economical and efficient generation. As shown in Figure 5 below, for the last two years, more than 80 percent of the Companies' net generation is from coal-fired units, well above the average level cited in the Commission's Order of November 2, 2022. Because they use their own generation units to meet nearly all of their power needs economically and have limited need to purchase economy power from wholesale markets, the Companies do not face the same price volatility as utilities that purchase power from the wholesale market and rely upon suppliers with a much different generation mix.

Figure 5

	Capacity		Energy			
	Current		2020		2021	
Gen Type	Net Summer Capacity (MW) (1/1/2022)	%	Net Generation (GWh)	%	Net Generation (GWh)	%
Coal *	4,889	63%	24,966	81%	25,970	84%
Gas	2,716	36%	5,385	18%	4,688	15%
Hydro / Solar	105	1%	385	1%	370	1%
Total	**7,710**	100%	**30,736**	100%	**31,029**	100%
*Coal generation includes LG&E and KU ownership share of TC1 and TC2 and OVEC generation.						

The Companies have taken several actions to reduce fuel price volatility. They have established guidelines for the amount of coal and natural gas to purchase under contract based upon the minimum projected fuel requirement. This contract position reduces the risks associated with the reliability of the Companies' coal and natural gas supply and the volatility of coal and

natural gas costs by securing a fixed price. The current projected requirement guidelines are shown in Figure 6 below.

Figure 6

Minimum Projected Requirement Under Contract (%)						
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Coal	98-102	80-90	40-90	30-70	10-50	0-30
Cane Run 7	40-60	20-40	0-20	*	*	*

*The Companies' natural gas guidelines only go out three years due to limitations in the natural gas market.

In addition, the Companies negotiated coal contract terms that allow for quarterly nominations to accelerate the delivery of the contract volume. This feature allows the Companies to reduce spot purchases when market coal prices are significantly higher than contract price. The resulting coal cost savings can be significant and are distributed to the Companies' customers through the FAC as credits.

For natural gas, the forward purchases are used solely for the Companies' Cane Run 7 natural gas combined cycle unit, which serves as a baseload unit. Using a procurement process similar to that used for coal procurement, the Companies issue at least quarterly solicitations for Cane Run 7's natural gas.

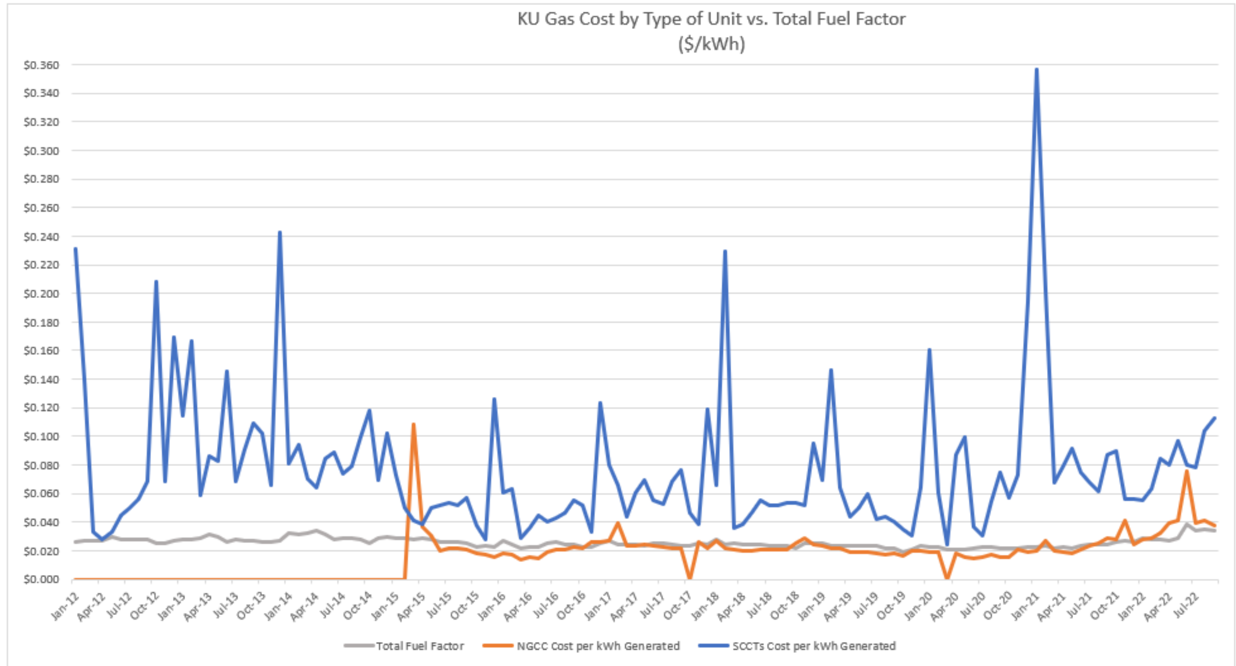
In June 2015, the Companies' Cane Run 7 natural gas combined cycle unit began commercial operations and has served as a baseload unit. In anticipation of Cane Run 7's impact on the Companies' fuel requirements, in January and August 2016, the Companies provided detailed presentations of these procurement practices to the Commission and its Staff. At that time, the Companies emphasized that one central objective of these practices was the reduction of customer bill volatility. Those presentations are attached to these comments as Attachments 1 and 2. As noted in the last page of the Attachment 1 presentation, the Companies' objectives for fuel procurement are to: 1) maintain a reliable fuel supply; 2) ensure the fuel supply meets all operational limits and environmental standards; 3) procure the lowest reasonable cost fuel; and 4) reduce customer bill volatility.

