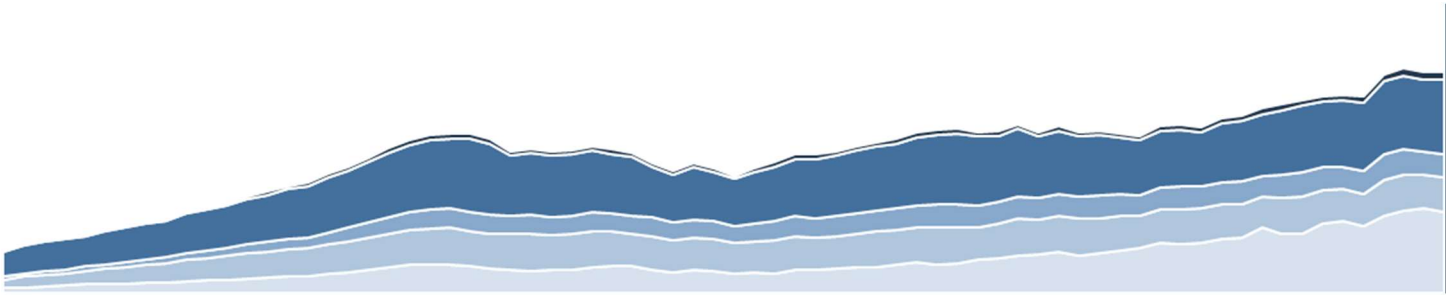

LEARNING TO SHARE: A PRIMER ON FUEL-COST PASS-THROUGH REFORM

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Executive Summary

Electric utilities in the United States spend billions of dollars annually buying fuel to generate electricity. These costs often make up a sizable share of customer bills, and unlike other bill components, they can vary substantially from month to month. This makes it imperative that utilities manage their spending on fuels carefully—but most utilities have no financial incentive to do so. This is because in most states today, utilities are allowed to pass on 100 percent of their actual spending to customers through policies called "fuel adjustment clauses" (FACs).

FACs create a problem that economists call "moral hazard." Moral hazard exists when one party does not suffer the consequences of making bad decisions, so it takes bigger risks as a result. Current 100 percent pass-through policies create moral hazard because if utilities manage to reduce fuel costs (for example, by negotiating better prices or reducing their fleet's reliance on fuel) their customers receive all of the benefits, and if utilities manage their costs poorly, their customers pick up the bill.

Ever since FACs were implemented, they have created this moral hazard problem. However, in recent decades its real-world consequences have grown more acute due to a series of developments. These include several trends which have magnified the risks of heavily relying on price-volatile fuels for electricity generation, and others which have decreased the cost of fuel-free alternatives. In addition to the heavy cost burden that FACs impose on today's customers, they also fail to incent utilities to aggressively pursue clean resources that could help lower carbon emissions.

Though FACs are the norm today, these policies are ripe for revision by legislators and public utility commissioners interested in addressing these growing challenges. However, not all policy makers understand the downsides of current FAC policies, and not all those who do are motivated to take proactive actions to address them. Advocates can play important roles in educating key policymakers, encouraging them to act, and enlisting the support of other parties when needed to advance reforms in their state.

Eliminating FACs altogether may seem like the simplest policy fix, but moving from a 100 percent pass-through to a zero-percent pass-through overnight could create financial difficulties for utility companies. Fortunately, such an abrupt change is not necessary. Updating the FAC to pass through a lower share of the utility's actual spending to customers can successfully address the moral hazard problem while limiting the total risk the utility is exposed to. This type of reform is called "fuel-cost sharing."

Fuel-cost sharing can be implemented in different ways. The basic fuel-cost sharing policy that has been adopted by most states to date represents only a modest departure from the status quo. It entails first building a forecast of fuel costs into the utility's base rates (as is true of FAC policies), and then truing up less than 100 percent of the difference between the forecasted and actual spending. However, this is not necessarily the optimal design, since relying on forecasts makes this approach vulnerable to gaming by the utility. FAC reforms can also be designed in other ways that may better serve local policy priorities.

A range of design considerations are relevant. These include the extent of fuel-cost sharing, whether the sharing is symmetrical, and which costs are included in the mechanism. Other policies can also

be used to complement the fuel-cost sharing mechanism or serve as alternatives to it, including reforms that increase transparency, encourage hedging, and increase the scrutiny of utility spending decisions.

While FAC policies remain the norm across the United States today, a few states have adopted fuel-cost sharing policies or other reforms. These include Hawaii, Idaho, Organ, Wyoming, Montana, Washington, Wisconsin, Vermont, and others.

Reforming FAC policies could enhance affordability by motivating utilities to manage their fuel costs more carefully. It could also reduce carbon emissions by encouraging utilities to switch more quickly to fuel-free technologies. It is time for these outdated policies to change, and both commissions and advocates can play important roles in advancing reforms.

Introduction

Every year in the United States, electric utilities spend billions of dollars purchasing fuel to generate electricity. During the COVID-19 pandemic, between 2020 and 2021, vertically integrated utility companies alone spent $70 billion in fuel costs.[1] This represents a sizable share of the total cost of producing electricity.

However, thanks to an obscure policy commonly known as the "fuel adjustment clause" (FAC), most US utilities lack any financial incentive to reduce how much money they pay for fuel.[2] Instead, these utilities are allowed to "pass through" 100 percent of these costs to their customers via a bill rider. Customers then have little choice but to pay for these costs—since the alternative would be to lose their access to electricity. In many states, the FAC is a specific line item on electric utility bills, as illustrated in Figure 1.

