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Before the Senate Utilities Committee
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Neutral Testimony on Senate Bill 24

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On Behalf of The Staff of the Kansas Corporation Commission

Chair Masterson, Vice Chair Petersen, Ranking Minority Member Francisco, and members of the committee, thank you for the opportunity to provide testimony to your committee today on behalf of the staff of the Kansas Corporation Commission (Commission).

The Commission Staff (Staff) is taking a neutral position on SB 24. However, I would like to use this opportunity to discuss some of Staff's concerns regarding this bill. Additionally, I will offer an amendment to the bill in an attempt to prevent some of the negative ramifications that Staff believes are possible if SB 24 were to be signed into law in its current form. SB 24 would revise K.S.A. 66-1237 to limit the Return on Equity (ROE) component of the Transmission Delivery Charge (TDC) to a rate no higher than the "the actuarially assumed investment rate of return established by the board of trustees of the Kansas public employees retirement system."

According to the KPERS 2017 Annual Report, its current actuarially assumed investment rate of return is 7.75%, inclusive of price inflation, and net of investment expenses. Importantly, this assumed rate of return is a weighted average of seven different classes of investments, including short-term investments, real estate, fixed-income securities, alternative investments, global equities, etc. The different classes of investments, and their expected real returns (net of inflation) are listed on page 43 of the KPERS 2017 Annual Report. Those asset classes and expected real returns are as follows:

Asset Class	Long-Term Target Allocation	Long-Term Expected Real Rate of Return
Global Equities	47.0%	6.85%
Fixed Income	13.0	1.25
Yield Driven	8.0	6.55
Real Return	11.0	1.71
Real Estate	11.0	5.05
Alternatives	8.0	9.85
Short-term Investments	2.0	(0.25)

As noted above, these are real returns, therefore, they are net of price inflation. As a point of reference, the expected nominal return of the "global equities" class of investments listed above is 9.6%. This encompasses the 6.85% real return plus the expected rate of inflation used by KPERS, 2.75%.[1]

Currently Westar and KCP&L are the only two electric utilities in the State that have applied for a TDC under K.S.A. 66-1237. In its current form, the TDC allows the Federal Energy Regulatory Commission (FERC)-authorized ROE to be charged to Westar and KCP&L's retail customers as part of the transmission revenue requirement, or cost of providing transmission service. The FERC-authorized ROE for Westar is 10.3% and 11.1% for KCP&L[2] (inclusive of a .50% ROE adder granted to all transmission owners in a FERC-approved Regional Transmission Organization (RTO) like the Southwest Power Pool (SPP)). In contrast, both utilities have the opportunity to earn 9.3% on their KCC-regulated retail business.

Westar's current TDC charge is approximately $15.04 a month on an average residential customer's bill, or approximately 12.55% of the total average bill.[3] For KCP&L, the current TDC charge is less significant, only representing $9.92 a month on an average bill, or approximately 7.9% of the total bill. Staff has calculated that a reduction in the authorized ROE used to calculate the TDC for Westar, from 10.3% to 7.75%, would result in an approximate reduction of $18.84 million in Westar's annual revenues.[4] This would equate to about $1.02 a month for an average residential customer.[5] For KCP&L, the reduction in authorized ROE used to calculate the TDC, from 11.1% to 7.75%, would result in an approximate reduction of $1.7 million in annual revenues[6], or about $0.34 a month for an average residential customer.[7]

Staff's concern is that SB 24 sets an unreasonably low ROE for Westar and KCP&L's transmission investments. This is in part because the 7.75% return used in the bill is not an expected return on KPERS equity capital (that rate is 9.6%) the 7.75% used in the bill includes short-term and long-term fixed-income investments, real estate, and other investment types. Consequently, 7.75% is not a return that is commensurate with the risks and rewards experienced by other investors in transmission assets throughout SPP or the United States generally.

