WHITE PAPER ON RCA ECONOMIC REGULATION OF PUBLIC UTILITIES

Introduction

This paper will address issues related to the Regulatory Commission of Alaska's ("RCA's") ability to oversee the economic regulation of public utilities in this state. It will explain what "economic regulation" means, describe the ratemaking processes that pass on the benefits of State financial support for infrastructure to ratepayers, explain how consumers will still retain those benefits if the utility is sold, and, in this context, provide detail on how a utility's return and investment base ("rate base") are calculated.

1. What does economic regulation mean?

The RCA applies "economic regulation" to public utilities operating in the State unless a public utility falls within a statutory exemption or is exempted by a customer election. If a public utility is economically regulated, the RCA has jurisdiction over its rates, services and practices related to its provision of utility service.

An economically-regulated public utility's rates must meet certain broad legal standards. Its rates must be fair, reasonable, and not unreasonably discriminatory. Generally, this means that a utility's rates must be based on its reasonable costs of operation, plus an opportunity for a fair return on its investment. To maintain "fair" rates, an economically regulated utility may not offer preferential rates to any one particular customer or any one customer class. It can charge different rates as long as the differences are reasonable or cost justified, based on customers' specific service characteristics. For example, some utilities charge lower rates to high volume commercial customers if the costs of serving those customers are lower on a per unit basis.

If an economically-regulated utility wants to increase its rates, it must apply to the RCA for approval. The RCA will investigate the utility's supporting cost data thoroughly. It will only allow a utility to recover its *reasonable* costs in rates. If the utility buys a Cadillac, and could have used a Ford, the utility may not be allowed to recover more than the cost of the Ford. Customers may participate in the proceeding by providing comments.

The RCA applies even higher scrutiny in circumstances where a utility has purchased goods or services from an affiliated company.[1] To recover its affiliate's costs in rates, the utility will have to show that the price it paid to its affiliate was reasonable, and no higher than the cost it would have incurred if it had used its own personnel and funds. In that way, the RCA prevents a utility from cross-subsidizing an affiliate's operations.

2. <u>If a utility receives a grant or low cost capital infusion, what is the impact on its rates and its return on investment?</u>

If a utility receives a grant or a low cost capital infusion from an agency such as AIDEA, the benefits of that financing will flow through to ratepayers in the form of lower rates. The flow through could occur in several ways.

First, if the utility receives lower cost debt, it will use the lower interest rate in the "return" on investment component of its rates. A utility's "return" has two elements: 1) its fair rate of return on any equity investment (expressed as a percentage), and 2) its cost of debt. The utility includes its actual interest rates to calculate its debt cost. Therefore, it will flow through the benefits of any low cost loan by using that lower interest rate in calculating the debt cost portion of its return.

If a utility receives a grant for build-out of plant, the utility will reflect this savings in its plant investment cost. For ratemaking purposes, a utility's plant is included in its "rate base" which forms the basis for its return on investment. The utility calculates its return amount by multiplying its rate of return (weighted average debt and equity costs) by its rate base. If, for

[1] AS 42.05.511(c).

example, $500,000 of a $1,000,000 plant is grant-funded, the utility will only earn a return on $500,000 worth of plant. Ratepayers will not have to pay for the utility to recover any return on the grant-funded portion of the investment.

The RCA has precluded utilities from recovering grant-funded plant costs in their rates for policy reasons. It has said that it has "not allowed grant funds the utility receives to improve its infrastructure to be recovered in rates because this would represent a windfall profit and departs from basing rates on the costs the utility experiences."[2]

3. <u>What happens to these savings when a utility is sold?</u>

When Utility A sells its operations to Utility B, its grant-funded plant savings will still be retained in rates. Utility B may pay more for Utility A than is reflected on its books (its "net book value"). If it does, generally, Utility B will not be entitled to recover this "acquisition adjustment" in rates (the price it pays over net book value).[3] Utility B's rates will still reflect Utility A's savings from funding part of its plant through a grant. The savings will be embedded in the plant's net book value.

4. <u>What is included in a utility's rate base?</u>

A utility's rate base consists of the plant, facilities and other investments that it uses in providing utility services to its customers. Generally, it includes in its rate base the original cost of the plant minus accrued depreciation, plus materials and supplies and a reasonable allowance for cash working capital.[4] A utility may only include plant that is actually "used and useful" in providing service. To meet this standard, the plant must be functioning and necessary to provide

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[2] R-04-3(1)/R-04-4(1), p. 13 (October 5, 2004).

[3] The Commission may permit a utility to include an acquisition adjustment in its rate base if the utility can establish a clear and tangible benefit to ratepayers that is at least equivalent to the amount of the acquisition adjustment. This can be a very difficult standard to meet.

[4] AS 42.05.441(b).

service. Also, a utility may not recover the full cost of “gold-plated” plant in rates. To be included, the plant must be adequate to serve customers’ needs, without being extravagant.

This analysis shows the Commission does not include grants or loans directly in rate base. Rather, they are reflected indirectly in other aspects of the return on investment formula. A utility’s rate base will reflect zero cost for any plant that is grant-funded. Its return on investment will include the lower interest rate on debt.

Conclusion

Through economic regulation, the RCA regulates a public utility’s rates to ensure that they are reasonable, fair and not unreasonably discriminatory. If AIDEA provides low cost capital or grants to build a gas utility’s infrastructure, those benefits will be flowed through to customers through the ratemaking process. The utility will include the lower interest rate in the debt component of its return. Additionally, the utility will not include any grant-funded plant in the value of its plant investment included in rate base. In these ways, consumers will receive the benefits of any low cost debt or grant money that the State provides to support utility infrastructure development.