COVID-19 Is Straining Compact Between Utilities, Regulators

By **Dane McKaughan and Todd Kimbrough**

Like most other industries in the U.S., rate-regulated electric utilities have been significantly impacted by COVID-19 and the public safety efforts implemented to address the spread of the virus. These impacts are twofold: increased costs and lost revenues.

Dane McKaughan

Regarding the former, utilities' costs have increased due to reasons such as increased reliance on overtime and increased sick leave during the pandemic, as well as additional safety-related costs. With respect to the latter category, utilities have lost returns both due to regulators' prohibitions on disconnecting for failure to pay bills and from the seismic reduction to electricity usage that has occurred since the initial stay-at-home orders.

This article focuses on efforts by utilities to recover these additional costs and lost revenues, and what we can learn from Indiana's recent consideration of the issues.

Todd Kimbrough

The Regulatory Compact and the Filed Rate Doctrine

Most regulators have allowed utilities to track their increased expenses attributable to COVID-19, i.e., bad debt expense. Some commissions, such as in Texas, have allowed a surcharge intended to mitigate the financial impact to providers caused by the prohibition from disconnecting customers.

However, on June 29, in one of the most high-profile orders on COVID-19-related cost recovery to date, the Indiana Utility Regulatory Commission, or IURC, took a different turn and unilaterally suspended provisions in previously approved tariffs regarding charges for late fees, convenience fees, deposits and reconnection fees. The utilities have not consented to these changes to their tariffs, and there is no express timetable for when the utilities would be permitted to return to their approved tariffs.

In that same order, the IURC said that utilities would be required to prove the prudence of expenses associated with these foregone tariffed revenue sources — a fundamental difference in the treatment of these tariffed services when provided during normal operations. There is no clear deadline for these orders, and they seem to be effective so long as the regulator deems it necessary.

The IURC order cites Indiana Code Section 8-1-2-113(a):
The Commission may, when it considers necessary to prevent injury to the business or interests of the people or any public utility of this state in case of any emergency to be judged by the commission, temporarily alter, amend, or with the consent of the public utility

concerned, suspend any existing rates, service practices, schedules, and order relating to or affecting any public utility or part of any public utility in this state.

The IURC nonetheless ordered the utilities to cease charging the tariffed rates for these services. This raises a number of legal and policy problems.

Given that the utilities did not consent to this action, and that the IURC's order is open-ended rather than temporary, there does not appear to be legal, statutory authority for the IURC's order. Moreover, the IURC's order violates the long-standing filed rate doctrine.

This doctrine holds that a utility must charge its tariffed rates at all times until they are changed in a subsequent rate proceeding, and has been central to numerous U.S. Supreme Court cases over many decades. Courts have even found the filed rate doctrine to require charging tariffed rates that were established with inflated costing information.

This article, however, explores an additional problem with the IURC's action — namely, that abruptly and unilaterally reducing previously approved sources of revenue used to meet the utility's authorized revenue requirement may run afoul of the regulatory compact between regulated utilities and their regulators.

Interestingly, the June 29 order acknowledges the regulatory compact, stating: "Under the regulatory compact, at a base level, utilities are obligated to provide safe, reliable service and customers are obligated to pay just and reasonable rates for any such service they receive." Put another way, utilities are entitled to earn revenues sufficient to recover reasonable costs and have a reasonable opportunity for a fair return on their investment, in exchange for providing universal service.

This raises the basic question: Can rates remain just and reasonable when — without the utilities' consent or a supporting cost of service study — a regulator zeroes out a previously approved revenue source in a tariff, without assurance that the utility can recover these revenues and associated returns later?

Recovery of Extraordinary Costs Related to Acts of God

Additionally, the June 29 order rejected the utilities' request to establish a regulatory asset for increased operation and maintenance and financing costs caused by the response to COVID-19, stating that insufficient evidence exists that the utilities faced substantial financial burden warranting extraordinary relief. The order concludes that costs "are not the direct result of a specific emergency government direction … [and have not] created [nor] will create any substantial financial burden on the utility."