Figure 1. Sample Electric Bill from Xcel Energy

ELECTRICITY CHARGES		RATE: Net Energy Billing Svc		
DESCRIPTION	USAGE UNITS		RATE	CHARGE
Basic Service Chg				$8.00
Basic Service Chg				$1.90
Energy Charge Winter	946 kWh		$0.088030	$83.28
Energy Charge Winter	0 kWh		- $0.121590	$0.00
Fuel Cost Charge	946 kWh		$0.035507	$33.59
Sales True Up	946 kWh		- $0.007360	- $6.96 **CR**
Affordability Chrg				$0.98
Resource Adjustment				$14.23
Interim Rate Adj				$8.14
Subtotal				**$143.16**
City Fees			5.00%	$7.06
Transit Improvement Tax			0.50%	$0.74
City Tax			0.50%	$0.74
County Tax			0.15%	$0.23
State Tax			6.875%	$10.20
Total				**$162.13**
Premises Total				**$162.13**

A FAC often appears as a separate line item on customer electricity bills. It is highlighted on this residential bill from Minnesota.

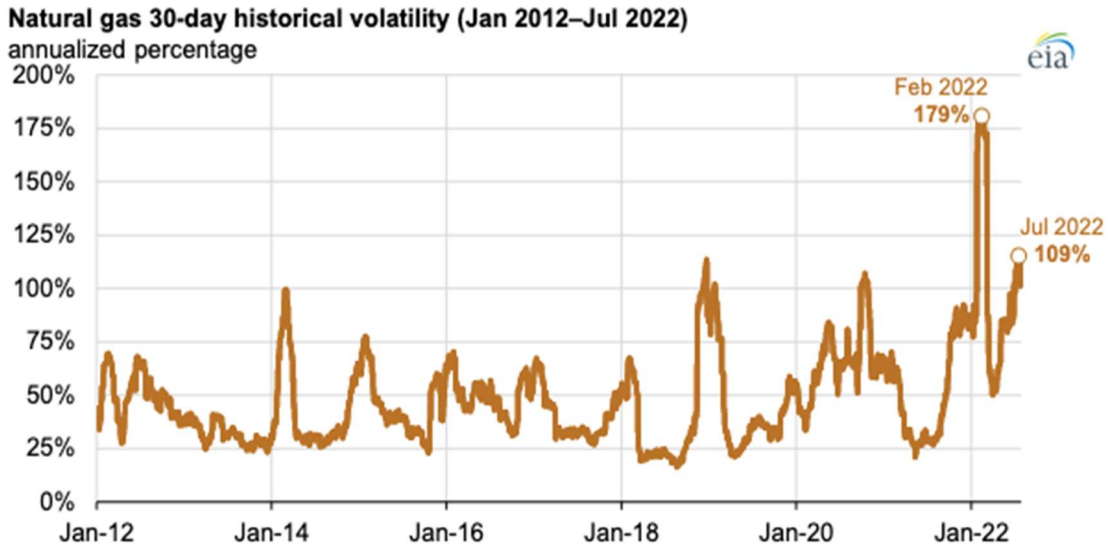
The burden on customers is further increased by the variability of fuel costs. Unlike most components of utility bills, the size of the fuel charge fluctuates substantially over time. This is largely due to the volatility of natural gas prices (and to a lesser extent, coal prices) coupled with changing weather. For example, in January 2022, fuel-cost volatility combined with Kentucky

[1] Lin, Albert, J. Daniel. "Electricity Customers are Getting Burnt by Soaring Fossil Fuel Prices. RMI. June 2023. www.rmi.org/electricity-customers-are-getting-burnt-by-soaring-fossil-fuel-prices/

[2] Fuel costs are passed through to customers via FACs by both electric utilities and natural gas utilities. While this primer focuses specifically on electric utilities, many of the same arguments for FAC reform apply to gas utilities as well. We refer to policies that pass 100% of fuel costs through to customers via a bill rider as "fuel adjustment clauses" (FACs), but in some states these policies go by different names (e.g., the Energy Adjustment Clause in Iowa, Energy Cost Recovery in Alabama).

Power's FAC resulted in roller coaster" rates that made it difficult for some customers to make ends meet.[3] Figure 2 illustrates the volatile nature of natural gas prices over the last decade.

Figure 2. Historical 30-day price volatility of natural gas



Natural gas prices are highly volatile. Though the price spike in early 2022 was particularly severe, gas prices continually rise and fall in unpredictable ways.[4]

Though FACs pass through 100 percent of actual costs to customers, most components of utility rates do not work this way. The basic rates utilities charge customers for electric service (known as base rates) are set in advance according to the projected costs of power generation and delivery over a set period of time. These base rates establish a predictable per-kWh rate, even if utilities spend more or less than was expected when the rates were set.

In contrast, a FAC allows a utility to charge customers for the exact amount spent on fuel. As a result, fuel does not represent a business cost or profit center for utility companies. This means utilities are able to ignore the cost and volatility of fossil fuels in their decisions, even though customers end up paying more as a result.

> "Because of this 100 percent pass-through policy, a utility that manages its fuel costs well earns no reward—and one that manages them poorly faces no consequences because its customers pick up the bill."

Allowing utilities to ignore the consequences of relying on fuels distorts decision-making about what types of resources to invest in, which can disadvantage fuel-free resources in utility planning and investment decisions. Since earnings are not affected if fuel prices rise, the utility can ignore the risk of volatile and elevated costs when making investment decisions. Ignoring the volatility of fossil fuels

[3] Emily Bennett, WSAZ Investigates: Kentucky Power bill spike, January 28, 2022, https://www.wsaz.com/2022/01/28/wsaz-investigates-kentucky-power-bill-spike

tips the scales towards them—and away from more cost-effective fuel-free alternatives like wind, solar, and energy efficiency. FACs also give utilities no incentive to find shorter-term strategies to lower fuel costs, such as negotiating better fuel-supply contracts.

This phenomenon differs from what happens in a competitive market, where a company that succeeds in reducing its costs will gain an advantage over its competitors. A regulated utility with a FAC gains nothing if it succeeds in reducing its fuel costs. Because of this 100 percent pass-through policy, a utility that manages its fuel costs well earns no reward—and one that manages them poorly faces no consequences because its customers pick up the bill.

