

# The Trouble with Trackers

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the Indiana General Assembly

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# Tracking Pros and Cons

- While tracking has a place in the utility cost recovery scheme, more recent utility tracking initiatives amount to backdoor deregulation, eliminating the need for traditional rate cases.

# The Traditional Criteria For Costs That Can Be Tracked Are That They Are:

- ❑ Largely outside the control of utilities
- ❑ Experience considerable price volatility
- ❑ Are significant in magnitude

Examples include: fuel, power purchases, energy efficiency.

# The Importance of a Traditional Rate Case

- The Commission's primary objective in every rate proceeding is to establish a level of rates and charges sufficient to permit the utility to meet its operating expenses plus a return on investment which will compensate its investors.

# How base rates are set:

- ❑ Normally rates are set based on test year figures and fixed, known and measurable changes as of the time the case is decided. Increases in costs arising after the case is decided are generally not recoverable from ratepayers unless and until the utility files a new rate case and the costs are found to be reasonable and prudent.
- ❑ This means that the risk of cost increases occurring between rate cases is largely borne by the utility. It also means utilities have an incentive to keep costs down between utility cases.

# Who supplies the capital?

- Under traditional regulatory concepts, utility company shareholders and bondholders, not the consumers, furnish the capital necessary for the operation of the business.

*City of Evansville v. Southern Indiana Gas & Elec. Co.*, 167 Ind.App. 472, 509, 339 N.E.2d 562, 585 (1975).

- The consumer pays a fair return on the utility's capital and in addition pays the costs of operation including taxes, but it is well-established that the company's investors, not its consumers, must contribute the utility's capital.

*Id.*

# Appropriate Rate of Return

The United States Supreme Court has found:

“A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.”

*Bluefield v. PSC*, 43 S.Ct. 675, 679 (1923)

# Trackers effectively reduce shareholders risk in that:

- ❑ Trackers reduce regulatory lag, or the time between when costs are incurred and when they are recovered;
- ❑ Trackers allow certain significant categories of costs (e.g., mandated environmental compliance costs) that increase to be put into rates without consideration of other, related categories of costs (e.g. cost of capital) that decrease;
- ❑ Trackers tend to defer general rate cases, with their attendant risks and costs; and
- ❑ Trackers tend to decrease the scope and detail of regulatory review of tracked costs compared to a general rate case.

# Other Utility Benefits From Trackers:

- ❑ In many situations, trackers also greatly reduce volatility of net earnings on a monthly, quarterly and annual basis, by virtue of the fact that they eliminate or significantly reduce the likelihood of failing to recover the costs associated with particularly volatile line items.
- ❑ Such a reduction of volatility in net earnings, per se, can constitute a material reduction in the financial risk of the firm as a whole from the perspective of shareholders and is of significant value to them, more generally.

# Utility Risk vs. Reward

- The utility receives a risk premium for bearing the risk of cost increases between rate cases. To the extent that the utility no longer bears the risk, the corresponding risk premium should be eliminated. There is no more reason for paying the risk premium to the utility under these circumstances than there would be for compensating the utility for expenditures on draft horses when they no longer use draft horses.

# Trackers Shift Risk to Ratepayers

- Whereas under normal regulation, cost increases occurring between rate cases would have to be absorbed or mitigated by the utility, under trackers those cost increases can be *automatically* passed on to ratepayers in higher rates whenever they occur. Therefore, the risk to customers of significantly higher prices for power, is heightened, while the risk to and responsibility of the utility is much reduced.

# There Are Many Drawbacks For Consumers from Trackers . . .

- ❑ Trackers reduce regulatory lag for the utility (the risk of which is already calculated into the utility's rates).
- ❑ Trackers tend to be one-way rate making in that they allow certain categories of costs that increase to be put into rates without the consideration of other, related categories of costs that decrease.
- ❑ Trackers tend to increase rates yet defer general rate cases, and therefore reduce the opportunity for a comprehensive review of a monopoly utility's actual cost of providing service.

# Tracker Drawbacks (continued)

- ❑ Trackers tend to decrease the scope and detail of regulatory review of tracked costs compared to a general rate case.
- ❑ Trackers reduce the likelihood of failing to recover the costs associated with a particularly volatile line item, which greatly reduces the financial risk to a utility. However, ratepayers are still paying for that the associated risk premium.

