

RATE SHOCK

A MATTER OF IF, OR WHEN?



BY ROBERT T. ZABORS

Better communication will be required in an environment of volatile and rapidly increasing commodity prices.

The utility industry is transitioning from its focus on “back to basics” to an emphasis on investment and consolidation—a shift some might describe as “déjà vu all over again.” In the near future, the majority of investor-owned electric utilities (IOUs) will request, and ultimately win, rate increases. For many, these will be the first significant increases in more than a decade. And in some areas, the completion of regulatory transition periods will enable utilities to claim increases they consider long overdue. Despite the length of time most utilities have taken between cases, it is unlikely that the rate-based component of increases will match the percentages of the 1970s and early 1980s.

Although these rate increases may be seen as reasonable and justified, rates are only part of the story. Consumers will see higher electric bills, which will result from a number of factors outside of traditional rate base and cost control. The confluence of these factors may catch some companies unprepared—pursuing the traditional argument of electric rate adequacy in what will be a public debate about total energy costs.

Higher electric rates will follow sharply higher costs of gasoline and natural gas that are beginning to have significant, and perhaps lasting, effects on businesses and consumer markets. For many businesses, evaluation of fuel switching and efficiency options is well underway. Residential customers have been reintroduced to volatility, with the price of gasoline fluctuating between \$2 and \$3 per gallon. This winter, a bigger surprise for consumers in colder climates will come through higher natural gas prices for home heating—resulting in individual bills that are hundreds of dollars more per month. EIA expects that the total amount spent for gas consumed by a representative residential customer this winter will be about 48 percent more than last winter.¹

For an average family using gas heat, the impact of higher

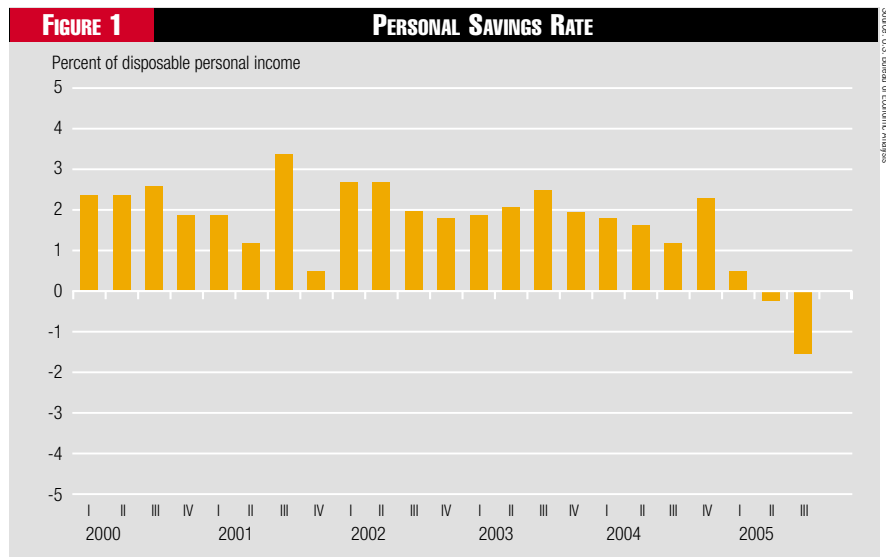
gasoline, electric and gas bills could be approximately \$1,300 per year—3 percent of after-tax income. (see sidebar). When combined with a low and declining national savings rate, this will force some difficult choices. On a per-capita basis, average personal savings in 2004 was \$530—only 1.8 percent of disposable income.

How will customers respond to higher electric rates following a rise in gasoline and heating costs that will absorb all discretionary savings for many consumers? Will “rate shock”—a term not heard in the industry for many years—return?

Responses May Vary

One response for electric utilities would be to continue to lower costs and further delay rate cases. However, they are facing a rising-cost environment driven by factors that are both powerful and long-term. Six structural factors are driving fundamental increases in electric prices:

- 1. Capital investment.** Many utilities are beginning a new wave of capital projects to meet increasing demand, improve environmental performance, and maintain the reliability of generation and transmission and distribution (T&D) infrastructure. Although there are clear customer benefits to more reliable, renewable and efficient energy, the resulting growth in rate base leads to a higher revenue requirement—and higher rates.
- 2. Fuel-cost increases.** Fuel typically is the largest component of the cost structure of an integrated utility, and more than two-thirds of total U.S. generation is from coal or natural gas. In the past 12 months, the cost of natural gas has more than doubled.² Coal prices also have



risen substantially—both commodity and transportation—and face continuing pressures on both demand and supply.

