



The Age of Alternative Ratemaking

January 2021

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The use of Alternative Ratemaking Mechanisms (“ARM”) is not a new concept.¹ Yet, despite its solid record of being beneficial to utilities, regulators, and stakeholders, it has historically had a slow level of adoption by many states. That has now changed, and we are entering a new regulatory age: The Age of ARM. Even states that have been extremely reticent to shift away from the traditional rate design methodology are now moving to embrace the use of alternative ratemaking. Whether or not your state has adopted the use of ARM, it is important to consider ways in which these mechanisms could create both opportunities and challenges.

It is important to recognize that ARM is not a single type of ratemaking. At its core, ARM is a shift from rates based on an historical test year supported by a cost of service study to “less traditional” methodologies that include a wide range of alternatives based on achieving predetermined performance metrics, decoupling sales and revenue, adjusting rates formulaically based on a preset schedule, and providing opportunities to retain/share earnings above “allowed” amounts. The mechanics of these alternatives can be complex and nuanced. For example, decoupling comes in many different forms that allow for adjustments related to weather, energy efficiency, customer growth, and/or total sales. Multi-year rate adjustments can have different time frames and allow for different, periodic rate adjustments to address changes in different, specific types of costs. Performance-based approaches can provide return on equity (“ROE”) adjustments based on the achievement of different performance goals often related to safety or customer service and at the same time create the threat of ROE reductions for failure to meet these goals.

These alternative rate mechanisms can create real value to each stakeholder:

- For utilities, ARM can provide more contemporaneous recovery of costs and assets, lessening regulatory lag and/or providing opportunities to earn above the “allowed” return based on performance.
- For regulators, ARM can lessen the administrative burden of continuous rate case filings and align utility performance with specific commission goals (e.g., improved customer performance, safety).

¹ See Figure 3 on page 5 for a detailed definition of ARM.

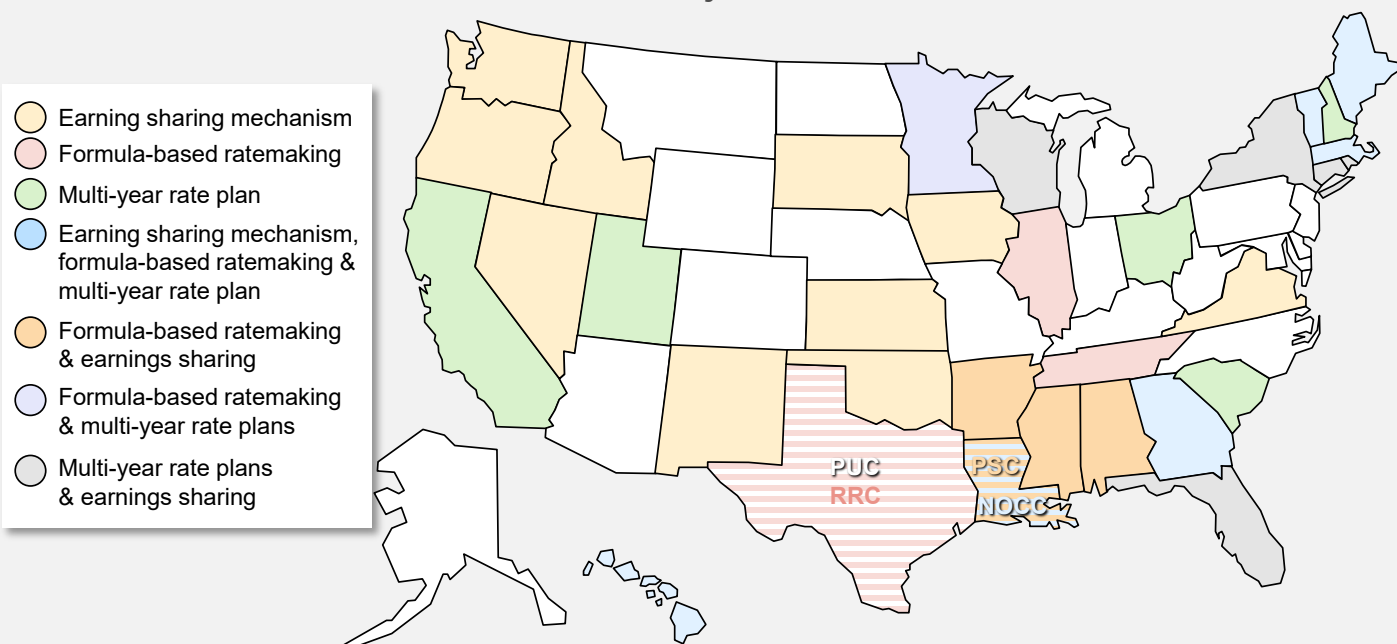
- For shareholders, ARM creates the potential of more consistent earnings and the opportunity for additional earnings.
- For customers, ARM can provide an opportunity to manage their bills if ARM includes innovative rate designs or smart meters with smart rate designs.

