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

KENTUCKY SOLAR INDUSTRIES ASSOCIATION, INC.
WRITTEN COMMENTS

Comes now the Kentucky Solar Industries Association, Inc. (KYSEIA), by and through counsel, and in response to invitation in the Kentucky Public Service Commission's (PSC) November 2, 2022, Order in the instant proceeding, submits its written comments for the Commission's investigation into the Fuel Adjustment Clause (FAC) regulation, 807 KAR 5:056. KYSEIA states as follows:

1. **The FAC was promulgated to address a short-term risk; however, because of significant changes in regulation and markets, it is no longer reasonable to consider the FAC in isolation or through a short-term approach.**

As the Commission states in its 1986 investigation:

> Absent a FAC, all fuel costs are recovered through base rates. Should fuel costs change from the level included in base rates, the utility is at risk until it can receive Commission approval of a change in base rates under KRS 278.180 and 278.190. In an effort to shift this short-term risk of over- or under-recovery of fuel costs from the utility to the ratepayers, the Commission has permitted utilities to voluntarily choose to utilize a FAC.[1]

In terms of context and how the regulatory framework for adjusting rates then-existed: The Commission's statement in 1986 was prior to the introduction of numerous

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[1] Administrative Case No. 309, *An Investigation of the Fuel Adjustment Clause Regulation 807 KAR 5:057*, (Ky P.S.C. Sept. 3, 1986), at page 19.

mechanisms expressly designed to reduce risk of over-recovery and/or under recovery of costs by a utility including, for examples, the environmental compliance recovery surcharge, the forward-looking test period, and weather normalization.

Additionally, the above statement was rendered, as manifest by the plain language in the September 3, 1986 Order, when coal, for all intents and purposes, was the near exclusive fuel cost for electric generation in Kentucky. The competitiveness of coal for domestic electricity generation has changed dramatically.[2] The statement was also rendered when integrated resource planning (while clearly then-recognized as necessary) was nascent,[3] in an era prior to wholesale power markets,[4] and prior to cost-effective distributed generation.

The Commission's current investigation of the FAC is well-founded because of the remarkable changes that have taken place since 1986. Equally important is consideration of the current state of fuel costs. Natural gas price in the United States is properly characterized as experiencing record volatility.[5] Coal is properly characterized as

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[2] Bone, *Kentucky Coal Facts* (Energy and Env. Cab. and Ky Coal Assn., 17th ed 2017), at page 9 ("Federal environmental regulations targeting mercury, sulfur dioxide, nitrogen oxide, and recently carbon dioxide, have further impeded the market competitiveness of coal for domestic electricity generation versus alternative energy sources.").

[3] Administrative Case No. 308, *An Inquiry Into Kentucky's Present and Future Electric Needs and the Alternatives for Meeting Those Needs*, Order (Ky P.S.C. Oct. 9, 1986).

[4] Order (Ky P.S.C. Nov. 2, 2022), at page 5.

[5] United States Energy Information Administration, Today In Energy (August 24, 2022) (discussing natural gas price volatility in the first quarter of 2022). https://www.eia.gov/todayinenergy/detail.php?id=53579 retrieved Nov. 30, 2022.

experiencing record high prices and increasingly difficult supply conditions. In fact, from recent FAC dockets:

> Maintaining supplier diversity has become increasing more difficult as the number of coal suppliers continues to decline because of falling coal demand and industry consolidation.[6]
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> During the past year, the coal market has experienced and continues to experience significant changes that have resulted in tight supply and record high prices.[7]

On both a state and national level, there have been, and will continue to be, significant changes in regulatory mechanisms and energy markets. While the foundational premise of the FAC was, as recognized in 1977, a short-term mechanism protecting the utilities, the premise is from a very different era. It is no longer reasonable to consider only the short-term benefits of the FAC that flow to the utilities through assigning the entire risk of price increases and price volatility to customers. It is appropriate to recognize that over time the FAC operates to create a moral hazard, and it is no longer reasonable to isolate the results of the FAC through a short-term approach.

