Regulatory Issues in Inflation Adjustment Mechanisms and Allowances

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Overview: Inflation Adjustment Factor Description

- **Inflation adjustment factors are relatively recent proposals that have arisen in several post-2005 rate cases.**
- **No real uniform or standardized approach like a performance-based regulatory mechanism although some can take PBR-type forms (i.e., recent National Grid proposals).**
- **Typically offered as a cumulative annual percent increase in rates at rates comparable (equal) to some measure of general economy-wide inflation such as the consumer price index ("CPI") or gross domestic product price index ("GDP-PI").**
- **Tend to be offered within the context of a limited range of costs/expenses such as operations and maintenance expenses (less other costs that may be recovered through separate recovery mechanisms such as pensions and other post-retirement benefits)**
- **Number of recent proposals in Nebraska, Indiana, and Massachusetts, to name a few. Usually offered in conjunction with other new regulatory mechanisms such as revenue decoupling and infrastructure cost/replacement cost recovery riders.**

Policy Challenge

Heart of the issue is the nature of regulatory lag and its impact on a utility's opportunity to earn a return on and of its investment.

Considerations:

(1) Is the adjustment necessary?

(2) Consistency with regulatory policy, practice, and theory?

(3) If accepted, what is the most appropriate measure of inflation?

Overview: Inflation Adjustment Factor Description

Standard criteria for trackers and other types of separate single item rate adjustment mechanisms has been:

(1) Is the adjustment large (and reoccurring) relative to a utility's overall costs?

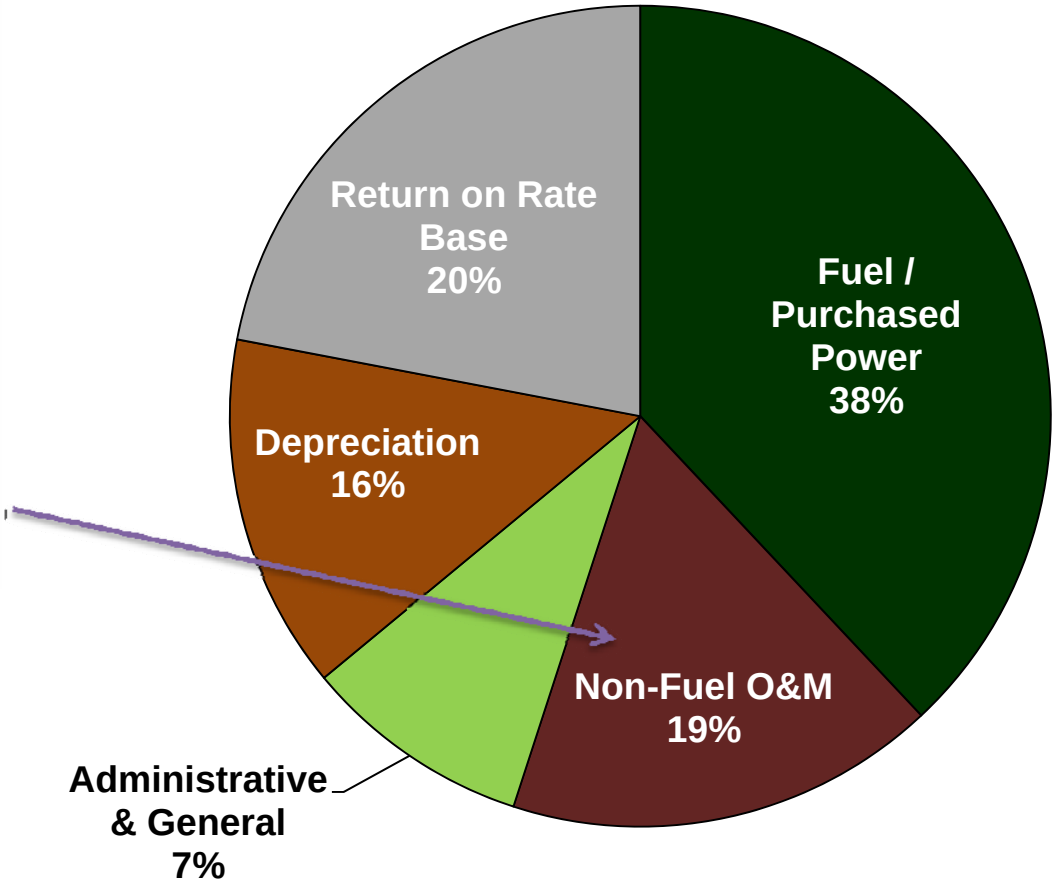
(2) Are the costs unpredictable and volatile?

(3) Are they largely outside a utility's control?

