

## *An Overview of Rate Regulation In Texas*

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## **Purpose of this presentation segment is to:**

- Provide a general overview of rate regulation, its theoretical underpinnings, and the ratemaking process
- Provide a general understanding of ratemaking components and related issues

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## **Economic Theory of Regulating Public Utilities**

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## **Economic Characteristics of the Regulated Utility Industry**

- Monopolistic conditions
  - Obligation to serve in exchange for exclusive franchise territory
  - Capital intensive
- State and/or federal rate regulation
- Electricity markets in Texas
    - Texas has its own independent power grid, called the Electric Reliability Council of Texas (ERCOT)
    - Within ERCOT, the “utility” is now the Transmission and Distribution Service Provider (TDSP or TDU)

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## **Utilities have traditionally been viewed as “Natural Monopolies”**

- Utilities’ status as natural monopolies require regulation:
  - Prevents duplication of investment in plant
  - Allows for larger and more efficient equipment
  - Results in lower average cost per unit of output, helping to minimize rates
- In the generation segment of the utility business, a push for a gradual movement to a competitive marketplace came about in the late 1990s as new technology made it possible for smaller generators to produce electricity at rates competitive with the larger utility generators. Thus, for generation, the concept of a natural monopoly has been altered
- “Wires service” (i.e., transmission and distribution) remains a natural monopoly

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## **Public Franchise and Obligation to Serve**

- Facilities are dedicated to public use
- Franchise granting utility right to provide service in a designated service territory
- Obligation to provide service:
  - On demand
  - At reasonable rates
  - In non-discriminatory manner
- Electricity services are essential to a developed, successful economy, especially in an age of electronic commerce

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## Utilities are Capital Intensive

- Large investment in plant relative to annual revenues and earnings
  - Traditionally, the ratio of plant dollars to annual revenue dollars for electric utilities is normally in the 2.0 to 2.5 times range, whereas for a more conventional manufacturing enterprise, the ratio is typically in the 0.10 to 0.15 times range
- Plant must be adequate to meet demand at any time, despite seasonal weather and other factors
- Large plant investment requirements result in substantial and recurring financing requirements
  - New equipment (e.g., growth, technological advancements)
  - Replacement of aging equipment
  - Pollution control additions and improvements

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## Forms of Ownership for Utilities

- Given the need for large amounts of capital, most major utilities in the U.S. are investor-owned utilities (IOUs); other forms of ownership include cooperatives (owned by ratepayers/members) and municipalities
- Given life of plant and equipment, investments in utilities are of a long-term nature
  - ➔ Regulation helps provide to investors in IOUs an assurance of reasonable rates of return in exchange for investing capital over long periods

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## Cost Recovery for Regulated Investor-Owned Utilities

- In Texas, Sec. 36.051 of the Public Utility Regulatory Act (PURA) states that:
  - “In establishing an electric utility’s rates, the regulatory authority shall establish the utility’s overall revenues at an amount that will permit the utility a reasonable opportunity to earn a reasonable return on the utility’s invested capital used and useful in providing service to the public in excess of the utility’s reasonable and necessary operating expenses.”
- PURA provides a reasonable opportunity for a utility to earn its authorized return but does not provide a guarantee that the rate of return will be achieved

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## Regulatory Compact

- Utilities are considered to have a “deep public interest” and are, therefore, subject to regulation
- Regulation is a substitute for economic controls of free-market competition in assuring:
  - Fair rates
  - Adequate service
- Goal of regulation is to balance investor and consumer interests
  - PURA Sec. 11.002.(a) states: The purpose of this title is to establish a comprehensive and adequate regulatory system for public utilities to assure rates, operations, and services that are just and reasonable to the consumers and to the utilities.

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## Quotable Quote:

“Competitive markets on their worst day are better than regulated markets on their best day.”

