Comments before the Senate Interim Committee

Good morning. My name is Natelle Dietrich and I am the Public Service Commission Staff Director. I'd like to thank the committee for the opportunity to speak today. My comments will be focused on the current regulatory environment in Missouri.

The Commission is charged with ensuring utilities provide safe and adequate service at just and reasonable rates. In determining whether rates are just and reasonable, the Commission must balance the interests of the investor and the general public.

So, what is involved with determining just and reasonable rates? There are two main components – revenue requirement and rate design.

Revenue requirement is the cost of providing utility service. As you saw in the formula yesterday, revenue requirement is determined by a review of such things as capital structure, operating costs, depreciation, taxes, the gross valuation of property required for providing service and the associated accumulated depreciation on that investment, and an allowed return. It should be noted utilities in Missouri are allowed by law an opportunity to earn a return set by the Commission, but it is not a guarantee. The process of determining a revenue requirement involves extensive audit and review by Commission Staff of company books and records, and consideration of all relevant facts by the Commission. The Commission reviews information not only provided to it by the utility and Staff, but also all other parties that have intervened in the rate case.

Rate design refers to how the revenue requirement pie, or the cost of the service, is sliced among various customer classes. Cost causation – customers who cause the cost of providing service pay that cost in rates - is typically a driving factor, although many other factors such as rate shock to any one customer class and rate continuity are also considered. Depending on the utility, rate design can include such things as usage charges, customer charges, a demand charge, or energy charges.

These basic fundamentals of ratemaking have worked for 100 years, and the Missouri Supreme Court has said the Commission has no authority to "change the

rate making scheme set up by the legislature." ***State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Service Commission,*** 585 S.W.2d 41, 56 (Mo. banc 1979). However, there have been revisions over time, both through legislative changes and through Commission action within its general authority, to meet the changing regulatory environment. Examples include:

i. The Fuel adjustment charge or FAC. The FAC is designed to address the volatility of fuel and purchased power, as well as off-system sales. The FAC attempts to capture these costs in a more timely fashion. If costs decrease, the electric customer receives more timely benefit through lower rates. If costs increase, the electric utility can recover those costs more quickly.
ii. Infrastructure System Replacement Surcharge or ISRS. The ISRS is designed to provide the utility company more timely recovery of a portion of the expenditures it incurs to replace and extend the useful life of its existing infrastructure. Most natural gas utilities have an ISRS, and Missouri American Water Company has an ISRS in St. Louis County.

Other adjustment mechanisms include the environmental cost recovery mechanism for electric and water utilities, and the renewable energy standard rate adjustment mechanism and the Missouri Energy Efficiency Investment Act mechanism for electric utilities.

As an example of Commission action addressing the current regulatory environment, in the current KCP&L Greater Missouri Operations Company rate case, the Commission ordered the ratemaking process to be concluded in10 months instead of the traditional 11 month timeframe. The Missouri Commission has for many years used certain procedures, known as "true-up audits," that allow costs incurred well after the filing of a rate case to be audited and included in rates by the Commission. The Commission has also, in the past, authorized a straight-fixed variable rate, a form of decoupling, for some natural gas utilities, and has moved toward rate consolidation for utilities with multiple service territories. Finally, the Commission has authorized the use of the purchased gas adjustment or PGA.

Similar to the FAC, the PGA allows natural gas utilities to recover the costs of fluctuating gas prices in a more timely manner.

The Commission has also periodically reviewed the regulatory environment. These reviews have included some of the suggestions you are receiving in this hearing process – accelerated discovery, enhanced reporting between rate cases, shortened processing timeframes. But due to differing interests and positions, many of the suggestions were opposed by one stakeholder type of another.

In June, the Commission opened a working docket to consider policies to improve electric utility regulation. Initial comments were received in July and responses to those comments were received on August 8. The Commission will host a workshop to further explore comments on September 13, and a Staff report is due October 17. We look forward to sharing information obtained as part of this docket with the Committee.

Many comments in the Commission's working docket addressed the concept of regulatory lag. Missouri rate cases are based on a historic test year. Generally, in order to be considered in rates, investments have to be "used and useful". Under Missouri law, compensation for "construction work in process" is prohibited for electric utilities. Thus, there is usually some amount of time between when a utility begins making a capital investment and when it may begin to recover that investment in rates, which is called regulatory lag.

Until fairly recently, regulatory lag operated to the benefit of utilities as they were in a "growth" environment with little additional investment. Now that we have shifted from a regulatory environment of growth to an environment promoting conservation with pressure for more investment, regulatory lag is often portrayed as a hindrance to investment.

It has often been asserted that regulatory lag can cause an electric utility to suffer prolonged under earnings (i.e., earnings below the level authorized by the Commission in the utility's most recent rate case) when it makes a significant plant investment to replace aging infrastructure or for other reasons. But these claims can be misleading, for several reasons.

First, while electric utilities are currently forbidden by statute to include the costs of electric plant under construction in rates before the plant asset is "in-service," Missouri utilities can capitalize a "carrying charge" on such facilities called the "allowance for funds used during construction," or AFUDC, during the construction period. The AFUDC charge has the effect of eventually fully compensating shareholders for their investment in utility construction projects by allowing the utility recovery of a deferred return on construction costs from ratepayers over the life of the asset in question.

