

MEMORANDUM

TO: Mark Sidran, Chairman
Pat Oshie, Commissioner
Phil Jones, Commissioner

FROM: Gene Eckhardt, Assistant Director of Transportation and Water
Dick Byers, Senior Electricity Advisor

CC: Dave Danner, Executive Director
Carole Washburn, Executive Secretary
Chris Rose, Director of Regulatory Services

DATE: October 30, 2006

RE: Solid Waste Fuel Deferred Accounting Mechanism
Dockets TG-061431, TG-061432 and TG-061433
Waste Management

SUMMARY

Although staff believes there are no compelling reasons to approve the proposed fuel deferred accounting mechanism, we also believe approving the filing would not set precedent for other expenses or industries and would not harm the company or the customers.

The proposed solid waste fuel deferred methodology:

- Removes all financial incentive for the company to manage fuel price. We believe the company has limited ability to manage or control price. Strong incentives remain for the company to manage fuel consumption.
- Removes the company's margin (about 3.8 percent) on fuel expense.
- Passes the benefit of fuel price reductions straight through to customers.
- Is similar to the current Purchase Gas Adjustments (PGAs): they track costs not included in base rates, do not include any return on capital or other margin, there is no sharing mechanism and the charge is shown as a separate line item on the customer's bill.
- It is dissimilar to PGAs in that natural gas costs represent about 50 percent of the natural gas company's costs and the customer's bill, while the solid waste fuel deferral represents less than 5 percent of the company's costs and the customer's bill. Because fuel represents a small amount of total costs, it is more likely that changes in other factors (costs or customer growth) could offset the company's need for additional revenue.

Staff believes approving the proposed fuel deferred mechanism would not set precedent for other costs and other industries because fuel expense is easily distinguished from other operating expenses and fuel expense for transportation companies is easily distinguished from fuel expense incurred by non-transportation industries.

The fuel cost component is a relatively small portion of total expense. That means it is more likely that changes in other factors (costs or customer growth) may offset all, or part, of the need for additional revenue. The policy analysis indicates this is a good indicator that the approved mechanism should include some sharing mechanism.

The memorandum first discusses how the commission has used deferral mechanisms and balancing accounts in the energy industries, discusses the proposed solid waste fuel deferred accounting mechanism and then addresses several policy issues to consider in making the decision whether to approve the deferral mechanism.

The attached Appendix A provides background information on solid waste cost structures, rate regulation, the solid waste fuel surcharge methodology and how the commission treats tip fees (pass through) and revenue from the sale of recyclable commodities (deferral) for ratemaking purposes.

BALANCING ACCOUNTS AND DEFERRAL MECHANISMS IN THE ENERGY INDUSTRIES

Regulatory mechanisms using deferral accounting and annual “true-ups” are used in both the natural gas and the electric industries. The mechanisms differ in some fundamental ways based on the following characteristics:

- The nature of the cost tracked by a balancing account:
 - Is it a component of the normalized costs recovered in base rates?
 - Is it a cost component that is evaluated and recovered separately from the normalized costs included in base rates?
- Whether the cost tracked includes depreciation and return on capital.
- Whether there are any provisions for sharing of risks and benefits between the company and its ratepayers.

Purchase Gas Adjustments (PGAs)

PGAs date from the period prior to deregulation of pipeline rates for wholesale gas supplies delivered to the local distribution companies (LDC). Prior to the early 1990s, the pipelines provided a packaged service including both the natural gas commodity and interstate delivery services at a FERC regulated tariff rate. The LDCs had no control over this regulated rate and therefore the cost of natural gas commodity was adjusted separately from other LDC capital and expenses through periodic PGAs driven by changes in pipeline tariffs. With deregulation of the wholesale gas markets, the PGA mechanism was retained under the theory that LDCs were “price takers” in a commodity market. The process has “evolved” to become an annual adjustment including a

prediction of the cost of gas for the up-coming year and a true-up in rates based on the actual costs for gas for the just concluded year.

PGAs have the following important characteristics:

- PGAs track costs that are not otherwise included in base rates.
- PGAs do *not* include any return of capital or other margin or mark-up.
- PGAs pass the cost of natural gas through to ratepayers with no provision for sharing of risks or benefits issuing from actual costs being higher or lower than projected costs.
- The gas purchasing strategies of the LDCs are reviewed and refined with input from customer groups and other stakeholders in the LDC integrated resource planning process.
- Natural gas commodity cost—tracked and adjusted by the PGAs — is a significant portion (more than half) of customer total LDC bills.
- Natural gas commodity cost — tracked and adjusted by PGAs — is a separate line item on customer bills.

