Approved: March 23, 2004 Carl Dean Holmes
Date

MINUTES OF THE HOUSE COMMITTEE ON UTILITIES.

The meeting was called to order by Chairman Carl D. Holmes at 9:08 a.m. on March 10, 2004 in Room 231-N of the Capitol.

All members were present except: Representative Nile Dillmore

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: Susan Cunningham, Kansas Corporation Commission
John Gaberino, OneOk

Others attending: See Attached List

SB 310 - Public utilities, subsidization of nonregulated affiliates

Chairman Holmes opened the hearing on **SB 310**.

Susan Cunningham, General Counsel for the Kansas Corporation Commission, addressed the committee in support of **SB 310** (Attachment 1). Ms. Cunningham provided testimony written by Don Low, Director of Utilities for the Commission. She told the committee that the Commission had requested the introduction of the bill in order to clarify it's authority to promulgate rules and regulations on certain matters. The Commission is considering rules that would restrict the potentially harmful effects of transactions involving the unregulated activities of a utility company or its affiliates. Ms. Cunningham responded to questions from the committee.

John Gaberino, Senior Vice President and General Counsel for OneOk, Inc., testified in opposition to **SB 310** (Attachment 2). Mr. Gaberino stated that the Commission already has the authority to address transactions between public utilities and their affiliates. He told the committee that action should not be taken in regulating the transactions between a public utility and its affiliate, with the net result possible higher prices to consumers. Mr. Gaberino responded to questions from the committee.

Additionally, Bruce Graham, Kansas Electric Power Cooperatives, and Stuart Lowry, Kansas Electric Cooperatives, responded to questions from the committee.

Chairman Holmes closed the hearing on **SB 310**.

The meeting adjourned at 10:13 a.m.

The next meeting is Thursday, March 11, 2004.

HOUSE UTILITIES COMMITTEE GUEST LIST

DATE: March 10, 2004

NAME	REPRESENTING
Whitney Dawson	KS Gas Service / ONEOK
Bob Alderson	Atmos Energy
Jim Bartling	" "
Dan Holthaus	KEC
Stuart Lowry	KEC
Bruce Graham	KEPCo
Sandy Braden	GPE / KCPL
Jack Glaves	Duke - P-H + KM
Mark Schreiber	Westar Energy
Tom Gleason	Independent Telecom Group
Shirley Allen	SITA
Jeff McClanahan	KCC
Janet Buchanan	KCC
Susan Cunningham	KCC
Tom Day	KCC
Steve Johnson	Kansas Gas Service / ONEOK
Anne Spiess	KTIA
John Pinegar	State Ind. Telephone Assn

Susan Cunningham

BEFORE THE HOUSE COMMITTEE ON UTILITIES
PRESENTATION OF THE
KANSAS CORPORATION COMMISSION ON

SB 310

Don Low – Director of Utilities

Thank you for the opportunity to speak to you today about SB 310. As you may know, the Commission originally requested this bill to clarify its authority to promulgate rules and regulations on certain matters. As a result of the recent experiences with Westar and Aquila, the KCC is considering rules that would restrict the potentially harmful effects of transactions involving the unregulated activities of the utility company or its affiliates. Such proactive rules can be more effective than attempting to monitor and react to individual company activities as they occur. The Commission therefore appreciates the Senate action on this clarification of KCC rule-making authority.

However, we have substantial concerns about the last amendment to the bill made by the Senate Utilities Committee. Unfortunately, that amendment could be used to cast doubt on the Commission's current regulatory authority and, at the very least, lead to unnecessary litigation. The amendment to Section 1(a) of the bill was as follows:

> Section 1. (a) The state corporation commission shall ensure that a public utility, as defined in K.S.A. 66-104, and amendments thereto, does not use regulated operations to subsidize nonregulated activities of such utility or to subsidize activities of an affiliated entity. ~~Except in rate making, revenue requirements, cost of service or similar proceedings, this paragraph and any rules and regulations of the commission adopted pursuant to this paragraph shall not apply to any member or consumer owned public utility or to a telecommunications public utility.~~ Nothing in this act shall affect any authority of the state corporation commission with regard to any member or consumer owned public utility or to a telecommunications public utility.

