

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)	CASE NO. 2022-00190
AND RELATED COST RECOVERY)	
MECHANISMS)	

REPLY COMMENTS OF KENTUCKY UTILITIES COMPANY
AND LOUISVILLE GAS AND ELECTRIC COMPANY

Pursuant to the Public Service Commission’s Order of November 2, 2022, Kentucky Utilities Company (“KU”) and Louisville Gas and Electric Company (“LG&E”) (collectively “the Companies”) submit their reply comments.

Introduction

The Companies appreciate the opportunity to submit further comment on the issues presented in the Commission’s Order of November 2, 2022 and the initial responses to that Order. The Companies further commend the Commission’s initiative to review the effectiveness of its Uniform Fuel Adjustment Clause (“UFAC”) regulation under the current economic circumstances. Based upon its more than 40-year history the UFAC Regulation is effectively performing the primary purpose for which it was created and continues to stand the test of time. Significant revisions are not required. While some limited revisions to the UFAC Regulation to reduce the extreme swings in fuel adjustment clause charges (“FAC charges”) should be considered, the Commission should limit the scope of its review to the UFAC Regulation and defer the consideration of other regulatory mechanisms to other proceedings.

The UFAC Regulation Performs Its Specific Purpose Well

In an earlier review of the operation of the UFAC, the Commission, when initiating its investigation in Administrative Case No. 309,¹ listed the following criteria for a sound regulatory framework for fuel expenses:

The regulatory framework for fuel expenses should (1) provide incentives for efficient management of fuel procurement and power-plant performance, (2) provide information that permits the Commission to adequately monitor fuel costs to protect ratepayers, (3) be consistent for all jurisdictional utilities, (4) be fair in billing costs to the cost-causer, (5) be administratively workable and efficient, and (6) provide for fair regulation of both distribution and generation utilities.

After completing its extensive review, the Commission found that the UFAC Regulation met these criteria and that no significant changes were required.²

The UFAC has continued to meet these criteria in the thirty-five years since the Commission made its findings. The UFAC Regulation continues to provide for the efficient collection and distribution of changes in an electric utility's fuel costs between general rate cases and to facilitate continuous regulatory oversight and, where necessary, timely remedial action when a utility engages in imprudent fuel procurement practices or miscalculates FAC charges or credits. None of the comments submitted in response to the Order of November 2, 2022, have suggested that the UFAC Regulation has failed in this regard.

Since its establishment in 1978, the UFAC Regulation has performed as a neutral ratemaking mechanism in its assignment of risks and benefits between utility customers and shareholders. Electric utilities and their customers equally share in the risks from the present UFAC Regulation. Subject to retroactive reviews of fuel purchases and the possible disallowance

¹ *An Investigation of the Fuel Adjustment Clause Regulation 807 KAR 5:056*, Administrative Case No. 309 (Ky. PSC Sept. 3, 1986) at 3.

² Administrative Case No. 309, Order of Sept. 21, 1988 at 30.

of unreasonable fuel expenses, electric utilities are permitted to timely recover their actual cost of fuel but are not permitted to gain from fluctuations in the price of fuel between general rate cases. Utility customers are required to pay any increased fuel costs as they occur but immediately receive reductions in fuel costs that occur as well. Through retroactive reviews of fuel purchases and the possible disallowance of unreasonable fuel expenses, utility customers are continuously protected from paying more than the reasonable cost of fuel.

Electric utilities and their customers also equally benefit from the present UFAC Regulation. Electric utilities avoid the cost of frequent general rate proceedings to recover the cost of fuel and incur lower capital costs due to the lower risk associated with the timely recovery of fuel costs. Their customers benefit through lower base rates due to lower capital costs and lower rate case expenses and the timely recognition of lower fuel costs during periods of declining fuel prices.

Additionally, the UFAC Regulation provides continuous transparency and ongoing review in fuel procurement matters. The Commission receives monthly reports from the Companies on their fuel costs, fuel inventories, power transactions, fuel purchases, and their collection of FAC charges. All fuel procurement and transportation contracts are filed with the Commission.³ All of these documents are available for public inspection and can be viewed through the Commission's website. In addition, formal reviews are conducted every six months on the operation of the Companies' FAC.⁴ And every two years the Commission conducts an additional formal review to further evaluate the past operation of the Companies' FACs, to disallow any improper expenses and, to the extent appropriate, reestablish the Companies' FACs.⁵ During these reviews, the

³ 807 KAR 5:056, § 2(1) and 2).

