The Thaw: The End of the Ice Age For American Utility Rate Cases—Are You Ready?

Rate cases are surging, but few energy utilities still boast the degree of in-house expertise that they did in the late 1980s. Today, with respect to two essential elements of the equation for regulated rates – costs and quantities – companies have to look outside for expertise and support. Planning and successfully prosecuting a rate case involves a host of detailed, interrelated technical and strategic analyses and policy decisions.

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I. Rate Case Activity Is Increasing

Utility rate cases, the “acme of American utility regulation,” are once again looming on the radar screens of American utilities and the state commissions. In many jurisdictions, the rates frozen in the mid-1990s to late 1990s (because of settlements and litigated proceedings related to introduction of retail competition, mergers, and experiments with incentive regulation) are now thawing, as Figure 1 shows. For energy utilities not subject to formal freezes, restructuring is no longer a major distraction, and many utilities need to address deferred maintenance, network improvements, increased security costs, new environmental costs, and growing reliability issues.

The trade press is full of stories about rate cases. For example, Consumers Energy has asked Michigan regulators for permission to recover about $25 million from ratepayers, starting...
in November, to cover post-Sept. 11 security costs for its electric generating facilities. Cincinnati Gas & Electric recently filed for a $78.1 million increase in electric delivery rates needed to cover investment in distribution system reliability. LG&E recently sent a proposed settlement to the Kentucky Public Service Commission that would raise electric and gas rates of its two companies by a total of more than $100 million annually. The company cited investment in gas mains, new generation capacity and electric transmission facilities and pension, post-retirement, health care and insurance expenses as contributors to the need for the rate increase. PSI Energy was raising electric rates, effective in May, by $153.5 million to cover costs of new generation capacity, environmental expenditures, and delivery system improvements.

In the last time there was a similar surge in rate cases was in the early 1970s. At that time, both electric and gas utilities faced new rate cases for the first time in decades, as a number of factors (including inflation and rising oil and gas prices) spurred unprecedented rate case activity. The rate cases of the 1970s and 1980s created vast rate case expertise at energy utilities. Rate cases themselves became formal and relatively efficient dispute resolution mechanisms between energy utility owners and state commissions. By the late 1980s, it was common for utilities to call upon only a single outside expert—a cost-of-capital witness.

II. Rate Case Expertise Is Now in Short Supply

Few energy utilities exhibit such rate case self-sufficiency these days. Both with respect to costs and quantities (two essential elements of the equation for regulated rates), the companies nowadays have to look outside for expertise and support.

Planning and successfully prosecuting a rate case involves a host of detailed, interrelated technical and strategic analyses and policy decisions. The staffs at major utilities who used to perform these analyses and make these decisions, however, are in many cases no longer available. Mergers and early (and normal) retirement have resulted in a loss of institutional memory and critical rate case skills. For example, a particular electric company created by the merger of three smaller utilities now has one rate department and one rate manager, who is familiar with the detailed history of rates at only one of the predecessor companies. When questions arose during a regulatory hearing about why certain cost-of-service methods and rate structures were adopted in the past for the other two predecessor companies, the utility was unable to give an authoritative response. In another example, a major integrated utility company in the Midwest, facing its first rate case in a decade, not only lost its cost-of-service and rate design staff members in the meantime, but also lost all staff members with the expertise to develop projected test year volumes and billing determinants.

In addition to analysts and managers who know how to perform cost studies, prepare test-year billing determinants, design rates, and provide expert testimony, a utility needs staff skilled in the logistics of a rate case. The people who used to identify assignments, set deadlines, coordinate review of testimony, keep on top of interrogatory responses, etc., may no longer be around either.

Loss of utility expertise is not the only problem. Key data may also be
hard to find. For example, cost-cutting measures at many utilities have meant cancellation of load surveys. There may be no up-to-date information on class load shapes, class non-coincident peaks, and various versions of class coincident peaks. Such figures are critical for embedded cost-of-service studies, class marginal cost revenue calculations, and predictions of billing determinants for redefined rate structures.

Weather-normalization of loads, another key element in cost studies and test-year billing determinant calculations, may have also fallen under the budgetary knife. Rate cases, at their simplest, involve the collection of costs and the apportionment of those costs over project sales volumes. As such, rate cases demand careful attention to both sides of the equation. Missteps in calculating weather-normalized test year volumes and billing determinants can have as deleterious an effect on rate case outcomes as failing to consider key projected cost items.

