

UTILITY RATEMAKING: The Kentucky PSC Process

June 2016

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

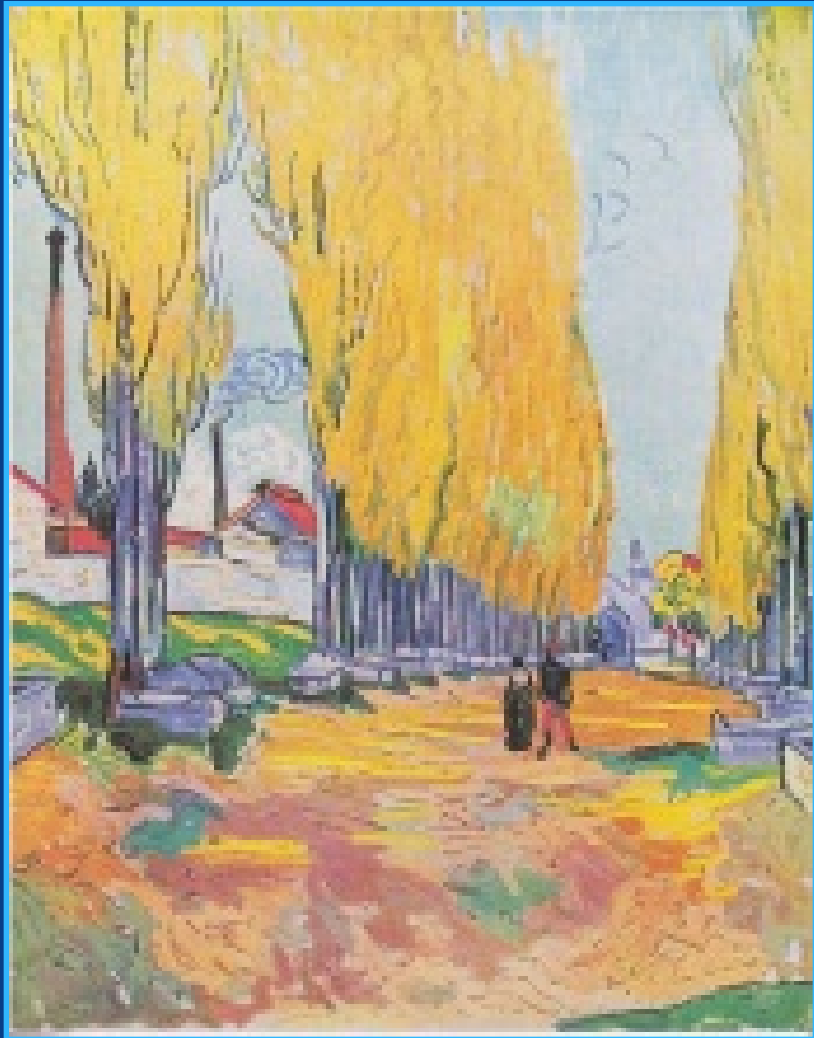
Rate design - issues

- 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?

