

MINUTES OF THE SENATE UTILITIES COMMITTEE

The meeting was called to order by Chairman Jay Emler at 9:30 A.M. on March 6, 2008 in Room 526-S of the Capitol.

Committee members absent:

Committee staff present: Raney Gilliland, Kansas Legislative Research Department
Cindy Lash, Kansas Legislative Research Department
Mike Corrigan, Revisor of Statutes
Ann McMorris, Committee Secretary

Conferees appearing before the committee:

Lyle Peterson, Department of Commerce
Don Low, Kansas Corporation Commission

Others in attendance: See attached list

Report on Existing BioFuel Incentives in Kansas

Lyle Peterson, Agriculture Marketing Division, Kansas Department of Commerce, reported on the review of biofuel incentives by various state agencies. The report focuses on incentives for Biomass-to-Energy Plants, Coal or Coke Gasification Nitrogen Fertilizer Plans and Renewable Electric Cogeneration Facilities.

Mr. Peterson explained the incentives in each of the following programs:

1. Ethyl Alcohol Production Incentive (KDOR)
2. Biodiesel Fuel Producer Incentive (KDOR)
3. Alternative Fuel Tax Credit (KDOR)
4. Storage and Blending Equipment Tax Credit (KDOC)
5. Renewable Electric Cogeneration Facility Tax Credit (KDOC)
6. Biomass-To-Energy Plant Tax Credit (KDOC)
7. Kansas Retail Dealers Incentive Fund (KDOR)
8. Waste Heat Utilization System (KDOR)
9. Coal or Coke Gasification Nitrogen Fertilizer Plant (KDOC)
10. Marketing of the Alternative Energy Incentives to Kansas Taxpayers

A fact sheet on Kansas Alternative Energy Incentives and a brief written explanation of each of the above programs was distributed to the committee. (Attachment 1)

Committee questioned how each program is funded, when funds were distributed, and the source of funds. Senator Taddiken asked - How many gallons of gas are sold in Kansas in a year? How much is a blended product? Mr. Peterson will get that information.

Continued the hearing on

HB 2632 - Energy efficiency, conservation and demand management programs at the Kansas corporation commission.

Opponent

Don Low, Kansas Corporation Commission, noted KCC opposes **HB 2632** because it is both premature to decide what incentives for energy efficiency programs are appropriate and imprudent to mandate any one incentive by statute. The Commission is devoting considerable effort to evaluating all options before reaching final decisions that will affect both utilities and rate payers. He cited the report released by the National Action Plan for Energy Efficiency (NAP) which explores various ways to provide for cost recovery of EE programs, to provide financial incentives for implementation of such programs and to address the lost margins that result when such programs lower energy consumption. (Attachment 2)

Chair closed the hearing on **HB 2632**.

CONTINUATION SHEET

MINUTES OF THE Senate Utilities Committee at 9:30 A.M. on March 6, 2008 in Room 526-S of the Capitol.

Approval of Minutes

Moved by Senator Reitz, seconded by Senator Taddiken, to approve the minutes of the meetings of the Senate Utilities Committee held on February 6, 2008 and March 4, 2008. Motion carried.

Adjournment.

Respectfully submitted,

Ann McMorris, Secretary

Attachments - 2

SENATE UTILITIES COMMITTEE GUEST LIST

DATE: MARCH 6, 2008

Name	Representing
Maril Hazlett	CEP
Paul Snider	KCPD
Don Low	KLL
Dane Hark	KFC
Larry Bess	MIDWEST ENERGY
Pat Mays	Freeman Smith, Assoc.
Mark Schreiber	Westar
Wes Ashton	Aquila
Karl Wenz	Kearney & Ass.
Whitman Damm	FS Gas Service
Becki Rhoades	KS Dept. of Commerce
Carole Jordan	KDOC
Bob Jones	KDOC
Adam Hoffman	Smalley H&H
Bill Smalley	Smalley HVAC

**Report on Existing BioFuel Incentives in Kansas
To
Senate Utilities Committee**

**By Lyle E. Peterson
Agriculture Marketing Division
Kansas Department of Commerce**

March 6, 2008

Good morning, Chairman Emler and members of the committee. I am Lyle Peterson of the Agriculture Marketing Division, Kansas Department of Commerce.

Since 2001, the Kansas Legislature has passed various incentives to promote the state's production and use of biofuels. These incentives join a number of federal incentives for renewable energy and are designed to encourage building and investment in those industries for the benefit of the state of Kansas.

The Kansas Energy Council has asked state agencies that administer biofuel incentives to review those incentives and report to the legislature on their effectiveness, as well as potential problems or inefficiencies as they are recognized. This essential information on the effectiveness of these incentives will allow decisions to be made when program improvements are needed.

This report focuses on incentives for Biomass-to-Energy Plants, Coal or Coke Gasification Nitrogen Fertilizer Plants and Renewable Electric Cogeneration Facilities. We also will discuss the Storage and Blending Equipment Tax Credit programs administered by the Department of Commerce and the Ethyl Alcohol Production Incentive, Biodiesel Fuel Producer Incentive, Alternative-Fuel Fueling Station Tax Credit, Kansas Retail Dealers Incentive Fund, and Waste Heat Utilization System Tax Credit and Deduction programs administered by the Department of Revenue. These agencies have established rules and regulations for each program, and implemented the programs.

*Senate Utilities Committee
March 6, 2008
Attachment 1 -1*

Ethyl Alcohol Production Incentive (KDOR)

Since 1988, when this program began, there have been 1,231,887,263 gallons reportedly produced and 739,854,771 gallons were paid on, for a total distribution of \$59,197,135.11 in incentives to producers.

In fiscal year 2007, 205,202,723 gallons were reported produced and 66,756,991 gallons were paid on, for a total distribution of \$4,597,935.75. Even though there were 11 producers during fiscal year 2007, due to the seven-year limit in participation, there were only 5 eligible producers participating in the program. Each producer is eligible for payment of 15,000,000 gallons per year.