History of Fuel-Cost Pass-Through Policies

Fuel costs were not always treated as a 100 percent pass-through to utility customers. For almost the whole first century of US utility regulation, utilities were expected to manage their fuel costs in the same fashion as other business expenses.

The first power plants were built in the last few decades of the 19th century. To prevent privately owned utilities from overcharging customers, local and state governments stepped in to regulate the rates they could charge. The newly created public utility commissions treated fuel costs as just one aspect of the costs of doing business, rather than as a unique cost category requiring special ratemaking treatment.[5]

When World War I caused fuel prices to soar, utilities lobbied commissions for relief from fuel-price volatility and the associated risk of significant financial loss. Public utility commissions responded by implementing the first temporary FACs, which they discontinued shortly after the war. When World War II also created global fossil-fuel supply challenges, commissions reinstituted temporary FACs—which were likewise curtailed once peacetime resumed.

The oil shocks of the 1970s again sparked utility demands for insulation from global supply disruptions, and this time both state legislators and public utility commissions responded. Though the gasoline lines of the 1970s soon disappeared, in most states the statutes and commission decisions that established FACs have never been meaningfully revisited.

Today, these policies are the norm across the country. In most states, the process through which costs are approved for recovery through FACs is opaque to customers and their advocates, since investor-owned utilities are allowed to treat their fuel-supply agreements as trade secrets. This means that despite being saddled with 100 percent of the costs, ratepayers cannot generally evaluate whether the fuel-supply agreement terms are reasonable.

It is reasonable to wonder why legislators and public utility commissions have left these policies in place for so long. FACs are typically justified based on the idea that utilities cannot control the cost of fuel. However, this assertion was never entirely true, and it is even less true today. For example, utilities make decisions about how much natural gas capacity to build, and they negotiate the fuel-supply contracts that determine the prices they pay for natural gas. In addition, due to technological

[5] We refer to all such regulatory bodies as "public utility commissions." In many states the body has a similar name (e.g., the Nevada Public Utilities Commission), but this is not always the case (e.g., the Maryland Public Service Commission, the Kansas Corporation Commission, the Washington Utilities and Transportation Commission).

advances, utilities can now displace fuel-based generation with a range of cost-competitive alternatives that use little to no fuel (e.g., solar, wind, batteries, energy efficiency). Yet, because FACs insulate utilities from the financial consequences of relying on fuel, the companies have little incentive to change.

The Problem: Moral Hazard and Inefficient Investment Decisions

FACs create a problem that economists call "moral hazard." Moral hazard exists when one party does not suffer the consequences of making bad decisions, so they may take bigger risks as a result. The moral hazard problem crops up in many spheres, including insurance, investing—and utility regulation.[6]

"The moral hazard problem has existed since the first FACs were implemented; however, in recent decades the real-world consequences of this have grown more acute."

In the regulatory sphere, 100 percent fuel-cost pass-through policies provide a particularly stark example of moral hazard. When a FAC is in place, the utility decides how much fuel to buy and at what price—but it is the utility's customers who pay the cost if the utility spends more money than necessary. In other words, the utility (and its shareholders) are held harmless from the consequences of poor fuel-management decisions.

The moral hazard problem has existed since the first FACs were implemented; however, in recent decades, the real-world consequences of this have grown more acute. This is due to two types of recent trends. First, a series of developments have magnified the risks of relying heavily on fuels. Second, the costs of fuel-free alternatives have decreased.

Trends that Have Magnified the Risks of Relying Heavily on Fuels

The first category is developments that have increased the risks associated with relying on fuels. These include the following:

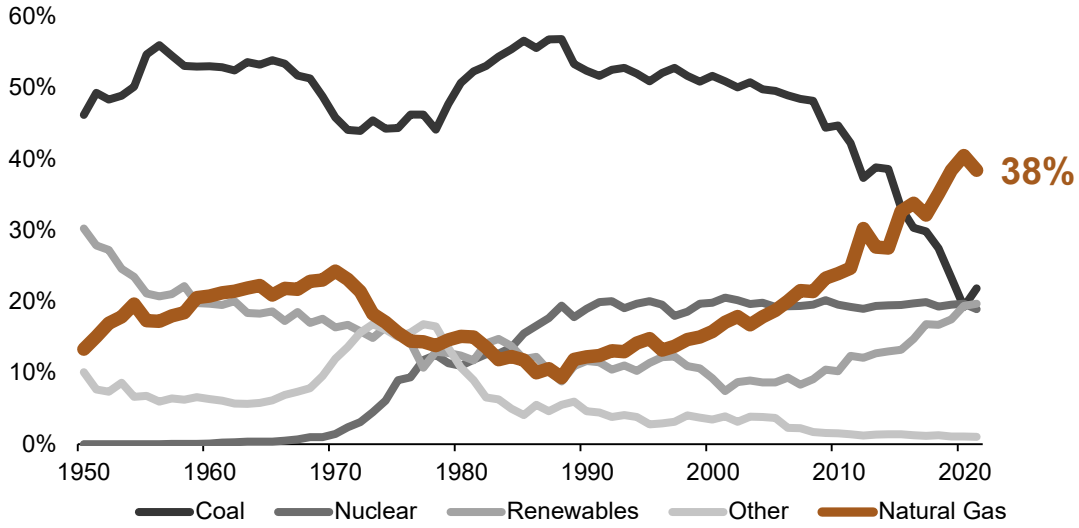
> **Greater utility dependence on natural gas.** Over the last two decades, utilities have been building gas-fired power plants at a rapid pace. Because of this construction spree, the share of electricity generated from gas has risen dramatically (Figure 3), and electric utilities have grown from being small, niche buyers of natural gas to being the gas industry's biggest market (Figure 4). This has created a situation in which customers are much more exposed to the effects of gas-price volatility than they used to be. Natural gas prices are by their nature volatile, and now a much higher share of electricity generation depends on gas purchases.[7] In addition, the electric sector's demand tends to rise and fall in a pattern driven by seasonal changes and regional weather events—which can cause supply constraints. For

[6] The classic insurance example is that an insured party may take more risks than they would otherwise, since the insurer will pay for any loss that may occur. An example from the world of investing is that a money manager may take excessive risks with other people's wealth.

