



# SENATE BILL 559: Storm Securitization/Alt. Rates.

2019-2020 General Assembly

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<b>Committee:</b>		<b>Date:</b>	July 9, 2019
<b>Introduced by:</b>	Sens. Rabon, Hise, Blue	<b>Prepared by:</b>	Jennifer McGinnis
<b>Analysis of:</b>	Fourth Edition		Staff Attorney

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**OVERVIEW:** *Senate Bill 559<sup>1</sup> does two different things:*

- *Part I would permit utility companies to use bond financing for certain storm recovery costs. This financing mechanism would not create any indebtedness for the State or any of its political subdivisions.*
- *Part II would authorize the Utilities Commission to fix rates for electric public utilities using "multiyear rate plan" and "banding of authorized returns" mechanisms.*

## PART I: STORM SECURITIZATION

### **CURRENT LAW of PART I:**

In 2018, Duke Energy incurred approximately \$571 million of storm expenditures from Hurricanes Florence and Michael and Winter Storm Diego within a four-month period. To finance these storm-recovery expenditures, the utility company would typically incur debt and recover the costs over time through the rate-making process. (See the Current Law of Part II for more details about rate-making.)

### **BILL ANALYSIS of PART I:**

Part I of Senate Bill 559 would create a new financing tool that may be used to recover the storm restoration costs: *utility cost recovery charge securitization*. Under this financing tool, the utility company could issue storm recovery bonds with lower financing costs that are secured through a dedicated storm recovery charge that is separate and distinct from the utility's base rate. Securitization typically benefits utilities and their current customers. Utilities benefit because they receive an immediate source of cash from the bond proceeds and customers benefit because the cost of securitized debt is lower than the utility's cost of debt, which reduces the impact on their monthly bills.

More than 20 states have used this model to finance storm recovery costs, stranded costs, environmental restoration, utility restructuring, deferred fuel costs, and renewable energy projects. This legislation only creates a financing tool for storm recovery costs of a public utility that sells electric power to retail electric customers in this State. Duke Energy filed requests for deferrals for the 2018 storm costs for the Utilities Commission (Commission) consideration during the next rate case. If this legislation is enacted, storm recovery bonds could be used to finance the storm recovery costs.

There are three major components of utility cost recovery charge securitization:

- State legislation.

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<sup>1</sup> As introduced, this bill was identical to H624, as introduced by Reps. Lewis, Bell, Howard, Lucas, which is currently in House Energy and Public Utilities.

Karen Cochrane-Brown  
Director



Legislative Analysis  
Division  
919-733-2578

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- A financing order.
- A true-up mechanism.

## **State Legislation**

The legislation creates the storm recovery charge and provides that the revenues generated by this charge, known as storm recovery property, is a property right that can be transferred and pledged as security for the storm recovery bonds. Since this property right may not be governed by the Uniform Commercial Code (UCC), the legislation establishes the procedures for creating, perfecting, and enforcing the security interest in storm recovery property.

This property right is created through the political and regulatory process; to ensure the credibility of the storm recovery bonds, the legislation includes a state non-impairment obligation. If the storm recovery bonds are issued, the State and its agencies, including the Commission, agrees not to take any action that would limit or alter the storm recovery charges (which is the property right securing the bonds) until the storm recovery bonds have been paid and performed in full.

The legislation protects bondholders in several additional ways:

- It provides that the sale of an interest in storm recovery property is a true sale and that ownership passes to the party characterized as the purchaser. The purchaser may be a limited purpose subsidiary of the public utility created for the sole purpose of issuing the storm recovery bonds. This provision protects bondholders from the interruption or impairment of cash flows in the event of a utility bankruptcy.
- It provides that the interest in the storm recovery property is not affected or impaired by the commingling of storm recovery charges with other amounts.
- It provides that the storm recovery charge must be imposed on all customer bills collected by the public utility or its successors or assignees. The charge must be stated as a separate, itemized charge on customer bills that is separate and apart from the public utility's base rate.
- It provides that the storm recovery charge must be paid by all existing or future retail customers receiving transmission or distribution service from the public utility, even if a customer elects to purchase electricity from an alternative electricity supplier. (nonbypassability)

## **Financing Order**

The legislation establishes the process by which a public utility that sells electric power to retail electric customers in the State may petition the Commission for a financing order. The financing order sets forth specific transaction terms and related provisions. Before granting a financing order, the Commission must find that the issuance of the storm recovery bonds and the imposition of storm recovery charges are expected to provide quantifiable benefits to customers as compared to the costs that would have been incurred absent the issuance of storm recovery bonds.

The petition must include a description of the storm recovery activities, an estimate of the storm recovery costs, the proposed level of storm recovery reserve, an indicator of the amount of storm recovery costs to be financed using storm recovery bonds, an estimate of the financing costs related to the bonds, an estimate of the storm recovery charges necessary to recover storm recovery costs, and a comparison between the net present value of the cost to customers estimated to result from the issuance of storm recovery bonds and the cost that would result from the application of the traditional method of financing and recovering storm recovery costs; this comparison must demonstrate that issuance of storm recovery bonds and the imposition of storm recovery charges are expected to provide quantifiable benefits to customers.

