Talking Points on Cost Trackers

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I. Seven Major Points

A. **We have seen a proliferation of cost trackers over the last several years covering a broad range of utility functions and activities**.

1. Utilities have argued that a more dynamic market environment, characterized by the increased unpredictability and volatility of certain costs, justifies the recovery of those costs, or changes in those costs, through a tracker rather than in base rates.

2. Utilities have also asserted that the static nature of the "test year" sometimes denies them a reasonable opportunity to earn their authorized rate of return. They contend that cost trackers advance ratemaking goals by matching revenues to actual costs.

3. In contrast to base rates, cost trackers offer utilities the advantages of:

a. Shortening the time lag between the incurrence of a cost and its recovery in rates (i.e., curtailing regulatory lag),

b. Increasing cost-recovery certainty,

c. Lessening the regulatory scrutiny of its costs:

(1) Normally, in a rate case a regulator closely reviews the utility's costs before approving them for recovery from customers.

(2) Regulators often less rigorously scrutinize a utility's costs when recovered through a tracker.

d. Taking everything into account, lowering a utility's financial risk by stabilizing its earnings and cash flow

B. **Regulators generally have acquiesced by approving new cost trackers for a wide array of utility functions.**

1. Current cost trackers in the natural gas sector, other than those for purchased gas costs, apply to functions including pipeline integrity management, pipeline replacement costs (e.g., accelerated cast iron main replacement program), bad debt, energy-efficiency costs, general infrastructure costs, manufactured gas plant remediation, stranded restructuring costs, property taxes, post-retirement employee benefits, and environmental costs.

2. National Grid in Massachusetts, as an example, has a score of cost trackers.

C. **Regulators in recent years have applied less stringent criteria for the approval of cost trackers.**

1. Regulators traditionally allow cost recovery only after a rate case review.

2. Other alternatives such as a cost tracker would require that a utility show violation of the "opportunity" condition for particular cost items.

3. A violation can occur when a certain cost is unpredictable, generally beyond a utility's control, and substantial and recurring.

4. Regulators recently have approved cost trackers when not meeting all three conditions, especially the third.

5. The third condition ("substantial and recurring costs") greatly restricts the costs eligible for cost tracker recovery.

a. Differences between test year and actual cost must have a material effect on a utility's rate of return.

b. Legal precedent dictates that regulators must set reasonable rates that allow a prudent utility to operate successfully, maintain its financial integrity, attract capital, and compensate its investors commensurate with the risks involved.

c. A utility should recover revenues in excess of its operating expenses to provide a "fair return" to investors. Businesses

including utilities need to earn a profit to compensate investors for business, financial, and other risks.

6. Several regulators have softened or ignored the "substantial and recurring" component of the "extraordinary circumstances" standard.

   a. Bad debt, the subject of recent cost trackers, features financial effects that are typically not substantial.

   b. Utilities have contended that the unpredictability of this cost makes it difficult to incorporate it accurately into the base rate.

7. Yet, even if this assertion is true, it is questionable whether any bad-debt cost unaccounted for in the test year would inflict substantial financial harm on a typical utility.

D. **Regulators have given inadequate attention to the negative features of cost trackers. By conflicting with certain regulatory objectives, cost trackers are at odds with the public interest:**

1. Cost trackers undercut the positive effects of regulatory lag and retrospective reviews in deterring utility waste and cost inefficiency.

2. They also could lessen regulatory scrutiny in evaluating the prudence of costs.

3. They also have the potential to create perverse incentives.

E. **A rate-of-return tracker in the form of an earnings sharing mechanism has advantages over having myriad trackers for a single utility (leaving out FACs/PGAs).**

1. This alternative overcomes some of the problems with cost trackers, namely perverse incentives and weak incentives for cost control, the mismatching of a utility's *total* costs and revenues, and inadequate regulatory oversight of costs.