Because the 7.75% return is not a return that is linked to the expected returns on utility equity securities, or a return that provides Westar and KCP&L an opportunity to earn a return comparable to other utilities with comparable risks, Staff's position is that this ROE would not meet the legal

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[1] Nearly all observed market returns are nominal returns, that is, the observed return includes the effects of price inflation. Rate-regulated ROEs are also nominal returns. The global-equities investment class includes both domestic and international equity securities.

[2] Westar's ROE of 10.3% is tied for the 4th lowest ROE out of the 14 transmission-owning Investor Owned Utilities in SPP. KCP&L's ROE is tied for 6th lowest.

[3] See page 28 of Westar's August 31, 2018, revised TDC filing before the KCC to implement reductions in the TDC associated with the implementation of the Tax Cuts and Jobs Act. Docket No. 18-WSEE-355-TA. http://estar.kcc.ks.gov/estar/ViewFile.aspx/S20180831112708.pdf?Id=300207f8-85ae-44e3-84b3-039aaf7479e0

[4] This equates to a reduction of approximately 7.36% of Westar's current retail TDC revenues, or .97% of Westar's total retail revenues.

[5] This calculation relies on the 12-Coincident Peak (CP) allocation percentages and billing determinants agreed to be used for the TDC charge in the 18-WSEE-328-RTS Docket.

[6] This equates to a reduction of approximately 3.44% of KCP&L's current retail TDC revenues in Kansas or .23% of KCP&L's total retail revenues in Kansas.

[7] This calculation relies on the 12-CP allocation percentages and billing determinants determined in KCP&L's most recent rate case in Kansas, Docket No. 18-KCPE-480-RTS.

standards set out in the *Hope* and *Bluefield* cases in which the United States Supreme Court established the legal standards that a utility's authorized ROE must meet.[8] The Kansas Supreme Court has also endorsed the standards established in *Hope* and *Bluefield*.[9]

It is widely accepted that an authorized ROE for a utility company must meet the following four characteristics if it is to meet the legal standards outlined in *Hope* and *Bluefield*:

1. <u>Comparable Earnings</u>—a utility is entitled to return similar to that being earned by other enterprises with similar risks, but not as high as those earned by highly profitable or speculative ventures;
2. <u>Financial Integrity</u>—a utility is entitled to a return level reasonably sufficient to assure financial soundness;
3. <u>Capital Attraction</u>—a utility is entitled to a return sufficient to support its credit and raise capital; and
4. <u>Changing Level of Returns</u>—a fair return can change along with economic conditions and capital markets.[10]

A 7.75% ROE that was determined based on a broad mix of investment options, including short and long term bonds, real estate, etc. would not meet the four standards identified above. Staff anticipates that Westar and KCP&L could not withstand an ROE that low for their transmission investments. Therefore, the practical impact of SB 24 would likely result in Westar and KCP&L terminating their use of the TDC mechanism. By terminating their use of the TDC mechanism, Westar and KCP&L would be eligible to include their respective retail transmission investments and operating costs in a general rate case. The general rate case would calculate a return on transmission investment commensurate with the Commission authorized rate of return, thus circumventing the lower KPERS return required by SB 24.[11] This would be problematic for at least two reasons.

First, as a result of a Settlement Agreement approving the merger of Westar and KCP&L last year, both utilities are currently under a base rate moratorium until December 20, 2023. This means that these utilities would have to invoke the *force majeure* clause in paragraph 32.iii of the Settlement Agreement in order to file for a general rate increase. This action would likely be highly contested by other signatory parties to the Settlement Agreement. The other option would be for Westar and KCP&L to seek to be released from its other merger commitments, like the requirement to provide guaranteed bill credits to customers during the base rate moratorium.