⁴ 807 KAR 5:056, § 3(3).

⁵ 807 KAR 5:056, Section 1(2).

Commission and interested stakeholders can conduct extensive discovery on fuel related matters and question at a public hearing the Companies' employees responsible for the fuel procurement, generation, and fuel accounting practices. Stakeholders can submit evidence and express any concerns through a variety of means in the public record.

The UFAC Should Not Be Changed To Create New Incentives Or A Sharing Mechanism

The Commission and some commenters have questioned whether the UFAC should be revised to create incentives to encourage efficient and prudent fuel procurement practices.⁶ Revising the UFAC Regulation to create new incentives or sharing mechanisms will alter its function and purpose. It would disrupt the proven balance central to the success of the current UFAC Regulation. Incentive mechanisms involving the "sharing" of fuel costs would increase an electric utility's risk without a commensurate increase in the customers' risk. It effectively permits customers to share the benefits of declining fuel costs without sharing the risks of increasing fuel costs. This increased risk placed upon an electric utility is likely to increase that utility's cost of capital and result in higher base rates. It may precipitate more frequent general rate cases.

A sharing mechanism does not take into account that many factors contributing to fuel cost are beyond an electric utility's control and over which the incentive mechanisms would have no effect. Market disruptions that cause significant increases in fuel prices frequently result from natural disasters, weather events, war, terrorism and supplier failure. An electric utility has no control over these factors but, under most incentive mechanisms would be required to bear the risk from these factors. Similarly, electric utilities have little or no control over factors contributing to lower fuel costs, such as supply development, pipeline expansion, and changes in national policies

⁶ See, e.g., Order at 12; Comments of Joint Movants for Joint Intervention at 10.

encouraging resource development. Under a sharing mechanism, these utilities would benefit from a reduction in fuel cost for which they played little or no role.

The use of a sharing mechanism is likely to lead to more complex and lengthy administrative proceedings with limited results. As the Commission has previously noted in reviewing such a mechanism, “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.”⁷

Before considering a new incentive mechanism, considerations should be given to the incentive features in the present UFAC Regulation. Utility fuel procurement practices are subject to extensive reviews at formal proceedings conducted semi-annually and biennially. Costs resulting from unreasonable fuel procurement practices are subject to timely disallowance. In addition, the Commission can conduct formal investigations into an electric utility’s fuel procurement practices outside the FAC review process, as well as retain independent auditing firms to audit an electric utility’s fuel procurement practices. The Commission has not limited its review to fuel procurement practices but has also closely reviewed generation dispatch practices, generation unit outages and energy purchases.

The current UFAC Regulation also encourages the use of good maintenance practices through its treatment of fuel costs incurred for forced outages.⁸ It limits an electric utility’s recovery of such fuel costs to the fuel cost related to lost generation, effectively and timely penalizing a utility that engages in poor maintenance practices.

⁷ Administrative Case No. 309, Order of December 18, 1989 at 11.

⁸ 807 KAR 5:056, § 1(3)(b).

Prior Commissions have found that effective incentives for electric utilities to minimize fuel costs existed within the present regulatory scheme. In Administrative Case No. 309, the Commission noted:

