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STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners: Kate Giard, Chairman
Dave Harbour
Mark K. Johnson
Anthony A. Price
James S. Strandberg

In the Matter of the Joint Petition by the Denali Commission; United States Department of Agriculture, Rural Development, Alaska Office; State of Alaska, Department of Environmental Conservation; Alaska Village Electric Cooperative; North Slope Borough; Alaska Power & Telephone; and Naknek Electric Association, Inc. to Adopt Proposed Revisions to 3 AAC 48.275) R-04-3
ORDER NO. 1

In the Matter of the Consideration of Changes to the Regulatory Treatment of Grant-funded Plant to Attain Long-term Sustainability Under AS 42.05) R-04-4
ORDER NO. 1

ORDER DENYING PETITION AND CLOSING DOCKET R-04-3, OPENING NEW DOCKET, ISSUING NOTICE OF INQUIRY, ESTABLISHING SCHEDULE FOR PUBLIC COMMENT AND SETTING PUBLIC HEARING IN DOCKET R-04-4

BY THE COMMISSION:

Summary

We considered a joint petition¹ proposing a specific regulation to address the important issue of rural utility financial sustainability. Although the petition has

¹Joint Petition by the Denali Commission, United States Department of Agriculture Rural Development Alaska Office, State of Alaska Department of Environmental Conservation, Alaska Village Electric Cooperative, North Slope Borough, Alaska Power & Telephone, Naknek Electric Association, Inc. to Adopt Proposed Revisions to 3 AAC 48.275 to Enable Utilities to Build Equity for Future Replacement of Grant-Funded Infrastructure, filed June 10, 2004.

1 considerable merit, we did not believe the proposed regulation was ready to notice.
2 Therefore, we denied the joint petition, closed Docket R-04-3, and opened Docket
3 R-04-4 to deal with the issue.

4 Docket R-04-4 will investigate the need for new regulations governing the
5 regulatory treatment of grant-funded plant for rural electric, water, and wastewater
6 utilities subject to our jurisdiction. We release the joint petition from Docket R-04-3 and
7 our questions for public comment in this new docket. We seek written public comment
8 on whether new regulations that allow utilities to build up equity funds to help replace
9 grant-funded infrastructure should be developed. We also set a public hearing for
10 January 6 and 7, 2005, to allow interested persons to provide oral comments in
11 response to this Order, and to respond to the comments filed in accordance with
12 Ordering Paragraph No. 4.

13 Background

14 Reliable electricity, clean water, and effective sanitation are basic
15 requirements for public health, social well being, and economic development. Because
16 these essential services are not available in many rural areas of the state, a broad
17 public initiative is underway to fund with grants the construction and improvement of
18 utility systems so these services can become available to rural citizens. Federal funding
19 is distributed to these projects through agencies like the Denali Commission, United
20 States Department of Agriculture (USDA) and Alaska Native Tribal Health Consortium
21 (ANTHC). These funds are combined with state funds through the Alaska Department
22 of Commerce, Community and Economic Development (Commerce). As a result, new
23 electric, water and wastewater utilities are forming throughout Alaska, significant new
24 community and utility infrastructure is being constructed, and existing utility systems are
25 being upgraded.

1 A chief concern among federal and state funding agencies is that these
2 grant-funded utility projects be well managed after construction is complete. Some of
3 the funders believe that the utility should charge rates that cover operating costs as well
4 as set aside money for the eventual replacement of grant-funded plant, so that the utility
5 is sustainable over the long term. One such funding agency, the Denali Commission,
6 approved resolutions in 2001 expressing a commitment to “sustainability” as a core
7 value and guiding principle.²

8 Under our statute, we have the responsibility to certificate utilities, and
9 depending on the utility’s business structure, to regulate its rates and quality of service.
10 While the concept of sustainability is interwoven throughout our certification and rate

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14 ²In September 2001, the Denali Commission approved *Resolution No. 01-15: A*
15 *Resolution Regarding Sustainability for Denali Commission Funded Infrastructure*
16 *Projects*, which incorporated the following related principles:

- 17 • Sustainability includes all costs necessary to maintain an acceptable level
18 of service.
- 19 • The high cost of infrastructure in rural Alaska makes it infeasible for the
20 total costs of all services in all communities to be borne by local users;
21 however, to the extent feasible, user rates should include all costs
22 necessary to achieve sustainability.
- 23 • All practical steps should be taken...that reduce the cost of sustainable
24 infrastructure.
- 25 • Before Denali Commission funding is applied to construction of any
26 infrastructure...there must be a sound business plan. Sound business
planning...demonstrating how all costs...necessary to assure a
sustainable level of service will be covered.
- All parties to the Commission...as individual entities or in collaborative
efforts will seek to reduce the cost of sustainable rural entities and support
subsidies that are...necessary to ensure that the basic infrastructure and
essential services are available in rural Alaska at an affordable cost.

1 regulation, the Petitioners³ propose we create new regulations to more directly address
2 the financial sustainability of utilities.

3 Work Done to Date on Utility Sustainability

4 The Denali Commission serves as a conduit of federal funding for utility
5 infrastructure in Alaska. As a primary funder, it has sought to direct its funding to
6 projects that will yield sustainable benefits to Alaska.⁴

7 The Denali Commission has published specific criteria for sustainability of
8 Rural Alaska electric utility systems.⁵ The Denali Commission is now considering
9 whether to levy these criteria on Denali Commission fund recipients.

10 To implement these policies, 20 state and federal agencies signed a
11 Memorandum of Understanding (MOU) outlining an interagency agreement to facilitate
12 the collaboration and coordination necessary to achieve Denali Commission goals and
13 the related missions of MOU signatories.⁶ As an element of the MOU, four work groups
14 were formed, one of which is the sustainable utilities work group (also called the
15 Sustainable Utilities Steering Committee).

16 Another major entity engaged in rural infrastructure development is
17 ANTHC's Division of Environmental Health and Engineering. This non-profit tribal

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19 ³Denali Commission; United States Department of Agriculture, Rural
20 Development, Alaska Office; State of Alaska, Department of Environmental
21 Conservation, Alaska Village Electric Cooperative, North Slope Borough, Alaska Power
& Telephone, and Naknek Electric Association (Petitioners).

22 ⁴The Denali Commission's investment policy states, "it is imperative that each
23 dollar be invested in a way that will maximize the sustainable long term benefits to
24 Alaskans." *Denali Commission Investment Policy, April 2004*, at page 1.

25 ⁵*Denali Commission Policy: Rural Alaska Energy Infrastructure Criteria for*
26 *Sustainability*, issued April 26, 2002.

⁶*Memorandum of Understanding* explanatory statement, available on our
website, at <http://www.state.ak.us/rca/RUS/>.

1 health organization works collaboratively with communities and other tribal health
2 organizations to plan, design, and build sanitation facilities, as well as renovate existing
3 systems, and provide operator training, and operations and maintenance plans. In
4 September 2003, ANTHC issued a report⁷ designed for native communities that
5 explained how to form a Regional Utility Cooperative. It recognizes that in some
6 situations, a cooperative approach to utility management enhances the overall
7 sustainability of all the utilities involved.

8 The Rural Utilities Business Advisor (RUBA) program within Commerce
9 works with rural utilities to build financial and managerial capacity. In July 2003, RUBA
10 published a guidebook⁸ that creates a template model streamlining community business
11 plans for each of the agencies involved in rural Alaska capital projects. This program
12 works on the premise that a solid business plan is essential for a utility's long-term
13 sustainability. RUBA is also in the process of publishing "*A Plain English Guide to Utility*
14 *Accounting.*"

15 USDA Rural Development, in association with the Denali Commission and
16 ASTF⁹ sponsored an extensive data report designed to provide a foundation of facts
17 and ideas to further this initiative for sustainable utility infrastructure.¹⁰ The study
18 considers electricity, water and wastewater, bulk fuel, and solid waste utility services in

19 ⁷*Strength in Numbers: How to Form a Regional Utility Cooperative*, September
20 2003 (1st Ed.).

