

How Utility Rates Are Set



Ratemaking is a two-step process. The first step is to determine the utility's annual "revenue requirement" — the amount of money it should get from retail customers each year. The second step is to design rates that will equitably collect that revenue requirement from the utility's customers.

The determination of revenue requirement focuses on four factors: (1) the "rate of return" or profit the utility has an opportunity to earn; (2) the total investment or "rate base" upon which a return may be earned; (3) the accumulated and on-going depreciation of plant and equipment; and (4) the company's reasonable and prudent operating expenses.

When a regulated utility files for a rate increase, the Missouri Public Service Commission typically has 11 months from the filing date to make its decision.

Once the case is filed, the PSC staff -- a group of engineers, accountants and economists -- reviews the utility's books and records. This usually takes several months to complete and allows the staff to provide a non-binding recommendation to the five-member Public Service Commission. Intervenors, such as consumer groups or industrial customers, may also file recommendations in the case.

Parties will meet to discuss the issues. In some cases, agreements are reached that can settle all or some of the issues of the filing. The Commission must approve any proposed agreements.

Evidentiary Hearing

Facts of a rate case are presented during formal evidentiary hearings. Expert witnesses testify and answer questions. Written testimony is also submitted by the utility, PSC staff, the Office of the Public Counsel (the state-appointed consumer representative) and the other parties.

The five members of the PSC read the written testimony, review the exhibits and briefs, hear the cross-examination, ask the witnesses questions and weigh the evidence in order to reach a result.

The Commission usually holds local public hearings in the utility's service territory -- giving customers an opportunity to express their opinions on the rate request and report any service-related or billing issues.

Reviewing The Record

After the hearings are completed, a transcript of the case is prepared, and attorneys prepare briefs outlining their parties' positions. The Commissioners review the record and the facts of the case to make their decision.

The Commission will only authorize rate changes that are fair and reasonable. By law, the company must be allowed the opportunity to make enough money to meet reasonable expenses, pay interest on debts, and provide a reasonable return to stockholders.

The Decision

When a decision is made, the Commission announces it through a written report and order. That order is subject to court review which may be initiated by any one -- except the PSC staff -- who has filed a timely request for rehearing with the Commission.

Rate Case Components

1) Rate Base:

The Commission decides what new plant has been put in service and is now "used and useful."

The new plant is added to rate base.

The Commission identifies plant that has been removed from service/reached the end of its useful life and subtracts it from rate base.

The Commission identifies, generally based upon contested depreciation studies and depreciation schedules, how much plant has been depreciated out of rate base since the company's last rate case and removes that amount from rate base. Depreciation is a decrease in value of an item based on normal use.

2) Return on Equity (ROE):

Generally speaking, return on equity is shareholder profit on investment in the company.

The Commission evaluates testimony from multiple witnesses. Based upon that analysis, the Commission determines what is the appropriate ROE for a given utility.

The Commission applies that ROE to the previously determined Rate Base to reach a dollar amount necessary for the utility to get the appropriate return on its investment. ***(The utility is not guaranteed this return, simply a reasonable opportunity to earn it.)***

3) Expenses:

A utility has many different types of expenses. The Commission determines what level to set each type of expense. The Commission then determines what is the total dollar amount to cover all of the utility's expenses.

4) Revenue Requirement:

The Commission adds the dollar amount associated with earning the authorized ROE on the rate base to the expense total. That number gives the utility's revenue requirement.

5) Rate Design:

The Commission reviews "cost of service" information/testimony and designs rates primarily to recover from each customer class the percentage of the utility's revenue requirement equal to the percentage of the utility's cost to provide service to that customer class.

Once the Commission determines how the revenue requirement will be divided among the customer classes (residential, commercial, etc.), it must determine how best to collect that revenue from the customers in each class.

For a gas company, the Commission may require some, or all, fixed costs to be in a base rate. This can avoid rate shock in the winter by spreading the fixed cost throughout the year. Fixed costs are those incurred by customers that do not change with the amount of usage.