

House Energy and Environment Committee

January 15, 2013

The Rate Setting Process

Jeff McClanahan, Utilities Director



# Agenda

- 1. Overview of the Rate Setting Process**
  - a. Legal Process**
  - b. Role of KCC Staff and Other Parties**
- 2. Types of Cases**
- 3. Styles of Ratemaking**
  - a. Rate Base/Rate of Return**
  - b. DSC/TIER**
- 4. Review of a Rate Case**
- 5. Rate Design**

# Overview of Rate Setting Process

- Legal Process
  - Utility regulation is governed by statutes, rules and regulations, and civil court cases (through appeals)
  - As such, there is a legal process that is followed (pleadings, motions, briefs, etc.)
  - Generally, due process rights are set out in procedural schedules (see attached procedural schedule)
  - Commission has 240 days to issue an order so procedural schedule defines the due dates within the 240 days
  - Commission issues orders that can be appealed to a civil court

# Overview of Rate Setting Process

- Role of KCC Staff and Other Parties
  - The KCC Staff's role is to balance the interests of the utility with that of the ratepayer
  - Citizen's Utility Ratepayer Board
    - Represents residential and small commercial customers
  - Other parties – such as industrial customers – represent their respective interests

# Types of Cases

- Rate Case
- Compliance
- Fuel Clause Review (PGA,ECA)
- Eligible Telecommunication Carrier (ETC)
- Mergers & Acquisitions
- General Investigations
- Accounting Authority Order
- Fuel Purchase and Hedging Review
- Certificate
- Interconnection Agreements
- Complaint
- Kansas Universal Service Fund (KUSF)
- Contract

# Types of Cases

- Price Deregulation
- Penalty
- Pre-approval of Ratemaking Principles
- Securities
- Show Cause
- Tariff
- Video Service Authorization

# Styles of Ratemaking

## Rate Base/Rate of Return

- Revenue Requirement = (RB \* ROR) + O&M + A&G  
+ Depreciation + Taxes
- Primarily used for Investor Owned Utilities
- Rate Base represents investor-supplied plant facilities and other investments required to provide utility service to consumers
- Rate of Return consists of Cost of Debt and Cost of Equity
- Cost of Equity (shareholder return) is the most contentious issue due to subjectivity
- There is an opportunity to earn a fair return but no guarantee

# Styles of Ratemaking

- Debt Service Coverage (DSC) & Times Interest Earned Ratio (TIER)
- Primarily used for Co-ops
- Under DSC & TIER, revenue requirement equals the total of:
  - O&M + A&G + Depreciation
  - Debt Service Requirements (TIER uses interest only while DSC uses principal and interest)
  - “Coverage” allowance in excess of the actual debt service payments required



# Review of a Rate Case

- KCC Staff's role in reviewing a rate case
  - Evaluate and analyze Utility rate case applications.
  - Accumulate and evaluate evidence obtained from the utility
  - Determine differences between utility's application and established policies and ratemaking concepts
  - There are few adjustments that are black and white
  - Provide pre-filed testimony to Commissioners
- Presenting evidence in support of Staff's position

# Rate Design

Rate Design is the development of prices customers will pay for service. There are two stages:

- Allocate the Revenue Requirement among the different classes of customers. This determines how much revenue needs to be collected from each class.
- Construct customer rates for each class and sub-class that generates the required class revenue

**THE STATE CORPORATION COMMISSION  
OF THE STATE OF KANSAS**

Before Commissioners:           Mark Sievers, Chairman  
  Ward Loyd  
  Thomas E. Wright

In the Matter of the Application of Kansas City )  
Power & Light Company to Make Certain )       Docket No. 12-KCPE-764-RTS  
Changes in Its Charges for Electric Service.    )

**ORDER SETTING PROCEDURAL SCHEDULE**

<b>I.</b>	<b>Background Information .....</b>	<b>1</b>
<b>II.</b>	<b>Procedural Schedule .....</b>	<b>2</b>
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This matter comes before the State Corporation Commission of the State of Kansas (Commission) for consideration and decision. Having reviewed the files and records, and being duly advised in the premises, the Commission makes the following findings:

**I. Background Information**

1. On April 20, 2012, Kansas City Power & Light Company (KCP&L) filed an Application (Application) seeking Commission approval to make certain changes in its charges for electric service, pursuant to K.S.A. 66-117 and K.A.R. 82-1-231. Application, April 20, 2012.

2. The Application presented KCP&L's request for rate adjustments necessary to cover the impacts of several items including mandatory compliance with Federal Environmental Protection Agency (EPA) regulations, compliance with the Kansas State Renewable Energy Standard Act, investment in plant and infrastructure, updated depreciation rates for plant assets,

jurisdictional allocation, other accounting treatment issues, and rate design changes. Application, ¶ 1.

3. The Commission held a Prehearing Conference to discuss a procedural schedule on May 21, 2012, with Prehearing Officer Fedotin presiding. The Commission noted the deadline for filing its Order is December 17, 2012. The Commission has jurisdiction over this Application pursuant to K.S.A. 66-117 and K.A.R. 82-1-231.

4. During the May 21, 2012 Prehearing Conference, the parties proposed an agreed upon procedural schedule setting deadlines for the filing of testimony, discovery, and submission of briefs, as well as scheduling an evidentiary hearing before the Commission. The parties also agreed to be served electronically in this docket, with no hard copy follow-up.

5. On May 24, 2012, the Prehearing Officer advised the parties of the proposed procedural schedule and gave the parties until Friday, May 25, 2012, at 5:00 p.m. to offer objections or amendments. On May 24, 2012, all of the parties affirmatively confirmed the proposed schedule.