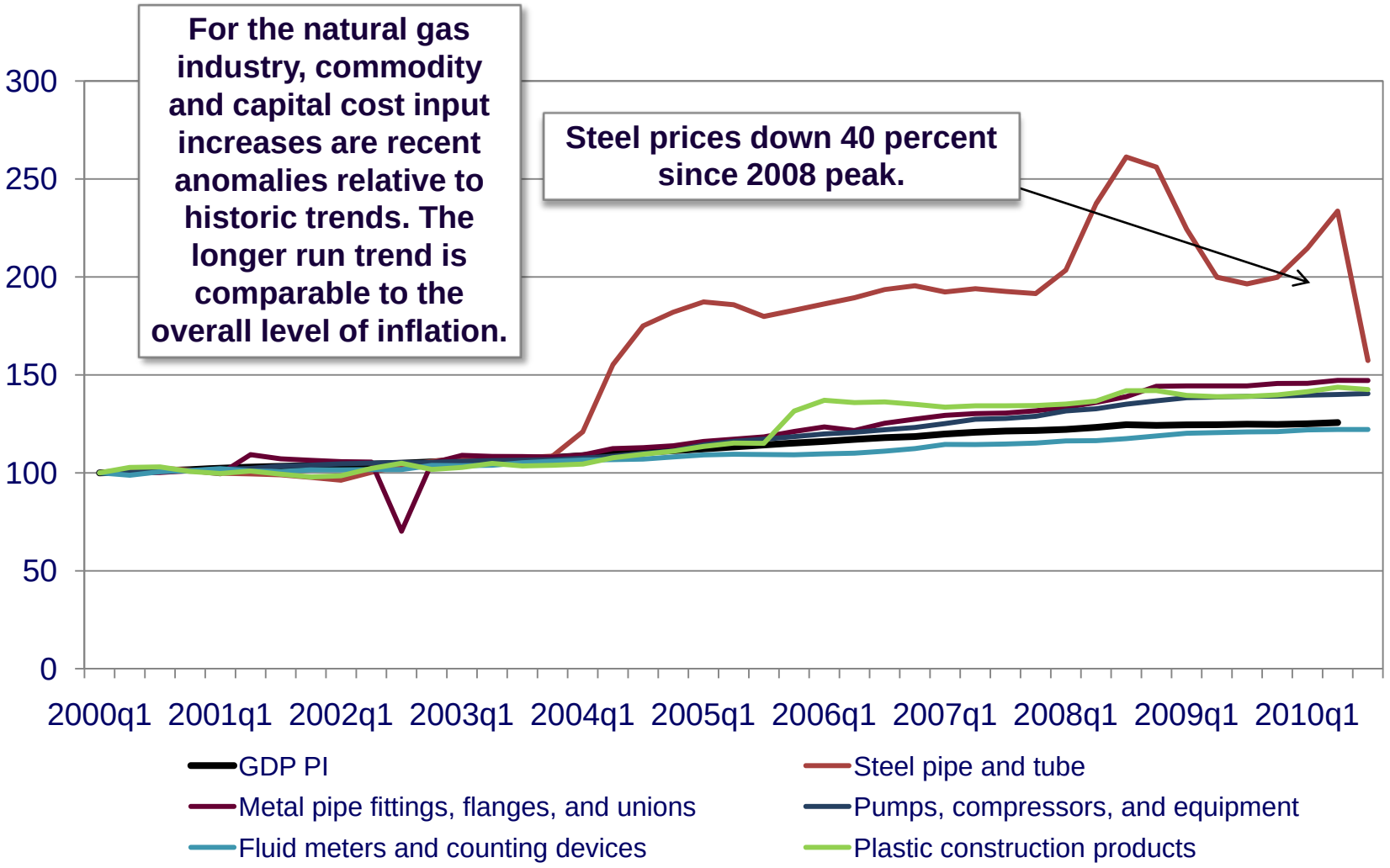
Electric Utilities – Typical Retail Rate Components

More recently, IAFs have been proposed to be applied to a relatively tight range of costs that are restricted to non-fuel O&M.

While these costs are clearly reoccurring, they are not large relative to the structure of overall rates.



