How The PSC Sets Rates

For most people the process the Missouri Public Service Commission uses to set the rates a public utility may charge its customers is mysterious. Utilities keep filing new rate cases and asking for more money. The Commission's Staff conducts an audit of each utility that requests a rate case and many utility expenses and spending decisions are challenged by Staff, The Office of the Public Counsel, or by one of many intervening parties during the 11-month course of a rate case.

Nevertheless, anyone faced with paying higher utility rates may question why rates go up even though the company is profitable and it may have just paid a bonus to its CEO. Perhaps the answer to that question can best be understood by examining the rates paid by customers to a utility as if they were the compensation paid by an employer to a single employee.

The rates the Commission establishes must compensate a utility in two ways: First, the Commission must allow the utility to earn enough to recover the expenses it has incurred to provide service to the public. Second, the utility must be allowed an opportunity to earn a reasonable profit on its investment. A business or organization that pays someone to do a job will compensate its employee in the same way.

Initially, the employer will compensate its employee for any expenses the employee incurs during the course of the job. Thus, an employer will reimburse its employee for a stay at a hotel while traveling for the job. In the same way, the Commission must allow rates to be set at a level that will compensate a utility for the expenses it incurs to provide utility service to the public. For example, the Commission must set rates high enough to allow an electric utility to recover the cost of the coal it burns to generate electricity and the salary it pays the linemen to repair the power lines necessary to provide electric service to its customers.

Of course, the utility cannot simply pass through any and all costs it incurs. Those costs must be reasonable and prudent. In the same way an employer will refuse to compensate its employee for unreasonable or imprudent expenses, the Commission will refuse to allow the utility to set rates that would allow it enough income to recover unreasonable expenses. For example, an employer is unlikely to compensate its employee for a weeklong stay with their spouse at a beachfront hotel in Hawaii. Similarly, the Commission may refuse to allow a utility to recover the cost of a coal contract that is above market rates, or for excessive compensation paid to a top executive.

The Commission must base its decision about the rate a utility may charge to recover its costs and to have an opportunity to earn a reasonable return on its investment, on competent and substantial evidence.

REASONABLE AND PRUDENT COSTS

Many of the issues presented to the Commission during a rate case concern the reasonableness and prudence of the utility's costs. But, just as an employer must compensate an em-

ployee for the reasonable and prudent costs the employee incurs to do his or her job, the Commission must allow a utility to charge rates sufficient for the utility to recover its reasonable and prudent costs to provide service to the public.

Compensation for reasonable and prudent expenses is not the end of the process. No employee will work only for reimbursement of job related expenses. The employee will also demand a salary or wage. For a utility, the corresponding compensation is a reasonable opportunity to earn a profit. (Contrary to popular belief, a utility is not guaranteed a profit.)

An employer does not randomly set an employee's wage or salary, nor is it a matter of the employer simply being generous or stingy toward its employee. Rather, wages and salaries are set in response to market forces. An employee, at least in theory, is paid a wage or salary sufficient to attract and retain a qualified worker within the applicable job market. Similarly, the amount of profit the Commission will allow a utility an opportunity to earn is set in response to market forces.

If an employee's pay is below market rates, that employee is likely to look for a new, better-paying job. An employer that pays below-market wages runs the risk of losing valuable production from experienced employees. A utility that is not allowed to earn a reasonable profit is in much the same situation.

CAPITAL MARKET

Although the utility is a retail monopoly and does not have to compete for customers, it does have to compete in the capital market for investors. If the Commission sets rates for a utility that are too low, the utility will not have an opportunity to earn a sufficient return on its investment. As a result, the available investment funds will flow to other utilities or companies that offer a greater potential return for a similar risk. If that happens, the utility will be starved for the capital it needs to maintain and expand its systems and will be unable to offer safe and reliable service to its customers. For that reason, the Commission must allow the utility an opportunity to earn a return on its investment sufficient to allow it to compete in the capital market against other utilities and other businesses.

REACHING A DECISION

When the Commission makes a decision about the rate a utility may charge to recover its costs and to have an opportunity to earn a reasonable return on its investment, it must base that decision on competent and substantial evidence. That evidence is presented as testimony from experts employed by the utility, from the experts the Commission employs to audit the utility, from experts employed by the Office of the Public Counsel to represent the public, and from experts employed by other interested parties who intervene in the rate case to represent their interests. After hearing and considering that competing evidence, the Commission will issue a written decision explaining how it has balanced the contending interests of all the parties.

Unfortunately, the Commission's written decisions in rate cases can be quite lengthy and large portions of those decisions may be devoted to resolution of important but detailed questions that are of interest primarily to the lawyers trying the case. As a result, many people continue to have questions and complaints about any decision that allows for an increase in utility rates. The most common complaints the Commission hears from the public are about advertising expense and large bonuses paid to utility executives. Frequently, the Commission treats such expenses as "below the line," meaning they are not included in the calculations used to determine the amount of compensation the utility can earn from the rates it charges its customers. Nevertheless, the utility ultimately obtains the money to pay those "below the line" expenses

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from the rates it charges its customers. As a result, customers of the utility understandably complain that their rates are going up to pay those costs.

HOW COSTS ARE TREATED

To understand how the Commission treats those costs and why such costs may not be the cause for increased rates, it is once again helpful to compare the utility to a single employee, this time an employee of the State of Missouri. Although the source of the state employee's wage or salary is the taxpayer, once the money is paid to the employee, it becomes the employee's money and he or she is free to spend it in any way he or she wants. The cost of staying for a week at a beachfront hotel in Hawaii might provoke outrage from taxpayers if paid to a state employee as compensation for expenses. However, the state employee might use his or her salary to take their spouse on vacation, even though that salary was paid with tax money.

In the same way, the Commission does not control how a utility chooses to spend its profits. If a utility chooses to proclaim its virtues to the public by buying advertising, the Commission usually will not allow the utility to recover those advertising costs as an expense of doing business. In the same way, the state will not reimburse its employee for a vacation as a job-related travel expense. But if a utility chooses to spend a part of its profits for such advertising it is free to do so, just as a state employee is free to spend his or her pay to take a vacation.

Similarly, the Commission may allow a utility to recover as an expense the amount for the salary it pays its CEO and other executives. If the utility chooses to use a part of its profits to pay a large bonus to those executives, that is its option. Profits are the utility's money to spend as it wishes. Remember the state employee vacationing on the beach at Waikiki; it is his or her money being spent, not tax dollars.

If the utility can afford to pay its executives bonuses, why do they need more money from ratepayers?

That is a good question, but remember, the profit the Commission will allow the utility an opportunity to earn is set by market forces in the same way an employee's wage or salary is set by market forces. The utility's profits and the employee's pay do not change depending upon how they choose to spend their money. The utility does not have a claim to a greater profit because it pays a bonus to its executives anymore than an employee can expect a raise because he or she chooses to pay for an extravagant vacation.

After hearing all the evidence, the Commission will issue a written decision explaining how it has balanced the contending interests of all the parties.

For the same reason, the amount of profit the utility is allowed an opportunity to earn, and the rates that pay for that level of profits, will not be reduced if executive bonuses are cut. The utility must answer to its shareholders for how it spends the shareholder's profits; it does not have to answer to the Commission.

No one wants to pay higher utility rates and it is certainly frustrating to see those rates increase. However, the Missouri Public Service Commission is on the job to ensure that the rates a utility charges its customers are no more than necessary to compensate the utility for the costs it incurs to provide service to its customers and to allow the utility a reasonable opportunity to earn a profit.

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