

Approved: February 24, 2004  
Date

*Carl Dean Holmes*

MINUTES OF THE HOUSE COMMITTEE ON UTILITIES.

The meeting was called to order by Chairman Carl D. Holmes at 9:07 a.m. on February 4, 2004 in Room 231-N of the Capitol.

All members were present except: Representative Mary Compton  
Representative Stanley Dreher

Committee staff present: Mary Galligan, Legislative Research  
Dennis Hodgins, Legislative Research  
Mary Torrence, Revisor of Statutes  
Jo Cook, Administrative Assistant

Conferees appearing before the committee: Larry Holloway, Kansas Corporation Commission

Others attending: See Attached List

Chairman Holmes welcomed Larry Holloway, Chief of Energy Operations for the Kansas Corporation Commission, to the committee. Mr. Holloway presented a power point presentation on 'Security Costs for Regulated Electric Utilities - A Regulator's Perspective' (Attachment 1). Mr. Holloway explained why utilities are regulated and how electric utilities' rates are set, as well as information on regulatory incentives. Mr. Holloway responded to questions from the committee.

The meeting adjourned at 10:18 a.m.

The next meeting will be Thursday, February 5, 2004.

# HOUSE UTILITIES COMMITTEE GUEST LIST

DATE: February 4, 2004

NAME	REPRESENTING
MARK SCHREIBER	Westar Energy
Richard Good	Westar Energy
Kon Seiber	Hain Law Firm
TOM DAY	KCC
LARRY HOLLOWAY	KCC
Sandy Braden	Great Plains Energy
Bob Jayroe	SBC
Mike Speck	AT&T
Whitney Damron	Empire District Electric Co.
<del>Amy Campbell</del>	Midwest Energy, Inc.
<del>David Spry</del>	carb
Steve Johnson	Ks. Gas Service
Dave Holtzhaus	KEC

## Security Costs for Regulated Electric Utilities

- A Regulator's Perspective

Presentation to the House Utilities Committee  
February 4, 2004

Larry Holloway, Kansas Corporation Commission

Security Costs for Regulated Electric Utilities

## Why Utilities are Regulated

- Intended to replace the discipline of competition
  - "The visible hand of public regulation is intended to replace the invisible hand of Adam Smith in order to protect consumers against extortionate charges, restrictions of output, deterioration of service, and unfair discrimination."

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Security Costs for Regulated Electric Utilities

## Regulator's Perspective

- Why Utilities are Regulated
- Expectations of Utility Regulation
- Setting the rates of a regulated electric utility
- Regulatory incentives
- Regulatory View of Security Costs

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## Expectations of Utility Regulators

- Generally, as provided by enabling statutes
  - "sufficient and efficient"
  - Reliable, and just and reasonable
    - "not unduly discriminatory"
    - In the end its all about rate design
- The public interest
  - Includes the interest of utilities, customers, economic development, etc.
  - Objective of all "utility regulators"
    - Municipal authorities
    - Cooperative boards

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## What Constitutes a Public Utility?

- Natural Monopoly
  - "An industry where the most efficient operation is through a monopoly"
  - "A single firm can supply a good or service to an entire market at a smaller cost than could two or more firms"
  - Market forces result in the survival of only one firm
    - Capital Intensive
    - Barriers to Entry
    - Economies of Scope and Scale
    - a product without close substitutes
- Provides a critical public service
  - "A high degree of public interest attached to the services rendered"
- Defined by Law

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## Expectations of Utility Regulators (cont)

- Requirements by other policy makers
  - Utilities are affected by more than utility regulators
    - Environmental requirements
    - Safety requirements
      - Both employee and public
    - Zoning requirements
    - Taxation and other social contributions
    - Shareholders or owners
    - Creditors and financial markets
- Utility regulators must recognize costs of utility's other requirements and obligations
  - Part of the broad public interest as defined by other policy makers

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HOUSE UTILITIES

DATE: 2-4-04

ATTACHMENT 1

## Setting the rates of Electric Utilities

- Determine the revenue requirement
  - The amount the utility is entitled to earn for its services
- Determine how the revenue will be collected
  - Rate Design

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## Determining the Revenue Requirement (cont)

- Regulators Perspective on Expenses
  - Were utility expenditures necessary?
    - Were the expenditures needed to address a responsibility of the utility?
  - Were expenditures reasonable?
    - Of all of the possible methods to address its responsibilities was the one selected by the utility among the better (or reasonable) solutions.
  - Were the expenditures prudent?
    - Did the utility efficiently implement its selected method or process.

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## Determining the Revenue Requirement

- Determine annual expenses
  - Review historic costs
    - Pick some test period – generally a “test year”
  - Adjustments
    - Consider forecasts
      - Fuel costs, etc
    - Normalize expenses
      - Weather, customer growth etc.
    - Changes in employees, inventories, taxes, etc.

