A Charge to Regulators Regarding Capital Cost Reduction Mechanisms[1]

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I want to walk you through some of the issues you must address as regulators regarding two capital cost recovery mechanisms designed to reduce risk and the cost of financing. The first is revenue-backed financing. The second is a capital cost recovery surcharge for completed projects. There are other capital risk mitigation tools such as allowing CWIP in rate base or funding projects through tax-free bonds issued by regional authorities, but for today, let's focus on the aforementioned mechanisms.

Let's start with revenue-based financing, revenue obligation charge bonds (ROCs), or securitization—all the same general principal by different names. ROCs have particular applicability for financing governmental mandates. Some are of the opinion that securitization requires express legislative authorization to make the Commission order irreversible. As the legislature mandates renewable generation, energy efficiency, AMI, carbon reduction, new base-load power stations, or even purchased power for providers of last resort, the same legislature could also enable the regulator to use ROCs. We've heard how the use of ROCs can cut the costs of capital-intensive projects by about a third. I've testified regarding how a utility can use ROCs to provide customers with price volatility protection in competitive markets at about one-tenth the premium of energy futures markets. Commissions can also use securitization to reduce the price required by third-party developers of renewable resources.

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[1] These comments can be found online at http://www.nrri.org/pubs/electricity/NRRI_Boonin_Cost_Reduction_Comments_july09.pdf.

[2] Mr. Boonin's comments and opinions are his own and not those of NRRI.

ROCs are also more applicable to mandated projects than to other investments, as there has already been a public interest determination made about the need for the project. Since the programs are mandated and ratepayers are on the hook to pay for them, isn't it reasonable to consider mechanisms that reduce the cost customers must shoulder?

I'd like to focus on three ROC-related questions:

1. Where are the profits under securitization?

2. What are the practical limits on ROCs?

3. What are your responsibilities regarding ROCs as a regulator?

First, profit motivation. Under traditional rate-base, rate-of-return ratemaking, the opportunity to profit starts with the authorized return on equity on rate base. With securitization, a utility can finance a project with 100% revenue-backed bonds. There is no equity component and no profit component in the ratemaking calculation.

So focus on creating other profit sources. For example, for power plants financed by ROCs, the regulator could set a profit incentive linked to completing the project on time and on budget or operating the plant at targeted efficiency and productivity standards. This approach ties the utility's performance to the utility's revenue and profits. Always work to align the private profit interest to the public interest.

Second, practical limits. The financial community sometimes cautions that there is a limit on the amount of special-purpose bonds a utility can absorb before the market sees the utility's financial structure as less sound. Given the recent Standard & Poor's report that found ROCs to be recession-proof, stable, versatile, and AAA rated, it is hard to envision that the financial market would place any overly restricted limit on these instruments. ROCs protect equity holders from dilution and bondholders from the politics of larger rate increase requests. If we initially focus the use of ROCs on projects where a utility is complying with mandates, we can worry about market limitations later, if necessary.

Third is a regulator's responsibility. If you knew your brother had a 10% mortgage and he could reduce it to 5% and you did nothing, I might think that you were not a responsible sibling. Regulators need to inform utilities and their legislatures about the potential benefit of ROCs. Effective regulation is not just reacting to the proposals of others. You need to identify opportunities to apply cost reducing financing techniques and make them fit within the rest of the regulatory paradigm. Only the regulator can ensure that utilities use ROCs to reduce costs while aligning the utilities' interest with the public interest.

On to capital cost recovery surcharges. I suggest applying capital cost recovery surcharges when the regulator has already determined that certain investments are in the public interest. Prudence ceases to be an issue. Properly designed, capital cost recovery surcharges reward a utility with additional revenues when the utility completes certain investments authorized by the Commission. These surcharges reduce regulatory lag and risk. Without a surcharge, when a utility completes a capital project, it stops collecting AFUDC and starts accumulating depreciation. The utility loses cost recovery until the investment is included in rate

base at the next rate case. Unlike future test year adjustments or other forecasts, utilities receive additional revenues only when they actually complete authorized projects.

A regulator must resolve many issues before implementing a capital cost recovery surcharge. What are the applicable projects? Can the utility time its rate cases to recover the costs of certain projects effectively? Does the project cause offsetting revenue or expense adjustments? What is the appropriate return to use in calculating the surcharge, and how does the surcharge affect a utility's authorized return on equity set in rate cases? Should the surcharge's calculation include accumulated depreciation from like projects already in service? Is the financial effect of the surcharge material enough to warrant establishing a surcharge? The answers to these questions will help you design effective public interest policies.

I'll leave you with these questions and now turn the program over to Commissioner McKinney.