

# UTILITY RATEMAKING: The Kentucky PSC Process

*Kentucky Power Co.*

*Case 2014-00396*

**March/April 2015**

**Kentucky Public Service Commission**



# RATEMAKING IS A LEGAL PROCESS

- State statutes
- Regulations derived from those statutes
- Legal principles derived from the application of the statutes and regulations

# The PSC ratemaking process

## Governed by statute – KRS 278

- Rates must be “fair, just and reasonable”
- Investors are entitled to an opportunity to earn a return on equity (equity is the net value of the shareholder investment)
- For non-profit utilities, rates are adequate to meet lender requirements and maintain financial stability

## Two-part process

- Revenue requirement
- Rate design

# The PSC ratemaking process

## Timetable

- 30-day notice of intent required
- Public notice required
- Clock starts when application complete
- Rates can't take effect for 30 days
- PSC typically imposes suspension period
- Suspension may be for either five or six months, depending on type of rate case
- Case must be completed within 10 months
- Rehearing requests – within 23 days of final order

# The PSC ratemaking process

## Intervenors

- **Kentucky Attorney General - statutory representative of ratepayers in general**
- **Full intervenors – must show they represent unique interests and will contribute evidence that otherwise might not be brought before the PSC – testimony, discovery, cross-examination**

# The PSC ratemaking process

## Process

- **Intervention – may come before filing of application**
- **Discovery – one or more rounds of data requests to/from parties; from PSC staff**
- **Public meetings – at PSC discretion**
- **Public comment**
- **Evidentiary hearing – not required**
- **Post-hearing filings**
- **Final order**

# The PSC ratemaking process

## Settlements

- Must be unanimous – all full intervenors agree
- Partial settlements (stipulations) are allowed
- Settlements typically are “black boxes” – do not specify details of trade-offs in areas such as expenses and rates of return
- However, resulting rates must still meet “fair, just and reasonable” test

# The PSC ratemaking process

## What is NOT in base rates:

- Low-income assistance program fee
- Ancillary (i.e. – KRA) fees
- Franchise fees
- Local taxes
- Purchased water costs
- Fuel cost adjustment (above or below base fuel cost)
- Commodity cost of natural gas
- Environmental compliance cost for electric utilities – separate by state law
- Demand-side management surcharge (energy efficiency programs – gas & electric) – separate by state law



# The PSC ratemaking process

## Two-part process

- Revenue requirement is determined first
- Rate design

# The PSC ratemaking process

## Revenue requirement – base rates

- Bottom-line number for total revenue
- Calculated over a “test year” – 12-month period
- Historic test year – previous 12-month period that ends within three months of filing date – actual numbers
- Forecasted test year – 12 months beginning at the end of six-month suspension period
- Suspension period is five months for historic, six months for forecasted

# The PSC ratemaking process

## Revenue requirement – base rates

- Allowable expenses
  - routine construction – replacing poles, new lines
  - equipment purchases
  - operations: maintenance, billings, customer service, etc.
  - personnel costs: salaries & benefits
  - major construction – some costs recoverable in progress, but most are not until project is in service
    - depreciation
    - borrowing costs

# The PSC ratemaking process

## Revenue requirement – base rates

- Calculating return on equity –
  - Capital structure – debt & common equity
  - Cost of debt – long-term & short-term
  - Examine risk factors
  - Compare to similar utilities
- Return on equity has to balance the ability to attract capital at reasonable rates against impact on ratepayers

# The PSC ratemaking process

## Revenue requirement – base rates

- Expenses not allowed –
  - promotional advertising (for example: customer information education/information expense is recoverable through rates, sports sponsorships are not recoverable)
  - executive bonuses
  - charitable donations
  - club memberships
  - any expense deemed unreasonable

# The PSC ratemaking process

## Revenue requirement – base rates

- Unusual or one-time costs or revenue are excluded from test year and accounted for separately as regulatory assets or liabilities, for example:
  - Storms costs
  - Asset sales
- Final revenue requirement = allowable expenses and the additional revenue needed for an opportunity to earn a fair rate of return on equity or, for non-profit utilities, to meet lender requirements and maintain financial stability

# The PSC ratemaking process

The bottom line –

what is fair, just & reasonable?