21 ⁸*Business Plan Guidebook: Business Planning for Rural Alaska Utilities*, July
22 2003. Commission Staff has provided ongoing regulatory input for the drafting of this
23 resource.

24 ⁹Alaska Science and Technology Foundation (ASTF). ASTF was a state agency
25 sunsetted by the legislature.

26 ¹⁰Institute of Social and Economic Research, in association with Mark Foster,
Sustainable Utilities in Rural Alaska: Effective Management, Maintenance and
Operation of Electric, Water, Sewer, Bulk Fuel, Solid Waste, Anchorage, Alaska, 2003.

1 areas away from our road system. The report also provides useful facts on the
2 economic conditions in rural Alaska, including costs of utility service, and current
3 subsidies.

4 In a number of meetings held over the last two years, the sustainable
5 steering committee, as one MOU work group, has made progress in defining the issue
6 of sustainability for rural utilities.¹¹ This work group has provided a forum for many of
7 the affected parties to consider infrastructure needs of communities and their serving
8 utilities and the role sustainability plays in funding and operating critical utility systems.

9 The Cooperatives in Rural Alaska Subcommittee (CRAS) of the
10 Sustainable Utilities Steering Committee produced a white paper¹² with the goal of
11 identifying utility service delivery models that would be community driven, enhance
12 management and operational efficiency, deliver high-quality service, and improve
13 regulatory compliance. Cooperatives were identified as desired vehicles for delivering
14 utility services due to their success in other states in creating self-reliant and
15 sustainable infrastructures within rural communities.

16 Another white paper document produced by a subcommittee of the
17 Sustainable Utilities Work Group recommended economic regulation by us, and
18 creation of an operating subsidy as a means to move toward long-term sustainability of
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21 ¹¹This committee has served as an important cross cultural forum where federal
22 and state funders, as well as others involved with rural infrastructure and rural public
23 health can meet. The committee has been effective in coordinating the actions of the
24 many agencies with rural interests. It continues to meet and has a focused agenda for
creating sustainable utilities. It is chaired by state (Commerce) and federal (USDA
Rural Development) leadership.

25 ¹²*Recommendation to the Sustainable Utilities Steering Committee from the*
26 *Cooperatives in Rural Alaska Subcommittee "CRAS", drafted September 10, 2003.*

1 water and wastewater utilities.¹³ This same group could not agree on cost recovery
2 mechanisms for grant investments by funders. The report was the subject of spirited
3 debate when presented to the sustainability work group. The concept of sustainability
4 and how to apply it at a community planning and utility design and operations level, is
5 clearly a current and actively discussed issue.

6 The Denali Commission has also commissioned professional analyses by
7 regulatory economists on the rate-making approaches we might take to both implement
8 an operating subsidy and allow recovery of prospective investments (i.e., recovery of
9 CIAC¹⁴ in rates). One such analysis considered our existing statutory language on
10 recovery of investments in rates and proposed a regulatory approach.¹⁵

11 On June 10, 2004, the Petitioners filed a joint petition to adopt proposed
12 revisions to 3 AAC 48.275. The petition proposed that we alter our regulations to allow
13 the recovery of grant-funded capital as depreciation for economically regulated utilities
14 and to embrace affordability and sustainability concepts in our rate-making
15 methodologies. This petition is included as an appendix to this order.

16 We discussed the petition at our July 14, 2004, public meeting and
17 determined that, while the petition had merit and draft regulations, we needed to collect

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20 ¹³The Sanitation Subcommittee produced written recommendations on
21 April 2, 2003, for changes to program and regulatory structures to improve sustainability
22 of rural water and sewer utilities. This document is included as a part of our web page
23 resources. Our former Commissioner Nan Thompson served individually on this
24 committee, not as a representative of our commission.

25 ¹⁴Income from other sources is termed "Contributions in Aid of Construction"
26 (CIAC).

¹⁵See Memorandum from Mark A. Foster to Al Ewing titled "*How Do We
Encourage Utilities to Fund Maintenance and Replacement of Grant Funded
Infrastructure,*" dated October 8, 2003.

1 more information before issuing draft regulations for comment.¹⁶ We elected to deny
2 the petition, but to open a new docket beginning with a notice of inquiry (NOI) to allow
3 interested parties to participate in the issues initiated by the Petitioners. Following an
4 inquiry, we may consider drafting new regulations that better respond to the goals of the
5 Petitioners and the public interest.

6 Discussion

7 With this new docket, we begin our inquiry into sustainability for rural
8 electric, water and wastewater utilities. We seek comment on whether we should create
9 a new rural-oriented electric, water and wastewater utility regulatory paradigm and new
10 regulations, and under what conditions these should be applied. We also schedule a
11 public hearing for January 6 and 7, 2005, to provide an opportunity for interested
12 persons to provide oral comments and reply comments to this Order.

13 The Petitioners seek to improve the overall financial sustainability of
14 essential services by reducing their reliance on grant funding. The Petitioners
15 encourage us to adopt regulations that meet the following goals:

- 16 1. Allow utilities to build equity and credit worthiness¹⁷ to replace
17 grant-funded plant in service;

20 ¹⁶The proposed regulation creates several questions by its broad nature which
21 can be cleared up through inquiry. For example, while the Petitioners' main concern is
22 the sustainability of small rural utilities, the proposed regulation could allow both large
23 investor-owned utilities and small rural utilities an exception from traditional ratemaking
24 practices. The inquiry can be useful to establish which utilities would be eligible for the
25 proposed new rate treatment. Additionally, the proposed regulation does not limit the
26 source of the grant funds, and could allow CIAC from customers to be double-recovered
through rates. This could also be better defined through our inquiry.

¹⁷The Petitioners assert that credit worthiness affects the ability to fund fuel and
other operating costs.

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2. Require utilities to file a **financial sustainability plan** describing how the utility expects to fund eventual replacement of **all** of its infrastructure (“sustainability plan”);
3. Require utilities to file schedules which support the specific rate change request and compares the specific request to the rates that would result from full recovery of grant-funded plant in current rates (“disclose full cost rates”);
4. Provide for a “safe harbor” where rate increases up to a specified level will be presumed reasonable by us in order to streamline procedures and reduce cost of simple regulatory filings; and
5. Limit residential water/sewer rates to an “affordability cap” to ensure that households do not drop off the system and compromise public health.

The Petitioners assert that to ensure these grant-funded utilities can begin to break the cycle of dependency on grant funds, especially for what should be routine equipment replacement, existing rates need to include some allowance for building working capital and equity in order to pay for equipment replacement and eventual replacement of the utility facilities. They state that many small utilities may be hard pressed to raise debt at reasonable interest rates absent some forward funding to enable a build-up of equity.¹⁸ They also propose we consider making this available to all utilities, subject to our case-by-case review.

¹⁸The Petitioners emphasize the importance of being able to generate adequate equity to provide leverage for debt or matching grant requirements.

1 The Petitioners proposed to modify 3 AAC 48.275(a), which outlines the
2 filing requirements for a rate-regulated utility seeking to change its rates, by inserting
3 the following paragraph as 3 AAC 48.275(a)(14):

4 A schedule showing the computation of rate base, return, tax allowances and
5 depreciation expense **associated** with used and useful **grant-funded plant**,
6 together with schedules showing the rates under full recovery of grant-funded
7 plant, the portion of grant-funded plant requested to be included in rates, and
8 a **financial sustainability plan** describing how the utility expects to fund
9 eventual replacement of **all** of its infrastructure. The commission shall
accept, as a rebuttable presumption, that residential rate changes to build
equity in order to replace grant-funded utility plant in service that **do not**
exceed an increase of one percent of household income in a community are
reasonable. The commission shall limit rate increases to a level that ensures
that local residential rates remain affordable. **[emphasis added]**

10 The current version of our regulations are predominately based on the
11 regulated entity being a sizeable utility employing complex rate structures with an
12 extensive installed plant and a significant customer base.

13 Alaska's rural electric, water and wastewater utilities do not fit this mold.
14 Many serve very small population centers, have limited management resources and
15 basic rate structures. Most are either publicly owned, are tribal associations or
16 cooperatives. The rates issues for these utilities revolve around establishing an
17 affordable rate that will promote long-term financial solvency.

