Approved January 27, 1987
Date

MINUTES OF THE SENATE COMMITTEE ON LOCAL GOVERNMENT.

The meeting was called to order by Senator Don Montgomery at
Chairperson

9:08 a.m./~~p.m.~~ on January 23, 1987 in room 531-N of the Capitol.

All members were present except: Senators: Bogina, Gaines and Mulich who were excused.

Committee staff present: Mike Heim, Theresa Kiernan and Lila McClaflin

Conferees appearing before the committee:
Richard D. Kready, KPL Gas Service , Topeka
Brian Moline, Kansas Corporation Commission, Topeka

Hearing continued on S.B. 10.

Richard D. Kready reviewed the background leading up to S.B. 10 and gave an in-depth look at what major changes it would make in present law. He stated S.B. 10 would make exchanges of territory between electric companies so prohibitively expensive that it would freeze present boundaries of electric territories permanently. This would hinder economic development and take away some of the authority of local elected officials. Senator Steineger questioned Mr. Kready in the area of financing and dual certification. (ATTACHMENT I)

In response to a question from Senator Daniels, Brian Moline, Kansas Corporation Commission stated at the present time the Corporation Commission is not involved in settling this type of dispute and settling damages and it would be breaking new ground for them to be involved in such a process.

Senator Daniels moved to adopt the minutes of the January 21, 1987, meeting. The motion was seconded by Senator Salisbury. The minutes were adopted.

The Chairman stated with the permission of the members of the Committtee he would like to request that the utility companies get-together and work out something that they feel is equitable. It appeared in all of the testimony that the Committee heard, that the main question was a fair and equitable settlement for the exchange of territory, if it is possible he would like them to work out an agreement. If that can not happen then we will go ahead and have discussion on S.B. 10 and work it. The Committee agreed to give the utility companies several weeks to work on an agreement.

It was suggested that it might be helpful to have the eminent domain issue reviewed for the members of the Committee.

The meeting adjouned at 9:58 a.m., next meeting will be January 27, 1987.

Chairman, Senator Don Montgomery

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

Date: January 23, 1987

GUEST REGISTER

SENATE

LOCAL GOVERNMENT

NAME	ORGANIZATION	ADDRESS
Judith McConnell	Ks. Corporation Commission	
Brian Moline	" " "	
Rick Kready	KPL Gas Service	Topeka
Jon Dean	"	"
Tom Taylor	"	"
Louis Stroup Jr.	KMU	McPherson
TREVA POTTER	PEOPLES NAT. GAS	~~KAN~~ TOPEKA
Joe Lieber	Ks Co-op Council	Topeka
John C Woodman	KCPL	KCMo
DICK COMPTON	MIDWEST ENERGY	HAYS
JERRY CCOONROD	KG&E	WICHITA

Testimony Before

SENATE LOCAL GOVERNMENT COMMITTEE

Senate Bill 10
Municipal Annexation of Electric Service Territory

By RICHARD D. KREADY
KPL GAS SERVICE
Director of Governmental Affairs

January 21, 1987

Mr. Chairman and Members of the Committee:

Senate Bill 10 would make exchanges of territory between electric companies so prohibitively expensive that it would effectively freeze present boundaries of electric territories permanently. This would lock customers into their present supplier, hinder economic development, and take away some of the authority of local elected officials.

I would like to take a couple of minutes to review the background leading up to this bill, and then take a more in-depth look at exactly what is in this bill and the major changes it would make in present law.

Originally, investor-owned utilities such as KPL Gas Service were granted county-wide jurisdiction by the state. In the 1930's, the federal government set up rural electric cooperatives in the rural areas of the counties and Kansas granted dual and overlapping certificates for both kinds of utilities to operate in those areas.

In the 1970's, when rural electric co-ops decided to build their own generating plants, such as Wolf Creek and Sunflower's Holcomb plant, they sought exclusive certified territories, instead of dual territories, to help gain financing for their costly projects.

