Regulatory Lag and the Incentives Question: Fact, Fiction and Myth

By
Karl McDermott
Ameren Professor of Business and Government
University of Illinois Springfield
Preliminary Issues

• The Historic Role of Price
• Customers as passive participants in a culture of consumption
  – Proud of the most consumption in the world
    • Kitchen Debate
  – Appliances not people should be efficient
  – Control appliance people can’t be trusted
• Psychology - Regret and Rejoice - show me the money
  – Prepaid meters stigma
  – Health, intergenerational equity
Preliminary Issues 2

• Unintended consequences of well intended actions- system evolution
• Convergence BTU versus KWH and Therms
• POTS and 1950s Electric System
• Need a clear vision of what your selling customers
Consumer View of Layers- Expense

- Modernization
- Growth
- Hardening
- Smartening
- Securing
- All I want is my 1950s electron
What is a Rate Case

• The Archaic Institutional Process of Setting Rates
• Can take as long as 18 months
  – You think about the system in terms of the speed of light- not going to happen
• Alternative Regulation- Trackers, Riders, PBR, ESM, etc.
I. Number of Rate Cases Filed (Quarterly)

U.S. Shareholder-Owned Electric Utilities

Source: SNL Financial / Regulatory Research Assoc. and EEI Rate Department
II. Average Awarded ROE (Quarterly)

U.S. Shareholder-Owned Electric Utilities

Source: SNL Financial / Regulatory Research Assoc. and EEI Rate Department
Figure 2. Significant U.S. Grid Weather-Related Grid Disturbances
(with inset of non-weather- vs. weather-related outage comparison)


Types of Lag

• **Regulatory Lag**: The period between rate cases when the primary incentive for cost control is that due to the prohibition on retroactive ratemaking that is the period when a utility can retain any revenues from cost savings between rate cases. This allows the utility to also retain any additional revenue associated with sales growth beyond the level assumed when prices were set.

and

• **Administrative Lag**: The period during the actual rate setting proceedings which generally take between six and twelve months to complete. During this time, in most jurisdictions, the utility is prohibited from modifying its prices yet costs continue to change and investment occurs. Administrative lag can cause gaps in the ability of utilities to recover prudently incurred costs.
Introduction

• Smart grid, modernization, and investments to accommodate wind, solar and other exotic technologies are generating potentially significant streams of new costs that customers must absorb

• Regulators are generally not enthusiastic about raising customers rates

• What arguments should you expect to see
Regulatory Review

- Prudence and after the fact reviews
- Reticence to adopt flow through models
- Appeals to a need for market discipline and the power of regulatory lag to induce this cost efficiency focus
- Argument of this paper:
  - Regulatory lag is a blunt instrument and is out of place when addressing investments of this nature
# Potential Roadblock to Smart Grid: Regulatory Ambivalence

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Smart Failures

- BGE
- PSE
- DP&L
- XCEL
- Consumers
- Conn L&P
- PG&E
Warren

• The notion that utilities will respond to regulatory lag as an incentive to cut costs rests on three unspoken premises: that costs actually can be cut by increased efficiency without degrading service standards, that inflation will cause production costs to rise, and that the total possible cost cuts will approximate increases in cost due to inflation over the lag period. [Warren:347]
Warren

- Regulatory lag simply acts as a squeeze on the utility. The need for the squeeze, the degree of the squeeze, and when the squeeze should be applied are not issues that the commissions consider when they permit lag. Interestingly, as a utility becomes more efficient, it has more to fear from regulatory lag. An inefficient utility has many cost reductions available to offset inflation during the interim… By contrast, an efficient producer has few cost cuts yet to be made. High inflation during a regulatory lag period may impair the efficient producer’s financial integrity. (Id.:348)
Warren 334

• “Most regulatory commissions have accepted the conventional wisdom that a fixed price between rate hearings provides an incentive for the utility to become more efficient. The support for that argument rests on unexplored, fallacious principles.”

• We doubt that regulatory lag has significant benefits over the long run. It cannot be justified in principle because it is arbitrary. It forces utilities to make do with less when commissions cannot say specifically why less should do. To the extent that a utility is already operating reasonably efficiently and is suffering cost increases beyond its control, regulatory lag merely starves the utility, ultimately resulting in a reduced quality of service, or a less than fair return to stockholders, or both.