In its Order of November 2, 2022, the Commission asserts that the use of natural gas leads to greater price volatility and possibly contributes to FAC rate volatility. Its assertion is based upon the assumption that natural gas purchases "are generally made as daily spot purchases based upon a generator's immediate need."[3] The Companies' experience does not support the Commission's assertion. While the Companies continue to purchase some of their natural gas requirements on a spot or next day basis, especially for their simple-cycle combustion turbines, their fuel procurement strategy of longer-term purchases for Cane Run 7 has resulted in more stable natural gas costs. As shown in Figures 7 and 8, fuel costs for the Cane Run 7 unit have been less volatile than fuel cost for the simple-cycle combustion turbine units supplied only through spot purchases and have frequently been lower than the total fuel factor. The Companies' experience demonstrates that use of longer-term contracts can result in less price volatility. It also shows that greater use of

[3] Order at 4.

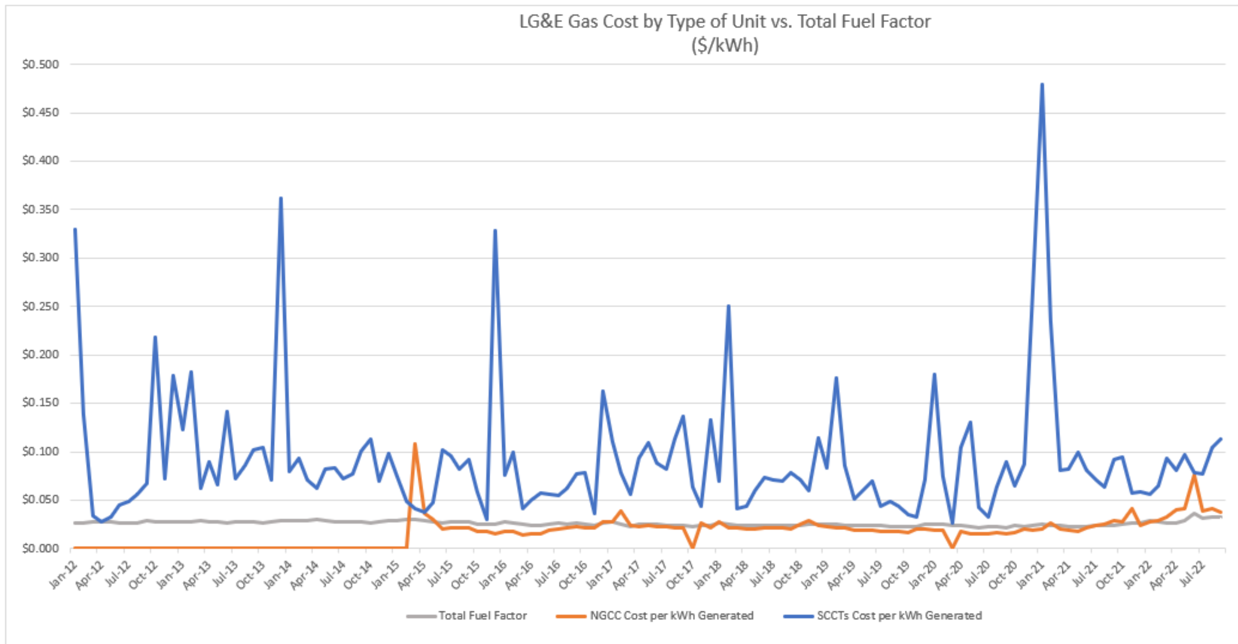
natural gas in the production of electricity will not necessarily result in significantly increased FAC rate volatility.

Figure 7



Notes:
1. Cane Run 7 Test energy for the months March through June 2015 served Native Load and was recovered through the FAC.
2. Cane Run 7 began commercial operation in July 2015.
3. Start-up and Stablization gas used for coal generating units was excluded from chart.
4. In the months Oct 2017 and April 2020, Cane Run 7 only had Auxiliary usage (no generation); cost per kWh is thus negative and shown as zero in the chart.

Figure 8



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3. Start-up and Stablization gas used for coal generating units was excluded from chart.
4. In the months Oct 2017 and April 2020, Cane Run 7 only had Auxiliary usage (no generation); cost per kWh is thus negative and shown as zero in the chart.

In summary, the Companies have long shared the Commission's concerns regarding FAC charge volatility. And they have specifically adopted several practices designed to reduce such volatility. These practices, in conjunction with the present UFAC Regulation, have produced more stable FAC charges. The Companies urge the Commission to exercise caution in its review of the UFAC Regulation. While the concerns expressed in the Commission's Order of November 2, 2022 may be applicable to some utilities under the Commission's jurisdiction, they are not applicable to the Companies. The Companies have developed an effective strategy within the framework of the present UFAC Regulation to control FAC charge volatility. They should be permitted to continue to work within that framework. If revisions to the UFAC Regulation are necessary to address the circumstances unique to those other electric utilities, the Commission should consider developing a new regulatory framework that would be applicable to those utilities while retaining the existing regulatory framework for the rest, including the Companies.

Question 2: What changes to the FAC regulation, if any, could reduce the exposure of the FAC to volatility in the wholesale power market?

The Companies are not members of any regional transmission organization. They own and operate generation units to economically meet nearly all of their power needs and thus have limited need to purchase economy power from wholesale markets because of the Companies' low generation costs. Therefore, the Companies have very limited exposure to volatility in the wholesale power market related to purchases. (Conversely, the Companies have captured volatile market opportunities on behalf of customers with off-system sales, returning $15.6 million to customers for the 12 months ended September 2022.) From the Companies' perspective, no changes to the UFAC regulation are necessary to address their lack of exposure to the volatility of the wholesale power market. If changes to the FAC regulation are necessary to reduce the exposure of certain electric generation utilities' FAC charges from the volatility in the wholesale power market, such changes should not be applied to the Companies at this time.