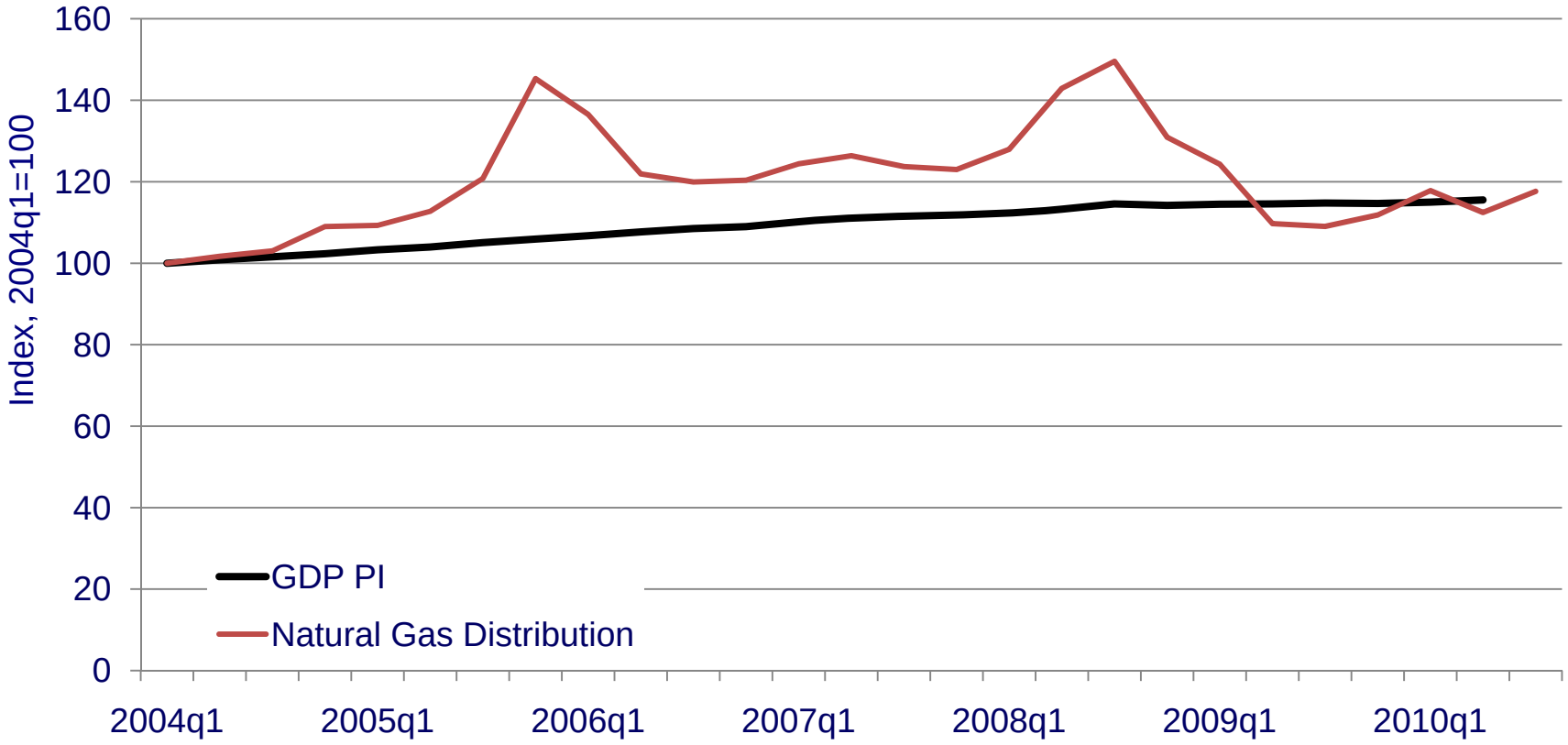
Price Trends: Steel & Metal Pipe, Pumps, Compressors, Meters & Plastic



Source: Bureau of Labor Statistics, U.S. Department of Labor; and Bureau of Economic Analysis, U.S. Department of Commerce.

Gas Distribution Price Index Movement Vs. GDP-PI

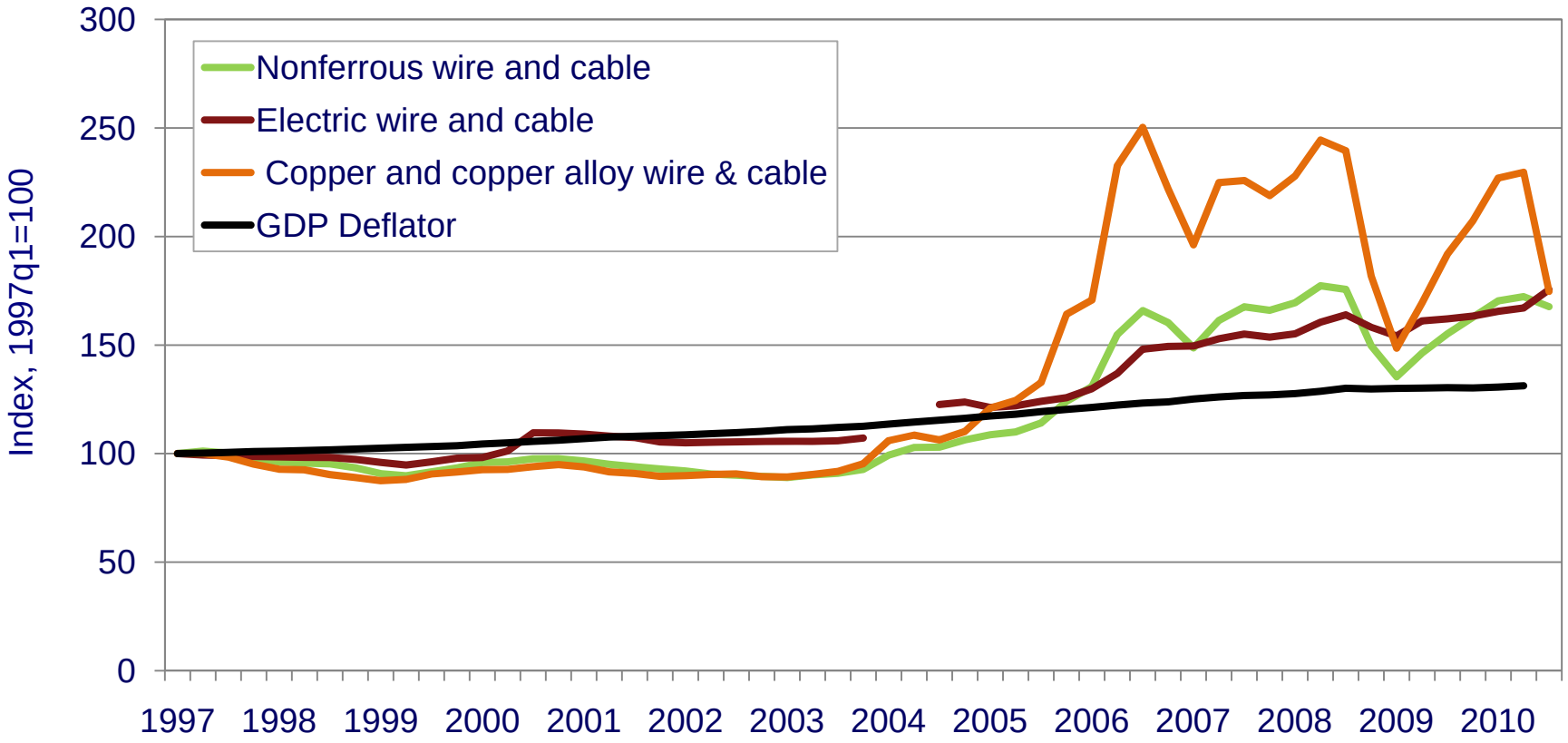
Inflation for gas distribution service did increase relative to 2004, but year-over-year rates of change have flattened considerably.



