

Utility Rates Study

Senate Energy, Utilities, Technology &
Communications Committee

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By the
Minnesota Public Utilities Commission

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Laws of Minnesota 2009

Chapter 110

- An assessment of the impact of automatic cost-recovery mechanisms on prices charged to utility consumers compared to traditional cost-recovery mechanisms
- An assessment of the impact of automatic recovery mechanisms on the level of customer understanding of utility rates compared to traditional cost-recovery mechanisms
- An assessment of alternative forms of utility rate regulation that may be used in place of automatic cost-recovery mechanisms
- Methods to improve administration and customer understanding of automatic cost-recovery mechanisms

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Utility Rate-making

- General Rate case: The Commission examines and establishes overall rate levels and rate design
- Special Recovery Mechanisms: Recovery of specific costs outside of a rate case
- Changes in tariffs or services which do not require a look at overall utility revenues may be examined in miscellaneous dockets.

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Rate Case Process

- Goal: Just and reasonable rates
- Two main components:
 - Revenue Requirement – What amount of revenue is needed?
 - Rate Design – Who pays and how do they pay?

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Cost Recovery

- “Reasonable opportunity” principle:
Reasonable *opportunity* to recover costs that were:
 - Prudently incurred
 - Needed for safe & reliable utility service
- Opportunity ≠ Guarantee
- Rates that are reasonable for ratepayers and enable utilities to attract capital on reasonable terms in order to finance capital investments

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Revenue Requirement

- Revenues needed in typical year; i.e., “Test year”
- Total Revenue = $OE + CD + VA * r$
 - OE is operating expenses (including taxes)
 - CD is current depreciation
 - VA is value of assets (minus accumulated depreciation)
 - r is authorized rate of return
- Rate case allows review ALL cost and revenue factors: i.e., those that are increasing as well as those that are decreasing

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Rate Case Process

- Procedural requirements: Minn. Stat. §216B.16
 - Utilities decide when to file
 - PUC has 60 days to suspend utility's proposed rate increase & establish interim rates
- Interim Rates: Minn. Stat. §216B.16, Subd. 3.
- Commission must reach final decision within 10 month of accepting the filing; Minn. Stat. §216B.16, Subd. 2.

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"Regulatory Lag"

- Regulatory lag: the delay between the incurrance of costs and the implement of rates that allow recovery those costs.
- Due to:
 - Time taken by utility management to decide whether to file a rate petition
 - Costs ↑ &/or revenues ↓ → rate case
 - Costs ↓ &/or revenues ↑ → no rate case
 - Time needed for administrative process

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Challenges to Reasonable Opportunity Principle

- Cost factors between rate cases that:
 - Change dramatically and unpredictably
 - Are substantial in magnitude
 - Are beyond control of the utility
- Example – fuel costs (Minn. Stat. §216B.16, subd.7)
- Special recovery mechanism for fuel costs:
 - Dampen financial risk
 - Diminish need for frequent rate cases
 - Provide better price signals to end-users

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Non-fuel special recovery mechanisms in Minnesota

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|-----------------------------------|--------------------------------------|
| • Conservation Improvement | • Utility owned renewable facilities |
| • Performance-base gas purchasing | • Mdewakanton/PI settlement |
| • Transmission cost | • Emissions reduction |
| • Transmission asset transfer | • Mercury emissions |
| • Low-income electric discount | • Real and personal property taxes |
| • Demand-Side Mgmt incentives | • Reliability Administrator |
| • Natural gas infrastructure | • Gas Affordability Program |
| • Renewable energy PPAs/RDF | • Electric Infrastructure |
| • Decoupling | • Greenhouse gas infrastructure |
| • Central Corridor utility zone | |

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Impact on rates

- Fuel cost recovery mechanisms
- Non-fuel related recovery mechanisms
 - More regulatory activity
 - Impact on incentives for efficiency
 - Limits scope of rate proceeding
 - BUT, share of overall revenues are small
- It does not appear rates are significantly higher due to use of non-fuel special recovery mechanisms

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Customer understanding

- Customers tend to focus on total utility charges
- Small, but growing number of inquiries about additional charge types on bill
- Customer awareness of special recovery mechanisms is relatively low

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Are there alternatives?

- Construction Work In Progress; Preapproval; Securitization
- Earnings sharing mechanism
 - Establishes one special recovery mechanism based on rate-of-return
 - Allows rate adjustments outside of rate cases when:
 - actual costs deviate from test year costs, and/or
 - actual revenues deviating from test year revenues

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Earning sharing mechanism

- ESM is an agreed upon plan governing rate adjustments outside of a rate proceeding
- Can be structured in many ways
 - Initial rates set in a rate case proceeding
 - Periodic review of costs, revenues, earnings
 - Rate adjustments to achieve targets of approved plan
 - Typically involve return on equity band (ROE band)

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Earning sharing mechanisms: Advantages

- Reduces need to administer numerous, individual recovery mechanisms
- Reduce frequency of rate cases
- Rates more accurately reflect changing market conditions
- Accounts for overall earnings, not just increases in individual cost categories
 - Provision for ratepayer sharing

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Earnings sharing mechanisms: Disadvantages

- Could adversely affect utility incentives for cost control
 - “Puts utility’s future on autopilot”
- Tends to shift more risk to ratepayers
- Periodic rate adjustments would be expected to prompt a customer reaction
- Would be a significant change over traditional rate-making

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Improve Administration

- Basic objectives:
 - Reduce administrative costs
 - Greater provision for ratepayer sharing
- Options for consideration
 - Allow special recovery only in instances of several financial risk; provide for cost recovery of everything else through traditional rate case process
 - Consolidate all special recovery mechanisms into one earnings sharing mechanism
 - Reduce the number of special recovery mechanisms; allow only those commonly used, involve largest financial impact, and incorporate greater accountability

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Conclusions

- Fuel related recovery mechanisms account for the largest share of revenues collected via special recovery mechanisms
- Because fuel costs are large, can change unexpectedly and are beyond the control of utilities, use of special recovery mechanisms help curb upward pressure on rates
- Non-fuel related special recovery mechanisms account for smaller share of revenues; expanded use may contribute to upward pressure on rates

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Conclusions - continued

- Customer understanding of utility rates is primarily focused on total bill; limited awareness of the role of the special recovery mechanism
- Alternatives to automatic cost recovery exist; represent significant change in ratemaking; impact on ratepayers

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Conclusions - continued

- Improving the current system should focus on:
 - Reducing administrative costs
 - Sharing of benefits with ratepayers

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Thank you

Questions?

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