If this amendment were enacted, the Commission would read it literally as having no effect on Commission authority. However, some might argue that it removes existing Commission authority to prevent cross subsidies of regulated and unregulated activities in a rate case or audit proceeding for telecommunications utilities, as well as cooperatives and municipalities. I will elaborate later on why this amendment could cause confusion. First,

HOUSE UTILITIES
DATE: 3-10-04
ATTACHMENT 1

however, I need to discuss the potential consequences if this amendment were incorrectly construed to take away current KCC authority.

Cost allocations are necessary to determine reasonable service rates and avoid cross subsidies.

One of the primary responsibilities of the KCC is to establish gas, electric, and telecommunications utility rates that are just and reasonable. Historically that has meant that rates are based on the utility's "revenue requirements" or total costs of providing utility services, including a reasonable rate of return on assets. That determination of revenue requirements occurs in a rate case or audit and is unavoidably complex. Among other things, there must be an exclusion or allocation of costs that aren't related to providing regulated services to Kansas ratepayers. Without an accounting for costs related to interstate services, services provided in other states, or services that aren't regulated by the Commission, Kansas customers would pay for costs of services they don't receive. At the same time, if those costs were not excluded, the non-jurisdictional services would receive a subsidy. Although there are frequently disputes on precisely how costs should be appropriately allocated, no one has ever disputed the basic premise that reasonable rates should only reflect the costs of the regulated services. Correspondingly, it has never been suggested that it is appropriate for Kansas ratepayers to subsidize services not regulated by the KCC.

As you know, the KCC is currently engaged in performing cost audits of rural telephone companies, known as Incumbent Local Exchange Carriers or ILECs, with regard to their receipt of support from the Kansas Universal Service Fund. Pursuant to K.S.A. 66-2008(e) and 66-2009, the amount of support to each company is to be based on that company's revenue requirements. Thus, the audits have involved the normal accounting reviews needed to determine the costs of providing regulated services for Kansas customers. In performing those audits, the Commission staff applies the existing FCC accounting rules regarding allocation of costs to interstate and unregulated services. Since many of the telephone companies are engaged in significant unregulated activities such as provision of cable television, internet access and other services, the audits must address appropriate allocation of the associated costs. I should emphasize that while there have been disagreements between Staff and the companies on the appropriate allocation methods, no company has contested the basic need to make such

1-2

allocations. The companies themselves make such allocations to exclude costs associated with unregulated services. The only issues have been whether the company's allocations have sufficiently captured all the associated costs. Attached is a more detailed explanation of how these unregulated cost allocation issues arise with regard to telecommunications companies.

If this amended bill were to result in the elimination of the KCC's authority to address these cost allocation issues, it could have several profound consequences. The KUSF audits are more far-reaching than the traditional rate case audits in that they affect all Kansas customers and not just those of the individual company. Since all Kansas long distance, local and wireless service customers indirectly provide the funds for the KUSF through charges on their bills, increases in the KUSF would mean rate increases for all Kansas telecommunications customers. Thus, even though these audits involve rural telephone companies, customers in all parts of the state would be affected.

After having completed the KUSF audits for about half of the companies, the high cost portion of the KUSF has been reduced by approximately $9 million or roughly 18%. Much of that reduction is associated with differences in the methods for allocation of unregulated costs. However, if no unregulated costs could be excluded from the KUSF at all, it should be evident that the size of the fund would increase very substantially. Contributions to the fund would also have to continue to grow in the future as the companies increased their unregulated activities.

This result, of course, would be inconsistent with the statutory mandates in K.S.A. 66-2008(e) and 2009 for a cost-based fund. The fund is intended only to support the revenue requirements associated with regulated services and not to subsidize other services. The result would also be inconsistent with the notion that the KUSF is intended to be competitively neutral. The costs of the unregulated services offered by the rural companies would not only be recovered from the KUSF, they would be paid in part by companies that are providing competing services. Thus, the following questions are raised by this potential result:

1. Should the KUSF be used to subsidize an ILEC's provision of broadband internet, cable television, wireless and other nonregulated services?
2. If the 38 ILECs that receive KUSF support were to receive funding for their unregulated activities, should other providers of such services also be allowed access to the KUSF, even if they don't provide regulated telecommunications services?

13

3. If such competitors are not allowed access to the KUSF, will the resultant competitive advantages given to ILECs reduce the degree of competition?

4. Are rural consumers better served by dominant ILECs providing KUSF-subsidized various services rather than having a number of competitive providers?