In fiscal year 2006, reported production was 142,776,486 gallons. Of these, 51,890,954 were paid on in the amount of \$3,891,821.56. In that year, existing ethyl alcohol plants were issued permits for a capacity of 244,000,000 gallons of production. Eight producers were eligible at the start of 2006 and only six at the end of the year.

In March of 2008, 12 ethyl alcohol plants are in production and have been issued permits that allow for 501,000,000 gallons of production, according the Department of Health and Environment. There is a current balance of \$960,231.34 in the payment fund.

Our departments are unaware of any apparent problems associated with administration of the Ethyl Alcohol Production Incentive. There does seem to be a level of discomfort by some producers about the proration of the funds and how it affects some more than others based on when they meet their 15 million gallon per year production level.

Biodiesel Fuel Producer Incentive (KDOR)

Since this program began in 2007, there have been 100,808 reported gallons of biodiesel produced. The total gallons paid on were 98,615, for a total distribution of \$29,584.50 in incentives to producers. Only three small producers currently participate in the program. Another large producer (60,000,000 gallons per year) that will be coming into the program is scheduled to go on line in late 2008 and would be expected to begin reporting gallons in the first quarter of 2009.

There is a current balance of \$370,415.50 in the Biodiesel Fuel Producer Incentive payment fund.

Alternative Fuel Tax Credit (KDOR)

Kansas also allows tax credits for operators of alternative fueling stations, and for individuals who purchase flexible fuel vehicles (FFVs). To date, there have been 159 filers beginning in tax year 2003 thru tax year-to-date 2006 with total tax credits of \$421,310 allowed. These numbers include taxpayers making expenditures for qualified alternative fuel fueling stations, as well as expenditures for a qualified alternative fuel motor vehicle. There were fewer than five filers making expenditures for alternative fuel fueling stations for tax years 2003-2006, with the remaining expenditures being for alternative fuel motor vehicles. The Department of Revenue promotes this program through its program to educate the state's CPAs and tax preparers. This program has also been publicized through the Kansas Automobile Dealers Association. The Department of Revenue reports no problems or inefficiencies associated with this program.

Storage and Blending Equipment Tax Credit (KDOC)

A sales and marketing plan for this program is being developed in Commerce at this time. With the proper marketing of this program, we expect the participation in this program to grow, which will lead to the increased availability of alternative fuels on the wholesale level. This will play a key role in the success of the Kansas Retail Dealers Incentive Fund, which begins in 2009. More detailed information will be available on this program at the beginning of the 2009 legislative session.

Renewable Electric Cogeneration Facility Tax Credit (KDOC)

To date, there has been no activity in the program. The success of this program will also depend on sales and marketing of the program to persons involved in industrial, commercial or agricultural processes, which is why a plan is being devised at this time. Many questions have been fielded regarding this program and we would expect to have numbers to report on this program at the beginning of the 2009 legislative session.

Biomass-To-Energy Plant Tax Credit (KDOC)

Abengoa Bioenergy currently has plans under development to build a plant in Hugoton that will be capable of producing 13,000,000 gallons per year of ethyl alcohol from biomass. Current projections are for operation in late 2010.

Kansas Retail Dealers Incentive Fund (KDOR)

This fund will reward retail dealers of motor fuels for providing renewable fuels as an option to their customers. For a gasoline-blended product, the threshold for 2009 is 10 percent of any quarter ending with 25% in 2025. The incentive level on gasoline-blended product is \$0.065 per gallon. For a diesel-blended product, the threshold for 2009 is two percent of any quarter ending with 25% in 2025. The incentive level on diesel-blended product is \$0.03 per gallon. This program does not go into effect until January 1, 2009.

Waste Heat Utilization System (KDOR)

There has been no activity, to date, in this program.

Coal or Coke Gasification Nitrogen Fertilizer Plant (KDOC)

There has been no activity, to date, in this program due to severe flooding that occurred in Southeast Kansas this past year. We plan on meeting with the management from Coffeyville Resources to market this program to them. We anticipate having something to report on this program at the beginning of the 2009 legislative session.

Marketing of the Alternative Energy Incentives to Kansas Taxpayers

Each program that has been provided by the Kansas legislature has a different target audience. An analysis has been made of who the key players are in each area that can help to market these programs. Those individuals or groups have been contacted in an effort to educate the public about the programs. Many times this has been accomplished by one-on-one meetings. The goal is to increase participation in these programs, which will result in increased utilization of renewable energy resources.

State and Federal Biofuel Incentives

	<u>State</u>	<u>Federal</u>
Ethyl Alcohol Incentive	\$0.075	
Small Producer Tax Credit		\$0.10
Volumetric Ethanol Excise Tax Credit		<u>\$0.51</u>
Total	\$0.75	\$0.61
Biodiesel Fuel Incentive	\$0.30	
Small Agri-Biodiesel Producer Tax Credit		\$0.10
Blenders Biodiesel Tax Credit		
Agri-Biodiesel		\$1.00
Biodiesel		<u>\$0.50</u>
Total	\$0.30	\$0.60-\$1.10

Flex Fuel Vehicles - Kansas and Surrounding States

Numbers provided by Alliance of Automobile Manufacturers

Kansas	48,519
Nebraska	36,859
Iowa	58,049
Missouri	107,888
Oklahoma	55,549
Colorado	63,725

Tax Credit and Income Deduction

	<u>Credit</u>		<u>Deduction</u>
	<u>Percent</u>	<u>Investment</u>	
Biomass-to-Energy Plant	10	≤\$250,000,000	55% Year One
	5	>\$250,000,000	5% Year Two-Nine
Renewable Electric Cogeneration	10	≤\$ 50,000,000	55% Year One
	5	>\$ 50,000,000	5% Year Two-Nine
Storage and Blending Equipment	10	≤\$ 10,000,000	55% Year One
	5	>\$ 10,000,000	5% Year Two-Nine

