

Innovative Ratemaking – Multiyear Rate Plans

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Introduction

This document:

- Discusses the current business and regulatory environment that is resulting in the increased use of innovative ratemaking techniques, including the consideration by some utilities and jurisdictions of a multiyear rate plan (MYRP) filing
- Provides an overview of the different MYRP approaches being utilized, including case studies in selected states and key takeaways from each approach
- Summarizes future trends regarding the use of MYRP filings

Outline

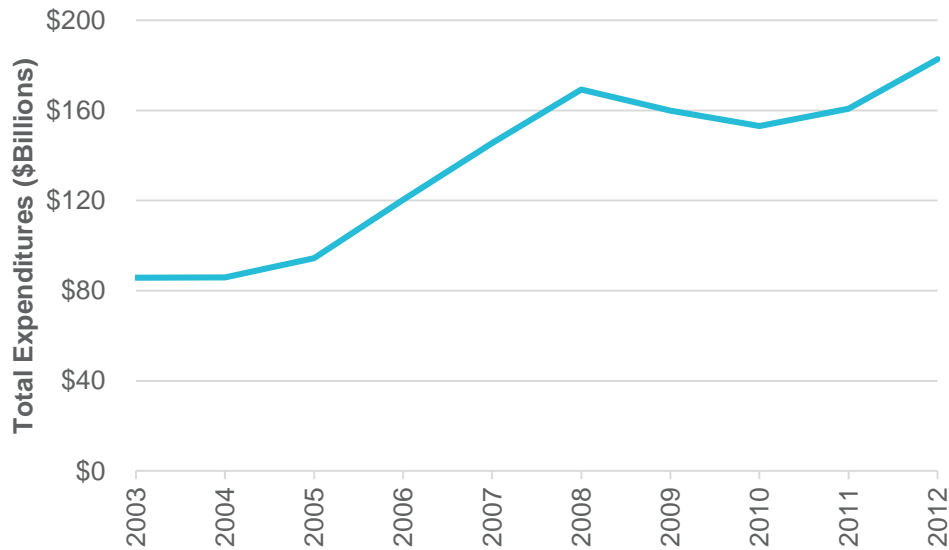
- Current Environment
- Overview of Multiyear Rate Plans
- Case Studies
- Issues for Utilities Considering MYRPs
- Conclusions

Current Environment

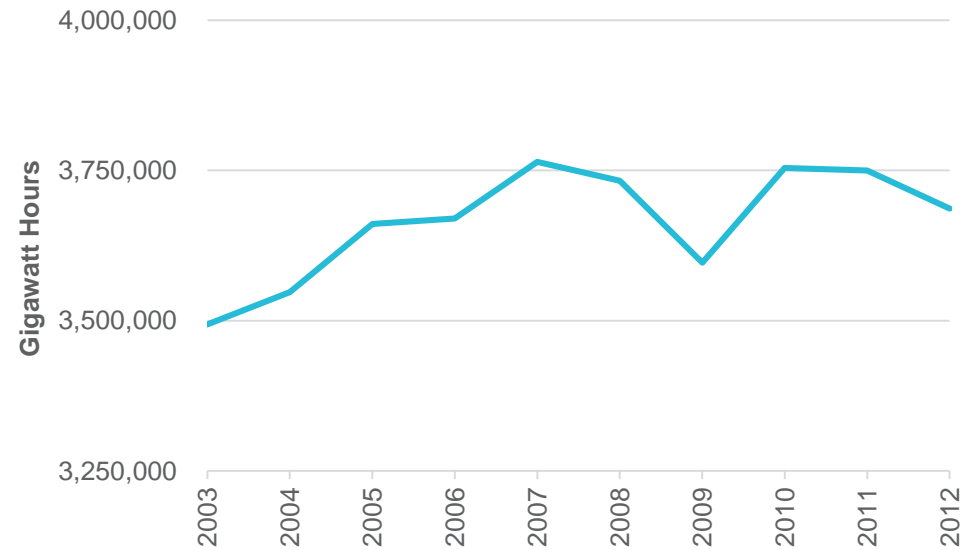
The current business environment is creating challenges for utilities

