

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

In the Matter of the Application of Westar)
Energy, Inc. and Kansas Gas and Electric) Docket No. 18-WSEE-163-TAR
Company for Approval of Revisions to)
their Policy for Residential Subdivisions.)

NOTICE OF FILING OF STAFF REPORT AND RECOMMENDATION

The Staff of the Kansas Corporation Commission (Staff) has investigated the Application of Westar Energy, Inc. and Kansas Gas and Electric Company (collectively “Westar”), filed in the above-captioned docket on October 16, 2017, requesting a revision to Westar’s Policy for Residential Subdivisions which would allow Westar to accept irrevocable letters of credit (ILOC) in lieu of cash deposits from developers of residential subdivisions to cover infrastructure installation costs exceeding Westar’s \$40,000 allowance.

Staff has prepared a Report and Recommendation dated April 20, 2018, recommending the Commission deny Westar’s proposal in the above-captioned docket. Instead, Staff recommends the Commission open a general investigation, the scope of which should be limited to determining whether accepting an ILOC, in lieu of a cash deposit, is an appropriate form of security for residential subdivision developers and, if so, whether any specific conditions should be placed on the financial institution issuing the ILOC.

WHEREFORE, Staff submits its Report and Recommendation dated April 20, 2018,
attached hereto, for the Commission's consideration.

Respectfully submitted,



Otto A. Newton, S. Ct. #08760
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STATE OF KANSAS)
) ss.
COUNTY OF SHAWNEE)

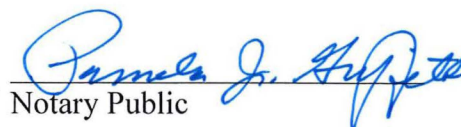
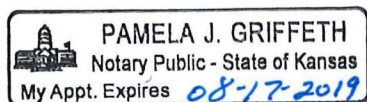
VERIFICATION

Otto A. Newton, being duly sworn upon his oath deposes and states that he is Litigation Counsel for the State Corporation Commission of the State of Kansas, that he has read and is familiar with the foregoing *Notice of Filing of Staff's Report and Recommendation* and that the statements contained therein are true and correct to the best of his knowledge, information and belief.



Otto A. Newton #08760
Kansas Corporation Commission

Subscribed and sworn to before me this 2nd day of May 2018.


Notary Public

My Appointment Expires: August 17, 2019

STATE OF KANSAS



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REPORT AND RECOMMENDATION UTILITIES DIVISION

TO: Shari Feist Albrecht, Chair
Jay Scott Emler, Commissioner
Dwight D. Keen, Commissioner

FROM: Darren Prince, Senior Research Economist
Josh Frantz, Senior Research Economist
Lana Ellis, Deputy Chief of Economics and Rates
Robert Glass, Chief of Economics and Rates
Jeff McClanahan, Director of Utilities

DATE: April 20, 2018

SUBJECT: Docket No. 18-WSEE-163-TAR: In the Matter of the Application of Westar Energy, Inc. and Kansas Gas and Electric Company for Approval of Revisions to their Policy for Residential Subdivisions.

EXECUTIVE SUMMARY:

Westar Energy Inc.'s (Westar or Company) Policy for Residential Subdivisions (Policy) is intended, in part, to limit Westar's investment in utility plant prior to eventual residential consumer demand for electricity. Under the current Policy, Westar requires a cash deposit (potentially refundable) from developers of residential subdivisions to cover infrastructure installation costs exceeding \$40,000 (Westar's allowance). In this Docket, Westar is requesting the Kansas Corporation Commission (Commission) approve proposed changes to the Policy, which would allow Westar to accept irrevocable letters of credit (ILOC)¹ in lieu of deposits from developers to cover installation costs in excess of the allowance. If, after five years, permanent meters have not been set on a sufficient number of lots to recover Westar's investment, Westar may draw on the ILOC for an amount equal to the unrecovered amount of its investment.