Restructuring and mergers often involve wholesale overhaul of the accounting systems. The data needed to update cost-of-service and other studies is probably not in the same place that it was a decade ago, and the details needed for rate case studies may not be available at all. Data that are available are likely to be in a different format, making comparisons over a period of years next to impossible.

The problem of loss of expertise is not limited to the utilities. Expertise at the regulatory agency may be in short supply too, after numerous years with no rate cases. At the end of May, the Web site of the National Association of Regulatory Utility Commissioners (NARUC) listed job openings for management or energy-related positions at nine state regulatory commissions. New commissioners and new commission staffers may be starting from scratch when it comes to reviewing rate case proposals and their myriad technical studies and analyses. In dealing with new regulatory personnel, even if they are fresh from “Camp NARUC,” the utility may need to provide extra support and be prepared for a deluge of data requests.

III. New Rate Case Issues Have Emerged

To further complicate matters, today’s rate cases are likely to encounter new issues that were not in the picture in the last rate case. Examples include:

- Embedded cost studies. Are the old methods for classifying and allocating costs still appropriate in a world of fierce wholesale competition and at least some retail competition?
- Marginal cost studies. How should marginal cost methods be changed to reflect market realities and RTO structure and rules?
- Cost of capital. What is the right cost of capital for a utility that is part of a holding company with significant non-regulated businesses?
- Delivery rate design. How should the delivery portion of rates be structured so that the same rates work for customers with distribution generation as well as for customers with no generation, thereby treating both types of customers consistently?
- Innovative rates. How can real-time or quasi-real-time price options be introduced that are consistent with new market and RTO arrangements?
- Demand response programs. How should rates be designed to facilitate new demand–response programs?
- Standard offer service. What is the right structure for standard offer service?
- Test-year billing determinants. How should customer switching to and from competitive service be handled in the sales forecast?
- Performance-based regulation (PBR). What incentive regulation program should be proposed, and how should the elements of the program be determined?
- Prudence. How should the uncertainties of retail and
wholesale competition be recognized in prudence reviews?

- Codes of conduct. How have codes of conduct changed the cost of doing business and the ways costs are accounted for?
The upshot is: heading into the new rate cases, many utilities are facing more issues with less expertise than they’ve had in 30 years.

IV. In Case You’ve Forgotten—A Rate Case Is Complicated

Putting together a rate case involves months (or years) of work, even before the first piece of paper is filed. And of course the filing of the paperwork is nowhere near the end of the process.

A. Pre-filing analysis

A myriad of technical studies provide the underpinnings for proposed rates, and guide the choice of strategies for a successful outcome. These quantitative studies must answer questions including:

- What are we trying to accomplish? What is wrong with current rates (other than delivering the wrong amount of revenue)? A formal analysis that identifies issues, objectives, and company vulnerabilities is the best way to begin preparation of a rate case. Too often key issues are not defined early and weeks of rate design work must redone to deal with a late-communicated concern.

- What should the test-year billing determinants be? Is the load forecast sufficiently detailed to provide billing determinants by class? Is analysis of load survey data required to estimate billing determinants by new time-of-use pricing periods? Are weather-normalization factors available for application to historical levels of sales?

- What rate structure makes sense for today’s market? Should more customers face time-differentiated rates? Should delivery costs be recovered on a more fixed basis? Can standard rates be redesigned so that they work equally well for all customers, including those with on-site generation, seasonal demands, and unusual load patterns?

- What would be the bill impacts of proposed new rates? Are the impacts acceptable? Are special mechanisms needed to limit the bill increases for a few customers, while permitting more appropriate rates for the many?

- What optional/innovative rate offerings should be proposed? Would prepaid meters help to solve problems of late payments and uncollectibles? Are customers interested in “insurance” against...
volatile bills that result from consumption changes, fuel price fluctuations, and market price spikes?

Not all of the pre-filing studies are quantitative. A successful rate case also depends on a well-crafted strategy for dealing with the Commission, intervenors, the press, and the public at large. Of course the strategy may change as the case progresses and new information and issues emerge. The strategic analysis needs to address questions such as:

- What are the company’s priorities?
- Is the rate case more likely to have a successful outcome if we litigate or settle?
- What is the best strategy for dealing with staff and commissioners, keeping in mind ex parte rules? Should we offer to discuss tentative proposals in workshops? Should we use informal contacts to share initial thoughts and get preliminary feedback?
- Who is likely to intervene in the case, what are their likely positions (other than: “Give the rate increase to someone else’”) and who would the company like to have intervene in support of its proposals?
- How should we deal with intervenors – those who support company and those who oppose – in order to defuse criticism and garner support?
- How can we involve the media in a positive way?
- How should the settlement process be handled (if that approach is taken)?

