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Before the House Committee on Energy, Utilities, and Telecommunications

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Opponent Testimony On House Bill 2527

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On Behalf of The Staff of the Kansas Corporation Commission

Chair Delperdang, Vice Chair Turner, Ranking Minority Member Ohaebosim, 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 (KCC or Commission).

Executive Summary

The Staff of the KCC is **opposed** to HB 2527 in its current form. This bill contains four separate sections that each could have been a separate bill. Accordingly, this testimony will address each section of the bill separately. Staff contends that Sections 1, 3, and 4 are largely a policy decision for the Kansas Legislature, and we stand ready to work through our concerns with these sections as part of a broader stakeholder process, should the Committee choose to further consider these sections of the bill. **However, Section 2 of this bill should not receive any further consideration beyond this hearing, and should be struck from the bill in its entirety**. **Should Section 2 of this bill become law, it would dramatically and negatively alter the landscape of utility regulation in this State to the direct benefit of utility shareholders and to the direct detriment of utility ratepayers.** Section 2 of this bill would strip the Commission of the authority to determine a reasonable capital structure and Return on Equity (ROE), two of the most material rate issues decided in every utility rate proceeding. **The result could very well be hundreds of millions of dollars in unjust wealth transfer every year, from utility ratepayers in Kansas to utility shareholders.**

Section 1

Background

Section 1 of the bill would only affect electric utilities in the State, principally Evergy Kansas Central (EKC), Evergy Kansas Metro (EKM), and Liberty-Empire. This section establishes what is known as Plant in Service Accounting (PISA) in Kansas, a more limited form of which is currently allowed in Missouri. While PISA is not a commonly found utility ratemaking practice across the United States, it is one way that utility shareholders can be protected from regulatory lag experienced when a utility invests in electric infrastructure in between rate cases. This regulatory lag occurs in the form of additional depreciation expense that begins to accrue when plant is placed in service, and the capital costs associated with carrying that capital investment, before the investment can be reflected in rates. Today electric utilities in Kansas manage these costs between rate cases until customer rates can be updated to reflect the new plant in service.

PISA would accrue these costs into a regulatory asset, which would then be placed in the utility's rate base to earn a return and be amortized over 20 years, beginning with the next rate case.

Analysis

The PISA elements of Section 1 are largely a policy decision for the Kansas Legislature. **However, if this Section is enacted into law, it will likely materially increase electric rates in Kansas.** Staff has attempted to quantify the rate impact of this section of the bill by evaluating how much higher rates would have been coming out of Evergy's most recent Kansas rate case, had PISA been in effect for each of the preceding five years during the rate moratorium. <u>Staff quantifies the regulatory asset EKC would have recorded for the years 2019 through 2022 at $158.5 million. The inclusion of this regulatory asset in rate base, as well as the amortization of this amount over 20-years would have increased EKC's revenue requirement by $18.7 million annually.</u> This is a substantial impact considering that the Commission approved a $74 million net increase for EKC. The rate impact of PISA would grow over time as additional regulatory assets were added to rate base and amortized. Staff calculates that EKC's regulatory asset would grow to approximately $396 million by year 20, which would increase rates approximately $58.6 million per year. Assuming a five-year rate case cycle and stable capital expenditures, this increase to EKC's rates would be permanent, with previous regulatory asset amortizations being replaced by a new regulatory asset every rate case.

<u>For EKM, Staff calculates an $87 million regulatory asset for years 2019-2022, which would have increased current rates by $10.2 million, offsetting nearly 30% of the $33 million rate reduction approved by the KCC.</u> This impact too grows overtime, to a permanent $217 million regulatory asset by year 20, and a permanent annual rate increase of $32.2 million for EKM.

In short, PISA would increase electric rates and diminish a utility's incentive to manage costs in between rate cases. On the other hand, PISA may also remove a utility's financial disincentives to proactively invest in infrastructure to support future economic development or other policy goals of the State. In the event that Section 1 of this bill receives further consideration from the Committee, there should at a minimum be additional customer protections included in the bill, including caps on the size of the regulatory asset that could accumulate, caps on the total rate impact that this legislation could cause for Kansas retail customers, and limitations on the types of investment that could be considered for PISA treatment.

