

**BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS**

APR 04 2013

In the Matter of the General Investigation into)
the Class Cost of Service and Rate Design)
Methods Used to Establish Gas and Electric)
Utility Rates.)

by
State Corporation Commission
of Kansas
Docket No. 13-GIMX-606-GIV

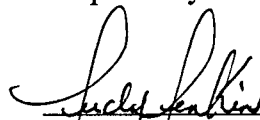
NOTICE OF FILING STAFF'S REPORT AND RECOMMENDATION

The Staff of the State Corporation Commission of the State of Kansas (Staff) hereby requests the Commission to open a general investigation into the Class Cost of Service (CCOS) and Rate Design methodologies available for use in the general establishment of utility rates by the Commission. Staff states as follows:

1. Because the Commission has not conducted a recent review of the CCOS and Rate Design methodologies available in the setting of utility rates, Staff hereby files a report identifying the issues raised in recent dockets and Staff's recommendation that the Commission explore the need and scope a potential general investigation of these issues. Staff's Report and Recommendation is attached hereto as "Attachment A."

WHEREFORE, Staff requests the Commission consider its Report and Recommendation and issue an Order granting the opening of a general investigative docket and for any further relief as the Commission deems just and proper.

Respectfully submitted,



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**REPORT AND RECOMMENDATION
UTILITIES DIVISION**

TO: Chairman Mark Sievers
Commissioner Thomas E. Wright
Commissioner Shari Feist Albrecht

FROM: Lana Ellis, Senior Research Economist
Robert Glass, Chief of Economics and Rates
Jeff McClanahan, Director of Utilities

DATE: April 4, 2013

DATE SUBMITTED TO EXECUTIVE DIRECTOR: 4-4-13

DATE SUBMITTED TO LEGAL: 4-4-13

DATE SUBMITTED TO COMMISSIONERS: 4-4-13

SUBJECT: Request to open a Generic Investigation into Class Cost of Service and Rate Design.

EXECUTIVE SUMMARY

The Commission has not had the opportunity to broadly review rate design and Class Cost of Service (CCOS) since the 98-KCPE-500-TAR Docket in 1998. Therefore, Staff believes it is time to conduct a thorough examination of the rate design process. In recent dockets, the efficacy of rate design and CCOS methodologies used to arrive at just and reasonable rates has been called into question, further supporting the need to establish a policy for rate design and consider alternative ratemaking models.

The majority of utility costs are joint and common costs not directly assignable to any service or customer class. Thus, considerable judgement is involved in allocating those common costs among customers and services. That allocation process determines the prices consumers pay for utility service.

Further information and analysis is needed to fully assess the effectiveness of CCOS and rate design methodologies to set rates. Therefore, Staff recommends the Commission open a General Investigation regarding CCOS and rate design methodologies to solicit and review comments on alternative rate design methodologies. To help determine the scope of the investigation, Staff recommends asking initially whether a Commission inquiry into cost allocation and rate design methodologies is appropriate or necessary. And, if an inquiry is appropriate, how the Commission should proceed.

BACKGROUND

In several proceedings, the efficacy of the rate design process and cost of service methodologies used to arrive at just and reasonable rates was raised as an issue bringing into question whether there is a need to establish policy for rate design and to consider alternative ratemaking models.

In Docket Number 10-KCPE-415-RTS (415 Docket), the Commission ordered the opening of a new docket specifically focused on rate design for KCPL.¹ The 415 Docket was also intended to address the promotion of economic development through rate structure, to provide revenue stability and risk mitigation, and to simplify the Company's rate structure.² Instead of opening a new docket, at KCPL's and Staff's request, KCPL's rate case and rate design dockets were consolidated into KCPL's rate case, Docket No. 12-KCPE-764-RTS (764 Docket).