¹An ILOC is an official correspondence from a bank that guarantees payment for goods or services being purchased by an individual or entity (the applicant) who requests the ILOC from the issuing bank.

Commission Staff (Staff) has concerns about the potential consequences of Westar's proposal due to the differences between the accounting treatment of cash deposits and ILOCs. However, Staff has not found Commission policy regarding the appropriateness of requiring ILOCs in lieu of deposits; and furthermore, Staff has discovered some jurisdictional utilities already accept ILOCs in lieu of deposits from developers of residential subdivisions without specific tariff language detailing such practice. Therefore, Staff recommends the Commission not approve Westar's proposal in this Docket. Instead, Staff recommends the Commission open a general investigation with the intent of determining when it is appropriate to accept an ILOC in lieu of a deposit and any conditions that should be placed upon such acceptance.

BACKGROUND:

Westar's Policy for Residential Subdivisions (Policy) is designed to allow Westar to build electric infrastructure for housing subdivisions before they are completed while protecting ratepayers from paying for potential stranded costs.

Under its current Policy, Westar provides an allowance for the first \$40,000 in electric infrastructure costs for each residential subdivision project. The developer pays Westar a cash deposit that is equal to the estimated cost for the project less the \$40,000 allowance. As the developer builds homes and meters are set, the deposit is refunded on a per meter basis. Under the Policy, the developer has five years to finish a development before forfeiting the deposit.

In the current Docket, Westar filed an Application requesting the Commission approve a revised version of its Policy for Residential Subdivisions. According to Westar, developers have approached Westar indicating the cash deposit requirement is burdensome and inhibits their development opportunities.² In addition, Westar believes an ILOC will modernize Westar's business practices and assist with economic development.³ Therefore, Westar is requesting that developers be allowed to either pay Westar a deposit or provide an ILOC equal to the estimated cost for the project less the allowance.

ANALYSIS:

Jurisdiction

The Commission derives its authority to review applications modifying tariffs from K.S.A. 66-117(d):

Except as provided in subsection (c), no change shall be made in any rate, toll, charge, classification or schedule of charges or joint rates, or in any rule or regulation or practice pertaining to the service or rates of any such public utility or common carrier, without the consent of the Commission.

Standard of Review

K.S.A. 66-101b requires every electric public utility to make just and reasonable rules, classifications, and regulations. The terms "just" and "reasonable" import flexibility and are not intended to bind regulatory discretion to an absolute or mathematical formula. "Just and

² Application, p. 2, ¶3 (Oct. 16, 2017) (Application).

³ Application, p. 2, ¶4.

reasonable” can be seen as a compromise or balance between the Commission, the Utility, customers, and the general public. Staff evaluates any proposed tariff revisions made by electric public utilities to determine the reasonableness of the proposed change.

In addition, Staff also reviews previous Commission Orders that contain Commission Policy statements about the issues involved in the tariff analysis. In the case of ILOCs, Staff tried to find prior Commission policy related to the use of ILOCs in lieu of cash deposits, but was unable to find any policy statements and is, therefore, seeking Commission guidance as to when it is appropriate to accept an ILOC and any conditions that should be placed upon that acceptance.

Residential Subdivision Extension Policy

Westar is proposing to allow developers the option of substituting an ILOC for the currently required cash deposit for electric infrastructure in new residential subdivisions. The purpose of the deposit or the ILOC is to ensure that Westar is able to recover its costs of infrastructure investment if construction for a particular subdivision is stopped before completion. However, accepting ILOCs in lieu of deposits from developers would have other ramifications which impact Westar customers such as a difference in the treatment of the funds for ratemaking purposes. Further, because Staff could find no Commission Policy Statement, Staff investigated subdivision policies of other jurisdictional utilities in Kansas to determine if there was a consistent approach to the use of ILOCs. All of these topics will be addressed below.