Question 3: How does the current structure of the FAC regulation affect the efficiency and reliability of power plants, if at all?

a. Does the current FAC regulation provide incentives to imprudently delay or forego necessary maintenance?

b. Does the current FAC regulation provide sufficient incentives for promoting the efficiency and reliability of power plants, and are there other incentives or changes that could be made that would provide further incentive for increased reliability and efficiency?

No. The current FAC has no detrimental effect on the efficiency and reliability of the Companies' generation fleet. The current regulatory regime provides sufficient oversight of and incentives for the efficient and reliable operation of the Companies' generation fleet.

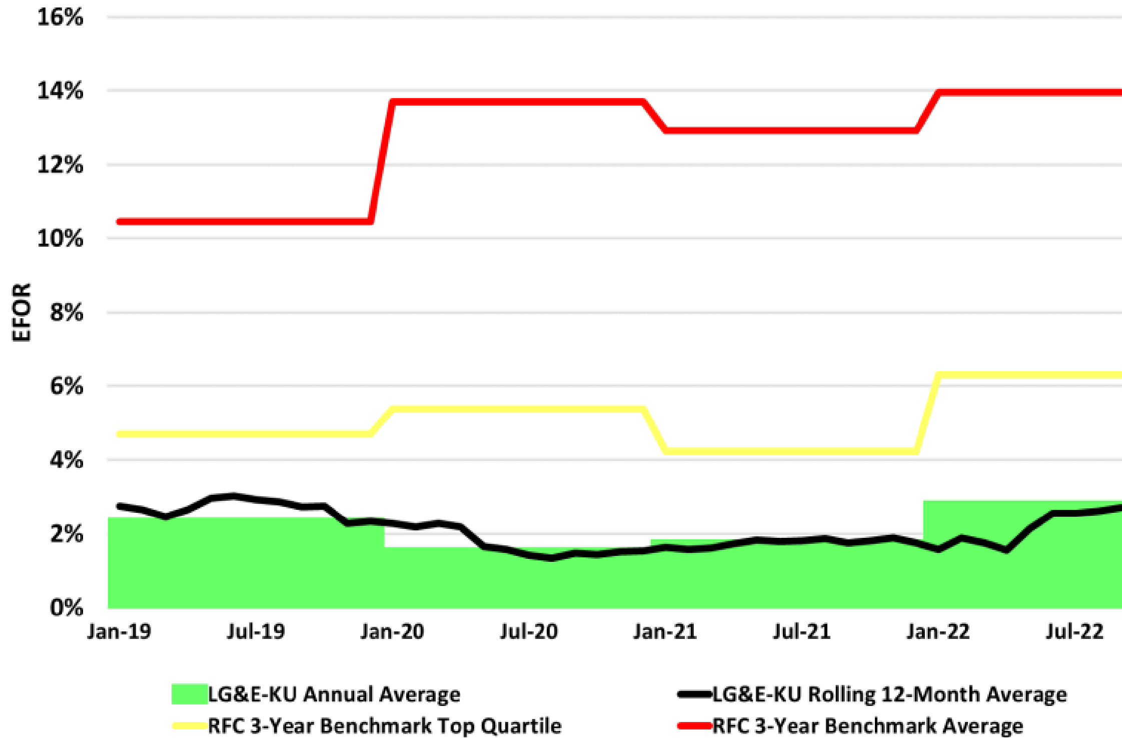
KRS 278.030 requires the Companies to "furnish adequate, efficient and reasonable service." The Companies have a statutory duty to operate their generation facilities in an efficient manner that ensures the reliability of service. Any failure to provide such service due to a willful and knowing failure to perform maintenance would subject the Companies to possible disallowance of costs in ratemaking proceedings and potential administrative sanctions, as well as tarnish the Companies' longstanding reputations for outstanding service.

The Commission reviews the operation and performance of the Companies' generation fleet in each base rate case, and if necessary, can make determinations based on the record evidence. The Companies have provided extensive information regarding their maintenance practices to the Commission in each of their last five general rate adjustment proceedings. The Companies' principal officers have testified at great length on the operation of generation units and maintenance practices. In their last rate case proceeding, Cases No. 2020-00349 and No. 2020-00350, the representative going forward level of the Companies' plant outages and maintenance practices were a major point of contention between the parties and subjected to intense scrutiny by intervening parties.

The efficiency and reliability of the Companies' generation fleet under the current regulatory regime are outstanding. The current equivalent forced outage rate ("EFOR") or the number of hours a unit is forced offline, compared to the number of hours a unit is running is a standard industry measure of generation performance and maintenance. As shown below, the comparison of the Companies EFOR for their generation fleet to the top quartile and average performance for similar sized base load units accounted for in Reliability First Corporation's measures over last three and half years shows the Companies' generation fleet performance is excellent:[4]

[4] Reliability First Corporation is a compliance region under the North American Electric Reliability Corporation.

Figure 9



The current UFAC Regulation has no adverse effect on the efficiency and reliability of the Companies' generation facilities. It provides no incentives to imprudently delay or forego necessary maintenance. To the contrary, the attention given to the Companies' maintenance practices in FAC review proceedings serves as further oversight to ensure proper and adequate maintenance of generation facilities. The Commission has established a longstanding practice at FAC two-year review proceedings to examine the Companies' scheduled, actual, and forced outages, as well as to question the Companies about their maintenance and operation practices and efforts to increase generation efficiency. Commission Staff has frequently questioned the Companies' witnesses at FAC review hearings about specific maintenance activities and plant outages.