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## Regulatory Incentives

- Regulatory Lag
- Price Caps
- Performance Based Incentives

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## Determining the Revenue Requirement (cont)

- Treatment of utility investments - Ratebase
  - Recovery of Investment
    - Depreciation
      - Recover over the life of the benefits
      - Generally straight line recovery
  - Recovery on investment
    - Rate of return
      - Cost of debt
      - Cost of equity
      - Capital structure
    - Recovery of income taxes
      - Profits also reflect return on equity

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## Regulatory Lag

- Principles
  - Utility has every incentive to lower costs between ratecases
  - Most effective for electric utilities
  - Utility expected to meet certain obligations, reliability standards and quality of service requirements between ratecases
  - Expectation is that investments stay in utility business
  - Utility or regulator can review rates at any time
- Regulatory lag is a powerful incentive for electric utilities!

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## Regulatory Lag (cont)

- Incentive – electric utilities
  - Electric utilities make large or lumpy investments
    - Depreciation likely decreases ratebase over time until the next large investment
      - A \$1 billion power plant depreciated over 40 years yields a 10% decrease in ratebase over a 4 year period.
        - » This alone decreases revenue requirement by over \$10 million
  - Productivity improvements
    - Utility costs per unit of service go down in real terms over time – like all industries
  - Customer and load growth
    - Over time increased sales may generate increased revenue over decreasing costs

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## Regulatory Lag (cont)

- Rates can be reviewed at any time
  - Utility can come in and request a rate increase when needed
    - Doesn't mean its easy – but raising prices isn't easy in competitive realm either!
  - Regulator can request rate setting at any time
    - Periodic reviews
      - By agreement or regulatory policy
      - Should be done for rate design regardless of revenue requirements!
    - Show cause may be legally difficult and allows extra lag

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## Regulatory Lag (cont)

- Regulatory lag assumes the utility meets its obligations
  - Utility still expected to make necessary expenditures
    - Reliability, safety, quality of service, environmental protection, etc.
  - Works best when utility's obligations are clearly defined
    - Clear standards, regulations and policies

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## Price Caps and PBR

- Price Caps are essentially a rate moratorium but allows discounting
  - Electric utilities often have ability to discount anyway
    - Special contracts
    - Special tariffs
- Performance Based Ratemaking (PBR)
  - Allows automatic rate adjustment
    - Must account for productivity
    - Must have a detailed expectation of service quality and reliability
    - Requires a detailed financial model
    - Requires a detailed economic model for fuel costs, purchase power expenses, etc.

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## Regulatory Lag (cont)

- Utility investments expected to stay in utility business
  - Little ability to grow demand for product
  - Major issue for electric utilities
    - Large investments made infrequently
      - Routine investments insufficient to stop decreasing ratebase
      - Incentive to either buy back shares or decrease ROE
        - » The natural incentive for organizations is to grow
        - » Buying back shares is expensive if business is stable
        - » Paying off debt decreases ROE between ratecases
  - Temptation is to diversify
    - Often promoted by financial community

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## Electric Utility Security Costs

- Public interest perspective
  - Public and employee safety
  - Environmental
  - Economic necessity of service
- Policymaker perspective
  - Decision should be made as to utility's responsibility and responsibility of public security
    - Police, fire departments, military, etc.
- Utility regulators perspective
  - Reliability of utility service
  - Utility requirement
  - Rate treatment
  - Single issue ratemaking

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## Regulatory View of Security Costs

- Are investments and expenses required?
  - Utility obligation
    - New industry standards
    - New regulatory requirements
    - Direction from policy makers
  - - There should be a stated objective and an industry standard for meeting that objective
  - Bottom line – necessary and prudent
    - Utility Regulators need guidance from policy makers and industry – not our area of expertise!

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## Regulatory View of Security Costs (cont)

- Rate design – who pays?
  - Everything to the customer
  - May be of little importance to the utility
  - In theory costs paid by cost causers
    - Costs related to power plants may be demand based
      - The higher the load factor the lower the incremental cost
    - Costs related to customer information systems may be customer based
      - Per customer cost assignment
    - Costs related to fuel procurement may be energy based
      - Could most effect industrial customers

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## Regulatory View of Security Costs (cont)

- Are costs incremental to other utility obligations?
  - Utility investments and expenses may compliment utility regulatory requirements
    - Changes may increase reliability for normal events
    - Should be incorporated into other necessary upgrades
    - Are there offsetting cost savings?
- Do additional costs create a need for a change in utility rates?
  - Concerns regarding one issue ratemaking

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## Regulatory View of Security Costs (cont)

- Conclusions
  - Public policy and industrial standards should clearly define utility's obligation and requirements
    - Utility investors deserve a clear understanding of what is expected of their industry
  - Utility regulators need to focus on making sure utility expenditures are needed and prudent
    - What would a responsible competitive business do to meet the same obligations?
  - Utility costs should be recovered with traditional ratemaking principles
    - Regulators and utilities obligated to make sure requirements are implemented and adequately compensated
    - Utilities don't need an incentive to meet a requirement and an obligation – just assurance that they will be allowed to recover necessary, reasonable and prudent costs

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## Regulatory View of Security Costs (cont)

- One issue ratemaking concerns
  - Would costs cause a competitive industry to raise prices?
    - Remember regulation of a natural monopoly is a substitute for Adam Smith's "invisible hand"
  - Do Costs increase the utility's revenue requirements?
    - Expenditures may offset other costs
    - Utility may be currently over earning
      - Changes in capital structure or capital costs
      - Time since last rate review
  - Who pays?
    - Rate design is everything to the customer
      - Could be off even is revenue requirements are unchanged

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