The most common form of an ARM is a rate decoupling mechanism, currently adopted by 18 states for electric and 26 for gas utilities. In this Age of ARM, more states are not only adopting decoupling for the first time, but they are incorporating more ARM mechanisms as well (see the map in Figure 1 below).

Some recent examples of ARM follow:

- The New Mexico state legislature recently mandated Commission approval of revenue decoupling mechanisms put forth by utilities, despite the Commission’s historic reticence to move away from traditional rate making.
- In Florida, ARM is focusing on cost recovery for the construction of new utility-scale solar projects. For example, as part of a 2017 rate case settlement, Tampa Electric was given permission to construct these types of projects through a review and approval process with recovery coming from a Solar Base Rate Adjustment (“SOBRA”). Under the SOBRA mechanism, recovery would happen contemporaneously with construction, and base rates would be adjusted annually for that cost recovery outside of a rate case (with a true-up mechanism once construction was complete). The SOBRA approval process included a \$/MW cost cap along with a mechanism to incentivize Tampa Electric to be below the cap. That mechanism allowed Tampa Electric to gain half of the savings below the cap.

Figure 1
ARM Activity in the US




- In Minnesota, per 2015 legislation, the state allows multi-year rate plans (“MRP”) with terms of up to five years and has adopted performance-based rating making. Northern States Power (Xcel Energy), for example, was granted an MRP per a 2017 docket (E-002/GR-15-826) that was approved as part of a multi-phase regulatory process. Performance-based rates was the subject of the second phase (docket E-002/CI-17-401), which was resolved by three commission orders; two orders (January 8, 2019 and September 18, 2019) advanced a performance incentive mechanism (“PIM”) and the third order (April 16, 2020) approved the full PIM.

Perhaps of more importance, the Age of ARM is expanding the breadth and scope of regulatory discussions. For example, in 2019, the State of Maryland sought to advance beyond the existing decoupling mechanisms and initiate a proceeding in which a stakeholder process would first develop recommendations to the commission on a framework for MRP and then address the incorporation of performance-based rates (“PBR”) or at a minimum a PIM into MRP.

When looking “behind the scenes” in Maryland, it becomes clear that the traditional arguments surrounding ARM were transformed into an exercise designed to create a “grand bargain” between utilities, regulators, and intervenors. This “grand bargain” is built on the premise that utilities would open up their capital planning and O&M budgeting processes to greater stakeholder scrutiny in exchange for a three-year mechanism for cost recovery and the decoupling of revenues from sales. It is important to appreciate that this process has stimulated stakeholder participation from a wide range of intervenors, most notably environmental activists.

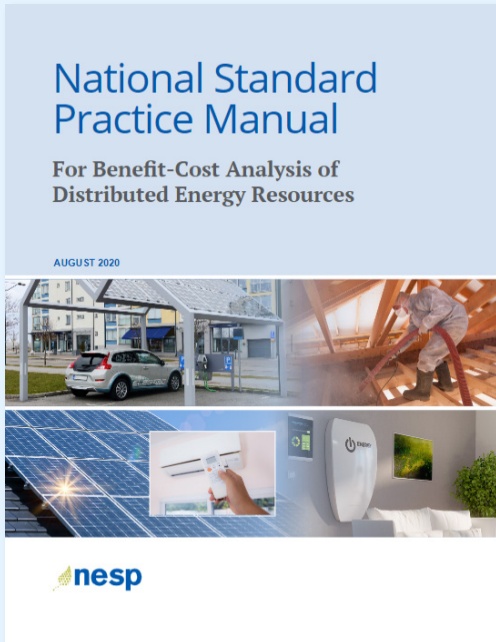
For example, industry consultancies and advocacy organizations² authored the National Standard Practice Manual for Distributed Energy Resources (“NSPM-DER,” see Figure 2 on the next page for more information on the NSPM-DER). The NSPM-DER brought a customer-owned DER and eco-justice perspective to the PIM discussion and emphasized PIM penalties rather than rewards on behalf of the Office of People’s Counsel and Montgomery County. In addition, the Apartment and Office Building Association brought a perspective on increased access to utility financial and planning models and data.

