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Kansas Corporation Commission
/S/ Jeffrey S. Wagaman

THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

STATE CORPORATION COMMISSION

NOV 19 1999

Docket Room

Before Commissioners: John Wine, Chair
Cynthia L. Claus
Brian J. Moline

In the Matter of the Application of Kansas Gas)
Service Company, a Division of ONEOK, Inc.)
for Commission Determination of the Rate) Docket No. 00-KGSG-420-RTS
Treatment of Discounted Service Agreements)
Entered Into to Meet Competitive Alternatives)

APPLICATION OF KANSAS GAS SERVICE COMPANY,
A DIVISION OF ONEOK, INC. FOR COMMISSION
DETERMINATION OF THE RATE TREATMENT OF
DISCOUNTED SERVICE AGREEMENTS ENTERED INTO
TO MEET COMPETITIVE ALTERNATIVES

COMES NOW Kansas Gas Service Company, a Division of ONEOK, Inc. ("Kansas Gas Service" or "Company") and files its Application for Commission Determination of the Rate Treatment of Discounted Service Agreements Entered Into to Meet Competitive Alternatives. Kansas Gas Service requests that the Commission issue an Order providing that there will be no imputation of revenue in the course of a rate case filed by Kansas Gas Service associated with such Discounted Service Agreements. In support of its Application, Kansas Gas Service states as follows:

1. Kansas Gas Service is a natural gas public utility operating in the State of Kansas pursuant to certificates of convenience and necessity issued by the Commission. Kansas Gas Service's principal place of business is located at 7421 West 129th Street, Overland Park, Kansas 66213.

2. Pleadings, notices, orders and other correspondence and communications regarding this Application should be sent to:

John P. DeCoursey
Larry M. Cowger
Kansas Gas Service Company,
A Division of ONEOK, Inc.
7421 W. 129th Street
Overland Park, Kansas 662 13

Larry G. Willer
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Kansas Gas Service Company,
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3. In the last twenty-five years, the natural gas industry has undergone significant changes. In the mid 1970s, producers sold gas, almost exclusively to interstate and intrastate pipelines. These pipelines, in turn, sold the gas to local distribution companies, which then sold the gas to their end use customers. The maximum price for gas sold to interstate pipelines was set by federal law. As a result of the artificially low price set for natural gas by federal regulation in the mid to late 1970s, an acute shortage of natural gas for delivery to customers developed. As a result of such regulation, producers had little incentive to drill for natural gas. Gas was more readily available for delivery to intrastate pipelines as federal price control regulation did not apply. Accordingly, Kansas consumers had greater access to natural gas supplies than customers in non-producing states. Nevertheless, gas shortages began to develop within the state of Kansas. During this time-frame, the Kansas Corporation Commission issued orders prohibiting local natural gas distribution companies from hooking up new customers. In 1978, the United States Congress passed the National Energy Act and its various components, the Natural Gas Policy Act (NGPA), the Power Plant and Industrial Fuel Use Act, and the Public Utility Regulatory Policy Act (PURPA). Under these laws, Congress attempted to resolve the energy shortage by providing incentives for drilling,

through natural gas price deregulation; curbing the use of natural gas in electric generation and other industrial boiler uses; and by attempting to increase electric supply through incentives for alternative forms of electric generation by requiring electric utilities to purchase electricity from alternative producers at above-market prices. As the Commission and the general public are aware, the results of this legislation were mixed.

4. In the mid-1980s, the Federal Energy Regulatory Commission (FERC) continued the process of restructuring the energy market by seeking to institute competition in the delivery of natural gas. One of the first steps taken by the FERC was the issuance of Order 436. Order 436 required interstate pipelines to allow shippers open access to transport natural gas over their pipelines, thus enabling end-use customers the opportunity to shop for their own supplies of gas rather than relying on the interstate pipelines to secure gas supplies for them. This was the beginning of the FERC's drive to bring competition to the natural gas industry, both in commodity and in transport. As a result of Order 436, it became inevitable that shippers would request that the local distribution companies would also begin to provide transportation service for these shippers moving their own gas over interstate pipelines. As a further inducement to encourage competition in the transportation industry, the FERC facilitated the ability of end-use customers to inter-connect with interstate pipelines and bypass local distribution companies. Finally, with the advent of Order 636, the FERC took interstate pipelines completely out of the gas merchant function. In addition to eliminating the interstate pipelines' gas merchant function, FERC instituted straight fixed variable (SFV) rate designs. These two actions were also designed to encourage competition by allowing all end users to negotiate directly with the producers or marketers and to allow an easier determination of transportation costs and allow a comparison of prices between competing interstate pipelines. As