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Ethyl Alcohol Production Incentive

- \$0.075 for each gallon sold by the producer.
- Producers who are in production prior to July 1, 2001 and who increase production capacity on or after July 1, 2001 by an amount of 5 million gallons qualify for the incentive for a maximum of 15 million gallons sold per year.
- Producers who commenced production on or after July 1, 2001 and who sold at least 5 million gallons qualify for the incentive for a maximum of 15 million gallons sold per year.
- \$875,000 per quarter is added to the fund for distribution. If production exceeds the fund balance, a proration of the distribution is performed.
- Program sunsets July 1, 2011.
- Reference Kansas Statutes 79-34,160-164

Lyle Peterson, (785) 296-6080, lpeterson@kansascommerce.com

Biodiesel Fuel Producer Incentive

- \$0.30 for each gallon sold by the producer.
- Kansas qualified biodiesel fuel producers may file for the incentive beginning July 1, 2007.
- A one-time payment of \$400,000 will be added to the fund for distribution through June 30, 2008.
- \$875,000 per quarter beginning July 1, 2008 is added to the fund for distribution. If production exceeds the fund balance, a proration of the distribution is performed.
- Program sunsets July 1, 2016.
- Reference Kansas Statutes 79-34, 155-159

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Biomass-to-Energy Plant Tax Credit

- An income tax credit, beginning with the 2006 tax year, for expenditures in new construction or expansion of the capacity in an existing plant.
- The credit is 10 percent of the taxpayer's qualified investment on the first \$250 million invested, and 5 percent of the taxpayer's qualified investment that exceeds \$250 million.
- Credit shall be taken in 10 equal annual installments.
- Before making a qualified investment, a taxpayer shall apply to the Secretary of Commerce to enter into an agreement for a tax credit.
- In addition to the income tax credit, a taxpayer shall be entitled to a deduction from Kansas adjusted gross income of the amortizable costs of a new facility. Such deduction shall be equal to 55 percent of the amortizable costs of the facility for the first taxable year, and 5 percent for the next nine taxable years. The provisions of this section shall apply to all taxable years commencing after December 31, 2006 and is administered by the Secretary of Revenue.
- Reference Kansas Statutes 79-32, 233-237

Lyle Peterson, (785) 296-6080, lpeterson@kansascommerce.com

Agriculture Value Added Loan

- Loans for feasibility studies, business plans or equity drives are typically funded at the 50 percent level.
- Loans for feasibility studies are forgivable if the project does not move forward. Equity drive loans are typically paid back within 120 days of successful conclusion of the equity drive.
- Other loans are interest-free for two years and 1 percent over prime for the balance of the loan.

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Enterprise Zone Incentives

- Investment tax credit of \$1,000 for each qualified business facility investment starting at \$51,000 or more.
- Jobs tax credit of \$1,500-\$2,500 with a minimum of two jobs created.
- Exemption from state and local sales tax on all tangible personal property or services purchased for the construction, enlarging or remodeling of a business. The sale and installation of machinery and equipment purchased for the installation at the business shall also be exempt from sales tax.
- Credits can be carried forward until used.

Darla Price, (785) 296-1868, dprice@kansascommerce.com

High Performance Incentive Program (HPIP)

- HPIP provides an investment tax credit to companies that pay above-average wages and have a strong commitment to skills development for their workers.
- Employer must invest 2 percent of payroll in training or participate in one of Commerce's workforce training programs.
- A capital investment tax credit equal to 10 percent of eligible investment that exceeds \$50,000.
- A project description must be submitted prior to any commitment of investment.
- Credits can be carried forward 10 years.
- A company can elect to take the High Performance Investment Credits or the Enterprise Zone Investment Tax Credits, but not both.

David Bybee, (785) 296-7174, dbybee@kansascommerce.com

CDBG – Economic Development Loans

- The maximum amount of funding is \$35,000 per created job up to \$750,000.
- At least 51 percent of the jobs must meet HUD's low-and-moderate income (LMI) test for the county in which the project is located.
- The local unit of government must apply for infrastructure funding on behalf of a private for-profit biofuel entity. Funds may be used for water, sewer, road or a rail spur.
- This program requires that half the funds be paid back over a 10-year period at a 2 percent rate. This payment stream is accomplished through a special assessment placed on the property.

Terry Marlin, (785) 296-4703, tmarlin@kansascommerce.com

Renewable Electric Cogeneration Facility Tax Credit

- “Renewable Electric Cogeneration Facility is a facility owned and operated by the owner of an industrial, commercial or agricultural process to generate electricity for use in such process to displace current or provide for future electricity use.
- Income tax credit equal to 10 percent of taxpayer’s qualified investment for the first \$50 million and an amount equal to 5 percent of the amount that exceeds \$50 million. Program is for taxable years commencing after December 31, 2006 and before January 1, 2012.
- Credit shall be taken in 10 equal annual installments.
- Before making a qualified investment, a taxpayer shall apply to the Secretary of Commerce to enter into an agreement for a tax credit.
- In addition to the income tax credit, a taxpayer shall be entitled to a deduction from Kansas adjusted gross income of the amortizable costs of a new facility. Such deduction shall be equal to 55 percent of the amortizable costs of the facility for the first taxable year, and 5 percent for the next nine taxable years. The provisions of this section shall apply to all taxable years commencing after December 31, 2006 and is administered by the Secretary of Revenue.
- Reference Kansas Statutes 79-32,245-249
Lyle Peterson, (785) 296-6080, lpeterson@kansascommerce.com
- New Renewable Electric Cogeneration Facility; The Kansas Development Finance Authority is authorized to issue revenue bonds in amounts sufficient to finance the construction costs of such facility.
- Reference Kansas Statute 74-8949c
Rebecca Floyd, (785) 357-4445 Ext. 303, rfloyd@kdfa.org