In addition to approving consolidation of the dockets, the Commission provided guidance to parties filing testimony in the 764 Docket (Guidance Order)³ by requesting academic literature supporting the concept of equalizing rates of return and inquiring about the prevalence of equalizing rates of return as a ratemaking principle in other industries and jurisdictions.⁴ The Commission also asked for an explanation of the assessment, measurement, and tracking of the efficiency/conservation impacts from any party advocating a green tariff or rate design that purportedly enhances energy efficiency or promotes energy conservation.⁵ Lastly, the Commission sought information on how rate design and the resulting rates compared to similarly situated states.⁶

At the hearing for the 764 Docket, the economic rationale for proposed rate structures was questioned and it was suggested that an assessment of rate design is needed.⁷ In that vein, concern was expressed about the seeming lack of a discernible relationship between rate-of-return index numbers and the actual class revenue increases awarded.⁸ The Commissioner questioning also probed the bounds of the zone of reasonableness.⁹ In addition, questions were raised regarding the impact of rate increases on customers and whether elasticity studies were used to determine how customers might respond to price increases and how rates impact economic development and jobs.¹⁰ Noting subjective and inconsistent results over time,¹¹ the weight that should be given to Fully Distributed Cost (FDC) allocation models¹² was called into question. The concerns raised in the June 29, 2012, Guidance Order regarding academic support and other jurisdictions' treatment of rate design were again raised during the 764 hearing.¹³ Finally, the issue of whether money was being spent unnecessarily on experts and overly

¹ Docket Number 10-KCPE-415-RTS Order: 1) Addressing Prudence; 2) Approving Application, in Part; & 3) Ruling on Pending Requests (415 Order), pg. 123, ¶3, November 22, 2010.

² 415 Order, p. 124.

³ Docket Number 12-KCPE-764-RTS, Order Granting Joint Motion of Kansas City Power & Light Company and Kansas Corporation Commission Staff Regarding Rate Design and Providing Guidance to Parties on Rate Design (Guidance Order).

⁴ 764 Docket Rate Design Guidance Order, ¶9a, June 29, 2012.

⁵ 764 Docket, ¶9b.

⁶ 764 Docket, ¶9c.

⁷ 764 Docket, Tr. Vol. 1 at 68, 80 (Bassam) 288, 306 (Lutz); 764 Order ¶ 8.

⁸ 764 Docket, Tr. Vol. 1 at 281-283 (Lutz).

⁹ 764 Docket, Tr. Vol. 1 at 166 (Normand).

¹⁰ 764 Docket, Tr. Vol. 1 at 290, 297, 304 (Lutz), 73, 76-77 (Bassam), 201 (Normand).

¹¹ 764 Docket, Tr. Vol. 1 at 66 (Bassam), 168 (Normand).

¹² 764 Docket, Tr. Vol. 1 at 158, 177 (Normand).

¹³ 764 Docket, Tr. Vol. 1 at 176, 178-179 (Normand), 313 (Lutz).

complicated analysis was examined and it was suggested alternatives to traditional FDC pricing should be considered.¹⁴

In Docket No. 12-ATMG-564-RTS (564 Docket), questions were again raised concerning the concept of equalizing rates of return and its relationship to the proposed rate structures.¹⁵ Additional questions focused on whether states, which may be similar to Kansas, offered an opportunity to compare rates and evaluate rate design methods. To assist the Commissioners in making more informed rate design decisions, the parties involved in designing and proposing cost of service studies and rate designs were asked to explain their respective methodologies.

Similar concerns were raised in 12-KGSG-835-RTS (835 Docket) with respect to the rate impact on average monthly bills, the sufficiency of rates to generate revenue requirement,¹⁶ the upper and lower bounds to just and reasonable rates,¹⁷ and the need for academic studies that support using a fully distributed cost methodology.¹⁸ In addition, an interest in further exploring the contours of the “zone of reasonableness” was expressed.¹⁹

ANALYSIS

Just and Reasonable Rates

The Commission’s core mission is to review, set or approve prices charged for utility services. The general statutory standard for utility prices is illustrated by K.S.A. 66-101b that describes the rate setting standard for electric utilities as follows:

Every electric public utility governed by this act shall be required to furnish reasonably *efficient and sufficient* service and facilities for the use of any and all products or services rendered, furnished, supplied or produced by such electric public utility, to establish *just and reasonable* rates, charges and exactions and to make just and reasonable rules, classifications and regulations. Every *unjust or unreasonably discriminatory or unduly preferential* rule, regulation, classification, rate, charge or exaction is prohibited and is unlawful and void. The commission shall have the power, after notice and hearing in accordance with the provisions of the Kansas administrative procedure act, to require all electric public utilities governed by this act to establish and maintain *just and reasonable* rates when the same are reasonably necessary in order to maintain *reasonably sufficient and efficient* service from such electric public utilities. [emphasis added]

Staff understands that Kansas Courts have interpreted “just and reasonable” to mean that those who cause a cost should be the ones who pay for the cost, unless there is a reasonable basis for deviation. To avoid being “unduly discriminatory,” rates must follow the cost causation principle.²⁰ Thus, the regulated utility’s design of a rate structure for its customers (rate design) is constrained by cost causation—a principle that has been endorsed by the Kansas Courts as

¹⁴ 764 Docket, Tr. Vol. 1 at 172-173, 199 (Normand), 285 (Lutz).