## II. Procedural Schedule

6. Finding the agreed upon proposed schedule to be reasonable, the Commission adopts the following:

<u>Date &amp; Time</u>	<u>Action</u>
July 31, 2012, at 6:00 p.m.	Public Hearing in Overland Park
August 22, 2012	Staff and Intervenor Direct Testimony
August 31, 2012	Staff and Intervenor Cross-Answering Testimony
September 11, 2012	KCP&L Rebuttal Testimony
September 17, 2012 (time & location TBD by parties)	Settlement Conference

September 21, 2012	Discovery cutoff
September 24, 2012	Motion cutoff & Settlement/Contested Issues
September 25, 2012, at 9:00 a.m. (3d Fl. Hearing Room)	Prehearing Conference
September 28, 2012	Public Comment cutoff
October 1, 2012, at 9:00 a.m. (1 <sup>st</sup> Fl. Hearing Room)	Evidentiary Hearing Begins
October 5, 2012	Evidentiary Hearing Concludes
October 12, 2012	Initial Rate Case Expense Update
October 19, 2012	KCP&L Initial Brief
November 2, 2012	Staff and Intervenor Brief
November 14, 2012	KCP&L Reply Brief
November 16, 2012	Final Rate Case Expense Update
December 17, 2012	Order due

*A. Prehearing Conference and Evidentiary Hearing*

7. The Commission finds that a prehearing conference is necessary prior to an evidentiary hearing to address any pending matters, to establish procedures for the evidentiary hearing, and to consider any other prehearing issues, which may promote the orderly and prompt conduct of this proceeding. K.S.A. 77-517; K.A.R. 82-1-222. Accordingly, the Commission sets the Prehearing Conference on September 25, 2012, beginning at 9:00 a.m. in the Commission's Third Floor Hearing Room, 1500 SW Arrowhead Road, Topeka, Kansas 66604-4027. Prehearing Officer Brian G. Fedotin, telephone (785) 271-3105, email address [b.fedotin@kcc.ks.gov](mailto:b.fedotin@kcc.ks.gov), will preside. Any party who fails to attend or participate in the Prehearing Conference or in any other stage of this proceeding may be held in default under the Kansas Administrative Procedure Act (KAPA). K.S.A. 77-516(c)(8); K.S.A. 77-520. At the Prehearing

Conference, this proceeding may be converted without further notice into a conference hearing or summary proceeding for disposition of the matter as provided by KAPA. K.S.A. 77-5169(c)(7).

8. In addition to the Prehearing Conference discussed above, the Commission schedules an Evidentiary Hearing, with the Commission presiding, beginning on October 1, 2012, at 9:00 a.m. and continuing as necessary through October 5, 2012, in the Commission's First Floor Hearing Room, 1500 SW Arrowhead Road, Topeka, Kansas 66604-4027. Any party who fails to attend or participate in the hearing or other stage of this proceeding may be held in default under the KAPA. K.S.A. 77-516(c)(8); K.S.A. 77-520.

*B. Public Hearing, Notice and Comment Period.*

9. The Commission orders that a public hearing be conducted in this docket as follows:

**Tuesday, July 31, 2012, beginning at 6:00 p.m.**  
Overland Park City Hall Council Chambers  
8500 Santa Fe Drive  
Overland Park, KS 66212

10. The Commission directs notice of KCP&L's Application and the public hearing be included in a bill insert with the monthly billing statement for each customer in KCP&L's service territory. The bill inserts shall comply with the Commission's regulations and explain the opportunity for the public to submit comments regarding the proposed changes. After consulting with the Commission's Director of Public Affairs and Consumer Protection (PACP), the Prehearing Officer shall approve the notice to be provided in the bill insert to KCP&L's customers, and shall provide the final notice to KCP&L on or before Wednesday, May 30, 2012. The Prehearing Officer shall rule on any dispute regarding the bill insert.

11. Finding KCP&L is required to provide information to the public about this proceeding by publishing notice in the major newspapers in the region, the Commission orders notice be published in the newspapers approved by the Director of PACP, and that KCP&L work with the Director of PACP to determine the timing of publication. After consulting with the Commission's Director of PACP, the Prehearing Officer shall approve the notice to be published in the newspapers.

12. The Commission encourages the public to submit comments concerning this docket via electronic mail and in writing. The Commission directs that the public comment period begins immediately and ends on September 28, 2012, at 5:00 p.m.

13. In addition, the Commission directs KCP&L, CURB, and the PACP Office to make information concerning the proceeding more accessible to the public through the use of websites. The Commission directs the parties to include on their respective websites links and contact information to assist the public to easily identify how to contact the PACP Office to submit comments and to easily access filings made in the docket. To the extent practicable, the parties are encouraged to include background information explaining this proceeding.

### **III. Electronic Service**

14. The Commission adopts the agreement of the parties to serve each other electronically, provide confidential information on a compact disc, and waive receipt of a follow-up hard copy as required in K.A.R. 82-1-216(a)(c). Electronic service shall occur by 3:00 p.m. on the date due, unless otherwise set forth in this or another order. The parties shall specify this electronic service constitutes official service and that no hard copy will follow, making clear that paper copies will not be provided to the parties. In addition, the parties shall include the Prehearing Officer on all electronic service of testimony and briefs at [b.fedotin@kcc.ks.gov](mailto:b.fedotin@kcc.ks.gov).

The parties are still required to file the original and seven paper copies with the Commission by 5:00 p.m., on the date scheduled for service. K.A.R. 82-1-215(a). Any electronic service or filing received after the deadline set forth in the procedural schedule, shall be accompanied by a Motion to File Out of Time.

**IV. Agency Attorneys of Record**

15. The attorneys designated to appear on behalf of the agency in this proceeding are Andrew Schulte, telephone number 785-271-3273, email address [a.schulte@kcc.ks.gov](mailto:a.schulte@kcc.ks.gov); and Judy Jenkins, telephone number 785-271-3181, email address [j.jenkins@kcc.ks.gov](mailto:j.jenkins@kcc.ks.gov), 1500 SW Arrowhead Road, Topeka, Kansas 66604-4027. K.S.A. 2011 Supp. 77-518(c)(2); K.S.A. 77-516(c)(2).

