

**COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION**

In the Matter of:

Investigation of the Fuel Adjustment Clause)	Case No. 2022-00190
Regulation 807 KAR 5:056)	

INITIAL COMMENTS OF KENTUCKY POWER COMPANY

The Public Service Commission of Kentucky (“Commission”) initiated this administrative proceeding to investigate the fuel adjustment clause (“FAC”), purchased power cost recovery, current and future fuel and power price volatility, and related cost recovery mechanisms, in response to Senate Resolution 316 titled “A RESOLUTION urging the Kentucky Public Service Commission to examine strategies to address utility costs to ratepayers” (SR 316).¹ The Commission requested comments from interested utilities and stakeholders to aid in the determination of specific alternatives and areas of concern within the general issues of this case.² Kentucky Power Company appreciates the opportunity to provide the following initial comments.

Comments in Response to Numbered Questions

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

The FAC as currently enacted provides material benefit to customers in that they pay no more and no less than the actual amount incurred by the load serving public utility, on a true-up basis, but the Company makes the following recommendations for potential improvements to that fundamental function.

¹ Order at 1 (November 2, 2022).

² *Id.* at 11.

The present mechanism's virtue of keeping the amounts owed by customers concurrent, as well as the credits associated with any short-term over-recovery, is fair, just, and reasonable. Moreover, failure to allow concurrent recovery of fuel expenses (i.e. if the FAC regulation did not exist) would undermine one of the most important bases for the original implementation of the FAC Regulation at its inception. Utilities would be required to come in for rate cases more frequently, which necessarily also means the added costs of rate cases and the increased burden on the Commission of "pancake" rate cases.

Furthermore, the very reason for the existence of the FAC is that these costs are volatile in nature, outside of the regulated utilities' control, and significant enough that determination of related costs of services for purposes of ratemaking would result in customers being exposed to either greater rate instability, due to more frequent cost deferral and base rate cases, and/or a delay in cost reductions for the situations in which the volatility of fuel and energy costs results in lower costs, as can be the case particularly in connection with reductions in the price of natural gas, which in the past decade has been significant, compared to prior periods.

Nonetheless, as currently implemented, the FAC Regulation places constraints on actions utilities can take to manage or mitigate the monthly volatility of the FAC which would be to the benefit of customers. The rigid mechanisms currently implemented for utilities to recover costs through the FAC make it more difficult for utilities to adapt to changing circumstances, which may involve additional costs or risks in hindsight, and tend to increase utilities' risk of non-recovery of prudently incurred costs in connection with approaches that would in fact be beneficial to customers. Specifically, the Company notes the following options may help to reduce volatility of the FAC for customers:

Long-Term Fixed Price Contracts

Long-term fixed price contracts for large percentages of coal and/or natural gas supply, assuming those contracts are available in the market, could reduce volatility. However, a high reliance on such contracts limit the ability of utilities to take advantage of periods of time when market prices decline. In such a situation, utility customers would realize protection from significant increases to coal and natural gas prices, but with the trade-off that such protection would limit the utility's ability to take advantage of times when market prices fall.

Flexibility to Defer Fuel Costs

Greater flexibility for utilities to defer fuel costs and to manage the timing of the recovery of these costs could reduce volatility. As illustration of the need for flexibility within the construct of the present regulation and any future enhanced FAC recovery mechanism is provided by the Company's efforts in the recent past (in particular Case No. 2022-00125) to spread out the customer impact of cost increases by voluntarily deferring some fuel expenses to keep customer rates lower and more stable in 2022. It would be an enhancement of the FAC Regulation to allow for such deferrals to be implemented without the need to create a case before the Commission.³

Annual Rate Utilizing a 12-Month Forward Forecast

Use of a 12-month forward-looking forecast to set the FAC rate, with cost true-up spread out on an annual rather than monthly basis could reduce volatility. This approach would result in more stable monthly FAC costs from month to month within any particular year, albeit with the trade-off that customers may be exposed to greater and more sudden changes in FAC rates from year to year. Either the present approach or this alternative 12-month forward looking forecast

³ Kentucky Power wishes to emphasize that this flexibility would not impair the Commission's ability to review costs recovered through the FAC, as the flexibility enhancement would rather pertain to the timing of when costs (including associated carrying charges) are billed to customers and recovered by utilities.

approach would result in customers paying actual tried-up costs, since any over or under recovery from one year to the next would be reflected in the following year's forecasted revenue requirement. Nevertheless, this alternative approach may result in greater rate shock in any given year should there be a material under-recovery combined with higher energy and fuel cost forecast.

