

Cost of Service Ratemaking and Alternative Regulation

Energy

Renewable Energy

Prepayment of Power Plans and Other Investments

Federal and state governments share responsibility for regulating utilities. Federal jurisdiction primarily relates to any interstate transmission and wholesale sales of electricity and transmission of natural gas between states. States and their public utility commissions generally regulate retail rates (i.e., charges to ratepayers) and approve construction of new power plants. They also often decide which power plants may be built in their state and other resource planning matters.

Before allowing utilities to change rates, regulators traditionally require a rate case review. Under “cost of service” (also called rate of return) regulation, state regulators determine, based on test-year evidence, the amount of revenue that must be collected in rates for the utility to recover its costs and earn a reasonable rate of return on investments. Once set, the rates remain in place until a new rate case is filed and approved. A rate case ensures scrutiny of all of a utility’s costs. Regulators can review costs, applying decreases that might partially offset a proposed rate increase. This process ensures a transparent examination of utility costs based on intervenor participation, evidence and analysis.

Alternative ratemaking is often described as procedures designed to streamline the current regulatory process, and give utilities revenue stability and an incentive to be more efficient, while also reducing regulatory expenses. These alternatives include mechanisms that adjust rates automatically outside of a full rate review, or with limited review. A related concept is “piecemeal ratemaking” where a rate change is made in isolation, outside a full rate case review. Alternative ratemaking typically provides a benefit to the utility by limiting risk and often includes opportunities for bonus earnings. Among the most common types of alternative ratemaking are:

- **Formula rate plans**—allow for automatic rate adjustments using predetermined formulas that are based in whole or in part on the utility’s earnings.
- **Earnings-sharing mechanisms**—allow for rate adjustments outside of a full rate case, based on the level of the utility’s earnings; if earnings fall or rise above a predetermined level, rates are increased or decreased.
- **Performance based ratemaking**—gives utilities earnings incentives for achieving certain pre-determined performance goals.
- **Revenue decoupling and lost revenue adjustment mechanisms**—adjust rates between rate cases to account for lost revenues due to lower sales (see this chapter’s section on Energy Efficiency Programs).

- **Multi-year rate plans**—allow for automatic rate changes in years between full rate reviews.
- **Future test years**—use projected costs to set rates rather than actual costs.
- **Cost trackers**—allow the recovery of specific costs outside of a rate case.
- **Infrastructure surcharges**—provide a utility with the recovery of capital costs outside of a rate case, similar to cost trackers.

Among the criticisms of alternative regulatory models are the following:

- They undermine the comprehensive review of utility costs and prudence of investment decisions; consumers cannot be assured they are paying just and reasonable rates.
- Formulas and rate changes made in isolation without regard to overall costs are unlikely to result in just and reasonable rates.
- Allowing the utility to earn higher profits through cost-cutting creates an incentive to increase profits by decreasing quality.
- Rate-case cost savings are questionable; although the number of rate cases may be reduced, those savings can be offset by costs of tracking, monitoring and evaluating alternative mechanisms.
- They create unintended results in which utilities pursue strategies to maximize their revenues under the alternative ratemaking, rather than through actual improvements in overall service and reliability.

COST OF SERVICE RATEMAKING AND ALTERNATIVE REGULATION: Policy

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Policymakers should not move away from fully contested rate cases under the traditional cost-of-service regulatory model.

At a minimum the following principles should guide rate reviews:

- The utility's revenue requirement should be based on just and reasonable expenses necessary to provide service and investments that are prudent and used and useful to ratepayers.
- The utility's rate of return should be fair and based on current market conditions.

COST OF SERVICE RATEMAKING AND ALTERNATIVE REGULATION: Policy

		<ul style="list-style-type: none">• Rates should be stable, predictable, and understandable, with costs allocated fairly among customers.• Ratepayers should not subsidize the costs of competitive market products and technologies. <p>If alternatives are proposed, they should be done under limited-term pilots and include the following minimum consumer protections:</p> <ul style="list-style-type: none">• Regular full rate case reviews should be used to determine whether the alternative achieved its intended result;• Performance data should be publicly reported;• Annual limits should be put in place for capital expenditures;• Proceedings should be transparent, open to the public, and include an evidentiary record;• The number of allowable surcharges should be limited;• Recovery should be limited to clearly defined costs for a limited period of time;• The authorized rate of return should be downwardly-adjusted to reflect the reduced business risk from the alternative regulation; and• The utility should absorb any cost overruns related to investments financed through alternative methods such as trackers, and any underspending should be returned to ratepayers.
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