<u>Section 2</u>

Background

Section 2 of the bill would apply to all large electric and natural gas public utilities in the State, including EKC, EKM, Kansas Gas Service, Black Hills, and Atmos. This section of the bill has two major components: 1) the Commission would no longer have the authority to choose a capital structure for ratemaking purposes (the mix between lower cost Debt and higher cost Equity financing) that balances the interests of both ratepayers and shareholders and that results in just and reasonable rates. Instead, the Commission would be required to utilize the actual test year capital structure chosen by utility management, regardless of how costly or inefficient that capital structure was for Kansas customers; and 2) the Commission could no longer set an ROE (the profit opportunity component of utility rates) that best balances the interests of ratepayers and shareholders, and which results in just and reasonable rates. Instead, the Commission would be bound by the utility's choice to use an average of the fully litigated ROE results from other states over the last 12-months, regardless of whether those underlying ROEs resulted from Commissions similar to Kansas, or utilities with similar risks, financial health, etc.

To Staff's knowledge, a bill of this form that allows a regulated utility to choose its own capital structure for ratemaking purposes, regardless of how costly that decision is to ratepayers, does not exist anywhere in the United States. This section of the bill would directly contradict landmark court decisions by both the United States Supreme Court[1] and the Kansas Supreme Court[2] that have unequivocally held that regulatory commissions like the KCC should have the authority to determine a reasonable capital structure and a reasonable ROE when setting utility rates in rate cases. In one Kansas court case, the Court cited the widely-accepted proposition that "the owners and management of a utility have the right to determine what the Debt-Equity ratio should be, but they may not always make the ratepayers foot the bill resulting from the choice."[3]

The following excerpts from a 2015 Kansas Court of Appeals case describes the importance of the KCC evaluating the reasonableness of a utility's chosen capital structure:

> In determining a utility's revenue requirement, the Commission must ascertain the company's reasonable and prudent operating costs, its rate base, and a reasonable rate of return.[4] In addition, a public utility is entitled to earn a return on its "rate base," or its "investment in the plant and property 'used and required to be used' in supplying the regulated service.".[5] As a result, the utility earns a return on its rate base by determining an appropriate "rate of return" that is multiplied by the value of the company's rate base.[6] The rate of return, which is multiplied against the utility's rate base, is generally calculated based on the company's "cost of capital."[7] The Commission examines the company's capital structure to identify the sources of its capital, including long term debt, preferred stock, and common stock. The cost of each of these items of capital is determined. Usually, the cost of common stock (*i.e.*, dividends) is the highest and the cost of debt is the lowest.[8]
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> Because the "rate of return" element is a multiplier, the capital structure of a company significantly impacts on its revenue requirement. When a capital structure is considered unbalanced, issues arise. A utility heavy in Equity as opposed to Debt increases the company's revenue requirement under the standard formula because (1) investors demand higher returns than lenders, resulting in Equity capital being

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[1] *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).
[2] *Kansas Gas & Electric*, 239 Kan. at 488-90; *Southwestern Bell Tel. Co. v. State Corp. Comm'n*, 192 Kan. 39, Syl. ¶ 17 (1963).
[3] *Sekan Elec. Co-op Ass'n, Inc. v. State Corp. Comm'n*, 4 Kan. App. 2d 477, 480 (1980).
[4] *See Moundridge Tel. Co. v. Kansas Corp. Comm'n*, No. 114,064, 2015 WL 7693784 at *15 (Kan. Ct. App. 2015).
[5] *Id*.
[6] *Id.*
[7] *Moundridge Tel. Co.*, 2015 WL 7693784 at *15.
[8] *Id.*

> more costly; and (2) interest paid on Debt is deductible by the company for tax purposes, whereas dividends are not.[9] A less than efficient capital structure which contains excessive Equity is likely is likely to result in higher rates.[10]

Analysis

The reason that State and Federal courts have recognized the importance of capital structure and ROE decisions in the ratemaking process is because of the material impact these decisions can have on the ultimate reasonableness and affordability of utility rates. For example, in Evergy's most recent rate case, if Evergy's actual operating utility capital structure had been used, with a 9.82% ROE (which is the most recent 12-month average for 2022 as called for in the bill) the result would have been a revenue requirement increase that was $26 million higher for EKC ($100 million increase versus the $74 million approved by the Commission) and $10.5 million higher for EKM ($21.5 million decrease versus the $33 million decrease approved by the Commission). **Thus, the rate impact of Section 2, for just these two utilities, would have been $36.5 million higher rates paid by Kansas customers every year.** When you consider the fact that Section 2 as written would not limit the amount of Equity in the capital structure in any fashion, it is not difficult to envision a result where utilities could increase their Equity to 60% or higher of the capital structure. A 60% Equity level in Evergy's recent rate case would have resulted in rates for EKC and EKM that were $103 million higher than what the Commission approved. **If every utility in Kansas took advantage of this bill and increased the Equity percentage in the capital structure to 60% or higher, the result would be hundreds of millions of dollars of higher utility rates in Kansas.**