By way of example, the sudden increase in gas prices beginning in the last two months of 2021 associated with unforeseeable market instability resulting from the war in Ukraine, under a 12-month forecast alternative likely would have delayed rate increases for customers, but it would have made those increases more sudden, possibly hitting customers during the winter heating season, when electricity bills tend to be seasonally the highest, at least in Kentucky Power's service area.

Three-Year Historical Average for the Denominator

The current FAC mechanism requires⁴ that the denominator be based on sales in the current period. This requirement can create a significant disconnect that may contribute to substantial over-or-under collection over a given period. Using a three-year average generally can be expected to result in smaller over-under recoveries, and potentially a less volatile fluctuation in charges billed to customers.

Base Fuel Modifications

Currently the base fuel rate is only updated in either a 2-year FAC review or a base rate proceeding. It would be beneficial to customers for there to be a standard formula that would allow utilities to update the base fuel rate annually, or upon material changes, without having a separate administrative case to be adjudicated by the Commission.

⁴ Administrative Regulation 807 KAR 5:056, Section 1 establishes the formula for calculating the monthly FAC factor.

Ultimately, the Company recommends that the FAC Regulation be made more flexible, and its implementation more supportive of utilities full recovery of costs associated with fuel and energy that are necessary to provide electric service to customers. It bears emphasizing that the volatility of FAC charges experienced by customers reflects the volatility of the fuel and energy costs that are recovered through the FAC. The purpose of the FAC is to allow for timely recovery of these potentially volatile fuel and energy costs, as they are incurred by regulated public utilities whose rates are determined by the Commission and which are subject to the Commission's jurisdiction.

2. What changes to the FAC regulations, if any, could reduce exposure of the FAC to volatility in the wholesale power market?

Physical and financial hedging contracts are a tool to manage wholesale power market volatility exposure. In order to obtain that protection, however, it is necessary to incur costs. In addition to the recommendations provided above, the Company notes that the FAC Regulation could be made more explicitly supportive of physical and financial hedging to manage the volatility of total average fuel and purchased power cost realized. It is important to highlight that additional costs may be incurred to reduce volatility, and that such measures will not always be the most economic in hindsight. If the goal is to mitigate volatility in FAC charges, then the lowest of cost or market can no longer be the standard to achieve increased insulation from the wholesale energy markets. Additional opportunity cost is the price of removing volatility and it would be in the public interest and to the benefit of customers for the FAC Regulation to explicitly allow for the recovery of those costs.

Of note, the FAC Regulation is a cost recovery mechanism. As such, it itself has little to no effect on the volatility of the wholesale power market. As discussed in connection with the previous question, the present FAC mechanism actually provides a significant benefit to

customers, in that it mitigates the risk of accumulating significant under-recoveries to be collected in future rate periods, which in turn would expose customers to more sudden and significant increases in their electric bills. However, in order to more appropriately reflect the cost of providing service, and to provide greater flexibility for utilities to mitigate the impact on customers of the inherent volatility of energy markets, it would be a marked improvement to explicitly support the recovery of costs associated with mitigating that volatility using the tools available within the markets to manage those price-variance risks and obtain a less volatile level of costs over time.

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

The efficiency and reliability of power plants is subject to other more significant factors, and the structure of the FAC Regulation itself has a marginal impact on those factors, if any at all. At a very general level, the FAC is supportive of efficient and reliable operation of power plants, in that it is supportive of timely recovery of costs of service, which in turn enables utilities to conduct their operations efficiently and reliably.

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

No. However, it is worth noting that the current FAC Regulation does cap the cost of purchased power that replaces internal generation during times of planned or maintenance outages at the lower of market or internal generation (in Kentucky Power's case, based on the peaking unit equivalent ("PUE")). In a period when market prices are above the average cost of internal generation, the current regulation does create an artificial penalty for utilities to carry out necessary maintenance during periods when in hindsight it would have been more economical to keep

generating units online and available, particularly when those periods occur outside of the seasonal averages for energy costs.

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?

The Company notes that the FAC Regulation is neither an effective nor an appropriate tool to seek to influence or penalize the operation of generation resources. Utilities have an obligation to serve, and to conduct their operations in a reliable and efficient manner, consistent with prudent utility practice and subject to the business and professional judgment of utility managers and operators. It would be poor policy and would erode the regulatory environment in which utilities operate to penalize utilities for changes in fuel and energy costs that are beyond their control. The purpose of the FAC Regulation is not to enable such punitive treatment, but rather to enable timely cost recovery. Trying to engraft into this recovery mechanism some type of parallel penalty system applicable to power plant reliability or efficiency measures would be to the detriment of customers, arbitrarily discriminate utilities based on the generation fleet's size, type, age, and other unknowable and unpredictable factors, and ultimately make it more costly to utilities and customers to obtain the energy and capacity resources necessary for utilities to fulfill their obligation to serve customers.