Alternative-Fuel Fueling Station Tax Credit

- Expenditures for qualified alternative-fuel fueling stations shall be allowed a credit against the income tax imposed against the owner of such facility.
- For any qualified alternative-fuel fueling station placed in service on or after January 1, 1996 and before January 1, 2005, an amount equal to 50 percent of the total amount expended but not to exceed \$200,000 for each fueling station.
- For any qualified alternative-fuel fueling station placed in service on or after January 1, 2005 and before January 1, 2009, an amount equal to 40 percent of the total amount expended but not to exceed \$160,000 for each fueling station.
- For any qualified alternative-fuel fueling station placed in service on or after January 1, 2009, an amount equal to 40 percent of the total amount expended but not to exceed \$100,000 for each fueling station.
- This fund is administered by the Kansas Department of Revenue.
- Reference Kansas Statute 79-32,201
Kathleen Smith, (785) 296-3070, kathleen_smith@kdor.state.ks.us

Storage and Blending Equipment Tax Credit

- “Storage and Blending Equipment” means any equipment which is used for storing and blending petroleum-based fuel and biodiesel, ethanol or other biofuel and is installed at a fuel terminal, refinery or biofuel production plant. This does not include equipment used only for denaturing ethyl alcohol.
- Income tax credit equal to 10 percent of the taxpayer’s qualified investment for the first \$10 million invested and an amount equal to 5 percent of the amount that exceeds \$10 million. Program is for taxable years commencing after December 31, 2006 and before January 1, 2012.
- Credit shall be taken in 10 equal annual installments.
- Before making a qualified investment, a taxpayer shall apply to the Secretary of Commerce to enter into an agreement for a tax credit.
- In addition to the income tax credit, a taxpayer shall be entitled to a deduction from Kansas adjusted gross income of the amortizable costs of a new facility. Such deduction shall be equal to 55 percent of the amortizable costs of the facility for the first taxable year, and 5 percent for the next nine taxable years. The provisions of this section shall apply to all taxable years commencing after December 31, 2006 and is administered by the Secretary of Revenue.
- Storage and Blending Equipment is exempt from all property taxes levied for the 10 taxable years immediately following installation.
- Reference Kansas Statutes 79-32,251-255 and 79-232
Lyle Peterson, (785) 296-6080, lpeterson@kansascommerce.com

Kansas Retail Dealers Incentive Fund

- Kansas Retail Dealers Incentive Fund was created for the payment of incentives to Kansas retail dealers who sell and dispense renewable fuels or biodiesel through a motor fuel pump.
- On January 1, 2009, and quarterly thereafter, \$400,000 will be directed from the general fund into the Kansas Retail Dealers Incentive Fund. On or after July 1, 2009 the unobligated balance in the fund shall not exceed \$1.5 million.
- The retail dealer’s renewable fuels threshold percentage must be 10 percent for any quarter in the calendar year 2009, and increase 1 percent per year to a total of 25 percent by the end of calendar year 2024. For any determination period in which the retail dealer attains the threshold percentage, the incentive rate is 6.5 cents per gallon.
- The retail dealer’s biodiesel threshold percentage must be 2 percent for any quarter in the calendar year 2009, and increase 2 percent per year to a total of 25 percent by the end of calendar year 2024. For any determination period in which the retail dealer attains the threshold percentage, the incentive rate is 3 cents per gallon.
- The provisions of the Kansas Retail Dealers Incentive Fund shall expire on January 1, 2026.
- Reference Kansas Statutes 79-32,170-176
Edie Martin, (785) 296-5327, edie_martin@kdor.state.ks.us

Waste Heat Utilization System

- “Waste Heat Utilization System” means facilities and equipment for the recovery of waste heat generated in the process of generating electricity and the use of such heat to generate additional electricity or to produce fuels from renewable energy resources or technologies.
- “Waste Heat Utilization Property” shall be exempt from all property taxes levied under the laws of the state of Kansas for 10 taxable years immediately following the taxable year in which construction or installation is complete.
- In addition to the property tax credit, a taxpayer shall be entitled to a deduction from Kansas adjusted gross income of the amortizable costs of a new facility. Such deduction shall be equal to 55 percent of the amortizable costs of the facility for the first taxable year, and 5 percent for the next nine taxable years. The provisions of this section shall apply to all taxable years commencing after December 31, 2006 and is administered by the Secretary of Revenue.
- Reference Kansas Statute 79-32,250
Kathleen Smith, (785) 296-3070, kathleen_smith@kdor.state.ks.us
- Waste Heat Utilization System; The Kansas Development Finance Authority is authorized to issue revenue bonds in amounts sufficient to finance the construction, purchase and installation of such a system at an electric generation facility.
- Reference Kansas Statute 74-8949d
Rebecca Floyd, (785) 357-4445 Ext. 303, rfloyd@kdfa.org

Coal or Coke Gasification Nitrogen Fertilizer Plant

- For the placement into service of a new integrated coal or coke gasification nitrogen fertilizer plant or the expansion of an existing integrated coal or coke gasification nitrogen fertilizer plant.
- Income tax credit equal to 10 percent of the taxpayer’s qualified investment for the first \$250,000 invested and an amount equal to 5 percent of the amount that exceeds \$250,000. Program is for taxable years commencing after December 31, 2005 and before January 1, 2011.
- Credit shall be taken in 10 equal annual installments.
- Before making a qualified investment, a taxpayer shall apply to the Secretary of Commerce to enter into an agreement for a tax credit.
- Reference Kansas Statutes 79-32,228-232
Lyle Peterson, (785) 296-6080, lpeterson@kansascommerce.com

Coal Gasification Power Plant

- For the placement of a new integrated coal gasification power plant into service or the expansion of an existing integrated coal gasification power plant.
- Income tax credit equal to 10 percent of the taxpayer’s qualified investment for the first \$250,000 invested and an amount equal to 5 percent of the amount that exceeds \$250,000. Program is for taxable years commencing after December 31, 2005 and before January 1, 2011.
- Credit shall be taken in 10 equal annual installments.
- Before making a qualified investment, a taxpayer shall apply to the Kansas Corporation Commission to enter into an agreement for a tax credit.
- Reference Kansas Statutes 79-32,238-241
Larry Holloway, (785) 271-3222, l.holloway@kcc.ks.gov