2. An earnings-sharing mechanism is also able to achieve the major objective of cost trackers, namely preventing utilities from suffering serious financial problems between rate cases.

3. It can also address the "fairness" issue of why a utility should not recover from customers a cost increase (e.g., property taxes) between rate cases that is completely beyond its control.

a. This mechanism would, in effect, allow the utility to recover the increased costs, but only if it was already earning a "low" rate of return (i.e., a return below the "band" region).

b. One major problem with cost trackers is that they allow a utility to increase its prices even if the utility is already earning a higher-than-authorized rate of return (or beyond the "zone of reasonableness" set in the last rate case).

c. A regulator would not allow this outcome under traditional regulation.

F. **Regulators should consider traditional regulation as the default policy unless a utility is able to demonstrate that it needs a cost tracker to prevent the possibility of a serious financial condition.**

1. This showing requires utilities to provide a distribution of possible cost futures and an assessment of their likelihood.

2. Good regulatory policy rejects cost trackers that are not essential for protecting a utility from a dire financial situation.

3. If a certain cost item has high volatility and unpredictability, represents a large component of the utility's revenue requirement, is recurring, and is generally beyond a utility's costs, it becomes a candidate for "tracker" recovery.

4. This limited application of cost trackers provides the benefits of:

a. Using the same cost-recovery mechanisms for all utility functions to prevent perverse incentives (i.e., incentives leading to a higher cost of service and utility rates);

b. Balancing a utility's total costs and total revenues:

(1) Without this balancing, it is conceivable that the utility could recover one cost item through a tracker and over-recover other costs set in the last rate case to result in the utility earning above its authorized rate of return.

(2) A rate case has the attractive feature of matching revenue with costs on an aggregate basis.

c. Retaining sufficient regulatory lag to provide the utility with stronger motivation to control costs (regulatory lag is an important feature of traditional ratemaking in forcing the

utility to shoulder the risk of higher costs between rate cases); and

d. Scrutinizing a utility's costs and performance in different areas of operation

(1) Regulators review costs more rigorously in a rate case setting.

(2) Reviews decrease the likelihood that customers will recover a utility's imprudent costs.

G. **Regulators should attach conditions to cost trackers.**

1. Regulators should condition any approval of a cost tracker on the utility's filing information on its performance for those functional areas directly or indirectly affected by the tracker.

2. Has the FAC, for example, caused a utility to spend less money on plant maintenance costs, jeopardizing reliability and inflating total utility costs because of higher avoidable fuel costs? These conditions can ultimately harm the utility's customers.

II. Explanation of Terms and Concepts

A. ***Cost trackers or riders***

1. A cost tracker allows a utility to recover its actual costs from customers for a specified function on a periodical basis outside of a rate case. A tracker, in other words, involves the recovery of a utility's actual costs in the periods between rate cases.

2. These costs could include those that deviate from some baseline or are zero-based.

3. Cost trackers, alternatively, could apply to *all* of the costs associated with a particular business function or task.

B. ***Traditional regulation***

1. Prices remain fixed between rate cases.

2. Regulators and other parties scrutinize costs during a rate case.

3. Regulators estimate costs for the period of new rates.

4. The utility benefits (suffers) from any unexpected cost decreases (increases) between rate cases.

C. ***"Reasonable opportunity"***

1. Regulators have used a number of criteria for utility cost recovery.

2. Regulators are legally bound to allow utilities the *opportunity* to recover prudently incurred costs. Prudent costs reflect utility management that makes rational and well-informed decisions.

3. The word "opportunity" refers here to the utility having a good chance of earning its authorized rate of return and is distinct from an entitlement.

4. It does not imply that the utility earns its authorized rate of return each year.

   a. One interpretation is that the utility earns its authorized rate of return over a number of years, rather than each year. Regulators, investors, and utilities do not expect uniform rates of return across years.

   b. Instead, they ostensibly presume that in some years the rate of return will be below the authorized level, while in other years it would be above the authorized level.

