

MEMORANDUM

TO: Rhode Island Public Utilities Commission
FROM: John Stutz, Tellus Institute, on behalf of the Rhode Island Division of
Public Utilities and Carriers
TOPIC: Narragansett Electric Company's Proposed SOS Rate, Docket 3739.
DATE: August 21, 2006

The Company has proposed reducing the rate for Standard Offer Service (SOS), from 10¢ to 9.4¢ per kWh for the remainder of 2006. The basis for the Company's proposal is, in large part, rate stability. The 9.4¢ rate is expected to produce a year-end balance of \$23.2 million. Based on this balance and other currently available information, the Company anticipates that a rate of 9.2¢ for all of 2007 would be possible. The purpose of this memorandum is twofold: to explain why, in general, stability is an important and appropriate goal for SOS rate design, and to discuss uncertainty in the estimation of SOS fuel index payments—a further practical concern which supports the Company's rate design proposal.

The Importance of Rate Stability

Rate stability has long been recognized as one of the appropriate and important goals for ratemaking. Bonbright's Criteria of a Sound Rate Structure includes it as Criterion No. 5.

5. Stability of the rates themselves, with minimum of unexpected changes seriously adverse to existing customers. (Compare "The best tax is an old tax.")

In past decisions the Commission has recognized the importance of stability. For example, in its recent decision in Docket No. 3706 the Commission stated:

The goal of ratemaking is to balance the need for revenues sufficient to cover costs with the desire for rate stability over time.

Support of rate stability is based on many considerations including the promotion of efficiency. The usage of electricity depends in large part on the stock of electrical equipment ratepayers purchase. Stable prices allow ratepayers to form a clear impression of their electricity costs, make purchases based on that information, and realize the benefits from investments in efficiency—such as the choice of high efficiency home appliances—that they choose to make. Instability in rates undermines this process. At its recent summer meeting NARUC endorsed a National Action Plan for Energy Efficiency. In Rhode Island, recently passed legislation refers directly to the benefits of stable rates and requires Narragansett to procure cost-effective efficiency as part of the portfolio of resources used to serve Standard Offer load after 2009. These developments make clear the importance and appropriateness of the Company's choice to emphasize stability of the SOS rate, thereby fostering efficiency.

Going beyond the matter of efficiency, there is the basic issue of consumer preferences. It has long been accepted that ratepayers have a preference for stable rates. In recognition of this, Bonbright includes the maxim “The best tax is an old tax” as part of his criterion for rate stability. Consumers’ preference for stability as well as their strong aversion to rate increases supports the course of action proposed by the Company—limiting decreases in the short run so that they can likely be followed by further decreases not increases in the longer run.

The strength of consumers’ answer to “losses,” such as electric rate increases, has been an important focus of recent research in microeconomics. The research shows that the adverse reaction to a loss is 2.5 times greater than the positive reaction to an equal gain. Prospect theory—the formal structure which embodies this and other related insights concerning consumer behavior—was central to the work which earned Daniel Kahneman a share of the Nobel Prize in Economics in 2003. These points support the course of action proposed by the Company—limiting decreases in the short run so that they can likely be followed by further decreases not increases in the longer run.

Uncertainty on Fuel Index Payments

The Company’s proposal for the SOS rates rests on its estimate of SOS expenses. In the past, these expenses have proved difficult to estimate. Each of the five most recent SOS filings by the Company has been followed by a substantial revision in the estimated SOS expenses. The attached table shows these revisions. Based on the data in the table it is reasonable to assume that there could be substantial revisions in the Company’s current estimates. In particular, I would note that the Gulf of Mexico has yet to be hit by a strong hurricane this year. Were this to happen, oil and gas prices could be affected, driving the SOS fuel index up. A cold fall could do the same thing, as Mr. Hager notes on page 7 of his testimony.

While one always wants rates to be as low as possible, one also needs to recognize uncertainty when setting SOS rates. In my view, the Company’s proposal strikes a reasonable balance in that regard. This point of view is reinforced by a comment made by the Commission in its last SOS Decision: Where the rates have increased by double-digit percentages over the last three months, the main goal should be stability. If stability is the “main goal,” then it is appropriate to have a substantial balance at the end of 2006. The Company is currently projecting a \$23.2 million SOS balance at the end of 2006. However, that situation could easily change. Given the record of revisions shown in the attached table, it would be reasonable, in my view, to proceed as the Company has suggested—making a substantial reduction now but waiting until next year end to “spend” the additional anticipated savings.

REVISIONS IN SOS EXPENSE ESTIMATES
(\$ Millions)

SOS Filing	Filing Dates		SOS Expenses		Period Covered		Difference	
	Initial	Revised	Initial	Revised	From	To	Actual	Annualized
Jan. 2005	11/10/04	12/13/04	617.7	560.5	10/04	12/05	- 57.2	- 45.8
July 2005	7/29/05	9/23/05	568.7	678.3	1/06	12/06	109.6	109.6
Oct. 2005	10/21/05	11/30/05	708.5	676.7	1/06	12/06	- 31.8	- 31.8
March 2006	3/31/06	4/21/06	527.3	546.2	4/06	12/06	18.9	25.2

Note: Annualized differences are simply actual differences scaled for periods other than 12 months. Thus, the annualized difference for the Jan. 2005 filing is $(12 \div 15)$ times actual difference. For the March 2006 filing the scaling is an increase of $(12 \div 9)$.