

# UTILITY RATEMAKING: The Kentucky PSC Process

April 2017

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 have been “black boxes” – do not specify details of trade-offs in areas such as expenses and rates of return
- Commission is now going to be opening the black boxes and looking inside
- In every case, resulting rates must still meet “fair, just and reasonable” test

# The PSC ratemaking process

## What is NOT in base rates:

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



# 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

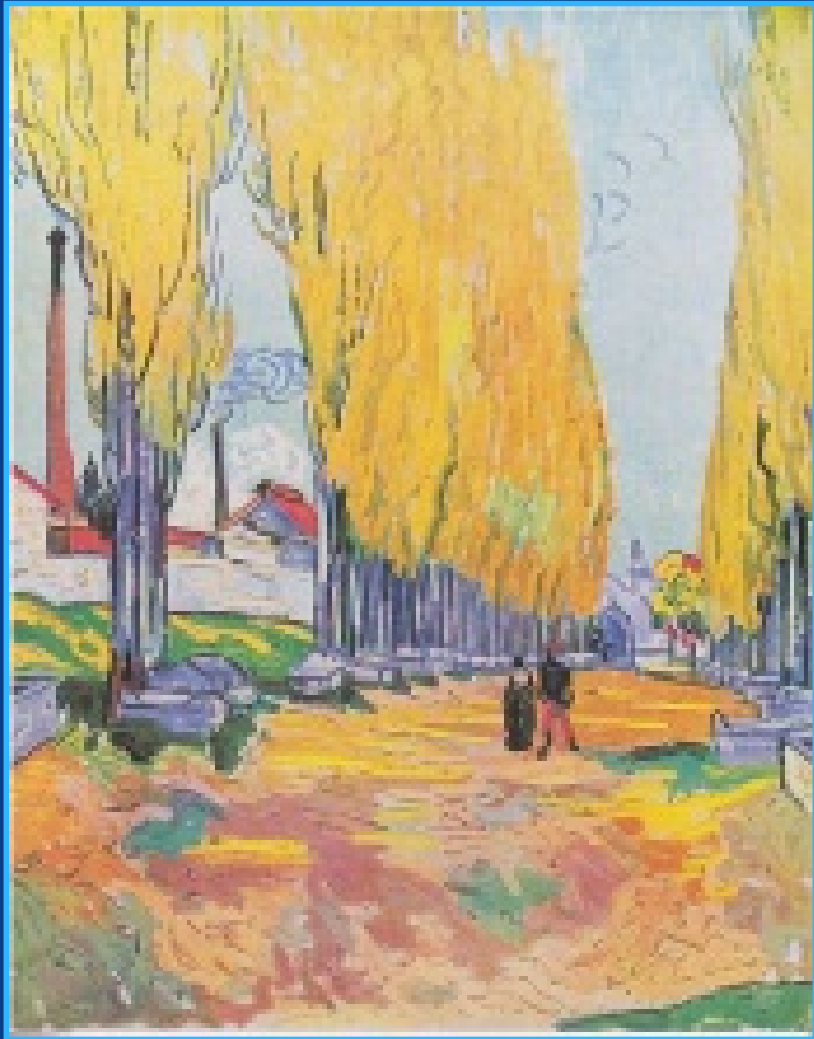
## Rate design - issues

- 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?