5. "Earning the authorized rate of return" means that the utility recovers its prudent variable costs (e.g., operations and maintenance) plus earns a return of and on prudently incurred fixed costs, including its cost of capital as determined in the last rate case.

D. ***Regulatory lag***

1. "Regulatory lag" refers to the time gap between when a utility undergoes a change in cost or sales levels and when the utility is able to reflect these changes in new rates.

2. Economic theory predicts that the longer the regulatory lag, the stronger the incentive a utility has to control its costs:

   a. When a utility incurs costs, the longer it has to wait to recover those costs, the lower its earnings are in the interim.

   b. The utility, consequently, would have an incentive to minimize costs.

3. Regulators rely on regulatory lag as an important tool for motivating utilities to act efficiently.

4. Regulatory lag is a less-than-ideal method, however, for rewarding an efficient, and penalizing an inefficient, utility:

   a. Some of the additional costs could fall outside the control of a utility (e.g., increase in the price of materials).

   b. Any cost declines might not correlate with a more managerially efficient utility (e.g., deflationary conditions in the general economy).

E. ***"Just and reasonable rates"***

1. Two meanings: the utility only recovers prudent costs, and the utility is given a reasonable opportunity to recover all of its prudent costs.

2. "Just and reasonable" rates require, for example, that customers do not pay for costs the utility could have avoided with efficient or prudent management.

F. ***Perverse and weak incentives***

1. Regulators, until recently, have taken a cautious approach to trackers, partially because they weaken the incentive of a utility to control its costs.

2. Controlling utility costs is a primary objective of regulators because it contributes to lower rates and reflects efficient utility management. Cost trackers can, in various ways, result in higher utility costs:

   a. They undercut the positive effects of regulatory lag on a utility's costs.

   b. When mechanisms for cost recovery differ across functional areas (i.e., non-uniform treatment of different costs), perverse incentives can arise that would make it profitable for the utility not to pursue cost-minimizing activities. The result is higher rates to utility customers.

   c. Cost trackers, in the long run, can bias a utility's technological and investment decisions.

   d. Cost trackers also could motivate utilities to shift more of their costs to functions subject to trackers.

e. An important incentive for cost control by regulated utilities is the threat of cost disallowance from retrospective review.

3. Theoretical and empirical studies provide some evidence of the incentive problems associated with one kind of cost trackers, namely, fuel cost adjustment mechanisms.

4. Rational utility management, as a general rule, would exert only minimal effort in controlling costs if it has little or no effect on the utility's profits.

a. This condition occurs when a utility is able to pass through (with little or no regulatory scrutiny) higher costs to customers with minimal consequences for sales.

b. Cost containment constitutes a real cost to management. Without any expected benefits, management would exert minimum effort on cost containment.

5. A contradiction seems to exist between the criterion that trackers should apply only to those costs beyond the control of a utility and the assertion that the modified incentives caused by trackers can lead to higher costs. In reality, a utility has at least some control over most of its costs.

a. Except for certain taxes and a limited number of other cost items, the actions of utility management can affect costs.

b. Even for fuel or purchased gas, utility management's actions can affect their total costs. Although for the most part the marketplace determines the price paid for these items, utilities can negotiate prices under long-term contracts and decide on the mix and sources of different fuels and purchased gas.

G. ***Earnings sharing mechanism (ESM) or rate-of-return tracker***

1. By consolidating different cost and revenue trackers, ESM represents one ratemaking procedure for stabilizing a utility's rate of return between rate cases.

a. Under this mechanism, the utility adjusts its rates periodically (e.g., annually) when its actual return on equity falls outside some specified band. (The band implicitly reflects the range for the return on equity that the regulator had deemed both adequate to keep the utility from financial jeopardy and not so excessive as to be exorbitant. The

interpretation of these financial conditions is subjective and open to debate.)