[T]he 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 . . .⁹

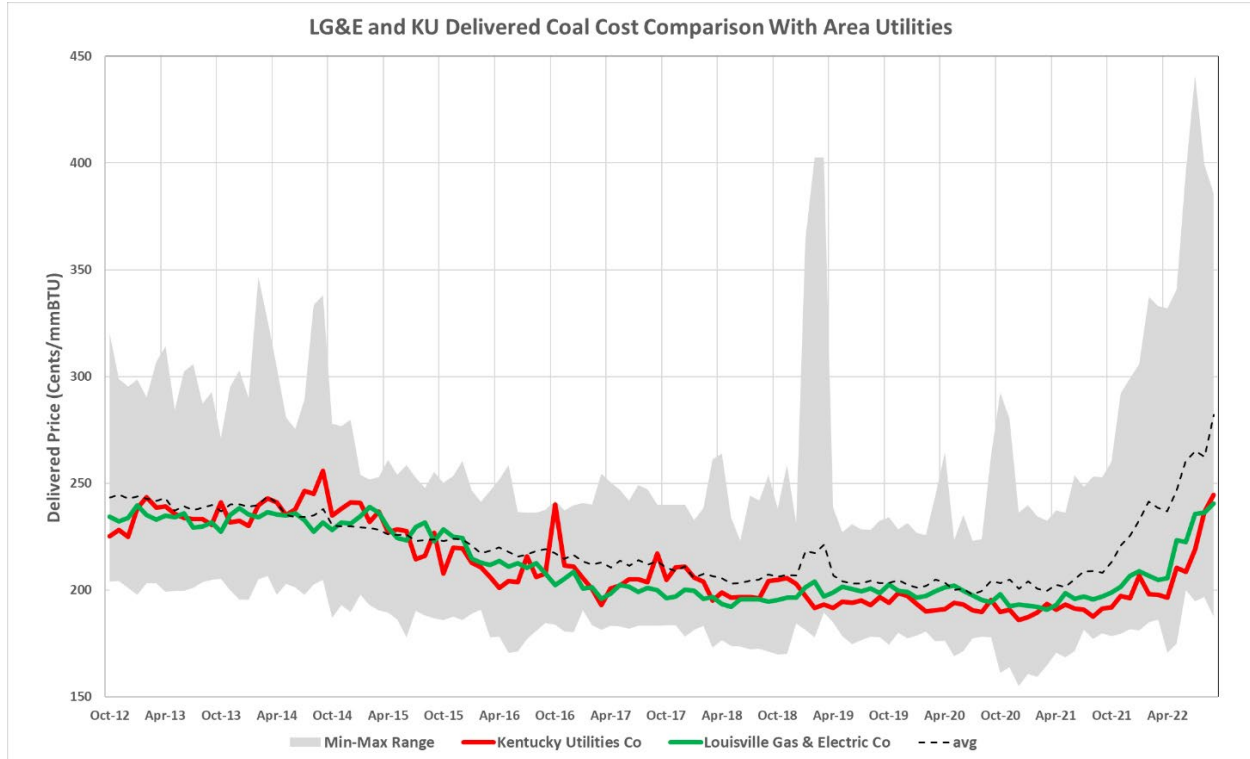
In Case No. 98-474, when rejecting KU's proposal for a fuel cost incentive mechanism, the Commission found that "significant incentives . . . [for an electric utility] to keep fuel costs at a minimum level already exist, including **a review of its fuel costs through the administrative process established under 807 KAR 5:056**, the increased margins realized from inter-system sales, and the increased opportunity to consummate profitable inter-system sales."¹⁰

The success of the current UFAC to encourage reasonable fuel procurement practices is demonstrated by the Companies' delivered coal cost comparisons with area utilities. As shown in Figure 1, the Companies have generally achieved a delivered coal cost that is below the average delivered coal cost of electric utilities in this area over the last ten years.

⁹ Administrative Case No. 309, Order of December 18, 1989 at 10.

¹⁰ *The Application of Kentucky Utilities Company for Approval of An Alternative Method of Regulation of Its Rates and Service*, Case No. 98-474 (Ky. PSC Jan. 7, 2000) at 17 (emphasis added). See also *The Application of Louisville Gas and Electric Company for Approval of An Alternative Method of Regulation of Its Rates and Service*, Case No. 98-426 (Ky. PSC Jan. 7, 2000) at 17.

Figure 1



The UFAC Regulation’s Ability to Control Fuel Cost Volatility Is Limited

As previously noted, fuel price volatility can be caused by a number of factors, such as natural disasters, weather events, war, terrorism and supplier failure. Absent strict and oppressive government price controls, fuel price volatility cannot be controlled. However, it can be mitigated. When established in 1978, the UFAC contained an effective tool to reduce price volatility and thus precipitous swings in FAC charges. Its requirement for weighted cost inventory smoothed fluctuations in an electric utility’s coal costs by effectively permitting electric utilities to engage in physical hedging through the use of longer-term coal supply contracts. As electric utilities are now transitioning to other forms of generation, including natural gas-fired units and renewable energy, their scope to engage in physical hedging is reduced.