Source: Bureau of Labor Statistics, U.S. Department of Labor; and Bureau of Economic Analysis, U.S. Department of Commerce.

Price Trends, Electric Wire and Cable

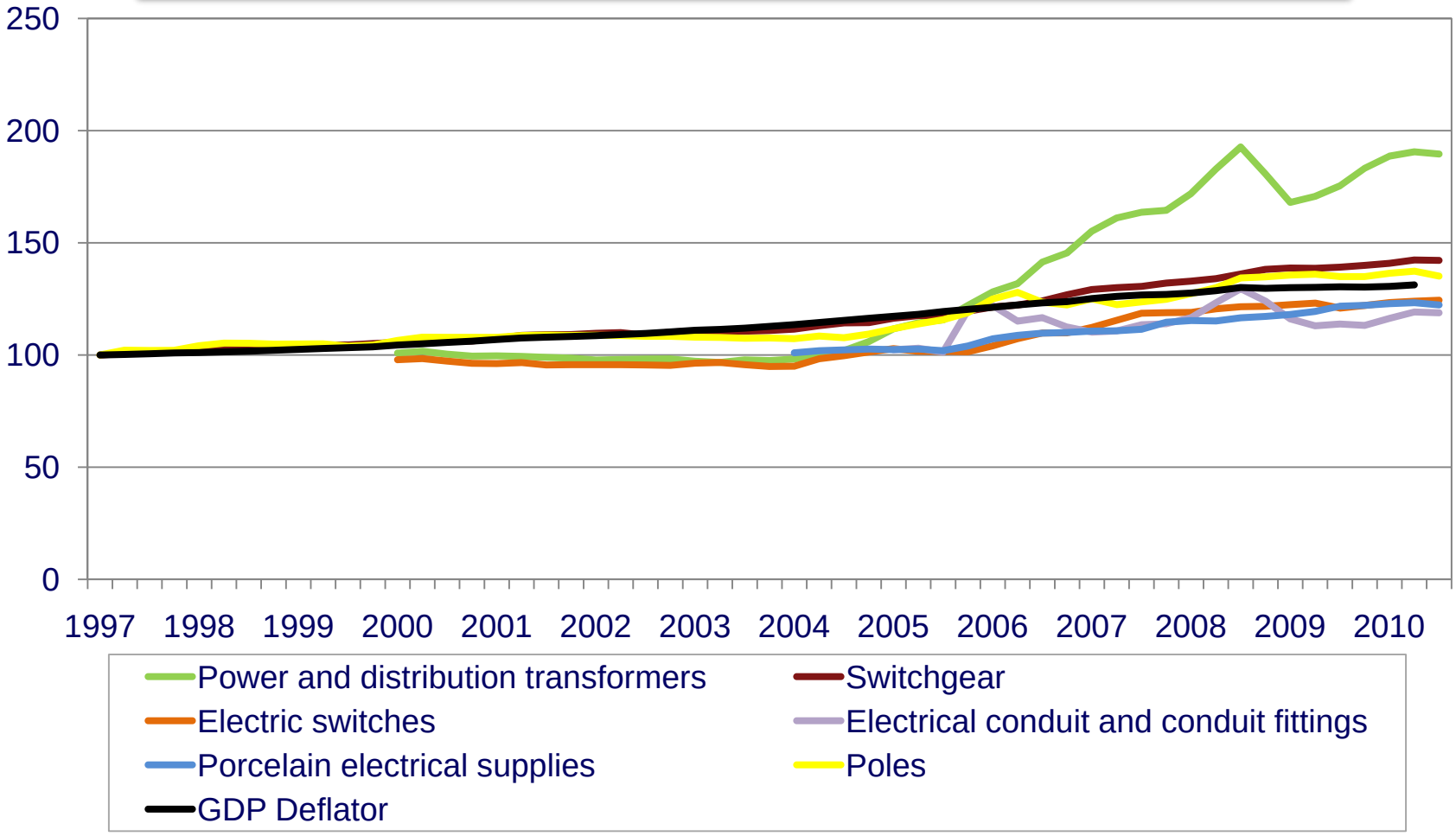
Commodities important to the electric industry have seen copper wire decrease by close to 30 percent from its high in 2006. Similarly, nonferrous wire has decreased over 17 percent in less than one year.