In addition, the way the UFAC Regulation treats recovery of costs of forced outages provides a direct and emphatic point to all electric utilities to properly maintain their generation facilities. 807 KAR 5:056, Section 1(4) prohibits the recovery of fuel costs related to forced outages that were "the result of faulty equipment, faulty manufacture, faulty design, faulty installations, faulty operation, or faulty maintenance." If an electric utility fails to maintain its generating facility in a reasonable manner, and an outage results because of that failure, the electric utility will not be permitted to recover the cost of substitute energy in excess of the cost of the unit forced offline through the FAC. This inability to recover the costs serves as powerful admonition to engage in proper and reasonable maintenance practices.

The Companies do not agree that the Commission should modify the UFAC Regulation to create additional incentives to influence their generation fleet's efficiency and reliability. The Commission, in establishing the UFAC Regulation, did not design the mechanism as a form of incentive regulation to promote greater generation efficiency. The Commission designed the FAC mechanism to protect customers and utilities from fluctuations in fuel costs caused by changes in the fuel markets. When the Commission promulgated the UFAC Regulation, it expressly identified three motivating objectives: (1) imposing an appropriate regulatory process on fuel cost charges to customers; (2) minimizing the economic burden on ratepayers and companies caused by fluctuating fuel costs; and (3) treating equitably all Kentucky generating companies, their ratepayers and investors.[5] Efforts to now address generation efficiency and reliability will likely unduly complicate the regulation; impose more regulatory burden on the Commission, electric utilities and the representatives of customers; potentially create unintended regulatory distortions; and hinder achievement of the regulation's primary objectives.

In summary, the UFAC regulation does not adversely affect the efficiency or reliability of the Companies' generation facilities. It provides no incentives to imprudently delay or forego necessary maintenance. The Commission's six-month and two-year review proceedings and the prohibition of the recovery of fuel costs related to forced outages due to faulty maintenance provide adequate incentives for electric utilities to properly maintain their generating facilities and penalties for failing to do so.

[5] Case No. 6877, Order of Dec. 12, 1977 at 6-7.

Question 4: Does the current FAC regulation provide sufficient incentives to ensure efficient and prudent fuel procurement practices? If not, what changes could be made to promote efficient and prudent fuel procurement practices?

Yes. The UFAC Regulation provides full and adequate authority to the Commission to encourage electric utilities to engage in efficient and prudent fuel procurement practices. The FAC regulation's retrospective review processes allow the Commission significant, timely and continuous oversight of an electric utility's fuel procurement activities. The regulation requires an electric utility to file with the Commission its fuel procurement contracts and "all other agreements, options, amendments, modifications, and similar documents related to the procurement of fuel supply or purchased power." 807 KAR 5:056 Section 2(1). Any changes in the contracts or other documents filed with the Commission, including price escalations, and any new agreements entered into after the initial submission are required to be filed at the time they are executed. 807 KAR 5:056 Section 2(2).

Prior to final Commission approval of a fuel charge, the fuel procurement practices that led to the fuel charge are subject to at least two reviews. The first review is the six-month FAC review proceeding required by Section 3(3). The second review occurs in the two-year review conducted pursuant to Section 3(4). As a matter of established practice at the start of each of its FAC review proceedings, the Commission requires electric utilities to provide detailed information regarding their coal purchases, coal inventory levels, coal supply solicitations, natural gas purchases, the results of audits conducted of fuel and transportation contracts, pleadings from and status reports on litigation with current or former fuel and transportation vendors, firm power commitments and contracts, and changes if any in fuel procurement policies and procedures. Furthermore, the Commission's authority to request the production of additional documents and information as its review proceeds is extensive.

In these reviews, the Commission may also employ the assistance of outside consultants and auditors to assist the Commission in its review and to audit an electric utility's fuel procurement practices. In Case No. 9631,[6] the Commission retained an independent consultant to conduct a thorough and independent analysis of KU's fuel procurement practices. The consultant investigated those practices, prepared a lengthy report of its findings, and was subject to discovery and cross-examination from the Commission and the parties regarding its findings. In a similar fashion, the Commission retained an independent consultant in Case No. 90-360-C[7] to investigate and report on the appropriateness of Big Rivers Electric Corporation's fuel procurement strategies and practices.

The FAC regulation further requires the Commission to disallow all unreasonable fuel costs associated with imprudent fuel procurement activities.

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[6] *An Investigation into the Fuel Procurement Practices of Kentucky Utilities Company*, Case No. 9631 (Ky. PSC Oct. 31, 1989).

[7] *An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1991 to April 30, 1992*, Case No. 90-360-C (Ky. PSC July 21, 1994).

But the Commission's investigative authority is not limited to the six-month and two-year reviews. KRS 278.250 and KRS 278.260 and Section 2 of the Regulation permit the Commission on its own motion "to investigate any aspect of fuel purchasing activities covered" by the Regulation. Following the issuance of an order in Case No. 2000-00497, the Commission engaged a management consultant to conduct a focused management audit of the fuel procurement functions of the Companies.[8]

The Commission's investigations into past actions of several electric utilities and corresponding disallowances of cost demonstrate that these features serve as a powerful inducement for electric utilities to engage in proper fuel procurement activities. FAC review proceedings have led to the disallowance of fuel costs related to fuel procurement practices. In Case No. 90-360-C, the Commission ordered a refund of approximately $10.8 million in fuel costs that resulted from an imprudent fuel procurement decision and prohibited a portion of future costs resulting from that decision to be included in future FAC charges.[9] In Case No. 2000-00497-B,[10] the Commission disallowed $673,000 of fuel costs related to the purchase of imported compliance coal. The disallowance of fuel costs serves as a powerful incentive for utility management to make efficient and prudent fuel procurement practices. Disallowance of fuel costs can seriously weaken a utility's financial condition.