Electric utilities that have baseload gas-fired generating units can, however, continue to engage in physical hedging. For example, the Companies hedge the gas supply for their baseload

generating unit Cane Run 7 to reduce FAC charge volatility by purchasing a portion of the unit's gas supply on a forward basis. They currently purchase up to 50 percent of the unit's forecasted gas burn on a forward basis for the current year. The balance of natural gas is purchased daily on the spot market. For the following years - one, two, and three - the Companies purchase 40-60 percent, 20-40 percent, and 0-20 percent, respectively, of the unit's minimum forecasted burn on a forward basis. The Companies plan to revise and update their forward gas purchase plans with the proposed addition of the Mill Creek and Brown natural gas combined cycle units to continue to reduce fuel price volatility for their customers and address operational considerations for their natural gas units.

Physical hedging is not practical for gas-fired *peaking* units. These units must be capable of going online in a relatively short period of time when needed. They are operated on an as-needed basis, not a predictable schedule that would permit contracting for a long-term supply of gas. Few electric utilities have access to gas storage fields to permit extensive storage of gas for such purposes.¹¹ Instead, they rely upon the spot market, which is subject to significantly greater price volatility.

The Commission has previously recognized that the use of financial hedges can reduce natural gas price volatility for utility customers and, in some instances, result in savings to utility customers. When faced with significant volatility in natural gas prices in the early 2000s, the Commission encouraged local gas distribution companies "to consider limited hedging strategies as a means of mitigating some portion of the price risks to which consumers are subjected."¹² Noting that the primary objective of such programs would be pricing stability, the Commission

¹¹ LG&E's gas storage fields are used to physically hedge gas prices for its gas distribution service to retail customers.

¹² *An Investigation of increasing Wholesale Natural Gas Prices and the Impacts of Such Increases on the Retail Customers Served by Kentucky's Jurisdictional Natural Gas Distribution Companies*, Administrative Case No. 384 (Ky. PSC July 17, 2001) at 8.

authorized the recovery of the cost of such financial hedges even when such programs resulted in customers paying more for natural gas than they otherwise would.¹³ The UFAC Regulation, however, currently restricts the use of this tool as it limits recovery of natural gas costs to natural gas consumed and thus prevents the recovery through a utility's FAC of costs associated with prudently executed financial hedges.¹⁴

Potential Tools to Address Fuel Cost Volatility

Three options that the Commission should examine to address FAC volatility are: (1) revising the UFAC Regulation to permit recovery of costs associated with financial hedges to reduce fuel price volatility; (2) allowing the creation of regulatory assets composed of unusually high fuel costs; and (3) considering the use of forward estimates of fuel market conditions to establish an electric utility's FAC base fuel factor.

The Commission should permit and encourage the prudent and reasonable use of financial hedges. As noted earlier, financial hedges provide a means to mitigate fuel price volatility. The UFAC Regulation's limitation on the recovery of natural gas costs to natural gas consumed, however, prevents the recovery through a utility's FAC of costs associated with financial hedges. Revising the UFAC Regulation to remove this limitation and permit the recovery of the costs

¹³ See, e.g., *Petition of Atmos Energy Corporation for Approval to Conduct Hedging Program for the Winter of 2003-2004*, Case No. 2003-00192 (Ky. PSC July 20, 2003) at 4-5 ("The Commission is not convinced that Atmos should be made to bear a portion of the cost of the hedging program. As stated in prior cases, the impetus for hedging is to provide insurance against an event such as price spikes, the cost of which would likely be borne by customers since Atmos does not control the market that gives rise to such an event. Since it is customers, not the utility or its shareholders, who stand to receive the benefits realized through a hedging program, we continue to find that customers should bear the cost of such a program."). In the mid-2010s, the Commission declined to continue the use of such hedging programs based in part upon its belief that the outlook for natural gas supplies and prices suggests the potential adverse impact of price volatility on customer bills was limited and the benefit to customers in terms of reduced volatility was no longer "sizable enough to justify extension of . . . hedging program[s]." *Application of Atmos Energy Corporation for Continuation of Its Hedging Program*, Case No. 2013-00421 (Ky. PSC Sep. 18, 2014) at 4, 7.

¹⁴ 807 KAR 5:056, § 1(3).

associated with prudently executed financial hedges would enhance the ability of electric utilities to reduce fuel cost volatility.