Workforce Training Funds

- The Kansas Industrial Training program is designed to help new and expanding companies offset the costs of training workers for new jobs.
- Training funds can be used to reimburse negotiated costs for pre-employment, on-the-job and/or classroom training.
- The average reimbursement level for Kansas Industrial Training is \$300-\$500 per position.
Cary Catchpole, (785) 296-8097, ccatchpole@kansascommerce.com

July 2007

Before the Senate Utilities Committee
March 5, 2008

Summary of Testimony of
Don Low
Kansas Corporation Commission
Regarding HB 2632

HB 2632 would mandate ratebase treatment of utility expenditures for energy efficiency programs if the utility company wished such treatment. The Commission supports energy efficiency efforts but opposes this bill because it is both premature to decide what incentives for such programs are appropriate and imprudent to mandate any one incentive by statute. The Commission agrees the issue raised by this Bill is extremely important and is devoting considerable effort within two dockets to evaluate all options before reaching final policy decisions that will affect both utilities and rate payers. The Commission is examining these issues on an expedited basis, and will be conducting informal workshops in both dockets with a goal of concluding one docket in late spring and the other during the summer. It will take discussion, study and deliberation to reasonably weigh all the pros and cons of various incentive mechanisms. For ratebase treatment of all EE expenses, some of the potential cons are that the rate impact grows significantly over time and that the incentive to the company doesn't correlate to the actual cost savings achieved. Because of these drawbacks, some states previously taking this approach have abandoned it. That is why we suggest that it is premature to decide on a single method of providing cost recovery and incentives for energy efficiency programs. Any conclusions should only follow careful consideration of the complicated issues surrounding these controversial topics.

Senate Utilities Committee
March 6, 2008
Attachment 2 -1



*Kathleen Sebelius, Governor
Thomas E. Wright, Chairman
Michael C. Moffet, Commissioner
Joseph F. Harkins, Commissioner*

Before the Senate Utilities Committee
March 5, 2008

Testimony of
Don Low
Kansas Corporation Commission
Regarding HB 2632

Thank you, Chairman and members of the Committee. I appreciate the opportunity to be here today to testify for the Commission on HB 2632. The bill would mandate ratebase treatment of utility expenditures for energy efficiency programs if the utility company wished such treatment. Ratebase treatment means that all expenses, such as labor and advertising, are treated as an investment so that such costs are not only allowed recovery but also given a "return on investment." The Commission supports energy efficiency (EE) efforts but opposes this bill because it is both premature to decide what incentives for such programs are appropriate and imprudent to mandate any one incentive by statute.

The Commission currently has underway two dockets regarding energy efficiency. In one, Docket No. 08-GIMX-442-GIV, the Commission is considering what benefit-cost tests should be applied to potential EE programs. The primary subjects of the other case, Docket No. 08-GIMX-441-GIV, are cost recovery, incentives, and margin recovery associated with EE programs, both Demand Side Management (DSM) and Demand Response (DR). The Order that opened the latter docket posed numerous questions for comment, with initial comments due January 25th and reply comments February 15th. The Commission is examining these issues on an expedited basis, and will be conducting informal workshops in both dockets with a goal of concluding the matters in late spring and summer, respectively.

Recently, the National Action Plan for Energy Efficiency (NAP), which is facilitated by the U.S. Department of Energy and Environmental Protection Agency, released a report,

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“Aligning Utility Incentives with Investment in Energy Efficiency,”¹ which explores various ways to provide for cost recovery of EE programs, to provide financial incentives for implementation of such programs and to address the lost margins that result when such programs lower energy consumption. Consequently, the report provides a good summary of most of the issues that the Commission will be exploring in detail. However, the Commission will also be examining the threshold question of whether financial incentives are necessary before utilities will promote EE programs, which the report does not explore in detail.

Attached to this testimony are tables from the report that summarize the pros and cons of the various performance incentive alternatives and also the considerations to apply to cost recovery and incentive decision making. In addition, there is a table showing how the various states address these issues, including whether the issues are pending. (Attachment A) As you can see from those tables, it will take discussion, study and deliberation to reasonably weigh all the various considerations. That is why we suggest that it is premature to decide on a single method of providing cost recovery and incentives for EE programs. Any conclusions should only follow careful consideration of the complicated issues surrounding these controversial topics. We suggest that the Commission’s proceeding will allow all interested parties with varying perspectives to have an adequate opportunity to weigh in on these issues.

Furthermore, there shouldn’t be any significant detriment to KCPL from awaiting the conclusion of the Commission proceeding. As a result of a compromise in the last KCPL rate case, which was the second of four annual rate cases, KCPL was allowed an annual rider for recovery of EE program expenses. This provides them with expedited recovery of such costs until the Commission makes a determination in the general EE docket.

We also suggest that it would be unwise to mandate a single cost recovery-incentive mechanism in Kansas statutes because it would remove Commission flexibility to provide for other mechanisms. The NAP Report, drawing on the experience of states that have had

¹ www.epa.gov/eeactionplan

significant efficiency investment and cost recovery policies in place for a number of years, noted that flexibility to modify policies has proven to be essential since there has been a need to change initial approaches.