--Pat Wood, former chairman of the Federal Energy Regulatory Commission (FERC) and former chairman of the Texas Public Utility Commission

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## Unique Aspects of Utility Financial Statements and Accounting

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## Regulated Utility Financial Statements

- For regulated investor-owned utilities, the regulatory process of setting rates and revenues affects the reporting accounting for these companies
- Utilities are subject to accounting regulation by federal and state agencies
- Generally, there is consistency between regulatory reporting and financial reporting
  - Regulatory reporting of some accounting items is “above the line”; some items are “below the line” (more later)

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## Statement of Financial Accounting Standards (SFAS) 71—“Accounting for the Effects of Certain Types of Regulation”

- Applies to entities that have regulated operations only if certain criteria are met:
  - Rates subject to regulatory approval
  - Rates designed to recover specific costs
  - Rates can be charged to and collected from customers
- SFAS 71 is the primary utility accounting pronouncement
  - Accounting by public utilities should generally follow ratemaking treatment

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## SFAS 71

- SFAS 71 includes provisions for including items on accounting books either before or after costs are incurred:
  - If regulation provides “probable” assurance that incurred costs will be recovered in the future, such costs are capitalized as a regulatory asset
  - If regulation provides for credits to ratepayers, such credits are recognized as a regulatory liability
- Examples of Regulatory Assets/Liabilities
  - Fuel Adjustment Clauses
  - Income Tax Related items
  - Pension Costs
  - Environmental Costs
  - Unamortized Loss on Recquired Debt

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## FERC Uniform System of Accounts (USOA)

- Utility books and records
  - FERC has authority over utility books and records
  - FERC requires that financial books and records be maintained in accordance with the FERC USOA
  - USOA classifications important to ratemaking process
  - Contains instructions and account classifications
    - General instructions and definitions
    - Electric plant instructions
    - Operating expense instructions
    - Chart of accounts

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## Utility Financial Statements

- Two-part income statement
  - “Above-the-line” expenses and revenues are items related to utility operations that are typically included in the rate-setting process
    - Operating revenues
    - O&M expense
    - Depreciation and amortization
    - Taxes (income and other)
  - “Below-the-line” expenses and revenues are not included in the rate-setting process
    - Include expenses either statutorily or typically prohibited from inclusion in revenue requirements; these items must be recovered from utilities’ earnings (i.e. shareholders) and not ratepayers.
    - Any other expenditure that the regulatory body determines to be unreasonable, unnecessary or not in the public interest
    - Other income and expense related to non-utility operations
    - Examples:
      - Lobbying expenses
      - Income from discontinued operations

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## Example—“Above the Line” Costs

|                          |           |
|--------------------------|-----------|
| Operating Revenues       | \$500,000 |
| Operating Expenses:      |           |
| Fuel Used in Operations  | 160,000   |
| Other Operation Expenses | 30,000    |
| Maintenance Expenses     | 10,000    |
| Depreciation             | 10,000    |
| General Taxes            | 6,000     |
| Income Taxes             | 40,000    |
| Total Operating Expenses | 244,000   |
| Operating Income         | \$256,000 |

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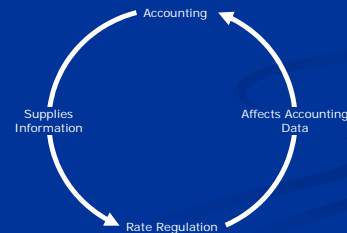
### Example—"Below the Line" Costs

|                                  |           |
|----------------------------------|-----------|
| Operating Income                 | \$256,000 |
| Other Income and Deductions:     |           |
| Non-utility Revenue              | 1,000     |
| Interest Income                  | 500       |
| Taxes Applicable to Other        |           |
| Income and Deductions            | (500)     |
| Other Income and Deductions--Net | 1,000     |
| Income Before Interest Charges   | 255,000   |
| Interest Charges:                |           |
| Interest on Debt                 | 100,000   |
| Net Income                       | \$155,000 |

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### Accounting Characteristics of Utilities

- Rate Regulation requires accounting information
- Effective regulation requires reliable accounting



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### Procedural Aspects of Traditional Utility Ratemaking

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### What Triggers A Rate Case?

- Earned return is too low
  - Company initiates a rate case
- Earned return is too high
  - Intervenor group files petition to initiate a rate case
  - PUCT Staff reviews annual PUC Earnings Monitoring Reports and makes recommendation to the Commission to require a company to file a rate case

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### Traditional Utility Ratemaking

- Regulatory Objective: On behalf of the public, attempt to replicate the results that would be achieved by competition within the context of a monopolistic company operating in a regulated industry
- ➔ By its very nature, the administrative process of rate proceedings results in filing costs, litigation costs, processing costs, and various other types of administrative costs

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### Basic Purpose of the Ratemaking Process

