Rate Stabilization Mechanisms for Natural Gas Utilities and Consumers

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The Changing Gas Industry Environment

- **Escalating and Variable Costs**
  - Infrastructure repairs and replacement costs necessary to maintain the safety and integrity of the system have been rising significantly
  - Wages and material costs continue to rise, so cost recovery based on historic test years will continue to under recover.
  - Uncontrollable, unexpected and variable costs also not sufficiently covered by traditional, historic cost based rates. Delays in recovering large, upward swings in costs can impact a utility's financial health.

- **Declining Gas Usage**
  - Compounding escalating and variable costs, customer and volume growth have been challenging and fluctuating weather patterns make revenue sporadic.
  - Natural gas consumer habits and usage changes have been dramatic over the last several decades, with more efficient appliances and better insulated homes.
  - Rates set on "normal" weather result in lower bills some years, and higher bills in others; meanwhile the costs for utilities is relatively fixed, resulting in over or under recovery of approved costs.

Regulatory and Ratemaking Reforms

- Consumers, legislators and utilities have worked with their regulators to appropriately address such shortfalls, **not for the purpose of maximizing profits, but for the same objective as before, recovering their prudently incurred costs.**

- To address such issues, a number of alternative rate mechanisms have been "tacked on" to the historic, traditional rate structure in place for the last century.
  - Purchased Gas Adjustment
  - Revenue stability mechanisms (SFV, decouplings, WNA, etc.)
  - Specific cost trackers (i.e. energy efficiency, environmental, etc.)
  - Infrastructure replacement riders (ISRS)
  - Main extension mechanisms for unserved or underserved areas

- This created a more complex, time-consuming, administratively burdensome and often contentious process to try to ensure all these parts work together as intended
  - More comprehensive solutions can provide benefits to customers, utilities and other stakeholders, with more timely, appropriate oversight of all relevant factors, while also structured to be more efficient and cost-effective

Superiority of Rate Stabilization Mechanisms

Rate stabilization mechanisms (RSM) are adjustments to approved and authorized rates that actually stabilize cost recovery and rates. RSM is more comprehensive review of all relevant factors.

- Many consider rate stabilization the best of the innovative, non-volumetric rate designs because it adjusts both utility revenues and costs for changes that occur on an annual basis, while also providing benefits to customers, utilities, and regulators.

1. Less Volatile Customer Bills; Reduced Rate Shock

Rate stabilization avoids rate shock with more frequent rate reviews that adjust rates on a more timely basis, rather than implementing infrequent, large rate changes all at once.

2. Reduced Customer Bills from Lower Financing Costs

Timely recovery reduces borrowing costs. Rates are reduced by a number of factors, including avoided cost of capital on deferred assets and reduced interest rates, among others.

3. Timely Changes in Rates Due to Weather

Weather normalization factors adjust for changes in volumes, so that customers don't pay to much in cold winters, like the Polar Vortex, and utilities can recover their largely fixed costs in warm winters.

Superiority of Rate Stabilization Mechanisms

4. Reduced Costs of Regulation Lower Customer Bills
Benefits all stakeholders. Traditional, fully litigated rate cases are lengthy and extremely costly. RSM proceedings more frequent, in-depth regulatory review of all relevant factors that take less time and expend fewer resources.

5. Energy Conservation Reduces Customers' Gas Cost (about 50% of their bill)
Rate designs are included that remove the conservation disincentive, and encourage utilities to partner with conservation groups and help customers become more energy efficient and reduce their gas usage and commodity costs.

6. Incentives for Cost Reductions and Efficiency Improvements
Allows utilities to share a portion of the benefit from their cost reduction efforts – incentivizing cost management. This aligns interests between customers and utilities and encourages cost efficiency, which results in rates lower than they would have otherwise have been.

7. Expedited Infrastructure Repair And Replacement
RSM mechanisms help accelerate necessary utility investment to enhance safety, reliability of the critical infrastructure by allowing more efficient recovery of associated costs. Such activities also help improve operating efficiency and reduce emissions.