KPL and the majority of the rural electric cooperatives reached a workable compromise, which was enacted by the 1976 Legislature. The compromise granted "single certified territories" to rural cooperatives, with one exception: when a city expands and takes in land served by a rural supplier, the city officials may either grant a franchise to allow the existing supplier to continue providing service, or not grant a franchise and thereby cause a transfer of the service territory to the urban utility. Of course, the urban utility must reimburse the rural supplier for the acquired facilities.

This law has worked well. Rural cooperatives have obtained the financing they wanted and have actually gained, not lost, customers since the law was enacted in 1976. Several cities have franchises for more than one supplier within their city limits, including Topeka, Silver Lake, Olathe, and Shawnee.

Now, however, several utilities -- Kansas Electric Cooperatives, Inc., KG&E and KCPL, want to throw out the compromise and make territory exchanges so prohibitively expensive that territories will be effectively frozen in the future.

During the 1986 Legislative Session, a moratorium was imposed on territory exchanges through June, 1987, while the Interim Energy Committee studied the situation. Upon the motion of Senator Montgomery, the staff of the Interim Committee was directed to draft a proposed compensation bill, similar to SB 677, which this committee developed last year, and which became law, to deal with the same situation when areas of rural water districts change hands.

I think it is important to emphasize that we're not talking about some new, complex area -- we're dealing with the same basic situation as you dealt with when you developed SB 677: Fair compensation for the utility whose facilities are taken over so its remaining customers are kept "whole". In this case, we're looking at substations and electric lines, rather than water towers and pipes.

The Interim Committee minority reports point out the Committee's original goal was to keep the displaced utility "whole" through fair and equitable compensation. This way, the customers of both the displaced utility and the utility assuming service to the area would neither suffer nor benefit because of higher prices as a result of the change in electric service to the area.

But, that's not what the Committee ended up doing. When the draft along the lines of SB 677 came back, the committee no more than began discussion of it, when a completely different substitute bill was introduced, incorporating the ideas of the rural electric cooperatives exclusively. There was very little discussion of what was actually in the bill, and it passed on a narrow 5 to 4 vote. The votes show that there was not an overwhelming recommendation for SB 10. The four members who voted against introduction of SB 10 -- including Chairman Merrill Werts -- issued very strong minority reports.

There are a lot of things in SB 10 that make very significant changes from current law. I would like to go through it and point out the most significant and inequitable ones.

- Lines 37 through 121 -- the first three pages, through the top of page 4, -- remove all of the 1976 rules that were established to originally divide territories. This is extraneous language that the revisor's office considers unnecessary.

- Section 2 -- lines 122 through 133 -- removes the one-year moratorium that was imposed on territorial changes by the 1986 Legislature. As you will see, although this freeze would be nominally removed, other sections of this proposal will, in effect, cause a territory freeze to continue.

- Subsection (b) -- lines 144, 145 and 146 --This is a major change and would, for the first time, give the State Corporation Commission jurisdiction over municipal utilities' right to serve customers in newly-annexed areas. This would take authority away from local elected officials.

• Section 3 -- lines 148 through 161 -- strikes the 1976 compromise and removes the authority of elected officials to determine which electric suppliers may provide service in certain parts of the city limits.

Under present law, local elected officials have the right to decide whether or not they want to grant a franchise to existing electric suppliers in these new areas. Without this authority, communities could end up with a hodgepodge of utilities, with different rates and different policies, which would be very confusing to citizens. For example, Pratt is served by a municipal electric utility, but is surrounded by two investor-owned electric companies and a rural electric cooperative. Under SB 10, there conceivably could be four electric suppliers in the same town at some point in the future.

• Subsection (b) -- lines 162 through 171 -- also pertains to removing the moratorium, which would be fine, if it were actually removed and not just continued under another guise whereby the compensation required in territory exchanges is so expensive that territories end up frozen.

• The language included in lines 171 through 174 is a complete reversal of present law, which has said that cities have the right to decide, in newly-annexed areas, whether to grant a franchise to the original supplier or allow the urban utility to serve the entire (developing) community. This reversal bluntly states that inclusion by annexation shall not in any respect impair or affect the original supplier's exclusive right to serve in the area which is becoming part of a city.