18 Much of Alaska's rural utility infrastructure has been constructed with
19 funding from non-recurring federal and state funding sources. The funding agencies
20 hope to create utilities or assist existing utilities to operate for a reasonable lifetime, and
21 maintain financial strength through cost-based rates to purchase new plant equipment
22 over time without resorting to a new round of infrastructure grants. The Petitioners,
23 through their promotion of sustainable utility infrastructure construction, view the capital
24 grants they make as one time investments.

25 The Petitioners seek for us to harmonize our rate-making with these
26 concepts. They ask us to create new rate-making methods that allow utilities to include

1 those assets purchased with grant funds (called contributed plant) in the utility's rate
2 structure. We currently do not allow utilities to charge their ratepayers for depreciation
3 of contributed plant. However, contributed plant may be the most significant component
4 of a rural utility, rate base. Thus, our current rate-making may not allow these utilities to
5 build adequate equity, which could limit their ability to leverage debt and maintain
6 adequate working capital. Petitioners request that we create regulation which allows
7 these grant funded utilities to recover contributed plant in rates, to resolve these
8 limitations.

9 Resources for Proceeding

10 We have created a web page on our website to provide access to
11 pertinent publications and links to companion rural assistance programs.¹⁹ Therefore,
12 we intend to consider this knowledge base on utility sustainability in our inquiry.
13 Commenters may wish to consider the information contained in these links as they
14 prepare their filings.

15 Current Regulations

16 Before utilities can provide services, they must receive certification from
17 us. In this process, we must find that the existence of the system is consistent with the
18 public interest and that the utility is fit, willing and able to provide the proposed service.
19 For small water and sewer systems, we also recently enacted regulations that create a
20 streamlined path to certification. See 3 AAC 52.700 - 52.749. All political subdivisions,
21 villages, and cooperatives are eligible for this reduced level of review, as well as
22 privately owned systems with gross annual revenues below \$50,000. This new
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24 ¹⁹The documents referenced in this Order are available on our website at
25 <http://www.state.ak.us/rca/RUS/>.

1 regulation specifically addresses the limited resources small utilities have available for
2 regulatory compliance, but allows us to discharge our responsibilities to protect the
3 public interest. Our regulatory structures are complementary to the goals of the Denali
4 Commission, since our public interest criteria and fit, willing, and able criteria are
5 founded on the creation of utilities that charge cost-based just and reasonable rates
6 over the long run.

7 Beyond certification, we economically regulate the rates of utilities in
8 situations where consumers do not have representation in the rate-making process.
9 Our statute exempts utilities owned and operated by political subdivisions from
10 economic regulation. See AS 42.05.711(b).

11 When we have economically regulated a utility, we have applied a
12 consistent ratemaking methodology to periodically set the utility's rates. As rate
13 regulators, we set rates prospectively to allow the utility to collect enough revenue in the
14 period when the rates are in effect to cover the utility's costs and an adequate, but not
15 excessive return on investment.

16 Because our statute requires rates to be just and reasonable, we always
17 begin with an inquiry into a utility's costs, generally on an annual basis. We consider a
18 utility's revenue requirement of a 12-month "test year", which consists of:

19 operating expenses + depreciation + taxes + return.

20 Our methodologies embrace both for-profit and non-profit utility business
21 structures by treating the "return" we allow in different ways.

22 The co-operative business structure distributes ownership through
23 patronage shares to co-op members. Federal tax rules strictly limit the abilities of
24 co-ops to earn a profit, so our ratemaking allows collection in rates of debt principal
25 repayment, plus ongoing interest charges, and an additional amount termed as
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“margin.” This margin gives the utility an opportunity to build equity for additional investment.

Our methodologies to date have only allowed recovery of and on investments the utility actually makes, and specifically excludes recovery of contributions a utility receives from other sources (CIAC). We exclude CIAC because it often comes from the rate payer, and recovering it in rates would mean the consumer would pay twice.²⁰ We have not allowed grant funds the utility receives to improve its infrastructure to be recovered in rates because this would represent a windfall profit and departs from basing rates on the costs the utility experiences.

Our statute requires that we establish just, fair, and reasonable rates, classifications, regulations, practices, services, and facilities for a public utility.²¹

²⁰The first recovery would come when the customer makes the contribution, and the second would occur when the customer pays a rate charge which includes the CIAC investment recovery.

²¹AS 42.05.381. Rates must be just and reasonable.

(a) All rates demanded or received by a public utility, or by any two or more public utilities jointly, for a service furnished or to be furnished shall be just and reasonable; however, a rate may not include an allowance for costs of political contributions, or public relations except for reasonable amounts spent for

- (1) energy conservation efforts;
- (2) public information designed to promote more efficient use of the utility's facilities or services or to protect the physical plant of the utility;
- (3) informing shareholders and members of a cooperative of meetings of the utility and encouraging attendance; or
- (4) emergency situations to the extent and under the circumstances authorized by the commission for good cause shown.

1 Specific guidance on how we value utility property is set forth in AS 42.05.441(b)²² and
2 AS 42.05.471.²³ Before we develop regulation, we must first determine whether
3 allowing grant-funded capital in rate base is consistent with our statutory directives.

4 There may be additional remedies available to us within our statute, such
5 as establishing a class of utilities under AS 42.05.691²⁴ and exempting them from
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9 ²²AS 42.05.441. Valuation of property of a public utility.

10 (b) In determining the value for rate-making purposes of public utility property
11 used and useful in rendering service to the public, the commission shall be
12 guided by acquisition cost or, if lower, the original cost of the property to the
13 person first devoting it to public service, less accrued depreciation, plus materials
14 and supplies and a reasonable allowance for cash working capital when required.

15 ²³AS 42.05.471. Depreciation rates and accounts.

16 (a) To provide for the loss in service value of its property, not restored by current
17 maintenance, a utility shall charge adequate, but not excessive, depreciation
18 expense for each major class of utility property used and useful in serving the
19 public. From time to time the commission shall determine the proper and
20 adequate rates of depreciation for each major class of property of a public utility.
21 The commission shall accept rates of depreciation and depreciation accounts
22 prescribed and maintained under regulations of a federal agency or the terms of
23 a bond ordinance. The commission shall determine and allow depreciation
24 expense in fixing the rates, tolls, and charges to be paid for the services of a
25 public utility.

26 (b) The commission is not bound in rate proceedings to accept, as just and
reasonable for rate-making purposes, estimates of annual or accrued
depreciation established under the provisions of this section, or to allow annual
or accrued depreciation on utility property directly or indirectly contributed by
customers or others.

²⁴AS 42.05.691. Utility classes.

The commission may by regulation provide for the classification of public utilities
based upon differences in annual revenue, assets, nature of ownership, and
other appropriate distinctions and as between these classifications, by regulation,
provide for different reporting, accounting, and other regulatory requirements.

1 certain requirements of economic regulation under AS 42.05.711(d),²⁵ if we find the
2 exemption to be in the public interest.

3 Scope of Inquiry

4 The Petitioners' five goals express the need for a different regulatory
5 approach to include mechanisms to make rates with simplified procedures. These
6 goals may have the effect of providing incentives to establish sustainable rates over the
7 long run, while encouraging patronage of the system through quality service and
8 affordable rates. We agree that consideration of the concepts proposed is in the public
9 interest, and therefore seek comment on the five goals.²⁶

10 With this inquiry, we wish to also assess how effective our current
11 methods of economic regulation are for rural electric, water, and wastewater utilities.
12 We seek comment on whether our inquiry should include other types of rural utility
13 service. We currently require detailed filings that may be burdensome to small utilities
14 without commensurate benefit. Rates for many of our economically regulated rural
15 utilities are very high, and exceed the rates for comparable utilities that are not under
16 our jurisdiction. We want to develop a practical regulatory environment where rural
17 utilities and their rate payers reap benefits from economic regulation and address the
18 issue of high regulated rates. We see this inquiry as a necessary part of our
19 consideration of the petitioners' goals.

21 ²⁵AS 42.05.711. Exemptions.

22 (d) The commission may exempt a utility, a class of utilities, or a utility service
23 from all or a portion of this chapter if the commission finds that the exemption is
in the public interest.

