UTILITY RATEMAKING: The Kentucky PSC Process

April 2017

Kentucky Public Service Commission

PSC
PUBLIC SERVICE
COMMISSION
OF KENTUCKY

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 allocates 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

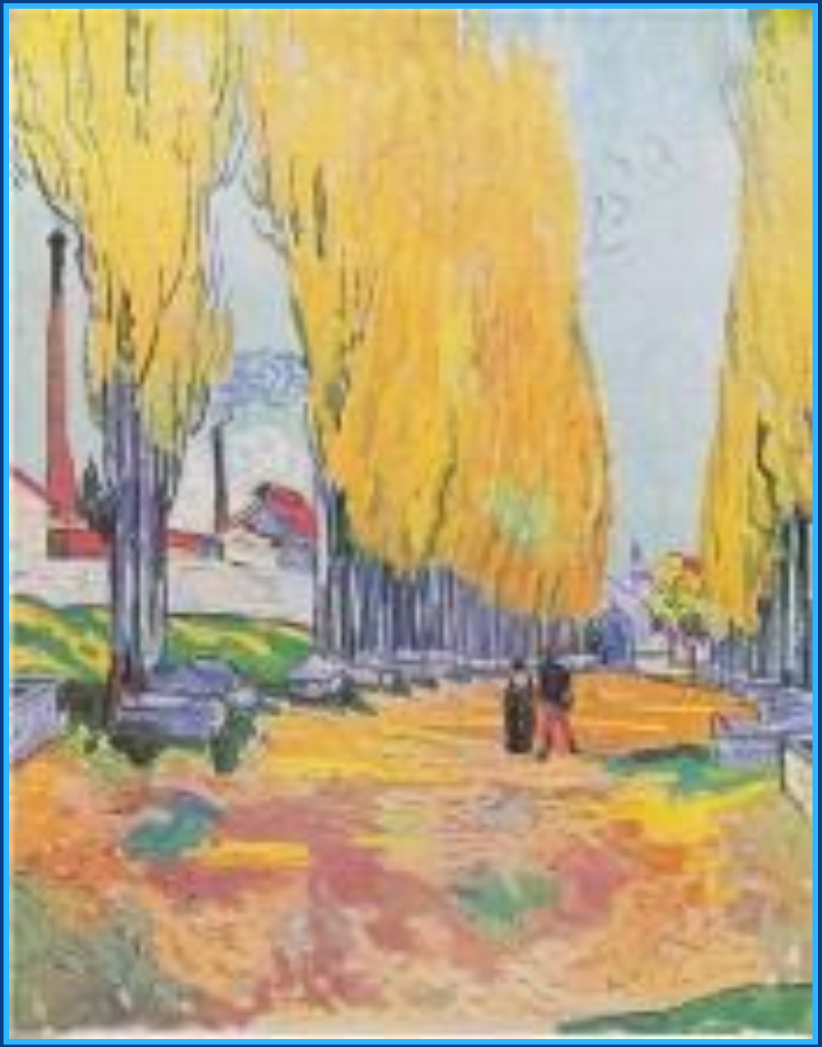
Rate design - issues

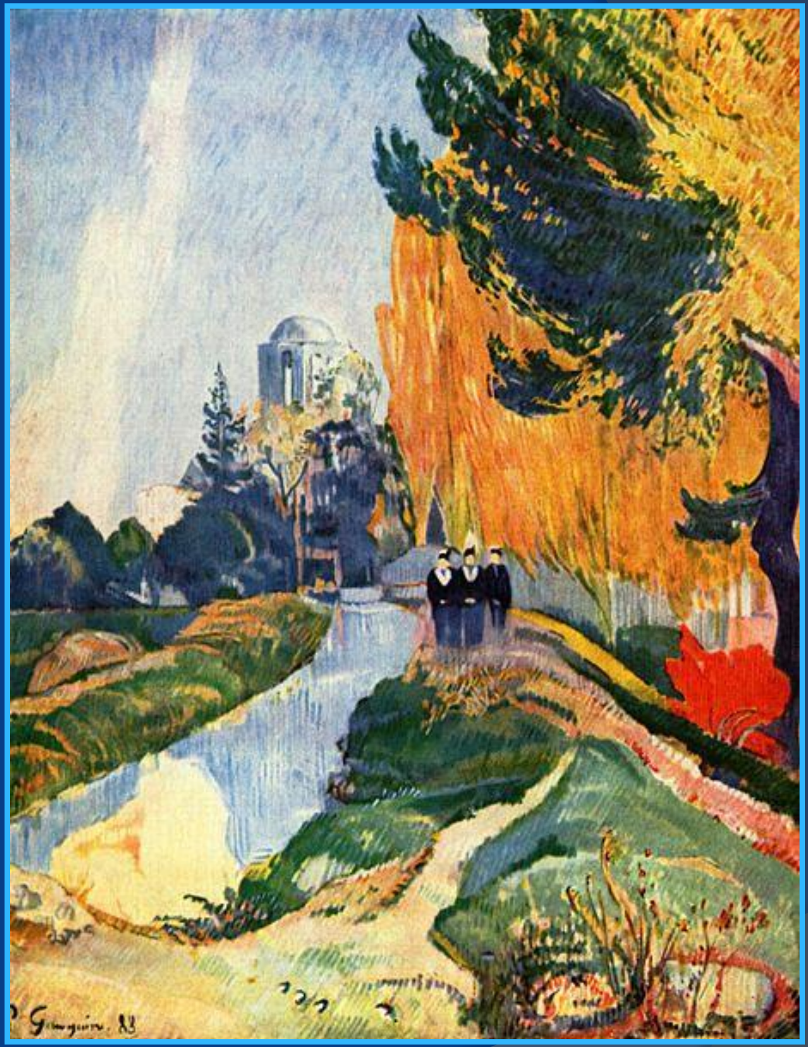
- Cross-subsidization across rate classes – how much is fair or acceptable?
- Fixed vs. variable cost allocation
  - Is a higher fixed rate component unduly burdensome on lower-income customers?
  - Does a higher fixed rate component discourage efficient usage and is it unfair to customers who take steps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

Case 2016-00371

Louisville Gas & Electric Co.

Case 2016-00371 - Electric

- LG&E is seeking to increase annual revenue by $93.6 million (8.5%)
- Most recent increase – June 2015 (case was settled)
  - *Requested about $30 million annual increase*
  - Received no annual increase
  - Average residential bills essentially unchanged
  - Fixed charge unchanged; energy charge increased by 6/1000 of a cent

Case 2016-00371 - electric

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 2016-00371 - electric

Rate impact

- LG&E estimate based on average monthly residential use of 957 kilowatt-hours (kWh)
- Monthly charge: $10.75 → $22
- Charge per kWh: 8.639₵ → 8.471₵
- Total: $93.43 → $103.07 +$9.64 (10.3%)

Case 2016-00371 - electric

Certificate of Public Convenience and Necessity (CPCN)

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

Case 2016-00371 - Gas

- LG&E is seeking to increase annual base revenue by $13.8 million (4.2%)
- Most recent increase – June 2015

  (case was settled)