5. Should the KUSF be aimed at ensuring affordability of regulated telecommunications services or protecting ILECs from competition?

I would suggest that if the Legislature wishes to consider making these far reaching changes to the KUSF, this bill is not the appropriate vehicle to do so. Instead, explicit amendments to the statutes dealing with the KUSF should be proposed and the above questions debated.

The Senate Committee Amendment Causes Potential Confusion.

The Senate Committee Amendment is a potential source of confusion because it deleted a straightforward provision and substituted vague language for no apparent reason. The deleted provision is set forth below:

> Except in rate making, revenue requirements, cost of service or similar proceedings, this paragraph and any rules and regulations of the commission adopted pursuant to this paragraph shall not apply to any member or consumer owned public utility or to a telecommunications public utility.

This provision clearly means that the Commission could continue to address cost allocations regarding unregulated activities in rate case and similar proceedings involving revenue requirements but could not otherwise apply potential restrictions to coops and telecommunications activities. This provision was not part of the originally requested Commission bill. However, electric coops had expressed concerns that the bill could prohibit some benign relationships they have with other cooperative associations. Since the coops had no desire to restrict the Commission's ability to prevent cross subsidies in the context of rate proceedings and the Commission staff had previously decided to exempt coops from proposed rules, we agreed on the above language. Subsequently, because we understood that some telephone companies also had concerns, we agreed to add telecommunications utilities to the exemption. As I noted previously, the FCC has existing cost allocation rules that the Commission already applies. Staff was originally considering whether more detailed rules might

1-4

be beneficial for everyone but was willing to accommodate the telecommunications companies if they didn't wish such rules.

Although the above language was therefore added to the bill, it was subsequently deleted in favor of the following language:

> Nothing in this act shall affect any authority of the state corporation commission with regard to any member or consumer owned public utility or to a telecommunications public utility.

This language, standing alone, simply suggests that the bill does not affect the existing authority of the Commission. However, the concurrent deletion of the prior amendment could be argued to imply a restriction on the KCC's ability to address cost allocations in the context of revenue requirement proceedings. The argument could be that the last amendment must have meant something different than the prior amendment and was therefore intended to remove existing Commission authority with regard to cost allocation issues. By also referring to "this act," there may also be an argument that the last amendment removes KCC authority with regard to the "financial impairment" concerns that are addressed in Subsection 1(b) of the bill since the deleted amendment limited the exemptions for cooperatives and telecommunications utilities to the cross-subsidy paragraph. Although the Commission does not agree that such interpretations would be correct, there is simply no reason to invite litigation over this language, regardless of the intent of the amendment. If it was indeed intended to remove existing KCC authority to address cross subsidy issues, it should be explicitly considered in the context of the statutes dealing with the KUSF, as I noted previously. If the intent of the amendment was to somehow clarify the bill, it doesn't do that but instead adds potential confusion.

We therefore request some additional amendments to SB 310, as shown on the attached. In addition to eliminating the potentially confusing last amendment, we believe some additional language changes may be desirable to clarify that the bill only addresses the Commission's rulemaking authority and that cooperatives, municipalities and telecommunications utilities are exempt from such rules. The new language is shown in italics.

Thank you again for the opportunity to testify on this bill.

Revised Language for Senate Bill 310
Proposed by the Kansas Corporation Commission
To Change Senate Committee Amendment and Clarify Bill

Section 1. (a) The state corporation commission shall *have full power and authority to adopt all reasonable and necessary rules and regulations to* ensure that a public utility, as defined in K.S.A. 66-104, and amendments thereto, does not use regulated operations to subsidize nonregulated activities of such utility or to subsidize activities of an affiliated entity. ~~Except in rate making, revenue requirements, cost of service or similar proceedings, this paragraph and a~~Any *such* rules and regulations of the commission adopted pursuant to this paragraph shall not apply to any member or consumer-owned public utility or to a telecommunications public utility. ~~Nothing in this act shall affect any authority of the state corporation commission with regard to any member or consumer owned public utility or to a telecommunications public utility.~~

(b) The commission shall *also have full power and authority to adopt all reasonable and necessary rules and regulations to* ensure that the nonregulated activities of a public utility or affiliated entity do not materially impair the finances or credit of a public utility.