Even if an extended investigation results in full recovery of the utility's fuel costs, such an FAC investigation imposes significant burdens on, and costs to, the utility. Extended review proceedings on fuel procurement matters tend to be lengthy, expensive and resource intensive. They divert the utility's management from other critical matters. In addition, the publicity surrounding such proceedings can be damaging to the utility's goodwill and reputation. These "costs" are an added reason for the utility to make reasonable procurement decisions.

As noted previously, the increase in FAC charges beginning in late 2021 is due to industry-wide increases in coal and natural gas costs and not inefficient or imprudent fuel procurement practices. As discussed in response to Question No. 6, the Companies are not economically indifferent to the procurement of reasonable fuel costs or managing the volatility of the changes in the fuel costs. As shown throughout the answers to the questions, the Companies have actively sought to manage the volatility of changes in the fuel markets through numerous strategies, procedures, policies, and tactics.

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[8] *See Final Report Focused Management Audit of The Fuel Procurement Functions of Kentucky Utilities Company and Louisville Gas and Electric Company* presented to the Kentucky Public Service Commission by Liberty Consulting Group (February 23, 2004).

[9] *Id.* at 36.

[10] *An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company from May 1, 2001 to October 31, 2001*, Case No. 2000-00497-B (Ky. PSC Jan. 28, 2003).

Question 5: If you have affiliates that operate in other jurisdictions, explain how those jurisdictions permit the recovery of actual or anticipated fuel and purchased power expenses.

KU operates in Virginia under the name of Old Dominion Power Company. Its tariff contains a levelized fuel factor ("LFF") that allows for recovery of fuel and purchase power costs. KU annually applies to the Virginia State Corporation Commission ("VSCC") for approval of a revised LFF based upon KU's estimated fuel costs, including purchase power, for a successive 12-month period. Its application includes, among other things, forecasted fuel costs and sales, a comparison of forecasted and actual fuel expenses for a five-year period, and historical information regarding the operation and availability of KU's generating units. In addition to a component to recover estimated fuel costs for the forthcoming fuel year, the LFF contains a component to address prior under- and over-recoveries of fuel costs from the previous fuel year. Both components sum to equal the proposed levelized fuel factor.

§56-249.6 of the Code of Virginia provides the statutory basis for the LFF. That statute authorizes the VSCC to disallow recovery of any fuel costs found "without just cause to be the result of failure of the utility to make every reasonable effort to minimize fuel costs or any decision of the utility resulting in unreasonable fuel costs." In making its determination, the VSCC must consider the reliability of service and the need to maintain reliable sources of supply, economical generation mix, generating experience of comparable facilities and the minimization of total cost of providing service.

KU also serves two wholesale requirements customers in Kentucky. The Federal Energy Regulatory Commission ("FERC") regulates fuel cost recovery for these requirement customers through a mechanism that functions similarly to the FAC in Kentucky. The FERC approves a base fuel rate that is embedded in the monthly energy rate. KU collects or distributes any monthly variance between the base fuel rate and the actual fuel rate through a fuel adjustment charge or credit on the customers' bills. The base fuel rate does not change through the operation of fuel adjustment clause. A Section 205 filing with FERC is necessary to change the base fuel rate. Fuel adjustment charges are subject to challenge and review in accordance with the annual review procedures established in the customers' service agreements.

The Companies also have affiliate utilities under their parent PPL Corporation that serve customers in Pennsylvania and Rhode Island. Neither of these utilities own generating assets to serve their load. Therefore, they do not have fuel adjustment clause mechanisms.

Question 6: The current FAC makes utilities economically indifferent to the cost and recovery of fuel. Should the Commission leave the FAC as is, and take this fact into account when reviewing applications for certificates of public convenience and necessity and financing and integrated resource plans, or should it amend the current FAC to provide for less economic indifference by the utility to cost and recovery of fuel and purchased power?

The Companies disagree with the Question's premise that the current UFAC Regulation makes electric utilities economically indifferent to the cost of fuel. The current UFAC Regulation and the Companies' FAC mechanisms cause the Companies to continuously focus on the cost of fuel for generation due to the level of scrutiny and review by the Commission and the specific guidelines for cost recovery in the UFAC Regulation. The increase in FAC charges beginning in late 2021 is due to industry-wide increases in coal and natural gas costs and not the asserted economic "indifference" of the Companies or some issue with the function of the UFAC.

The cost of fuel for electric generation and purchased power is a significant expense for the Companies. As an example, for the 12 months ended September 2022, the cost of fuel for electric generation and power purchased expenses compared to total operating expenses is 39% for KU, 29% for LG&E, and 34% for the two utilities together. The continuous oversight and review under the UFAC Regulation and the associated transparency from the UFAC regulation proceedings in no way renders the Companies indifferent to fuel costs. On the contrary, the records from the six-month and two-year UFAC reviews show the Companies devote significant time and resources in developing their fuel procurement strategies, executing on those strategies, monitoring vendor performance, and when necessary, seeking legal recourse to address vendor performance issues.

For example, to achieve cost savings for their ratepayers, both KU and LG&E have bought out higher priced coal contracts and replaced the higher priced coal with lower priced contracts.[11] If they were economically indifferent to the cost of fuel, the Companies would not have executed the transactions.