Power Cost Adjustment Mechanisms (ERM, PCA)

Various forms of deferred accounting and rate true-ups are also used by electric utilities in Washington. The Energy Cost Adjustment Clause (ECAC) and the Periodic Rate Adjustment Mechanism (PRAM) were near “automatic” rate adjusters employed by Puget Sound Power and Light (now PSE) in the 1980s (the ECAC) and the first half of the 1990s (the PRAM). Both involved adjustments to power cost expenses and capital costs included in the utility’s base rates. Neither involved any form of risk and benefit sharing. Both were terminated for a number of reasons including rate instability, customer (and regulator. . .) confusion, administrative burden, single-issue ratemaking, and lack of any capital cost offsets.

In the early 2000s, new forms of power cost adjusters were developed for both PSE (the PCA) and Avista (the ERM). Again, these mechanisms operate to adjust rates for deviation in actual power costs from the normalized power costs included in base rates. Both include fuel expenses, wheeling expenses, O&M, certain capital costs and depreciation as well as certain revenue accounts that offset these costs. Costs are reviewed annually and rate adjustments may or may not be triggered annually depending on the magnitude of deviations from the normalized base power costs. The major difference between these current power cost adjusters and the earlier ECAC and PRAM is that both the ERM and the PCA include provisions to share the risk and benefits of deviation from power normalized costs between the company and its ratepayers. Both include a “dead-band” and both include progressive sharing-bands.¹

¹ Recently, the Commission has consistently promoted the following principles to guide design of acceptable power cost adjustment principles.

- The purpose is to recognize variability in the cost of operating *existing* power supply resources as a result of abnormal weather conditions that are out of a utility’s control. Ratepayers understand the connection between weather and rates;

Power cost adjustment mechanisms have the following characteristics:

- PCAs operate as adjustments to costs that are included as normalized components of base rates – they are not adjusters to costs recovered separate and apart from base rates like PGAs.
- PCAs operate on costs that include both expenses for which there is no provision for return and capital costs for which return and depreciation are included.
- PCAs are not “automatic” adjusters, the costs and revenues are reviewed annually for appropriateness and are subject to prudence challenges.
- PCAs include dead-band and sharing-band provisions for apportioning the risks and benefits of deviation from normalized costs between the utility and its ratepayers.
- PCAs operate on power costs over which the utility has some, but limited, control (i.e., weather, hydrologic conditions, fuel markets, etc.).
- PCAs operate on power costs that are the subject of review and analysis during a utility’s integrated resource plan.
- While power costs are a significant component of base rates, the deviations in power costs tracked by PCAs are a relatively small proportion of overall utility revenue.

Other Deferral Accounts Used in Electricity and Natural Gas

There are a number of other examples where deferred accounting and balancing accounts are used in the energy industry: tree trimming, environmental remediation come immediately to mind. However, none of these other examples operate as periodic adjustments to rates outside of the context of a general rate case.

The PGAs and PCAs are types of single-issue ratemaking – they involve adjustment up or down in one component of a company’s total revenue requirement without consideration of whether other components of the company’s cost structure may also have changed. For this reason they are often controversial. However, single-issue ratemaking is a regulatory doctrine rather than a hard-and-fast rule and the Commission has found it to be acceptable and in the public interest based on particular circumstances, including:

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- Power cost adjustment mechanisms are *short-run* accounting procedures to address *short-run* cost changes resulting from unusual weather;
 - It is not appropriate to include new resources in a power cost adjustment mechanism. New resources must be considered in general rate cases or power cost only rate cases;
 - Ratepayers should receive the benefit of a reduction in cost of capital, as a power cost adjustment introduces rate instability for ratepayers and earnings stability for stockholders, and;
 - Power cost adjustment mechanisms should not interfere with least cost planning, conservation or other regulatory goals.

