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# Effective Rate Case Management

2017 Fall Accounting Conference – Highlights

November 15, 2017

# Introduction

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- This document contains the highlights of a presentation made at the EEI Fall Accounting Conference in Miami, Florida on November 15, 2017
- The presentation was entitled “Effective Rate Case Management” and discussed:
  - How the current regulatory landscape is impacting rate cases
    - How some utilities are responding (best practices)
  - How you can improve regulatory outcomes
    - Future test year and multi-year rate plan considerations
  - How to plan and manage a successful case – lessons learned
- For additional information, please contact us at [www.scottmadden.com](http://www.scottmadden.com)

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# Current Regulatory Landscape

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## Observations

- The number of rate cases filed each year continues at a brisk pace; there were 61 cases approved in the first half of 2017
  - However, average approved ROEs continue to decline
- Utilities continue to be concerned about the potential treatment of new rate base items
  - New capacity, including renewables, and new delivery infrastructure
- Historic test year remains a favored rate case requirement
  - Almost 2/3 of the states still require a historic test year; adjustments for known and measurable changes are typically allowed
- The average lag between the filing date of a rate case and the commission approval date is about 10 months
  - Factoring in the time to develop the case before the filing date means the overall lag can be more than 12 months
- Some states have instituted various types of innovative ratemaking to help address this lag, but these approaches have some criticisms
  - Ratemaking outside traditional rate reviews creates a “piecemeal” approach
  - Risks may be shifted from the utility to customers
  - Special riders or trackers sometimes require a “separate set of books”
- Heightened regulatory scrutiny will continue
  - Continuing demand for transparency

***Rate cases will continue to be more complex than in the past***

# Current Regulatory Landscape (Cont'd)

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## What the Financial Community Values

- Credit rating services continue to actively monitor rate proceedings and will factor the effects of the local regulatory environment into ratings
- Moody's focuses on the following four rating factors:
  - Regulatory framework (consistency, predictability, supportiveness)
  - Ability to recover costs and earn returns (rate/tariff reviews, outcomes, timeliness)
  - Diversification (market position, generation, and fuel diversity)
  - Key credit metrics (liquidity, various cash flow from operations metrics, and debt-to-equity and leverage ratios)
- According to Standard & Poor's, supportive regulation is characterized by:
  - Consistency and predictability of decisions
  - Timeliness of rate orders
  - Use of forward-looking measures
  - Support during times of stress

***Predictable regulatory outcomes are desired***

# How Some Utilities Are Responding

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- Structured and more rigorous base rate filings
  - Focusing on rate case fundamentals: administrative compliance and full cost recovery
  - Supported by improved processes and quality assurance steps
- Regulatory strategies linked to corporate financial strategy
  - Reporting frameworks to improve management of jurisdictional earnings
- Alternative cost recovery mechanisms: future test year filings, pass-throughs, riders, trackers, etc. to reduce regulatory lag
- Renewed product portfolios: real-time and critical peak pricing, demand response/energy efficiency, and fixed bill products
- Re-energized regulatory relationships
  - Working more cooperatively with commission staff during proceedings to answer questions and address concerns
- More efficient rate case development processes
  - New analytical tools and supporting systems

***A combination of initiatives are being pursued by most utilities***

# Future Test Years: Considerations

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- Favorable regulatory treatment from a future test year is primarily tied to believability of the forecast
  - Future test period reasonably reflects expected conditions when rates go into effect
  - Forecast underlying the test period can analytically and experientially be shown to be reliable
- Many utilities (and commissions) have had challenges implementing future test years
  - Inconsistencies or deficiencies in planning, budgeting, and variance reporting
  - Inadequate documentation or lack of an audit trail depicting cost drivers, assumptions, or changes
  - Emerging issues and actions during the year, that were not reflected in the budget, can make it seem as though the budgeting process is inadequate
- Over time, many utilities have implemented budgeting process improvements; however, some are still not in a strong enough position to successfully file and defend a future test year
  - Linkages between strategic direction, key assumptions, cost drivers, and/or positions on emerging issues are not explicitly tied to the development and management of organizational O&M and capital budgets
  - Organizations manage to O&M and capital re-forecasts; managing to budgets is not always a focal point
  - Budgeting accuracy could be further improved and may lead to test year disallowances—due to significant year-to-year differences (e.g., 2018 budget in 2016 versus 2018 budget in 2017)—or consistent under-runs
  - Root cause analyses of budget variations are often not completed; opportunities to learn and improve are missed