[7] Jamison Cocklin, U.S. Natural Gas Price Volatility at All-Time High in 2022, Natural Gas Intelligence, August 16, 2022, https://www.naturalgasintel.com/u-s-natural-gas-price-volatility-at-all-time-high-in-2022

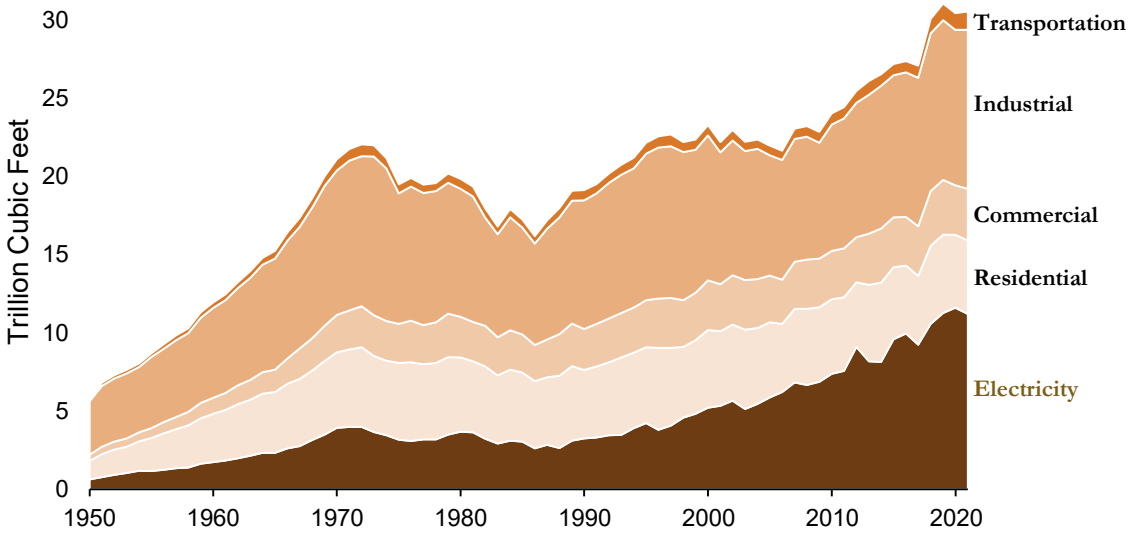
example, if a major heat wave hits the eastern United States, the electric utilities in all impacted states will consume more natural gas than usual to meet the increased need for air conditioning, resulting in rapid price increases as regional gas inventories are depleted.

Figure 3. US Electricity Generation by Resource



Between 1950 and 2022, the share of electricity generated from natural gas roughly tripled, from 13 percent to 38 percent.[8]

Figure 4. US Natural Gas Consumption by Sector



In recent years, the electric power sector has become the largest customer of the natural gas industry.[9]

More severe weather. Another recent trend is that weather is becoming more severe due to climate change. The growing intensity of both summer heat waves and winter cold snaps

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increases the odds of large fuel-price spikes as gas demand outstrips available supply. For example, in 2021, Winter Storm Uri led to a steep drop in natural gas production, leading to supply constraints and record-setting prices.[10] Forest fires, hurricanes, and other severe weather events can also trigger fuel-supply disruptions.

Increasing exposure to geopolitical risks. Globalization has made the international economy increasingly interconnected. With heightened natural gas prices in Asia and Europe, US producers ship a sizable share of domestically produced gas abroad as liquified natural gas (LNG)—and the United States recently became the world's largest LNG exporter.[11] This heavy involvement in international trade makes the US natural gas sector vulnerable to conflict-induced supply disruptions, which can translate into increased fuel-price volatility. For example, when Russia invaded Ukraine in February of 2022, the combination of sanctions against Russian gas and increased exports to Europe caused global prices to soar.[12]

Trends that Have Made Fuel-Free Alternatives More Attractive

In addition to the trends magnifying the risks of relying heavily on fuels for electricity generation, a series of developments have made fuel-free alternatives more reliable and cost-effective. These include the following:

Cheaper fuel-free alternatives. Through the end of the twentieth century, most commercially viable generation technologies (e.g., coal, natural gas, nuclear) required fuel. Today, fuel-free energy resources like energy efficiency, solar, and wind are often the lowest-cost sources of power,[13] while new technologies like advanced metering infrastructure (AMI) and distributed energy resource management systems (DERMS) can enable storage, energy efficiency, and demand response to be deployed in ways that allow a much higher share of demand to be met by these resources.[14] Utilities today can choose to reduce fuel dependence in ways that were not possible even a few years ago.

Supportive federal policies. The Inflation Reduction Act (IRA), passed in 2022, featured a range of provisions that increased the economic attractiveness of fuel-free alternatives. These include the extension of the production tax credit (PTC) and investment tax credit (ITC) that are available to renewable and storage facilities, changes that better position regulated utilities to take advantage of these tax credits, and access to low-cost debt to help retire existing fossil-fired power plants.[15]

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[10] American Public Power Association, Winter Storm Uri, Extreme Winter Events, And Natural Gas Reforms, Issue Brief, January 2022, https://www.publicpower.org/system/files/documents/January%202022%20-%20Winter%20Storm%20Uri.pdf

[11] EIA, The United States became the world's largest LNG exporter in the first half of 2022, July 25, 2022,

[12] IEA, Russia's War on Ukraine: Analysing the impacts of Russia's invasion of Ukraine on global energy markets and international energy security, https://www.iea.org/topics/russias-war-on-ukraine

[13] Zachary Shahan, Wind & Solar Are Cheaper Than Everything, Lazard Reports, CleanTechnica, November 15, 2020, https://cleantechnica.com/2020/11/15/wind-solar-are-cheaper-than-everything-lazard-reports

[14] Lauren Schwisberg, The Business Case for New Gas Is Shrinking, RMI, December 8, 2022, https://rmi.org/business-case-for-new-gas-is-shrinking

[15] Jessie Ciulla, Gennelle Wilson, and Rachel Gold, What Utility Regulators Needs to Know about the Inflation Reduction Act: How to Ensure the Biggest Boon to the Energy System in US History Supports Affordable, Reliable Electric Service, RMI, 2022, https://rmi.org/insight/what-utility-regulators-need-know-about-ira

The Consequences of Moral Hazard Have Grown More Acute

Taken together, these recent trends have fundamentally changed the US energy landscape. The risks of overreliance on fuel-based generation have increased while fuel-free alternatives have become more reliable and cost effective. In this new world, it literally pays to reduce utilities' reliance on fuel.