a result of these changes, an even greater demand for transportation services at the local distribution company level developed along with a correspondingly greater incidence of potential bypass.

5. Kansas Gas Service and its predecessor, Western Resources, Inc. (Unless otherwise noted, Kansas Gas Service, Western Resources and Western Resources' predecessors, the Kansas Power and Light Company and the Gas Service Company, are collectively referred to hereafter as "Kansas Gas Service") addressed these competitive alternatives. First, Kansas Gas Service established transportation tariffs in the mid-l 980s. Later, as end-use customers began to seek direct access to interstate pipelines, Kansas Gas Service began to implement discount rates for these customers seeking gas supply alternatives. The alternatives faced by Kansas Gas Service were not just with interstate pipelines but also with alternative fuel providers such as fuel oil, propane or electricity. Kansas Gas Service's current Commission-approved tariffs provide the following language regarding discount rates:

> The charge per Mcf in the NET MONTHLY BILL section may be reduced by Company to meet a competitive alternative to Company's transportation service. The customer shall be required to sign a special agreement listing the reduced charge, term of service and other conditions of the service to be provided to the customer.

This language, or language very similar to it, is contained in Kansas Gas Service's LVTt, LVTk, GTt, GTk and GSk tariffs.

6. Prior to Kansas Gas Service's implementation of discounted rates ("Flex Contracts"), the Commission conducted a thorough investigation and hearing on the issue of bypass in the Complaint filed by Owens-Coming Fiberglas Corporation against Kansas Power and Light Company/Gas Service in Docket No. 162,960-U. The Complaint was filed in September, 1988, and a hearing was conducted in June 1989. During the course of this Complaint, many issues were raised

and addressed by the parties who participated in the Complaint proceeding. Among the issues considered was the level of rates being charged by Kansas Gas Service to industrial end-users. Industrial end-users complained that they were not being charged cost-based rates and that their rates were being used to subsidize residential customers. The industrial end-users claimed that such high rates were forcing them to seek bypass to interstate pipelines. Kansas Gas Service sought guidance as to the rate treatment to be accorded Flex Contracts. The Company requested that the Commission should specify that the revenue requirement established for the Company in any retail rate proceeding that may occur during the term of the contract will be based on the level of revenues actually generated by the rate provided for in the Flex Contract. The Commission specifically addressed this issue in its Order as follows:

> KPL should be allowed to introduce flexible rates for transportation service, and be required to file written reports involving the details of each transaction with the Commission. A minimum rate for each unbundled service should be established at the marginal cost of providing each unbundled service.
>
> A maximum rate for transportation service should be established at the current tariff rate.
>
> The revenues received from flexible rates should be accounted for at their actual level subject to prudence review by the Commission. As long as the services provided under the flexible rate are fully regulated, the actual revenues should be allocated to cost of service for that class of customers. Based upon that cost of service, the Commission will establish proper rates on a prospective basis.

(In the Matter of the Complaint of Owens Coming Fiberglas Corporation against Kansas Power and Light Company/Gas Service Company Docket No. 162,960-U, paragraphs 31,32 and 33, pages 15-16.)

In its final ordering paragraph in the Owens-Corning Complaint, the Commission specifically ordered: “The transportation issues set forth in this matter are resolved and ordered instituted as above stated.” ***Id.*** p. 17.

