

PROPOSED RULEMAKING

PENNSYLVANIA PUBLIC UTILITY COMMISSION

Advance Notice of Proposed Rulemaking for Revision of the Commission's Regulations on Automatic Adjustment Clauses Related to Electric Default Service

Public Meeting held
May 22, 2014

Commissioners Present: Robert F. Powelson, Chairperson; John F. Coleman, Jr., Vice Chairperson; James H. Cawley; Pamela A. Witmer; Gladys M. Brown

Advance Notice of Proposed Rulemaking for Revision of the Commission's Regulations on Automatic Adjustment Clauses Related to Electric Default Service;
Doc. No. L-2014-2421001

Advance Notice of Proposed Rulemaking Order

By the Commission:

In order to fully recover the cost of providing service, public utilities are permitted to utilize automatic adjustment clauses to increase or decrease rates to reflect changes in certain costs. Traditional methods of reconciliation accounting could, however, cause a great deal of volatility in utility service rates associated with the recovery of revenue and cost imbalances created by the use of these automatic adjustment clauses. The Pennsylvania Public Utility Commission's (Commission) objective is to ensure that: (1) utilities' rates reflect projected costs as accurately as is feasible, (2) utilities are able to fully recover their just and reasonable costs and (3) customers pay the full cost of service. The Commission also desires to establish a uniform policy regarding whether interest is recoverable when reconciling costs through automatic adjustment clauses and the rate of interest that is paid or collected.

To accomplish these objectives, the Commission proposes to establish a symmetrical rate of interest which will be applicable to both over and under collections resulting from the reconciliation of utilities' actual costs and revenue collected through automatic adjustment clauses regarding electric default service. If the Commission finds that establishing this uniform interest to electric default service does not adequately accomplish the Commission's objectives stated above, the Commission will consider establishing a modified interest rate applicable to "excessive" portions of over and under collections. By way of this Advance Notice of Proposed Rulemaking Order, the Commission seeks comments from all interested parties on its proposal to apply a symmetrical rate of interest to the over and under collections resulting from reconciliation of automatic adjustment clause costs and revenues regarding electric default service.

Background

Section 1307(a) of the Public Utility Code, 66 Pa.C.S. § 1307(a), generally provides that public utilities may establish automatic adjustment clauses. Automatic adjustment clauses allow utilities to increase or decrease rates to reflect changes in specific costs without the extensive filing requirements and review process of a traditional base rate case. 66 Pa.C.S. § 1307(a). Some

examples of costs that are recovered through automatic adjustment clauses include, but are not limited to: Electric Default Service, Act 129 Energy Efficiency and Conservation Programs, Smart Meter, Universal Service, Distribution System Improvement Charges and the Alternative Energy Portfolio.

Before implementing an automatic adjustment clause, public utilities must file a tariff, or tariff rider, for the Commission's approval. Id. The tariff or tariff rider will outline the specifics of each automatic adjustment clause, including: to which customers the rate applies, how often the rate is adjusted (i.e. monthly, quarterly, semi-annually, or annually), which costs are recoverable and the reconciliation period.

Within thirty days following the end of the reconciliation period set forth in the tariff, each public utility using an automatic adjustment clause must file with the Commission a statement specifying the total revenues received pursuant to the adjustment clause, the total amount of expenses incurred pursuant to the adjustment clause and the difference between the total revenues received and the total expenses incurred. 66 Pa.C.S. § 1307(e). The difference between the total revenues received and the total expenses incurred is referred to as the over or under collection. After reconciling their actual costs with what was recovered from consumers, utilities then make adjustments to their rates to either refund over-collected amounts to customers or collect under-collected amounts from customers.

Ideally, utilities would reasonably forecast and match expenses to sales, resulting in only minor over or under collections. Unfortunately, this may not always be the case going forward. Traditional methods of reconciliation accounting and of allocating costs to rate classes could cause a great deal of volatility, especially in the electric default service market. In addition, the rules vary as to whether interest is paid or collected on over and under collections and also as to the rate of interest that is paid or collected. Further, these interest rates are often not reflective of current market conditions. As a result, utilities may have little or no incentive to accurately forecast expenses and sales and the amount of costs that are over-collected or under-collected could potentially be significant.

