

**REPORT OF
THE ARKANSAS PUBLIC SERVICE COMMISSION
ON MANDATORY RATE REDUCTIONS
FOR ELECTRIC UTILITIES
July 13, 2000**

INTRODUCTION

Act 1556 of 1999 provides for the restructuring of the electric utility industry in Arkansas so that retail consumers will be able to choose their supplier of generation services among competing suppliers. The Act is designed to foster a retail electric market that encourages full and fair competition among those competitors.¹

Section 21 of the Act provides:

Whereas the primary motivation for electric deregulation is achieving the lowest possible electric rates for all consumers, in order to secure this objective, a just and reasonable mandated rate reduction for residential and small business customers of electric utilities, taking service under a standard service package to be implemented at the beginning of retail open access for the duration of the freeze periods specified in Arkansas Code 23-19-402(b), as added by this act, will be the subject of hearings conducted by the House Insurance and Commerce Committee and the Senate Insurance and Commerce Committee meeting jointly or separately, in which the members will receive input from the Public Service Commission, the Attorney General's Office, and other interested parties, with findings reported to the 83rd General Assembly so that appropriate measures can be approved to assure rate goals inherent in this act are met.

This report addresses whether a rate reduction for residential and small business customers taking service under a standard service package for the duration of the freeze periods should be mandated in order to achieve "the lowest possible electric rates."

¹Ark. Code Ann. §23-19-101(d).

I. APPLICABLE LEGAL PRINCIPLES

The regulation of utilities is one of the most important functions associated with the police power of states.² Traditionally, utilities have been granted monopoly status, and states have empowered regulatory commissions to regulate the utilities' rates in order to protect consumers from monopoly exploitation. Although a variety of different methods may be used to set a utility's rates, the rates must be "just and reasonable."³ The "just and reasonable" standard requires a balancing of the interests of the utility's shareholders and its ratepayers. The shareholders' interest is earning a return on their investment; the ratepayers' interest is being charged no more than the utility's reasonable cost of providing service, including capital costs.⁴

There are constitutional ramifications with respect to the government's determining the prices a utility may charge. Specifically, a regulator may not establish rates that are confiscatory, *i.e.*, so low that they amount to a "taking" of the utility shareholders' investment. Traditionally, the utility is required by law to devote its assets to providing service to the public. Therefore, the government may not deny the utility the opportunity to recover its reasonable costs associated with providing that service:

Rates which are not sufficient to yield a reasonable return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property in violation of the 14th Amendment.

²*Arkansas Elec. Coop. Corp. v. Ark. PSC*, 461 U. S. 375, 377 (1983).

³Ark. Code Ann. §23-19-103.

⁴*See, e.g., Acme Brick Co. v. APSC*, 227 Ark. 436, 441, 229 S.W.2d 208 (1957).

Bluefield Water Works and Improvement Co. v. PSC of West Virginia, 262 U.S. 679, 690 (1923).

Under this standard, a utility is entitled to rates that give it the opportunity to earn a return equivalent to that being earned by other businesses with similar risks. *Id.* at 692-93.

However, the utility is not entitled to any specific method of ratemaking. The leading case on this issue is *Federal Power Commission v. Hope Natural Gas Co.*, 320 U. S. 591 (1944). In that case, the Court ruled that:

It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.⁵

The Supreme Court expressly “reaffirm[ed] these teachings of *Hope Natural Gas*” in its most recent opinion addressing the confiscation issue, *Duquesne Light Co. v. Barasch*, 488 U. S. 299 (1989). In *Duquesne*, the Court addressed a Pennsylvania law that prohibited two utilities' from recovering their investment in canceled nuclear power plants. In affirming the disallowance, the Court rejected arguments that ratemaking methods should be evaluated on a piecemeal basis, and stated:

[t]he overall impact of the rate orders . . . is not constitutionally objectionable. No argument has been made that these slightly reduced rates jeopardized the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for the risk associated with their investments. . . .⁶

The Arkansas Public Service Commission (“APSC” or “Commission”) is an agency of the legislature and, in setting rates, it acts in a legislative capacity.⁷ The General Assembly can change the rules

⁵320 U. S. at 602.

⁶488 U. S. at 312.