- Electric utility costs are increasing more rapidly than retail sales
 - Utilities are actively modernizing and enhancing their delivery infrastructure
 - Sales growth, which enabled utilities to finance new investments in the past, has not bounced back from pre-recession lows, and in some areas is declining

Total Capital Expenditures 2003–2012



Total Retail Sales 2003–2012



Current Environment (Cont'd)

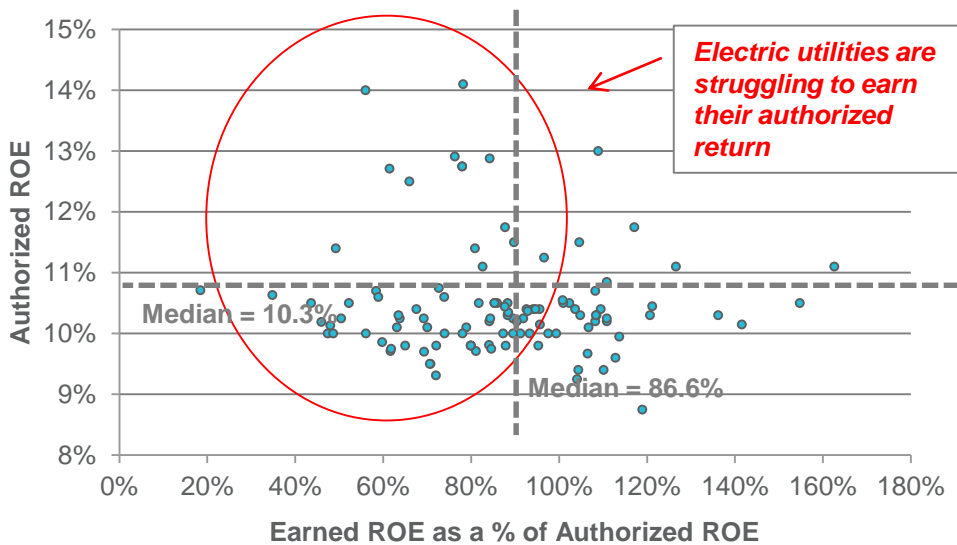
Traditional regulatory mechanisms are also impacting financial performance

- Regulatory lag makes timely cost recovery difficult
- Consistent “under-earning” impacts utility credit ratings, increases cost of capital, and may discourage needed investment

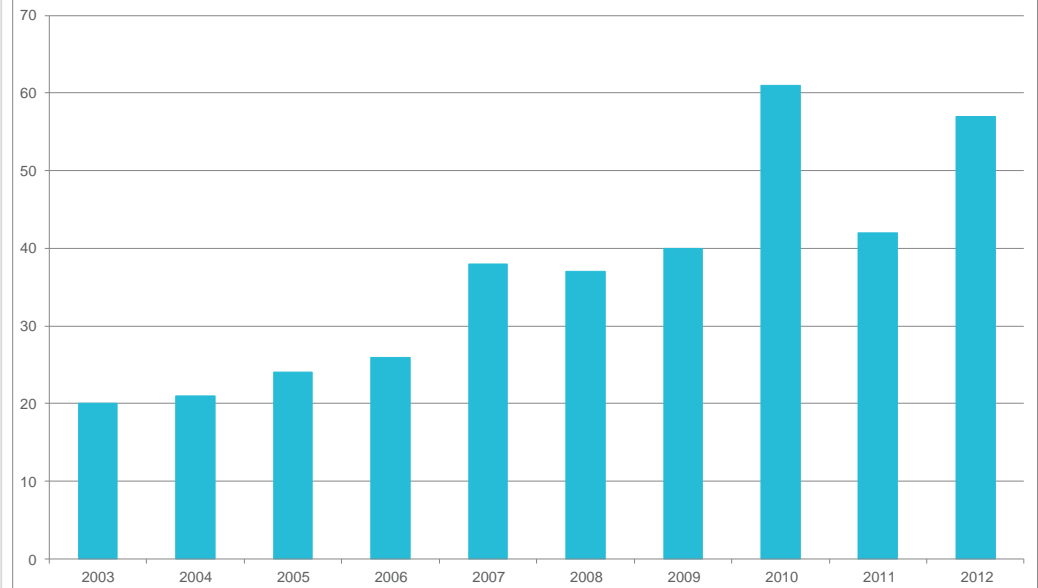
Utilities have responded by filing rate cases more frequently, which leads to additional challenges