However, when a FAC is in place it's not the utilities who receive this benefit—it's customers. While a utility doesn't profit from using more fuel, it doesn't profit from decreasing fuel usage either. It's also important to realize that managing fuel costs carefully isn't free. It takes managerial effort and investment in expertise, and utility managers are incentivized to focus on other areas of operations and investment. Because of this, utilities are not taking full advantage of current opportunities to reduce fuel costs. Fortunately, a practical solution to this moral hazard problem is available. We turn to this next.

A Promising Solution: Fuel-Cost Sharing

FACs are the norm today, but this can be changed. These outdated policies are ripe for revision by legislators and public utility commissioners who care about making utility services more affordable, protecting customers from unnecessary risks, and/or reducing carbon emissions. The moral hazard created by 100 percent pass-through policies undermines all of these goals—so updating these policies can yield multiple benefits.

Since FACs have only been the norm for a few decades, it may seem like the best solution would be to eliminate them altogether. However, such a marked departure from current practice could pose significant risks. Today's utilities would be more sensitive to unexpected fuel-cost fluctuations than their early 20th-century counterparts, since current business models have developed based on the expectation that utilities will be sheltered from this source of volatility.[16] For this reason, suddenly moving from a 100 percent passthrough to a zero-percent pass-through policy could undermine a utility's financial stability, driving up its cost of capital and eventually necessitating rate hikes.[17]

Fortunately, states do not need to shift 100 percent of the fuel-cost risk back onto the utility. The goal of reforming the FAC is simply to motivate the utility to keep its fuel costs in check—and this can be done while limiting the total risk the utility is exposed to.

This reform can be accomplished by updating the FAC to only pass through part of the fuel costs to customers. This does not mean that customers wouldn't pay anything for the rest—just that they would reimburse the utility for the rest of the fuel in the same way they pay for most utility expenditures. In other words, these costs would be recovered in rates that are set in advance and not trued up afterwards to match actual expenditures. This reform is called "fuel-cost sharing," though in reality what it does is share the risk that fuel costs will deviate from expectations between the utility and its customers.

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[16] The relevant features of current utility business models include but are not limited to their capital structure, organizational structure, and risk profile.

[17] A utility's cost of capital is the minimum amount the utility would need to pay debt and equity investors to secure the funds it needs to run its business. This is sometimes referred to the utility's "true" cost of capital to distinguish it from the estimated cost of capital regulators use when setting rates, which is generally higher than the true cost of capital.

Fuel-cost sharing can be implemented in different ways—and we discuss key design options later. However, at this point it would be helpful to understand the basic mechanics of the form that has been most often adopted by states thus far.

This form of fuel-cost sharing requires only a modest departure from the way most FACs are implemented today. Under the typical 100 percent pass-through policy, a forecast of fuel costs is first built into base rates and the FAC then trues up the forecast once the actual expenditure has been made. The FAC does this by charging or crediting customers for the difference between the forecasted and actual fuel costs via a rider; this usually appears as a separate line item on customer bills. The only change to this status-quo policy that is made to implement the reform is to true up less than 100 percent of this difference.

For example, a fuel-cost sharing policy of this type could true up just 90 percent of the gap between the forecasted and actual fuel costs. This would mean that if fuel costs are less than forecast the utility will get to keep 10 percent of the underspend, and if fuel costs exceed the forecast it will bear 10 percent of the excess amount. In other words, the utility will now have a financial incentive to seek ways to reduce fuel costs—and customers will receive 90 percent of any savings.

While this is the variant of fuel-cost sharing that has been most widely adopted to date, it is not necessarily the optimal one. One of its biggest drawbacks is that if the utility is able to inflate the fuel-cost forecast that is built into base rates, it will be able to retain a share of that inflated amount (e.g., 10 percent in our example). In other words, anchoring the fuel-cost sharing mechanism to a forecast can invite the utility to game the forecast.

Fortunately, there are ways to avoid this problem, and there are also more complex structures that can allow regulators to tailor their fuel-cost sharing policy to local circumstances. We will discuss these policy design options later.

Avenues for Reform

It is one thing to identify a needed reform—and a different thing entirely to make it happen. The most fruitful strategy will vary by state, and it may also vary by utility.

To identify appropriate reforms, it is important to first understand how fuel costs are currently regulated. The biggest question is whether 100 percent of fuel costs are passed through to customers or if there is some form of fuel-cost sharing already in place. Keep in mind that 100 percent fuel-pass-through mechanisms are sometimes called different names, even though we refer to them all as FACs here.

The next step is to determine which decision makers have the ability to reform the existing policy. Public utility commissions are responsible for overseeing regulated utilities and setting the prices they can charge, so achieving FAC reform will likely require engaging with the commission. However, some state legislatures have passed laws that mandate 100 percent pass-through policies, so, in these states, reform will require revising these statutes. In addition, interested legislatures can motivate reform at the commission by encouraging or requiring it to revisit these policies.

How to Engage a Public Utility Commission on Fuel Adjustment Clause Reform

To engage a public utility commission on the topic of FAC reform, advocates first need to identify the best formal venue.