- Balancing act
  - Fair to investors
  - Sufficient to support safe and reliable service
  - Not unduly burdensome on ratepayers
- Rates cannot be confiscatory
- PSC has discretion, but only within the legal limits

# The PSC ratemaking process

## Rate design

The purpose is to allocate costs and revenue proportionately over various rate classes

- Residential
- Commercial
- Large industrial
- Miscellaneous – fire service, hydrants, etc.

Each large rate class may be divided into several categories of service



# The PSC ratemaking process

## Rate design –cost of service studies

As part of a rate application, utilities must submit a “cost of service” study that determines how much it costs to serve each rate class and also may examine fixed versus variable costs

# The PSC ratemaking process

## Rate design – customer classes

Basic premise – customers receiving same type of service should pay the same rate

In general, larger customers have lower cost of service, due to economies of scale – it costs less to serve a 1-megaWatt load than 1,000 1-kiloWatt loads

Among the major customer classes, cost of service is highest for residential class

# The PSC ratemaking process

## Rate design – fixed vs. variable costs

Fixed costs – independent of consumption

- Basis for monthly service charge
- Monthly service charges historically have not fully recovered fixed costs

Variable costs – based on consumption

- Variable charge (per kWh, per gallon, etc)
- Variable charge generally recovers a portion of fixed costs

# The PSC ratemaking process

## Rate design

PSC uses cost of service study as a guideline, but rates are not set to strictly reflect costs

- Industrial customers may pay higher rates than cost of service study would indicate
- Residential rates, while higher than industrial, may not fully cover cost of service
- Fixed and variable costs are not allocated on a strictly proportional basis to fixed and variable charges

# The PSC ratemaking process

## Rate design

- Some rebalancing of costs and rates typically occurs in every rate case
- PSC has adopted gradual approach to attaining fully balanced rates
- This gradual approach applies both across rate classes and with respect to fixed vs. variable costs

# The PSC ratemaking process

## Rate design - issues

- Cross-subsidization across rate classes – how much is fair or acceptable?
- Fixed vs. variable cost allocation
  - Is a higher fixed rate component unduly burdensome on lower-income customers?
  - Does a higher fixed rate component discourage efficient usage and is it unfair to customers who take steps to reduce consumption?

Kentucky Power Co.

Case 2014-00396

Overview

# PROCEDURAL SUMMARY

Filed in late 2014

Suspension period ends June 22, 2015

Intervenors

- Attorney General
- Kentucky Industrial Utility Customers
- Kentucky School Boards Association
- Wal-Mart/Sam's

Evidentiary hearing

- Tuesday, May 5, 2015 – 10 a.m. EDT
- May last two or three days
- Open to public
- Streamed live at [psc.ky.gov](http://psc.ky.gov)



# THE CASE

Annual revenue increase of \$70 million (12.5%)

- \$37.7 million to pay for Mitchell power plant acquisition
- \$10.7 million for continued accelerated right-of-way vegetation management
- \$12.8 million – changes in depreciation rates
- \$ 8.8 million – increased operational costs

Requested return on equity – 10.62%

# THE CASE

Application also includes several matters NOT INCLUDED in the base rates:

- Approval of revised environmental compliance plan – reflects shutdown of Big Sandy #2 and inclusion of Mitchell
- Economic development surcharge – to fund efforts in service territory - 15¢/month per customer (will raise ~\$300,000 year, to be matched by AEP shareholders)
- Riders
  - Big Sandy #2 retirement costs
  - Big Sandy #1 operational expenses
  - Regional transmission costs (above/below baseline)
  - Cybersecurity costs (placeholder – set at zero)

# THE CASE

## Residential rate changes

Monthly service charge

current - \$8

proposed - \$16

Consumption charge

current – 8.59 ¢ per kilowatt-hour

proposed – 9.035 ¢ per kilowatt-hour

# THE CASE

## Residential customer impact

Based on average usage for all residential customers averaged over 12-month period

1362 kilowatt-hours/month

Current - \$138.67

Proposed - \$160.92

Increase - \$22.25 (16%)

***Thank you***

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***Questions?***

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