3. Labor costs. Wages, health care benefits, and pension costs continue to rise. As the industry struggles with retirements, recruiting, and the growing need for a more skilled and engaged workforce, containing per-employee expenditures has become increasingly difficult. Also, total labor costs may rise as hiring needs related to new capital projects affect the industry's long term trend of reducing headcount.

4. Market structure and compliance costs. Transmission restructuring costs are increasing, as are compliance costs for Sarbanes Oxley, security, and other regulatory reporting. The costs of Electric Reliability Organizations stipulated in the 2005 Energy Policy Act also will affect consumers. Once in place, these are notoriously difficult to rein in. And as utilities file rate cases, regulatory and legal costs will escalate.

5. Commodity prices other than fuel. Global demand also has increased the price of many commodities used by utilities—everything from steel to gasoline. Improved sourcing and supply chain management has eliminated major costs within the supply chain, but this is being eroded, and in some cases overwhelmed, by higher material costs. This factor will be amplified in the construction cycle now underway.

6. Financial de-leveraging. Through “back-to-basics” strategies, free cash flows are increasingly staying in the core utility. As utilities focus on their core business, while preparing for rate cases that accompany capital investment, they are de-leveraging balance sheets.

The industry has a solid track record of reducing costs, and that will continue. The question is whether opportunities exist for most utilities to reduce costs in the near-term that outweigh the factors driving cost increases.

FIGURE 2

STATES WHERE ENERGY AND FUEL COST ADJUSTMENTS ARE USED BY AT LEAST ONE UTILITY

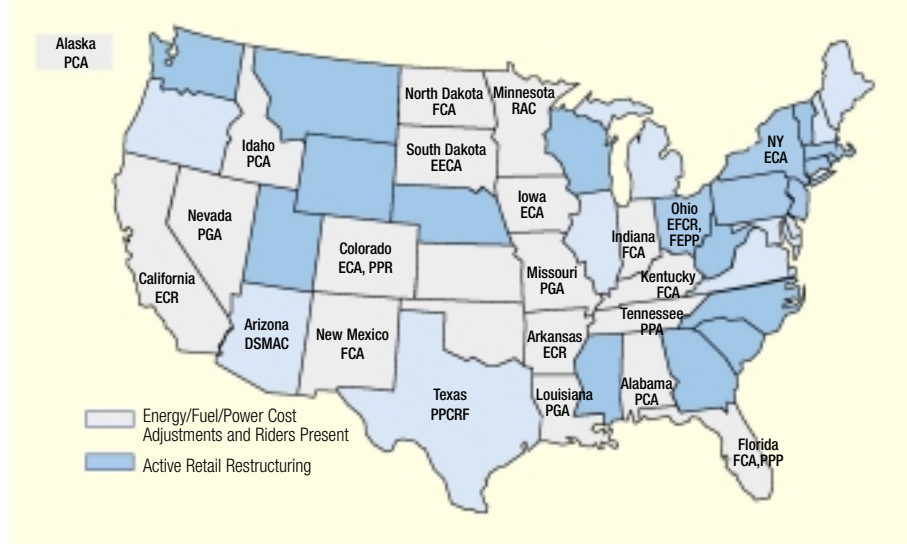
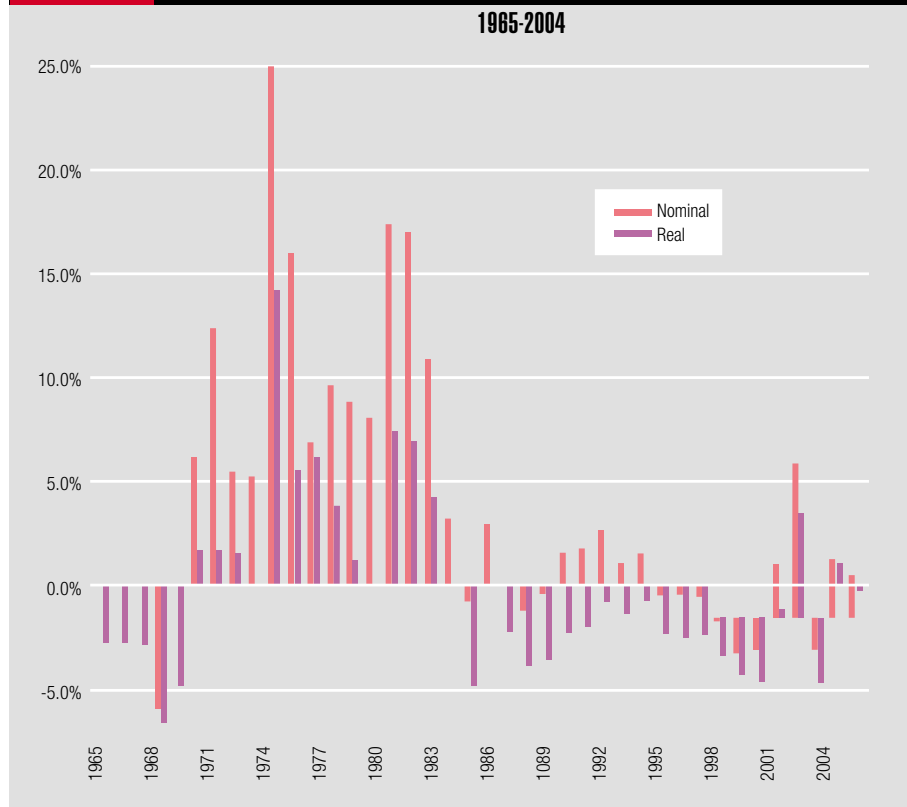