- The mechanism adjusts for costs over which the utility has little or no control.
- Where there is the potential for some control over costs, or where cost-drivers are expected to be cyclical and symmetrical (i.e. hydro, weather), the mechanism includes sharing of risks and benefits. These risk-sharing provisions are intended to encourage the company to exercise any control over costs and efficiencies that it may have.
- The mechanism provides for revenue offsets to the costs being tracked (i.e. increased sales revenue, customer growth, wheeling revenue, etc.).
- The mechanism operates on normalized costs recently reviewed and approved in a general rate proceeding (or limited scope power cost proceeding).
- The mechanism operates on short-term rather than long-term variation in costs.

PROPOSED SOLID WASTE FUEL DEFERRED ACCOUNTING

The proposed deferred accounting method would stabilize the company’s earnings, reduce the company’s business risk, remove fuel expense from the Lurito-Gallagher methodology and eliminate the company’s margin (approximately 3.8 percent) on fuel expense. It would also remove any direct incentive for the company to manage its fuel expense. Indirectly, the company must still demonstrate that it acted prudently and the resulting prices were reasonable.

Except for the small magnitude of the expense and the small effect on customer’s bills, the proposed solid waste fuel deferred accounting mechanism is similar to the PGA mechanism:

Table 1
Comparison of PGA and Proposed Solid Waste Fuel Deferral

	PGA	Solid Waste Fuel
Track costs not otherwise included in base rates.	Yes	Yes
Do <i>not</i> include any return of capital or other margin or mark-up.	Yes	Yes
Pass Through - no provision for sharing of risks or benefits	Yes	Yes
Purchasing Strategies Reviewed	Yes (IRP process)	Yes (Annual true-up. Review for prudence and reasonable prices.)
Cost is a significant portion of customer’s total bill.	Yes (> 50%)	No (< 5%)
Separate line item on customer’s bill.	Yes	Yes

ANALYSIS AND POLICY QUESTIONS

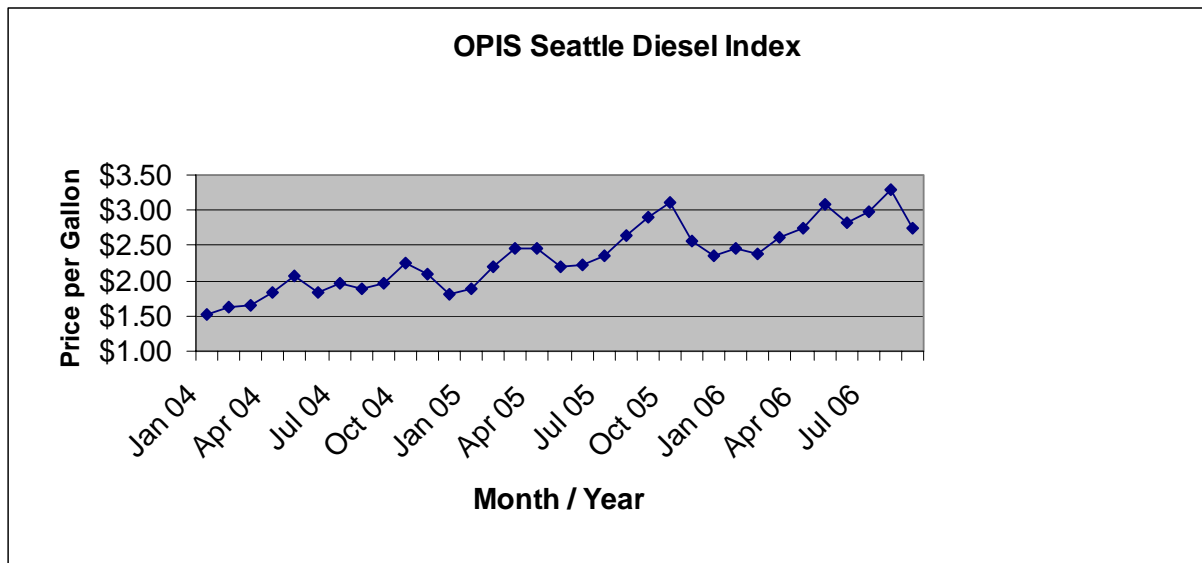
1) Should a Fuel Expense Adjustment for Waste Management expose the Company to some of the risk of fuel price volatility?