  - *Requested about $14 million annual increase*
  - Received $7 million annual increase
  - Average monthly residential bills rose by $1.30
  - Fixed charge unchanged; delivery charge increased by 23 cents per 1,000 cubic feet

Case 2016-00371 - gas

Reasons for requested increase

- Upgrades to distribution system
- System-wide meter upgrades with AMS (Advanced Metering Systems a.k.a. “smart” meters)
- Safety improvements – main replacements
- Increased operating costs

Case 2016-00371 - gas

Rate impact

- LG&E estimate based on average monthly residential use of 5,487 cubic feet/month
- Monthly charge: $13.50 → $24
- Delivery charge: $2.87 → $2.54
- Total (base rate only): $29.24 → $37.93 +$8.69 (30%)
- Surcharge for gas line replacement program would decline by $4.87 - from $5.70 to $0.83
- LG&E estimates increase in TOTAL average monthly bill at $3 (5%)

Case 2016-00371 - gas

Certificate of Public Convenience and Necessity (CPCN)

- For system upgrades

  - Transmission line expansion and upgrades

  - Distribution line upgrades

  - Meter upgrades

Case 2016-00371

Intervenors:

- Kentucky Attorney General – Office of Rate Intervention
- Louisville/Jefferson County Metro Government
- Kentucky School Boards Association
- Metropolitan Housing Coalition
- Association of Community Ministries
- US Department of Defense, et. al.

Case 2016-00371

Intervenors:

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

Case 2016-00371

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
- Suspension period ends June 30
- PSC must issue decision by September 22

Thank you

Questions?

Contact information:

Andrew Melnykovych
Communications Director
Kentucky Public Service Commission
211 Sower Boulevard, Frankfort KY 40602
502-782-2564
Psc.info@ky.gov