Further, the Companies have established guidelines for the amount of coal under contract based on the minimum projected coal requirement as discussed in the response to Question No. 1. The maintenance of this minimum contract position reduces risks associated with the reliability of coal supply and the volatility of coal cost.

In addition, to expand coal options and reduce coal cost, the Companies have conducted multiple test burns across the generation fleet on coals outside the unit design specifications. The results of these tests have allowed the Companies to purchase alternative coals that have reduced the average annual coal cost by more than $10 million over the past several years.

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[11] *Application of Kentucky Utilities Company for an Order Approving Certain Accounting Treatment of Amounts Paid for Coal Contract Release*, Case No. 10214 (Ky. PSC Oct. 7, 1988); *Application of Louisville Gas and Electric Company for an Order Approving Certain Accounting Treatment for and Authorizing Recovery of Coal Contract Costs*, Case No. 96-089 (Ky. PSC Aug. 21, 1996). *See also Application of Big Rivers Electric Corporation for an Order Approving Certain Accounting Treatment of Amounts Paid for Coal Contract Amendment*, Case No. 8921 (Ky. PSC Feb. 13, 1984).

In another example, the Companies successfully developed the Refined Coal facilities at three coal fired stations following regulatory approvals in Case 2015-00264. Over the life of these projects as shown in Case No. 2015-2021, the Refined Coal facilities created more than $73 million in revenue, all of which the Companies distributed to customers

Still further, the Companies have pursued legal actions against coal suppliers who have defaulted on their contract obligations. For example, in 2008, Resource Sales defaulted on their contract. The Companies instituted litigation, causing Resource Sales to pay over $7.5 million in damages, all of which the Companies distributed to customers.

Finally, the Companies negotiated new contract terms that allowed them to make quarterly nominations to accelerate the delivery of the contract volume. This feature allows the Companies to reduce spot purchases when market coal prices are significantly higher than the contract price. This has previously, and is currently, resulting in significant coal cost savings for the customer. The Companies thus disagree with the contention that the Commission should modify the UFAC "to provide for less economic indifference by the utility to cost and recovery of fuel and purchased power."

The Commission has previously considered and rejected amending the UFAC Regulation to include such incentives. In Administrative Case No. 309,[12] the Commission found such 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.[13]

The Commission concluded that the present UFAC contained "effective incentives for the efficient management of fuel costs," which were "provided primarily through the Commission's review and oversight."[14]

Amending the current UFAC to reduce or defer the recovery of incremental costs or distribution through credits of decreases in costs compared to the level of fuel costs in base rates

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[12] *An Investigation of the Fuel Adjustment Clause Regulation 807 KAR 5:056*, Administrative Case No. 309 (Ky. PSC Dec. 18, 1989).

[13] *Id.* at 10.

[14] *Id.*

will not function as an incentive for an electric utility to further manage its fuel costs. Instead, it will create new and real risks for the utility's ratepayers and investors. The total amount the Companies spend on fuel is material. For the 12-month period ending September 2022, KU spent approximately $615 million on fuel and purchase power; LG&E spent approximately $396 million on fuel and purchase power. Effectively disallowing recovery of expenses of this magnitude will increase an electric utility's risk of not earning a fair and reasonable rate of return; investors are likely to demand a higher rate of return to compensate for the additional risk; and rating agencies will assess this risk when rating the utility's creditworthiness, all of which is likely to increase the utility's revenue requirement.

When fuel costs are rising, investors will be harmed by the utility's inability to fully recover a cost which is not completely under the utility's control. Further, for such an incentive to be symmetrical, when fuel costs are declining, ratepayers will be harmed by not receiving the full distribution of cost savings. Such an amendment to the FAC mechanism disturbs the careful balancing of interests found in the present UFAC, which permits an electric utility to fully recover its reasonable fuel cost and protects customers in periods when fuel market prices decline between rate cases.

In summary, the present UFAC Regulation in no way makes electric utilities economically indifferent to the cost of fuel. It presently contains effective measures for the continuous oversight and scrutiny for the management of fuel costs, making the efficiency of fuel procurement paramount. Amending the UFAC Regulation to include effective disallowances or deferrals of cost recovery are not likely to result in greater efficiencies but will cause greater financial risk and customer bills ultimately to be larger than they currently are.

Question 7: Does the current FAC appropriately balance the risk accompanying the incurrence and recovery of fuel and purchased power costs between customers and the utility? If so, why? If not, why not?

Yes. The present UFAC Regulation appropriately balances the risks of changing fuel costs and purchase power costs between ratepayers and the utilities. It allows an electric utility to fully recover its reasonable fuel and purchased power costs while permitting customers to timely receive all savings resulting from reductions in fuel costs in a declining fuel price market. Recovery of purchase power costs is limited to energy purchased on an economic dispatch basis to substitute for the buyer's own higher cost energy. Moreover, it provides procedural protections for utility ratepayers in the form of continuous Commission review and oversight to ensure that utilities are acting in a reasonable and prudent manner in their fuel procurement activities and in the operation and maintenance of their generation facilities. Finally, the present UFAC recovers and distributes changes in the reasonable cost of fuel so that the current customers who cause and benefit from the generation of the electric power correspondingly pay for the incremental increases and receive the incremental decreases between rate cases.

Question 8: The current FAC regulation is uniformly applicable to all utilities. If changes to the FAC regulation are made, should the FAC regulation continue to be uniformly applicable? If not uniformly applicable, should the FAC regulation prescribe different FACs from which a utility may choose?