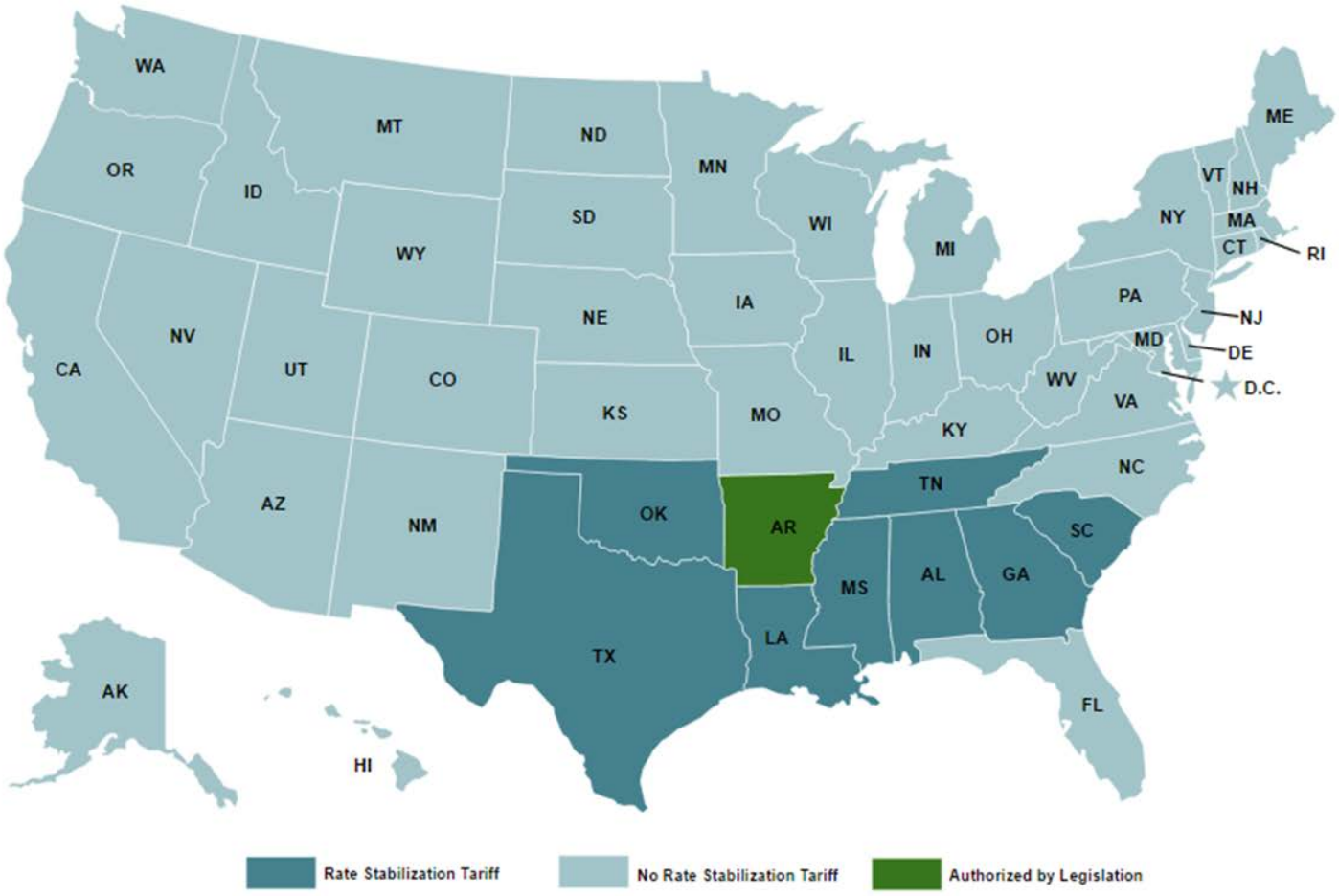
Superiority of Rate Stabilization Mechanisms

8. Better Matching of Costs and Revenues Reduced Regulatory Lag
With less regulatory lag, a utility facing decreasing sales or increasing costs is in a better financial position. Revenue stabilization removes both the upside and the downside of regulatory lag, thereby making rates fairer and more equitable for both utility and the customer.

9. Utility Incentives for Growth
With RSM, utility growth comes from new customers, not increased volumes of natural gas, so utilities remain committed to economic development within its franchise area. Revenues from customer growth helps lower rates and the utility's largely fixed costs are spread over a larger base, resulting in benefits for both customers and utilities.