Of further note, for those utilities who participate in Regional Transmission Organizations ("RTO"), a participation that for decades has provided material and very significant benefits to their customers, those organizations have market participation rules and mechanisms, regulated by the Federal Energy Regulatory Commission ("FERC"), which already provide market participation signals and requirements that do have an effect on how power plants are operated, subject to market conditions related to fuel and energy prices that are beyond

the control of any particular utility. For this further reason, the FAC Regulation should not be used to create a penalty system that may expose utilities to inconsistent Federal and State regulatory requirements, create a discriminatory environment for utilities participating in federally-regulated energy markets, and erode the opportunity for utility customers in Kentucky to obtain the very significant benefits resulting from participation in RTOs.

In that context, it would be in the public interest to eliminate from the FAC Regulation the concept of a PUE, which is anachronistic, and provides no representative point of reference for utilities operating within RTOs and federally-regulated energy markets.

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 better promote efficient and prudent fuel procurement practices?

Yes, Kentucky's current FAC Regulation promotes transparency and enables utilities to procure fuel and other consumables in different markets, and attend to changing market conditions. The current FAC Regulation provides sufficient flexibility for utilities to participate in these markets effectively.

The Company notes, however, that the FAC Regulation should not be used to hinder a utility's ability to protect the interest of utilities and customers alike, such as when a utility faces counter-party under-performance, or market conditions in which hedging and other common commercial practices would be beneficial to respond to market conditions and mitigate risk. The current application of the FAC Regulation does not provide sufficient support and clarity regarding, for example, the range of appropriate actions a utility can take when counterparties are unable to meet their contractual obligations for a period, including, for example, procuring fuel at possibly a higher price to ensure the reliability or availability of a power plant. It would be for the benefit of customers to enable utilities to make appropriate business decisions, within the

range of options that market conditions present, without the impairment of rigid recovery requirements that cannot, in real market conditions, provide the adaptability that would be optimal to provide service to customers.

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.

While it is common in other jurisdictions to have tracking recovery mechanisms for fuel and energy, those mechanisms are sufficiently different from jurisdiction to jurisdiction to make any comparison necessarily be at a very high level. More important than the specifics of those recovery mechanisms, however, is the manner in which those mechanisms are regulated and applied in practice. The Company notes that compliance with the mechanism requirements in Kentucky tends to be less predictable and less flexible than in jurisdictions that allow forecasted energy and fuel costs and more easily adjustable fuel factors, such as Virginia and Indiana.

In the past, application of the FAC Regulation in Kentucky has eroded the predictability of cost recovery for utilities (sometimes with significant credit metrics impact), and made more cumbersome to even out the timing of customer impacts when the utility otherwise had the opportunity to do so. A robust application of the current FAC Regulation facilitating the predictable and timely recovery of cost from customers would be a benefit for utilities and customers alike.

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 the cost and recovery of fuel and purchased power?

As a threshold matter, utilities are not economically indifferent to the cost and recovery of fuel. Utilities are subject to limits on the availability of capital and any resources used to

obtain fuel, unless recovered, cannot be deployed elsewhere. Therefore, a deterioration of FAC recoveries results in a direct erosion of a utility's ability to earn its Commission-authorized rate of return. Crucially, any utilities' fuel procurement practices are subject to review and disallowance by the Commission in six-month and two-year FAC review cases.

To the extent that the FAC Regulation can be considered to be an economically-neutral mechanism in that the utility does not earn a return on the costs passed-through to customers, it is important to recognize that the FAC Regulation, which concerns short-term costs, is not an appropriate tool to provide economic incentives or disincentives related to long-term and very long-term decisions, such as those associated with Integrated Resource Plans ("IRPs"). Of note, IRPs take into account the costs of future resources, which includes their costs and ability to dispatch energy to serve load, and which depend heavily on long-term planning horizon assumptions about energy and fuel prices. Similarly, long-term decisions pertaining to electric plant and facilities generally requiring certificates of public convenience and necessity, or with the types of facilities and contracts such as those discussed in a utility's integrated resource plans. The review of short-term fuel costs within the scope of the FAC Regulation is not an appropriate vehicle to evaluate these type of long-term decisions related to long-term facilities and resource plans.