Source: Bureau of Labor Statistics, U.S. Department of Labor; and Bureau of Economic Analysis, U.S. Department of Commerce.

Price Trends: Other Electric Distribution Capital Cost Components

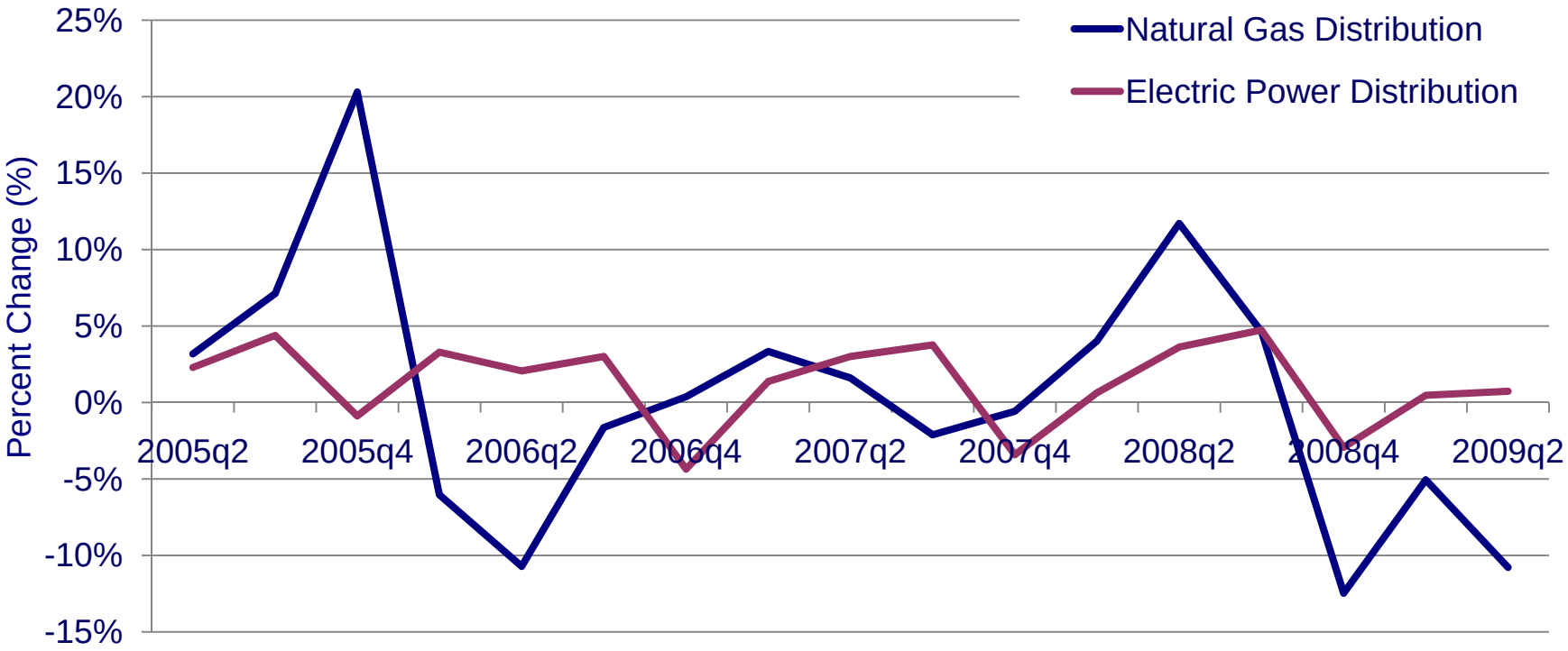
The costs for other important electric cost components has actually been below the general rate of inflation.



Source: Bureau of Labor Statistics, U.S. Department of Labor; and Bureau of Economic Analysis, U.S. Department of Commerce.