There have been statements made to the Committee that the Commission's capital structure policies are "almost unique" among regulatory commissions in the United States. The reality is that downward adjustments to utility capital structures are quite common in utility ratemaking proceedings across this country. In fact, Regulatory Research Associates (RRA) reports that 19 out of the 61 (31%) vertically integrated electric utility rate cases decided from 2019-2023 in the United States involved some form of downward adjustment to the amount of Equity in the capital structure. For example, in 2021 and 2022, the average vertically integrated electric utility Equity percentage requested nationwide was 51.21% and the average Equity percentage granted by Commissions was 50.39%. This can be compared to Evergy's 52.2% to 52.6% Equity request and Evergy's 50.01% to 50.32% approved Equity from the most recent rate case. To summarize, in the most recent rate case, Evergy's requested Equity percentage was higher than other utilities request on average, and the Commission adjusted that Equity percentage downward to a level that was very close to what other utilities receive from their regulatory commissions, on average.

The Commission denied the original KCPL/Westar proposed merger in Docket No. 16-KCPE-593-ACQ (16-593 Docket) in part because the financing plan for that merger involved taking out $4.3 billion in holding company debt (in order to lower the overall Cost of Capital), but then shielding that lower cost capital from the ratemaking process in rate cases by requiring the use of operating company capital structures. The Commission stated the following on page 21 of the Order Denying Merger:

> Third, it appears that while the Joint Applicants do not propose to include the acquisition costs in rate base, they still plan to recover the acquisition premium

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[9] *Id.* at *16.

[10] *Id.* (quoting *In re Zia Natural Gas Co.*, 998 P.2d 564, 567, 2000 NMSC 011 (2000)).

> indirectly from ratepayers. As CURB, BPU, KEPCo, and Staff claim, if the Joint Applicants are allowed to use a capital structure for ratemaking purposes that is not representative of the financing for the transaction, the ratepayers are actually subsidizing the acquisition premium. There is a separate weighted cost of capital at the operating utility level versus the parent level. Traditionally, there is little difference between the weighted cost of capital at both levels. But as proposed by the Joint Applicants, the parent (GPE) is taking on additional leverage at historically low rates. As a result, the weighted cost of capital for GPE will be significantly less than that of the operating utility subsidiaries. Such a financial structure allows the Joint Applicants to recover the acquisition premium by taking advantage of the difference between the higher returns paid to the operating utilities and the low cost of debt. GPE acknowledges that there is a financial benefit derived from the way the transaction is being financed. Rather than refund the difference to the ratepayers, GPE is retaining those funds to pay the acquisition premium. Essentially, GPE is using the ratepayers as its bank.

The Commission denied the merger in the 16-593 Docket because it was obvious that Evergy was planning on using the difference between the holding company capital structure and the operating company capital structure to the advantage of shareholders, and to the detriment of ratepayers. If Section 2 of this bill became law, the Commission would be powerless to stop this kind of financial engineering from harming Kansas ratepayers in the future, to the direct benefit of shareholders.

Section 3

Staff views the changes to K.S.A 66-101j contained in Section 3 to be a policy decision within the purview of the Kansas Legislature. Staff is interested in participating in stakeholder discussions to explore these revisions to current law pertaining to economic development rates and discounted rate contracts. Staff is supportive of Evergy's proposed amendment to remove current sections (e)(1) and (e)(2) from the bill, which pertain to mandatory lost revenue tracking, as Staff opposed the original inclusion of these provisions in K.S.A. 66-101j when this law was originally enacted in 2020.

Section 4

Staff views the changes to K.S.A. 66-1239 contained in Section 4 to be a policy decision within the purview of the Kansas Legislature. Staff is interested in participating in stakeholder discussions to explore these revisions to current law pertaining to the current predetermination process, and whether a surcharge should be used to recover the real capital costs associated with constructing a new dispatchable natural gas fired generation facility. Recovering capital costs associated with construction of a new generating facility through a surcharge on customer bills, as opposed to more frequent rate cases, may actually result in lower overall customer rates. This can occur due to the avoidance of Allowance for Funds Used During Construction (AFUDC), as well as lower rate case expenses for rate cases which are driven solely by the construction activity. While there are a few revisions we would prefer to see made to this section, we will be prepared to address those concerns during stakeholder discussions, if the Committee chooses to further its consideration of this portion of the bill.

Thank you for the opportunity to offer Staff's perspective on the proposed bill and the opportunity to appear before your Committee.