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?

No, the application of the FAC Regulation currently provides for a biased and unrealistic calculation methodology that makes it more difficult for a utility to recover their actual costs of service. This ultimately is to the detriment of customers, as it erodes the utility's financial condition, which in turn impedes the utility's ability to provide service. A recovery mechanism

that more predictably and accurately allowed for the recovery of energy and fuel cost incurred to serve customers would benefit customers both in the short term, causing customers to pay no more and no less than the actual costs required to serve them, and in the long run, supporting the financial condition of the utility, which ultimately has a direct positive effect on the utility's ability to serve its customers.

Moreover, when evaluating the balancing of the risks accompanying the incurrence and recovery of fuel and purchased power costs in the FAC Regulation, as currently implemented, ignores the reliability implications of these risks. It is a policy failure to focus on the price of energy in isolation without recognizing that customers in Kentucky have not had to endure any shortages, rolling blackouts, and disruptions of service in large measure because of the business judgment of utility managers and operators in the Commonwealth – and that there is a direct causal connection between reliability and a supportive environment in which fuel and energy costs are fully recovered on a timely basis by the regulated utilities responsible for providing actual service to customers.

Ultimately, it is not in the public interest, and is a disservice to customers, to jeopardize the recovery of fuel and purchased power costs prudently incurred by utilities. Jeopardizing or making more difficult the recovery of these costs does nothing to address the volatility of energy and commodity prices, but it has much to do with an erosion in the financial integrity of utilities in the Commonwealth, and consequently with their ability to serve customers safely and reliably.

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?

Different utilities serve different customers, are subject to different specific commercial conditions, and may differ significantly in the way in which they meet the needs of their

customers. While sufficient uniformity is required to avoid creating a discriminatory environment, the FAC Regulation should be flexible enough so that different utilities can adapt to changing market conditions within a broad range of permissible and reasonable approaches, subject to the business judgment of managers and operators. This flexibility may include having multiple FAC methodologies available to utilities, so that different utilities may avail themselves from time to time of the mechanism that best suits a particular situation or time period. For example, from time to time it may be beneficial for a particular utility's customers that the utility be allowed to use a forecasted energy cost for a period of time, a different time period for the calculation of fuel factors, or other specific FAC calculation or recording features.

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 review of costs recovered through the FAC should not include a review of expenses that are not recovered through the FAC. First, FAC review cases, which currently are limited to FAC expenses, are complex enough, and the added review of non-FAC expenses would not only be unnecessary, but also would only increase that complexity. Further, it would be inappropriate to preclude the recovery of non-FAC expenses through the recovery mechanisms that actually would be the vehicle for their recovery. The scope and timing of the FAC is appropriately narrow, given the specific nature of the costs recovered and the fact that the costs recovered through the FAC are pass-through. Increasing the scope of the FAC review to include costs that are not recovered through the FAC would make poor policy, cause significant complexity, and erode the benefit to customers of having a straightforward mechanism to recover the short-term costs that are the appropriate subject of FAC review.

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

To the extent the FAC cost recovery process should be changed, it actually should be simplified, rather than made more complex and less accurate. It is not in the public interest to attempt to have the Commission, and not utilities, to exercise the business judgment required to manage and operate a public utility. To that effect, the FAC should not be used to apply hindsight to decisions that by necessity must be taken at a particular time, with the limited information available, and within the context of market conditions. Thus, in applying the FAC Regulation, it is important that the regulation explicitly recognize that decisions are made by Company management at a point in time, and using hindsight is an unfair and unrealistic way to evaluate reasonableness of such decisions.

By the very nature of the tracking mechanism, the costs recovered through the FAC are volatile, and most importantly are subject to market conditions that are beyond the control of public utilities. These costs are subject to true-up, so that customers pay no more and no less than what it costs to serve them. Moreover these costs, like all costs recovered by regulated public utilities, are subject to review by the Commission. As it is, the methodology requirements of the FAC can result in an inaccurate calculation of the cost of fuel and energy, biased towards understating the costs incurred to serve customers. The FAC Regulation should not be changed to make it more difficult and/or less accurate to recover these costs.

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

As discussed in connection with the previous comments, all the costs recovered by a regulated utility through rates regulated by the Commission is already subject to prudence review. It would be inappropriate for the FAC Regulation to subject the recovery of these costs

to a review based on hindsight, and it would be further inappropriate for the mechanism to seek to substitute the business judgment of managers and operators of public utilities. In that regard, the current regulations should be simplified, rather than made more complex and restrictive, to allow managers and operators to exercise their expert business judgment for the benefits of customers. There is a broad range of decision making that needs to be available for these experts to do their job, and it is not in the public interest to use the FAC cost recovery process to restrict that range of decision making, after the fact, and with a bias to disallow prudently-incurred costs necessary to serve customers.