Commissions make decisions through individual proceedings (aka "dockets") that focus on particular regulatory issues. Each proceeding is assigned a specific identifying number (often called a "docket number"), and the documents associated with the proceeding can generally be obtained through a commission's online docket search.[18] Participating in a proceeding typically requires applying for intervenor status, but sometimes the commission will issue a notice inviting comments from the general public.[19] The types of proceedings that may be good venues for FAC reform include the following:

Dedicated FAC dockets. Commissions typically periodically review and approve fuel costs for recovery in specific FAC-related dockets, so engaging in these proceedings can be one way to push for changes. However, in some states, these proceedings offer little opportunity to scrutinize utility requests for fuel-cost recovery—for example, where stakeholders lack access to key data, face rapid turn-around times for comment submission, are constrained by a narrow definition of the issues in scope for the proceeding, or face other barriers that prevent them from advocating effectively for reform. In these cases, pushing for changes to the way the commission conducts these dockets may be a prerequisite to reforming a FAC through them.

Rate cases. General rate cases may also provide a venue for stakeholders to raise concerns about fuel-cost treatment and offer solutions. The basic function of rate cases is to set the utility's base rates going forward, and to do this the commission examines a wide array of different topics that pertain to utility expenditures. Rate cases are typically conducted over a longer time frame than dedicated FAC dockets and in a way that invites more input from stakeholders.

> "It is one thing to identify a needed reform—and a different thing entirely to make it happen. The most fruitful strategy will vary by state, and it may also vary by utility."

Performance-based regulation proceedings. Proceedings that focus on investigating or implementing performance-based regulation (PBR) are another potential venue for FAC reform. The purpose of fuel-cost sharing is to better align the utility's incentives with the interests of customers and society, which is precisely the definition of

[18] The structure of PUC docket searches varies greatly—some are relatively intuitive while others can be very difficult to navigate. If you have trouble with the docket search (or more general questions about what to look for), PUC staff are often willing assist if asked.

[19] To become an intervenor, a party must typically submit a request to the PUC that justifies why they should be granted intervenor status. Generally this means showing that they have a compelling interest in the outcome and that they will make some kind of unique/valuable contribution because they represent a particular group/perspective. The PUC will then either grant or deny them intervenor status.

PBR. In other words, fuel-cost sharing can be considered a PBR mechanism, and it is therefore appropriate to discuss in PBR proceedings.

Special dockets. Commission rules vary on the authorized scope and process for dockets on special topics. However, in nearly every state, a commission could open a special docket to review current fuel-cost recovery policies, consider the implications of updating these policies, and solicit public input. In some cases, a legislative hearing can spur a commission to open a special docket, and in other cases customers or other stakeholders can petition it to do so.

Public utility commissions vary greatly across states. Some may quickly recognize the problems created by 100 percent pass-through policies and act decisively to change them. In many cases, this type of response is driven by a particularly proactive commission member, so it is worthwhile for advocates to consider which commissioners may be inclined to act as champions for reform. Other commissions may not be receptive to the idea of addressing FAC reform without outside pressure.

How to Enlist Other Actors to Encourage a Commission to Act

Where a public utility commission is not inclined to take up the issue of FAC reform or is prohibited from doing so, advocates should consider enlisting the help of other parties. These include the following:

State Legislators. Though setting utility rates is the commission's responsibility, state legislators may be able to direct or encourage the commission to take action. For example, lawmakers could hold a hearing on the FAC, introduce legislation directing the commission to align its mission and operations with state policy goals, distribute sign-on letters for colleagues to join them in encouraging commission attention to fuel-cost pass-through policies, or hold stakeholder meetings on the topic.

Governors. Governors may also be able to encourage FAC updates. For example, a governor may be able to issue an executive order requiring the commission to consider or recommend reforms that align its activities with affordability or climate goals, or one that provides guidance about key design criteria (e.g., what constitutes "the public interest" for the purpose of regulatory decision-making). Also, in many states the governor is responsible for appointing commission members. In these cases, the governor could prioritize FAC reform as a significant consumer protection agenda item when appointing (or reappointing) individuals to serve on the commission.

Attorneys general. In some states, the attorney general can petition the public utility commission to open a proceeding to consider a particular issue—which could include FAC reform. Also, in most states, an attorney general can initiate a review of confidential information in fuel-supply agreements to determine whether alleged trade secret information meets the legal standard for being withheld from public view. Such a review could examine key contract terms, such as guaranteed delivery volumes regardless of need, as well as cost or price escalators that are above consumer price index averages. Some attorneys general also serve as the consumer advocate, which may give them the power to request commission dockets and take other actions to support FAC reform.

Utilities. Since the idea of FAC reform is to expose utilities to a share of the fuel-cost risk, they may not be in favor of updating the policy. However, in some cases a utility may be receptive to the idea if it expects to be able to profit by reducing fuel costs. Utility proposals often carry substantial weight with both public utility commissions and legislators, so utility support of reform can help move the process forward.

> "Exactly which steps will be needed might not be clear at the outset, and advocates should be prepared to adapt their strategy if they encounter twists and turns on what they had imagined would be a straight path. However, to be successful the most important thing is to get started."

Though the recommendations discussed are broadly applicable, every public utility commission is unique. FAC reform advocates can tailor their approach to their particular commission by researching its processes, mission, and relevant recent decisions, as well as the attitudes and policy positions its members demonstrate through their statements and actions.

How to Achieve Reform Through Legislative Action

In all states, a public utility commission can only operate within the constraints of state statutes, which are established by state legislatures.

In some states, the legislature has enshrined the FAC into statute. In these states, the public utility commission alone will not be able to update the policy since the legislature must first amend the statute. Where this is the case, would-be changemakers should develop a legislative strategy prior to—or at least in parallel with—their efforts to engage the commission.