**IT IS THEREFORE, BY THE COMMISSION ORDERED THAT:**

- A. The Commission adopts the procedural schedule set forth above.
- B. The Commission schedules the Prehearing Conference for September 25, 2012, beginning at 9:00 a.m., in the Third Floor Hearing Room of the Commission's offices, 1500 SW Arrowhead Road, Topeka, Kansas 66604-4027. Prehearing Officer Brian G. Fedotin will preside.
- C. The Commission schedules the Evidentiary Hearing beginning October 1, 2012, at 9:00 a.m., in the First Floor Hearing Room of the Commission's offices, 1500 SW Arrowhead Road, Topeka, Kansas 66604-4027. Any party who fails to attend or participate in the hearing or in any other stage of this proceeding may be held in default under the KAPA. K.S.A. 77-516(c)(8); K.S.A. 77-520.



D. The Commission orders that a public hearing be held on Tuesday, July 31, 2012, beginning at 6:00 p.m. at the Overland Park City Hall Council Chambers, 8500 Santa Fe Drive, Overland Park, KS 66212.

E. The Commission orders KCP&L to provide notice to its customers of the Application and public hearing through a bill insert included with the monthly billing statement for each customer in its service territory. The Commission directs its Director of Public Affairs and Consumer Protection to work with KCP&L and the Prehearing Officer to develop a proposed notice for the Prehearing Officer to share with the parties. After receiving feedback from the parties, the Prehearing Officer shall consult with the Director of PACP, and approve the notice to be provided in the bill insert to KCP&L's customers.

F. The Commission also orders KCP&L to provide general information to the public about this proceeding by publishing notice in the major newspapers throughout its region. The Commission directs KCP&L to provide a list of newspapers by May 30, 2012, for publishing such notice, and work with the Director of PACP to determine the timing of publication and newspapers in which notice will be published.

G. The Commission encourages the public to submit comments concerning this docket via electronic mail and in writing. The Commission approves the use of websites to make information available and directs the PACP Office and the Commission's IT Staff to work with the parties to further this effort. The PACP Office shall receive public comments and provide a summary of those to the Commission. The public comment period ends on September 28, 2012, at 5:00 p.m.

H. The Commission approves the use of electronic service for all testimony and briefs among the parties, and for orders of the Commission and Prehearing Officer, without

follow-up hard copies. But the Commission requires the filing of the original and seven paper copies with the Commission.

I. The Commission directs this Order be served by electronic mail, with a note that no hard copy will follow. This Order is procedural and constitutes non-final agency action. K.S.A. 77-607(b)(2). Parties have 15 days from the date of electronic service of this Order to petition the Commission for reconsideration. K.S.A. 66-118b; K.S.A. 2010 Supp. 77-529(a)(1).

J. The Commission retains jurisdiction over the subject matter and parties for the purpose of entering such further orders, as it may deem necessary.

**BY THE COMMISSION IT IS SO ORDERED**

Sievers, Chairman; Loyd, Commissioner; Wright, Commissioner

Dated:           MAY 29 2012          



ORDER MAILED MAY 29 2012  
ELECTRONIC

Patrice Petersen-Klein  
Executive Director

BGF

**CERTIFICATE OF SERVICE**

**MAY 29 2012**

12-KCPE-764-RTS

I, the undersigned, hereby certify that a true and correct copy of the above and foregoing Order Setting Procedural Schedule was served by electronic mail this 29th day of May, 2012, to the following parties who have waived receipt of follow-up hard copies:

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ORDER MAILED MAY 29 2012  
ELECTRONIC

**CERTIFICATE OF SERVICE**

**MAY 29 2012**

12-KCPE-764-RTS

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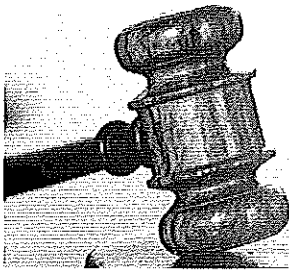
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Sheryl L. Sparks  
Administrative Specialist

ORDER MAILED MAY 29 2012  
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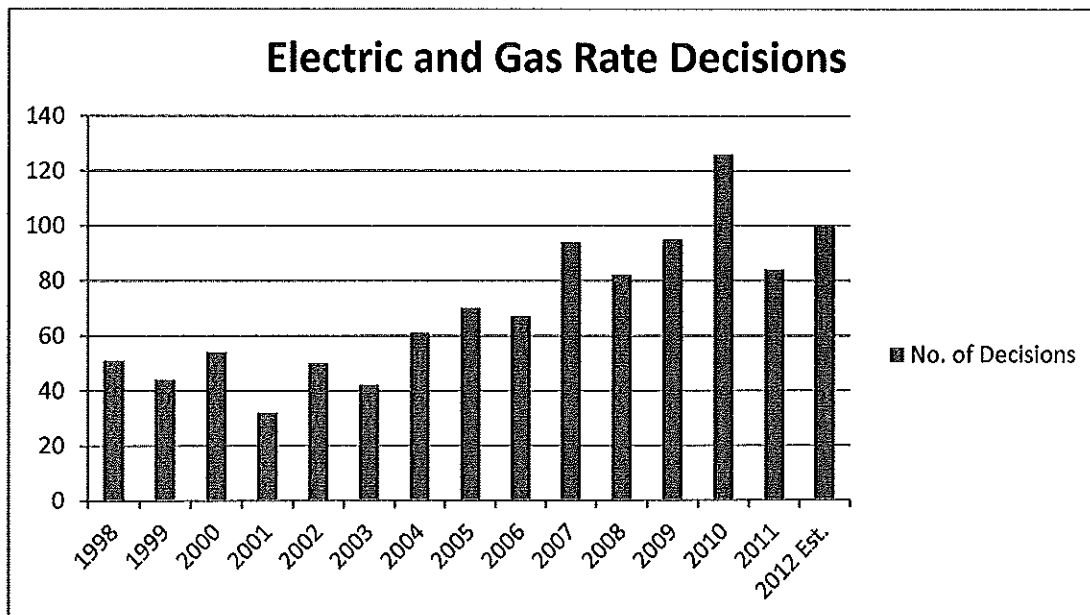
RRA TOPICAL SPECIAL REPORT

October 16, 2012

## THE RATE CASE PROCESS: A BASIC GUIDE

(a.k.a.: REGULATION FOR DUMMIES)

Electric and gas rate case activity across the U.S. continues to be robust. Year-to-date through Sept. 30, 2012, there were 59 electric or gas case decisions, and we expect an additional 40 or so cases to be decided before year-end, bringing the total number of rate case decisions in 2012 to roughly 100. (At the current time there are 85 major electric or gas retail rate cases pending nationwide.) As the graph below indicates, the number of rate case decisions in each of the last six years (2007-2012) has ranged from 83 to 126, far exceeding the 32-to-70 range over the prior nine years (1998-2006).