(c) ~~The commission shall have full power and authority to adopt all reasonable and necessary rules and regulations and orders for carrying out this section.~~

~~(d)~~ As used in this section:

(1) "Affiliate" or "affiliated entity" means any person, including an individual, corporation, firm, partnership, limited liability partnership, limited liability company, corporation or firm, corporate entity or subsidiary, or nonutility business unit which is not a public utility and which directly or indirectly, through one or more intermediaries, is controlled by or is under common control with a public utility.

(2) "Control", including the terms "controlled by" and "common control", means the direct or indirect possession of the power to direct or the ability to cause the direction of the management or policies of an entity. Control may exist whether the power to direct or ability to cause the direction is exercised alone, through one or more intermediary entities or in conjunction with or pursuant to an agreement with one or more other entities. Control may be exercised through a majority or minority ownership or voting of securities, common directors, officers or stockholders, voting trusts, holding trusts, affiliated entities, contract or any other direct or indirect means. The beneficial ownership of 10% or more of voting securities or partnership interest of an entity constitutes control for purposes of this article.

(3) "Nonregulated activity" means all business activities, whether performed by the public utility or an affiliate, not involving the utility business for which the public utility is certificated.

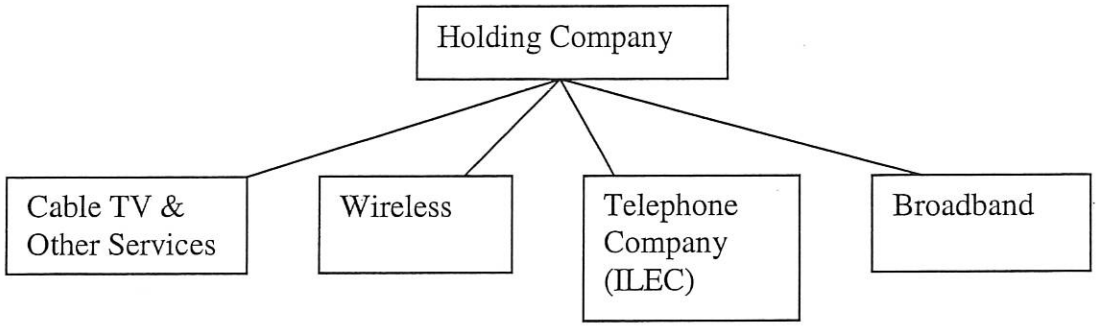
(4) "Nonutility business unit" means any division, business unit, employee or group of employees of a public utility conducting a nonregulated activity.

Sect. 2. This act shall take effect and be in force from and after its publication in the statute book.

1-10

TELECOMMUNICATIONS AFFILIATE COST ISSUES

Although telecommunications companies are organized in various ways, below is an illustrative example of a company legal structure where an overall holding company has several subsidiaries that provide various services:



In this example there are separate affiliates for the various services. However many of the costs associated with providing the services are not kept separate. Thus, for example, a single office building, owned by the holding company, may house both regulated and unregulated operations. Also, telephone company technicians may also work on cable TV maintenance and repair and use telephone company trucks and other equipment to do so. Other costs that may be common to the various affiliates would include those associated with billing, customer service, advertising, accounting, human resources, legal, executive management and general management. There is no requirement to keep these kinds of costs separate and in many cases it is not cost efficient to do so. However, to ensure no cross subsidization, there must be an allocation of the costs between the regulated and unregulated activities. Thus, for example, if a building houses employees for more than one affiliate, the telephone company should be allocated only those costs associated with its portion of occupied space. Because circumstances vary greatly, there is no specific allocation method that can be applied in every case but the FCC rules set out principles for making reasonable allocations.

ONEOK

A DIVERSIFIED ENERGY COMPANY

Before the House Utilities Committee
Testimony of John Gaberino
Senior Vice President and General Counsel
ONEOK, Inc.
SB 310
March 10, 2004

- The Kansas Corporation Commission already has authority to address transactions between public utilities and their affiliates and additional legislation is not necessary.

- The legislature and the Kansas Corporation Commission should not take any action in the regulation of transactions between a public utility and its affiliate, which would make such transactions financially impractical through asymmetrical pricing. The net result of such regulation will be higher prices to consumers.

- The proposed bill extends the KCC's authority over unregulated affiliates of public utilities far beyond the purpose of the Public Utility Act.

- The proposed legislation will give the KCC the authority to issue rules that will require pre-approval for an unregulated affiliate to enter into any transaction with an unrelated third party. Such legislation will unnecessarily prevent non-regulated affiliates from entering into appropriate business activities.