# Tracker Drawbacks (continued)

- ❑ Trackers reduce a utility's cost of capital, another factor used to set its rate of return. Therefore, the utility's return (and base rates) should be reduced to reflect the lower cost of capital.
- ❑ Trackers shift risk to ratepayers who are not in a position to manage the risk and away from utility management who are in a position to manage risks. This risk shifting reduces or eliminates the incentive for a utility to properly manage its costs and risk associated with tracked costs, thus increasing risks and costs to ratepayers.

# **The person who manages the risk should bear the risk.**

Management runs the company and has responsibility and control for costs. Shifting the burden to ratepayers who have no hand in the management of the risk runs counter to the principle that the person who manages the risk should bear the risk.

# Trackers reduce incentives to control costs.

When the Company bears the risk, the company has an active incentive to manage the risk so as to minimize costly outcomes. When the Company no longer bears the risk, however, the incentive to actively manage the risk is diminished.

## **Trackers can create improper incentives or conflicts of interest.**

When the risk of price increases lies with ratepayers, the Company's managers (especially if incentivised improperly through executive compensation plans based on holding company profits) have an incentive to game the system to the advantage of the holding company and the disadvantage of the ratepayers. This problem would not exist, or at least be minimized, if the risk remained with the Company.

## Existing trackers authority provided for in statute:

- ❑ Fuel Clause Adjustments and Gas Cost Adjustments (I.C. § 8-1-2-42 and I.C. §8-1-2-42.1, enacted in 1975. But fuel trackers have been used since 1938)
- ❑ Environmental Compliance or QPCP (I.C. § 8-1-2-6.6 enacted 1985) and Utility Generation and Clean Coal (I.C. § 8-1-8.8 enacted in 2002).
- ❑ Alternative Utility Regulation (I.C. § 8-1-2.5 *et. seq.*, enacted in 1995).

# Tracked Costs Not Expressly Provided For In Statute:

- Demand-Side management costs
- Merger savings
- Direct load control costs
- Purchased Power costs
- ISO/RTO costs
- "Green power" costs
- Emissions allowances costs and revenues
- Off-system power sales revenues
- Net Metering
- Pipeline safety compliance costs
- Stand-By service
- Weather normalization
- Gas Margin Decoupling
- Customer load characteristics

# Can Trackers Benefit Consumers?

- ❑ Reduced volatility and risk exposure may have a positive impact on the utility's credit rating. This can reduce the cost of capital for both equity and debt. This could tend to reduce retail electric rates *if* there is a rate case or the Commission orders a revision to the utility's rates.
- ❑ However, several other factors also affect electricity rates, including the utility's approved return on equity. But, if the utility's approved ROE is not adjusted to account for the risk reduction effects of its trackers and other risk reduction measures, then customers may be required to subsidize excessive shareholder earnings by paying inordinately high rates.

# The Commission Does Not Need New Authority For Trackers

- “Since there is no provision of the Act which prohibits the adoption of an automatic rate adjustment mechanism, [the Court’s] standard of review only requires that the Commission's decision be reasonably related to the establishment of ‘reasonable and just’ rates.”

*City of Evansville v. Southern Indiana Gas & Elec. Co.,*  
167 Ind.App. 472, 523, 339 N.E.2d 562, 593 (1975)(*discussing the FAC*).

- The Alternative Utility Regulation Act (I.C. § 8-1-2.5 et. seq.) provides the Commission with complete flexibility.

# Other Relevant Statutes

- I.C. § 8-1-2-4: “Every public utility is required to provide reasonable adequate service and facilities.” Charges must be reasonable and just.
- I.C. § 8-1-2-61: Any public utility may make a complaint as to any matter affecting its own rates or service.
- I.C. § 8-1-2-68: Whenever the commission find any rates unjust, unreasonable, or insufficient it shall determine and fix just and reasonable rates.
- I.C. § 8-1-2-113: Emergency rates provision

# Transmission and distribution system improvements

- If the current systems are in need of improvement, then utilities are not providing reasonable, reliable and adequate service. They should be penalized, not rewarded.

# Transmission and distribution system improvements

- If the current state of the transmission and distribution system is in need of repair, then the utilities Integrated Resource Plan (IRP) process is flawed. The Commission should be directed to revise its IRP rules.

# Recommendations

- There should be regular rate reviews to flow back cost reductions (Reviews under I.C. § 8-1-2-42.5 seem insufficient).
- There should be reductions to ROE, not additions, to reflect lower risk profile resulting from increased use trackers.
- The Commission should develop new IRP rules.