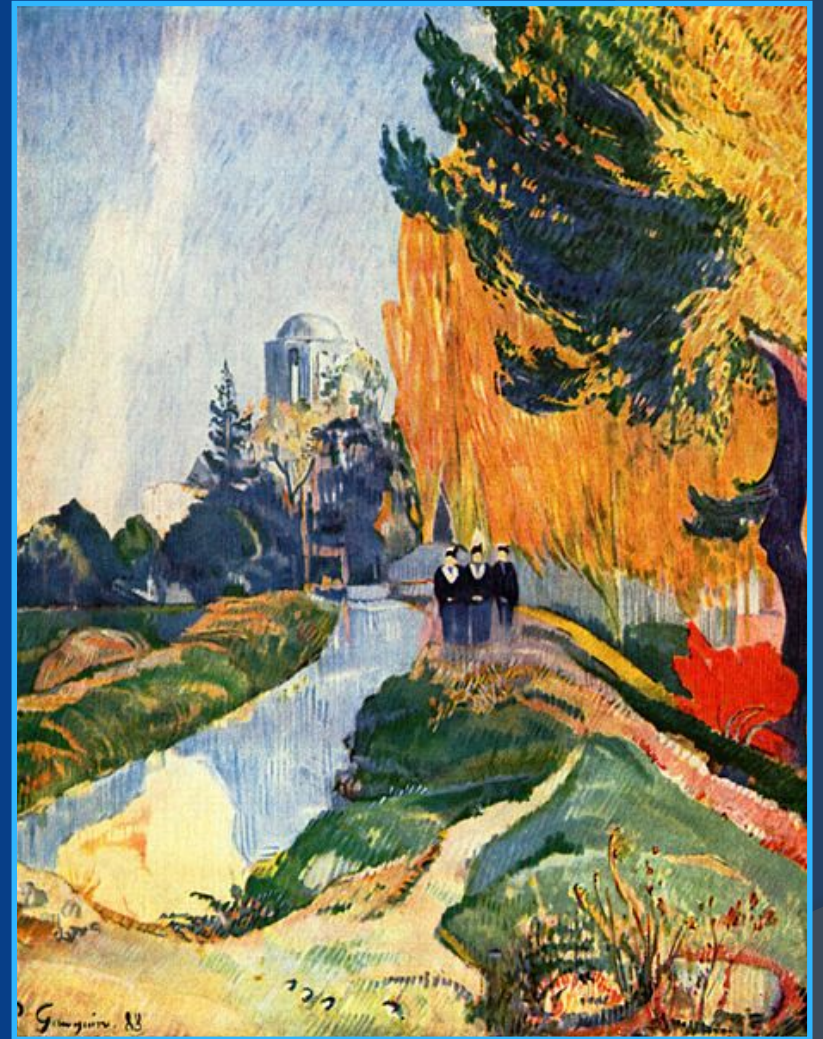
# **RATEMAKING IS ALSO AN ART**

**A balancing act**

- **Low rates vs. adequate service**
- **Low rates vs. financial stability**
- **Low rates vs. shareholder return**
  - **Small vs. large customers**



Van Gogh



Gauguin





Reality: les Alyscamps, Arles, France

**Prior to making any major capital investment (power plant construction or acquisition, major system upgrade, etc.), a utility must apply for a certificate of public convenience and necessity (CPCN)**

# The CPCN process:

## Key points:

- Statute (KRS 278.020) is general – parameters of PSC decision have evolved over time through legal precedents
- Applicant must show a need for proposed facility
- Utility must show it has considered a range of reasonable alternative options

# The CPCN process:

## Key points:

- Wasteful duplication is not allowed – a utility may not overbuild or incur unnecessary costs
- “Least cost” principle flows from absence of wasteful duplication
  - Least cost not just construction or acquisition cost
  - Long-term costs also considered
  - PSC seeks least-cost reasonable option
- Grant of a CPCN leads to a presumption of future cost recovery

# The CPCN process:

## Procedure:

- No statutory time frame (unless part of a case that has a statutory timeline)
- Intervention permitted
- Hearings/public comment meetings
  - Hearing webcasts at [psc.ky.gov](http://psc.ky.gov)
- Public comments

**Case 2016-00370**  
**Kentucky Utilities Co.**

# Case 2016-00370

- ⦿ KU is seeking to increase annual revenue by \$103.1 million (6.4%)
- ⦿ Most recent increase – June 2015 (case was settled)
  - *Requested about \$154 million annual increase*
  - Received \$125 million annual increase
  - Average residential bills increased about \$9/month
  - Fixed charge unchanged; energy charge increased

# Case 2016-00370

## Reasons for requested increase

- ⦿ Upgrades to generation, transmission and distribution systems, including advanced technology
- ⦿ System-wide meter replacement with AMS (Advanced Metering Systems a.k.a. “smart” meters)
- ⦿ Ongoing infrastructure replacement
- ⦿ Increased operating costs



# Case 2016-00370

## Rate impact

- ⦿ KU estimate based on average monthly residential use of 1,179 kilowatt-hours (kWh)
- ⦿ Monthly charge: \$10.75 → \$22
- ⦿ Charge per kWh: 8.87¢ → 8.523¢
- ⦿ Total: \$115.33 → \$122.49 +\$7.16 (6.2%)

# Case 2016-00370

## Certificate of Public Convenience and Necessity (CPCN)

- ⦿ For system upgrades
  - Transmission upgrades
  - Distribution upgrades
  - Meter replacements

# Case 2016-00370

## Intervenors:

- ⦿ Kentucky Attorney General – Office of Rate Intervention
- ⦿ Lexington-Fayette Urban County Government
- ⦿ Kentucky League of Cities
- ⦿ Kentucky School Boards Association
- ⦿ Community Action Council for Lexington-Fayette, Bourbon, Harrison, and Nicholas Counties, Inc.

# Case 2016-00370

## Intervenors:

- ⦿ Kentucky Industrial Utility Customers
- ⦿ Kroger
- ⦿ Wal-Mart
- ⦿ Kentucky Cable Telecommunications Association
- ⦿ AT&T Kentucky
- ⦿ Sierra Club

# Case 2016-00370

## What's next:

- ⦿ Formal evidentiary hearing (delayed one week to allow additional discovery)
- ⦿ May 9 through ?? – 1 pm EDT
- ⦿ PSC offices – 211 Sower Blvd., Frankfort
- ⦿ Open to public
- ⦿ Streamed live at [psc.ky.gov](http://psc.ky.gov)
- ⦿ Suspension period ends June 30
- ⦿ PSC must issue decision by September 22

***Thank you***

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***Questions?***

## Contact information:

**Andrew Melnykovych**

**Communications Director**

**Kentucky Public Service Commission**

**211 Sower Boulevard, Frankfort KY 40602**

**502-782-2564**

**[Psc.info@ky.gov](mailto:Psc.info@ky.gov)**