- Public utility consumers benefit through the growth of non-regulated affiliates by spreading overhead costs such as human resources and information technology over a larger base, thereby reducing costs to public utility consumers.

- The KCC already has the statutory authority to ensure that consumers are not harmed by any financial distress that a public utility may endure and the proposed legislation is not necessary.

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HOUSE UTILITIES
DATE: 3-10-04
ATTACHMENT 2

ONEOK

A DIVERSIFIED ENERGY COMPANY

Before the House Utilities Committee
Testimony of John Gaberino
Senior Vice President and General Counsel
ONEOK, Inc.
SB 310
March 10, 2004

Chairman Holmes and Members of the Committee,

Thank you for the opportunity to address your committee today in opposition to SB 310, a bill which addresses the jurisdiction of the Kansas Corporation Commission over two items: the first item in the bill addresses transactions between public utilities operating in Kansas and their non-regulated affiliates. The second item in the bill addresses transactions entered into by non-regulated affiliates that are not necessarily related to any matters within the state of Kansas.

Before I begin, I would like to provide a brief background regarding ONEOK. My name is John Gaberino and I am Senior Vice-President and General Counsel of ONEOK, Inc. I know you are familiar with Steve Johnson who regularly appears before the Committee on our behalf. I am here rather than Steve because although the bill I am testifying on today does affect our operations in Kansas, it more importantly, affects ONEOK's business operations throughout the country.

I know that you are familiar with Kansas Gas Service as the local natural gas distribution utility in Kansas. We have approximately 640,000 customers in Kansas. ONEOK also has approximately 800,000 natural gas distribution customers in Oklahoma, and 540,000 natural gas distribution customers in Texas. We are also engaged in natural gas production, gathering, liquids extraction, transmission, storage, power generation, and natural gas marketing activities.

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2-2

ONEOK had total annual revenue of approximately $3 billion last year. Our natural gas distribution revenues in Kansas totaled approximately $700 million last year. Through our marketing subsidiary, ONEOK Energy Marketing & Trading, we provide natural gas service to customers throughout the United States and Canada, with last year's net revenue being approximately $235 million. ONEOK Inc. is a Fortune 500 company with approximately 4,300 employees company wide and 1,150 employees in Kansas. We have investment grade credit rating with both Moody's and Standard & Poors. We entered the utility business in Kansas when we acquired Western Resources' natural gas distribution business in 1997. When we announced that acquisition in 1996, ONEOK had a market capitalization of approximately $700 million. Today, ONEOK has a market capitalization in excess of $2.3 billion dollars. You will find that ONEOK is a financially secure company, which has been able to achieve growth and profitability in the energy industry without excessive risk and without investments in industries over which we have little expertise.

With regard to the first item contained in the bill, we believe that the Kansas Corporation Commission does have jurisdiction over transactions between public utilities operating in Kansas and their non-regulated affiliates. Our concern is that we want to ensure that the Commission does not take any action which will necessarily preclude our utility in Kansas, Kansas Gas Service, from selecting the lowest price opportunity from our non-regulated affiliate, to the significant detriment of our customers. With regard to the second item, we believe that the Kansas Corporation Commission is attempting to extend its jurisdiction far beyond anything this legislature could have intended the Commission to engage in.

The intent of the first part of the bill is to ensure that public utilities do not utilize regulated operations to subsidize non-regulated activities of affiliates of the public utility. That

2-3

is a general principal with which ONEOK agrees and a principal which we believe that the Commission already has the authority to address. The Commission has already issued rules governing the relationship between natural gas utilities and their marketing affiliates to ensure that the utilities do not provide an unfair advantage to the marketing affiliate over nonaffiliated marketing entities. Such rules were issued pursuant to existing statutes. Such statutes would authorize the Commission to promulgate additional rules, which would address the concern with cross-subsidization. If the Commission believes that it needs additional authority to issue such rules, we would not be opposed to the legislature giving it the limited authority that I shall now describe.

Kansas Gas Service does not oppose the Commission's goal of precluding public utilities from subsidizing non-regulated affiliates. We further recognize that there is justification for extra scrutiny by the Commission over transactions between a public utility and its non-regulated affiliate. We believe that one of the best ways to do that is through an open competitive bidding process. To the extent that an affiliate provides the lowest bid in an open process, that bid should be accepted and the affiliate should receive its benefit. To the extent that an affiliate provides service through any other process, that service should be subject to extra scrutiny and the burden should be on the utility to justify the selection. Attached to my testimony is the proposed amendment to the bill.