¹⁵ 564 Docket, Tr. Vol. 1 at 47 (Christian).

¹⁶ 835 Docket, Tr. Vol. 1 at 52 (Dittemore).

¹⁷ 835 Docket, p. 51.

¹⁸ 835 Docket, p. 71.

¹⁹ 835 Docket, Order Approving Stipulated Settlement Agreement, ¶47, December 5, 2012.

²⁰ *Jones v. Kansas Gas & Elec. Co.*, 222 Kan. 390, 401 (1977); *Midwest Gas Users Association v. State Corporation Commission*, 5 Kan. App. 2d 653, 663 (1981).

“the touchstone of public utility law.”²¹ Given these statutory standards and the principle of cost causation, the Commission is faced with two fundamental questions:

1. How should recovery of costs, particularly common costs that cannot be directly attributed to any particular customer class, be allocated among customer classes?
2. How should rates be set to recover the costs allocated to any specific customer class?

Orthodox Rate Design Methodology

The unattributable component of a utility's expenses and rate base are referred to as joint and common costs, or simply shared costs. Examples include generation, transmission, distribution, and administration. For at least the last forty years, Kansas has allocated shared costs based on a CCOS which is an FDC allocation mechanism. In the orthodox rate design process, the CCOS acts as the cost causation link between the revenue requirement and the customer rates designed to recover the revenue requirement. Using a CCOS to create new rates to collect the revenue requirement is a three stage process.

The first stage is the creation of a CCOS from historical, test year, accounting data. This stage involves considerable data collection and multiple layers of cost allocation to fully allocate all costs to the customer classes. The second stage is the calculation of rates of return for the system as a whole and for each customer class. The class rates of return are calculated by taking the net operating income for each class and dividing it by the rate base assigned to that class.²² The class rates of return test whether the revenue historically collected from the classes matches each class allocation of rate base.²³

In the final rate design stage, the rates for each customer class are constructed based on the CCOS and other factors. The usual implementation of CCOS pricing begins by comparing each class rate of return to the system rate of return. If a class rate of return is less than the system rate of return, then its revenue requirement should increase, and if the class has a rate of return greater than the system average, then its revenue requirement should decrease. Thus, by using the class rates of return to guide rate design, the rate designer aims to avoid cross-subsidization.

²¹ *Jones v. Kansas Gas & Elec. Co.*, 222 Kan. 390, 401 (1977).

²² The comparison of the class' net operating revenue with the class' rate base can be expressed in several different forms. The class rate of return can be divided by the system rate of return. The result is an index of class rates of return where an index number less than one means the class is under paying and an index greater than one means the class is overpaying. Another possibility is to compare the proportion of net operating revenue of each class compared to the total net operating revenue and the proportion of rate base for each class compared to total rate base. The final possibility, using each class rate base and multiplying it by the system rate of return, may be the most straight-forward. The result is the net operating revenue that should have been generated by the customer class.

²³ The use of historical class rates of return to guide future rate design has a timing problem. The historical rates of return are based on historical cost data that is functionally dependent upon the historical rate design. Changing the rate design also changes costs, especially if the rate design asymmetrically assigns revenue requirement to different classes. Thus, using historically derived class rates of return to change future rates does not guarantee that the future rates will reflect costs they will cause and thus, the future rates will not necessary reflect the future class rates of return that will be calculated based on future costs.