Second, while the cost of new plant is an addition to utility rate base, this is offset in the rate base calculation by the amount of ongoing depreciation expense collected from customers relating to past plant in service additions. In other words, the two things are happening at the same time; the utility incurs the cost of new plant while earning depreciation on existing plant. The increase in utility depreciation expense collections over time, which is many millions of dollars annually for our large utilities, offers these companies the opportunity to make a commensurate amount of plant additions for infrastructure replacement or for other purposes without suffering any reduction to utility earnings.

Also, as you know, general rate case proceedings can take up to eleven months to complete in Missouri. However, the amount of regulatory lag that is incurred in respect to utility plant costs or expenses is generally much less than eleven months since procedures, known as "true-up audits," allow costs incurred well after the filing of a rate case to be audited and included in rates by the Commission. Under these procedures, the major categories of costs are updated to a point in time usually no more than five months prior to the effective date of rates for a utility. This procedure allows for the inclusion in rates of costs that have been subject to Commission audit and review, and yet also allows for rates to reflect a reasonably current utility cost of service.

The existence of regulatory lag means that utilities are unable to automatically update their rates to reflect changes in their cost of service, whether increasing or decreasing. In this same light, though, regulatory lag creates incentives for utilities to operate over time in the most productive and efficient way possible. A utility that reduces its costs over time will receive a reward by seeing its earnings increase because its rate revenues will not automatically decrease in proportion to its cost

reductions. Conversely, a utility that is not able to control its costs effectively will as a result see its earnings reduced by the effects of regulatory lag, as its rate revenues will not automatically increase in proportion to its expenses. For this reason, initiatives with the purpose of eliminating or greatly reducing the amount of regulatory lag faced by utilities should be considered very carefully to avoid also eliminating the practical incentives Missouri utilities now have in place to encourage cost-effective and efficient operations.

As the Committee explores ways to address the current regulatory environment, it should be noted that not all state regulation is created equal. Missouri is a vertically integrated state. In other words, generation, transmission and distribution are owned by a single electric firm. Vertical integration typically has led to low-cost production and long-run efficiencies. In contrast, states such as Illinois have restructured or deregulated portions of their electric operations. Separate entities own generation, transmission and/or distribution allowing for wholesale competition.

The same thing is true with regulation. Several states have historic test years and audited rates such as Missouri, other states have employed decoupling, formula rates or performance-based rate structures. But, even in the states with seemingly "like" regulation, there are different methods of determining rates. Some states allow forward-looking test years under varying circumstances. In states that have formula or performance-based rates most states allow for "sharing" of any utility over or under-earnings, and do not guarantee the utility a particular earnings result. In other words, one should proceed with caution when comparing Missouri regulations to those of other states.

As with any complex process, there are challenges. Missouri has aging infrastructure needs for all utility sectors. Environmental mandates have required large investments, which will likely continue into the next decade. According to the US Energy Information Administration, Missouri ranks 25th in total energy consumed per capita. In 1997, Missouri ranked 32nd with an average annual electric rate of 7.8 cents per kilowatt hour compared to the national average of 8.4 cents. At the end of 2015, Missouri ranked 16th with an average residential electric rate of 10.99 cents per kilowatt hour compared to the national average of 12.67 cents. In the packets that were distributed, we have included some graphs and

charts which compare Missouri rates to Illinois, Iowa and Kansas. These were part of the Comprehensive State Energy Plan, and provide handwritten, updated numbers for year end 2014 and 2015.

Since 2000, the Commission has processed 23 natural gas rate requests, 27 electric rate requests and 7 large water rate cases. The Commission recently finished rate cases for Missouri American Water Company and The Empire Electric District Company. It should be noted, some of these rate cases were statutorily required to maintain interim rate adjustments such as the FAC and the ISRS. In recent years, many contested issues, and even entire cases have settled through the settlement process discussed at length yesterday. KCP&L Greater Missouri Operations, Kansas City Power and Light and Ameren Missouri have pending rate requests. The Office of the Public Counsel has filed an over-earnings complaint against Laclede Gas Company and Missouri Gas Energy. Staff is conducting an earnings investigation of Ameren Missouri's gas operations in conjunction with the electric rate case.

Details on the specific requests can be found in the packets that were circulated to the Committee.

Recognizing these challenges, the Commission is not opposed to change to the regulatory construct, but any change should be informed change that provides benefits to all stakeholders, and truly balances the myriad of interests that interconnect in very complex ways.

Discussions related to change should include asking the utilities – If there was change in ratemaking practices, what investment would you make that you cannot or will not make today under existing practices?

Instead of making sweeping changes, a more practical approach may be to provide the Commission with "more tools in its toolbox". One option would be to allow the Commission the ability to utilize a decisional pre-approval process with post-construction review.

The Commission should retain its ability to balance the interests of the shareholder and the public, and allow the Commission to continue to audit the books and finances of each regulated utility.

In short, the best approach to change would be to provide the Commission with flexibility to address the changing needs of the regulatory environment while continuing to maintain its core responsibilities of ensuring customers receive safe and adequate service at just and reasonable rates.