Table 3 in Attachment A, sets forth the pros and cons associated with a “ratebase” or “capitalization” treatment as included in the NAP report. One drawback is that the incentive is not tied to actual program performance. In other words, even though the EE program may not result in the projected cost savings, the goal of energy efficiency programs, the utility will still get return of and on the expenses. One other big problem associated with this incentive method is that the regulatory asset created by treating expenses as a capital item can grow substantially over time, especially in comparison to traditional treatment. Attached are illustrative examples of this. (Attachment B) For a hypothetical EE program with a one time \$200,000 upfront capital investment and annual expenses of \$1million, and with a 10 year amortization and carrying costs on deferred expenses between rate cases, over 17 years there is a cumulative difference of \$4 million between traditional ratemaking and the capitalization of all expenses. This is approximately an 80% increase in revenue requirement which leads to higher end user rates. The exact results would vary with the specific details of how HB 2632 would be implemented but there is no question that the nontraditional “ratebase” would grow significantly. As noted in the NAP report, this phenomenon has caused some states that once allowed this approach to now abandon it.

I am not suggesting that the Commission will find that the ratebase option is not desirable or inappropriate after it considers all the pluses and minuses of the alternatives. It is too early make any conclusions. But I would suggest that, even if the Commission were to conclude this year that ratebasing is appropriate, it may conclude that other alternatives or mix of alternatives is also appropriate and it may conclude in the future that conditions have changed and ratebasing of expenses is no longer desirable or necessary. Passage of this Bill may unwisely limit the Commission’s flexibility to provide for alternatives or to change those alternatives with changes in policies, industry structure and other considerations.

In summary, the Commission agrees the issue raised by this Bill is extremely important and we are devoting considerable effort to evaluate all options before reaching final policy decisions that will affect both utilities and rate payers. However, we believe the Bill is premature and it would be imprudent to mandate one incentive mechanism by statute. For these reasons we oppose HB 2632. Thank you for your consideration.

Table 1: Cost Recovery and Incentive Design Considerations

Variable	Implication
Related to Industry Structure	
Differences between gas and electric utility policy and operating environments	Wide variety of embedded implications. Gas utility cost structures create greater sensitivity to sales variability and recovery of fixed costs. In addition, as an industry, gas utilities face declining demand per customer.
Differences between investor-, publicly, and cooperatively owned utilities	Significant differences in financing structures. Municipal and cooperative ownership structures might provide greater ratemaking flexibility. Shareholder incentives are not relevant to publicly and cooperatively owned utilities, although management incentives might be.
Differences between bundled and unbundled utilities	Unbundled electric utilities have cost structures with some similarities to gas utilities; may be more susceptible to sales variability and fixed-cost recovery.
Presence of organized wholesale markets	Organized markets may provide an opportunity for utilities to resell "saved" megawatt-hours and megawatts to offset under-recovery of fixed costs.
Related to Regulatory Structure and Process	
Utility cost recovery and ratemaking statutes and rules	Determines permissible types of mechanisms. Prohibitions on single-issue ratemaking could preclude approval of recovery outside of general rate cases. Accounting rules could affect use of balancing and deferred/escrow accounts. Use of deferred accounts creates regulatory assets that are disfavored by Wall Street.
Related legislative mandates such as DSM program funding levels or inclusion of DSM in portfolio standards	Can eliminate decisional prudence issues/reduce utility program cost recovery risk. Does not address fixed-cost recovery or performance incentive issues.

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. Table3-1. www.epa.gov/eeactionplan (Continued on next page)

Table 1: Cost Recovery and Incentive Design Considerations (continued)

Variable	Implication
Related to Regulatory Structure and Process (continued)	
Frequency of rate cases and the presence of automatic rate adjustment mechanisms	Frequent rate cases reduce the need for specific fixed-cost recovery mechanism, but do not address utility incentives to promote sales growth or disincentives to promote customer energy efficiency. Utility and regulator costs increase with frequency.
Type of test year	Type of test year (historic or future) is relevant mostly in cases in which energy efficiency cost recovery takes place exclusively within a rate case. Test year costs typically must be known, which can pose a problem for energy efficiency programs that are expected to ramp-up significantly. This applies particularly to the initiation or significant ramp-up of energy efficiency programs combined with a historic test year.
Performance-based ratemaking elements	Initiating an energy efficiency investment program within the context of an existing performance-based ratemaking (PBR) structure can be complicated, requiring both adjustments in so-called "Z factors" ⁴ and performance metrics. However, revenue-cap PBR can be consistent with decoupling.
Rate structure	The larger the share of fixed costs allocated to fixed charges, the lower the sensitivity of fixed-cost recovery to sales reductions. Price cap systems pose particular issues, since costs incurred for programs implemented subsequent to the cap but prior to its expiration must be carried as regulatory assets with all of the associated implications for the financial evaluation of the utility and the ultimate change in prices once the cap is lifted.

Table 1: Cost Recovery and Incentive Design Considerations (continued)

Variable	Implication
Related to Regulatory Structure and Process (continued)	
Regulatory commission/governing board resources	Resource-constrained commissions/governing boards may prefer simpler, self-adjusting mechanisms.
Related to the Operating Environment	
Sales/peak growth and urgency of projected reserve margin shortfalls	Rapid growth may imply growing capacity needs, which will boost avoided costs. Higher avoided costs create a larger potential net benefit for efficiency programs and higher potential utility performance incentive. Growth rate does not affect fixed-cost recovery if the rate has been factored into the calculation of prices.
Volatility in load growth	Unexpected acceleration or slowing of load growth can have a major impact on fixed-cost recovery, an impact that can vary by type of utility. Higher than expected growth can lessen the impact of energy efficiency on fixed cost recovery, while slower growth exacerbates it. On the other hand, if the cost to add a new customer exceeds the embedded cost, higher than expected growth can adversely impact utility finances.
Utility cost structure	Utilities with higher fixed/variable cost structures are more susceptible to the fixed-cost recovery problem.
Structure of the DSM portfolio	Portfolios more heavily weighted toward electric demand response will result in less significant lost margin recovery issues, thus reducing the need for a specific mechanism to address. Moreover, a portfolio weighted toward demand response typically will not offer the same environmental benefits.

Table 2: Pros and Cons of Utility Performance Incentive Mechanisms**Pros**

- Provide positive incentives for utility investment in energy efficiency programs.
- Policy-makers can influence the types of program investments and the manner in which they are implemented through the design of specific performance features.