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[8] See— *Bluefield Water Works & Improvement Co. v. Pub. Svc. Comm'n of West Virginia*, 262 U.S. 679, 692-3 (1923) and Federal Power Comm'n. v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).
[9] See—*Kansas Gas & Electric*, 239 Kan. at 488-90; *Southwestern Bell Tel. Co. v. State Corp. Comm'n*, 192 Kan. 39, Syl.
¶ 17 (1963).
[10] See-- The Cost of Capital – A Practitioner's Guide by David C. Parcell; Prepared for the Society of Utility and Regulatory Financial Analysts; 1997; pp. 3-13 to 3-14.
[11] It should be noted that while our rate study referred to the TDC as one of the "legislatively mandated" surcharge mechanisms, this was in the context of it being mandatory that the KCC approve the charge if the utility requests it. From the utility's perspective, these mechanisms are "legislatively authorized", as an electric utility always has the right to file for a general rate application under K.S.A. 66-117 if it chooses not to use a legislatively authorized mechanism like the TDC.

While the Commission would ultimately have to rule on any application to revise rates or a request to be relieved of merger commitments, this action could jeopardize the base rate stability, guaranteed rate credits, and Earnings Review and Sharing Plan (ERSP)[12] components of the Settlement Agreement. Westar is currently obligated to provide customers $8.65 million in rate credits by March 31st of each of the years 2019, 2020, 2021, and 2022. KCP&L is currently obligated to provide $2.81 million in credits to its Kansas customers for each of the same four years. This totals $45.84 million in credits for Kansas customers during the rate moratorium.

Second, significant portions of the TDC charge are outside of the control of Westar and KCP&L, as these charges are approved by FERC and assessed by the SPP. For example, $131 million of Westar's total $291 million TDC revenue requirement is associated with the allocation of regional transmission projects to Westar.[13] Also, less than half of KCP&L's TDC revenue requirement is associated with transmission projects it owns. If these charges increased significantly on an annual basis, Westar and KCP&L would be more likely to file more frequent rate cases, which is generally not desirable because base rate cases do not provide base rate stability, are expensive and time-consuming. More frequent base rate cases also are contrary to one of the stated goals of the five-year base rate moratorium which is to incentivize Westar and KCP&L to reduce their controllable costs, to the benefit of ratepayers when these utilities do reset base rates. Staff believes it is in the public interest to avoid a base rate case because of costs that are uncontrollable to the utility.[14]

In order to avoid the negative ramifications discussed above of limiting the ROE in the TDC to 7.75%, Staff recommends the following amendment to the bill:

(d) (1) Any electric utility electing to recover the utility's transmission-related costs through a transmission delivery charge may include, as a component of such charge, a return on common equity capital associated with transmission facilities owned by such utility, but such return shall not exceed the ~~actuarially assumed investment rate of return established by the board of trustees of the Kansas public employees retirement system~~. authorized return on common equity used to set rates in the utility's last general rate case before the state corporation commission. This limitation on recoverable equity capital costs shall not apply to costs associated with the use of transmission facilities not owned by such utility.

If this revised version of SB 24 were to become law, the result would be a reduction of Westar's TDC revenues of approximately $7.38 million, or 2.89% of Westar's total retail TDC revenues.[15] This would equate to a bill impact of approximately $.40/month for an average Westar residential customer. For KCP&L, the result would be a reduction of TDC revenues of approximately $905,820, or 1.85% of KCP&L's total retail TDC revenues.[16] This would equate to a bill impact of approximately $0.18/month for an average KCP&L residential customer.

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[12] The ERSP is an earnings review mechanism that evaluates Westar and KCP&L earnings during the moratorium period and calculates additional rate credits to customers in the event that Westar and KCP&L exceed synergy savings estimates and earn above the authorized rate of return.

[13] Includes facilities charges for projects with notice to construct dates prior to June 19, 2010.

[14] One of the most important factors utility regulators consider when evaluating for the reasonableness of a surcharge or a rider mechanism is whether the cost is within the control of the utility or not.

[15] This equates to approximately .38% of Westar's Total Retail Revenue.

[16] This would represent approximately .12% of KCP&L's Total Retail Rate Revenues.

Staff does not believe that this monetary impact would be enough for Westar and KCP&L to request Commission authorization to modify the commitments agreed to in the Merger Settlement Agreement, but that remains to be seen.

Thank you for the opportunity to appear before the Committee today to provide Commission Staff's perspective on SB 24.