SNL Financial/RRA

In the early 2000s, there was a dearth of rate cases. For instance, in 2001, there was a total of only 32 electric or gas decisions. There were various reasons for this low level of regulatory activity. Interest rates were relatively low, and many utilities had previously been authorized rates of return that were deemed to be much higher than those being awarded in more current rate proceedings. Also, construction activity was down during this period, and there may have been no large capital investments for which utilities would typically seek rate recognition. Additionally, technological improvements that reduced utility costs may have caused a delay in the filing of rate proceedings.

However, many utilities stayed out of the rate case arena during that time because of the advent of electric industry restructuring in many states. In the late-1990s, "competition" was the electric industry's buzzword, and many utilities were attempting to minimize their retail prices in an effort to remain "competitive." In several states, the utility commissions established multi-year rate plans, under which rates were frozen in an attempt to allow utilities to recoup stranded costs, i.e., the costs that were considered to be unrecoverable in a competitive retail market for electric generation service.

During these rate freezes, utility companies had to absorb any increases in operating costs (e.g., labor, health care, pension, etc.) that occurred, and as a result, profit margins were sometimes compromised. Many companies embarked on cost-cutting efforts to support profits during this time, and

this led to increased regulatory scrutiny on utility service quality -- the thinking being that utilities would attempt to maintain earnings at the expense of customer service. Additionally, in an effort to boost earnings, some utilities became heavily involved in energy marketing and trading, an avenue that ultimately did not provide the boost in profits that many in the industry expected.

Also during this period, it was not clear as to what entities would construct the new generation that would be required to satisfy increased power demand and to replace the aging generation infrastructure. Most utilities did not want to bear the regulatory uncertainty associated with the rate increases that would be required and the potential for regulatory disallowances from cost overruns determined after-the-fact. Additionally, the competitive power suppliers were reluctant to construct new generating facilities, given the lack of true market-based pricing in some of the "restructured" states and the uncertainty associated with the long-term retail pricing mechanisms that were established in those states. Those rate freezes have since concluded, and the trend toward expanding competition has died down; as a result, over the last five years or so, rate cases have been filed at a brisk pace, reflecting both increased operating expenses and new investment in electric generation (including environmental compliance and renewable resources) and electric and gas delivery infrastructure.

Given the increased regulatory activity nationwide, we have assembled this report that provides a very basic description of the rate case process, the reasons why companies file rate cases, and the typical rate case formula used by most of the public utility commissions in the U.S. Additionally, we will apply the rate case formula to an actual rate proceeding, and use that case to show you how we analyze the outcome of a rate case.

### **Determining Prices**

The first question that needs to be asked is "why is the provision of utility services a regulated industry?" Utilities are by no means typical companies. In any competitive industry, a customer has many purchasing choices. In the auto industry, or the food industry, customers pick and choose among a variety of providers -- the customer can consider the quality of the product as well as the price. If a seller's prices are too high or the quality of the product does not meet the customer's standards, the customer will go elsewhere. Prices in such industries are set by supply and demand in the competitive marketplace.

As we know, the utility industry is quite different. You move into a new town and you are told which utility serves the area. Typically, there's not much you can do except sign up for the service and pay your bill. Given the monopoly status of these companies, there has to be some control on pricing because there is no competition to keep prices reigned in. So, this is why we have public utility commissions -- every state has one. These commissions are required to balance the interests of ratepayers and utility shareholders. Another words, the commissions are to ensure that the utilities' rates allow the companies they regulate to earn what is considered to be an adequate profit commensurate with each company's investment risk, while ensuring that each utility offers high quality service, i.e., "reliable service at just and reasonable rates."

Since there is no market-setting method for the typical utility business, utility rates are based on what we call the "cost-plus method." The regulator looks at all of a utility's prudent costs and prudent capital investments, and then adds a risk-adjusted profit margin for the utility's shareholders. The regulator then takes this total number, which is referred to as the "revenue requirement," and translates it into a fixed monthly charge and an additional per-kilowatt-hour usage-based rate that are used to determine each customer's monthly bill. This sounds very simple, but in reality it is not.

### **Reasons for Filing a Rate Case**

We have established that a utility is a monopoly -- the sole supplier of a product that is considered a necessity. So, if your utility decides it needs to raise its prices, can the utility raise prices to whatever level it desires? Of course not. It must file a "rate case" before the state's public utility commission.

At this point you might be thinking about the fact that in certain states customers are able to select a competitive power supplier, as we mentioned earlier. Yes, it is true that retail electric generation is now competitive in some states, but certain functions continue to be regulated. A typical utility has three functions -- generation, transmission, and distribution. And, in most states, all three of these

functions are still fully regulated, but in 13 states, the generation piece is now competitively priced for all customers, and is no longer traditionally regulated. In some of these "restructured" states, the price of the generation piece for all customers who have not selected an alternative supplier is priced through an annual auction. In other restructured states, the power commodity to serve these customers is purchased in the open market by a separate state agency or by the incumbent utility. In all of these states, the incumbent utility is simply a regulated deliverer of competitively priced power. And, unless another company is permitted to run a second set of wires down your street and connect those wires to your house, the delivery function will continue to be a fully regulated monopolistic business.