Westar’s Current Policy

Residential Subdivision Extension Allowance and Deposits

Under the current policy, Westar provides a \$40,000 allowance toward a conventional overhead distribution system per subdivision or portion to be built in a 12-month period.⁴ The developer is required to provide Westar a cash deposit equal to the difference between the \$40,000 allowance and the cost of the conventional overhead distribution system.^{5,6} Payment of the deposit must be completed by the developer prior to the start of work. However, the developer is eligible for potential refunds of the deposit on a per lot basis after construction and setting of permanent meters on at least the number of lots sufficient to cover Westar’s investment.⁷ The developer will forfeit the remaining amount of its deposit if it does not complete the subdivision within a five-year period.⁸

Westar’s Proposal

Optional ILOC in Lieu of Extension Deposit for Residential Subdivisions

The proposed policy would allow developers to choose between providing an ILOC or a cash deposit to cover any excess costs above the \$40,000 allowance Westar provides. As stated in Westar’s proposed Tariff:

If the Developer provides an ILOC in lieu of a deposit, ILOC may be: 1) terminated at such times as the number of lots with permanent meters set are sufficient to cover Company’s investment, as defined in Section 5, or 2) reduced based on the number

⁴Westar Tariff, Policy for Residential Subdivisions, Sheet 2 (Policy).

⁵ Policy, Sheet 2.

⁶ If the developer chooses to install something other than a conventional overhead distribution system, the developer is responsible for the difference between the cost of the conventional system and the cost of the system selected by the developer (Policy, Sheet 3).

⁷ Policy, Sheet 3.

⁸ Policy, Sheet 3.

of lots with permanent meters at the discretion of the Company. If, at the end of the five-year period beginning from the date the deposit is made by Developer and Company installs the distribution system, permanent meters have not been set on a sufficient number of lots to cover the investment, Company may draw on the ILOC for an amount equal to the unrecovered amount of Company's investment.⁹

ILOC Form and Financial Institution Requirements

Section 10 of Westar's proposed revisions to its Policy for Residential Subdivisions lays out several criteria the ILOC form and backing financial institution must meet; provides instructions for a developer if the backing financial institution does not renew the ILOC, fails to allow Westar to draw on an outstanding letter of credit, or enters bankruptcy proceedings; and establishes that the costs of establishing, renewing, substituting, cancelling, or increasing/decreasing the amount of an ILOC shall be borne solely by the developer.

Potential Ramifications of Westar's Proposal

Accounting Treatment for Extension Deposits vs. ILOCs

The cash deposits in question are treated for regulatory accounting purposes as Customer Advances for Construction (CAFC), which means the developer funds are used to fund the extension of Westar's infrastructure necessary to connect the new subdivision. For ratemaking purposes, these CAFC are removed from rate base, thus recognizing the utility has not actually incurred the capital costs associated with the plant investment related to the subdivision.

With a cash deposit on hand, that cash is used as a rate base offset, as it is recognized as cost free capital. Thus, not only are ratepayers protected from the possibility of stranded costs, but also from funding the cost of capital associated with building out the infrastructure for residential housing developments.

Under the ILOC scenario, there would not be any up-front cash from the developer available to fund the investment in infrastructure, so the funds would come from utility operations. For ratemaking purposes, the cash used from utility operations to fund the extension of Westar's infrastructure would not be cost free capital and would not be removed from rate base. If Westar's proposal is accepted, Shareholders would finance the cost of extending the infrastructure until there is a rate case, and then ratepayers would finance the carrying costs of the capital used to fund infrastructure going forward.

Cross-Subsidization

The current policy, where developers' deposits are treated as CAFC and removed from rate base, protects ratepayers from stranded costs and funding the cost of capital investments associated with residential housing developments. The proposed tariff changes shift the risks and carrying costs from the developers to Westar's shareholders or ratepayers. The shift in risk and carrying costs is a result of the lack of developers' up-front cash deposits. For example, in Westar's current rate case, Docket No. 18-WSEE-328-RTS, Table 1 below shows the developer deposits, and the resulting carrying costs.¹⁰ As proposed, if all developers used an ILOC in lieu of cash deposits, the carrying costs in Table 1 would be included in rate base or financed by shareholders.