Cons

- Typically requires post-implementation evaluation, which entails the same issues as cited with respect to fixed-cost recovery mechanisms.
- Mechanisms without performance targets can reward utilities simply for spending, as opposed to realizing savings.
- Mechanisms without penalty provisions send mixed signals regarding the importance of performance.
- Incentives will raise the total program costs borne by customers and reduce the net benefit that they otherwise would capture.

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. Table 6-7. www.epa.gov/eeactionplan

Table 3: Pros and Cons of Capitalization and Amortization**Pros**

- Places energy efficiency investments on more of an equal footing with supply-side investment with respect to cost recovery.
- Capitalization can help make up for the decline in utility generation and transmission and distribution assets expected to occur, as energy efficiency defers the need for new supply-side investment.
- As part of this equalization, enables the utility to earn a financial return on efficiency investments.
- Smooths the rate impacts of large swings in annual energy efficiency spending.

Cons

- Treats what is arguably an expense as a capital item.
- Creates a regulatory asset that can grow substantially over time; because this asset is not tangible or owned by utility, it tends to be viewed as more risky by the financial community.
- Delays full recovery and boosts recovery risk.
- To the extent that the return on the energy efficiency program investment is intended to provide a financial incentive for the utility, this incentive is not tied to program performance.
- Raises the total dollar cost of the efficiency programs.

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. Table 4-4. www.epa.gov/eeactionplan

Table 4: Pros and Cons of Expensing Program Costs**Pros**

- Expensing treatment is generally consistent with standard utility cost accounting and recovery rules.
- Avoids the creation of potentially large regulatory assets and associated carrying costs.
- Provides more-or-less immediate recovery of costs and reduces recovery risk.
- The use of balancing mechanisms outside of a general rate case ensures more timely recovery when efficiency program costs are variable and prevents significant over- or under-recovery from being carried forward to the next rate case.

Cons

- A combination of infrequent rate cases and escalating expenditures can lead to under-recovery absent a balancing mechanism.
- Can be viewed as single-issue ratemaking.
- If annual energy efficiency expenditures are large, lump sum recovery can have a measurable short-term impact on rates.
- Some have argued that expensing creates unequal treatment between the supply-side investments (which are rate-based) and the efficiency investments that are intended to substitute for new supply.

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. Table 4-1. www.epa.gov/eeactionplan

Table 5: Pros and Cons of Revenue Decoupling**Pros**

- Revenue decoupling weakens the link between sales and margin recovery of a utility, reducing utility reluctance to promote energy efficiency, including building codes, appliance standards, and other efficiency policies.
- Through decoupling, the utility's revenues are stabilized and shielded from fluctuations in sales. Some have argued that this, in turn, might lower its cost of capital.⁵ (For a discussion of this issue, see Hansen, 2007, and Delaware PSC, 2007). The degree of stabilization is a function of adjustments made for weather, economic growth, and other factors (some mechanisms do not adjust revenues for weather or economic growth-induced changes in sales).
- Decoupling does not require an energy efficiency program measurement and evaluation process to determine the level of under-recovery of fixed costs.
- Decoupling has a low administrative cost relative to specific lost revenue recovery mechanisms.
- Decoupling reduces the need for frequent rate cases and corresponding regulatory costs.

Cons

- Rates (and in the case of gas utilities, non-gas customer rates) can be more volatile between rate cases, although annual caps can be instituted.
- Where carrying charges are applied to balancing accounts, the accruals can grow quickly.
- The need for frequent balancing or true-up requires regulatory resources; may be a lesser commitment than required for frequent rate cases.

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. Table 5-3. (Footnotes omitted) www.epa.gov/eeactionplan

Table 6: Pros and Cons of Lost Revenue Recovery Mechanisms**Pros**

- Removes disincentive to energy efficiency investment in approved programs caused by under-recovery of allowed revenues.
- May be more acceptable to parties uncomfortable with decoupling.

Cons

- Does not remove the throughput incentive to increase sales.
- Does not remove the disincentive to support other energy saving policies.
- Can be complex to implement given the need for precise evaluation, and will increase regulatory costs if it is closely monitored.
- Proper recovery (no over- or under-recovery) depends on precise evaluation of program savings.

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. Table 5-5. www.epa.gov/eeactionplan

Table 7: Pros and Cons of Alternative Rate Structures**Pros**

- Removes the utility's incentive to promote increased sales.
- May align better with principles of cost-causation.

Cons

- May not align with cost causation principles for integrated utilities, especially in the long run.
- Can create issues of income equity.
- Movement to a SFV design can significantly reduce customer incentives to reduce consumption by lowering variable charges (applies more to electric than gas utilities).

National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. Table 5-7. www.epa.gov/eeactionplan

Table ES-1. The Status of Energy Efficiency Cost Recovery and Incentive Mechanisms for Investor-Owned Utilities

State	Direct Cost Recovery			Fixed Cost Recovery		Performance Incentives
	Rate Case	System Benefits Charge	Tariff Rider/Surcharge	Decoupling	Lost Revenue Adjustment Mechanism	
Alabama	Yes					
Alaska						
Arizona	Yes (electric)	Yes (electric)		Pending (gas)		Yes (electric)
Arkansas				Yes (gas)		
California	Yes	Yes		Yes		Yes
Colorado	Yes		Yes	Pending		Yes
Connecticut		Yes (electric)			Yes	Yes
Delaware	Yes			Pending		
District of Columbia	Yes			Pending (electric)		
Florida			Yes (electric)			
Georgia	Yes					Yes (electric)
Hawaii				Pending (electric)		Yes
Idaho	Yes (electric)			Yes (electric)		
Illinois	Yes (electric)					
Indiana	Yes			Yes (gas)	Yes	Yes
Iowa	Yes		Yes			
Kansas						Yes
Kentucky			Yes	Pending (gas)	Yes	Yes
Louisiana						
Maine		Yes (electric)				
Maryland				Yes (gas) Pending (electric)		
Massachusetts		Yes (electric)		Pending (electric)	Yes	Yes (electric)
Michigan				Pending (gas)		
Minnesota	Yes			Yes		Yes
Mississippi	Yes					
Missouri				Yes (gas)		
Montana	Yes (gas)	Yes (electric)				Yes
Nebraska						
Nevada	Yes (electric)			Yes (gas)		Yes (electric)
New Hampshire		Yes (electric)		Pending (electric)		Yes (electric)