FIGURE 3

RATE SHOCK: REAL AND NOMINAL CHANGES IN RETAIL ELECTRIC PRICE 1985-2004



- Productivity improvements and strategic sourcing have delivered substantial savings in recent years. Although much of the “low hanging fruit” may have been captured, new outsourcing agreements may be one way to continue improvements in cost and quality.
- Innovation has the potential for breakthrough cost performance, particularly in areas such as demand response

and distributed technologies. To deliver savings, these require regulatory approvals, customer participation and investment. Efficiency programs will also play an important role in the long term, but so far have demonstrated a slow pace of adoption.

- And in some cases, significant savings are possible through M&A.

Unless these savings outweigh the impact of rising costs, utilities will have no choice but to pursue a regulatory path to significantly increased rates.

A Lost Art

Because of the success of the industry in reducing costs during the past 15 to 20 years, and rate freezes associated with transition periods in many states, rate cases have become a lost art. Utilities no longer have many of the skills or the infrastructure to pursue such cases. In addition, most customers under the age of 35 are unfamiliar with significant increases in rates from their electric providers.

Another contributing factor to rate shock is the degree to which many utilities and state regulators have embraced forms of energy or fuel cost adjustments.

In light of current natural-gas prices and wholesale electric costs, customers in many states will receive energy or fuel charge adjustments that are larger than any increases in electric rates in 2006. And these mechanisms typically “pass through” faster than rate-based changes.

Assuming an environment of rising costs will lead to higher prices, will the impact be substantial enough to constitute “rate shock”? What constituted “rate shock” the last time the phrase was popular?

Using historical data in Figure 3, on an inflation-adjusted basis, rate shock appeared around 1973-1974 in some areas when a double-digit percentage spike in prices occurred, and in the early 1980s, when there were consecutive years of real increases exceeding 5 percent. With fuel and energy cost

DISPOSING OF DISPOSABLE INCOME

Rising energy costs represent a reduction in after-tax income greater than the average per-capita savings rate.

Gasoline: The average American household (with 1.9 cars) drives 26,610 miles per year.¹ Average fuel economy is 21MPG. An increase in gasoline prices of \$0.60, similar to what's been experienced in 2005 excluding hurricane-related spikes, results in an increase of roughly \$760 per year.

Natural gas, for those in home-heating climates, likely will increase at least \$350. The average residential customer bill was \$742 in 2004, with a 48 percent increase expected in 2005.²

Electricity: Based on an average bill of \$75, a 20 percent increase would be \$180 per year.

The total annual impact of these three components is \$1,290. Two perspectives can put it in a consumer context.

From a household perspective, 2004 median pre-tax income was \$44,389, and \$41,532 after-tax.³ This collective increase in energy costs represents 3.1 percent of after-tax household income.