The dawning of the new Age of ARM represents both an opportunity and a threat. For years, utilities have looked to ARM as a panacea to gain earnings stability, incremental returns, customer satisfaction, and reduced regulatory burden. Now that states are opening the door to these discussions, utilities need to recognize that the process may require them to give up a lot more than they might have anticipated (“the grand bargain”). How these discussions end for a utility will, in a large part, depend on how much they prepare for this new Age of ARM and engage the processes that define it in their jurisdiction(s). 

² Among the authors are Synapse Energy Economics and the Pace Clean Energy Center. The National Energy Screening Project (“NESP”) coordinated the effort.

Figure 2

What is the NSPM?



The National Standard Practice Manual for Assessing Cost-Effectiveness of Energy Efficiency Resources (“NSPM”) and its companion volume, the National Standard Practice Manual for Benefit-Cost Analysis of Distributed Energy Resources (“NSPM-DER”) have been utilized by intervenors in Maryland, among other states. Intervenors use the NSPM and NSPM-DER in a wide range of proceedings to influence outcomes that sometimes result in reduced rate base investment in transmission and distribution systems, reduced reliance on traditional sources of power supply, and a corresponding increase in cost recovery and earnings opportunities for alternative investments that may or may not be in the best interests of the utility system and its customers.

For more information on the NSPM and NSPM-DER, see MCR’s breaking news alert, “Environmental Advocates Have Proposed a Sweeping New Approach to Regulating Utility Capital Investments and Earnings.” and MCR’s white paper, “EE Cost Effectiveness Where You Least Expect It,” at www.mcr-group.com/energy-efficiency.

Figure 3

What is Alternative Ratemaking?

According to most, alternative ratemaking mechanisms (ARMs) represent a shift away from rates that are designed from traditional cost of service studies and towards the less traditional form of performance-based rates, decoupled rates, formula rate plans, earnings sharing mechanisms, and multiyear rate plans. Some methodologies under consideration by many utilities across the county include:

- **Decoupling:** Under traditional volumetric, cost of service ratemaking, in effect, the rate is set, which results in revenue and thus earnings fluctuating based on sales volume. When sales are lower than forecast, there is a revenue deficiency, so the recourse for the utility is to attempt to cut costs to achieve the allowed return or to file a new rate case. Decoupling addresses this challenge by setting the revenue and allowing sales to fluctuate. That is, when sales decline below the forecast, rates are adjusted upward to enable collection of allowed revenue. A utility's specific decoupling mechanism is of particular importance and is a measure of success when it accomplishes a utility's specific goals. According to the Regulatory Assistance Project, 18 states have adopted decoupling for electric utilities, and 26 states have done so for gas utilities.
- **Performance-based rates ("PBR"):** Whether in conjunction with or in lieu of cost of service ratemaking, PBR associates revenue and earnings with achieving specific outcomes established in advance via a rate case. To date, no jurisdictions have moved fully to performance-based rate structures in lieu of cost-of-service-based rates. Instead, in an increasing number of jurisdictions, performance incentive mechanisms ("PIM") are established in conjunction with cost of service-based rates to provide increments (or decrements) to earnings based on performance relative to outcome-oriented goals and associated metrics. The intent of PIMs from a regulatory perspective is to incentivize utilities to do things they otherwise would not do; thus, the argument can and should be made that penalties (earnings decrements) should be rare if they exist at all.
- **Formula rate plans ("FRP")** and multiyear rate plans ("MRP") are similar to one another in that they serve to define a multiyear path for recovery of a revenue requirement based on either a narrowly or widely defined set of expenditures with minimal regulatory lag. Whether rates in the initial year of an FRP or MRP are developed based on a historic or forecasted future test year, rates are formulaic (FRP) or defined (MRP) based on forecasts of costs and billing determinants in subsequent years of the plan.

About MCR's Regulatory Services Practice

MCR specializes in the electric, natural gas and water utilities marketplace. Our clients have a goal of optimizing the value of current and future investments in their regulated businesses. We help them by developing regulatory strategies, designing advanced rates and cost recovery mechanisms and managing the regulatory process to realize the full revenue potential from their assets.

Through our consulting assignments, we have created millions of dollars in value for our clients and broken new regulatory ground for our client base with landmark decisions in regulatory rulings. Our Regulatory Services practice provides the following services:

Rate Case Support & Strategic Analysis

- Rate case strategy
- Rate case management
- Pre-filing review

Cost of Service

- COST™ Model (including rate design module)
- Cost of service regulatory support

Rate Design

- Traditional rate design
- Alternative rate design
- Tariff analysis
- Rate schedule determination

Expert Testimony

- Expert regulatory testimony
- Witness training

Regulatory Support

- Regulatory/legislative support & policy development
- Load forecasting process review
- Revenue enhancement opportunities
- Energy efficiency & demand response regulatory support
- Stakeholder participation/advisory services

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