Theoretical Problems with the Orthodox Rate Design Methodology

Pricing Based on CCOS is not First Best

FDC pricing differs from marginal cost pricing (first-best pricing) or Ramsey pricing (second-best pricing) because FDC cost allocation is based upon historical average costs.²⁴ Only in rare instances will historical average costs be equal to forward-looking marginal costs. Hence, FDC pricing can only be coincidentally the same as marginal cost pricing and cannot be first-best pricing. Since FDC pricing is based on average costs, it will, in general, not give the same results as Ramsey pricing which is demand and marginal cost driven. Therefore, FDC pricing is inefficient from an economic perspective.²⁵

CCOS Reflects Past Costs

To send the proper price signal, rates should reflect the future costs of new generation, not past sunk costs. CCOS is based on historical accounting data but a utility's future production cost is determined, in part, by the new rates when they become effective. If rates are set based upon a CCOS, then as soon as those rates become effective, the rates cease to reflect the underlying cost of service because the change in rates itself affects customer behavior,²⁶ which alters the economic dispatch and, in turn, changes the firm's cost structure. Thus, rates based on CCOS are not aligned with the costs they cause, and because these rates are not based on forward-looking marginal costs, they fail to send the proper price signal.

Orthodox Methodology is Not Mechanical

The allocation process is highly technical and can seem unintelligible to the uninitiated. The process begins by creating a baroque set of allocators used by the CCOS expert to allocate shared costs first among production, transmission, distribution, customer service, and administrative and general categories (functionalization). Separating generation from transmission is easier than separating transmission from distribution because reasonable people disagree about the line size and voltage levels that distinguish transmission lines from distribution lines. Next costs are classified as either demand, energy, or customer related. Operations and maintenance (O&M) costs can be separated between generation and transmission, but separating generation O&M between demand and energy becomes problematic. Finally, costs are allocated among the different customer classes. At the class allocation stage, load research is used and customer classes are treated as statistical averages.

Given the necessary layers of allocation and number of decisions that must be made by the CCOS expert, the result can become an impenetrable Excel workbook that only its creator can navigate. To add to the ambiguity, the decisions made by CCOS experts can result in different experts obtaining different outcomes using the same methodology. In Kansas rate cases, at a

²⁴ See 764 Docket, Glass Testimony, Exhibit 1, pp. 9-16.

²⁵ Ronald R. Braeutigam, "An Analysis of Fully Distributed Cost Pricing in Regulated Industries," *The Bell Journal of Economics*, Vol. 11, No. 1 (Spring 1980), pp. 182-196. Braeutigam was highly critical of FDC pricing, but added the caveat that, "Whether Ramsey pricing is actually operational, however, or under what conditions, remains to be shown," p. 183.

²⁶ When a utility gets an increase in its rates, the customers will, on average, cut back consumption. Unless the utility has sufficient growth, the utility will under-recover its revenue requirement because of the success of the price signal.

minimum, the petitioning utility and Staff each introduce their own CCOS and the Commission must choose which one is correct.

CCOS is an Expensive Rate Design Methodology

Substantial effort is required to develop the CCOS studies. Therefore, using CCOS as a basis of rate design is an expensive process in both the pecuniary cost of utility consultants and Staff time. For example, in the 764 Docket, the utility's witness charged \$150,000 to develop the CCOS for KCP&L, and Commission's Staff spent four weeks analyzing KCP&L's CCOS and developing its own CCOS and rate design.

CONCLUSION AND RECOMMENDATION

Given these difficulties, a thorough assessment of the rate design process is needed to determine whether the orthodox method used by the Commission should continue or be changed. The Commission would benefit from a method of allocating shared costs among classes of customers that reduces the discretionary choice of cost allocators. The basic criteria for cost allocation and rate design methodology should: (1) establish an articulable standard for judging whether a cost allocation and rate design meets the statutory standards (*i.e.*, that the proposed rates are not "*unjust, unreasonable, unreasonably inefficient or insufficient, unduly preferential, unjustly discriminatory*") while being theoretically defensible; (2) be simple and transparent; and (3) be cost effective.