The Commission believes that many of the utilities' costs are currently being forecasted accurately. However, in order to specifically meet the Commission's objective that utilities' current prices reflect current costs as accurately as is feasible, the Commission desires to set forth uniform rules regarding default service related automatic adjustment clauses. Specifically, the Commission desires to create uniformity as to whether interest is to be paid or collected on over or under collections and the rate of interest that is paid or collected.

Discussion

A. Current Varying Interest Rate Structure

By way of background, the Public Utility Code (Code) and the Commission's Regulations expressly permit reconciliation for default service costs through automatic adjustment clauses. 66 Pa.C.S. § 2807(e)(3.9); 52 Pa. Code § 54.187(b). Section 2807(e)(3.9) of the Code specifically provides that electric default service providers may recover all costs incurred under a Commission-approved competitive procurement plan pursuant to a

reconcilable automatic adjustment clause under 66 Pa.C.S. § 1307 (relating to sliding scale of rates; adjustments). 66 Pa.C.S. § 2807(e)(3.9). As previously stated, however, the rules vary as to whether interest is paid or collected on over and under collections and also as to the rate of interest that is paid or collected.

The guiding principal of any adjustable rate approved under Section 1307 of the Code, in addition to its being in the public interest, is that it comply with the just and reasonable mandate of 66 Pa.C.S. § 1301 (relating to just and reasonable rates). Section 1307 specifically seeks to ensure that qualifying rates provide utilities with the opportunity to achieve a just and reasonable return. Thus, a primary purpose of Section 1307 is to provide qualified adjustable rate relief to utilities that may be subject to significant expense swings.

The adjustable expense recovery permitted under Section 1307 of the Code is limited to those expenses expressly authorized, or those easily identifiable, variable and beyond a utility's control. In the wake of electric restructuring, the Commission has approved a host of automatic adjustment clauses for EDCs to recover, including electric default service expenses. Costs recoverable through automatic adjustment clauses related to electric default service include, but are not limited to, the costs to procure energy, capacity, ancillary services, Federal Energy Regulatory Commission approved transmission charges and administrative costs associated with portfolio procurements for the default services supply.

This Advance Notice of Proposed Rulemaking Order focuses only on those automatic adjustment clauses related to electric default service as bulleted below. The Commission has limited the proposed application of a uniform interest rate paid or collected on over or under collections resulting from reconciliation of automatic adjustment clauses to electric default service for several reasons. First, all electric distribution companies (EDCs) use automatic adjustment clauses related to electric default service. Second, default service represents the largest dollar amount on most consumer electric bills and invoices (other than distribution). Third, default service is still the electric service used by a majority of customers in Pennsylvania. Accordingly, the proposals set forth herein for comment regarding the uniform interest rates applicable to over and under collections are limited to the following automatic adjustment clauses related to electric default service:

- Price-to-Compare (PTC)
- Hourly Pricing Default Service Rider (HPDSR)
- Transmission Service Charge (TSC)
- Generation Supply Charges 1 & 2 (GSC-1 & GSC-2)
- Generation Supply Adjustment 1, 2, 3, 4 (GSA 1, 2, 3, 4)
- Generation Supply Service Rate (GSSR)
- Default Service (DS)
- Default Service Supply (DSS)

To provide an example of varying interest rates set forth in these automatic adjustment clauses, PPL Electric Utilities Corporation (PPL), an EDC, utilizes the following automatic adjustment clauses related to electric default service: a Transmission Service Charge (TSC), a Generation Supply Charge-1 (GSC-1) and a Generation Supply Charge-2 (GSC-2). PPL's TSC is computed separately for each of the following four customer classes: (1) residential, (2) small commercial and industrial, (3) large

commercial and industrial-primary and (4) large commercial and industrial-transmission. PPL's GSC-1 applies to residential and small commercial and industrial customers. PPL's GSC-2 applies to large commercial and industrial customers.

For the TSC, interest is calculated at an "appropriate rate" under Section 1308(d) of the Code. 66 Pa.C.S. § 1308(d). Section 1308(d) defines interest as "the average rate of interest specified for residential mortgage lending by the Secretary of Banking in accordance with the act of January 30, 1974 (P. L. 13, No. 6), referred to as the Loan Interest and Protection Law." 66 Pa.C.S. § 1308(d). This Residential Mortgage Interest Rate is based on the monthly index of long term United States Government Bond Yields. Loan Interest and Protection Law, Act of Jan. 30, 1974, P. L. 13, No. 6. (Loan Interest Act). The Pennsylvania Residential Mortgage Interest Rate changes monthly. In 2013, the Residential Mortgage Interest Rate ranged from a low of 4.5% to a high of 6.0%.

