

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER of the Petition of the) REGULATORY DIVISION
Montana Consumer Counsel to Amend)
ARM 38.5.2527 and 38.5.2528) DOCKET NO. N2017.9.76

**COMMENTS AND RESPONSE TO THE PETITION OF THE MONTANA CONSUMER
COUNSEL TO AMEND ARM 38.5.2527 AND 38.5.2528**

The Montana Consumer Counsel (MCC) applied on September 25, 2017, to either amend or repeal the Standard Rate Rules in ARM 38.5.2527 and 38.5.2528.

First, a brief background on myself. I have both a degree in Accounting and in Finance from Montana State University. I retired from the Montana Public Service Commission (PSC) in 2015 after serving as a rate analyst for 18 years. During that time, I was the primary PSC analyst for small water and waste water utilities.

The purpose of the standard rate and simplified regulatory process was to encourage small utilities to be compliant without a burdensome and costly regulatory process. Justin Kraske, Chief Legal Counsel for the PSC, Kate Whitney, Regulatory Administrator of the PSC, and myself, under the guidance of Commissioner Gallagher drafted the small water rules with this goal in mind. During the drafting process, input was sought by a number of stakeholders including the MCC.

Traditional rate making using rate base rate of return regulation simply will not work for small utilities. When I attended the advanced regulatory school in Albuquerque, New Mexico, it was emphasized by the instructor numerous times that traditional rate making is a slow death spiral for most utilities and is particularly exacerbated in the case of small utilities. As an extreme example, if a utility has zero rate base, under traditional rate making, the utility is allowed to recover only its expenses. The investor in the utility gets no return even though there is the obligation to serve. As a result, the market value of the system is forced to be worthless, regardless of the actual value of the system.

I agree that the standard rules could be modified, but disagree theoretically, philosophically and intellectually with the approach that the MCC is suggesting. I do see a number of changes that could be considered as an alternative to MCC's proposal.

MCC's position in a nutshell, appears to be that a small utility can file a standard rate case or that a small utility can file a standard rate case.

Given that, the following changes should be considered:

1. The standard rates should be tied to an external source.

Tying the standard rates to an outside source such as the DNRC survey assures both the company and customers that there will be little volatility in pricing. If one or two of the survey participants increases or decreases rates, it will have little overall effect on the average rate. A potential customer that purchases a home will know up front what the rates will be, regardless of what the developer may be charging at the outset. Developers are developing, they have rarely operated a utility and oftentimes do not charge or dramatically undercharge for water and wastewater utilities in order to encourage people to purchase the homes. I believe this is where the actual "perversion" occurs to which MCC is referring. Over time, the standard rates may gradually increase, or decrease, but would not be subject to the volatility of a rate case. The rate shock of adjusting rates to a standard rate is minimized by the utility's and the PSC's willingness to phase the change in over time.

2. The standard rates should be determined by the Montana Public Commission to be considered "reasonable and prudent."

There is no better proxy for the cost of a product than what is being charged for it in the market. If you look at the price of fuel at a gas station, it is virtually the same everywhere, but each individual station's cost structure is a little different. Some may be selling it at a loss, because they can make up the loss through sales in other parts of the business, a loss leader, if you will. Others may make a small amount simply because they can purchase in larger quantities. But overall the expenses pretty much total the same amount. If a station starts charging a materially different price, it would either lose customers to competitors or lose money.

Applying that concept to small utilities, it would make sense that similar utilities of a similar size, delivering a similar product would be charging similar rates to what others are charging. The DNRC survey includes many small utilities including water districts, homeowner's associations and a number of municipalities. All of these entities try to keep the rates as low as possible, oftentimes shortchanging necessary infrastructure repair and charging only for the pumping costs. All have the ability to set rates at whatever they wish, are not subject to regulation and do

not pay taxes. Even though each of the entities individually may have slightly different cost structures, on average, the overall expense of operating a system is similar. This is not the case for privately owned companies. A small utility has in addition to the similar operating expenses, income taxes, property taxes and regulatory expense.

A significant problem with using a traditional rate making approach for small utilities is the determination of risk. Risk is the proxy of what a utility would earn in a “competitive” environment. In order to avoid the extreme expense of attempting to quantify that risk, small utilities often request a waiver of that part of the traditional rules and use the last approved Return on Equity of companies often 100 times or more its size. Standard rates remove from consideration the cost structure and return on equity. The standard rates limit revenue to a specific amount regardless of the costing structure of the company. As indicated in the preceding paragraph, overall expenses are about the same and given that many of the small utilities that were in the survey attempt to charge as little as possible, there simply are no “windfall” profits at the average rate.

To use the average rate as the proxy for competition is not an unreasonable approach to the determination of “reasonable and prudent.” Rates once set would only change when the average changes. The PSC could simply restrict changing rates for a period of time, such as a biannual adjustment.

Setting standard rates would have the secondary advantage of setting a price cap as the maximum that can be charged unless a company applies for a different methodology. During the ETIC meeting, it was brought up that there is no “de minimis” provision in the present law. The standard rate cap would not incentivize utilities to reorganize into numerous smaller utilities in order to qualify for that provision, should it ever be enacted.

Advantages of utilizing a standard rate that by definition is “reasonable and prudent” would not only allow rate stability for the customers but would insure regulatory certainty for both the customer and the utility.

3. The MCC should be allowed to intervene and offer comment on the rates.

It is MCC’s constitutional right to intervene in any of the rate applications, but its participation should be limited to comments.

4. If the Commission determines additional information is required to determine if standard rates are in fact “reasonable and prudent”, any costs incurred by the company should be fully recoverable. Those costs that are incurred by the company should be fully recoverable in the following 12 months that rates become effective, After the costs are fully recovered, rates should be adjusted to reflect the change.

A rate case or even additional inquiry requires a private company to incur legal and possibly consulting expenses. Those expenses come out of the company’s immediate cash flow. The costs should be paid back to the company as quickly as possible in order to negate the long-term effects of that impact on cash flow.

5. The standard rates should remain in place until such time as a company wishes to change its rates.

The costs of a rate case, either traditional or an operating ratio method will include significant legal and consulting expenses. It should be the company’s business decision to determine whether it wishes to settle for the standard rates or pursue additional revenue through a rate case.

MCC’s petition, though its intent may be well meaning, contain a number of arguments that really should have been expressed during the rule-making process, and proposes for all practical purposes a standard rate case or at a minimum a rate case process in order to establish rates. MCC’s proposal is the antithesis of why the standard rate rules were established and its petition should be denied. The PSC should take this opportunity to establish once and for all that the standard rates are reasonable and prudent.

Respectfully submitted this 23rd day of October, 2017.

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