# Does the New Mexico PRC Insure that you get a “Fair” Rate of Return on Your Money?

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# What Does the NMPRC have to do with your Money?

- Investor owned utilities (IOUs) such as PNM, SPS and EE are regulated by the NMPRC
  - Utilities are natural monopolies
    - Without regulation they could set any price (rate) they want.
      - Customers are “captured consumers”
      - Utilities provide essential services
  - Because utilities are natural monopolies of essential services, the State enforces a contract between the utility and the PRC
    - CCN – Certificate of Convenience and Necessity
      - Utility is granted exclusive right to serve a service territory
      - Must serve all qualifying customers - can not abandon service
      - Costs and investments must be prudently incurred
    - Rates are set so that the utility earns a “fair” rate of return on its investments

# What is a fair rate of return (FROR)?

- A return to an investment is how much money per year the investment makes.
  - A rate of return (ROR) expresses this on a percentage basis of the total investment.
- In utilities, the rate base is considered the investment.
  - Stock holders, through the purchase of stocks have invested in the equity portion of the rate base (usually less than 100%).
  - Some of the rate base is financed by the issue of debt, mostly through bonds.
- It is accepted regulatory theory that rates for essential services should be set so that the equity portion of the rate base earns a rate of return that is competitive with other investments of equal risk (whatever that means).
  - In utilities this is about 9 to 12%. The FROR is granted by the PRC depending on the skill of the utility arguing for its case.
  - PNM is asking for 11.75% in its next rate case.
  - Lets assume 10% as a round number.

# Is the Rate of Return Guaranteed?

- NO
  - The PRC only sets rates going forward
    - The future is hard to predict
  - Income = Revenue – Expenses
  - Both revenues and expenses can vary
    - Revenue = Usage x Rates
    - Usage can vary
      - Weather
      - Growth or recession
- What happens if a company doesn't earn its fair rate of return?
  - It asks for a new rate case (PNM – Sept 22, 2008)

# What is the Criteria for setting new Rates

- Lets examine a hypothetical (economist's favorite term) rate application of a utility
  - Enchantment Gas (EG)
- It has been several years since EG has had a rate adjustment
- EG believes its income (earning or profits) has fallen below the fair rate of return and it seeks a rate increase
  - Utilities never apply for a rate decrease
- The following is EG's claim about its current financial situation
  - I assume that you the stockholder are the owner of EG, so it's YOUR money
  - Did you ever see the movie "Other People's Money"?
    - Great movie
    - Danny Devito is "Larry the Liquidator"

## EG Bottom Line before Rate Hearing

| | | | |
|---|---|---|---|
| Your Investment - Rate base | | | |
| | Equity | $600,000 | |
| | Debt | $400,000 | |
| | | | $1,000,000 |
| Your Income | | | |
| Revenues | | | $500,000 |
| Expenses | | | |
| | O&M | $200,000 | |
| | Fuel | $100,000 | |
| | Depreciation | $100,000 | |
| | Taxes | $60,000 | |
| | | | $460,000 |
| | | | $40,000 |
| Interest | | | |
| | 5% | $400,000 | $20,000 |
| Your Return (net income or profit) | | | |
| Return to equity | | | $20,000 |
| Rate of return on equity | | | 3% |

# EG's Argument

- We have had the same rates for decades
- Inflation is eating us up
- We provide safe and reliable service to everybody including those rats that don't pay
- We are only earning a 3% rate of return
- If we don't get relief soon, the rating agencies will downgrade us to
  - JUNK BOND STATUS
- Our expensive 'Experts' tell us that we need the following rate increase

# Points about EG’s Argument

- EG’s investment in its plant is called ‘rate base’
  - $1,000,000 total investment
  - $400,000 was financed through bonds at 5% interest
  - Leaves $600,000 financed by investors (equity)
  - 10% FROR x $600,000 = $60,000
- EG needs a return (net income of $60,000) to earn its fair rate of return
  - We are only earning $20,000, thus we have a deficiency of $40,000
  - Because we also pay taxes on our return and the PRC has set 10% as an after tax rate of return,
  - we need to gross up the deficiency to pay for the extra taxes
- Gross up factor (actual term) is 1.5

| EG Argument for Rate Increase | | | | | |
|---|---|---|---|---|---|
| A fair rate of return | | 10% | Need to increase rates and thus revenues | | |
| Equity | $600,000 | $60,000 | | | |
| | | | | Revenue | |
| Current return | | $20,000 | Currently | $500,000 | |
| Equity deficiency | | $40,000 | Proposed | $560,000 | |
| | | | | | 12% increase |
| "Gross up factor" | | 1.5 | This translates to | | 12% rate increase |
| | | | | | |
| Revenue deficiency | | $60,000 | | | |
| Change in Taxes | | $20,000 | | | |
| | | $40,000 | | | |

# Adjustments

- Lets assume that the PRC buys the argument.
- How does this change EG’s bottom line?