24 ²⁶Our statutory responsibility is to protect the public interest which includes the
25 long term health and welfare of Alaskan communities. Creating rules that facilitate
26 financially sustainable utilities improves the long-term health and welfare of Alaskan
communities, and is in the public interest.

1 Most of the utilities addressed by the petition are not currently subject to
2 economic regulation and are therefore able to set their rates without our oversight. The
3 recently adopted water and sewer regulations establish a class of utilities that are
4 eligible for provisional certification and are exempt from economic regulation.
5 Provisionally certificated utilities provide a simple annual filing that indicates whether the
6 utility is covering its operating expenses and setting aside some funds for capital
7 replacement. We do not set the rates for these utilities, but encourage the
8 establishment of rates that are consistent with their long-term sustainability.

9 However, a new more effective regulatory environment may be needed for
10 these utilities if they are encouraged to opt into rate regulation by their funders. The
11 Petitioners, as grant funders, seek a specific, rural Alaska form of economic regulation
12 to ensure funds are appropriately used for permanent utility service.

13 Request for Comments

14 We request commenters address our questions, so we can create a
15 record. We also welcome other comments germane to the issues presented by the
16 petition.

17 Creation of New Regulation

- 18 1. Should we create a new rural-oriented regulatory paradigm that responds to
19 regulatory needs for rural electric, water and wastewater utilities?
20 a. How should we define a “rural” utility?
21 b. Should we consider other utility services beyond electric, water and
22 wastewater service in this inquiry?
23 2. Should we develop a simplified method of economic regulation for smaller
24 utilities?
25 3. How would we fund the regulatory cost of this program?
26 4. Should these regulations be applied to all utilities or limited to certain classes?

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- a. If so, what classes of utility should this policy pertain to?
 - b. What definition could be used to differentiate these classes from other utilities?
5. Can regulations be developed that require sustainable rates which recover all costs of operation and a recovery of grant funding for construction, while at the same time remaining below an affordability rate cap?

Recovery of Grant Funds in Rates

6. Do we have authority to allow recovery of grant-funded plant in rates?
7. Should the commission allow utilities to employ alternate rate-making methodologies to build equity for future replacement of grant-funded plant in service?
8. Would allowing the recovery of grant funds in rates result in intergenerational inequities, where current ratepayers replace grant-funded plant in the future?
- a. Is this in the public interest?
9. Should the recovery of funds, for the replacement of grant-funded plant be limited to certain funding sources?
10. How should the rate payer be assured that the funds that are collected will be properly managed? Should a centralized agency be responsible for holding, investing and dispersing such funds?
11. Should we develop new revenue requirement elements/terms for the recovery of funds for the replacement of grant-funded plant, which would distinguish grant-funded plant from the traditional elements/terms of a revenue requirement equation (ex: rate base, depreciation)?
12. Should there be limits on grant amounts to be recovered?

1 a. If so, should the recovery be limited to an amount sufficient to establish an
2 equity basis for future loans?

3 13. Should the funds be placed in an escrow accounts?

4 14. Should grant recovery be limited by a maximum allowed equity to debt ratio?

5 15. Would allowing grant-funded plant in rates result in the power cost equalization
6 subsidy building equity?

7 Financial Sustainability Plan

8 16. Should utilities that are recovering grant-funded plant be evaluated for
9 sustainability on a periodic basis?

10 17. How should sustainability be measured?

11 18. Should we require utilities to file a financial sustainability plan describing how the
12 utility expects to fund eventual replacement of its entire infrastructure?

13 19. What level of detail should be required with the plan?

14 20. Should the plan include financial projections and proposed rates to demonstrate
15 ongoing financial solvency? Over what time period?

16 21. Should the plan make any assumptions concerning potential future operating
17 subsidies?

18 Rate Comparison

19 22. Should we allow affordable rates to be collected which are lower than computed
20 full cost sustainable rates? If not, how will facilities be sustained?

21 23. How should the difference between affordable rates and sustainable rates be
22 collected? Should a subsidy be created to make up this difference?

23 24. Should these comparisons include revenue requirement analysis for both
24 affordable and full cost sustainable rates?

25 25. Should rate designs for affordable rates be across-the-board reductions from full
26 cost rates?

1 26. Should we require utilities to file schedules that support the specific rate change
2 request and compare the specific request to the rates that would result from full
3 recovery of grant-funded plant in current rates (“disclose full cost rates”)?

4 27. Should financial audits be required for revenue requirement cost information?

5 a. Should standards be set for these audits?

6 b. Who will pay for the audits?

7 Safe Harbor Rate Increases

8 28. Should we provide for a “safe harbor” where rate increases up to a specified
9 affordability level will be presumed reasonable by us in order to streamline the
10 schedule and cost of simple regulatory filings?

11 29. To what extent should simplified rate filings (SRF) be modeled after our SRF
12 regulations?

13 30. Should these simplified filing requirements be allowed only from utilities with self
14 governance by rate payers?

15 31. Should safe harbor rate increases only be allowed where a revenue deficiency is
16 shown through simplified financial filings?

17 Affordability Cap

18 32. Should we limit residential rates to an affordable level or should it limit
19 commercial, industrial and wholesale rates as well?

20 33. What standard defines affordability for a given community?

21 34. What criteria should be used to establish affordability caps?

22 35. Should there be a unique cap computed for each community with rural utilities?

23 36. Under what conditions should the cap apply? Should the cap apply only when
24 establishing initial rates?

25 37. Should the cap apply for a distressed utility that must increase revenues to cover
26 unforeseen costs?

1 38. What standards should the commission use to determine average income for a
2 given community?

3 As this is a regulations proceeding, commenters are not required to serve
4 their comments on the other entities set out on the service list of this Order. We will
5 post copies of all filed comments on our website.

6 **ORDER**

7 THE COMMISSION FURTHER ORDERS:

8 1. The *Joint Petition by the Denali Commission, United States*
9 *Department of Agriculture Rural Development Alaska Office, State of Alaska*
10 *Department of Environmental Conservation, Alaska Village Electric Cooperative, North*
11 *Slope Borough, Alaska Power & Telephone, Naknek Electric Association, Inc. to Adopt*
12 *Proposed Revisions to 3 AAC 48.275 to Enable Utilities to Build Equity for Future*
13 *Replacement of Grant-Funded Infrastructure*, filed June 10, 2004, is denied.

14 2. Docket R-04-3 is closed.

15 3. Docket R-04-4 is opened to investigate the issues further identified in
16 the body of this Order.

17 4. By 4 p.m., December 3, 2004, any interested person may address the
18 issues and questions set out in the Order and the appended petition.²⁷ Commenters
19 are requested to reference Docket R-04-4.

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²⁷If you are not interested in receiving future orders or notices concerning this
25 subject matter, please e-mail rca@state.ak.us or notify our office by mail or at
26 1-907-276-6222, and we will take your name off of our mailing list.

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5. A public hearing²⁸ shall convene at 9:00 a.m., January 6, 2005, in the East Hearing Room of the Commission's offices at 701 West Eighth Avenue, Suite 300, Anchorage, Alaska, and continue thereafter, as necessary, through January 7, 2005, to allow an opportunity for interested persons to offer comment in response to this Order and to respond to the comments filed in accordance with Ordering Paragraph No. 4.

DATED AND EFFECTIVE at Anchorage, Alaska, this 5th day of October, 2004.

BY DIRECTION OF THE COMMISSION

(S E A L)

²⁸If you are a person with a disability who may need a special accommodation, auxiliary aid, or service or alternative communication format in order to participate in any of the hearings, please contact Grace Salazar at 1-907-263-2107 or TTY 1-907-276-4533 at least one week before the hearing to make the necessary arrangements.

Any party wishing to appear telephonically at any of the hearings must advise us, in writing, at least one week before the hearing to make the necessary arrangements and provide a telephone number where it may be reached for that appearance.