This will restrict cities' ability to promote economic growth and development. As cities encourage growth, industrial parks are developed near, but often outside, city limits. Most industries, however, desire electricity from urban suppliers, because rates are usually lower and their larger systems are better able to serve large industrial loads. Industrial prospects may look elsewhere if they cannot have access to the lowest cost and most reliable electric service.

For example, the City of Atchison was able to land a large metal fabricating plant, only by annexing an industrial park and offering lower rates and better service from the city's urban electric supplier. Otherwise, plant officials were considering locating in Nebraska.

• Line 176 <u>requires</u> the city to grant a franchise to the existing supplier, or apply to the KCC for reassignment of the territory. Again, the KCC is brought into a local city matter, and the city's option of whether or not to grant a franchise is removed.

• Lines 181 through 184 -- takes more rights away from the cities. It says even if the city does not grant a franchise, the utility continues to have an exclusive right to serve in the area. Of course, this is a complete reversal of present law.

• New Subsection (b) at line 185 adds a new prior notification requirement to the law which requires the city to notify the electric supplier of the proposed boundaries and plans for electric service of any annexation at least one-half year before final action. This may be a back-door attempt to prevent certain annexations. But at the very least, it would make the annexation process -- even for routine, uncontested annexations -- much longer and more costly.

- New Subsection (c) -- lines 190 through 198 -- is another new requirement for cities and a new area of jurisdiction for the KCC. It says if cities want to reassign territory, they must file an application with the KCC within six months following annexation. The KCC will have no power to determine whether or not to reassign that territory until after issuing official notice and holding official hearings. Again, it appears that the time frame involved and the extra cost is merely another back-door attempt to stop the orderly development of cities and their retail electric suppliers.

- New Subsection (d) -- lines 199 through 203 --This says if the KCC were to approve an exchange of territory, it is the <u>city</u> that must buy all of the electric system facilities in the affected area; not the utility that is taking over the area. This seems to be directed at cities that operate municipal electric systems, and it shuts out the possibility of private investor-owned utilities buying other facilities in annexed territory. Regardless, the cost would be so prohibitively expensive because of the one-sided compensation formula imposed by SB 10, that most cities probably could not afford to buy the facilities anyway. Again, this seems to be an attempt to halt annexation or territory exchanges, rather than develop a fair and equitable method of compensating for the acquired facilities.

  This section also indicates that "service rights", which have been granted by (not purchased from) the State to give utilities the opportunity to serve in specific areas, can be bought and sold. This would be an entirely new concept of state regulation. It has been determined in similar situations in the past that it is inappropriate for a price to be affixed to those service rights. Rural suppliers did not pay for service rights and therefore should not attempt to demonstrate ownership of those rights to serve, nor attempt to sell their service rights or territories.

- Also in Subsection (d) -- lines 203 through 208 -- is a statement that says the originally certified utility does not have to sell any of its facilities at all, if such facilities are necessary for providing service to any other customers. It appears that a rural supplier may refuse to sell facilities, rather than reintegrate the system. Since that refusal could necessitate the duplication of some facilities, which would be against public policy, the Commission would probably have to reject the territory transfer. In other words, the rural utility holds all the cards in the process and can prevent many territory exchanges simply by refusing to sell certain facilities.
- New Subsection (e) includes a curious reference that the city must pay "cash" compensation for the facilities and service rights (line 209 and repeated in line 233). I hope this doesn't mean city officials must come to the closing meeting bearing briefcases and suitcases full of 100-dollar bills. Perhaps this is just another roadblock inserted to stop territory exchanges.

Now, we come to the most inequitable part of SB 10: the formula for determining compensation for the acquired utility facilities. The formula begins with subsection (1) at line 213 and continues with subsections (2) and (3) through line 231 on page seven.

It moves far from the concept of fair and equitable compensation to keep both sides whole, to a method that the dissenting members of the interim committee called in their minority reports; "grossly one-sided," "exorbitant," "unnecessarily cumbersome," and "economic suicide." This formula would make territorial exchanges so costly, it would effectively freeze territories, building a "territorial wall" around customers and locking them into their present supplier, with no opportunity to change to more reliable or less costly suppliers in the future.