2. The FAC creates a moral hazard.

> A moral hazard is the tendency of behavior to change after contracts are signed, resulting in unfavorable outcomes from the use of a good or service.[8]

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[6] Case No. 2022-00265, *An Electronic Examination of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company from November 1, 2021 to April 30, 2022*, and Case No. 2022-00266, *An Electronic Examination of the Application of the Fuel Adjustment Clause of Louisville Gas and Electric Company from November 1, 2021 to April 30, 2022*, KU and LG&E Joint Direct Testimonies (filed Sept. 30, 2022) (Billiter Testimony at 4 [PDF 5 of 24]).

[7] *Id.*

[8] McKenzie and Lee, *Microeconomics for MBAs*, (Cambridge Univ. Press, 2nd ed 2010) at page 157.

The FAC creates for utilities a reimbursement mechanism for fuel costs. Utilities know *ex ante* that they stand to recover all fuel costs that are deemed prudent in a short-term review of utility activity, successive period-by-period considerations of intra-period prudence. It is not designed to consider the impacts the reimbursements under the FAC are having in the long-term.

As one of the leading sources of authority on regulation observes:

> Finally, if rates were based entirely on costs, however incurred, there would be severe problems of moral hazard. A moral hazard is involved when someone other than the purchaser pays for the purchase and hence the purchaser acts, unconstrained by ethics or other institutions, as if there is no resource cost on society from his or her purchases.[9]

A finding of short-term prudence for costs of fuel purchased during a period is developed from the circumstances of the period in isolation. It does not mean that the long-term strategy of the utility concerning fuel, including choice of generation and resource, is reasonable. For this reason, the FAC prudence review is not a meaningful consumer protection over the long-term. The period-by-period prudence review does not eliminate this moral hazard. In fact, it does not even reduce it.

Proof of the limitations in the FAC to consider generation and resource on other than a short-term basis is manifest in the Commission's initiation of integrated resource planning, which entails a comprehensive view of all factors bearing on resource over a significantly longer period than the FAC. It is unremarkable that the Commission's shift to develop integrated resource planning occurred in the aftermath of its 1986 FAC investigation Order. The FAC does not serve the purpose of minimizing fuel costs in the

[9] Bonbright, *Principles of Public Utility Rates*, (Public Utilities Reports, Inc. 2nd ed 1988) at page 138.

long-run because it does not realistically consider the long-run but only the short-term period of review.

As another leading source of authority, when considering criticism of automatic fuel adjustment clauses, observes: "[T]hey [adjustment clauses] reduce a utility's incentive to minimize fuel costs."[10] Further:

> [U]tility companies that are subject to an automatic fuel adjustment clause may invest fewer resources in searching out the relatively lower-priced supply sources than firms that have no adjustment clause.[11]
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> …
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> [F]irms with adjustment clauses may have a reduced incentive to switch their existing plants to the fuel that exhibits a slower rate of escalation, especially when such fuel switching is costly. Thus, the adjustment clause may lead to a further increase in aggregate fuel price by encouraging an overutilization of relatively expensive fuels.[12]

The utility, rather than the customer, makes the decision on how to manage fuel risks including the selection of generation sources and technologies. Nonetheless, 100 percent of the fuel risks falls upon the customer. The utilities are insulated against both increases in fuel price and fuel price volatility. The utility, through the FAC, has no incentive to invest in technologies or facilities that use low amounts of fuel or no fuel. The moral hazard is that the FAC permits a utility to be indifferent in the long-run to lower-

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[10] Phillips, *The Regulation of Public Utilities*, (Public Utilities Reports, Inc. 2nd ed 1985) at page 236.

[11] *Id.*, at Footnote 19.