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STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:

Mark K. Johnson, Chair
Kate Giard
Dave Harbour
James S. Strandberg
G. Nanette Thompson

In the Matter of the Joint Petition by the DENALI
COMMISSION; UNITED STATES
DEPARTMENT OF AGRICULTURE, RURAL
DEVELOPMENT, ALASKA OFFICE; STATE OF
ALASKA, DEPARTMENT OF
ENVIRONMENTAL CONSERVATION, ALASKA
VILLAGE ELECTRIC COOPERATIVE, NORTH
SLOPE BOROUGH, ALASKA POWER &
TELEPHONE, NAKNEK ELECTRIC
ASSOCIATION to Adopt Proposed Revisions to
3 AAC 48.275

R-04-003

JOINT PETITION BY THE

DENALI COMMISSION, UNITED STATES DEPARTMENT OF
AGRICULTURE RURAL DEVELOPMENT ALASKA OFFICE, STATE OF
ALASKA DEPARTMENT OF ENVIRONMENTAL CONSERVATION,
ALASKA VILLAGE ELECTRIC COOPERATIVE, NORTH SLOPE
BOROUGH, ALASKA POWER & TELEPHONE, NAKNEK ELECTRIC
ASSOCIATION TO ADOPT PROPOSED REVISIONS TO 3 AAC 48.275
TO ENABLE UTILITIES TO BUILD EQUITY FOR FUTURE
REPLACEMENT OF GRANT-FUNDED INFRASTRUCTURE

Denali Commission
510 L Street, Suite 410
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Summary

Utility rates set under a strict "no current rate recovery for prior period grant funded capital" policy have not generated enough revenue to fund adequate maintenance and replacement of grant-funded infrastructure in many Alaskan communities especially where grant funds have contributed a significant portion of the infrastructure investment.¹

If a heavily grant funded utility is not allowed an opportunity to build up equity to leverage loans for the infrastructure replacement, the utility will be extremely hard pressed to raise adequate replacement capital without returning to the well of grant funds.

Given the possibility that State and Federal grants funds for Alaskan utilities will diminish as the requirements to replace substantial utility infrastructure investments come due in the future, the time to begin to build up equity to enable timely replacement of grant funded infrastructure is now.

Without timely replacement of grant-funded infrastructure, utility service reliability will diminish as systems age and component failure rates increase and compound.

In the case of water and sewer utilities, the public health costs of failing systems can be significant. In the case of electric utilities, the economic costs of outages and unreliable service can be substantial.

¹ See Appendix B: Proposed Regulations and Standard Utility Ratemaking for a discussion of strict utility ratemaking standards and how the Commission may wish to distinguish between the narrow application of the strict standards which implicitly assume relatively little grant funding and present circumstances where many utilities around the State have significant grant funded investments.

Sustainability Policy

1 We need to move away from the cycle of grant funded utility infrastructure
2 toward a more self-sufficient and financially sustainable system where local ratepayers
3 make a contribution toward the replacement of their utility facilities.

4 We encourage the Regulatory Commission of Alaska (RCA) to adopt
5 regulations that meet the following goals:

- 6 1. Allow utilities to build equity to replace grant-funded plant in service
- 7 2. Require utilities to file a **financial sustainability plan** describing how
8 the utility expects to fund eventual replacement of **all** of its
9 infrastructure ("sustainability plan")
- 10 3. Require utilities to file schedules which support the specific rate
11 change request and compares the specific request to the rates that
12 would result from full recovery of grant-funded plant in current rates
13 ("disclose full cost rates")
- 14 4. Provide for a "safe harbor" where rate increases up to a specified level
15 will be presumed reasonable by the Commission in order to streamline
16 schedule and reduce cost of simple regulatory filings.
- 17 5. Limit residential water/sewer rates to an "affordability cap" to ensure
18 that households do not drop off the system and compromise public
19 health.

20 We have provided draft regulations (see Appendix A) for the Commission
21 to review and encourage the Commission to move expeditiously to issue a public notice
22 of the proposed regulations and move expeditiously toward adoption of regulations that
23 meet the goals described above.

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Background

Alaskan utilities and their ratepayers have benefited from significant capital contributions from State and Federal government funds over the past twenty-five years.

In the early to mid 1980s, the State of Alaska invested hundreds of millions of dollars in utility infrastructure throughout Alaska – especially electric generation and transmission and water and sewer system improvements.

In the 1990s, Federal programs provided hundreds of millions of dollars for utility infrastructure in Alaska, particularly water/sewer systems in rural Alaska.

In the late 1990s and into the 2000s, Federal programs, including the Denali Commission, have provided millions of dollars for utility infrastructure, including telecommunications, electric, and water and sewer systems.

The combined State and Federal contribution to local utility infrastructure in *urban and rural* Alaska remains considerable.

As that utility infrastructure ages and requires more frequent repair, refurbishment and eventual replacement, the demands for replacement capital will increase while the supply of government contributions declines.²

Discussion

In an effort to ensure that utility infrastructure investments will be well maintained and last well into the future, the Denali Commission has adopted a policy that requires projects to begin to demonstrate financial sustainability through the use of

² On a statewide basis, State funded utility capital contributions have declined since the early to mid 1980s. While Federally funded utility capital contributions have increased in recent years, many observers believe we are near an apex in Federal funding and that we should begin to start planning for a decline in Federal funding.

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Sustainability Policy

1 a business plan that provides for charging rates that are sufficient to fund an equipment
2 repair and replacement fund. In addition, the business plans provide for back-up
3 operators to come in and take over if the existing operator of the utility fails to maintain
4 adequate performance.

5 There has been some concern expressed that, to the extent that these
6 projects involve utilities that are regulated by the RCA *or might be regulated* by the RCA
7 in the event that a back-up operator is called upon to take over a distressed utility, the
8 general RCA policy against allowing recovery of grant funded infrastructure in rates may
9 preclude the utility from generating adequate cash flow to meet its working capital
10 requirements – especially for the routine repair and replacement of equipment that is
11 typically amortized or capitalized in RCA ratemaking.³

12 Furthermore, while the future replacement of the grant-funded
13 infrastructure may require some amount of grants due to the limited resources of the
14 local ratepayers, unless the utility is given an opportunity to build equity from local rates,
15 the utility may be hard pressed to come up with an equity contribution at the last minute
16 to provide leverage for debt or matching grant requirements – effectively requiring the
17 utility to seek grant funds to replace its existing grant funded infrastructure.

18
19 _____
20 ³ See for example, 3 AAC 52.630(3) PCE Standards for Non-Fuel Costs, where
21 “major overhauls on equipment must be amortized over an appropriate period.” Thus a
22 rural electric utility typically funds major overhauls from working capital and loans and is
23 allowed an opportunity to recover those expenditures from future rates over a period of
24 years. In a heavily grant funded and thinly capitalized utility with a significant
25 infrastructure investment, typical of many small rural utilities, the ability to raise sufficient
26 working capital may be quite limited.

27 Many utility managers are faced with the choice of raising rates to generate
28 working capital to pay for an overhaul, deferring some other maintenance item, or
29 waiting for the next available grant funding opportunity to replace the diesel gen set that
30 would have otherwise been scheduled for overhaul.

Sustainability Policy

1 In order to ensure that these grant funded utilities can begin to break the
2 cycle of dependency on grant funds, especially for what should be relatively routine
3 equipment replacement, existing rates need to include some allowance for building
4 working capital and equity in order to pay for equipment replacement and eventual
5 replacement of the utility facilities.

6 Some large utilities *may* be able to raise debt and equity capital on a going
7 forward basis to replace grant-funded infrastructure - depending upon the size of the
8 capital replacement program, the health of the capital structure (debt/equity ratios),
9 interest rates, and the magnitude of the rate increase that may be required. Other
10 utilities may find that their customers prefer smaller rate increases to build up equity to
11 leverage debt funds. Many small utilities may be hard pressed to raise debt at
12 reasonable interest rates absent some forward funding to enable a build-up of equity.
13 Thus, the Commission may wish to consider making some form of forward build up of
14 equity to replace aging grant funded infrastructure available to *all utilities* – large and
15 small, water, sewer, electric, telecommunications, subject to a Commission case-by-
16 case review of particular circumstances.