• Beginning at line 213, the compensation formula requires the acquiring utility to pay present-day fair market value of the electric system facilities being purchased. There is certainly a logical argument to be made for reimbursing the selling utility at fair market value. And, it is fair for the cost to be placed on the acquiring utility's books and included for ratemaking purposes. It would represent a reasonable measure of what the selling utility's customers are no longer using, and a reasonable value for what is being added to the system serving the customers of the acquiring utility.

This is generally what happens under present laws and Corporation Commission rules. When a utility takes over facilities from another utility, it pays book value, which is original cost less depreciation. This is what the Corporation Commission has determined is fair to include in a utility's rate base. Under this method, the utility pays for exactly what it gets. If it buys an electric substation and pole, it pays the amount on which the KCC will allow a return to be made.

• Subsection (2) requires the payment of all costs of detaching the electric system utilities. This reimbursement should be minimal, so it would not be a burden to either group of customers. However, the section goes on to require that the acquiring company's customers will also be responsible to pay for any reintegration expense (line 216). We fear this could encourage the selling supplier to create unnecessary and duplicative facilities, rather than explore all of the alternatives.

• But, now that payment has already been made for the actual facilities, Subsection (3) adds extra compensation for anticipated gross revenues for the subsequent 35 years. This is extremely one-sided, redundant and exorbitant, plus it dictates an unnecessarily cumbersome method for calculating the amount of compensation, as the Wertz, Martin and Lacy minority report points out.

First, this requirement for payment of extra compensation is redundant. As stated in the minority report, it "duplicates consideration for items already reflected in the previously required determination of fair market value of electrical facilities acquired. A fair market value appraisal would reflect the worth of the property as determined by "cost," "market" and "income" approaches. The 'Income approach' estimates the present value of the anticipated future earnings and cash flow from the property being appraised. It would be redundant and unfair to require the purchaser to pay for anticipated revenues already reflected in the fair market value."

Secondly, this proposed extra compensation is not only redundant, but exorbitant. Again, the minority report explains why: "The selling utility does not need to be paid the full, gross revenues from those transferred customers. Gross revenues are generated for an electric supplier by rates designed to provide a return on investment and to recoup operating and

maintenance expenses. Since the selling utility will no longer be incurring the fuel costs or purchased power costs to supply those customers, nor the related maintenance or operating costs for customer billing, along with other costs, that portion of the gross revenues would equate to excessive compensation -- a sizable windfall profit for the displaced electric utility supplier."

The minority report continues: "To require compensation based on future expenses not even incurred by the seller is patently unfair and unreasonable to customers of the acquiring utility for the following reasons. In addition to paying the excessive compensation to the previous supplier, the acquiring utility would also be responsible for operating and maintaining the effected facilities and for paying for the production of power to serve those customers. In effect, the customers of the acquiring utility will be paying twice for those things."

- The level of compensation is already exorbitant, but SB 10 goes on to require that the compensation be recalculated annually to include the value of any additions or modifications installed on that system during the subsequent 35 years (line 226). In other words, the acquiring utility must pay the original supplier for future growth and modernization, even though the original supplier did not do anything to promote that growth and did not make any investment to update or modernize the system after it was sold. But the original utility gets a reward nonetheless. And, of course, the acquiring utility's customers would end up paying for it. There is nothing fair or equitable about a compensation formula based on that kind of concept.

The 35-year payment period established by SB 10 is itself unreasonable. Thirty-five years is the average life of utility property, but this compensation formula falsely assumes all of the acquired property is brand new.

- In summary, the proposed extra compensation as required in subsection (3) -- lines 219 through 231 -- is computed by first adding the subsequent investment to the value of the previous company's facilities in the annexed area, and dividing that sum by the previous supplier's total fair market value. That fraction is then to be multiplied by the previous supplier's annual gross revenue for the appropriate year.