For the Generation Supply Charges, interest on under collections is calculated at the legal rate of interest, and interest on over collections is calculated at the legal rate of interest plus two percent annual interest. The legal rate of interest was also defined by the Loan Interest Act and codified at 41 P. S. § 202. Section 202 reads, in pertinent part, "[r]eference in any law or document...to 'legal rate of interest' . . . shall be construed to refer to the rate of interest of six per cent per annum." 41 P. S. § 202. Under this statutory definition of legal interest, PPL recovers under collections of its Generation Supply Charges with six percent (6%) interest. PPL refunds over collections of its Generation Supply Charges with eight percent (8%) interest. 52 Pa. Code § 54.187(g).

In addition to the residential mortgage interest rate and the legal interest rate, there is also the prime interest rate. The prime interest rate is the interest rate charged by banks to their most creditworthy customers. The prime interest rate is almost always the same amongst major banks, and adjustments to the prime interest rate are made by banks at the same time. The prime interest rate is usually adjusted at the same time and in correlation to the adjustments of the Federal Funds Rate (the interest rate that banks charge each other for overnight loans made to fulfill reserve funding requirements). As of May 2014, the prime interest rate is 3.25% in the United States.¹

As exemplified by PPL's Generation Supply Charges, interest rates on under and over collections are often asymmetrical. Asymmetrical interest rates create an incentive for the utilities to under project or under collect in order to avoid over collection penalties and to receive an interest rate higher than that which can be found in the market. This practice can lead to an understated price-to-compare (PTC). An understated PTC undermines the competitive market because electric generation suppliers (EGSs) cannot under collect and then make-up that under collection later as can the utilities. This Advance Notice of Proposed Rulemaking Order will recommend for comment the use of symmetrical interest rates for both under and over collections.

The Commission's current use of the legal rate of interest for under collections and the legal rate of interest plus 2% for over collections, used for most electric default service automatic adjustment clauses, results in interest rates that are well above current market-based rates. This Advance Notice of Proposed Rulemaking Order will

¹ The Wall Street Journal, Market Data Center, http://online.wsj.com/mdc/public/page/2_3020-moneyrate.html (May 20, 2014).

recommend for comment the use of the prime interest rate for the calculation of interest on both over and under collections resulting from automatic adjustment clauses related to electric default service. The Commission believes that using the prime interest rate is most appropriate here as this rate is most commensurate with market rates. Additionally, the prime interest rate is publicly known and available, and transparent. Further, the prime interest rate also reflects the terms and risks inherent in the utility reconciliation process.

The proposals set forth herein for comment are supported by the comments filed in response to the Commission's Default Service Reconciliation Interim Guidelines at Docket No. M-2012-2314313 (Order entered August 14, 2012). In that Order, the Commission sought comments on several questions, including: "Should the Commission alter how interest is charged/credited on under/over collections? Is the current statutory rate of interest reflective of market rates of interest? How can these interest provisions be improved?" Commission Order at 4.

Citizens' Electric Company of Lewisburg, PA and Wellsboro Electric Company (Citizens'/Wellsboro) are two of the smallest EDCs in Pennsylvania. In response to the above-referenced questions, they stated that "[t]he Commission should alter the method for charging/crediting interest on under and overcollections by eliminating asymmetrical interest rates and, instead, applying an equal interest rate reflective of market conditions." Citizens'/Wellsboro Comments at 7. Citizens'/Wellsboro further responded that the "[a]pplication of asymmetrical interest rates serves no purpose" because "today's competitive retail and wholesale market structure greatly marginalizes any threat of EDC price manipulation," and "the Commission has developed far more effective means of ensuring least cost procurement." Citizens'/Wellsboro Comments at 7-9.