10. More Frequent, In-Depth Regulatory Review Leads to Better Understanding
Annual examination of the utility's books leads to greater familiarity and expertise with the utility's books and operations. When the time arrives to hold rate reviews, staff is already well informed and familiar and does not need to start from scratch.

Rate Stabilization Mechanisms



Widely Adopted by Numerous Gas Utilities

The average length of time RSMs have been in place is 12 years.

- **Nine states have implemented Gas RSM plans:**
  - Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, Tennessee, Texas
- **At least 19 gas utilities have implemented or have pending RSM plans:**
  - Alabama Gas (AL)
  - Atmos Energy
    - Louisiana Gas Service (LA)
    - Trans Louisiana (LA)
    - Atmos Energy Mississippi (MS)
    - Atmos Energy Tennessee (TN)
    - Atmos Energy Mid-Tex (TX)
    - Atmos Energy Dallas Division (TX)
  - CenterPoint Energy
    - CenterPoint Energy (AR) pending – decision expected Sep 1, 2016
    - CenterPoint Energy Arkla (LA)
    - CenterPoint Energy Entex (LA)
    - CenterPoint Energy Mississippi (MS)
    - CenterPoint Energy Oklahoma (OK)
  - Entergy New Orleans (LA)
  - Mobile Gas (AL)
  - Liberty Utilities (GA)
  - Oklahoma Natural Gas (OK)
  - Piedmont Natural Gas (SC)
  - South Carolina Gas and Electric (SC)
  - Willmut Gas (MS)

Mechanics: How RSM Works

- **Initiation and termination requirements.**
  - While most plans have no requirement to initiate the mechanism, while some require a rate case within the last 5 years.
  - Companies may exit the plan due to force majeure events and certain conditions, becoming subject to traditional rate making at that point.

- **Key elements are reviewed for modification every ~5-6 years.**
  - Some plans have no defined review date, while the shortest term length is three years. ROE may be fixed or annually adjusted during that time.
  - Plans do not have to be modified, but as the business environment and company-specific situations change, there have been updates.

- **Ongoing and timely review, with rates adjusted at least annually.**
  - More frequent, smaller changes are more predictable, easier to manage
  - Costs subject to being reasonable/prudent, and include typical disallowances.
  - Utilities provide schedules and work papers supporting the filing and adjustment calculation to the Commission.
  - Commission staffs review required filings and defined supporting documentation and request clarification or additional data as needed.

Mechanics: How RSM Works

- **Cap limits the annual rate adjustment.**
  - Rate adjustment caps are typically 3-5% of the previous year's revenues.
  - If plans are capped, sometimes excess may be banked until the next year.
  - Adjustments mechanisms to address extraordinary charges.
- **Earnings band around the authorized ROE ensures fair return.**
  - Removes both the upside and the downside of regulatory lag, thereby making rates fairer and more equitable for both utility and the customer.
  - The band width typically is +/- 1% around the ROE, with some more narrow.
    - Typically symmetrical around the ROE, but a couple use an asymmetrical band.
  - Rate adjustments typically return the utility to the allowed ROE by the commission, but some plans adjust rates to the edges of the earnings band.
- **Performance metrics and benchmarks are basis for incentives.**
  - Customers benefit from enhanced business operations and lower costs
    - Customer service/satisfaction, cost management, service reliability, safety, etc.
    - Implemented as adders to ROE, or specific riders to address certain areas of focus
  - Some plans allow the customer and company to share earnings above the ROE band, with a graduated scale that increases customers' share at higher levels.

SUMMARY

- The best ratemaking and regulatory reform of the last three decades is the rate stabilization mechanism because it is comprehensive.
- Other rate mechanisms that stabilize customer bills and utility revenues, like revenue decoupling and flat fee rates, when combined with cost trackers, have been successful across the US.
- Flat fee and partially flat fee rate designs have moved Missouri rate design in the right direction.
- Missouri has implemented about half as many trackers as some states, but has implemented no revenue sufficiency or revenue adjustment mechanisms.
- Previous legislation allowed, but did not mandate revenue stability and sufficiency measures, and Missouri regulation has lagged behind in this measure.
- Investors and rating agencies compare and contrast states, and Missouri is behind in the eyes of many in the investing and debt rating communities.
- Implementing a comprehensive modern rate structure like RSM by statute would be the best thing for Missouri stakeholders – customers, utilities and the State.