7. The Commission policy set forth in Owens-Coming is based on well-established cost of service principles, sound public policy, and is in accordance with the constitution and laws of the State of Kansas. If the local distribution company does not reduce its rate when the customer threatens to secure its energy needs through an alternative means, whether it be through bypass or fuel oil or any other alternative sources available, then the customer will simply leave the system. The full loss of this customer will immediately be borne by the local distribution company pending the filing of a subsequent rate case and upon such filing, the lost revenues from that departed customer will be made up by remaining customers. The Kansas Court of Appeals specifically rejected attempts to impute revenues associated with departing customers in the case of Gas Service Co. v Kansas Corporation Commission, 8 Kan.App.2d 545 (1983). In that case, Phillips Petroleum closed its refinery in Kansas City, Kansas and the Commission imputed approximately $3 million in net revenue as if the utility was still receiving that revenue from Phillips. In justifying its imputation of revenue associated with the lost revenues from the closure of the refinery, the Commission stated: "We do not believe that applicant should be allowed to pass the loss in revenues associated with one large industrial customer on to the customers remaining on the system." In rejecting the Commission's imputation of revenue associated with the closed refinery the Court of Appeals stated: "We conclude the Commission abused its discretion and unreasonably refused to adjust the test year to recognize the loss of sales to the refinery." 8 Kan App. 2d at 550.

8. In Kansas Power and Light Company's next gas rate case, Docket No. 176,716-U, there was no revenue imputation for customers receiving discounts.

9. The FERC has followed a policy to not impute revenues where transportation customers with competitive alternatives have been given discounts. In pipeline rate cases, the FERC has

consistently held that, to the extent a pipeline was required during its applicable test period to give discounts either to attract or retain load, it need not design its rates on the assumption that such discounted volumes would flow at maximum rates. In support of its policy, the FERC has stated that a contrary policy would be a disincentive to pipelines to discount their rates in order to capture and retain marginal firm and interruptible business. Accordingly, the FERC has held that such discounts benefit all customers by allowing a pipeline to maximize throughput and thus spread fixed cost recovery over more units of service. See, e.g., Williams Natural Gas Co., 77 FERC ¶ 6 1,277 (1996); Koch Gateway Pipeline Co., 74 FERC ¶ 61,088 (1996); Opinion No. 404, Panhandle Eastern Pipe Line Co., 74 FERC ¶ 6 1,109 (1996): Williston Basin Interstate Pipeline Co., 67 FERC ¶ 61,137 (1994); see *also* Rate Design Policy Statement, 48 FERC ¶ 61,122 at 61,448-49 (1989).

10. Recently, the Commission's Staff has made rate case adjustments based upon imputation of discounted revenue in two proceedings related to Kansas Gas Service's gas business where the imputation issue either was not contested at hearing or it was unrelated to the critical focus of the hearing. The first imputation of revenue occurred in Docket No. 193,305-U. In this matter, Western Resources tiled its gas rate case in conjunction with a review of its electric rates. Western Resources' gas filing showed a revenue deficiency of $60 million, but the application requested a revenue increase of only $36 million and suggested that it would attempt to make up for the $24 million shortfall through efficiency improvements. Staff conducted its audit and filed its case suggesting a revenue deficiency of approximately $33.8 million. Western Resources and the Staff entered into a Stipulation and Agreement which provided for a revenue increase of $36 million as originally filed by Western Resources. At the hearing on the Settlement, there was no cross examination of the witnesses as provided for in the Settlement. Following the closingofthe hearing,

the Commission rejected the Settlement and issued its Order authorizing a revenue increase of $33.8 million, thereby accepting every adjustment of Staff needed to reduce the revenue deficiency from $60 million to $33.8 million. Included in these adjustments was a revenue imputation adjustment of $6.9 million related to discount customers. The amount of the imputation was based on 100% imputation even though Staffs witness supporting the revenue imputation adjustment suggested that the Commission may want to consider a 50-50 sharing of revenues lost from discounting. As legal support for the revenue imputation, Staff made reference to the Commission's February 13 and March 21, 1990 Orders (hereafter the "Wolf Creek Imputation Order") in Docket No. 142,098-U in which the Commission required revenue imputation in establishing the future rates for Kansas Gas and Electric Company (KG&E). When Western Resources filed its Petition for Reconsideration on the revenue imputation issue, the Commission stated that Western Resources had chosen to enter into the Settlement Agreement and elected not to cross-examine Staffs witness on the issue of revenue imputation. In denying Western's Petition for Reconsideration, the Commission stated that it was not bound by the Settlement, and accordingly denied Western the opportunity to cross-examine Staffs witnesses on the issue of revenue imputation.'