The UFAC Regulation was originally intended to establish a standard, uniform format to allow the Commission to compare the operation of FACs. Establishing different FAC formats may make such comparisons and the Commission's administration of the UFAC Regulation more difficult. The issues arising from the volatility of the FAC factors in recent months are largely associated with the volatility in wholesale power markets supervised by regional transmission organizations. The Companies generate almost their entire power requirements and are not members of a regional transmission organization. However, the Companies recognize that adjustments to the existing UFAC regulation may be necessary to address issues unique to those electric generating utilities that are members of a regional transmission organization. If the Commission finds that such adjustments are necessary, the Companies recommend that the UFAC Regulation should not continue to be uniformly applicable, but the Companies' FACs continue to be governed by the current UFAC regulation.

Question 9: Should the FAC be the only mechanism to review non-FAC expenses for reasonableness as a predicate for recovery through base rates or tariff riders?

The Companies disagree with the premise to the question, i.e. that the FAC should be used as the exclusive method of reviewing non-FAC expenses for reasonableness or that an additional predicate for cost recovery in base rates is necessary.

Section 3 of the UFAC Regulation limits FAC review proceedings to an examination of a utility's past fuel adjustments, its fuel purchasing activities, and the past operation of the utility's FAC, making the focus of the FAC reviews rightfully on the operation of the utility's fuel procurement matters. The addition of other issues would unduly complicate the proceedings and lessen attention given to FAC issues, which is the primary purpose of the review proceedings.

Review of non-FAC expenses in FAC proceedings is unnecessary. These expenses are currently subject to review in general rate adjustment proceedings. Review in general rate proceedings, especially those in which the proposed rates are based upon a forward-looking test period, is likely to be more in-depth and efficient than in an FAC proceeding or a separate investigation, which are retrospective in focus. For example, the Companies base their forecasted non-FAC expenses on actual historical FAC exclusions. The most recent and accurate information regarding non-FAC expenses, therefore, would be in the record of a general rate adjustment proceeding.

As to the contention that non-FAC expenses are somehow "overlooked" in general rate adjustment proceedings, the experience of the Companies in the rate cases for the last 20 years has been just the opposite. The Commission and intervening parties in those proceedings have had wide latitude in conducting discovery and cross-examining utility witnesses and generally were afforded ample opportunity to explore non-FAC expenses in detail. The record of the Companies' last general rate adjustment proceedings contained a large quantity of information regarding the Companies' operations, including cost projections and historical cost information. Additionally, their witnesses were subject to extensive examination at hearing. The records in the Companies base rate cases demonstrate non-FAC expenses receive a robust examination by the proceeding's participants or the Commission.

To the extent the Commission determines further investigation of non-FAC expenses is necessary, the Commission has the authority to conduct management or operations audits, or both, at any time to investigate "any portion of the management and operating procedures or any other internal workings of the utility" under KRS 278.255(2). The cost of the audit is borne by the utility and included the cost of service of the utility for ratemaking purposes. KRS 278255(3).

Conditioning recovery of non-FAC expenses in a general rate proceeding upon their prior review in an FAC proceeding is problematic. If the utility, based on its statutory right, uses a forward-looking test period, the base period expenses in the test period will include between three and six months of estimated expenses. The forward-looking test period would be based upon projected expenses for a period beginning at least seven months after the filing of the general rate application. Unless the FAC review is expanded to address projected expenses, which it currently

does not, coordinating the FAC review of base period non-FAC expenses, much less the forward-looking test period creates confusion, conflict, and inefficiency.

Conditioning recovery of non-FAC expenses in a general rate case proceeding on its review of those expenses in a prior proceeding appears to establish an additional requirement to the statutory scheme for rate adjustments set forth in KRS 278.190 and thus modifies that statute. That action would violate KRS 13A.120(2)(i) and established precedent in Kentucky law.[15]

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[15] *Franklin v. Natural Resources and Environmental Protection Cabinet*, 799 S.W.2d 1 (Ky. 2004).

Question 10: What additional information should be required to support the reasonableness of FAC charges and expenses?

An electric generating utility files monthly a Form A report, which shows the calculations for the month's FAC charge, and a supplemental Form B report, which contains extensive supporting information about fuel inventories, power transactions and fuel purchases for the month. The reports are filed no later 45 days after the close of the month subject to the report.

As part of its order initiating an FAC review proceeding, the Commission typically requires an electric generating utility to provide detailed information regarding coal purchases, coal inventory level, coal supply solicitations, natural gas purchases, results of audits conducted of fuel and transportation contracts, pleadings from and status reports on litigation with current or former fuel and transportation vendors, plant outages, firm power commitments and contracts, and fuel procurement policies and procedures. The Commission also requests information that may be specific to the operating conditions of the utility or the industry.

The Companies believe that the currently required information fully supports the reasonableness of the calculation of their FAC changes and fuel expenses. To the extent that the Commission finds the information submitted pursuant to the UFAC and to the order initiating an FAC review does not adequately address its concerns, the Commission has wide discretion to request additional information.

Question 11: What additional information should be required to support the prudence of the utilities' fuel procurement actions?

Electric generating utilities are currently required to furnish a large number of documents regarding their fuel procurement activities. The UFAC Regulation requires an electric generating utility to file with the Commission its fuel procurement contracts and "all other agreements, options, amendments, modifications, and similar documents related to the procurement of fuel supply or purchased power." 807 KAR 5:056 Section 2(1). Any changes in the contracts or other documents filed with the Commission, including price escalations, and any new agreements entered into after the initial submission are required to be filed at the time they are executed. 807 KAR 5:056 Section 2(2).