b. As an illustration, if the band encompasses a 10 to 14 percent rate of return on equity (with 12 percent as the utility's authorized rate of return established in the last rate case) when the actual return is 9 percent, the utility could adjust its rates upward to increase its return to, or bring it closer to, 10 percent.

c. An ESM helps to stabilize a utility's rate of return without a full-scale rate case review. Earnings sharing should reduce the frequency of future rate cases and allow adjusted rates to reflect recent market developments, including those affecting a utility's costs.

d. Compared to traditional ratemaking, where rates remain fixed between rate cases, ESM weakens regulatory lag and thereby reduces the incentive of a utility to control its costs between rate cases. A regulator can lessen this problem by requiring the utility to demonstrate its prudence and offer reasons why specific cost items were higher than their test-year levels.

e. In sum, an ESM would trigger a price adjustment between rate cases only when the aggregation of revenue and cost departures from test-year levels cause the utility's rate of return to fall outside a specified "band" region.

(1) An ESM directly takes into account the overall profitability of a utility.

(2) It assumes the role of a rate-of-return tracker that, in effect, combines different cost trackers into a single cost-recovery mechanism.

H. ***"Extraordinary circumstances"***

1. Regulators have traditionally approved cost trackers only under "extraordinary circumstances."

a. They recognize the special treatment given to costs recovered by a tracker

b. They consider cost trackers an exception to the general rule for cost recovery.

c. This view places the burden on a utility to demonstrate why certain costs require special treatment.

2. The "extraordinary circumstances" justifying most of the cost trackers that regulators have historically approved apply to costs that are:

   a. Largely outside the control of a utility,

   b. Unpredictable and volatile (e.g., costs difficult to predict in the short run because of cyclical movements),

   c. Substantial and recurring.

3. Historically, regulators required that all three conditions exist if a utility hoped to have costs recovered through a tracker.

4. Fuel costs and purchased gas costs were good candidates because of their influence by factors beyond the control of a utility, their volatility, and their large size.

5. Regulators recently have approved cost trackers when not meeting all three conditions, especially the third.

6. The third condition ("substantial and recurring costs") greatly restricts the costs eligible for cost tracker recovery.

I. ***"Severe financial consequences" or "financial jeopardy***

1. Historically, regulators have approved cost trackers to avoid the possibility of a utility suffering a serious financial problem because of cost increases unforeseen at the time of the last rate case.

2. The term "financial jeopardy" has different interpretations.

   a. This condition, no matter how it is defined, has the potential to harm customers as well as the utility shareholders. It could cause the deferment of needed capital investments to maintain reliable service, the lowering of the utility's credit rating, and an increase in the utility's cost of capital.

   b. The time period over which these effects would cause injury to utility shareholders generally would be more immediate than the injury to customers.

3. Regulators do not expect utilities to earn the authorized rate of return during each future period over which new prices are in effect.

   a. Regulators implicitly impute a risk premium in the authorized rate of return, partially to account for the earnings volatility from fluctuations in costs or revenues from the test year.

   b. Trackers reduce "business risk."

      (1) Business risk refers to the uncertainty linked to the operating cash flows of a business.

      (2) Business risk is multi-dimensional, inclusive of sales, cost, and operating risks.

      (3) In the Capital Asset Pricing Model (CAPM), the lower the utility's expected earnings volatility, the lower the measure of the utility's risk relative to the market portfolio (i.e., "beta").

   c. Because trackers reduce a utility's business risk, a regulator might want to consider revising downward the risk premium of a utility with additional cost trackers, resulting in a lower return on equity.

4. If a regulator wants to guarantee that the utility will recover its authorized earnings, it would favor a rate design that allows the utility to recover all of its fixed costs in a monthly service charge or a customer charge.

   a. Since generally regulators do not, they implicitly recognize the positive incentive effect and other benefits from allowing a utility's actual rate of return to deviate from the authorized level.

   b. Regulators also know that if a utility is continuously earning below its authorized rate of return, the utility has the right to file a general rate increase.