In other states, the legislature has provided the public utility commission with the statutory authority necessary to revise the fuel-cost pass-through policy. In these states, advocates may wish to focus their efforts solely on the commission. However, even in these states, a legislative route to change is possible. For example, state lawmakers could introduce legislation to reform the FAC, even if the existing policy was implemented by the commission.

When drafting a bill, state legislators often meet with other lawmakers and affected parties to inform policy design and secure buy-in. Advocates should be aware that this may occur, and they may even wish to encourage their legislative champions to meet with utility representatives, consumer advocates, and other stakeholders. These parties may be more open to policy reforms when consulted early and away from the media attention that can occur once a bill is introduced or a hearing is in progress, and meeting with them may also result in better policies. However, utilities or other stakeholders may also use this opportunity to urge lawmakers to weaken or abandon the proposed reforms. To guard against this possibility, advocates can educate their legislative

champions ahead of time about the arguments against reform that they are likely to hear and whether those arguments are reasonable.

Depending on the state's policies governing communication between lawmakers and commissioners, legislators may also wish to engage commissioners directly in crafting statutory reforms to fuel-cost pass-through policies. Some commissioners may choose to be deeply involved in such discussions, and they may even be willing to endorse specific legislative changes or testify at public hearings. Other commissioners may be reluctant to step outside of their quasi-judicial role in this way, even if they agree that a legislative update would be beneficial.

Advocates interested in legislative reform can increase the chances for success by providing their legislative champions with specific policy recommendations and examples to follow. In particular, advocates would be wise to point to precedents for FAC reform from other states, as lawmakers may be reluctant to act if they believe they will be the first state to implement such a change.[20]

How to Get Started on Reforms in Your State

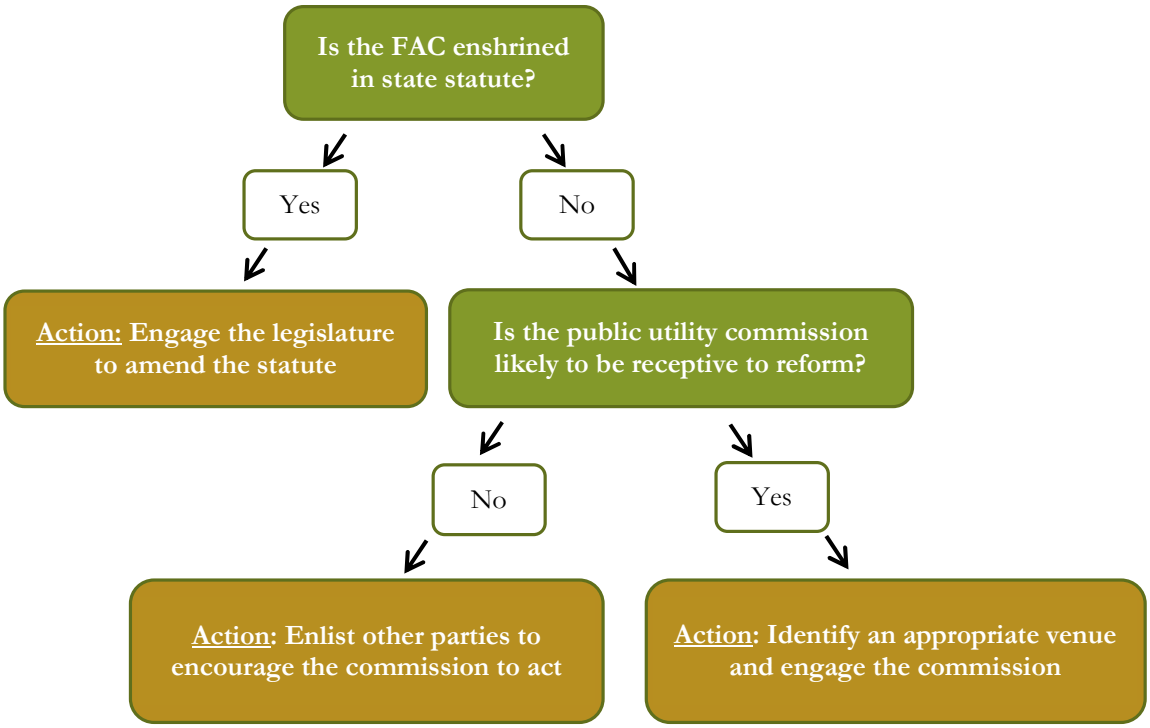
Achieving fuel-cost pass-through reform in a state may be a complex process, as advocates may need to intervene in arcane regulatory proceedings, navigate legislative policymaking, and/or enlist the support of other parties. The process may be relatively quick, but it could also take years to update a FAC policy.

Exactly which steps will be needed might not be clear at the outset, and advocates should be prepared to adapt their strategy if they encounter twists and turns on what they had imagined would be a straight path. However, to be successful, the most important thing is to get started.

Once advocates have decided they want to reform the policy in their state, they are ready to start crafting a strategy. Figure 5 illustrates the key questions that advocates embarking on this process will face.

[20] We provide some examples of states that have implemented FAC reforms later in this primer, and national nonpartisan organizations like the National Conference of State Legislators may be able to provide additional information.

Figure 5. Key Steps for Achieving Fuel Adjustment Clause Reform



Key Policy Considerations

Though the concept of fuel-cost sharing is simple, this reform can be implemented in a variety of ways. In addition, there are other reforms that could also help address related problems. When considering ways to reform an existing FAC, the following topics are worthy of consideration.

Amount of Fuel-Cost Sharing

When designing a fuel-cost sharing policy, advocates should consider the degree of sharing between the utility and its customers. For example, a utility could be responsible for just 5 percent of fuel costs (i.e., passing through 95 percent to customers) or for 20 percent (i.e., passing through 80 percent to customers). The ideal sharing percentage is a level that is high enough to motivate the utility to keep its fuel costs in check, but low enough that the utility is not exposed to unreasonable levels of risk and volatility.[21]

There is not one "best" sharing amount that should be applied to all utilities because utilities vary in multiple ways. For example, utilities rely on different mixes of fuel- and non-fuel generation sources, and they face different risk profiles in their jurisdictions.