As discussed earlier, the commission has previously imposed risk-sharing in some, but not all, similar circumstances. Specifically, the commission has previously established risk sharing in the fuel surcharge methodologies for both solid waste companies and auto transportation companies. Both current methodologies allow companies to recover that portion of increased fuel expense that exceeds one percent of total revenue. The commission is considering revising the threshold for the auto transportation companies to allow recovery of fuel increases that exceed 10 percent of the fuel price imbedded in rates. The Waste Management companies (and other solid waste collection companies) do not meet the one percent of revenue threshold. That is why the solid waste industry wants an alternate methodology.

The proposed deferred accounting methodology eliminates fuel expense from the Lurito-Gallagher model return calculation. That eliminates the company's return on fuel expense. However, the return is very small, only 0.13 percent (3.5 percent fuel x 3.8 percent margin) of total revenue, compared to 1.0 percent of total revenue for the solid waste surcharge methodology. In addition, the fuel surcharge threshold is asymmetrical because the customer does not benefit if fuel prices fall below the price level imbedded in rates.

Establishing a sharing mechanism would require far more sophisticated measurements of total fuel costs and projections for future fuel prices. Staff is not prepared to make recommendations on appropriate standards and measurements at this time.

Although fuel prices have generally risen over the last several years, prices have fluctuated.



Solid waste companies bear the risk of increasing prices and reap the reward of decreasing prices. That is, once fuel prices are imbedded in rates, any operational costs (savings) caused by price increases (decreases) are paid (retained) by the company, not customers. Customers continue to pay the “return” portion on the fuel expense imbedded in rates until the next rate case. As prices increase (decrease), the “return” portion is understated (overstated).

Fuel is a relatively small portion of the company’s total expenses, three percent to eight percent. Total fuel expense is the product of the units consumed multiplied by the cost per unit. As previously stated, staff believes the Lurito-Gallagher rate setting method provides strong incentives for companies to operate efficiently to capture and retain cost savings. That incentive remains under a deferred accounting approach. Inefficient fuel usage, by definition, requires other additional operating units, and costs, such as labor, vehicles, etc.

Companies have limited ability to control fuel price. Solid waste collection companies are small compared to energy companies. Their employees cannot develop and implement sophisticated hedging mechanisms. Building and operating storage for bulk purchasing is not a viable option in many cases due to expense and environmental risk. The primary tool available to most companies are long term fuel contracts, which companies have reported have not been available in the last couple of years because of the price volatility. Companies have little ability to manage unit price on the spot market.

The proposed deferred accounting mechanism would eliminate all monetary incentive for the company to control price. This is not a blank check. The company must still demonstrate that it acted prudently and the resulting prices were reasonable. Staff will still audit the results, but our ability to ensure efficiency and effectiveness is limited.

2) Is the Fuel Expense Adjustment proposed for Waste Management consistent with the policies and principles that apply in other industries with similar issues?

Policy analysis of rate adjustment mechanisms should focus on two levels of inquiry. First, is the cost appropriate for treatment as a single-issue (or single-item)? Second, if the cost is appropriate for single-issue treatment, what mechanism will best preserve, or enhance the utility’s incentive to manage the cost involved.

Using fuel-cost as an example, the table below compares the characteristics and adjustment mechanisms (if any) across industries.

Table 2
Comparison of Fuel-Cost Component and Adjustments

	Fuel-Costs				
	Natural Gas LDC (PGA)	Electric Utility (PCA)^a	Utility Vehicle Fuel (No Mechanism)	Solid Waste Vehicle Fuel Deferred (Proposed)	Solid Waste Vehicle Fuel Surcharge
Proportion of total costs.	>50%	<10%	<1%	Approx. 3.5%	Approx. 3.5%
Utility Expense or Commodity.	Commodity	Expense	Expense	Expense	Expense
Mark-up.	No	No	No	No	Yes
Normalized Component of Base Rates.	No	Yes	Yes	No	Yes
Potential to Manage Fuel Costs. ^(b)	Moderate: Portfolio Management and Hedging	Moderate to High: Generation Alternatives and Portfolio Management and Hedging	Moderate: Fleet management, vehicle efficiency, fuels stockpile.	Low: Few practical usage alternatives, modest potential for improved usage efficiency. Fuel inventory.	Low: Few practical usage alternatives, modest potential for improved usage efficiency. Fuel inventory.
Potential for Expense Offsets (single-issue risk). ^(c)	Low: Fuel costs are a dominant component of total costs	High: Fuel costs significant, but not a dominant component of costs	High: Vehicle fuel costs a very small component of overall costs.	High: Fuel costs a small component of costs.	High: Fuel costs a small component of costs.
Regulatory Review.	Gas purchase strategy in IRP. PGA review is generally cursory.	Power supply costs reviewed in IRP. PCA costs subject to prudence review.	NA	Annual true-up. Costs subject to prudence review.	None.
Risk / Benefit Sharing?	No	Yes – dead-bands and sharing-bands	NA	No	Risk only. Haulers absorb increase equal to first 1% of revenue. Customers do not benefit from price decrease.
Separate Charge on Bill?	Yes	Yes	NA	Yes	Yes

