Management Efficiency

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A public utility is required to operate in an efficient manner and the Iowa Utilities Board (Board) may reduce the level of profit or adjust the revenue requirement for inefficient utility operations. The Board may also increase the level of profit or adjust the revenue requirement of extraordinarily efficient utility operations. Iowa Code § 476.52 provides:

> **476.52 Management Efficiency**
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> It is the policy of this state that a public utility shall operate in an efficient manner. If the board determines in the course of a proceeding conducted under section 476.3 or 476.6 that a utility is operating in an inefficient manner, or is not exercising ordinary, prudent management, or in comparison with other utilities in the state the board determines that the utility is performing in a less beneficial manner than other utilities, the board may reduce the level of profit or adjust the revenue requirement for the utility to the extent the board believes appropriate to provide incentives to the utility to correct its inefficient operation. If the board determines in the course of a proceeding conducted under section 476.3 or 476.6 that a utility is operating in such an extraordinarily efficient manner that tangible financial benefits result to the ratepayer, the board may increase the level of profit or adjust the revenue requirement for the utility. In making its determination under this section, the board may also consider a public utility's pursuit of energy efficiency programs. The board shall adopt rules for determining the level of profit or the revenue requirement adjustment that would be appropriate.
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> The board shall also adopt rules establishing a methodology for an analysis of a utility's management efficiency.

When rules were initially adopted regarding management efficiency in the mid-1980s, much of the focus was on annual management efficiency reports that the utilities were required to file. The reports were designed to provide a basis for utility-to-utility comparisons. However, prior Boards found that comparisons to other utilities were of limited value because of differences in service territories, customer mixes, weather patterns and disasters, and other factors. The current management efficiency rules (last revised in 1997) provide that "[t]he efficiency or inefficiency of a utility will be evaluated on a case-by-case basis, based upon the utility's particular facts and circumstances," as well as noting that management efficiency does not lend itself to an absolute measure. 199 IAC 29.3(1). In evaluating management efficiency, 199 IAC 29.3(1) lists several factors the Board <u>may</u> consider, including price per unit of service, operation and maintenance costs per unit of service, quality of service, executive compensation, fuel costs, utility-wide load factors, innovative ideas implemented by management, and bad debt ratio. For electric utilities, 199 IAC 29.3(2)"d" lists development and implementation of energy efficiency programs as an additional factor the Board may consider. Much of this information used to be filed in the annual management efficiency reports; the current rule provides that the Board can request that information at its discretion. In the order adopting the 1997 revisions and rescinding the annual report requirement, the Board said:

> The Board intends to continue closely scrutinizing management efficiency. The adopted amendments are simply recognition that the management efficiency reports are not, in many cases, a useful tool to determine management efficiency or inefficiency. Also, much of the information contained in these reports is duplicated in other regulatory filings. The Board's limited resources can be better applied in other areas and in focusing on a particular utility's unique attributes which, judging from prior cases, are a better determinant of management efficiency.

<u>In re: Management Efficiency</u>, "Order Adopting Rules," Docket No. RMU-97-2 (10/17/1997).

Management efficiency has been an issue in several rate cases. Some examples are:

1. The Board imposed a 1 percent reduction (100 basis points) in Great River Gas Company's (Great River) return on equity, which resulted in a reduction in rate base of about $20,000, in an order issued on April 3, 1986, in Docket No. RPU-85-16. The Board was critical of Great River for signing a 20-year supply contract where Great River agreed to pay demand charges for that period of time with no exit clause for changing conditions. The Board was generally critical of Great River's supply planning because while it planned for growth it expected the Board to protect it from losses. The Board did not disallow the costs of the contract; however, because the contract was not imprudent when entered into, the criticism was directed at Great River's supply planning in general and the lack of an escape clause in the contract.

2. Another example is the Board's imposition of a 1 percent reduction (100 basis points) on Iowa Gas Company's (Iowa Gas) return on equity, which translated to a reduction in rate base of about $250,000, in an order issued June 27, 1986, in Docket No. RPU-85-22. Here, the Board compared Iowa Gas to other gas utilities in Iowa and found the company deficient, particularly with respect to the quality of its service because of the large number of complaints regarding reading meters and lack of responsiveness to customers.

Management efficiency has been an issue in two recent electric rate cases involving Interstate Power and Light Company (IPL). While the Board did not impose a management efficiency penalty, the Board ordered that a management audit be conducted of IPL. The Board recently signed a contract with an independent auditing firm to conduct the audit. Among other things, the audit will look at IPL's performance as compared to industry standards and best management practices, with an emphasis on customer service and maintenance of distribution systems. The audit will also examine the due diligence exercised by IPL in the supply planning process and in evaluating potential rate ramifications of the sale of IPL's transmission assets to another company; IPL no longer owns transmission but purchases transmission service from a separate transmission company that is not owned by IPL.

In ordering the management audit, the Board noted that management efficiency issues typically arise in the context of a rate case proceeding, as one of many issues being litigated. Often, the testimony focuses on just a few management decisions as an indicator of inefficiency or efficiency and there is no overall evaluation of the utility's management practices. This is understandable because such an examination can be expensive and time-consuming and cannot realistically be completed within the statutory ten-month deadline (Iowa Code § 476.10) to complete rate cases, particularly in light of the deadlines applicable to prefiled testimony. In addition, there are numerous other issues in a rate proceeding with significant and immediate financial ramifications, such as return on equity; parties have limited resources and must carefully select the issues on which to focus. As a result of these and other rate case limitations, the Board can be left with an incomplete record on which to consider a company's overall management efficiency.

The Board also noted that because gas and electric rate cases are filed separately, the Board does not have the opportunity to review IPL's combined operations in the context of a regular rate review proceeding. A management audit provides an opportunity to examine IPL's overall operations without an artificial division between electric and gas operations or the constraints of rate case deadlines. A management audit allows the primary focus to be on identifying problem areas, if any, and offering remedies, if needed; in a rate case, the focus of management efficiency is on whether there should be a monetary penalty. Depending on the findings of the audit, parties to IPL's next rate proceeding may again propose management efficiency adjustments.