

Will there be a new “Normal” in water utility ratemaking?

2013 Water Training Seminar

Kentucky Public Service Commission

13 August 2013 (Lake Cumberland State Resort Park)

What are the requirements?

“Every utility may demand, collect and receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person.” KRS 278.030(1)

“We have declared that rates established by a regulatory agency must enable the utility to operate successfully and maintain its financial integrity in order to meet the just and reasonable nonconfiscatory tests.” *PSC of Ky v. Dewitt Water Dist.*, 720 S.W.2d 725 (Ky. 1986) citing *Comm. ex rel Stephens v. S. Central Bell Tel. Co.*, 545 S.W.2d 927 (Ky. 1976)

Operate Successfully

Maintain Financial Integrity

- Meet the requirements of the Safe Drinking Water Act and Kentucky drinking water requirements.
- Meet the requirements of the PSC.
- Make timely payments to vendors and lenders.
- Address the concerns and requests of customers.

- Other?

Is the “system” actually broken? (What is normal at the moment?)

- Standard rate adjustment proceeding
 - Historical test period or
 - Forward-looking test period;
- Alternative rate adjustment procedure
 - “immediate past year and for the two (2) prior years”;
- Authorization for non-recurring charges;
- Purchased water adjustment mechanism; and
- KRS 278.023 (federally-funded construction)

Can the “system” handle what is on the way (if not already here)?

- Infrastructure repair and replacement;
- Compliance costs associated with the Safe Drinking Water Act;
- Costs associated with energy and chemicals; and
- Potential reductions in customer usage.

What do other utilities have?

- KRS 278.183 (surcharge to recovery costs of compliance with environmental requirements for coal combustion wastes and by-products);
- 807 KAR 5:056 (fuel adjustment clause);
- KRS 278.509 (cost recovery for investment in natural gas pipeline replacement programs which are not recovered in existing rates of utility);
- 807 KAR 5:026(9) (gas cost adjustment mechanism); and
- KRS 278.516 (alternative regulation process for small telephone utilities)

Case No. 2012-00520

- A request has been made for authorization of a distribution system improvement charge (DSIC) mechanism;
- A request has been made for a purchased power and chemicals expense rider; and
- A request has been made for a declining usage adjustment.

“The views I express are my own, but...”

- A request has been made for authorization of a distribution system improvement charge (DSIC) mechanism
 - OAG: The mechanism is not necessary or advisable for a utility that frequently files rate cases based upon a forward-looking test period and is protected against unfavorable actual-to-budget variances in construction spending;
- A request has been made for a purchased power and chemicals expense rider
 - OAG: The expenses are not material to warrant special treatment between rate cases. If either becomes an issue between rate cases, then the deferred debit process exists.
- A request has been made for a declining usage adjustment.
 - OAG: Declining usage claim based upon speculation and conjecture.

Guidelines or Principles from a consumer advocate's viewpoint:

- Departure from the current, normal method of setting rates should be for material or important policy or financial reasons.
 - Financial stability and financial integrity cannot reasonably be maintained through a normal method.
 - General Assembly provides instructions on an issue.
- Benefits should **clearly** outweigh the costs.
 - Increase/decrease overall regulatory burden (primarily time)?
 - Impact on capital cost rates?
 - Evidence necessary to establish and maintain the mechanism?
 - Will the customers believe it is an improvement? (Will they realize value out of the change?)
- Will it solve a problem, avoid a problem, or create or continue a problem?

Inflation – Historical Test Period

- “The Commission has included adjustments to reflect the results of inflationary pressures, to the extent that they can be identified, in Columbia’s adjusted test-period operations. It would, therefore, be inappropriate to make an additional adjustment specifically for inflation. Moreover, any adjustment for inflation on a going-forward basis would be speculative.” KY PSC Case No. 10498, 6 Oct 1989, page 46.
- “Water Service has not presented any evidence in this proceeding that would persuade the Commission to reverse its prior findings regarding pro forma adjustments based upon the CPI or the disallowance of budgetary projections in a historical test period.” KY PSC Case No. 2008-00563, 9 Nov 2009, pages 12, 13.

Inflation – Forward-looking Test Period

- “Revenue and expense adjustment based upon the CPI are widely used by utilities when they are preparing annual budgets or rate applications that use forecasted test periods. Regarding budgetary adjustments, the Commission has previously found that ‘[w]hile such projections may be acceptable when an applicant bases its application upon a forecasted test period, they are not when the basis for the proposed rate adjustment is a historical test period.’” KY PSC Case No. 2008-00563, 9 Nov 2009, page 12.

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- “An automatic adjustment mechanism must provide an accurate measurement of changes in the cost of providing water service. It therefore should be based principally on those goods and services that are reasonably likely to be used to provide water service.”
- “Second, a proper automatic adjustment mechanism should reflect all changes in the cost of the inputs that are required to provide water service.”

KY PSC Case No. 2006-00067, 21 Nov 2006, pages 3 and 4.

What is depreciation?

- IRS: “It is an annual allowance for the wear and tear, deterioration or obsolescence of the property.”
<http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/A-Brief-Overview-of-Depreciation>
- “Depreciation is the process of allocating the cost of long-lived assets over the useful life of the asset.”
<http://accountingstudy.com/accounting-courses/financial-accounting-terms-dictionary/depreciation-overview-accounting-terms.htm>
- Per *PSC v. Dewitt*: “The guidelines of the Commission define depreciation as ‘loss in service value not restored by current maintenance.’”
- PSC Staff: “Depreciation is the periodic allocation of the cost of a tangible long-lived asset of its estimated useful life.”
(emphasis in original)

Something else...

- “Depreciation is uniformly recognized as an operating expense and it is important that the amounts set aside to cover depreciation of public utility property be large enough to replace the property when it is worn out.” *Kentucky Public Service Commission v. Dewitt Water District*, 720 S.W.2d 725, 730 (Ky. 1986) citing 64 Am.Jur.2d *Public Utilities* § 182 (1972).
- “The purpose of depreciation expense applied to nonprofit water districts does not relate to a recoupment of investment.” *Dewitt*, 720 S.W.2d at 731.

The Opinion speaks for itself, but the focus is on replacement.

- “If the districts do not have sufficient revenues to cover replacement costs, they will be forced to the short-term credit market for funding which will raise the overall costs to the district.” *Dewitt*, 720 S.W.2d at 730.
- “The water district must eventually replace this plant which customers are using and the ratepayers are therefore obligated to provide funds for this replacement.” *Dewitt*, 720 S.W.2d at 731.

Questions:

- What should happen if the water district has not sought and does not seek to “fully fund” depreciation?
- Can we (or should we) ever decide an issue relating to repair and replacement of infrastructure in isolation from depreciation practices?
- Although depreciation pertains to replacement, line upsizing and system development charges may not be separable from depreciation. (North Shelby Water Co., PSC Case No. 2005-00327 and Henry Co. Water District No. 2., 2009-00370)

KRS 278.290 (Valuation of utility property in connection with rates, service or issuances of securities – Unit rate base.)

- Kentucky “is not exclusively an original cost jurisdiction.” *Dewitt*, 720 S.W.2d at 729.
- “The Commission **must** consider various factors including cost of reproduction as a going concern.” (emphasis added) *Dewitt*, 720 S.W.2d at 729.
- “If the Commission must consider all plant property for rate-making purposes, it follows that it must consider all operating expenses incurred in conjunction with the use of the property.” *Dewitt*, 720 S.W.2d at 729.

Thank you.

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