The same issues exist for the natural gas industry, with the gas commodity portion of the service being competitively offered in many states, and the delivery piece remaining regulated.

So, why does a utility file a rate case? The utility's profits may no longer be adequate because the company is experiencing rising operating costs. Or perhaps the economy in its service territory is not doing as well as expected. Or possibly, the company may be constructing a new power plant, retrofitting generation to meet environmental requirements, or replacing aging gas mains, and needs to have these investments reflected in rates.

### **The Commissioners**

In most states, commissionerships are appointed positions, and these appointments are made by the state governor or the mayor in the District of Columbia. However, in 14 states, utility commissioners are elected. In two of these states the commissioners are elected by the legislature, but in the other 12, the commissioners are elected by the general population (we include Texas in this total; the Texas Railroad Commission, which regulated gas utilities has elected commissioners, however, the Texas Public Utility Commission, which regulates electric utilities, has appointed commissioners). All else being equal, we attribute more investment risk to those states in which the utility commissioners are elected. If you think about it, how can a commissioner run for election by stating that he or she promises to raise utility rates and to make sure that the utility earns a very strong rate of return for its investors? It is an obvious conflict of interest.

In the 1980s, the Louisiana Public Service Commission, an elected commission, promised not to permit any rate increases despite that fact that its largest electric utilities were constructing nuclear generators that cost billions of dollars. The utilities had to appeal each PSC rate decision, and it was the courts that became the de facto regulators through that period. Also, we note that the timing of an election may affect when a utility files a rate case. For example, if you know that next November there will be an election for three of the five commissioner slots in your state, you will want to time your rate case so that your request will not become an election issue.

Just because we attribute more investment risk to elected jurisdictions, this does not indicate that all of the elected jurisdictions are at the bottom rung of our ratings. Many years ago, the Alabama PSC, an elected commission, realized that rate increases were required if the state was going to have acceptable utility service quality -- so the commission put the state's utilities on "autopilot." Periodically, each company's rates are automatically adjusted based on a variety of issues including the company's earned rate of return. And this happens without the PSC's direct intervention. So the company gets the rate adjustments it needs, and the Alabama PSC stays out of the news. And, we do rank Alabama regulation in one of our top categories, meaning a category signifying comparatively lower investment risk.

Utility commissions in the U.S. have between three and seven members, most of whom are attorneys, but there are some economists and some accountants as well. There are also some commissioners who run private businesses. All but three commissions in the U.S. have full-time members: all members of the Delaware PSC serve part-time; in Vermont, the commissioners other than the chairman serve part-time; and effective Jan. 1, 2013, all members of the Tennessee Regulatory Authority will have part-time status.

### **The Rate Case Process**

A rate case is a judicial process that is usually controlled by a judge called an administrative law judge (ALJ) or a hearing examiner. There is no jury, and the final outcome is determined by the public service commission. In some states, the commission actually presides over the hearings and all aspects

of a case, but in most states the commission gets involved at the end, and makes its decision after reviewing the entire record in the case.

The process begins with the company's filing. Usually about five to 20 witnesses provide testimony. The company discloses the amount of the rate increase it is requesting, and then supports this position with testimony on the individual rate case components. Each witness supports an individual piece of a case -- one witness might be limited to depreciation, another testifies on the appropriate profit level. Another might deal solely with pension costs. Usually there is one witness -- it could be the CFO, who files general testimony describing why the company needs a rate increase.

Public hearings are held, and customers are given an opportunity to tell the ALJ or the commissioners why the company should not be authorized a rate increase. This is just a way for the state to take the pulse of the public regarding their experience with the utility. If there are service problems, that issue usually comes up at public hearings.

The next step in the process is the cross-examination of the witnesses. Witnesses are sworn in, and there's a court stenographer in the room who is typing or recording every word that is spoken. Several weeks later the commission staff and consumer intervenors file their position through the same type of testimony. And then those witnesses are cross-examined.

Each party then files rebuttal testimony stating why the commission should not adopt the other parties' positions. Then surrebuttal testimony is filed addressing the rebuttal testimony, and this is followed by rejoinder testimony, which addresses the surrebuttal testimony. Final briefs are then submitted containing each party's final supported position. Along the way there may be settlement discussions to see if the parties are willing to come up with a compromise on some or all of the issues in the case. Many ALJs and commissions encourage the settlement process because it depoliticizes ratemaking to some extent, especially if all parties realize that the company really needs a rate increase. But some commissions believe that certain important issues need to be fully adjudicated in order to set precedent for future cases. However, in some instances, stipulated positions must be fully supported by the record in the case.

Regardless of whether there is a settlement, in most cases the ALJ submits a recommended decision to the commission. Essentially, the ALJ's function is to make it easier for the commission to get through the record in the case. After another month or two, the PSC takes a vote, and then issues a final order. Some commissions discuss a case at length in public and then issue a final order a couple of weeks later. Others circulate a draft decision in private, and then come up with a document that contains each commissioner's signatures. In those instances, a final order is issued at the time the final vote is taken.

The typical rate case is usually decided in nine months to a year after the company files the case, but some commissions take much longer. For instance in Arizona, the Corporation Commission, an elected commission, takes about 17 months to decide a case -- this has, at times, been a problem for Pinnacle West Capital subsidiary Arizona Public Service, as this is a company that has been one of the fastest growing utilities in recent years.

After a final order is issued, any party is free to ask the commission to reconsider the decision on certain issues, or the party can appeal the decision to the courts. The court process is not a quick one -- a case can take more than a year to make its way through the courts. Sometimes, during an appeal, the commission's initial ruling remains in place, but other times, the ruling is "stayed," meaning that the commission's ruling is not implemented until the issue is decided by the courts.

### **Revenue Requirement**

In a rate case, the commission is required to review the company's rate case filing and all intervenors' positions and determine what rate change, if any, is appropriate. So, how does the commission determine whether a rate change is warranted?