Water/Sewer Infrastructure Examples:

17
18
19 In Alaska, water and sewer systems range from septic and haul systems
20 for individual households, small community piped systems that serve trailer parks,
21 condominiums, housing developments, and small rural villages, up through regional
22 treatment, distribution, collection and disposal systems serving urban centers and their
23 surrounding suburbs, i.e., Golden Heart/College Utilities and Anchorage Water and
24 Wastewater.

25 While acknowledging that the problem of aging infrastructure appears to
26 be statewide in scope, encompassing both urban and rural communities, the problem

Sustainability Policy

1 appears to be most acute in small rural villages where remoteness, soil conditions, poor
2 water source quality, and climate compound the cost of service. At the same time rural
3 incomes are highly variable and often low which has resulted in a large public
4 investment in water/sewer systems to bring affordable service and improved public
5 health to many small communities.

6 In order to illustrate the relative magnitude of costs under consideration, a
7 sample of piped water/sewer system costs from rural Alaska will be used to benchmark
8 the relative magnitude of costs under consideration on a per household per year basis.

9 Table 1: Estimated Life Cycle Cost of Service – Piped Rural Alaska Water/Sewer
10 Systems (*\$ per household per year*)

	Tanana	Ft. Yukon	Goodnews Bay
Households (Census 2000)	121	225	71
Total Life Cycle Cost of Service	\$4820	\$4920	\$5200
O&M (Annual expenses)	\$1680	\$1230	\$2000
Short-Lived Assets (2 - 7 year asset life)	\$50	\$20	\$35
Long-Lived Assets (7 years+)	\$3090	\$3670	\$3165

18 Source: MAFA Estimates, May 2004.

19 The total life cycle cost of service includes capital and operating
20 expenditures. The total capital infrastructure investment can be broken down into short-
21 lived assets and long-lived assets. The short lived assets include pumps, motors,
22 washeteria equipment (washers, dryers), equipment with moving parts or electronics
23 that typically can be expected to require replacement in two to seven years. The long-
24 lived assets include structures, facilities, pipes, and tanks that can be expected to
25 require replacement in 30-40 years or so if properly designed and constructed.

Sustainability Policy

1 Local rates are typically set to recover annual operations and maintenance
2 plus a contribution toward replacement of short-lived assets. Roughly half of local
3 revenues are recovered from residential household rates with the balance of local
4 revenues recovered from the school, clinic, and other institutional and commercial
5 ratepayers. To date, long-lived assets in many rural communities have typically been
6 paid for by state and federal grant funds.

7 For many rural villages, this often results in residential household rates for
8 water/sewer that are in the range of 3% to 5% of median household income. In
9 comparison, Fairbanks residential customers typically pay roughly 2.3% of median
10 household income for piped water/sewer service.⁴

11 Rural Alaska Water/Sewer Projections

12 Estimating roughly 26,000 households in rural Alaska,⁵ using an average
13 life cycle cost for piped water/sewer for rural villages of \$4800 per household per year⁶
14 amounts to an annual average nominal life cycle cost of roughly \$125 million.

15 Over the past last decade the level of state and federal grants for rural
16 sanitation capital infrastructure has climbed to its current peak of roughly \$100 million
17 per year. We do not expect this level of grant funding to be sustainable.

18
19
20 ⁴ A Golden Heart Utilities residential customer with a ¾-inch service who uses
21 5,000 gallon per month pays about \$76.10 per month, or \$913 a year, or 2.3% of the
22 Fairbanks median household income of \$40,577 (2000 Census).

23 ⁵ For reference, the PCE annual program statistics report indicates rural electric
24 utilities in FY03 served 25,713 residential meters.

25 ⁶ See Table 1 above. While many small rural villages have life cycle costs that
26 range from \$4800 - \$5200 per household per year and above, rural regional hub
communities typically exhibit economies of scale and achieve lower life cycle costs.
Thus, we use a middle range figure of \$4800 per household per year to illustrate the
rough order of magnitude of costs under consideration.

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Sustainability Policy

1 Based upon the 2000 Census data, it appears that the average median
2 household income in the roughly 26,000 rural Alaska households is on the order of
3 \$40,000. This amounts to a total rural household purchase power of roughly \$1 billion
4 dollars.⁷ Depending upon assumptions one makes about what might be affordable,
5 many households may be able to make a larger contribution toward replacement of the
6 grant funded infrastructure if a reasonable amount can be included in rates now and
7 collected over a period of time.

8
9 Electric Utility Infrastructure Examples

10 In Alaska, electric service ranges from small individual household light
11 plants, remote rural communities served by diesel generators and small scale
12 hydroelectric with distribution to a school and village households, up through the
13 regional Railbelt system serving urban centers from Homer, Kenai/Soldotna, Seward
14 Anchorage, Palmer, Wasilla, Fairbanks and their surrounding suburbs using a
15 combination of natural gas, coal, hydroelectric and oil-fired generation sources and
16 electrical transmission facilities to interconnect the Railbelt communities and their
17 generation sources.

18 While acknowledging that the problem of aging electric utility infrastructure
19 appears to be statewide in scope, encompassing both urban and rural communities, the
20 problem appears to be most acute in small rural villages where remoteness, soil
21 conditions, seasonal flooding and climate compound the cost of service. At the same
22 time rural incomes are highly variable and often low which has resulted in a large public
23 investment in electric systems to bring affordable service to many small communities.

24
25 ⁷ See Appendix C: Rural Alaska Regional Census Data

Sustainability Policy

1 In order to illustrate the relative magnitude of costs under consideration, a
2 sample of electric utility system costs from rural Alaska will be used to benchmark the
3 relative magnitude of costs under consideration on a per household per year basis.

4 Table 2: Estimated Life Cycle Cost of Service – Rural Alaska Electric Utility
5 Systems (*\$ per household per year*)

	Tanana	Fort Yukon	Goodnews Bay
6 Households (Residential Meters)	118	246	92
7 Total Life Cycle Cost of Service	\$2,680	\$3,000	\$3,000
8 Fuel (Annual Expenses)	\$1,030	\$1,320	\$1,050
9 O&M (Annual expenses)	\$1,060	\$1,220	\$1,090
10 Medium Lived Assets (Gen Sets)	\$350	\$280	\$500
11 Long Lived Assets (Power Plant Facility)	\$240	\$180	\$360

12 Sources: FY03 PCE Statistical Report, MAFA Estimates, May 2004.

13 The total life cycle cost of service includes fuel, operations and
14 maintenance, and capital expenditures. Fuel and annual operations and maintenance
15 costs can comprise roughly 2/3 to 3/4 of the total life cycle cost of service, leaving
16 capital assets running around 1/4 to 1/3 of the total life cycle cost of service. While the
17 capital asset portion of the life cycle cost of service is relatively small for electric utilities
18 compared to water/sewer utilities, the timely replacement of capital remains critical in
19 maintaining reliability and continuing to improve fuel efficiency and reduce the overall
20 cost of the fuel per kilowatt-hour.

21 Local rates are typically set to recover the total cost of service, excluding
22 grants that historically have been made available to the more remote communities with
23 high costs and limited local resources. Roughly half of local revenues are recovered
24 from residential household rates with the balance of local revenues recovered from the
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Sustainability Policy

1 school, clinic, and other institutional and commercial ratepayers. Local utilities typically
2 receive power cost equalization (PCE) support for local residential and community
3 facility (street lighting, water/sewer systems) rates that they pass through to the
4 customer.

5 For many rural villages, this often results in residential household bills for
6 electricity that are in the range of 2% to 4% of median household income. In
7 comparison, Fairbanks residential customers typically pay roughly 2.5% of median
8 household income for electrical service.⁸

Rural Alaska Electric Utility Projections

9
10 Estimating 26,000 households in rural Alaska,⁹ using an average life cycle
11 cost for electric utilities serving rural villages of \$3000 per household per year amounts
12 to an annual average nominal life cycle cost of roughly \$80 million. The power cost
13 equalization program (PCE) funded at roughly \$15 million a year covers roughly 20% of
14 the life cycle cost of service. The remaining 80% of the life cycle cost is funded by a
15 combination of local rates, loans and capital grants.