Citizens'/Wellsboro also discussed how "the Commission adopted the legal rate of interest for default service supply reconciliations from the reconciliation provisions in the Gas Choice Act. 66 Pa.C.S. § 1307(f)(5)." Citizens'/Wellsboro Comments at 10. Instead of the legal rate of interest, Citizens'/Wellsboro put forth that "the Commission should apply an interest rate tied to some indicator of market conditions." Citizens'/Wellsboro Comments at 10-11. Citizens'/Wellsboro offered the residential mortgage interest rate or the prime interest rate as alternatives to the legal rate of interest. Citizens'/Wellsboro Comments at 11.

In agreement with comments provided by Citizens'/Wellsboro, Constellation Energy Commodities Group, Inc., Constellation NewEnergy, Inc., Exelon Generation Company, LLC, and Exelon Energy Company (collectively, Exelon), similarly provided that the Commission should apply the same interest rate to both over and under collections "to further reduce the potential that an EDC would favor under estimates of the C-factor as a general practice." Exelon Comments at 6. Exelon also agreed that "the Commission should choose a transparent, market-based interest rate index as the basis for the interest charged and collected for collection variances." Exelon Comments at p. 6. Exelon explained that this market-based interest rate index would replace above-market rates which can create an incentive for an EDC to under-collect. Exelon pointed out that in relation to certain automatic adjustment clauses, if a utility over-collects, the utility must refund the money with interest at a rate of 8%. Under the same automatic adjustment clause, if a utility under-collects, the utility receives

interest at a rate of 6% from its customers. Exelon noted that structure can create an incentive for an EDC to intentionally underestimate its C-factor in an attempt to avoid the 8% penalty and benefit from the 6% return. Exelon Comments at 6.

Metropolitan Edison Company, Pennsylvania Electric Company, Pennsylvania Power Company and West Penn Power Company (collectively, FirstEnergy Companies) shared the concerns of Exelon. They stated, "[s]ince the asymmetrical interest provisions in the Commission's regulations require an EDC to pay interest at a higher rate on over-collections than it recovers on under-collections, there may be a perception that default service rates are understated..." FirstEnergy Companies Comments at 8. The FirstEnergy Companies argued that "[t]he several concerns attendant with the asymmetrical application of interest rates could be fully resolved by modifying or waiving the Commission's regulations to remove the asymmetrical interest provision." FirstEnergy Companies Comments at 8. The FirstEnergy Companies also noted that the legal rate of interest may be higher or lower than a market-based interest rate "depending upon the point in time, or over what period, an evaluation is to occur." FirstEnergy Companies Comments at 8.

Similarly, the National Energy Marketers Association (NEM) also recognized that asymmetrical interest rates provide the utility with an incentive to under collect and to understate the PTC. NEM Comments at 7. This then "provides consumers with an erroneous benchmark price for evaluating competitive offers." NEM Comments at 8. NEM characterized the interest rate on under collections (i.e. the legal rate of interest or 6%) as "well in excess of the current market rate of interest." As utility costs are fully recoverable and the utility is at no risk of loss, this above market rate is a "regulatory windfall." NEM Comments at 7. NEM encouraged the Commission to base the interest rate on market indicia. NEM Comments at 7.

The Office of Consumer Advocate (OCA) identified the same concerns as the aforementioned stakeholders. As the legal rate of interest is greater than short term interest rates, there may be an improper incentive to under collect in order to take advantage of the 6% rate. Also, the 8% rate on over collections is a heavy penalty for over collections which adds to the incentive to "underestimate costs and 'err on the side of caution.'" OCA Comments at 5. The OCA submitted that "[i]t would be appropriate to adjust the interest rate to more closely align with current short term interest rates." OCA Comments at 5.

The Office of Small Business Advocate (OSBA) offered similar comments. The above-market interest rate on under collections "creates a strong incentive for the DSP [default service provider] to 'low-ball' its cost forecast." OSBA Comments at 17. The above-market interest rate on over collections "creates an even greater disincentive for DSPs to over-forecast costs." OSBA Comments at 18 (emphasis in original). These incentives add to EGSs' fears that their prices are uncompetitive because the DSPs have under-estimated costs. OSBA Comments at 18. The OSBA suggested that the Commission use "a reasonable market parameter for short-term interest rates" to set interest on over and under collections. Id. The OSBA argued in favor of symmetrical interest rates, as any differential between the interest rate applied to over and under collections would continue the incentive to under collect. Id.