[12] *Id.*

priced supply sources if not incented to continue to invest in higher-priced technologies or facilities.[13]

3. **A reform is necessary to remove the moral hazard present in the FAC because it is no longer reasonable to allow the FAC to function as if current facts and circumstances are similar to those in a prior era. At minimum, there is a need for a more robust Integrated Resource Planning process and a removal of the ability of a utility to be indifferent to pursing no cost and low cost fuel alternative strategies for generation.**

As the Commission observed in its investigation in 1986:

> The first criteria is the extent of control or influence utilities have over fuel costs. All jurisdictional distribution electric utilities purchase 100 percent of their requirements from generators at rates set by this Commission or the Federal Energy Regulatory Commission. Generators have significant influence over fuel costs through fuel purchasing practices, fuels handling, and power plant operations. However, the level of coal-market prices is clearly beyond utility control.[14]

This part of the criteria warrants reexamination because the discussion pertains to a short-term analysis. In the decades since the promulgation of the FAC, a significant amount of generation has been shifted away from coal to gas. Thus, over a longer term, utilities have certainly exercised control over the choice of generation as between coal and gas and, in turn, a measure of control over fuel price. Utilities do not occupy the same position today as in the prior era because, over a longer term, they have made choices in their facilities and technologies. They continue to have ability to make choices in facilities and technologies including those that are low fuel or no fuel options. Through the FAC,

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[13] *See, for comparison,* Bonbright, *Principles of Public Utility Rates*, (Public Utilities Reports, Inc. 2nd ed 1988) at page 369.

[14] Administrative Case No. 309, *An Investigation of the Fuel Adjustment Clause Regulation 807 KAR 5:057*, (Ky P.S.C. Sept. 3, 1986), at pages 6 and 7.

though, they do not have the incentive to shift to technologies that reduce exposure to increasing fuel prices and increasing fuel price volatility.

As the Commission observes: "The current FAC makes utilities economically indifferent to the cost and recovery of fuel."[15] Exactly. The Commission should take this fact into account when reviewing applications for certificates of public convenience and necessity, financing, and integrated resource plans.

In terms of amending the current FAC to provide for less economic indifference by the utility to the cost and recovery of fuel and purchased power, the Commission spoke to this issue in 1986.[16] Consistent with that discussion, there needs to be incentives for the utilities to efficiently manage fuel-related choices, particularly those associated with the pursuit of long-lived assets. The risks that the current generation and resource options may prove stranded are due in no small part to the FAC.

An amendment to the FAC that shifts the negative consequences of that risk away from the customers resulting in a fairer and more reasonable balance is merited. Examining the plain language from the Commission's 1986 investigation, a utility has the option to pursue its recovery of costs through base rates.[17] There is no prohibition against

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[15] Order (Ky P.S.C. Nov. 2, 2022), at page 12.

[16] It once again merits mention that the Commission's discussion in 1986 was before forward-looking test periods, weather normalization, and various other regulatory options available to the utility for pursing the opportunity for a fair return.

[17] Administrative Case No. 309, *An Investigation of the Fuel Adjustment Clause Regulation 807 KAR 5:057*, (Ky P.S.C. Sept. 3, 1986), at page 19.

revisions to the FAC. If anything, the Commission's plenary authority to revise the FAC and rebalance the assignment of risks is far more certain today than in 1986.[18]

Solar generation, among other alternatives, carry no fuel price risk or price volatility risks. The utilities should not be allowed to be indifferent to this fact. Requiring ratepayers to bear the full costs of fuel without risk to the utility is an outdated, inefficient, and unfair practice, and it provides no incentive for utilities to pursue least cost alternatives in the long-term.

Certainly, there needs to be a robust regulatory process in place in which the applicable utilities are not indifferent to fuel costs and the volatility of fuel prices. The integrated resource planning process is well-suited to consider fuel cost issues in a comprehensive manner over a long-term rather than the short-term review that takes place through the FAC. On this point, nonetheless, integrated resource planning must be based upon each utility's actual internal resource planning and actual conditions.

Wherefore, KYSEIA submits these written comments.

Respectfully submitted,

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[18] *Kentucky Public Service Commission v. Commonwealth ex rel. Conway*, 324 S.W.3d 373 (Ky. 2010).

Notice For Filing

Undersigned counsel provides notice that the electronic version of the paper has been submitted to the Commission by uploading it using the Commission's E-Filing System on this 2nd day of December 2022. Pursuant to the Commission's Order in Case No. 2020-00085, *Electronic Emergency Docket Related to Novel Coronavirus Covid-19*, the paper, in paper medium, is not required to be filed.

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