Annual Changes in Natural Gas and Electric Distribution Price Indices

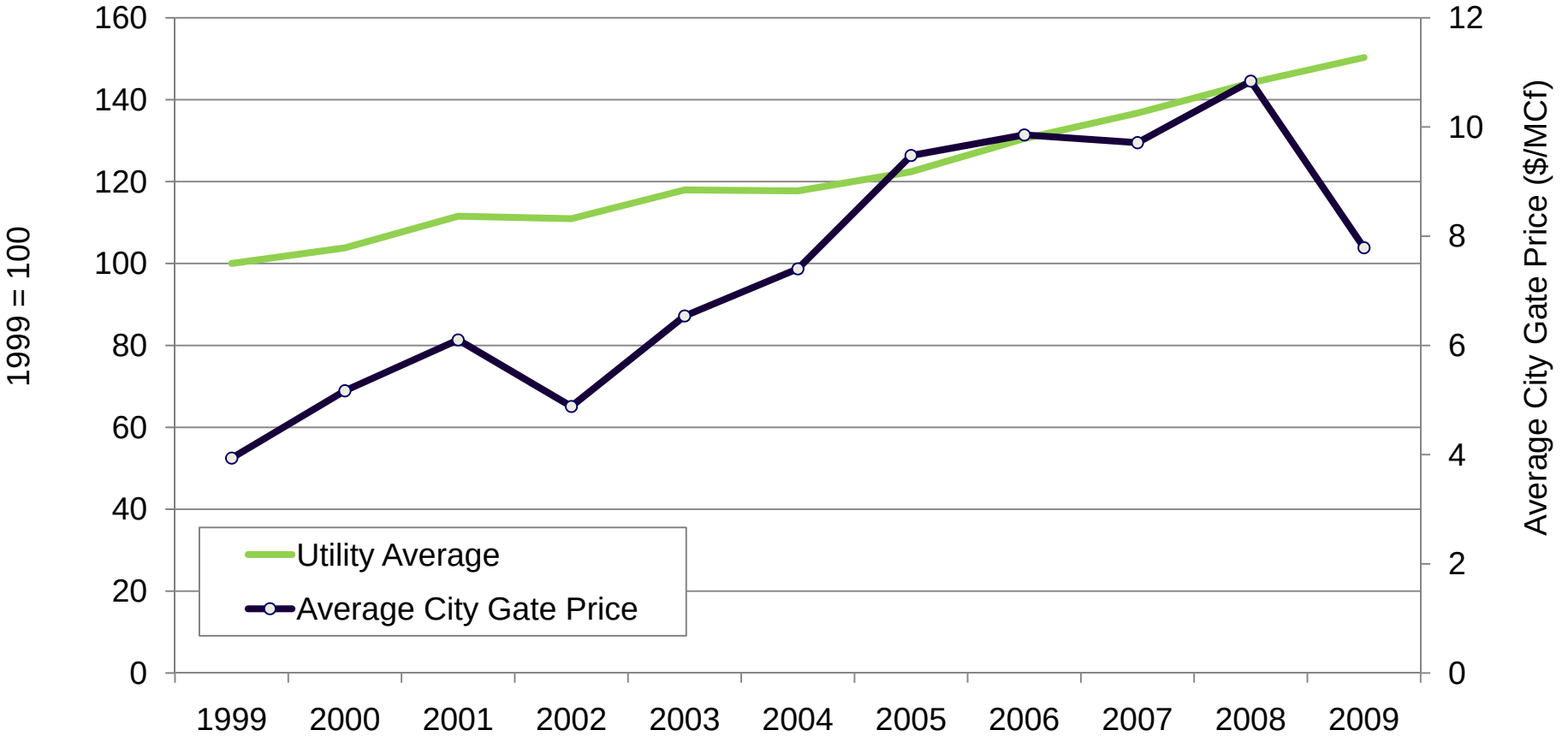
The annual rate of change for both indices has been falling.



Source: Bureau of Labor Statistics, U.S. Department of Labor; and Bureau of Economic Analysis, U.S. Department of Commerce.

Northeast Natural Gas Utility Distribution O&M Expenses and Fuel Costs

The distribution O&M expenses are significantly more stable than fuel costs.



Source: FERC Form 1; State Public Utility Commissions;
U.S. Department of Energy, Energy Information Administration.

Inflation Adjustments: Regulatory Theory and Practice

Interestingly, inflation adjustment factors are not new proposals.

Some proposals date back to the 1960s and 1970s.

The nature of the adjustments then were slightly different usually composed of proposals to increase (inflate) allowed returns over time to compensate for inflation.

Raised controversy then (as now), and some of the classic regulatory textbooks have discussed these issues.

Inflation Trackers: James Bonbright

"The inflation allowancers' position that fairness and constitutional non-confiscatoriness mandates an adjustment is wrong and is not an appropriate basis for an inflation adjustment. Such an adjustment is selective, non-remedial, and unfair to others. Fixed security holders are not safeguarded against inflation either. Common shareholders are not promised an inflation-adjusted return -- indeed no return is promised. Non-regulated shareholders are not given inflation-proof securities, although they have tended to do better in recent inflationary periods. Under rational expectations, the technique probably would not work and if it did, it would unsettle regulation." [Bonbright, pp. 350-351].