- Requires significant resources that could otherwise be used to run the business
- Contributes to increased uncertainty of revenues and ROE and puts upward pressure on financing costs
- Creates an additional burden and resource requirements for regulators and interveners

Earned vs. Authorized ROE for Electric Utilities



Number of Rate Cases Approved 2003-2012



Current Environment (Cont'd)

In light of the challenges associated with traditional regulatory approaches, some utilities and public utility commissions are experimenting with alternative approaches

- Various methods have been introduced across many states including:
 - Cost trackers
 - Inclusion of construction work in progress (CWIP) in the rate base
 - Revenue decoupling
 - Forward test years
 - Formula rates
 - MYRPs

MYRPs represent one alternative regulatory approach to addressing the limitations of traditional regulatory mechanisms in the current business environment.



Overview

Characteristics

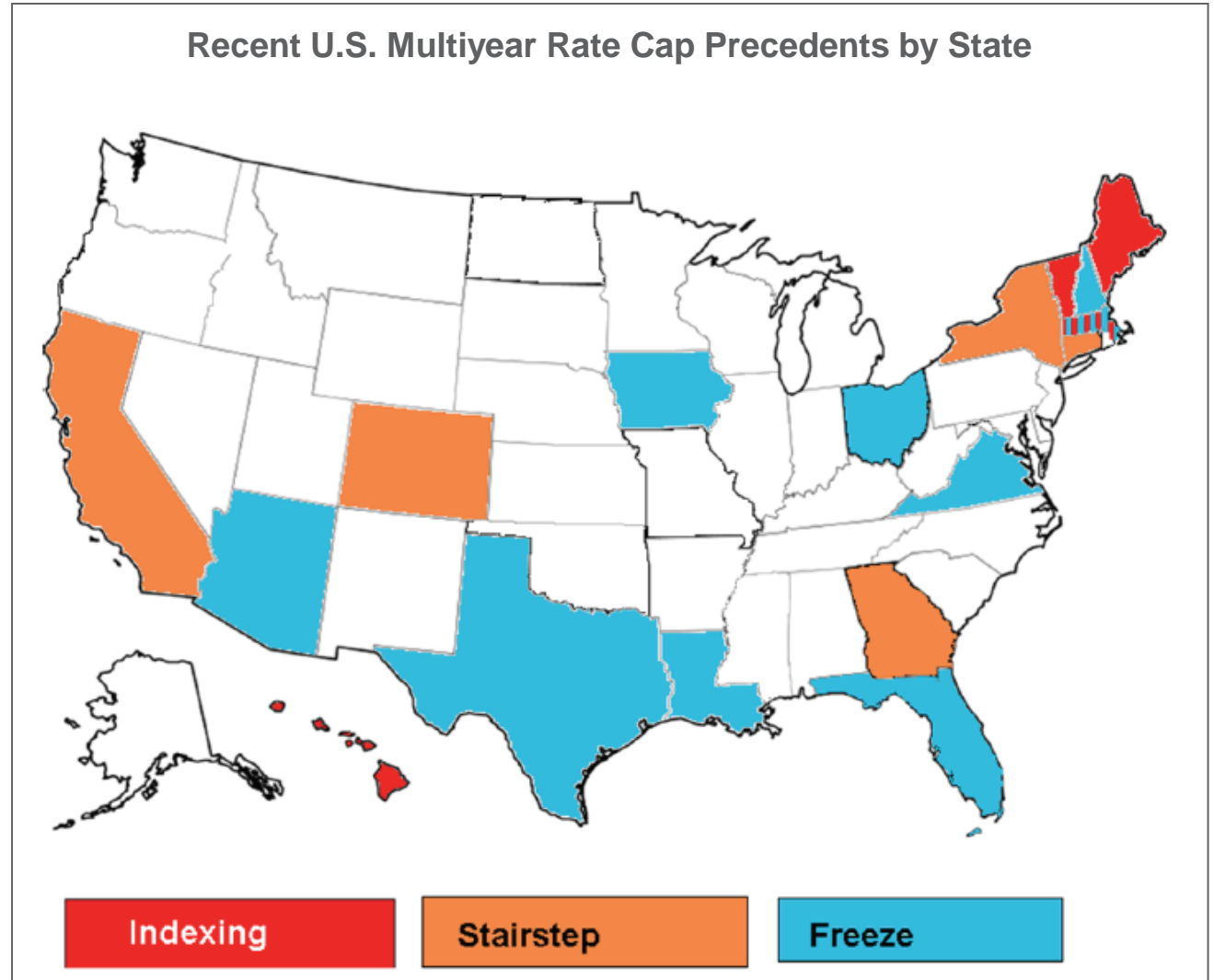
- Originally utilized in the railroad, telecommunications, and oil pipeline industries
- Typically designed for a three- to five-year period
- Attrition relief mechanisms (ARMs) define annual rate escalations
- ARMs are usually capped either in terms of rates or total revenue
- Typical ARM designs include:
 - Stairsteps – predetermined increases in rates or revenues based on cost growth forecasts
 - Indexing – variable increases tied to an index like the CPI inflation rate
 - Hybrids – indexing for O&M and stairsteps for CapEx
- Additional provisions sometimes included in MYRP structure include:
 - Cost trackers
 - Earnings sharing mechanisms to distribute excess earnings between utility and customers (when allowed ROE is exceeded)
 - “Off-ramps” to allow for plan suspension in the event of unusually high or low earnings