Since the traditional utility regulation formula is based on cost, we need to start with the following formula -- it is essentially a simple income statement:

$$\text{Revenue} - \text{Operating Expenses} - \text{Depreciation} - \text{Taxes} = \text{Net Operating Income}$$



In the next equation, we have isolated revenue on the left side, and renamed it "revenue requirement":

$$\text{Revenue Requirement} = \text{NOI} + \text{Operating Expenses} + \text{Depreciation} + \text{Taxes}$$

In the third variation, we have renamed net operating income (NOI) as the product of rate-of-return and net assets. Since NOI includes the funds necessary to service all of the utility's securities (debt, preferred stock, common shareholders), the NOI must equal the product of your overall rate of return (or cost of capital) and your asset base.

$$\text{Revenue Requirement} = \text{ROR (Net Assets)} + \text{Operating Expenses} + \text{Depreciation} + \text{Taxes}$$

In the fourth iteration, we have renamed net assets as "rate base," which is a regulatory term that refers to the company's utility assets, net of depreciation, as determined by the commission, that are "used and useful" in the provision of service to ratepayers.

$$\text{Revenue Requirement} = \text{ROR (Rate Base)} + \text{Operating Expenses} + \text{Depreciation} + \text{Taxes}$$

The above equations show you how a commission calculates a company's total revenue requirement, but now we need see how the commission determines what rate change is needed, so that the company can achieve its total revenue requirement. In simple terms, the PSC reviews the company's revenue and prudent costs for a selected "test year," and considers the resulting earnings for that test year. If the earnings are determined to be inadequate, a rate increase is authorized. However, if earnings are determined to be too high, a rate reduction is ordered.

The following equation is the typical rate case formula, and it is the basic rate change calculation that is used in every rate case. This formula produces the rate change that is required:

<p style="margin: 0;"><b><i>Rate of Return*</i></b></p> <p style="margin: 0;">× <b><i>Rate Base*</i></b></p> <p style="margin: 0;"><i>Required NOI</i></p> <p style="margin: 0;">- <b><i>NOI Under Current Rates*</i></b></p> <p style="margin: 0;"><i>NOI Deficiency</i></p> <p style="margin: 0;">× <b><i>Tax Factor</i></b></p> <p style="margin: 0;"><i>Rate Adjustment</i></p> <p style="text-align: right; margin: 0;"><small>*Rate Case Variable</small></p>
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The formula starts with the required "rate of return" (ROR), which is the return that the company should have an opportunity to earn to service all of its financial securities. This is considered to the firm's weighted average cost of capital.

Next is the "rate base," which includes all prudent capital investment, net of depreciation -- essentially the asset base upon which the company should be allowed to earn a full return. Rate base also can include construction work in progress, working capital, and an offset for deferred income taxes. And, as we saw from the previous equation, the product of the ROR and the rate base gives you the required NOI. From this result, the commission subtracts the NOI that the company is currently earning or is projected to earn. In other words, without a rate case, what NOI will current rates produce? Subtracting that number from the Required NOI gives you what we call the NOI deficiency.

The NOI deficiency is then grossed up for income taxes to yield the rate adjustment that is required. You must gross up the NOI deficiency because customers' rates are revenue, which of course is a pre-tax number.

Notice that three variables in this formula have asterisks. These are the three variables that are essentially the critical issues in each and every rate case. Any disallowance that the commission makes to the company-proposed rate increase is always in one of these three areas -- rate of return, rate base, or net operating income.

## Rate of Return

In order to calculate (or estimate) a company's ROR, you start with the firm's capital structure. Utilities sometimes support a capital structure with a greater equity component than other parties because equity is always assigned the highest cost, and therefore the overall return would be higher, leading to a larger rate increase. At times, a commission may adopt a "hypothetical" capital structure if it determines that the utility's actual capitalization is inappropriate, e.g., the commission may believe that the actual capital structure contains an excessive level of common equity. A typical rate case capital structure and cost rates are shown below.

	Capitalization <u>Weight</u>	Cost <u>Rate</u>	Weighted <u>Cost</u>
Long-Term Debt	48%	5.5%	2.64%
Preferred Stock	2	5.0	0.10
Common Equity	<u>50</u>	10.0	<u>5.00</u>
	<u>100%</u>		<u>7.74%</u>

In a rate case, the cost of debt, 5.5% in the table above, is the "embedded" cost of debt, usually an average of the cost of the debt issues that the company has outstanding. It is not the current yield – it is the embedded cost which reflects the bonds' coupon payments. This issue is usually straightforward. The same methodology applies to the cost of preferred stock.

The return on equity, however, is probably the most widely litigated issue in a rate case. There is no stated return that an equity holder is promised, and of course there is no stated interest rate. The only stated number is the company's dividend, and that is not considered a contractual part of a shareholder's return. Then there is the growth component of the return, and of course no one can predict with any certainty what level that should be.

In a rate case, the company hires a witness, usually an outside financial consultant, who provides "evidence" regarding the level of the return on equity required by investors. And, the commission staff and the intervenors provide their own witnesses. Even though these witnesses use very similar methodologies to estimate the ROE, they usually come up with very different results. For instance, in today's environment, company witness' seem to support an ROE ranging from 10.5% to 11.5%, while the Commission Staff witness' come up with a 9% to 10% equity return, and the consumer advocate witness can often be counted on to support an even lower number. Yet they all use the same methods.

The most common ROE method used in utility rate cases is the discounted cash flow (DCF) model, or the Gordon Model:

$$\text{Required ROE} = \text{Dividend/Market Price} + \text{Growth}$$

On the face of it, the DCF is a simple model -- it looks like all you have to do is plug in a few numbers and you have your answer. First you plug in the company's dividend, divide that by the current stock price, then add a growth factor to the dividend yield. However, the parties argue about the appropriate dividend -- is it today's dividend rate or tomorrow's? What stock price is appropriate to use -- today's price? Or an average price of some representative period of time? And then there is the growth rate; should it be the growth rate of dividends, book value, or earnings? And should it be historical growth or expected growth? Basically, with all of these variations, a witness can mold the DCF to arrive at any desired result.