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The financing order must include the amount of storm recovery costs to be financed using storm recovery bonds, the imposition and collection of storm recovery charges that are nonbypassable and paid by all existing and future retail customers receiving transmission or distribution service from the public utility or its successors or assignees, the maturity period of the bonds, a formula-based true-up mechanism, the creation of storm recovery property that will be used to secure the bonds, and a method of tracing funds collected as storm recovery charges. The financing order is irrevocable.

## **True-Up Mechanism**

The legislation specifies that the financing order must include a requirement that the public utility file with the Commission at least annually a petition or letter applying the formula-based mechanism, and request adjustments in the storm recovery charge, if necessary, to a sufficient level to ensure the bond payment obligations. The Commission does not have the discretion to disapprove or alter the true-up calculation, except to correct mathematical and clerical errors. The adjustment of the storm recovery charge through this mechanism is the most significant credit component of these transactions.

## **EFFECTIVE DATE of PART I:**

Part I would be effective when it becomes law.

## **PART II: AUTHORIZE RATES USING ALTERNATIVE MECHANISMS**

### **CURRENT LAW of PART II:**

G.S. 62-133 requires the Commission to fix rates for electric public utilities based upon the following criteria:

- Rates must be fair to both the public utilities and the consumer.
- The Commission must fix such rates to be charged by the public utility as will earn, in addition to reasonable operating expenses, a rate of return fixed on the cost of the public utility's property. In order to establish such rates, the Commission must:
  - Ascertain the reasonable original cost or the fair value of the public utility's property used and useful, or to be used and useful within a reasonable time after a test period, less that portion of the cost that has been consumed by previous use recovered by depreciation expense.

The test period must consist of 12 months' historical operating experience prior to the date the rates are proposed to become effective, but the Commission must consider such relevant, material, and competent evidence to show actual changes in costs, revenues, or the cost of the public utility's property, which is based upon circumstances and events occurring up to the time a hearing is closed.

Reasonable and prudent expenditures for construction work in progress may be included in the cost of the public utility's property in certain circumstances to the extent the Commission considers inclusion of such expenditures in the public interest and necessary to the financial stability of the utility in question.

- Based on its determination of the reasonable original cost of a utility's property, fix a utility's rate of return as will enable the public utility to produce a fair return for its shareholders, considering changing economic conditions and other factors, to maintain its facilities and services in accordance with the reasonable requirements of its customers in the territory covered by its franchise, and to compete in the market for capital funds on terms that are

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reasonable and that are fair to its customers and to its existing investors. In fixing a utility's rate of return, the Commission must also:

- Estimate the public utility's revenue under the present and proposed rates.
- Ascertain the public utility's reasonable operating expenses, including actual investment currently consumed through reasonable actual depreciation.

## OVERVIEW OF RATEMAKING:

- Based on the cost of service in the test period.
- Test period – Financial data from a historical 12-month period, which serves as a proxy for the anticipated level of costs for the period of time the rates will be in effect.
- Rates are prospective, but are established based on what the utility has already spent – utilities typically do not recover expenses and capital costs in advance.

### General Ratemaking Formula

- Revenue Requirement is determined as  $(\text{Rate Base} \times \text{Rate of Return}) + \text{Expenses}$ .
- Rate Base – value of the property (net of depreciation) on which a utility may earn a rate of return. Property must be "used and useful" (power plants, transmission and distribution lines, etc. actually used in providing service to customers).
- Rate of Return – % return that utility may earn on invested capital, including debt and equity investments.
- Expenses – can recover reasonable and prudent expenses based on an historical test year.

### Rate Base

- Rate base is the value of reasonable and prudent property on which a public utility is authorized to earn its rate of return.
- Rate base calculation: Original cost of the utility assets (prudent capital investment) minus accumulated depreciation.

### Rate of Return

- Percentage return that the utility is allowed to earn on its invested capital.
- Designed to compensate investors for the use of their capital and associated risk.
- Rate of return is composed of three components:
  - Cost of equity
  - Cost of debt
  - Capital structure (debt and equity ratios)

Rate of return is not a guaranteed return, it is the return the utility is authorized to earn.

### Expenses

Utilities are authorized to recover reasonable and prudent expenses.

## BACKGROUND FOR PART II:

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Comprehensive information on multiyear rate plans (MRPs), their prevalence, rationale for their use, disadvantages associated with MRPs, and their impact on cost performance, is available in a report entitled "State Performance-Based Regulation Using Multiyear Rate Plans for U.S. Electric Utilities" issued by the Grid Modernization Laboratory Consortium of the U.S. Department of Energy in 2017, see:

[https://eta.lbl.gov/sites/default/files/publications/multiyear\\_rate\\_plan\\_gmlc\\_1.4.29\\_final\\_report071217.pdf](https://eta.lbl.gov/sites/default/files/publications/multiyear_rate_plan_gmlc_1.4.29_final_report071217.pdf)

## **BILL ANALYSIS of PART II:**

Part II of the bill would provide that notwithstanding the methods for fixing rates established under G.S. 62-133, upon application of an electric public utility, the Commission could approve multiyear rate plans, banding of authorized returns, or a combination of these mechanisms ("alternative mechanisms"), in and along with a general rate case proceeding.