⁹ Application, Proposed Policy, Sheet 3.

¹⁰ Response to data request KCC-6.

Table 1		
Rate Case	Developer Deposits	Carrying Costs
18-WSEE-328-RTS	\$ 6,385,336.00	\$ 560,817.68

Risk of Non-Payment

It is not absolutely certain that the financial institution backing an ILOC will be able to cover the developer's debt when called upon. This is the reason Westar is proposing criteria the backing financial institution must meet along with contingency instructions for developers, if the original backing financial institution undergoes bankruptcy proceedings or fails to allow Westar to draw on an outstanding ILOC.

The conceptual risk of non-payment is substantiated by the difference between confirmed and unconfirmed letters of credit:

A confirmed letter of credit is a letter of credit with a second guarantee obtained by a borrower in addition to the first letter of credit. A confirmed letter of credit is typically used when the issuing bank of the first letter of credit may have questionable creditworthiness... If the first letter of credit is not backed by a second guarantee then it may be considered unconfirmed.¹¹

In its proposal, Westar does not require an ILOC be confirmed by a second guarantor. The bottom line is: receiving cash upfront is always less risky for the utility than accepting credit.

Inconsistency across Jurisdictional Utilities' Acceptance of ILOCs

As part of its review of Westar's proposal, Staff contacted other jurisdictional utilities—both electric and gas—to discuss their extension policies for developers of residential subdivisions, as well as their acceptance of ILOCs for other purposes.

Through its conversations with other jurisdictional utilities, Staff discovered some of these utilities already allow for ILOCs in lieu of deposit for developers and/or for other purposes. Such accepted alternatives to cash deposit were not specifically defined in the utilities' tariffs. Where ILOCs were accepted, the specific criteria of the backing financial institution was not explicitly defined.

RECOMMENDATION:

As discussed above, Staff has concerns about the differences in potential consequences of accepting ILOCs in lieu of cash deposits (in particular, the difference in accounting treatment and the potential shift in risk to ratepayers). In addition, Staff has found some jurisdictional utilities already accept ILOCs in lieu of deposits from developers of residential subdivisions without tariff language detailing such practice. Staff was unable to find prior Commission policy related to the acceptance of ILOCs in lieu of cash deposits and is, therefore, seeking guidance as to when it is appropriate to accept an ILOC and any conditions that should be placed upon acceptance.

Because of the need for Commission policy regarding the acceptance of ILOCs in lieu of deposits, Staff's concerns regarding the consequential differences between cash deposits and ILOCs, and the lack of consistency in jurisdictional utilities' policies regarding the acceptance of ILOCs for

¹¹Confirmed Letter of Credit. (Retrieved Apr. 3, 2018, from <https://www.investopedia.com/terms/c/confirmed-letter-credit.asp>).

security, Staff recommends the Commission deny Westar's proposal in this Docket. Instead, Staff recommends a general investigation be opened.

Staff's hope is that a general investigation will provide the Commission with enough information regarding the differences between a cash deposit and an ILOC to establish when it is appropriate to accept one or the other or both, and any conditions that should be placed upon acceptance. The scope of the general investigation should be limited to determining whether accepting an ILOC, in lieu of a cash deposit, is an appropriate form of security for residential subdivision developers and, if so, whether any specific conditions should be placed on the financial institution issuing the ILOC.

CERTIFICATE OF SERVICE

18-WSEE-163-TAR

I, the undersigned, certify that a true and correct copy of the above and foregoing Notice of Filing of Staff Report and Recommendation was served by electronic service on this 2nd day of May, 2018, to the following:

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