On a per-capita basis, average personal savings as a percent of discretionary income (\$29,475) was 1.8 percent in 2004. A two-person household with combined annual savings of \$1,061⁴ could consume all those savings through higher energy prices in 2005.—RTZ

Endnotes:

1. U.S. Department of Transportation, Energy Information Administration, November, 2005 (2001 survey with estimated 3.6 percent growth rate).
2. Energy Information Administration, *Short Term Energy Outlook*, October 2005.
3. U.S. Census Bureau, August, 2005.
4. U.S. Department of Commerce, Bureau of Economic Analysis, November 2005.

adjustments layered on rate increases, it is easy to envision such a spike in 2006 reaching nominal and real precedents, and the potential for several years of 5% real increases in 2005-2007. This can be even higher when one-time events, such as the end of a regulatory transition, or storm-related costs also pass-through to customers.

Utilities will face two challenges. The more traditional challenge is mitigating long-term price trends and finding lowest-cost, long-term solutions. This is not a trivial task, given the structural dynamics and the absence of a single, preferred supply alternative (as natural gas was in the 1990s and nuclear was in the 1970s). The second challenge will be to ensure that customers understand the value of their electric service and the efforts of utilities to deliver low-cost, reliable, and environmentally responsible service.

Perception vs. Reality

Ultimately rate shock is a matter of perception. What a cus-

customer sees is a higher bill: rates *plus* fuel charges *plus* increased per-customer usage *plus* structural charges *and* taxes. Unfortunately, in general, utilities have not done a good job of translating total bill and “customer wallet share” perspectives into internal performance reporting. Nor do these perspectives receive the airtime of a metric like reliability, which is measured frequently, extensively, and precisely.

Utilities typically do a poor job of communicating value despite its importance in shaping perception. Major components of future electric increases are attributable to increased value, including environmental improvements, increased reliability and security, and better customer service. In an era of rising and volatile costs, the perception of control also is a key value driver. Investments in communications infrastructure and demand response programs will enable customers to better manage their costs. And from a relative cost perspective, electricity is now even more competitive against natural gas and oil.

Some utilities already are taking action to prepare for a rising cost scenario. And some best practices are emerging from their actions that can minimize the potential for rate shock:

1. Take the time to build the right plan. It will produce a more coherent and comprehensive story, enable a more creative approach to regulation, and pay dividends through aligned organizational performance management and cultural development throughout the course of a growth plan.

One example of higher returns on a planning investment is We Energies’ “Power the Future” plan.² A comprehensive five-year plan led to a variety of groundbreaking initiatives. As a first mover, the utility faced plenty of challenges. However, the power of a comprehensive plan supported steps such as creation of a state-wide transmission company, major network upgrades, a significant commitment to renewables, and new fossil generation financed through an innovative leasing model. The plan also kept the broader organization moving forward—lowering costs and improving reliability and customer service.

2. Collaborate with more constituents, early and often.

The factors driving increases make for a complex story—one that requires clarity and consistency to have impact. Effective collaboration starts in the early stages of developing a plan and continues throughout implementation. It involves a broad section of constituents, and engages all employees. Collaboration also can help build

understanding and consensus that leads to successful innovation in regulatory approaches and proceedings.

For example, Great Plains Energy hosted an innovative set of issue-driven “seminars”—panel discussions with national experts representing a variety of perspectives. Customers, community leaders, regulators, media, board members, and all employees were invited, and had ample opportunities to ask questions of the panel. On average, each session was attended by more than 250 people. This approach set the tone for a successful regulatory process, resulting in unanimous approval of a \$1.3 billion growth plan by the commissions of two states.

3. Don’t swing for the fences. Successful plans have adopted a balanced portfolio instead of the single-fuel strategy typical of prior growth cycles. In this environment, betting on the success of one single-fuel or renewable solution to emerge as the winner is risky. In an era of higher and volatile prices, customers will be less forgiving of the downside of a risky bet, as will regulators. Successful plans will be built on a balanced portfolio of fossil, renewable, distributed, and efficiency technologies that mitigate both cost and risk.

4. Timing is everything. As in any development cycle, there are likely some benefits to starting early. This advantage can manifest itself through lower costs, better access to labor, availability of equipment (*e.g.*, turbines), and establishing differentiation and industry leadership. Recent examples are utilities that were proactive on environmental retrofits prior to regulatory and legislative certainty.

Although the timing of the upcoming wave of electric price increases unfortunately coincides with substantial increases in other energy costs, electric utilities are well positioned to take control of their destiny. Utilities that move forward with a comprehensive approach will be able to better create and communicate value through a time of rising and volatile energy costs. Only time will tell if these increases will be no big deal or the last straw, but the time to work toward the former is now. ■

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Endnotes:

1. Energy Information Administration, November 2005.
2. www.powerthefuture.com.