A fair rate of return 10%

| EG Bottom Line before Rate Hearing | | | Hearing Adjustments | Bottom Line After Rate Hearing | | |
|---|---|---|---|---|---|---|
| <u>Your Investment - Rate base</u> | | | | <u>Your Investment - Rate base</u> | | |
| Equity | $600,000 | | | Equity | $600,000 | |
| Debt | $400,000 | | | Debt | $400,000 | |
| | | $1,000,000 | | | | $1,000,000 |
| <u>Your Income</u> | | | | <u>Your Income</u> | | |
| Revenues | | $500,000 | $60,000 | Revenues | | $560,000 |
| Expenses | | | | Expenses | | |
| O&M | $200,000 | | | O&M | $200,000 | |
| Fuel | $100,000 | | | Fuel | $100,000 | |
| Depreciation | $100,000 | | | Depreciation | $100,000 | |
| Taxes | $60,000 | | $20,000 | Taxes | $80,000 | |
| | | $460,000 | | | | $480,000 |
| | | $40,000 | | | | $80,000 |
| Interest | | | | Interest | | |
| 5% | $400,000 | $20,000 | | 5% | $400,000 | $20,000 |
| <u>Your Return (net income or profit)</u> | | | | <u>Your Return (profit)</u> | | |
| Return to equity | | $20,000 | | Return to equity | | $60,000 |
| Rate of return on equity | | 3% | | Rate of return on equity | | 10% |

# Counter Arguments

- The PRC Commissioners are elected by ratepayers
  - They don’t like to raise rates
  - Sometimes they might work backwards
    - OK we will grant EG a 3% increase in rates that is fair to our voters
    - The “fair” rate of return is some theoretical argument by economists
      - The Commissioners never liked economics

# Other Malcontents

- Consumer Advocates (CAs), can put forth a more sophisticated argument to achieve the same thing:
  - We don’t think that the company has invested wisely…
    - We believe the rate base should be reduced for “excessive” investments by $200,000…
      - CEO’s pension fund, etc.
    - With these type of adjustments, CAs argue the PRC should only grant a 6% rate increase.

Consumer's Advocate Argument for Rate Increase

| | | | | | |
|---|---|---|---|---|---|
| A fair rate of return | 10% | | Need to increase rates and thus revenues | | |
| Equity | $400,000 | $40,000 | | | |
| | | | | Revenue | |
| Current return | | $20,000 | Currently | $500,000 | |
| Equity deficiency | | $20,000 | Proposed | $530,000 | |
| | | | | | 6% increase |
| "Gross up factor" | | 1.5 | This translates to | | 6% rate increase |
| Revenue deficiency | | $30,000 | | | |
| Change in Taxes | | $10,000 | | | |
| | | $20,000 | | | |

A fair rate of return 10%

| EG Bottom Line before Rate Hearing | | | | Hearing Adjustments | Bottom Line After Rate Hearing | | | |
|---|---|---|---|---|---|---|---|---|
| Your Investment - Rate base | | | | | Your Investment - Rate base | | | |
| | Equity | $600,000 | | -$200,000 | | Equity | $400,000 | |
| | Debt | $400,000 | | | | Debt | $400,000 | |
| | | | $1,000,000 | -$200,000 | | | | $800,000 |
| Your Income | | | | | Your Income | | | |
| Revenues | | | $500,000 | $30,000 | Revenues | | | $530,000 |
| Expenses | | | | | Expenses | | | |
| | O&M | $200,000 | | | | O&M | $200,000 | |
| | Fuel | $100,000 | | | | Fuel | $100,000 | |
| | Depreciation | $100,000 | | | | Depreciation | $100,000 | |
| | Taxes | $60,000 | | $10,000 | | Taxes | $70,000 | |
| | | | $460,000 | | | | | $470,000 |
| | | | $40,000 | | | | | $60,000 |
| Interest | | | | | Interest | | | |
| | 5% | $400,000 | $20,000 | | | 5% | $400,000 | $20,000 |
| Your Return (net income or profit) | | | | | Your Return (profit) | | | |
| Return to equity | | | $20,000 | | Return to equity | | | $40,000 |
| Rate of return on equity | | | 3% | | Rate of return on equity | | | 10% |

# Where does the stockholder fit in this picture?

- The net income and ROR on rate base roughly translates into return on stocks.
  - The higher the return, the higher the value of the stock.
  - Contrasting the EG presentation and the Consumer Advocates, the same 10% ROR does not translate into the same return to the stockholder.
    - The CA's net income is $40,000 less than EG's.
- The stock market and rating agencies often judge the regulatory environment and…
  - NM does not rate high in these assessments.

# What to do?

- Does the PRC always give utilities a fair rate of return? – NO
- What to do: Intervene
- The company's interests are not always perfectly aligned with the stockholder.
  - They will claim otherwise
- Stockholders are Voters
  - The PRC always notices Voters
- Questions???