Since the rates (and thus, the gross revenues) are considerably higher for many rural suppliers when compared to the gross revenues generated per customer for their urban counterparts, the proposed compensation formula could cause an acquiring urban utility with low rates actually to pay more in compensation than it collects in total gross revenues from the affected customers. Of course, the urban utility would have to make up the shortfall through increasing the rates of its other customers. As Representative Ginger Barr said in her minority report, this would be "economic suicide."

SB 10 is not fair because it would benefit a select group of utilities at the expense of the customers of other utilities. The interim committee originally stated a legitimate goal of providing for compensation so neither group of customers would be better or worse off than before the acquisition. SB 10 is a one-sided proposal that doesn't even attempt to reach a fair and equitable solution.

• Even if adjustments could be made to eliminate the duplicative and exorbitant compensation requirements of SB 10, KPL Gas Service could not support the cumbersome procedures dictated by the proposed formula. The bookkeeping burden would be excessive. Every time the acquiring utility replaces a utility pole or builds a new customer extension in the ensuing 35 years, the exact boundaries of various annexations would have to be analyzed. To give a hypothetical example, when a utility line is too old and must be replaced, a company could have to make a series of complex calculations based on a combination of facilities acquired through several annexations. We believe this could become an oppressive procedure that is unwieldy and unnecessary. A more simplified method should be enacted to finalize the sale of utility properties right up front, just as when anyone else buys a home, an office building or a car.

• This concludes the compensation formula section of SB 10. Next is subsection (f) at line 232, where the Corporation Commission again is given new jurisdiction to determine not only the amount of "cash" compensation, but also which facilities should or should not be transferred.

• Subsection (g) at line 237 requires the city that applies for any reassignment of electric territory to pay all fees and expenses of the KCC as well as the previous supplier in connection with the application and its review.

• And finally, subsection (h) beginning at line 241 is a very curious section that emphasizes the one-sided nature of SB 10. It says that even if a city is able to raise the cash up front to pay for another utility to take over an area, if at any time in the future, the succeeding supplier ever stops serving the area, the service rights and facilities revert back automatically to the original supplier, apparently including all improvements made by the subsequent supplier. Then the original supplier has the <u>option</u> of whether to pay anything or not (line 245).

In other words, the city is required to pay large amounts of cash up front and over 35 years, and go through an extensive review process and hearings in order to take over part of a territory. But, the original supplier could get the territory and improved facilities back at some point in the future without any hearings or review, and perhaps without even having to pay anything.

In summary, we urge the committee to reject this extreme and formulate a reasonable conclusion that will provide fair and equitable compensation, similar to the way you handled the rural water district situation last year.

As cities grow in the future and expand into areas served by another utility, a potential problem arises, since future annexation could theoretically cause the rural electric supplier to be left with nearly the same operating costs to be spread over a smaller number of customers.

Since the law provides in some cases that the urban utility can begin providing service to those newly-annexed electric customers, it is important to make sure the price paid for those facilities is fair and reasonable. If the acquisition price is too low, the selling utility's remaining customers

could have to bear an unfair increase in their rates because of the loss of that portion of the utility's customer base. At the same time, if the compensation is set too high, the other customers of the acquiring utility could end up unfairly, with higher rates.

A continued freeze, in any guise, hinders industrial development since prospects would not have the option of choosing the best and most cost effective service when they locate in industrial parks and other areas which are usually near city boundaries. The continued territory freeze that SB 10 would cause would merely build a wall around customers to lock them up forever with no opportunity to get the most reliable and efficient service at the most reasonable cost.

Instead of SB 10 and its one-sided compensation formula, KPL Gas Service believes compensation should be based on a formula providing fair and equal treatment of the customers of both the acquiring and acquired utility, and which would keep the displaced utility "whole". Under such a formula, customers of both the displaced utility and the utility assuming service to the annexed area would neither suffer nor benefit from the change in electric service to the area because of windfall profits for one utility at the expense of higher rates for the other group of customers. Legislation based on SB 677 which this committee developed last year to handle this same situation for rural water districts would provide consistency in the state's law and would accomplish the goal of fairness and equality.

Thank you.