11. The second matter where the imputation of revenue issue arose was in Docket No. 97-WSRG-486-MER relating to the transaction between Western Resources and ONEOK, Inc., wherein ONEOK acquired the natural gas business of Western Resources. During the course of the hearing, the level of revenue deficiency associated with the gas business was discussed. The applicants in

'Kansas Gas Service provides this historical background, not for the purpose of challenging the level of rates associated with the Commission's Order in Docket No. 193,305-U, but to provide the Commission with the understanding that the issue of revenue imputation was not adequately addressed in that docket in a policy context as was the case in the Owens Coming Complaint case discussed above.

that case suggested that the revenue deficiency for the gas business was between $25 and $29 million, while Staff suggested that the level of revenue deficiency was approximately $12 million. A large part of the difference between the revenue deficiency suggested by the Company and Staff was attributable to revenue imputation, which Staff suggested was $7.7 million. The staff suggested level of imputation was based on 100% imputation. The Staffs justification for its imputation was based on the Wolf Creek Imputation Order and the Commission's Order in Docket No. 193,305-U.[2]

12. Kansas Gas Service is requesting that the Commission issue an Order in this Docket clarifying that it is not the policy of the Commission to impute revenues associated with Flex Contracts when such discounts are given to customers which have competitive alternatives and where the level of the discount is above the marginal cost of providing service to the discount customer. Kansas Gas Service is requesting such an order now for the three reasons set forth below:

(a) First, it is consistent with the Commission's well reasoned decision in the Owens Coming case.

(b) Second, it is necessary to correct the misconception which has developed in the cases which have evolved following the issuance of the Wolf Creek Imputation Order. In Docket No. 142,098-U, the Commission imputed revenue for KG&E, regarding the third step of the phase-in of the Wolf Creek Generating Station. In order to receive the full amount of the third step of the phase-in, KG&E had to show that its load had grown by 41 MW. The Commission stated that the load growth and corresponding discount revenues associated with the cogeneration deferral discount

[2]Again, the purpose of this historical background is not to challenge the level of revenue deficiency suggested by Staff in Docket No. 97-WSRG-486-MER, which was a minor matter in the context of the case to transfer Western's gas business to ONEOK, but to provide the Commission with the understanding that the issue of revenue imputation was not adequately addressed in a policy context as it was in the Owens Coming case described above.

agreements and the off-system sale of electricity to the Oklahoma Municipal Power Authority should not be considered based on actual revenues in establishing the rates of Kansas Gas and Electric and that it was appropriate to impute revenues in that situation where KG&E needed to show load growth to justify a higher level of rates.' Such a rationale does not apply to this situation where Kansas Gas Service provides natural gas service at rates below the national average and must discount its rates to keep existing customers whose primary competitive alternative is the same interstate wholesale transporter who delivers gas to the Company. It is extremely difficult for a retailer to compete with its wholesale supplier for large volume customers located closely to the wholesale supplier's system.

(c) Third, the potential level of imputation has grown significantly since the Commission's Order in Docket No. 97-WSRG-486-MER. In that case, the Staff suggested that imputed revenues totaled approximately $7.7 million for year-end 1996. Today, utilizing Staffs imputation methodology, the Company would be faced with an imputation of approximately $13 million when, in fact, actual revenues from these customers are only approximately $6 million. This increase in the potential level of imputation has grown significantly because the Company has been able to recover a large volume customer who previously had switched to a competitive alternative supplier and because certain existing discount customers have significantly increased their level of consumption, thereby greatly leveraging the potential level of imputation.