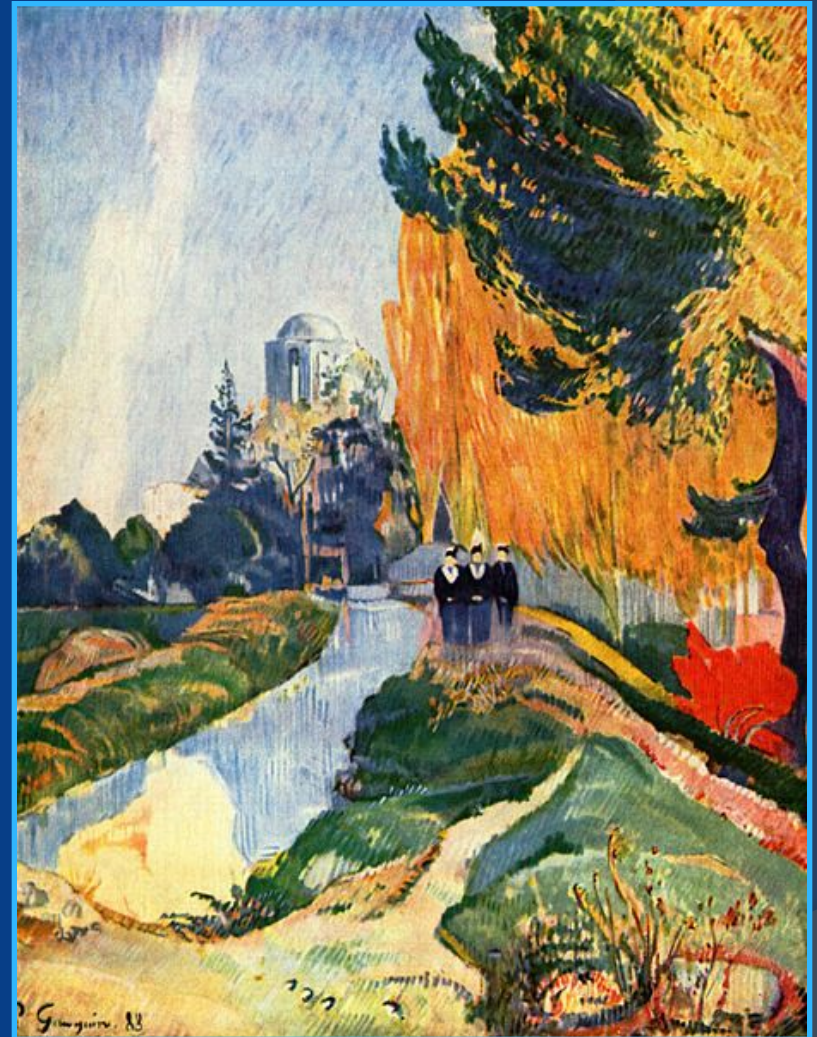
RATEMAKING IS ALSO AN ART

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

Case 2015-00418

**Kentucky-American
Water Co.**

Case 2015-00418

- ⦿ KAWC seeking to increase annual revenue by \$13.5 million (15.2%)
- ⦿ Total revenue sought: \$95 million
- ⦿ Most recent increase – October 2013
 - *Requested \$12.2 million annual increase*
 - Received \$6.9 million annual increase
 - Residential bills increased about 10%
 - Fixed charge increased; usage charge unchanged

Case 2015-00418

Reasons for requested increase

- ⦿ Major construction projects – Richmond Road filter building replacement (approved previously by PSC)
- ⦿ Ongoing infrastructure replacement
- ⦿ Increased operating costs

Case 2015-00418

Rate impact

- KAWC estimate based on average monthly residential use of 4,130 gallons
- \$6 increase per month (17%)
- Monthly charge: \$12.49 → \$14.85
- Charge per 1,000 gallons: \$5.30 → \$6.18
- Total: \$34.38 → \$40.38

Case 2015-00418

Infrastructure improvement rider

- ⦿ Would fund distribution system upgrades
- ⦿ Focused mostly on replacement of old water mains
- ⦿ Calculated annually, with annual true-up
- ⦿ Subject to PSC review, but less extensive than full rate case
- ⦿ PSC rejected similar proposal in 2013

Case 2015-00418

Infrastructure improvement rider – KAWC position

- Reduce frequency of base rate adjustments
- Reduce water loss
- Reduce energy costs
- Concept is similar to adjustments used in other utility sectors in Kentucky (natural gas & electric)
- No such riders for water utilities in Kentucky - other states have similar riders

Case 2015-00418

Intervenors:

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

Case 2015-00418

What's next:

- ⦿ Formal evidentiary hearing
 - July 13 – 9 am EDT
 - PSC offices – 211 Sower Blvd., Frankfort
- ⦿ Open to public
- ⦿ Streamed live at psc.ky.gov
- ⦿ Suspension period ends August 27
- ⦿ PSC must issue decision by November 28

Thank you

Questions?