The following five alternatives or options could be considered to address expressed concerns with the current methodologies:

1. Status Quo (e.g. recognize that, although imperfect, the current methodologies reach the most reasonable outcome for the time and analysis involved);
2. Marginal Cost Pricing (e.g., set prices based on the change in total costs associated with adding one more customer or an additional unit of output, plus some "fair" allocation of common costs based on academically defensible Ramsey pricing²⁷ or Attributable Cost Method of cost allocation²⁸ methodologies);

²⁷ Ramsey pricing is described in W. Baumol & D. Bradford, *Optimal Departures from Marginal Cost Pricing*, 60 AM. ECON. REV. 265 (June 1970). In general, it allocates fixed or common costs to customers or products inversely to the price elasticity associated with those customers or products. Customers who are least likely to leave the company or adjust their volumes demanded pay a larger proportion of fixed or common costs. By reducing the burden of common cost recovery imposed on price-elastic customers or products, the firm encourages more customers to remain and maximizes the base of customers or products over which common costs are recovered. Said differently, if a firm raises prices on an industrial customer and the customer leaves the state or dramatically curtails usage in response, that shrinks the base of customers over which common costs can be recovered.

²⁸ The Attributable Cost Method (ACM) of cost allocation is described in the 764 Docket, Glass Testimony, Exhibit 1, pg. 21. Under an ACM cost allocation, directly attributable costs for customer classes are identified. Total directly attributable costs would be calculated and any unrecovered common costs are allocated proportionately. For example, if total costs were \$1,000, and \$200 were attributable to customer class X and \$100 were attributable to customer class Y, there would be a total of \$300 in assignable costs and \$700 in unassignable common costs. The \$700 in common costs would be assigned 1/3 to customer class Y (\$100/\$300) and 2/3 to customer class X (\$200/\$300).

3. Baumol's Corridor Pricing and Faulhaber's tests for cross subsidization²⁹ (e.g. setting floors and ceilings limiting price increases and decreases for any customer class, but otherwise allowing flexibility within those bounds; measuring cross-subsidization by reference to stand-alone and incremental costs, which is relevant to the statutory standard of avoiding undue preference or discrimination);
4. Comparing Kansas' or Kansas utilities' prices with similar states or utilities as a test for reasonableness and attempting to control or account for differences (e.g. performing a regression analysis of prices controlling for differences between states and differences in fuel mixes, utility scale, climate, etc); and
5. Price or revenue cap mechanisms and formula rates similar to the mechanisms adopted by Canada, Australia, and the UK³⁰ and by the FERC³¹ and some U.S. states during inflationary periods of the 1980s (e.g., the Commission sets limits on the annual percentage change in prices—or total revenues—and sets service standards, but otherwise does not regulate profits, allocate costs among customer classes or judge the prudence of investments, and rate changes within those limits are presumptively "just and reasonable").

Because more information and analysis are needed, Staff recommends the Commission open a General Investigation to begin to assess cost allocation methodologies and rate design in setting just and reasonable rates.³² Staff proposes specifically asking first whether a Commission inquiry into these topics – cost allocation and rate design methodologies – is appropriate or necessary. If an inquiry is appropriate, how the Commission should proceed (e.g. responsive comments, roundtable, contested docket with testimony, solicit white papers from the parties, etc.).

cc: Patrice Petersen-Klein, Executive Director

²⁹ Under Faulhaber's criteria, which is widely accepted in the academic literature, a service receives a subsidy only if the price of that service falls below its marginal cost. Conversely, a service provides a subsidy only if its price exceeds its stand-alone costs (the costs of providing the service by itself, without combining its production with that of other services). If the price is between these bounds (marginal costs and stand-alone costs), it is indeterminate whether a service generates or receives a subsidy. See G. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AM. ECON. REV. 966 (1975).

³⁰ See, e.g., Alberta Utilities Commission, *Rate Regulation Initiative Distribution Performance-Based Regulation* (September 12, 2012); The price setting methodology used in Ontario is described at <http://www.ontarioenergyboard.ca/OEB/Consumers/Electricity/Electricity+Prices>. The Ontario Energy Board rate regulates 77 utilities using this methodology.

³¹ An example of formula rates is seen in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), where the Supreme Court held setting rates for several utilities was Constitutional and it was unnecessary to set prices based on the individual costs of each utility.

³² Staff is recommending only that the ratemaking process after the establishment of the revenue requirement be examined.

CERTIFICATE OF SERVICE

13-GIMX-606-GIV

I, the undersigned, hereby certify that a true and correct copy of the above and foregoing Notice of Filing Staff's Report and Recommendation was placed in the United States mail, postage prepaid, or hand-delivered this 5th day of April, 2013, to the following:

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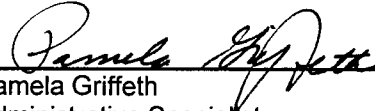
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