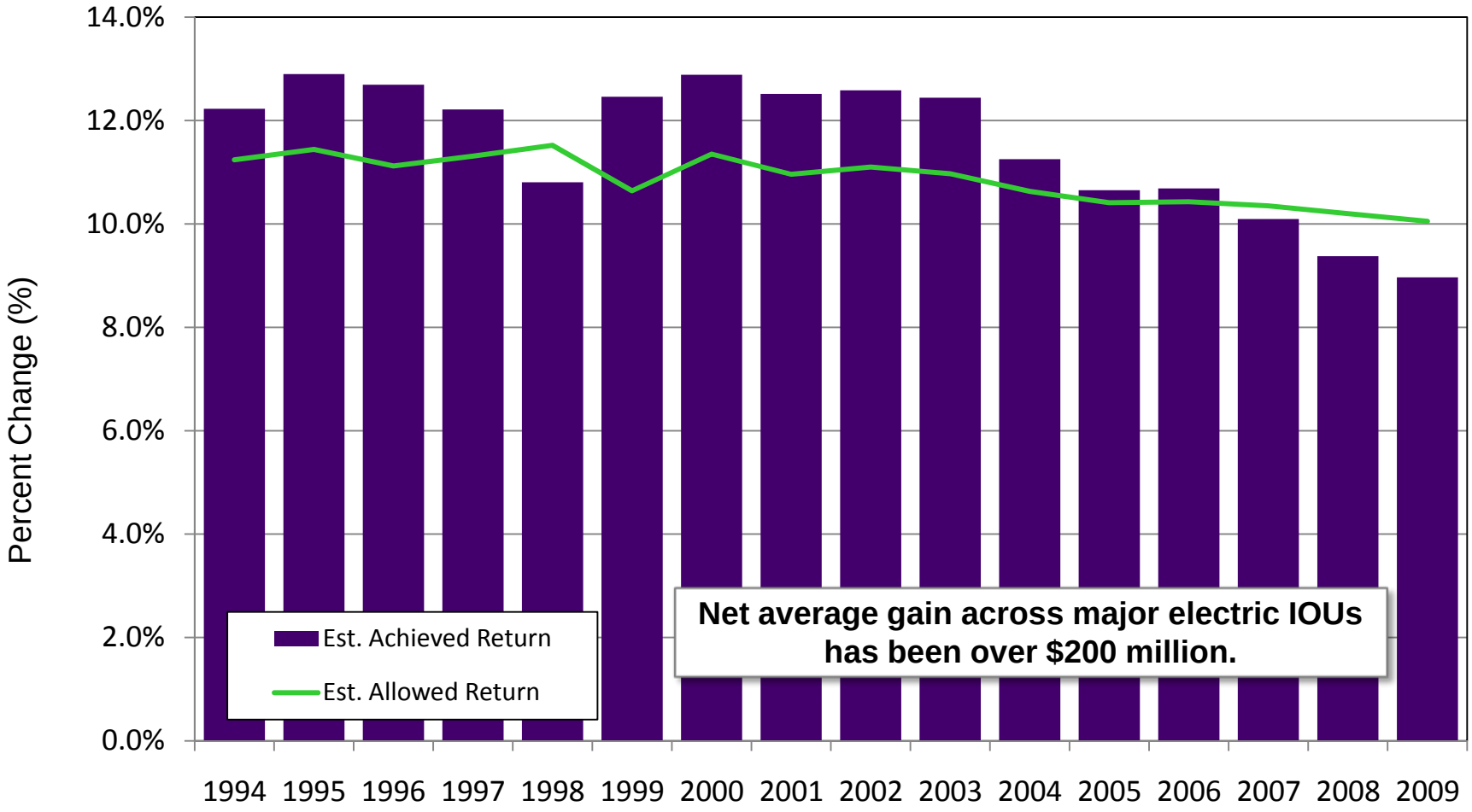
Inflation Trackers: Alfred Kahn

Any scheme of compensation is fair provided only that it was reasonably expected by investors. As long as investors are informed in advance of whether they will be explicitly protected against inflation they can in fairness be left to take the fact into account in the prices they pay for the stock at the time of the purchase.

It is impossible to compensate future stock purchasers for past inflation, they will simply bid up the price of the sock and thereby offset that compensation. Further, a change to the regulatory rules that gives stockholders compensation for inflation, where one was not offered before, will confer a "windfall" to existing shareholders. Any inflation mechanism, to the extent it is adopted, should apply broadly to an average of all costs (not a selective few) and average estimated from a number of years.