While the use of financial hedges will likely bring greater fuel cost stability, it may also result in fuel costs that necessarily are higher than current market prices. In effect, more stable fuel costs during a period of market volatility may come with an additional price. The Commission previously recognized this trade off when addressing the use of financial hedges by local distribution gas companies to mitigate price volatility:

A hedging program can be viewed in a manner similar to an automobile liability insurance policy. The costs incurred in conjunction with a hedging program are somewhat comparable to premiums paid for an insurance policy. The premium is paid for the insurance policy in order to mitigate the exposure to financial risk in the event of an accident. In a hedging program, costs are incurred in order to mitigate exposure to the risk that wholesale natural gas prices might increase to exorbitant levels. Since an LDC cannot exert control over market prices, it can expect to recover the cost incurred for natural gas purchases so long as those costs reflect market clearing prices, consistent with the Commission's finding in Administrative Case No. 297. If the LDC is able to recover 100 percent of the cost of gas acquired at market clearing prices, then ratepayers are bearing 100 percent of the risk attendant to allowing the LDC such cost recovery. Likewise, ratepayers, not the LDC, should be the beneficiaries of the hedging program, since the risk that is mitigated is risk otherwise borne by the ratepayers. Inasmuch as ratepayers will be the beneficiaries of the proposed hedging program, it is entirely appropriate and reasonable that they bear the full amount of the costs of the program.¹⁵

The Commission ended hedging programs for local gas distribution companies in the mid-2010s, based on the belief that the market's return to low and stable gas prices would reduce the need for hedging. The return of price volatility in the market provides a basis for reexamining that decision.

¹⁵ *Re Western Kentucky Gas Company*, 2001 Ky. PUC LEXIS 1073 *8-9; 210 P.U.R.4th 331 (Ky. PSC Jun. 15, 2001).

A second option to mitigate FAC charge volatility is to allow electric utilities to defer recovery of large fuel price increases through the creation of a regulatory asset. Under this approach, the electric utility could recover this asset through its FAC over an extended period of time and thus avoid a significant increase in its current FAC charge. However, this could also lead to step change increases and intergenerational inequities in cost recovery.

Finally, when setting the base fuel factor in its biennial FAC reviews, the Commission could consider forward estimates of fuel market conditions rather than historical factors that may not depict reasonably foreseeable changes in forward fuel markets. If the selection of a higher base factor over time causes recovery to be greater than the anticipated change in the cost of fuel, customers will timely receive credits of the difference between biennial FAC reviews. This option requires no revision to the UFAC but only a change in Commission practice.

Finally, should the Commission determine that changes are required to the UFAC or to the Commission's approach to addressing FAC volatility, the Commission should strictly observe the procedures set forth in KRS Chapter 13 to implement those revisions. Those procedures ensure that the concerns of all stakeholders are heard and considered before the changes are made. Failure to follow those procedures will be unproductive for all interested parties.¹⁶

Conclusion

The current UFAC Regulation works well, is accomplishing its intended purpose, affords transparency through monthly filings and review proceedings, allows for continuous oversight and review of fuel procurement practices and the operation of the FAC mechanism, and provides significant benefits to electric utilities and their customers. It does not encourage inefficiency in

¹⁶ See, e.g. *Commonwealth ex rel Cowan v. Kentucky Public Service Commission*, Civil Action No. 90-CI-00798 (Franklin Cir. Ct. Ky. July 10, 1990) (declaring Commission Order adopting guidelines for use a forecasted test period as contrary to KRS Chapter 13A).

plant maintenance or fuel procurement and, indeed, has protected utility customers from unreasonable fuel procurement decisions. While the current UFAC Regulation provides for some protection from fuel price volatility, the use of financial hedges, regulatory assets and setting the base fuel factor in its biennial FAC reviews using forward estimates of fuel market conditions should be examined as additional tools to further mitigate price volatility. When examining these and other potential tools to address price volatility, the Commission must recognize that price stability and lowest cost are competing goals and may at times be mutually exclusive. More stable FAC charges during periods of market volatility has a price. Finally, any revision to the UFAC Regulation will have significant consequences for Commission-regulated electric utilities and their customers and should be made only after a thorough examination of all issues and consideration of all stakeholders' concerns in accordance with KRS Chapter 13.

Dated: December 19, 2022

Respectfully submitted,



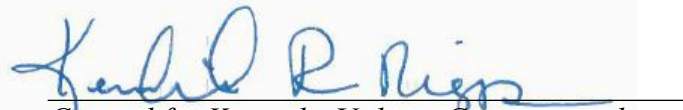
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CERTIFICATE OF SERVICE

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 19, 2022 and that there are currently no parties that the Public Service Commission has excused from participation by electronic means in this proceeding.



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