B. Rate case management

A successful rate case also involves a host of management and organizational activities. Questions that need to be addressed include:

- How many witnesses (internal and external) are needed? Who should testify? Should they appear individually or in panels?
- What should prefilled testimony cover and what should be left to rebuttal (or dealt with on the stand)?
- What exhibits are needed and which ones should be covered by confidentiality agreements?

Organizational tasks include:

- Developing a schedule for studies and testimony.
- Creating a plan for review and coordination of draft testimony.
- Lining up and dealing with outside experts and outside counsel.
- Witness training.
- Logistical and backup support at hearings: Who schleps the documents to the hearing room? Who makes copies of the documents that must be distributed to the hearing examiner and other participants? Who reserves meeting rooms and hotel rooms in the state capitol?
- Interrogatory management (assigning, scheduling, keeping track, reviewing drafts, distributing final copies).

V. Marshalling Rate Case Resources

As the long list above illustrates, preparing for and running a rate case involves many interrelated tasks and requires input from many parts of the organization. A key early step in the planning process for a rate case is to evaluate the in-house resources and identify tasks that need to be outsourced. For example, it may make sense to hire consultants for the cost studies, cost-of-capital calculations, and PBR work. If in-house counsel have not conducted rate cases (or not recently done so), it may be appropriate to hire outside counsel to run the case, or to assist in-house counsel. The decision to outsource specific tasks should include an analysis of whether the consultants are expected to train the utility staff (so that they can do it themselves for the next case), or whether the long-term strategy is to hire outside help of this sort in future cases as well.

What can be done to get your own staff up to speed and reduce the need for outside help? There are a number of training programs offered. Some
are regularly scheduled classes open to utilities, regulators, or both. Some are available on a private basis for a single utility or regulatory commission. Some private consultants like NERA Economic Consulting offer training. Also, check the Web sites of organization such as the following for current offerings:
- Edison Electric Institute (EEI)
- Electric Power Research Institute (EPRI)
- Michigan State University’s Institute of Public Utilities
- National Association of Regulatory Utility Commissioners (NARUC)
- National Regulatory Research Institute (NRRI) at Ohio State University
- New Mexico State University’s Center for Public Utilities
- University of Florida’s Public Utility Research Center

Cross-training is a longer-term strategy for keeping staff skilled in rate-case-related tasks. Salt River Project is one utility that has long had a policy of extensive cross-training. Opportunities are provided to managers to participate in rotations, typically every two to three years, depending on corporate needs. The Corporate Pricing Department has an informal policy of assigning responsibility for no more than two marginal or embedded cost studies in a row to an individual. In addition, select entry-level analysts move every six months for the first two years at SRP, before applying for a permanent position. Thus, a new analyst might rotate among pricing, forecasting, strategic planning, supply and trading, and financial planning.

Participation in industry groups such as the following is another way to keep up to date on rate-related skills:
- EEI
  - Distribution Committee
  - Energy Delivery Public Policy Executive Advisory Committee
  - Metering Committee
  - Policy Committee on Energy Delivery
  - Standards Participation Program
  - Transmission Committee
  - Transmission Policy Task Force
- EPRI (projects and training programs)
- NARUC
- NERA’s Marginal Cost Working Group

VI. Five Pieces of Advice

From our many years of experience helping utilities and regulatory commissions in rate cases, we have developed a list of key pieces of advice:
1. The total revenue requirement is the most critical issue in a rate case and rightfully receives the most attention by the utility, intervenors, and regulators. But rate design should not be far behind. Both class revenue allocation and the structure of rates are critical determinants of whether the utility will actually receive the allowed revenue requirement, how competition will develop, and how much capacity will be required in the future (and thus will influence future revenue requirements).
2. PBR offers risks and rewards. A well-structured incentive program can be a win-win situation for both the utility’s investors and consumers, and can demonstrate that the regulators are doing a fine job.
3. Start early. Particularly in the upcoming round of rate cases, when all the machinery is rusty, early planning and organization will be key to execution of a successful rate case.
4. Don’t skip the first step. Take the time to identify objectives, issues, and vulnerabilities early in the process.
5. Make sure everyone knows the rate case is a high priority. Obviously many players will be contributing data, studies, and analysis in addition to doing their normal jobs of keeping the lights (or pilot lights) on. They need to have clear direction from the top that their inputs are critical to the rate case preparations.

Good luck with your rate case!

Endnotes:
2. Elec. Util. Week, supra note 1, at 22.