13. Kansas Gas Service requests that the Commission issue its Order setting forth the policy described above. It makes absolutely no sense for the Company to compete for business where it must offer a rate of 15¢ to keep or earn a customer's business whose marginal cost to serve

[3] It should be noted that the revenue imputation ordered by the Commission in Docket No. 142,098-U was not supported by Commission Staff but was proposed by the Citizens' Utility Ratepayers Board.

is 1 0¢, and then, in the course of a rate case, the Commission imputes an additional 44¢ of revenue[4]. The net 5¢ gain in the example above turns into a 44¢ loss per unit. If this is to be the policy of the Commission, the Company will not be able to offer discounts to keep or attract such customers if the result of such bids is to incur significant losses. The Company's shareholders in the example above will lose the short term benefit of the 5 ¢ contribution to earnings and the remaining customers will not receive the comparable marginal revenue benefit from the discount customers which keep rates lower than they otherwise would be. Staffs imputation adjustment is comparable to the policy which created the gas shortages of the 1970s. By holding prices down, consumers benefitted in the short-term. In the long-term, consumers suffered a shortage of gas for delivery even though it was available in the ground. In this situation, customers may benefit in the short-term, but in the long-term rates will increase. The Company can not make up for unprofitable sales by increasing similar sales to those same customers.

14. In addition to the financial ramification set forth above associated with a policy of imputation, the Commission should be aware of safety concerns associated with such a policy. Many of the bypass situations faced by the Company occur as a result of a customer building an interconnection to an interstate pipeline. If the Company loses more bids to customers who bypass the Company's facilities and interconnect with interstate pipelines (due to the disincentives associated with imputation), the risk of an accident increases. There will be more pipelines in the ground in urban areas carrying large volumes of gas which will increase the risk of third parties damaging these underground facilities.

[4] The 44¢ imputation represents the difference between the first block under Rate Schedule LVTk, i.e., $0.5923 and the $.15 example.

15. Kansas Gas Service understands that the Commission, its Staff or intervenors may suggest that this is an issue that should be addressed in the context of a rate case. Given the dynamics of the market place, at times the Company must provide longer-term bids to retain customers. Kansas Gas Service is reluctant to provide such bids because of the inherent risks associated with such bids and a policy of imputation. Kansas Gas Service does not desire to file a rate case just to find out the answer to this question. Inevitably, the Company will have to file a rate case in the near future to recover its cost of service but would like to delay filing such a case as long as possible. If Kansas Gas Service is able to retain and/or increase transportation revenues as a result of these Flex Contracts, the necessity for filing for an increase in rates may be delayed. Thus, this is an important policy question which requires attention today. The Commission has opened dockets on its own to investigate many other issues outside the context of a rate case, for example, the issue of whether to install excess flow valves, Docket No. 99-GIMG-670-GIG, the Commission's Inquiry into Retail Choice and Alternatives, Docket No. 99-GIMG-538-GIG, Gas Distribution Competition, Docket No. 99-KGSG-233-GIG and investigations into Billing Practices of Local Distribution Companies, Docket No. 97-GIMG-5 14-GIG.

WHEREFORE, for the reasons set forth above, Kansas Gas Service requests that the Commission issue an Order ruling that there will be no imputation of revenue in the course of a rate case filed by Kansas Gas Service associated with Discounted Service Agreements entered into in accordance with the Company's tariffs.

Respectfully Submitted,

KANSAS GAS SERVICE COMPANY,
A DIVISION OF ONEOK, INC.

John P. DeCoursey

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ITS ATTORNEYS

VERIFICATION

STATE OF KANSAS)
)ss
COUNTY OF JOHNSON)

John P. DeCoursey, being duly sworn upon his oath deposes and says that he is an Attorney for Kansas Gas Service Company, a Division of ONEOK, Inc.; that he as read and is familiar with the foregoing **Application of Kansas Gas Service Company;** and that the statements contained therein are true to the best of his knowledge, information and belief.

John P. DeCoursey

John P. DeCoursey

Subscribed and sworn to before me, a notary public, this 19th day of November, 1999.

Colleen Evans

Notary Public

My Appointment or Commission Expires:

November 13, 2000

NOTARY PUBLIC - State of Kansas
COLLEEN EVANS
My Appt. Exp. 11/13/2000