



National Regulatory
Research Institute

**Pre-Approval Commitments:
When And Under What Conditions Should Regulators
Commit Ratepayer Dollars to Utility-Proposed Capital
Projects?**

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A. Example #1: A relatively small water utility seeks pre-approvals in connection with a relatively large — but otherwise routine — investment

Assume that a small water utility is required by statute or regulation to undertake a relatively large capital investment. The investment concerns a program that, while substantial for the utility, is routine for the industry. An example could be the development of a leak detection and mitigation program, which may include the removal and repair or replacement of a large portion of the utility's underground plant. The utility asserts that it needs upfront assurances that would not be available under the traditional approach of cost recovery after-the-fact.

The small utility might request two kinds of pre-approvals: one involving cost recovery and one involving approval without addressing cost recovery. An example of the former would be the utility arguing that it has no access to the level of financing required to complete the project, and that it cannot proceed absent assurance of contemporaneous cost recovery. An example of the latter would be seeking the regulator's blessing of the proposed program as a prudent course of action. Given the commission's statutory obligation to support any decision with substantial evidence, it must require that the utility document the specific challenges. If a utility wants advance approval, it must demonstrate that the program is the best option available. Identifying a statutory mandate, state or federal, would serve this purpose if the mandate specifies the solution.

The commission will need to consider whether conditions should be imposed on pre-approval, including these questions:

- Should the pre-approval, if granted, be contingent on the receipt of periodic progress reports?
- Should any cost recovery be capped at no more than the estimated price tag for the program? Should that cap be a hard cap, or one that the commission can raise or lower depending on future facts?
- Does the small utility have the technical resources sufficient to undertake a major capital project? If not, should the commission condition pre-approval on the utility procuring engineering and project management assistance? To what extent should or must the commission become involved in monitoring project progress?⁵⁰
- Will a pre-approval aimed at shifting regulatory risks involve other associated adjustments? For example, should the utility's return on equity be adjusted if assurances are provided that result in changes in the utility's risk profile?

Each of these questions have a common theme: cost-benefit analysis. The commission should be satisfied that the risks associated with providing approvals in advance — including the constraints on the commission's ability to take action after the fact because of approvals granted

⁵⁰ To the extent the commission is involved in monitoring progress, the commission staff or an outside consultant will have to examine the progress of the project, measure it against whatever standards are available, and help the commission render a judgment as to whether the job is being done adequately.

before-the-fact — are outweighed by the benefits derived from the timely implementation of the infrastructure upgrade. Then the commission should ensure that those benefits arrive.



B. Example # 2: A utility with reasonable access to capital seeks pre-approvals in connection with a routine investment

In this example, the utility has ready access to capital on reasonable terms, and the needed capital project presents few new or unusual challenges. Unlike the first example, there is no reasonable claim that, absent pre-approvals, the project cannot be financed. As in the first example, the project will provide substantial benefits for customers, assuming efficient implementation.

The utility here seeks the same two types of pre-approvals: one that directly involves cost recovery and one that does not. For the pre-approval that does not directly involve cost recovery, the utility must demonstrate that its selected project is the best feasible option.

As to pre-approval of cost recovery, the utility's access to capital requires assessment of at least the following issues:

- The utility can make the investment without a pre-approval commitment. One question is whether pre-approval of cost recovery will lower the cost of capital while having no effect on management's incentive to act efficiently.
- The commission can address the efficiency issue directly by considering whether any advance authorization should be capped at the estimated cost of the project and, if so, whether the cap is hard (no later adjustments) or soft (later adjustments, up or down, possible based on fact changes). If the authorization is entirely "upside" for the utility, it may lack sufficient incentive to manage the project efficiently.
- As in the first example, the commission might consider conditioning cost recovery commitments on the submission of periodic project status reports. Continued regulatory supervision should encourage management to conduct construction of the project in a cost-efficient manner. Moreover, regulatory oversight can readily catch and prevent glaring inefficiencies and errors, especially as concerns routine infrastructure repair and replacement projects.
- The commission should consider why a utility with access to capital needs pre-approval of cost recovery. Is the utility seeking pre-approval to rectify prior management neglect? Was this project, for example, something that should have been pursued several years ago? Is early approval and cost recovery in such situations merely a reward to a utility that may have unreasonably delayed making necessary repairs and improvements to its system? To the extent there is evidence of management imprudence, the commission might consider combining early approval and cost recovery with reductions to the allowed return on equity to reflect (a) the lower risk to the utility where its costs are approved or recovered before project completion, as well as (b) management imprudence in delaying necessary investments.