

Testimony of
Bob Glass, Chief of Economics and Rates
Kansas Corporation Commission

Before the Joint Committee on Energy and Environmental Policy
Regarding Utility Recovery of the Cost of SO₂ allowances
October 17, 2011

Chairman Holmes and Committee Members:

My name is Bob Glass and I am the Kansas Corporation Commission's Chief of Economics and Rates. Thank you for allowing me to appear before you this morning on behalf of the staff of the Commission.

I am appearing today to provide more detail on the recovery of the cost of emission allowances through an Energy Cost Adjustment (ECA) mechanism. The ECA is the mechanism the Commission has in place for investor owned utilities to recover the costs associated with the purchase of SO₂ emission allowances.

Energy Cost Adjustment Mechanism

The Energy Cost Adjustment (ECA) is a pass-through mechanism that allows electric utilities to recover fuel costs, purchase power costs, and other operating costs that are tied to energy usage. As part of the other operating costs, the ECA also incorporates the net sale or purchase of emission allowances along with the combustion materials and limestone needed to run the pollution control equipment.

- In Kansas the ECAs vary from monthly to quarterly adjustments and whether the utility is an investor owed utility or a cooperative utility. In calculating the ECA value the cooperatives tend to use actual cost data while the investor owned utilities use projected costs. In both cases, the Commission staff reviews the monthly ECA reports from the utilities; however, the full audit is done annually and is the basis for the annual true-up.
- At the end of the year, an annual energy cost audit is done by the Commission's audit staff to determine whether there has been an over or under collection of revenues through the ECA. The result is the calculation an Annual Cost Adjustment (ACA) which is a true up mechanism for the past year's ECA. The ACA, which can be either positive or negative, is added to the next year's monthly ECA charge to adjust the next year's ECA collections to reflect the true-up of the previous year's collections.

Background History

The National Electric Light Association tariff manual (published in January 1920) mentions fuel cost adjustment mechanisms and coal clauses. These fuel cost adjustment mechanisms were a response to the increase in coal prices as a result of World War I. Over the next 50 plus years fuel prices were either stable or declining for the most part so electric utilities felt little need for fuel cost adjustment mechanisms. This all changed with the early 1970s oil price shock. Fuel prices became more volatile and waiting to recover fuel cost increases through rate cases exposed utilities to significant financial risk. The response was the reestablishment of fuel cost adjustment mechanisms. Then as fuel prices first stabilized and then declined beginning in the early 1980s, these fuel cost adjustment mechanisms tended to be dropped again. Finally, the fuel cost volatility of the 2000s again spurred the reestablishment of fuel cost adjustment mechanisms across the United States.

The brief history of the United States electric utility experience with fuel cost adjustment mechanisms is mirrored by the experience of Kansas electric utilities with ECAs. In the 1970s and early 1980s the Kansas Corporation Commission monitored more than 70 ECAs and Purchase Gas Adjustment (PGA) mechanisms. PGA mechanisms provide the same cost recovery protection for natural gas utilities that ECAs provide for electric utilities. Then in the late 1980s and early 1990s Empire, KCP&L, and Westar all dropped their ECAs. In the 2000s all three reestablished their ECAs.

This brief history suggests two conclusions:

- Electric utilities want ECAs when fuel prices are volatile and
- Electric utilities are content with not having ECAs when fuel prices are stable or declining.

The expected initial price volatility of the new SO₂ and NO_x markets created by the cross-state rule might create cost uncertainty for Kansas investor owned utilities. Having an ECA in place should mitigate cost recovery uncertainty for investor owned utilities if they need to purchase emission allowances. However, if the costs of meeting EPA requirements increase to the point where baseload coal plants are forced to curtail generation or are decommissioned, then grid reliability could potentially become a problem.



Testimony of
Lana Ellis, Senior Research Economist
Kansas Corporation Commission

Before the Joint Committee on Energy and Environmental Policy
Regarding Recouping Cost of SO₂ Allowances
October 18, 2011

Chairman Holmes and Committee Members:

My name is Lana Ellis and I am a Senior Research Economist at the Kansas Corporation Commission. Thank you for allowing me to appear before you this afternoon on behalf of the staff of the Commission.

I am appearing today, along with the Commission's Economics Chief, Dr. Bob Glass, on behalf of the KCC Staff to address the formal processes and cost recovery mechanisms available to the regulated companies for recovering the compliance cost of SO₂ and NO_x regulations from the United States Environmental Protection Agency (EPA). I will provide an overview of the formal processes available to regulated utilities and discuss, at a high level, the automatic cost recovery mechanisms specifically designed for environmental capital and operating expenditures. Dr. Glass will explain, in more detail, the recovery mechanism available for recovering SO₂ allowance expenses specifically.