The next most popular method for determining the required ROE in utility rate cases is the Capital Asset Pricing Model (CAPM):

$$\text{Required ROE} = \text{Risk-Free Rate} + (\text{Expected Market Return Premium} \times \text{Beta})$$

This model seems to involve less guesswork, but still the results can vary. The CAPM starts with a risk-free rate (usually a Treasury rate) and then a risk premium is added that is based either on the specific company in question, or the entire utility industry. To estimate the appropriate risk premium,

you use a general stock market return premium and multiply that premium by "Beta," which is a sensitivity factor for stock in question or the relevant industry. By definition, the beta for the entire stock market is one, and for the utility industry, which tends to have below average price variability, the beta has historically been below one.

Like the DCF, the CAPM has its own set of variables that you can mold to arrive at a desired result. Is it appropriate to use a short-term Treasury rate or a long-term rate? What is the historical market premium? Should the commission measure that over five years or 20 years?

A third method is "Comparable Earnings." The rate-of-return witness selects a group of companies that have similar risk characteristics to the company in question. Then the witness performs a DCF or CAPM for each company in the group, and comes up with an average ROE. Usually the company witness selects a group of companies that have greater risk characteristics than their company, and the commission staff and the consumer advocate witnesses select a group of companies that have lower risk characteristics. Many times you have to use a comparative method like this, because the utility company may be a subsidiary of a very large holding company, and there is no stock price for the subsidiary that can be plugged into the DCF formula.

Bottom line: there is no correct way to calculate or estimate the appropriate ROE. Another issue that factors into the decision is whether the utility is an electric distribution company with no regulated generation. Commissions consider these companies as lower-risk entities, and are authorizing slightly lower ROE levels. Also, commissions may authorize a slightly lower ROE for companies that use a decoupling mechanism, which allows a utility to recover revenues that may have been lost due to customers' conservation efforts, or an adjustment clause or rider that provides for timely recognition of changes in certain expenses outside of a general rate case. Fully integrated electric companies, those with generation, are sometimes considered higher-risk companies, and have been authorized slightly higher ROEs.

### **Rate Base**

The second rate case variable is the company's rate base, which again is the asset base from which the utility provides electric or gas service. The largest portion of an electric company's rate base is made up of the firm's net plant -- generation, transmission, and distribution, assuming that the company is still vertically integrated and still has generation. In some states, e.g., New York, Connecticut, and Massachusetts, the utilities sold off their electric generation plants a few years ago to independent, non-utility companies -- so, for those utilities, their rate bases would include the delivery assets, but no generation.

Allowing construction work in progress (CWIP) in rate base was a controversial issue in the 1970s and 1980s when huge nuclear construction projects were commonplace, but the issue is again receiving attention. Including CWIP in rate base allows the utility to collect a cash return on the asset under construction prior to its completion. If the CWIP is not included in rate base, the utility records a non-cash regulatory asset known as "allowance for funds used during construction" (AFUDC), which is equal to the assumed return on the CWIP. With AFUDC, during construction, earnings remain whole because the company is booking a non-cash additive as earnings, but cash flow takes a hit. Once the plant is used and useful for utility service, the accumulated AFUDC is included in rate base as plant in service. Several states have statutes that prohibit the inclusion of CWIP in rate base.

Rate base may also include inventories, cash working capital, regulatory assets, and an offset for deferred taxes. Essentially, deferred tax balances represent interest-free or cost-free loans from the U.S. Treasury caused by accelerated deductions (compared to book expenses) permitted by the Internal Revenue Code, such as accelerated depreciation. Over time, the accelerated deductions will reverse and the interest-free loan will be repaid. Commissions generally treat these balances as a cost-free source of capital for the company, and logically use these balances as an offset to rate base (or make no adjustment to the rate base, but impute the deferred tax balance in the approved capital structure at zero cost).

Like rate of return, rate base is fairly controversial. What period should the commission use to measure rate base? Should it be a specific historical date, with known-and-measurable changes recognized? Should it be a date in the future that contains projections? (Using projections generally

produces a higher rate base). Does the commission include CWIP in rate base? Does it permit working capital in rate base?

### **Net Operating Income**

The third rate case variable is the company's NOI under current rates. The commission has to project what the company's NOI would be assuming it did not file a case.

It should be noted that a rate case is always based on a "test year," which is a 12-month period that is used to measure revenues and expenses to come up with the NOI that the company would earn during that period without any change in rates. Sometimes the test year is forward looking, but most times the test year is an historical period. From a utility's viewpoint, a forward-looking test year is more appropriate, because looking forward usually allows the utility to recover its actual costs, and if costs are rising, using a forward-looking test year will allow the utility to have a better opportunity to earn its authorized return.

In rate case filings, the utility usually supports an NOI that is quite a bit lower than the NOI projected by the Staff and the consumer advocate. Referring back to the rate case formula, a lower NOI under current rates produces a greater NOI deficiency, which in turn produces a greater rate increase. But as with the first two variables, rate of return and rate base, there are a lot of moving parts.

The NOI components that are discussed in rate cases include sales forecasts. To determine a sales forecast, weather issues are reviewed. What is normal weather? An electric company might say that last year's cold summer was normal, and the consumer group might say that the hot summer from two years ago is the norm. And gas companies might say that last year's warm winter is the norm, in an effort to minimize the test year revenue level that goes into the NOI calculation. Conservation issues have also come into play, as a utility might testify that its revenues have been, and will continue to be, reduced by customers' conservation activities. The state of the local economy may also figure into the discussion of sales forecasts. The company would say the economy is weak, while the consumer advocate might be more optimistic.