Benefits

- Produces more predictable revenue stream and certainty for utility to make investments (reduces cost of capital)
- Reduces regulatory costs
- Incentivizes utility to manage costs
- Enables utility to allocate resources to running the business rather than rate case administration

MYRP Adoption by State

- 17 states have implemented MYRPs in one form or another
- California and the states in the Northeast have the most experience with MYRPs
- Indexing is more common with distributors than with vertically integrated utilities
- MYRPs with rate freezes are most often accompanied by extensive supplemental funding through trackers



Source: "Alternative Regulation for Evolving Utility Challenges: An Updated Survey," EEI, January 2013

Case Study – New York:

Consolidated Edison

Background	
Utility	Consolidated Edison (ConEd)
Rate Year	2010
MYRP Type	Levelized Stairsteps
Length of Plan	Three Years

Key Takeaways from the Order	
<ul style="list-style-type: none"> ■ ConEd required to reduce O&M by a set amount annually ■ Net plant targets established for three categories <ul style="list-style-type: none"> • If actual net plant in service is less than targets, ConEd must defer carrying costs for the benefit of customers • If actual net plant exceeds targets, ConEd must absorb costs during term of plan • Any overages must be justified ■ Plan includes 2% annual productivity adjustment to revenue requirement ■ ConEd encouraged to consider the rate impacts on customers in their capital budgeting and planning ■ Commission's order specifies significant requirements related to improving corporate culture with an emphasis on increased effectiveness and accountability to customers and other stakeholders ■ Commission finds that three-year plan is beneficial by providing rate payers with certainty for budgeting purposes and providing utility with clarity of revenue expectations for the next three years ■ Order includes a reliability performance mechanism that penalizes revenue allowance if performance on certain metrics is not achieved 	