Duquesne Light Company (Duquesne) agreed that "[r]ates should be symmetric, uniform and market-based." Duquesne Comments at 10. PECO Energy Company

(PECO) similarly suggested that the current methodology could be improved by establishing market-based symmetrical interest rates. PECO Comments at 4. In addition to symmetrical interest rates, PPL advanced “that the interest rate used should be a publicly known and available rate that is consistent with the terms and risks associated with utility reconciliation processes.” PPL Comments at 8.

As additional support for the proposals contained in this Advance Notice of Proposed Rulemaking Order, the Commission analyzed House Bill 1188, H.R. 1188, Printer’s No. 1484 (Pa. 2013). House Bill 1188, currently under consideration by the General Assembly,² would amend the Gas Choice Act, 66 Pa.C.S. § 1307(f), to change the interest rate from the legal rate of interest to the prime interest rate for both over and under collections. The proposed language specifically states that “[r]efunds to customers shall be made with and recoveries from customers shall include interest at the prime rate for commercial borrowing in effect 60 days prior to the tariff filing made under paragraph (1) [relating to the filing of tariffs by natural gas distribution companies] and as reported in a publicly available source identified by the commission or at an interest rate which may be established by the commission by regulation.” Id.

At this time the Commission is not aware of any intentional over or under collecting being done by EDCs in order to earn more interest. However, in addition to the volatility of rates caused by unpredictable weather and shopping patterns of customers, there is the widely-recognized possibility that an EDC could attempt to use the automatic adjustment clause methodology related to electric default service to increase interest earnings. In general, EDCs have a 50/50 split in over collections versus under collections relating to electric default service. Additionally, the over and under collections by month are well within a reasonable percentage of allowable costs in the associated months. However, in order to ensure accurate projections and to create uniformity, the Commission proposes to apply a symmetrical interest rate, reflective of market conditions, to under and over collections as set forth below.

B. Proposed Uniform Interest Rate Structure

By way of this Advance Notice of Proposed Rulemaking Order, the Commission seeks comments on its proposal to establish a symmetrical rate of interest which will be applicable to over and under collections resulting from the reconciliation of utilities’ costs and revenues resulting from automatic adjustment clauses related to electric default service. The proposed applicable rate of interest on over and under collections would be interest at the prime rate for commercial borrowing in effect on the last day of the month the over or under collection occurred, as reported in the Wall Street Journal or other publically available source identified by the Commission. For example, the interest rate applied to over or under collections in the month of March would be the prime rate that was in effect on March 31. This rate of interest will be computed monthly from the month the over collection or under collection occurs to the effective month that the over collection is refunded to customers or the under collection is collected from customers. Additionally, this rate of interest will apply universally to all over and under collections reconciled through the automatic adjust-

² House Bill 1188 is currently in legislative committee and has not yet been approved.

ment clauses related to electric default service, as bulleted in Part A of this Advance Notice of Proposed Rulemaking Order.

In the event the Commission finds that the application of the symmetrical rate of interest set forth above does not adequately prevent EDCs from using automatic adjustment clause methodology related to electric default service to increase interest earnings, the Commission may consider the application of a modified interest rate applicable to “excessive” portions³ of over and under collections. In addition to the prime rate of interest applicable to the “non-excessive” portion of all over and under collections, the Commission may consider applying a modified interest rate of prime rate plus 100 basis points on the “excessive” portion of all over collections and a modified interest rate of prime rate minus 100 basis points on the “excessive” portion of all under collections. This modified interest rate, adjusted up or down by 100 basis points, would only apply to the “excessive portion” of the over or under collection. This modified rate of interest would not apply to the “non-excessive” portion of the over or under collection.

The Commission recognizes that the interest rate structure proposed herein does not currently comply with the Commission’s regulations, 52 Pa. Code §§ 1.1—111.14, and/or public utilities’ current tariffs regarding electric default service. As such, after reviewing the comments provided in response to this Advance Notice of Proposed Rulemaking Order, the Commission intends to initiate a rulemaking to amend our regulations, as necessary, to implement this new interest rate structure. Additionally, the Commission’s Final Rulemaking Order may direct EDCs to revise their tariffs and tariff riders to reflect this proposed interest rate structure. To execute this proposal, the Commission envisions using the following language to amend our regulations and to revise the EDCs tariffs and tariff riders:

Interest collectible on over collections and under collections. If revenues exceed costs, the over collections shall be refunded with interest. If costs exceed revenues, the under collections shall be collected from customers with interest. Interest on over collections and under collections shall be computed at the prime rate of interest for commercial banking in effect on the last day of the month the over or under collection occurred, as reported in the Wall Street Journal or other publically acceptable source identified by the Commission. Interest shall be computed monthly from the month the over collection or under collection occurs to the effective month that the over collection is refunded or the under collection is collected.