- "Banding of authorized returns" means a rate mechanism under which the Commission sets an authorized return on equity for an electric public utility that acts as a midpoint and then applies a low- and high-end range of returns to that midpoint under which an electric public utility will not over earn if within the high-end range and will not under earn if within the low-end range.
- "Multiyear rate plan" means a rate mechanism under which the Commission sets base rates and revenue requirements for a multiyear plan period based on a known and measurable set of capital investments and all the expenses associated with those capital investments and authorizes periodic changes in base rates during the approved plan period without the need for a base rate proceeding during the plan period.

In setting a midpoint authorized rate of return on equity for banding, the Commission must consider any decreased or increased risk to an electric public utility that may result from having an approved multiyear rate plan, banding of authorized returns, or a combination thereof. Any banding of authorized returns approved by the Commission could not exceed 125 basis points above or 125 basis points below the authorized return on equity that is set by the Commission, and would otherwise be subject to all of the following conditions:

- If an electric public utility that is operating under a banding of authorized returns exceeds the midpoint return on equity up to the high-end range of the band that is approved by the Commission based on its normalized, earned return on equity for the prior 12-month year-end period, the utility must determine the after-tax dollar value of the amount of the earnings that exceeded the midpoint return on equity up to the high-end range of the band and must, within 60 days of determining that after-tax dollar value, submit that after-tax dollar value to the Commission for verification along with a petition to the Commission to make investments of an equivalent amount in one or more of the following categories:
  - Electric infrastructure investments in economically distressed areas or low-income communities that facilitate job creation.
  - Electric infrastructure investments that further creation of affordable housing for low-income customers.
  - Electric infrastructure investments in communities that will result in quantifiable and measurable benefits for low-income customers in those communities.
  - Energy efficiency and demand-side management programs for low-income customers.

In any petition submitted to the Commission to make such investments, the utility must include a detailed explanation as to why the investments identified in the petition were selected and must

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describe other potential investments that may have been considered, but not included in the petition, with an explanation therefor. The Commission must review such a petition in accordance with the laws governing cost recovery for the type of investment proposed in the petition and, if approved, the Commission must include the costs of the approved investments in the utility's cost of service or rate base, as appropriate. If the Commission denies such a petition, the utility must, within 60 days of the Commission's order, submit a new petition for investments.

- If an electric public utility that is operating under a banding of authorized returns exceeds the high-end range of the band that is approved by the Commission, the electric public utility would be required to refund or credit earnings above that high end range to customers in a manner to be prescribed by rules adopted by the Commission.
- If an electric public utility that is operating under a banding of authorized returns falls below the low-end range of the band that is approved by the Commission, the electric public utility may file a general rate case proceeding.

The Commission could approve use of these alternative mechanisms, however, only upon a finding that the mechanisms are just and reasonable, and are in the public interest. In reviewing an electric public utility's application to use these alternative mechanisms to set rates, the Commission must consider whether the electric public utility's application as proposed would:

- Establish rates that are fair both to the electric public utility and to the consumer.
- Reasonably assure the continuation of safe and reliable electric service.
- Not unreasonably prejudice any class of electric customers.
- Be otherwise consistent with the public interest.
- Will not result in sudden substantial rate increases, or "rate shock," to consumers.

The Commission is given authority to impose any or all conditions for approval of an application for use of alternate rate mechanisms that it deems necessary to ensure that rates are just and reasonable, and are in the public interest, including periodic reviews to be held during the period that a multiyear rate plan may be in effect, with opportunities for public hearings during such periodic reviews so that interested parties may be heard. If the Commission approves the application with modifications, the utility subject to such approval may, at its option, accept the modifications and implement the proposed plan as modified or may, at its option, withdraw its application for use of alternative mechanisms and be governed under the Commission's order ruling on the electric public utility's request to adjust base rates under the general rate making proceeding.

Part II would also:

- Provide that rates using alternative mechanisms could remain in effect for a period of no more than three years.
- Require an electric public utility to make an annual filing that sets forth the electric public utility's earned return on equity for the prior 12 month period, for the purpose of measuring its earnings under rates set using alternative mechanisms.
- Provide that the alternative mechanisms for rate-setting would operate independently from riders or other cost recovery mechanisms otherwise allowed by law, unless the riders or other cost recovery mechanisms are incorporated in a rate, plan, or settlement.
- Provide that the language may not be construed to:

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- Limit or abrogate the existing rate-making authority of the Commission.
- Invalidate or void any rates approved by the Commission prior to the effective date of the provision.

The Commission would be required to adopt rules to implement the provisions of this Part no later than 120 days after the bill became law.

**EFFECTIVE DATE of PART II:** Part II of the bill would be effective when it becomes law and apply to any rate making mechanisms, designs, plans, or settlements filed by a public utility on or after the date that rules adopted by the Commission, as required by the bill, become effective. The remainder of the bill would be effective when it becomes law.

*Cindy Avrette, counsel to Senate Finance, substantially contributed to this summary.*