The other part of NOI is the company's expenses, and these can be very controversial. How much has been or is going to be spent on fuel and purchased power? How does the company's level of wages compare to other companies? Are executives receiving excessive bonuses? Are the company's depreciation schedules appropriate given the useful lives of the equipment? It needs to be noted that not all expense disallowances in rate cases will affect a utility's earnings in the coming year. If the company is spending money on something that the commission has disallowed for ratemaking purposes, the company's earnings will clearly suffer; however, if the commission disallows, for instance, accelerated depreciation, the company can adjust its amortization schedules to reflect what was approved by the commission, and therefore, there would be no earnings effect from the commission's action. Cash flow might suffer, but earnings should remain whole.

Another controversial NOI issue is the practice of capturing the benefits of consolidated taxes for utility customers through a rate case adjustment. A number of states adopt this type of adjustment on a consistent basis when the utility parent company files its tax return on a consolidated basis. Filing a consolidated return allows the holding company to capture the tax benefits associated with operating losses generated by unregulated subsidiaries. Since the tax benefits of corporate losses are generally not considered refundable from the government in the year they arise, the filing of a consolidated tax return may allow the holding company to immediately realize the tax benefits associated with an affiliate's operating losses, by netting those losses against other affiliates' profits. To flow through these benefits to ratepayers, the commission would impute the lower consolidated tax expense to the utility, thereby reducing the overall revenue requirement in a rate case. (For further information on this issue, refer to our Sept. 12, 2012 Topical Special Report entitled Consolidated Tax Adjustments (a.k.a. Regulatory Confiscation?))

### **Rate Case Example**

The table below shows the rate case formula as it applies to a rate proceeding for New York State Electric and Gas (NYSEG) that was filed in September 2005 and decided in August 2006.

<u>NYSEG (Case No. 05-E-1222), Decided August 23, 2006</u>			
	<u>NYSEG</u>	<u>PSC</u>	<u>Approximate</u>
	<u>Filing</u>	<u>Ruling</u>	<u>Difference</u>
<i>Rate of Return*</i>	7.88%	7.18%	\$17
x <i>Rate Base (millions) *</i>	<u>\$1,513.6</u>	<u>\$1,459.9</u>	\$7
<i>Required NOI</i>	\$119.3	\$104.8	
- <i>NOI Under Current Rates *</i>	<u>\$85.2</u>	<u>\$126.2</u>	\$70
<i>NOI Deficiency</i>	\$34.1	-\$21.4	
x <i>Tax Factor</i>	<u>1.7</u>	<u>1.7</u>	
<i>Rate Adjustment</i>	\$58.0	-\$36.3	\$94
Source: Regulatory Research Associates/SNL Energy		*Rate Case Variable	

NYSEG was supporting a \$58 million electric rate increase based upon a 7.88% return on a rate base valued at more than \$1.5 billion. Instead of authorizing the company its requested rate increase, the New York Public Service Commission (PSC) ordered NYSEG to reduce its electric rates by \$36.3 million. As you can see from this comparison, adjustments were made to each of the three rate case variables. The authorized rate of return is lower than that requested, the adopted rate base is lower, and the net operating income under current rates is higher. Each of these adjustments eats away at the rate increase requested by the company.

At Regulatory Research Associates, we analyze the individual rate case adjustments -- in this case, the adjustments totaled \$94.3 million, which is the difference between the \$58 million increase requested by NYSEG and the \$36.3 million reduction ordered by the PSC. Through a variety of formulas, we determined that about \$17 million of the total difference stemmed from the PSC's decision to adopt a lower rate of return than that supported by the company. Regarding rate of return, we considered the Commission's decision negative because the authorized ROE, 9.55%, was, at that time, very low by industry standards (in 2006 the average ROE authorized for electric utilities nationwide was about 10.4%), and because of certain major adjustments to the capital structure, the company would probably not have been able to earn even that very low return.

There was \$7 million of difference attributable to various reductions to rate base, most of which came from the PSC's decision to maintain a deferred balance of funds from a previous rate case that was held for future ratepayer benefit. These are funds that the company continues to hold. Therefore, this disallowance would not have had a negative effect on the company.

NOI adjustments accounted for the remaining \$70 million of the total revenue requirement difference. About \$11 million of this amount came in the form of a tax expense difference associated with the capital structure change; about \$23 million was due to an adjustment in depreciation rates -- the PSC used whole-life rather than remaining life -- so cash flow suffered here, but not earnings. A test period sales adjustment accounted for \$4 million, as the PSC used a higher sales growth estimate than what the company proposed. There was also an \$8 million difference related to pension expense -- apparently the Commission used a different discount rate to measure pension expense. About \$7 million of NOI difference came from the disallowance of management incentive compensation. Remember that just because the PSC disallowed this expense, it did not mean that the company could not make that expenditure. It only meant that if that expense was incurred, there would be no recovery from customers, and the company's earned return would be reduced. Bottom line: this was a negative decision for NYSEG.

### **Adjustment Clauses**

In addition to the traditional rate case, most commissions make use of adjustment clauses that allow companies to adjust rates for certain items outside of a rate case. Adjustment clauses for fuel costs are the most common. These clauses became popular back in the 1970s during the oil embargo, when fuel prices skyrocketed and the utilities had no easy way to recover the increased costs. The

companies could not file rate cases fast enough, so the commissions started using these types of clauses, which isolate this specific expense.

The use of adjustment clauses tends to shift the risk associated with rising fuel costs from shareholders to customers, because the utility is able to recover these higher costs fairly quickly, without the complications associated with a full rate case filing. A number of states also use this type of mechanism to allow recovery of demand-side management program costs, employee pension expenses, transmission costs allocated to the companies by the federal Energy Regulatory Commission, as well as certain capital items, such as environmental compliance costs, projects undertaken to meet renewable resource requirements, certain types of new plant investment, or infrastructure upgrade/replacement costs. Additionally, adjustment clauses can be used to pass through to customers any revenues that the company may receive from selling excess power or excess gas pipeline capacity in the open market. (For further information on this issue, refer to our March 21, 2012 Topical Special Report entitled Adjustment Clauses and Rate Riders -- A State-by-State Overview.)

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