With regard to the second portion of the bill, it is our belief that the bill will give the KCC jurisdiction over matters far beyond what it should have. The bill provides that the KCC will have jurisdiction to issue rules to ensure that non-regulated affiliates will not engage in activities that materially impair the finances or credit of a public utility. While such legislation appears to be well intentioned in light of recent experiences, the practical consequences of such

2-4

legislation may very well be devastating to well run companies, such as ONEOK, as well as their customers and employees. The financial concerns which the bill attempts to address do not require that this legislation be enacted and the rules which are contemplated therein. The Commission has demonstrated that it has the authority to step in and address the financial concerns of utilities and their potential impact on customers.

I would like to give you an example of the concerns that we have with the bill. Under this legislation, the KCC may take jurisdiction over transactions far afield from utility regulation and far afield from the state of Kansas. Under this bill and ensuing rules the KCC could have jurisdiction to regulate a transaction involving the purchase of a liquids extraction facility in Texas by a non-regulated affiliate. Under this bill and ensuing rules, the Commission could require review and pre-approval of a contract entered into by our marketing affiliate to buy 10,000 MMBtus per day from a Chevron well in New Mexico, which is then sold to a smelter in Utah, which I'm sure you will agree would have a distinct chilling affect on our business enterprise.

ONEOK's business model is in part based on growth. We are one of the largest natural gas distribution utilities in the United States. The natural gas distribution business is a cornerstone of our business and we are in the mode of further acquisitions, not selling. We also actively engage in buying and selling energy assets and entering into energy transactions through our marketing affiliate. The legislation being considered will significantly impede all of these goals.

We understand the Commission's desire to ensure the financial stability of utilities operating in the state of Kansas. A high credit rating is also very important to our business model. However, the financial concern of the KCC should be with financially distressed

2-5

utilities. The KCC has the statutory authority to address the impact of a financially distressed utility as it has previously demonstrated. The financial distress of a utility is a matter, which will be well known before a calamity may befall it, as utilities continually have their credit ratings reviewed by ratings agencies.

I am aware that the argument is made that it may be too late to review the financial condition of a utility as past investments may catch up to the company later on. While all investments do involve some level of risk, such after the fact risk assessment reflects an investment view that all risks must be avoided. That is a view that can have costly ramifications for customers and the state of Kansas. As a result of our investments in assets outside of the state of Kansas, we have been able to spread corporate overhead costs, such as human resources, information technology, financing costs, over a much larger base of operations, which has reduced costs to Kansas customers. By having a diverse set of assets, the risk of our business does not necessarily go up, but in fact may go down, as a profitable segment of the business may offset the temporary downturn of another business unit. This diversity of risk between regulated and non-regulated also compares favorably to the utility-only business model.

ONEOK agrees that the Commission has a right and a duty, and currently has the existing authority, to address the concerns of financially distressed utilities. If the Commission believes that it needs additional authority, this bill is going in the wrong direction. If a bill is needed at all, it should focus on financially distressed utilities. Attached to my testimony is another amendment to the bill, which would give the Commission the authority to issue rules governing financially distressed utilities without impeding the progress of financially secure utilities.

Thank you for this opportunity, and I am available for questions at this time.

24

Senate Bill 310 Amendments to existing draft of Bill

First Amendment: add the following to the end of paragraph (a)

The price paid by a public utility for products or services from a non-regulated affiliate shall be deemed reasonable and recoverable through rates charged to customers to the extent such price is pursuant to a competitive public bidding process. Any other transaction between a public utility and a non-regulated affiliate shall be lawful but the burden shall be on the public utility to demonstrate that the price paid for the product or service is reasonable and therefore recoverable through rates charged to customers.

Second Amendment: Paragraph (c) shall be deleted in its entirety and rewritten as follows:

(c) The commission shall have authority to adopt rules and regulations and make orders for carrying out this section provided however any such rules and regulations of the commission adopted for purposes of paragraph (b) shall not apply to any public utility which has any debt security which is rated investment grade by a debt rating agency such as Moody's, Standard & Poors, Fitch Incorporated, or a comparable debt rating agency.

2-1