Terms		
Component	Requested	Awarded*
Award		
Rate Year	\$854.4M*	\$420.4M
Year 2	6% on Total Bill Basis	\$420.4M
Year 3	6% on Total Bill Basis	\$420.4M
ROE	10.90%	10.15%
Profit Sharing	ROE Threshold → Percent Shared with Customers	11.15% → 50% 12.149% → 75%

Compliance Reporting	
Computation and Disposition of Earnings Report (Annual)	
<ul style="list-style-type: none"> ■ Filed within 60 days after the rate year is complete ■ Includes detailed computations of ROE for the year to be submitted to the secretary ■ Calculation determines profit-sharing levels as specified in plan 	
Capital Expenditures Report (Annual)	
<ul style="list-style-type: none"> ■ Filed with the secretary by February 28. Provides list of new projects, canceled projects, and explanations for variances in actuals versus budget ■ Review meeting: Meet with commission staff on or before December 15 prior to Year 2 and Year 3 to review capital spending plans 	

* Award levelized across three-year plan. Individual year increases calculated at \$540.8M, \$306.6M, \$280.2M for 2010, 2011, 2012
Sources: New York State Public Service Commission; SNL

Case Study – Georgia:

Georgia Power Company

Background

Utility	Georgia Power Company
Rate Year	2011
MYRP Type	Stairstep
Length of Plan	Three Years

Key Takeaways from the Order

- If earnings fall below 10.25% ROE, GA Power may petition the commission for a interim cost recovery (ICR) tariff
- ICR process will involve minimum filing requirements established by the commission and subject to public input

Terms

Component	Requested	Awarded
Award		
Rate Year	\$615M	\$562.3M
Year 2	Unable to Discern	\$189.7M
Year 3	Unable to Discern	\$92.6M
ROE	11.95%	11.15% (Dead band = 10.25% to 12.25%)
Profit Sharing	ROE Threshold → Percent Shared with Customers	Above 12.25% → 66%

Compliance Reporting

Retail Surveillance Report (Annual)

- Includes detailed calculations for ROE and supporting documentation
- Also includes company financials and actuals vs. budgeted non-fuel O&M

Retail Base Revenue and Electricity Sales Forecast

- Forecast of base rate revenue and megawatt-hour sales
- Redacted for “trade-secret status”

Case Study – Colorado:

Public Service Company of Colorado

Background	
Utility	Public Service Company of Colorado
Rate Year	2012
MYRP Type	Stairstep
Length of Plan	Three Years

Key Takeaways from the Order	
■	PSCo agrees not to file a new rate case unless the revenue shortfall for a 12-month period is more than 2% of the targeted revenue for the year (“stay out” provision)
■	Proposed plan would have increased base rates by \$281M but be offset by \$139.1M in reductions to riders currently in the tariff
■	PSCo filed both future test year (FTY) and historical test year (HTY) calculations. HTY calculations resulted in \$160.8M revenue deficiency due to the effects of accelerated depreciation (compared to \$141.9M for FTY)
■	All interveners (except one) urged the use of the HTY rather than the FTY
■	Staff recommended a lower ROE, lower cost of debt, and a different capital structure which resulted in a reduction of the revenue deficiency of \$125.7M
■	Commission accepted the settlement agreement without revisions or modifications

Terms		
Component	Requested	Awarded
Award	\$141.9M	\$114M
Rate Year	\$141.9M	73
Year 2	Unable to Discern	16
Year 3	Unable to Discern	25
ROE	10.75%	10.0%
Profit Sharing	ROE Threshold → Percent Shared with Customers	Above 10.0% → 60% Above 10.2% → 50% Above 10.5% → 100%

Compliance Reporting	
Earnings Sharing Mechanism Report	
■	Presents ROE performance with supporting calculations. Based on ROE level, revenue sharing agreement may be triggered
■	Report includes: <ul style="list-style-type: none"> • Common Plant Allocation and supporting documentation • Calculation of Earnings Sharing and supporting documentation • Information related to CWIP and allowance for funds used during construction (AFUDC)
■	Report does not include: <ul style="list-style-type: none"> • Capital project execution information (actuals versus budget with variance explanations)

Case Study – California:

