Evaluating Alternative Rate Mechanisms: A Conceptual Approach for State Utility Commissions

Ratemaking is as much an art as a science, requiring regulators to impute their subjective values and judgment in decision-making. Analysts can still play an important role by providing regulators with vital information on the inevitable tradeoffs among the various objectives that they assign to ratemaking.

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I. Pressure for Alternative Rate Mechanisms

Ratemaking is a major regulatory function that touches all aspects of utility operations. It also has wide-ranging ramifications for the different objectives that state utility regulators try to achieve. In pursuing these objectives, regulators attempt to promote the public interest. As this article contends, good ratemaking is difficult, requiring both good analytics and sound judgment on the part of regulators.

Utilities and other parties have continuously proposed alternative rate mechanisms before state utility commissions over the past several decades. These mechanisms reflect a direction away from traditional ratemaking practices. As some readers may recall, similar attacks on traditional ratemaking occurred about 20 years ago. Before then, one can go

 1040-6190/$–see front matter http://dx.doi.org/10.1016/j.tej.2014.04.009

as far back as the late 1960s and early 1970s to see that utilities, as well as some environmental groups,[1] also pushed for alternative rate mechanisms because of technological developments, and a changing market and operating environment.[2] This time, the alternative ratemaking mechanisms have encompassed a wider umbrella. Electric utilities in recent years, for example, have expanded their interest in nontraditional rate mechanisms to include different cost trackers for an increasing number of utility activities, time-of-use rates, performance incentives for energy efficiency, revenue decoupling, formula rates, and surcharges for new investments.

State utility commissions have always been open to non-traditional ratemaking mechanisms[3] but the recent onslaught is unprecedented in terms of intensity and the variety of such rate mechanisms. To no surprise, their primary motivation is to promote the self-interest of those proposing them. Each stakeholder group expectedly takes positions and makes arguments that it regards as economically beneficial to itself. As this article stresses, alternative rate mechanisms inevitably involve a cost in terms of impeding one or more regulatory objectives. Commissions must, therefore, make decisions that balance the different objectives. Their job is to sift these arguments in identifying those that arise only from self-interest, and in discovering those arguments that arise from self-interest but promote the public interest.[4] These decisions then implicitly represent commissions' relative preferences for achieving different objectives. Commissions tend to make policy, for example, that favors those regulatory objectives to which they assign a high weight. Overall, a commission's assessment of rate mechanisms is complex, requiring a combination of analytics, unbiased information, and judgment, with the goal of advancing the public interest.

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This article outlines a general framework for decision-making by state utility commissions. This framework, in addition to identifying the cardinal objectives and core principles of utility ratemaking, describes conceptually how a commission can (1) take the available information and (2) process it using its subjective values for decision making that intends to advance the public interest. These values can include relevant regulatory objectives and the relative weights of each in affecting the public interest. The public interest, as argued in this article, relates closely to the aggregation of objectives that regulatory actions try to achieve.

II. Reasons for Consideration of Alternative Rate Mechanisms

A. Displeasure with traditional ratemaking

1. The need to periodically revisit ratemaking practices

This section identifies the major factors that have triggered the recent unprecedented interest in alternative rate mechanisms. A revisiting of the merits of existing ratemaking practices and their underlying premises has occurred periodically throughout the 100-plus years of public utility regulation. One lesson learned over this time is that commissions should consider the merits of alternative rate mechanisms when market, economic, operating, technological, and other conditions change.[5] If in fact the underlying assumptions of traditional ratemaking no longer hold, it becomes less likely that regulation will serve the public interest. One outcome might be the utility failing to recover its prudent costs. Another outcome might be the utility earning excessive profits and customers

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