Table ES-1. The Status of Energy Efficiency Cost Recovery and Incentive Mechanisms for Investor-Owned Utilities (continued)

State	Direct Cost Recovery			Fixed Cost Recovery		Performance Incentives
	Rate Case	System Benefits Charge	Tariff Rider/Surcharge	Decoupling	Lost Revenue Adjustment Mechanism	
New Jersey		Yes		Yes (gas) Pending (electric)		
New Mexico	Yes			Pending (gas)		
New York		Yes (electric)		Yes		
North Carolina				Yes (gas)		
North Dakota						
Ohio			Yes (electric)	Yes (gas)	Yes (electric)	Yes (electric)
Oklahoma						
Oregon		Yes		Yes (gas)		
Pennsylvania	Yes					
Rhode Island		Yes (electric)		Yes		Yes
South Carolina						Yes
South Dakota						
Tennessee						
Texas	Yes					
Utah	Yes (electric)		Yes (electric)	Yes (gas)		
Vermont		Yes (electric)			Yes	Yes
Virginia				Pending (gas)		
Washington	Yes (electric)		Yes (electric)	Yes (gas)		
West Virginia						
Wisconsin	Yes (electric)	Yes (electric)		Pending (electric)		
Wyoming						

Source: Kushler et al., 2006. (Current as of September 2007.) Please see Appendix C for specific state citations.

Hypothetical Example of Difference between Traditional Ratemaking and Capitalization of Investments and Expenditures for Energy Efficiency

Scenario:

1. 5 year EE Program
2. \$200,000 one-time capital investment
3. \$1,000,000 per year program expense
4. 10 year amortization period for program
5. Assumes carrying costs allowed for program expenses during period between rate cases
6. 4 year rate case cycle with first rate case in year 1
7. Pre-tax cost of capital of 11.3% (50/50 capital structure with 6% cost of debt and 10% cost of equity)
8. Traditional Revenue Requirement calculation normalizes \$1M program expense to \$250,000 in year 5 rate case
9. Revenue Requirement calculations are before tax

Result:

Capitalization per HB 2632:	\$9,419,290
Traditional Ratemaking:	<u>\$5,295,618</u>
Increased Cost of HB 2632:	\$4,123,672

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Traditional Treatment

	Rate Case Year 1	Year 2	Year 3	Year 4	Rate Case Year 5	Year 6	Year 7	Year 8	Rate Case Year 9	Year 10
Plant in Service	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Accumulated Depreciation	20,000	40,000	60,000	80,000	100,000	120,000	140,000	160,000	180,000	200,000
Net Plant	180,000	160,000	140,000	120,000	100,000	80,000	60,000	40,000	20,000	0
Pre-tax Rate of Return	11.30%				11.30%				11.30%	
Return on Investment	20,345				11,300				2,260	
Depreciation Expense	20,000				20,000				20,000	
Operating Expense	1,000,000				250,000					
Revenue Requirement	1,020,345	1,020,345	1,020,345	1,020,345	281,300	281,300	281,300	281,300	22,260	22,260

	Year 11	Year 12	Rate Case Year 13	Year 14	Year 15	Year 16	Rate Case Year 17	Cumulative
Plant in Service	200,000	200,000	200,000	200,000	200,000	200,000	200,000	
Accumulated Depreciation	200,000	200,000	200,000	200,000	200,000	200,000	200,000	
Net Plant	0	0	0	0	0	0	0	
Pre-tax Rate of Return			11.30%					
Return on Investment			0					
Depreciation Expense								
Operating Expense								
Revenue Requirement	22,260	22,260	0	0	0	0	0	5,295,618

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Capitalization of Expense Per HB 2632

	Rate Case Year 1	Year 2	Year 3	Year 4	Rate Case Year 5	Year 6	Year 7	Year 8	Rate Case Year 9	Year 10
Plant in Service	1,200,000	1,200,000	1,200,000	1,200,000	5,710,834	5,710,834	5,710,834	5,710,834	5,710,834	5,710,834
Accumulated Depreciation	120,000	240,000	360,000	480,000	1,051,083	1,517,058	1,983,033	2,449,008	2,914,983	3,380,958
Net Plant	1,080,000	960,000	840,000	720,000	4,659,751	4,193,776	3,727,801	3,261,826	2,795,851	2,329,876
Pre-tax Rate of Return	11.30%				11.30%				11.30%	11.30%
Return on Investment	122,067			0	526,552		0		315,931	263,335
Amortization Expense	120,000				465,975				465,975	
Operating Expense	0			0						
Revenue Requirement	242,067	242,067	242,067	242,067	992,527	992,527	992,527	992,527	781,906	781,906

	Year 11	Year 12	Rate Case Year 13	Year 14	Year 15	Year 16	Rate Case Year 17	Cumulative
Plant in Service	5,710,834	5,710,834	5,710,834	5,710,834	5,710,834	5,710,834	5,710,834	
Accumulated Depreciation	3,846,933	4,312,908	4,778,883	5,011,871	5,244,859	5,477,847	5,710,835	
Net Plant	1,863,901	1,397,926	931,951	698,963	465,975	232,987	(3)	
Pre-tax Rate of Return			11.30%					
Return on Investment			105,334	0				
Amortization Expense	0	0	232,988					
Operating Expense				0				
Revenue Requirement	781,906	781,906	338,322	338,322	338,322	338,322		9,419,290