San Diego Gas & Electric

Background	
Utility	San Diego Gas & Electric
Rate Year	2012
MYRP Type	Hybrid – Fixed % Based on Cost Projections Tied to an Index
Length of Plan	Four Years

Key Takeaways from the Order	
■	SDG&E required to update reliability performance metrics and targets
■	Includes allowances for two-way accounts in a number of categories, e.g., compliance with certain EPA rules, energy storage, transmission and distribution integrity management programs
■	SDG&E must provide detailed accounting of and justification for AFUDC in next case
■	SDG&E used a five-year average (2005–2009) as the basis for all cost forecasting <ul style="list-style-type: none"> • Opponents suggested the use of the most recent recorded data is more appropriate • Commission ruled that it depends on the cost center and each should be considered separately
■	SDG&E proposed post-test year (PTY) adjustment mechanism that included six components: O&M adjustment, capital-related cost adjustment, medical cost adjustment, Z-factor adjustment if applicable, earnings sharing mechanism, and productivity investment sharing mechanism <ul style="list-style-type: none"> • The Commission elected to simplify and use one PTY adjustment mechanism established ahead of time and based on CPI – Urban index

Terms		
Component	Requested	Awarded
Award		
Rate Year	\$237.5M	\$123.4M
Year 2	Unable to Discern	2.65% Increase
Year 3	Unable to Discern	2.75% Increase
Year 4	Unable to Discern	2.75% Increase
ROE	N/A*	10.7%
Profit Sharing	60/40 for RD&D Revenues (Cust./Utility)	75/25 for RD&D Revenues (Cust./Utility)

* ROE is settled in a separate proceeding in California
Sources: California Public Utilities Commission; SNL

Case Study – Minnesota:

Minnesota PUC Authorizes MYRPs

Legislation Leads to Commission Order

- Minnesota legislature authorized the commission to approve MYRPs in 2011 with Minn. Stat. 216B.16, subd. 19
- Commission solicited and received comments on appropriate terms and conditions for MYRPs
- Commission met to consider the motion on April 4, 2013
- Final order issued June 17, 2013 (Docket No. E,G-999/M-12-587)
 - Benefits and concerns associated with MYRPs (as noted in the order):

Benefits	Concerns
<ul style="list-style-type: none">■ Reduced regulatory lag■ Reduced financing costs■ Reduced need for rate cases and other riders■ More predictable utility bills (gradual rate changes)■ Reduced rate shock	<ul style="list-style-type: none">■ Difficulty of accurately forecasting costs and revenues■ Mismatch of relevant costs to relevant revenues■ Challenges associated with evaluation and administration of plans

- The commission's goal is to permit plans that generate sufficient benefits to outweigh concerns and justify the burdens of plan administration

Case Study – Minnesota:

Key Structural Decisions

- The following table summarizes the outcome of MPUC deliberations on the various parameters of MYRPs under consideration:

Item	Options Proposed	Commission Decision	Rationale
Procedural Context	<ul style="list-style-type: none"> File MYRP within context of general rate case File shortly after rate case when factual record is still fresh File plan to coincide with capital project 	File MYRP within context of general rate case	Evaluation of MYRP presents same challenges as general rate case and more. General rate case process provides best foundation for meeting challenges
Subsequent Rate Cases	<ul style="list-style-type: none"> Utilities seeking approval of MYRP must agree to forego any rate case filings throughout duration of MYRP 	Utilities will not be permitted to file a new rate case until MYRP has expired	Evaluation of MYRP creates additional challenges in exchange for reduced regulatory burden. Filing a new rate case would force commission to incur the burdens without the benefits
Formula Rates	<ul style="list-style-type: none"> Specific rates for each year of plan Automatic formulas for annual rate adjustment 	Plans will specify fixed rates for each year of the plan. MYRPs that propose formula rates will not be approved	Fixed multiyear rates allow prices to adjust over time but are based on fact-driven rate-making process and substantial evidence. Formulaic rates automatically pass through utility costs to customers and reduce incentive to manage costs
Return on Equity	<ul style="list-style-type: none"> Reduce ROE in each year of the plan Maintain same ROE throughout term of plan Address ROE on a case-by-case basis 	The established ROE will be used to determine rates for all years of MYRP	Difficult to forecast changes in ROE over time. Doubtful benefits outweighed by burden of generating estimates