⁷*APSC v. Lincoln-Desha Telephone Co.*, 271 Ark. 346, 350, 609 S.W.2d 20 (1980).

applicable to a utility's regulated rates so long as the legislation does not violate the Constitutional strictures discussed above. Although the Court in *Duquesne* upheld the statute at issue in that case, it cautioned as follows:

This is not to say that any system of ratemaking applied by a utilities commission, including the specific instructions it has received from its legislature, will necessarily be constitutional....[A] [s]tate's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions.⁸

These cases indicate that there is no prohibition *per se* against the General Assembly's enacting mandatory rate reductions. However, those reductions would be unconstitutional as applied if they result in confiscatory rates for a specific utility. It is therefore unclear what form the legislation might take. It may not be practical for the General Assembly to address the particular economic circumstances of each affected utility in crafting legislation.

II. POLICY CONSIDERATIONS

As stated in Section 21 of Act 1556, the primary motivation in electric restructuring is to achieve the lowest possible rates for all consumers. There are competing considerations, however, in determining whether a mandatory rate reduction is the most effective means of achieving that goal. Proponents of rate reductions point to the potential for market-based price increases to consumers as a result of the change from cost-based rates to market-based prices. Rate reductions (or freezes) will protect consumers from those increases *during the period that those reductions are in effect*.

⁸488 U.S. at 304.

There are legitimate grounds for concern, however, as to the effect of mandatory reductions on consumer prices over the long-term. Artificially low rates may impede competition by making it unprofitable for new competitors to enter the market. If new competitors do not enter, consumers may be subject to above-market price increases by the incumbent utilities at the expiration of the reduction/freeze period. Over the long-term, the discipline of effective competitive markets should be the most effective means of achieving the lowest possible rates for consumers.

III. RATE MAKING CONSIDERATIONS

In determining whether a rate reduction should be made, consideration must be given to the current and projected earnings level of each electric utility. Since 1998, the APSC has approved general rate changes for five of its regulated retail electric utilities.⁹ In addition, other ongoing and anticipated APSC proceedings will affect Arkansas retail rates.

The wholesale rate change by Arkansas Electric Cooperative Corporation ("AECC") approved in Docket No. 99-243-TF reduced its wholesale power costs to its member distribution cooperatives by an average of 5.4%. The disposition of the reduced wholesale power cost will be addressed during the unbundling proceedings for the distribution cooperatives. In addition, all of the electric distribution

⁹**Farmers Electric Cooperative**, Docket No. 98-368-U, rate decreases for all classes except irrigation and reflecting the savings from a new EAI wholesale power contract; **Mississippi County Electric Cooperative**, Docket No. 99-356-TF, rate decreases for all classes except special contracts as result of immediate pass-through of savings from Docket No. 99-243-TF AECC rate reduction; **Oklahoma Gas & Electric ("OG&E")**, Docket No. 98-036-U, rate decreases for all customer classes; **SWEPCO**, Docket No. 98-339-U, class rates of return equalized with no change in rate for residential, increase in lighting class rates, rate decreases for all other classes; and **Empire**, Docket No. 98-043-U, rate increases for all classes.

cooperatives filing newly prepared cost of service studies in their unbundling dockets will undergo a traditional rate review during 2000 through 2001.

Rate impacts are expected to result from mergers involving two Arkansas investor-owned utilities ("IOUs")—Southwestern Electric Power Co. ("SWEPCO") and Empire District Electric ("Empire"). In Docket No. 98-172-U, the APSC approved the merger of SWEPCO's parent, Central and South West Corp., into American Electric Power Co. The rate impacts for SWEPCO's customers include:

- the sharing of net non-fuel merger savings through a credit rider that reduces its rates in five annual increments expected to begin in July 2000;
- 100% pass-through of all fuel savings based on combined joint dispatch;
- a most-favored-nation clause ensuring that Arkansas ratepayers will receive the full equivalent of any benefits and protections ordered in any other jurisdictions in excess of those benefits and conditions ordered in Arkansas;
- hold harmless clauses ensuring that Arkansas ratepayers are protected from adverse merger-related effects; and
- a moratorium on general rate increases prior to January 1, 2002.¹⁰

On January 31, 2000, Empire and UtiliCorp United, Inc., ("UtiliCorp") filed a joint application in Docket No. 00-021-U requesting the Commission's approval of the companies' plans to merge. UtiliCorp intends to operate Empire as a separate and distinct retail energy distribution unit. Empire expects to file a rate case October 1, 2000, to recover costs associated with its State Line Combined Cycle Plant, which is scheduled to go into service by June of 2001. Once those new rates are effective, the companies

¹⁰It is anticipated that SWEPCO will add production capacity in 2002 in order to meet customer requirements. It may then seek recovery of a portion of the cost of that capacity through the standard service package if it elects to have the rates for that service set using traditional regulatory methods. Ark. Code Ann. §23-19-402(a).

propose to implement a five-year moratorium on rate changes. In the fifth year of the moratorium, a rate case would be filed in Arkansas for the Empire distribution unit to include ongoing net benefits from the merger and recovery of 50% of the unamortized acquisition premium.¹¹ Those proposals are currently pending before the Commission.