Consequently, the IURC concluded that operation and maintenance costs should be considered in a subsequent phase, "and/or through an individual utility's request for a sub docket wherein evidence of the impact of any costs or offsetting savings can be presented and considered in an evidentiary hearing." The Office of Utility Consumer Counselor, or OUCC, argued that recovery of increased operation and maintenance expenses should only be permitted if the utility takes efforts to reduce other expenses, such as "deferring non-critical capital projects, reducing employee incentive payments, or taking advantage of lower interest rates for outstanding debt."

Despite recognizing that the COVID-19 pandemic is an extraordinary event similar to other acts of God such as hurricanes, neither the June 29 order nor the OUCC comments focus on whether the increased operation and maintenance expenses are reasonable and prudently

incurred, which is the normal standard applied to whether costs are recoverable. Instead they suggest that other factors should control whether the utility can recover these costs, including the lack of specific emergency government direction, the financial burden on the utility and whether the utility has refinanced debt.

These criteria for cost recovery differ materially from those applied in other states, and for previous acts of God, i.e., hurricanes, ice storms, etc. Decades of case law from across the country supports this concept. Typically, in the natural disaster context and otherwise, utilities are allowed to recover expenses that are not the product of imprudence, and which are used and useful in the provision of service.

Questions of whether the utility is cutting employee compensation, or whether it is acting in response to the act of God or the government's orders associated with the act of God, are normally irrelevant — because, as the June 29 order notes, under the regulatory compact utilities are obligated to provide safe, reliable service and customers are obligated to pay just and reasonable rates. Traditionally, just and reasonable rates charged by a utility are based in cost of service ratemaking principles.

Importantly, unanticipated costs to a utility caused by an act of God — such as a hurricane or pandemic — create problems for recovery in normal rate cases. In a typical rate case, a utility's rates are set based on its costs and the level of investment in a normalized test year.

Because rates are set anticipating normal operations, any nonrecurring costs during that test period are deleted. So, even assuming a utility filed a new rate case where the test year included these unanticipated COVID-19-related effects, a utility would be at great risk that it could not recover them.

This is one reason why regulators often allow utilities to recover unanticipated costs resulting from an act of God through riders outside the normal ratemaking process. Impeding recovery of increases in operation and maintenance expenses resulting from an act of God puts a utility's ability to recover these extra costs at risk, and encourages the utility to reduce other operation and maintenance costs to compensate for its losses — which in turn reduces the quality of service provided during that extraordinary time relative to normal operations.

The requirement to link recovery of unanticipated COVID-19-related operation and maintenance costs to unrelated factors, i.e., debt refinancing, is limited to Indiana at this time. But other regulators will likely have to address these same issues — and the linking of recovery of legitimate costs to unrelated considerations could impair other utilities as they seek to recover increased operation and maintenance expenses elsewhere.

This article does not suggest that these public safety orders were unnecessary, or that protecting customers from higher rates during this economic downturn is not merited. But the policy choice of how to mitigate the financial burden on customers should not drive the legal analysis related to utility cost recovery.

Tools such as securitization can lessen any impact on customers. Likewise, commissions can use longer amortization periods for riders to minimize the immediate effects on consumers.

The IURC analysis failed to consider important aspects of the legal framework that defines the relationship between the state and a rate-regulated utility. For instance, in order to be consistent with the regulatory compact, the utilities' request for extraordinary relief should

be viewed in the context of the COVID-19 pandemic as an extraordinary event, like other acts of God.

The state previously set "just and reasonable" rates based on a level of revenues it determined necessary to meet the legal standard of reasonable costs and a fair return. But after utilities' ability to recover those revenues was significantly and artificially constrained by the pandemic and state action in response to the pandemic, the IURC applied a more restrictive standard requiring a showing of financial emergency before considering any relief.

And while the IURC and OUCC argue that the impacts of this act of God should be considered normal business risk, unlike other acts of God, considering increased costs and lost load due to pandemic response as a normal variation or risk that is covered by the return on equity set in a rate case prior to the pandemic could have unintended consequences.

For instance, if the regulatory compact is insufficient to protect utilities from lost revenues during a public emergency, then the capital markets may start demanding higher returns to compensate for this higher risk profile. This could cause rates to rise in the future. And utilities may need to file for new rates very soon to account for the revenues they cannot recover through existing rates.

Dane McKaughan and Todd Kimbrough are partners at Holland & Knight LLP.

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