C. Anticipated Effects of the Proposed Uniform Interest Rate Structure

Although the Commission cannot completely eradicate all imbalances in the amount of costs that are overcollected and undercollected, the proposed symmetrical interest rate structure set forth herein will deter utilities from inaccurately forecasting costs and sales to improperly increase interest earnings. This symmetrical application of interest to over and under collections uses the prime rate of interest which is not only commensurate with market rates, but is also publicly known, available and transparent. Overall, application of the symmetrical

³ When determining whether a portion of an over or under collection is “excessive,” the Commission would use a threshold equal to a percentage of certain costs of the EDC related to the relevant automatic adjustment clause.

rate of interest, at prime rate, to over and under collections reflects the terms and risks inherent in the utility reconciliation process.

In addition to the proposed interest rate structure set forth herein for comment, the Commission reminds EDCs to consider filing an interim rate adjustment and/or cost reconciliation when the EDC anticipates substantial over or under collections. In fact, the Commission recognizes that such interim rate adjustments and cost reconciliations are in the public interest as they provide utilities with a mechanism to reduce significant imbalances in over and under collections. For example, Section 69.1809(c) of the Commission's regulations regarding default service provide in relevant part that:

It may be in the public interest to reconcile default service costs more frequently than at each PTC [price-to-compare] adjustment interval. The DSP [default service provider] should propose interim reconciliation prior to the next subsequent PTC adjustment interval when current monthly revenues have diverged from current monthly costs, plus any cumulative over/under recoveries, by greater than 4% since the last rate adjustment. . . . Interim reconciliation proposals should result in a PTC adjustment that will resolve cumulative under or over recoveries by the time of the next PTC adjustment interval.

52 Pa. Code § 69.1809(c).

Conclusion

Establishing a symmetrical rate of interest applicable to over and under collections resulting from reconciliation of automatic adjustment clause costs and revenues will better ensure that utilities' current prices reflect current costs as accurately as is feasible. By way of this Advance Notice of Proposed Rulemaking Order, the Commission seeks comments from all interested parties on its proposal to apply a symmetrical rate of interest to over and under collections resulting from reconciliation of automatic adjustment clause costs and revenues related to electric default service.

Accordingly, pursuant to its authority under Sections 501, 1301, 1307 and 2804 of the Public Utility Code, 66 Pa.C.S. §§ 501, 1301, 1307 and 2804, the Commission issues this Advance Notice of Proposed Rulemaking Order for comment; *Therefore,*

It Is Ordered That:

1. This Advance Notice of Proposed Rulemaking Order be issued to solicit comments regarding revisions to the Commission's existing regulations regarding automatic adjustment clauses related to electric default service.

2. The Secretary shall certify this Advance Notice of Proposed Rulemaking Order and deposit it with the Legislative Reference Bureau for publication in the *Pennsylvania Bulletin*.

3. Interested persons may submit an original of written comments to the Office of the Secretary, Pennsylvania Public Utility Commission, P. O. Box 3265, Harrisburg, PA, 17105-3265, within 60 days from the date this Advance Notice of Proposed Rulemaking Order is published in the *Pennsylvania Bulletin*.

4. A copy of this Advance Notice of Proposed Rulemaking Order shall be served on the Office of Consumer Advocate, the Office of Small Business Advocate and the Bureau of Investigation and Enforcement, and will be posted on the Commission's website at www.puc.state.pa.us.

5. A copy of this Advance Notice of Proposed Rulemaking Order shall be served on all Electric Distribution Companies.

6. The contact person for this matter is Krystle J. Sacavage (717-787-5262), Law Bureau. Alternate formats of this document are available to persons with disabilities and may be obtained by contacting Sherri DelBiondo, Regulatory Coordinator, Law Bureau, 717-772-4597.

ROSEMARY CHIAVETTA,
Secretary

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