Pursuant to a Stipulation and Settlement Agreement in Docket No. 96-360-U, Entergy Arkansas, Inc. ("EAI") is subject to a base rate¹² freeze until July 1, 2001. Excess earnings, as determined by annual review, are placed in a Transition Cost Account ("TCA"). If the Commission determines that EAI has stranded costs, the TCA can be used to offset those costs. Any excess funds in the account after stranded cost recovery can be returned to ratepayers by order of the Commission. EAI has had excess base rate earnings since the inception of the TCA,¹³ which suggests the possibility for a future rate decrease after July 1, 2001.

Charts ranking Arkansas residential, commercial, industrial, and average rates during 1999 are appended to this report as Attachment I. For residential customers, rates range from 5.7¢ per kWh for OG&E to 8.21¢ per kWh for Entergy. All twenty-one Arkansas utilities ranked below the national average residential rate for the period, and eleven ranked below the regional average. Commercial rates ranged from 4.25¢ per kWh for OG&E to 8.06¢ for Ashley-Chicot Electric Cooperative. Thirteen utilities'

¹¹As provided for in Ark. Code. Ann. §23-19-106(e), Empire has indicated that it will delay implementing retail open access in its service area until January 1, 2004. (Reference the Direct Testimony of John McKinney, pages 32-33.)

¹²There are separate revenue requirements for Rider M26 nuclear decommissioning and Rider M33 Grand Gulf that are adjusted annually.

¹³Annual updates to the TCA are filed in Docket No. 98-114-U. The January 1, 2000, balance is was approximately \$114 million.

commercial rates were above the regional average, with three of the thirteen also above the national average. Industrial rates ranged from 2.89¢ per kWh for Mississippi County Electric Cooperative to 6.28¢ per kWh for Petit Jean Electric Cooperative. Ten utilities' industrial rates ranked above the regional and the national average.

IV. STATES SURVEY

Commission Staff surveyed the other twenty-two states that have entered into electric industry restructuring activity.¹⁴ Legislation has been passed in eighteen of those states. Eleven of those eighteen states have enacted legislative provisions for rate reductions. Eight of those eleven rate reductions were incorporated in the enabling restructuring legislation as a result of negotiation among the affected parties.¹⁵ Because the affected utilities agreed to the reductions, they have in effect waived any claims that the rates are confiscatory, and the reductions are not considered "mandatory" as contemplated in Section 21. In three states, the mandated reductions were based on the fact that the affected utilities were over-earning.¹⁶ It does not appear that any state has effected a legislative rate reduction in the absence of one of those two factors.

The details of each state's legislative rate reduction are provided in Attachment II.

¹⁴Commission Staff additionally surveyed a group of stakeholders and other interested parties for their views on mandatory rate reductions. The results of that survey are appended as Attachment III.

¹⁵Those include California, Delaware, Illinois, Massachusetts, Michigan, New Jersey, Ohio, and Pennsylvania. It should be noted that the California and Michigan "reductions" are financed by bonds, the costs of which will be recovered from ratepayers at a later date. This financing of a rate reduction is referred to as "securitization".

¹⁶Those include Connecticut, Maryland, and Texas.

CONCLUSION

As discussed above, any mandatory rate reductions must consider the economic circumstances of each affected utility in order to pass constitutional muster. Thus any legislation mandating an across-the-board rate reduction would be in danger of being found unconstitutional in its application to a particular utility. The only exception to this rule is when the utility agrees to waive its constitutional arguments in the context of negotiations, as has been the case in several other states. There is no constitutional or other legal impediment to the General Assembly's addressing the potential for rate reductions on a utility-by-utility basis. However, pursuant to its existing jurisdiction and authority, the Commission is engaged in an ongoing process of evaluating the rates and earnings of all jurisdictional electric utilities. If the existing rates and earnings of any jurisdictional electric utilities are found to be excessive the Commission has the necessary authority to adjust such rates downward to a just and reasonable level.