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?

As previously discussed, the participation of a utility in federally-regulated energy markets is subject to requirements that are subject to FERC's jurisdiction. It is not an appropriate or effective use of the FAC Regulation to attempt to displace the expert business judgment of managers and operators regarding the participation of the utility in those energy markets, and potentially such misuse of the FAC construct recovery mechanism could result in imposing inconsistent and incompatible obligations for utilities at the Federal and State level.

Moreover, the business strategy pertaining the potential selection of a unit for economic dispatch involves a complex matrix of decisions, subject to a myriad of factors and market conditions. Such decision making requires a great deal of flexibility, and a very broad range of prudent decisions is possible in any given circumstance, let alone the innumerable different scenarios that operators and managers of public utilities face on a day-to-day basis over years and decades. It would be a great disservice to customers to try to cripple the business decision-making of these experts by imposing after the fact a narrow set of bidding strategy requirements,

inevitably with the result of second-guessing with the aid of hindsight the decisions made, or at a minimum creating an environment in which such real-time decisions cannot be made with the flexibility necessary to adapt to varying market situations.

The FAC Regulation and recovery mechanism process should not include a prescribed bidding strategy approach that would interfere with the utility's business decision making. Such a prescribed approach cannot possibly account for the changes in market conditions that managers and operators face, and would deprive customers of the benefit of the utility's expertise applied to real market situations on a day-to-day basis over years and decades.

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?

Please refer to the previous responses. A utility's activities are already subject to prudence review, and it would be a disservice to customers to create a set of prescribed requirements and approaches that would hinder the utility's ability to exercise its business judgment when participating in energy markets on a day-to-day basis and based on their expertise. The factors involved are numerous and complex, and require a high degree of professional judgment, within the context of a broad scope of possible prudent actions. It would not be in the public interest to restrict the ability of managers and operators to make decisions based on a set of pre-determined requirements that could not possibly anticipate the various conditions and variables that those decisions may entail in any particular situation.

This is particularly the case for utilities participating in an RTO. The obligations and responsibilities of those utilities participating in these markets and coordinate operational regions are regulated by FERC, and it is critical that state regulations such as the FAC do not create

conflicting and potentially irreconcilable obligations under Federal and State regulatory frameworks.

By way of example, Kentucky Power is a member of PJM, an RTO regulated by FERC. Pursuant to FERC's regulatory framework, Kentucky Power offers its generation and purchases its load requirements through PJM. Within that framework, there may be purchases resulting from market conditions causing economically constrained dispatch in which Kentucky Power's generating units are not selected, purchases in the real-time market because a generator could not satisfy its day-ahead obligation, and purchases resulting from an increase in load beyond what was purchased in the day-ahead market. None of these circumstances are within Kentucky Power's control, and instead are the consequence of market activity, involving a wide variety of market participants, and affected by a multitude of economic factors, weather, and other external circumstances.

Against that back-drop, it is obvious that the FAC Regulation should not be the measure, nor a punitive mechanism, for the economics and historical dispatch of a utility's generating units. For example, units that do not generally receive awards in the day-ahead market should not be expected to eliminate the need for purchased power if they could not do so economically. Implementing the FAC Regulation in this manner would be unrealistic and arbitrary.

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?

Neither of these measures is appropriate to determine whether an energy purchase is an economy energy purchase, particularly for utilities that participate in RTOs. The RTO determines the system economic dispatch on an hourly and hourly locational basis. The FAC

Regulation should not use a different measure, since the regulated utilities *cannot*, pursuant to federal regulation, use a different measure.

An illustration of the importance of a realistic measure, to ensure that utilities in fact have an opportunity to recover the fuel and purchased power costs intended to be recovered through the FAC tracking mechanism, is provided by the use of a PUE proxy to compare the cost of purchases to the total cost of starting and dispatching a hypothetical combustion turbine peaking unit. This is an unrealistic measure that bears no relationship to actual operational requirements for a utility participating in an RTO such as PJM, particularly for utilities whose generation unit operational requirements do not include the capability to quick-start a unit, and in actual real-life performance it is unrealistic to consider starting a unit to generate for only a single particular hour.

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?

None. Please see the response to Question 14.

Respectfully submitted,



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