Conclusion

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18 The Commission may wish to examine the differences between utility
19 sectors, size of utilities, urban and rural utilities in the course of reviewing the proposed
20 regulations to determine whether or not it might make sense to tailor the regulations to
21 the particular utility sector and geographic or demographic category.

22
23 ⁸ A Golden Valley Electric Association residential customer who uses 780 kWh
24 per month pays about \$86 per month, or \$1,032 a year, or 2.5% of the Fairbanks
25 median household income of \$40,577 (2000 Census).

26 ⁹ For reference, the PCE annual program statistics report indicates rural electric
utilities in FY03 served 25,713 residential meters.

Sustainability Policy

1 Regardless of whether the Commission tailors the regulations based upon
2 the utility sector and geographic or demographic considerations, we believe that the
3 Commission should begin its inquiry with the following basic principles that apply across
4 the board:

- 5 1. Allow utilities to build equity to replace grant-funded plant in service
- 6 2. Require utilities to file a **financial sustainability plan** describing how
7 the utility expects to fund eventual replacement of **all** of its
8 infrastructure ("sustainability plan")
- 9 3. Require utilities to file schedules which support the specific rate
10 change request and compares the specific request to the rates that
11 would result from full recovery of grant-funded plant in current rates
12 ("disclose full cost rates")
- 13 4. Provide for a "safe harbor" where rate increases up to a specified
14 affordability level will be presumed reasonable by the Commission in
15 order to streamline the schedule and cost of simple regulatory filings.
- 16 5. Limit residential rates to an affordable level.

17 The time to begin to build up equity to enable timely replacement of grant-
18 funded infrastructure in Alaska is now.

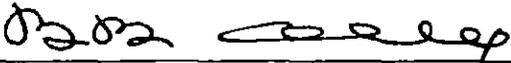
19 We encourage the Commission to initiate a regulations proceeding by
20 noticing the proposed regulations and to move expeditiously to adopt regulations that
21 enable utilities to begin to build equity to enable timely replacement of grant-funded
22 infrastructure.

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Sustainability Policy

1 DATED at Anchorage, Alaska, this 27th day of May 2004.

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United States Department of Agriculture,
Rural Development, Alaska Office

State of Alaska,
Department of Environmental Conservation

Alaska Native Tribal Health Consortium

North Slope Borough

Alaska Power & Telephone

Alaska Village Electric Cooperative

Naknek Electric Association

Denali Commission

R-04-__ - (__/__/04)

RCAPetition final doc

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Sustainability Policy

1 DATED at Anchorage, Alaska, this ___ day of _____ 2004.

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4 United States Department of Agriculture,
Rural Development, Alaska Office

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State of Alaska,
Department of Environmental Conservation

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9 Alaska Native Tribal Health Consortium

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20 Naknek Electric Association

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Sustainability Policy

1 DATED at Anchorage, Alaska, this ___ day of _____ 2004.

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4 United States Department of Agriculture,
Rural Development, Alaska Office

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7 State of Alaska,
Department of Environmental Conservation

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10 Alaska Native Tribal Health Consortium

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12 *James King - Director, DMS- NSB*
North Slope Borough

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15 Alaska Power & Telephone

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18 Alaska Village Electric Cooperative

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21 Naknek Electric Association

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R-04-__ - (___/___/04)

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Sustainability Policy

1 DATED at Anchorage, Alaska, this ___ day of _____ 2004.

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4 United States Department of Agriculture,
Rural Development, Alaska Office

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7 State of Alaska,
Department of Environmental Conservation

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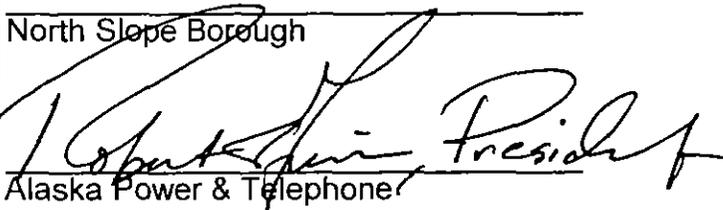
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Sustainability Policy

1 DATED at Anchorage, Alaska, this 8th day of June 2004.

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4 United States Department of Agriculture,
Rural Development, Alaska Office

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7 State of Alaska,
Department of Environmental Conservation

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RCAPetition final

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Sustainability Policy

1 DATED at Anchorage, Alaska, this 27th day of May 2004.

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United States Department of Agriculture,
Rural Development, Alaska Office

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State of Alaska,
Department of Environmental Conservation

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Alaska Native Tribal Health Consortium

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Alaska Power & Telephone

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Alaska Village Electric Cooperative

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Donna Verkich, Gen Mgr.
Naknek Electric Association

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R-04-__ - (__) /04)

RCA Political Panel 1

Order R-04-3(1)/R-04-4(1)

Appendix

Page 18 of 27

Sustainability Policy

1 DATED at Anchorage, Alaska, this 8th day of June 2004.

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4 United States Department of Agriculture,
Rural Development, Alaska Office

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7 State of Alaska,
Department of Environmental Conservation

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22 Denali Commission

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APPENDIX A: PROPOSED REGULATIONS

3 AAC 48.275 Supporting Information

(a) Except as provided in (b) of this section, each filing with the commission of a permanent or interim tariff revision which involves a change in rates to the customers of a utility or shippers of a pipeline carrier **must** include the following supporting information in the following order:

...

[ADD A NEW ITEM 14]

(14) A schedule showing the computation of rate base, return, tax allowances and depreciation expense associated with used and useful grant-funded plant, together with schedules showing the rates under full recovery of grant-funded plant, the portion of grant-funded plant requested to be included in rates, and a financial sustainability plan describing how the utility expects to fund eventual replacement of all of its infrastructure. The commission shall accept, as a rebuttable presumption, that residential rate changes to build equity in order to replace grant-funded utility plant in service that do not exceed an increase of one percent of household income in a community are reasonable. The commission shall limit rate increases to a level that ensures that local residential rates remain affordable. [emphasis added]

Commentary:

1. This regulation allows, but does not require, a utility to seek a rate increase to fund the future replacement of grant funded infrastructure

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- 1 2. This regulation requires utilities that are seeking a rate increase to fund the
2 future replacement of grant funded infrastructure to disclose full cost rates
3 and to develop and file a financial sustainability plan.
- 4 3. This regulation provides utilities with a "safe harbor" where the Commission
5 will accept, as a rebuttable presumption, that residential rate increases
6 associated with forward funding to enable replacement of grant-funded
7 infrastructure that do not exceed the EPA Small Systems Work Group
8 Affordability Guidelines (April 2003) – which endorse an affordability guideline
9 which limits rate increases to 1 percent of median household income – are
10 reasonable. The Commission may find that, after issuing these regulations
11 for comment and investigating the circumstances of different utility sectors
12 and different utility groupings (geography, size, demographics), that the safe
13 harbor provisions of the regulation may need to be tailored to the
14 circumstances of different utility groups. To the extent possible, the
15 regulation should provide for a low cost, streamlined schedule for simple rate
16 increase filings in this area.
- 17 4. This regulation limits local residential rate increases to a level that ensures
18 that residential households can continue to afford utility services. The
19 commission may establish affordability criteria in regulations or it may develop
20 them for each utility sector on an ongoing basis as part of a regular review
21 process – perhaps once every four or five years.
- 22 5. The regulation does not limit the Commission in how restrictive it may wish to
23 be with respect to the accounting for the funds that are raised as a result of a
24 rate increase to forward fund replacement of grant funded infrastructure. In
25 some forward funding scenarios, the Commission may wish to create escrow
26 accounts. In other forward funding scenarios, the Commission may simply

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Sustainability Policy

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require that utilities maintain a clear accounting of the amounts in the annual reports. The accounting for these funds and any associated restrictions on their use is thus left up to the Commission on a case-by-case basis.

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1 **APPENDIX B: PROPOSED REGULATIONS AND STANDARD UTILITY**

2 **RATEMAKING**

3 In utility ratemaking, depreciation is the annual return of an investment in
4 an asset. In short, it the annual amount that an investor gets back for putting in the
5 initial investment that results in an asset that is used to provide service. The investor is
6 free to use the cash flow that derives from the depreciation allowance in rates for
7 building equity, paying dividends, funding a capital improvement program,
8 demonstrating cash flow for debt service coverage ratios, etc.