Source: Order Establishing Terms, Conditions, and Procedures for Multiyear Rate Plans: MNPUC, June 17, 2013

Case Study – Minnesota:

Key Structural Decisions (Cont'd)

Item	Options Proposed	Commission Decision	Rationale
Rate Riders and Differed Accounting	<ul style="list-style-type: none"> ■ Eliminate all riders (no longer necessary as need is met through MYRP) ■ Consider riders on case-by-case basis 	Allow some riders on case-by-case basis. Push utilities to consolidate where possible, and under no circumstances allow double-dip recovery	Not all supplemental cost-recovery categories are addressed in an MYRP (e.g., energy costs, emissions, conservation). Utilities should seize efficiencies where they can and prove in the filing that no costs are being recovered through both the MYRP and a rate rider
Rates at Plan Expiration	<ul style="list-style-type: none"> ■ Require new rate case filing 	No decision. Commission will not specify how to determine rates, but the utility will be required to propose what those rates will be or how they will be calculated as part of the MYRP filing. The utility is certainly permitted to file a new rate case	
Commission Initiated Rate Change	<ul style="list-style-type: none"> ■ Imprudent rate increases should be subject to refund and utilities should waive any claim that such a decision would constitute retroactive rate making 	Imprudent rate increases will be subject to refund and utilities must waive any claim that such a decision would constitute retroactive rate making	Follows from language of Minn. Stat. 216B.16
Plan Duration	<ul style="list-style-type: none"> ■ Two-year maximum (until experience is gained) ■ Three-year maximum or even longer 	Three-year maximum (term will begin on effective date of new rates)	Commission sees no reason to preclude consideration of three-year plans as specified in the statute. Further, given the administrative burdens, commission sees no reason to limit the period over which parties hope to reap the benefits of MYRP

Issues for Utilities Considering MYRPs

- Additional scrutiny
 - MYRPs involve setting rates based on planned capital expenditures rather than reimbursing investments already made. Therefore, utilities must be prepared to provide more detailed information than what has been required in the past
- Budgeting and project management skills
 - Utilities must be able to show that investments were made according to the plan submitted at the time of the filing. Failure to adhere to the plan may result in refunds or other costly regulatory issues. Ability to budget properly and execute projects to plan is critical with MYRPs
- Project selection
 - Determining which projects to include in the plan can be challenging. Utilities should consider:
 - Size of projects (impact on revenue requirement)
 - Execution risk associated with projects (scope, schedule, and budget)
- Compliance
 - Compliance mechanisms will play a significant role in whether a MYRP is the best solution for a utility
 - Some specific issues that must be addressed include:
 - Threshold for determining rate refunds
 - Aggregate versus project-by-project approach
 - Internal surveillance
 - Reporting mechanisms

Conclusions

We believe the use of MYRPs will continue to grow as utilities and commissions work to overcome the limitations of traditional ratemaking in order to balance the needs of the ratepayers and shareholders with the realities of operating and maintaining a safe, reliable, and sustainable power delivery system

- Business as usual is not sustainable in the current business environment
- MYRPs provide a promising strategy for addressing some of the regulatory challenges facing the industry
- Additional scrutiny associated with MYRPs means utilities will have to improve their budgeting and project management practices in order to be compliant and successfully earn the maximum allowable rate of return
- The success of early adopters will influence the direction of ratemaking across the country—utilities and commissions will be watching closely

Alternative regulatory mechanisms are in the early stages of development, and utilities have an opportunity to help shape the regulatory construct going forward.

Contact Us

ScottMadden has helped several utilities develop the tools necessary to successfully develop and defend a multiyear rate plan filing. Please let us show you how we can help.

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