# Future Test Years: Considerations (Cont'd)

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## In our opinion, utilities must:

- First, understand whether the various stakeholders in the regulatory process are willing to consider, or even embrace, this type of change
  - What are their concerns? How might these be addressed?
- Strengthen linkages between planning assumptions and the development of capital and O&M budgets; define and establish positions on key drivers, assumptions, inputs, and emerging issues
- Develop and put in place documentation and analytical templates for both budget development and effective variance analysis/reporting; train/support corporate and field organizations on usage
- Improve capital budgeting and reporting practices so that cost estimates, in-service dates, AFUDC calculations, and year-end rate base estimates are more accurate

# Future Test Years: The Experience of Others

Historically, the use of future test years (FTYs) has required a significant burden of proof on the part of the utility to ensure the future test period reflects expected conditions when rates go into effect.

## FTY Standards Seen in Various Jurisdictions

- FTY must bear a reasonable resemblance to available historic data and the filing date—the further beyond either that an FTY is selected significantly increases the burden of proof
- Sufficient detail must be provided to show how the utility arrived at its forecast; linkages between the forecast and actual historical data must be explicitly shown, verified, and substantiated
- Projected test periods must be predicated on as much actual data as possible and must be based on reliable forecasting techniques
- Filing standards contain budget documentation on a total company and organizational unit basis, including work papers and notes used in developing budgets
- The reliability of the budgeting process must be proven and shown to be consistent year over year

## Examples of Utility Responses to FTY Standards

- Beyond the typical filing requirements, the application includes budget documentation, capturing purpose, organizational structure, O&M and cost drivers, major programs and activities, and detailed financial schedules
- Budgets are summarized by cost type and by FERC account; budget documentation includes work papers, notes, analysis, and calculations used in developing the budget
- Summary of overall forecasting (budgeting) process and variance reporting practices are provided along with an analysis depicting budgeting consistency year to year
- Comparisons of actual and budgeted O&M expense levels for three historical years are provided along with similar comparisons for capital projects
- Changes between projected test year O&M and recent historical data are provided detailing the underlying drivers of the changes

# Multi-Year Rate Plans: Considerations

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- The current business environment is creating challenges for utilities
  - Electric and gas 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
- 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

# Multi-Year Rate Plans: Considerations (Cont'd)

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**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 in the rate base
  - Revenue decoupling
  - Forward test years
  - Formula rates
  - Multi-year rate plans

# Multi-Year Rate Plans: Overview

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## 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:
  - Stair steps – 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 stair steps for capital expenditures
- Additional provisions sometimes included in multi-year rate plan structure:
  - 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

- Produce more predictable revenue streams and certainty for utility to make investments (reduces cost of capital)
- Reduce regulatory costs
- Incent utility to manage costs
- Enable utility to allocate resources to running the business rather than rate case administration

# Multi-Year Rate Plans: Issues

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**For utilities considering implementation of an MYRP, there are several potential issues:**

- Additional scrutiny
  - Multi-year rate plans 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 multi-year rate plans
- 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 multi-year rate plan 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

# Multi-Year Rate Plans: Conclusions

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**We believe the use of multi-year rate plans 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
- Multi-year rate plans provide a promising strategy for addressing some of the regulatory challenges facing the industry
- Additional scrutiny associated with multi-year rate plans 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



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