9 When the investment comes from an entity other than the utility owner,
10 i.e., ratepayer contributions in aid of construction, grants from government, it is
11 considered contributed capital. Contributed capital is characterized as "cost-free"
12 capital by regulators who are trying to ensure that utility owners receive an opportunity
13 to earn a return of and on their investment but not the investment made by others.
14 Thus, depreciation on contributed capital is seen as a return of an investment to the
15 utility owners who did not make the investment in the first place and is not typically
16 allowed in rates.

17 An allowance in rates for the future repair and replacement of contributed
18 capital **is similar** to depreciation on contributed capital in that:

- 19 1. Both approaches collect funds from current ratepayers based upon
20 assets that are used to provide service
21 2. The funds collected from both approaches may be used to repair
22 and replacement assets

23 An allowance in rates for the future repair and replacement of contributed
24 capital **is different** from depreciation on contributed capital in that:

- 25 1. Depreciation funds may be used for repair and replacement *as well*
26 *as other uses*. An allowance may be required to be used for repair and replacement –

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1 either directly or as match for grants or loans that raise funds for repair and
2 replacement.

3 2. Depreciation funds are not typically escrowed. An allowance may
4 be required to be escrowed and only used for specific purposes.

5 3. Depreciation is calculated based on original cost, estimated life,
6 salvage value and a method to recover the investment over time (straight-line, double
7 declining balance, etc). An allowance may be based on a capital recovery,
8 depreciation, or a sinking fund approach.

9 While it would appear that the approaches can be made sufficiently
10 different to enable the Commission to distinguish between them and survive arguments
11 that an allowance in rates to build for future replacement is nothing more than
12 "depreciation on contributed plant", it may be prudent for the Commission to consider to
13 what extent it already has sufficient flexibility to consider depreciation on contributed
14 plant.

15 An inquiry into the flexibility the Commission may have with respect to
16 "depreciation on contributed plant" starts with the governing statute.

17 **AS42.05.471 Depreciation rates, initial losses and accounts.**

18 *a) To provide for the loss in service value of its property, not restored
19 by current maintenance, a utility shall charge adequate, but not excessive, depreciation
20 expense for each major class of utility property used and useful in serving the public.
21 From time to time the commission shall determine the proper and adequate rates of
22 depreciation for each major class of property of a public utility. The commission shall
23 accept rates of depreciation and depreciation accounts proscribed and maintained
24 under regulations of a federal agency or the terms of a bond ordinance. The
25 commission shall determine and allow depreciation expense in fixing the rates, tolls and
26 charges to be paid for the services of a public utility.*

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1 b) The commission is not bound in rate proceedings to accept, as just
2 and reasonable for rate-making purposes, estimates of annual or accrued depreciation
3 established under the provisions of this section, **or to allow** annual or accrued
4 depreciation on utility property directly or indirectly contributed by customers or others.

5 **[emphasis added]**

6 Possible Readings of 471

7 Some have read 471(b) literally along the lines that the Commission is not
8 bound in rate proceedings to allow depreciation on contributed plant. "Not bound to
9 allow" suggests that the Commission is not required to permit depreciation on
10 contributed plant. This would appear to allow the Commission **the flexibility to accept**
11 **or not** depreciation on contributed plant.

12 Historically it appears that the Commission has declined to exercise its
13 flexibility and has been inclined to disallow depreciation on contributed plant as a
14 general matter.

15 For example, in the 1970s, the Commission ruled that amounts associated
16 with state and government grants were excluded from rate base as "cost free capital" –
17 thus no depreciation associated with the grant funded infrastructure was allowed in
18 rates.

19 In the late 1980s, the Commission established regulations that
20 "depreciation expense is not allowed on plant funded with grants, contributions in aid of
21 construction, or other nonutility money." [See 3 AAC 52.630(2) Standards for Non-fuel
22 Costs, Costs used in the Calculation of Power Cost Equalization]

23 Another reading of 471(b) that has been suggested is that the
24 Commission is **not allowed** to accept depreciation on contributed plant.

Sustainability Policy

1 Even if one assumes that 471(b) prohibits the Commission from allowing
2 depreciation on contributed plant, the Commission can investigate whether the public
3 interest in certain circumstances warrants an alternative approach where the utility can
4 begin to include an allowance in rates that builds working capital and equity to begin to
5 enable the utility to fund repair and replacement of infrastructure from local sources
6 rather than grants.

7 **AS42.05.711(d):**

8 *The commission may exempt a utility, a class of utilities, or a utility service*
9 *from all or a portion of this chapter if the commission finds that the exemption is in the*
10 *public interest*

11 If the Commission finds that the public interest warrants a shift toward less
12 reliance on grant funded infrastructure, the Commission may formally exempt a class of
13 utilities from the requirement that rates cannot include depreciation on contributed
14 capital.

15 Then the question becomes under what circumstances does it make
16 sense to include an allowance in rates to help build working capital and equity and how
17 much and how fast should working capital and equity be built. While this tends to lend
18 itself to a case-by-case approach, it may be efficient for both the regulated and the
19 regulators to explore some regulatory "safe harbors" where utilities can raise their rates
20 up to some "rate caps" in order to build working capital and equity to replace grant-
21 funded plant. The rate caps would be presumptively reasonable, but subject to
22 challenge by ratepayers or other interested parties.

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APPENDIX C: Rural Alaska Regional Census Data

Financial Sustainability Model

in Rural Alaska Census Areas

Source: Census Data 2000

Geographic Area	Households	Median Household Income (MHI)	Purchase Power = MHI X Households	Potential Affordable Utility Expenditures	
				Affordability Estimate as Percentage of MHI 2.5%	Affordability Estimate as Percentage of MHI 5.0%
Aleutians East Borough	526	\$ 47,875	\$ 25,182,250	\$ 629,556	\$ 1,259,113
Aleutians West Census Area	1,270	\$ 61,406	\$ 77,985,620	\$ 1,949,641	\$ 3,899,281
Bethel Census Area	4,226	\$ 35,701	\$ 150,872,426	\$ 3,771,811	\$ 7,543,621
Bristol Bay Borough	490	\$ 52,167	\$ 25,561,830	\$ 639,046	\$ 1,278,092
Denali Borough	785	\$ 53,654	\$ 42,118,390	\$ 1,052,960	\$ 2,105,920
Dillingham Census Area	1,529	\$ 43,079	\$ 65,867,791	\$ 1,646,695	\$ 3,293,390
Haines Borough	991	\$ 40,772	\$ 40,405,052	\$ 1,010,126	\$ 2,020,253
Lake & Peninsula Borough	588	\$ 36,442	\$ 21,427,896	\$ 535,697	\$ 1,071,395
Nome Census Area	2,693	\$ 41,250	\$ 111,086,250	\$ 2,777,156	\$ 5,554,313
Northwest Arctic Borough	1,780	\$ 45,976	\$ 81,837,280	\$ 2,045,932	\$ 4,091,864
Prince of Wales - Outer Ketchikan	2,262	\$ 40,636	\$ 91,918,632	\$ 2,297,966	\$ 4,595,932
Skagway-Hoonah-Angoon	1,369	\$ 40,879	\$ 55,963,351	\$ 1,399,084	\$ 2,798,168
Southeast Fairbanks Census Area	3,225	\$ 38,776	\$ 125,052,600	\$ 3,126,315	\$ 6,252,630
Wade Hampton Census Area	1,602	\$ 30,184	\$ 48,354,768	\$ 1,208,869	\$ 2,417,738
Yakutat City and Borough	265	\$ 46,786	\$ 12,398,290	\$ 309,957	\$ 619,915
Yukon - Koyukuk Census Area	2,309	\$ 28,666	\$ 66,189,794	\$ 1,654,745	\$ 3,309,490
Subtotal	25,910	\$ 40,225	\$ 1,042,222,220	\$ 26,055,556	\$ 52,111,111

Notes:

Excluding North Slope Borough

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