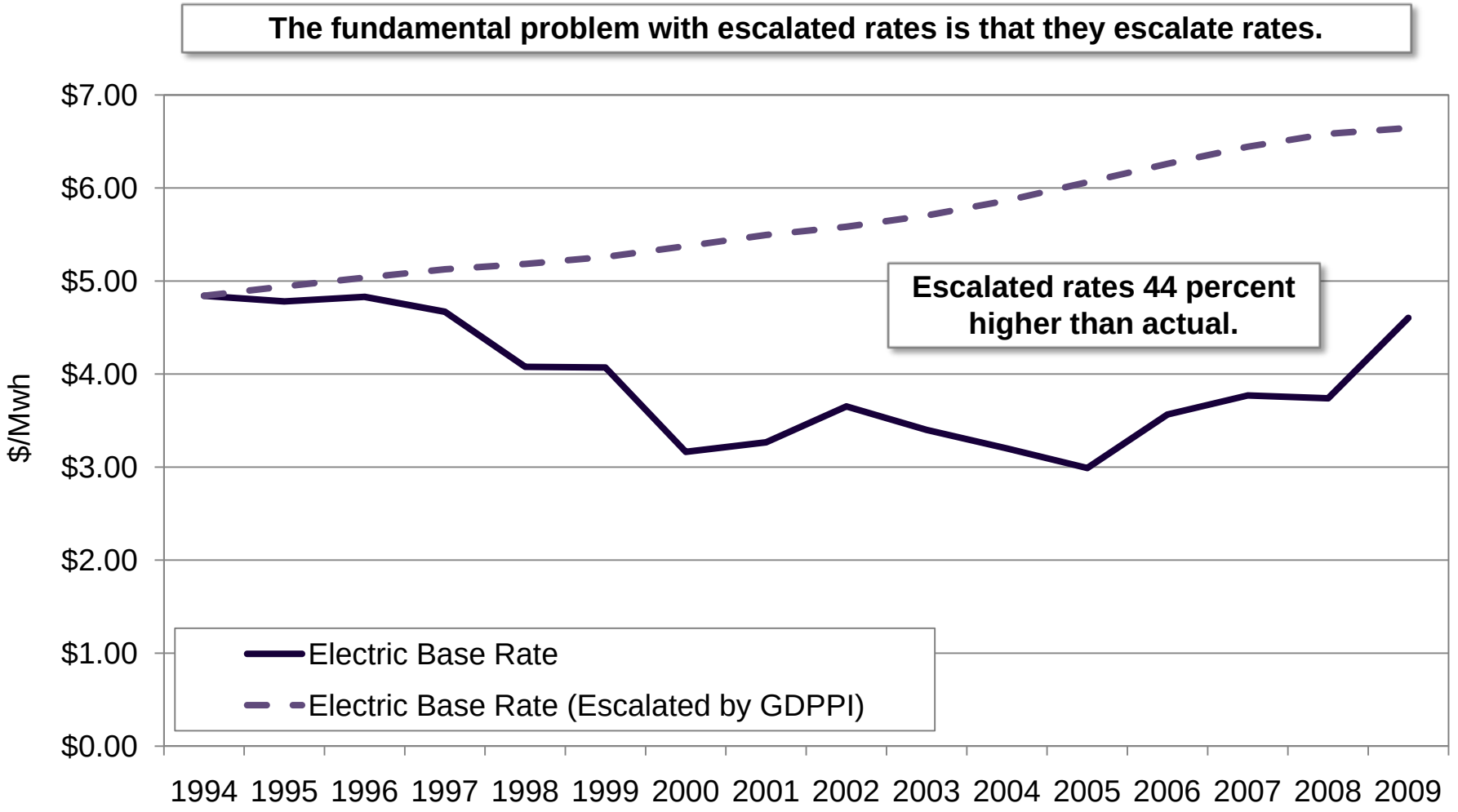
Alfred Kahn. *The Economics of Regulation*. Vol. 1. (1988). Cambridge, MA: MIT Press, 115-116.

Major Electric Companies, Achieved ROE



Source: Federal Energy Regulatory Commission.

Base Rates – Actual and Escalated



Source: Federal Energy Regulatory Commission.

Overview: Inflation Adjustment Factor Description

Net inflation factors tend to take the worst aspects (from ratepayers' perspective) of PBRs, namely the price increase, with none of the benefits:

- **Open ended, no fixed terms or stay out provisions.**
- **No productivity adjustments tempering increase.**
- **Typically no benchmarked inflation measure.**
- **No earnings sharing mechanism.**

Overview: Inflation Adjustment Factor Description

Other considerations if an IAF is required:

(1) Best measure of utility cost inflation?
GDP-PI, CPI, utility-specific indices (PPI)

(2) Use of actual cost inflation versus index?

(3) Benchmarking to other peers?

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Nebraska Public Service Commission (Application No. NG-0060)

The [inflation adjustment or "IA"] adjusts rates based upon changes in inflation. It may be true that certain indices may show an increase or decrease in prices throughout the economy. However, such changes in prices do not necessarily flow directly, dollar for dollar, to a utility's costs. Further, it does not allow for cost savings that may result from increased efficiencies on the part of the utility or costs that may 'not change due to existing contracts. Finally, such an arbitrary adjustment does not encourage innovation and efficiency on the part of utilities. There is simply an insufficient nexus between changes in inflation and the actual costs incurred by utilities. Therefore, the Commission finds that the proposed IA should be denied.

Overview: Inflation Adjustment Factor Description

Department of Public Utilities ("DPU") has rejected net inflation factor mechanisms on two different occasions – both for National Grid (electric operating companies, gas operating companies).

Most recent rejection (National Grid gas operations), the Department took a relatively firm stand against the need for the mechanism:

(1) Not needed since RPC approach in decoupling should provide for revenue growth.

(2) Not needed since it "removes" a favorable component of PBR and ignores the other positive components that benefit ratepayers (fixed term, ESM, etc.)

(3) Company still has traditional (and statutory) remedy: the ability to come in for rate case.

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Massachusetts Department of Public Utilities (D.P.U.10-55.)

"In an era of low inflation that is unprecedented in recent history, it is difficult for the Companies to demonstrate that an inflation adjustment factor is warranted. The Companies claim the absence of such an adjustment will lead to more frequent, and even perhaps annual, rate filings. We are not persuaded. By contrast, we find that adoption of an inflation adjustment mechanism may lead to rate case filing intervals that are too long…

Questions, Comments and Discussion

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