- Develop the utility's revenue requirement (i.e., the utility's reasonable cost of service)
  - Design rates to recover cost of service
    - Cost of Service study is developed to allocate the utility's revenue requirement to various customer classes (e.g., residential, commercial, industrial)
    - Rates are designed, based on the Cost of Service study, to recover the utility's revenue requirement from the various customer classes
- ➔ Conceptually simple process, but massive undertaking in relation to effort and information required to complete process

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## The Rate Filing Package (RFP) Filing Requirements – General

- Generally, there are standardized requirements for filing statements and schedules
  - Rate filing packages contain instructions and schedules for presentation of data
- Supporting data includes adjustments and other computations and information on which the applicant relies to justify the proposed rates
- Various other documents may be filed as required and/or pursuant to discovery

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## The Rate Filing Package Prepared Testimony

- An RFP must be accompanied by the applicant's prepared testimony
  - Examples: General policy issues, Cost of Service, Rate Design, Rate of Return, Accounting, Depreciation, etc.
- Testimony and other forms of evidence (e.g., responses to requests for information) of the applicant and all other parties must be filed with the commission, with copies to each party of record

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## The Parties—Applicant/Utility

- Rate case team will be inter-departmental and will include participation from:
  - Accounting
  - Finance and Budgets
  - Rates (rate design, cost of service, tariff management)
  - Economists
  - Engineering
  - Legal
- Outside consultants and experts are also often involved
  - Example: Cost estimates to decommission nuclear generation plants

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## The Parties—Applicant/Utility

- Rate case team must:
  - Develop and review work papers and schedules
  - Develop and review testimony
  - Coordinate submission of the RFP including testimony, work papers and schedules
  - Conduct research and respond to discovery
  - Assist in development of direct and cross-examinations of witnesses for all parties
  - Maintain cross-referenced records and supporting documentation

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## The Parties—Intervenors

- Parties interested in playing an active role in proceedings
  - Friends and foes
  - Could include State-appointed rate/consumer advocates, other utilities, competitors, independent consumer groups, legislators
- Interested intervenors must file motion, and have motion granted, to formally intervene in a rate proceeding

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## The Parties—PUCT Staff

- Inter-departmental representatives on Commission's case review team
- Requires expertise in:
  - Electric and energy industry issues
  - Economics
  - Accounting and Finance
  - Legal and regulatory issues and analysis
  - Engineering

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## Regulatory Timeline

- Hearings
  - Presentation of evidence and development of record
  - Witnesses may be cross-examined by commission staff, opposing counsel and commissioners/hearing examiner, as appropriate
- Settlement conferences
  - Any settlement needs commission approval
- Findings by hearings judge (hearings examiner)
  - Includes recommendation to commission

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## Regulatory Timeline

- Commission Order
    - Based on evidentiary record developed at hearing
    - Adopts, modifies or rejects hearing examiner's recommendations
  - Motions for Rehearing, Rehearings
  - Appeals
- ➔ After Commission decision, tariffs are revised and compliance tariffs filed

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## Compliance Tariff

“Tariffs are just tariffs.”

- Utilities make tariff filings consistent with the Commission's Final Order.
- Tariff contains the provisions that the utility operates under (standardized Pro-Forma Tariff).
- Tariff contains Rate Schedules and Riders for all of the Rates to be charged to customers per the Rate Case.
- Tariff is the official document that reflects Commission decisions with which the utility must comply.

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## Tariff Changes

- Non-substantive changes to tariffs can be requested and approved on an expedited basis.
- Changes in Riders (such as surcharges) can be made by the Commission on a case-by-case basis.
- Changes in the Rates contained in the Rate Schedules can only be changed as the result of a Commission Order in a Rate Case.

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## Tariffs—other issues

- Time-of-use tariffs have traditionally not been used in Texas
  - With advent of advanced metering technology, time-of-use tariffs may become more common
  - “Dynamic pricing” can include time-of-use rates, which are different prices for different blocks of time over a day.
  - Dynamic pricing can also include real-time pricing, in which actual market prices are transmitted to consumers, generally in increments of an hour or less.
    - Dynamic pricing can actually improve system reliability because it can help alleviate peak-period consumption and strain on the system
- Cross-subsidization from tariff implementation is typically a consequence of rate-design decisions.
  - Cross-subsidies may sometimes be justified on policy grounds (more later)

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Questions?

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