As part of its order initiating an FAC review proceeding, the Commission generally requires an electric generating utility to provide detailed information regarding coal purchases, coal inventory level, coal supply solicitations, natural gas purchases, results of audits conducted of fuel and transportation contracts, pleadings from and status reports on litigation with current or former fuel and transportation vendors, plant outages, firm power commitments and contracts, and fuel procurement policies and procedures.

The Companies believe that the currently required information adequately supports the prudence of their fuel procurement activities. To the extent that the Commission finds the information submitted pursuant to the UFAC and to the order initiating an FAC review is not adequate to address the issues presented in a specific review proceeding, the Commission has wide discretion to request additional information from the utility in the course of that proceeding.

In its Order of November 2, 2022, the Commission refers to "the working expectation that FAC Charges are presumed reasonable absent evidence to the contrary in the record" and states that such "presumption that FAC charges are reasonable removes the burden of proof off the utility and places the onerous burden upon the Commission and its resources in reviewing FAC charges, reviewing thousands of pages of information every six months, and without any information or evidence on the operation or status of relevant generation units."[16]

No such presumption that removes the burden of proof exists at law. KRS 278.190(3) makes clear that "[a]t any hearing involving the rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the utility." No statute transfers a utility's burden of proof to the Commission upon a showing that an expense was incurred.[17] The presumption that a utility's management decisions are presumed to be reasonable[18] is a rebuttal presumption and does not remove the burden of persuasion from the utility. The Commission has for decades consistently recognized this venerable legal principle for

[16] Order at 10.
[17] "Standing alone, unimpeached, unexplained and unrebutted evidence may or may not be so persuasive that it would be clearly unreasonable for the board to be convinced by it." *Energy Regulatory Commission v. Kentucky Power Co.* at 50.
[18] *West Ohio Gas Co. v. Ohio Pub. Util. Comm'n*, 294 U.S. 63 (1935).

good reasons.[19] Absent the presumption, the utility's application would need to support every single cost and action, making the filings enormous and complex. But the Commission has "no duty to refute evidence submitted to it by an applicant who had the burden of proof." *Energy Regulatory Commission v. Kentucky Power Co.*, 605 S.W.2d 46, 50 (Ky.App. 1980). The Commission has the legal right to examine the utility's books or records, require the production of the books, accounts and records in verified form and require the utility to file reports or other information that the Commission reasonably requires. KRS 278.230. The Commission is afforded wide discretion on the questions it may ask.

As noted in the opinion by the Court of Appeals, shifting the burden of proof to the Commission "would place the Commission in an adversary position." *Id.*

The Commission has a statutory duty to enforce the provisions of KRS Chapter 278,[20] which includes a "utility's right to receive fair, just and reasonable rates for the services rendered or to be rendered by it."[21] The Companies respectfully submit that such duty, though sometimes difficult, is the quintessential reason for the Commission's existence and requires the Commission to conduct a thorough, complete, and timely investigation.

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[19] *Missouri ex rel Southwestern Bell Telephone Co. v Pub. Serv. Comm'n of Missouri*, 262 U.S. 276 (1923); *W. Ohio Gas Co. v. Pub. Utils. Comm'n*, 294 U.S. 63 (1935); See, e.g., *Application of Water Service Corp. of Kentucky for an Adjustment of Rates*, Case No. 2010-00476, Order at 11 (Ky. PSC Nov. 23, 2011); *Proposed Adjustment of the Wholesale Water Service Rates of the City of Pikeville,* Case No. 2002-00022, Order at 9 (Ky. PSC Oct. 18, 2002); *City of Newport v. Campbell County Kentucky Water District and Kenton County Water District No. 1*, Case No. 89-014, Order at 6 (Ky. PSC Jan. 31, 1990); *National-Southwire Aluminum Company v. Big Rivers Electric Corp. et* al, Case No. 89-376, Order at 5-6 (Ky. PSC Jan. 31, 1990).

[20] KRS 278.040(1).

[21] KRS 278.030(1)

Question 12: If applicable, what additional information should be required to support the prudence of utilities' bidding strategy governing the potential selection of a unit for economic dispatch?

This question is not applicable to the Companies.

Question 13: If applicable, what additional information should be required to support the prudence of utilities' power purchases in instances when units are not selected for economic dispatch?

This question is not applicable to the Companies.

Question 14: When determining whether an energy purchase is an economy energy purchase, should energy purchases be compared to the highest cost unit available during an FAC expense month or the highest cost unit available during the hour the energy purchase is made?

When determining if an energy purchase is an economy energy purchase, the energy purchase should be compared to the highest cost unit available during an FAC expense month. Given the complexity of real-time interactions between all elements of a generation system, it is exceedingly difficult to attribute generation to load using the highest cost unit available during a given hour. The Companies jointly dispatch the generation system to meet the constantly varying energy needs of customers (load following), with most units adjusting to demands through the use of automatic generation control. Unit characteristics, including ramp rates and the time it takes to bring a unit online, vary considerably. In addition to units producing energy to serve customers, other units are also operating at an appropriate, but varying, level to satisfy spinning reserve requirements that support system reliability. It is not practicable to retrospectively identify all the complex relationships and variables in system dispatch to determine and assign load based upon unit availability at a given hour. Consistent with historical practice, the Companies use the average generation cost of the highest cost unit available to operate during the month in its calculations to determine if an energy purchase is an economy purchase. The Companies have used this method since 2002 and believe it is the most appropriate method to classify an economy energy purchase.

Question 15: What details should be taken into account in considering a change in the definition of an economy energy purchase, including its recovery through the fuel adjustment clause?

As the current definition of economy energy purchase has worked well and is easily applied, the Companies recommend that no revisions be made to the current definition.