(a) – Refers to the annual accounting and any rate true-ups associated with deviation from base power costs. This column does not cover the PCORC or any other mechanism to “re-set” the base power costs.

(b) – Byers’ qualitative estimates

(c) – Byers’ qualitative estimates

While it would be an overstatement to conclude that a fully articulated set of standards has guided the application of single-issue cost-adjustments, the table supports some practical conclusions.

- Single-issue cost-adjustment is acceptable when the cost at issue is a significant portion of overall costs and the utility's ability to manage the cost is limited.

The proposed deferred accounting mechanism may not meet this standard. Although fuel costs amount to just 3.8 percent of total costs, companies' have limited ability to manage fuel costs.

- If single-issue adjustment is found to be appropriate, the application of risk-sharing depends on the proportion the cost to be adjusted represents of total costs and on the potential for managing the cost. Risk-sharing is appropriate when the proportion of total cost is small (and therefore the potential for cost increases to be offset by reductions in other costs is high). And risk-sharing is appropriate when the utility has some potential (even if limited) to manage the cost at issue.

Because costs are small, the potential is high that changes in other factors (costs or customer growth) will offset all, or part of, the need for additional revenue. The principles suggest that risk sharing would be appropriate.

3) What are the implications of the proposed approach for other industries and for other expenses like labor?

Staff believes the implications to other industries and other expenses are very limited. We think there are sufficient differences, regarding size of expense, price volatility and the company's inability to manage or control usage or prices, in both the short and long run, to distinguish fuel from other expenses, and to distinguish solid waste, and other transportation, companies for other regulated industries.

If the commission allows the proposed deferred accounting mechanism, we expect other regulated companies will ask the commission to authorize similar treatment for fuel, and perhaps other, expenses. Some water companies have asked staff about the possibility of getting a surcharge for the fuel used in water service vehicles.

All regulated companies use fuel. Transportation companies use fuel directly to operate trucks, vans, buses and boats. Telecom, energy and water companies use fuel to operate service vehicles. Customers purchase fuel for their personal vehicles. We all face the same challenge to manage fuel consumption and control price. Other than shopping for the best price, opportunities to control price are very limited.

We think the public understands that companies have limited ability to control fuel prices. Fuel surcharges for transportation services, both regulated and nonregulated, are commonplace today. However, in rate increase filings, the commission still receives

comments from solid waste customers saying they have not received a raise to pay for higher fuel prices and the commission should require companies to manage their fuel costs just like the consumer.

There are few, if any expenses, that have incurred the volatility that fuel prices have in the last several years. However, deferred accounting programs are intended to remain in effect over the long run. In that respect, just about any expense, regardless of the proportional size, may be subject to significant price volatility at some time.

4) How do municipal governments address fuel price volatility in their contracts with waste haulers?

City contracts vary with respect to rate adjustments. Some contracts are “linked” to rates set by the commission. Some contracts provide an annual rate adjustment using the Consumer Price Index, but no specific adjustments for fuel. Some contracts provide specific fuel adjustments:

- Contracts with specific fuel adjustments vary from 2.2% to 3% of base rates.
- Some contracts allow companies to recover the portion of fuel expense that exceeds 10% of the fuel price imbedded in the base rates.

Waste Management states that it adopted a policy that starting in January 2006, it would not sign any municipal contract that does not provide some mechanism for the company to request rate increases to cover increased fuel expense. Waste Management advised staff that it negotiated just two municipal contracts this year and both contain a fuel adjustment mechanism.

Solid waste collection companies do not file city contracts with the commission. Staff reviews those contracts only when auditing for a general rate case.

CONCLUSION

Although staff believes there are no compelling reasons to approve the proposed fuel deferred accounting mechanism, we also believe approving the filing would not set precedent for other expenses or industries and would not harm the company or the customers.

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