Background

I am sure this Committee is already well aware of the plethora of EPA rules that have been imposed on electric utilities in recent years and that federal environmental regulations continue to evolve. Kansas electric utilities are meeting these requirements, but are incurring significant costs in doing so. A recent example is the environmental retrofits required at the La Cygne Generating Station co-owned by Kansas City Power and Light and Westar Energy. The costs of those retrofits, now underway, are estimated to be \$1.23 billion. Ultimately, these costs must be recovered from their customers.

As I will first discuss, the two primary processes the Commission has available for jurisdictional utilities to request cost recovery for costs incurred to comply with environmental mandates are a General Rate Case and a Predetermination Proceeding. After explaining those two processes, I will discuss the cost recovery mechanisms specifically designed for automatic recovery of environmental compliance expenditures.

Formal Processes Available to Utilities

The Commission has two primary processes available for jurisdictional utilities to request cost recovery for their expenditures: 1) A General Rate Case; and 2) A Predetermination Proceeding.

General Rate Case

In Kansas, a regulated utility can apply for a change in its rates at anytime. In a general rate case, all the costs of doing business incurred by the utility are under scrutiny as the Commission considers all the costs and revenues associated with the business and establishes rates necessary to recover those costs.

The KCC, to date has not turned down any environmental cost related requests to increase rates. However, as part of a general rate case, it may be shown that other costs of doing business have decreased and these decreases can be used to off-set increases in environmental and/or other costs of doing business. In that case, the amount that must be recovered through rates is reduced.

Predetermination Proceedings

Under K.S.A. 2010 Supp. 66-1239, before undertaking a proposed project, a regulated utility may ask the Commission to determine the rate-making principles and rate treatment that will apply to recovery of the costs incurred by the utility to make environmental upgrades. While a predetermination is not a cost recovery mechanism itself, it can be the first step in determining the need for a specific environmental project and in establishing rate-treatment applicable to the project. During a predetermination case the benefits and costs of a large capital investment can be vetted by interveners, Staff, and the Commissioners before the project begins.

A recent example of predetermination for an environmental project is the upgrades to the La Cygne Generating Station mentioned before. In that case, the Commission found that the proposed retrofit was “reasonable, reliable and efficient” but denied recovery of the cost through an environmental cost recovery rider (ECRR).¹ I will explain the Commission’s reasons for denying the ECRR after I provide an overview of the automatic cost recovery mechanisms available for recovery of environmental compliance expenditures beginning with the environmental cost recovery rider.

Automatic Cost Recovery Mechanisms for Environmental Compliance Expenditures

The Commission has automatic cost recovery mechanisms specifically designed for recovery of environmental capital and operating expenditures.

Automatic Adjustment Clauses

An automatic adjustment clause allows the utility to increase (or decrease) its rates, usually annually, by a pre-approved regulatory formula in response to a change in costs outside the utility’s control. Thus, as environmental capital expenditures or operating costs change, the

¹ *Order Granting KCP&L Petitions for Predetermination of Rate-Making Principles and Treatment*, Docket No. 11-KCPE-581 PRE; *Order on Petitions for Reconsideration and Order Nunc Pro Tunc*, Docket No. 11-KCPE-581 PRE.

utility can quickly and automatically recover those costs through a change in its rates without the time and expense associated with a formal rate case. As I will discuss next, automatic adjustment clauses can be used to recover the capital costs and operating costs associated with new environmental related plant investments.

Environmental Cost Recovery Rider

In the case of capital investments in environmental projects, an automatic rate adjustment is made through an Environmental Cost Recovery Rider (ECRR). The ECRR mechanism allows for a true-up for over/under recovery of the capital costs associated with new plant built to date, leading to a decrease/increase in rates the following year. At the present time, only Westar has such a rider.² KCP&L has twice requested authorization for a similar rider, but the Commission denied those requests.³ In KCP&L's recent predetermination case, the Commission denied both Westar and KCP&L the use of an ECRR to recover the \$1.23 billion costs for the La Cygne upgrades. As expressed in its order, the Commission is reluctant to approve such riders because, among other reasons, capital costs for environmental improvements have risen substantially since Westar's ECRR was approved in 2005. For this reason, the Commission stated it wants more time to closely scrutinize the costs and benefits of environmental compliance projects. Given the current state of the economy, the Commission is also concerned about the immediate significant rate increase that would result under an ECRR.

Energy Cost Adjustment

In terms of operating costs, actual fuel, purchased power, and the related cost of other commodities such as chemicals, limestone, and other pollution control elements associated with the burning of fossil fuels may be automatically recovered through an Energy Cost Adjustment (ECA). The ECA factor increases or decreases periodically (monthly/quarterly/annually) for any changes in fuel cost. As Dr. Glass will explain, the Commission's approved ECA mechanisms allow recovery of emission allowances so a recovery mechanism that addresses the recovery of allowance costs is currently in place and available to Kansas utilities.

Conclusion

Thank you for your consideration of these comments. I am available for questions at the appropriate time.

² Docket No. 05-WSEE-981-RTS.

³ Docket Nos. 10-KCPE-415-RTS and 11-KCPE-581-PRE.