[21] If the utility is exposed to a level of risk that is excessive, it could make it harder for the company to access low-cost capital. This could drive up its cost of capital (and by extension, the rates it must charge customers to remain financially whole), and at the extreme it could even create cash-flow problems severe enough to prevent it from serving its customers. While moderate sharing percentage would be unlikely to cause such problems, there is an upper limit to how much sharing is in customers' best interest.

Symmetry

Another design question is whether a fuel-cost sharing mechanism should be symmetrical or asymmetrical. A symmetrical mechanism shares the same percentage regardless of whether the actual fuel costs are higher or lower than expected. An asymmetrical mechanism shares a different amount in each case. Both symmetrical and asymmetrical sharing can be structured to provide both rewards and penalties.

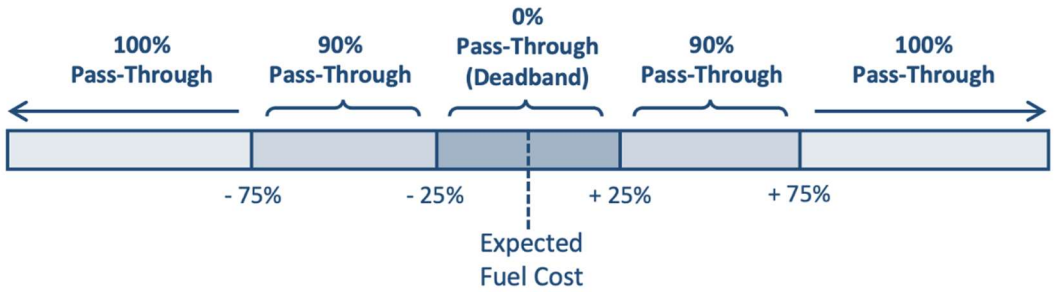
For example, a commission may design a mechanism with a higher pass-through percentage when fuel costs are lower than expected (thus passing more of the savings on to customers) than when fuel costs are higher than expected. Such a mechanism can direct more of the benefits of fuel-cost savings to customers—but it also weakens the utility's incentive to pursue opportunities to reduce fuel costs below a certain level. Symmetrical mechanisms also tend to be easier for customers to understand than asymmetrical mechanisms. These tradeoffs should be carefully considered when deciding between symmetrical and asymmetrical designs.

Straight Sharing Versus Sharing Bands

The simplest structure for a fuel-cost sharing mechanism is to always require the same level of utility fuel cost responsibility (e.g., 10 percent) regardless of how much the utility's actual costs deviate from expectations. This approach, which is sometimes call "straight sharing," is the most common among existing fuel-cost sharing policies.

Another option is to use bands (also sometimes called thresholds). For example, a regulator could adopt a mechanism that performs no true-up if actual fuel costs fall within 25 percent of the expected value (this is called a "deadband"), a 90 percent true-up if actual costs are 25-75 percent greater than or less than that value, and a 100 percent true-up if they deviate by more than 75 percent. Figure 6 illustrates this hypothetical banded design.

Figure 6. Example of a Policy Design with Sharing Bands



In this example, the pass-through amount increases as the size of the deviation from the expected fuel cost becomes larger. Such a design can reduce the risk to the utility posed by large fuel-cost spikes, as well as the risk to customers of paying for large windfall profits if fuel costs dip very low. Alternatively, sharing bands could be used to increase (rather than decrease) the utility's risk exposure as fuel costs deviate more from the expected level; this could greatly increase the utility's incentive to reduce its reliance on fuel. Sharing bands could also be deployed in an asymmetrical fashion.

While banded designs can reduce the risk of extreme outcomes to the utility or its customers, they can also create uneven incentives. For example, a banded design that passes through 100 percent of fuel costs beyond a certain threshold dissolves the utility's financial incentive to reduce costs beyond that threshold. In addition, banded designs can be harder for customers to understand and more complex to administer than straight sharing.

Forecast Versus Historical Prices

Fuel-cost sharing mechanisms in place today share the difference between the actual fuel costs a utility incurs and the costs it was expected to incur. These "expected" costs can be based on either a forecast (i.e., a forward-looking estimate) or historical values. Forecasts are the most common approach used today, but that does not necessarily mean they are the best choice.

Traditional 100 percent pass-through policies typically utilize forecasts to set the base rates that the FAC then trues up, and most states that have adopted fuel-cost sharing have continued to rely on them. Forecasts may also be preferred because they can be tailored to reflect changing conditions—but, in reality, the accuracy of fuel-cost forecasts may be low. This is particularly true for forecasted natural gas costs, as this fuel is subject to substantial price volatility that is hard to predict.[22, 23]

However, forecasts have another drawback in the context of fuel-cost sharing: they open the door to possible gaming. Specifically, if the utility is able to inflate the forecast, it will be rewarded with a greater amount of "savings" relative to it (and also be less likely to have to bear a share of any "overspends"). It is important to note that any such gaming will not reduce the utility's financial incentive to seek savings once the forecast is adopted – so the fuel-cost sharing mechanism will still encourage the utility to reduce fuel costs. However, if the utility manages to game the forecast this will increase the costs of the policy to customers.[24]

The alternative is to use historical spending to set the expected fuel-cost baseline. Relying on historical actuals rather than forecasts avoids the gaming problem just described, and it is also more straightforward to calculate.

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[22] The price volatility of natural gas is driven by multiple factors. These include domestic transportation and storage constraints, shifting levels of international demand, and global supply-chain disruptions (e.g., due to extreme weather events and geopolitical events).

[23] Deloitte, See: https://www2.deloitte.com/ca/en/pages/resource-evaluation-and-advisory/topics/deloitte-canadian-price-forecast.html

[24] The company will have the same financial incentive to reduce fuel costs because the utility's marginal incentive (i.e., the reward it can earn for reducing fuel costs by the next increment) is not changed by the level of the forecast. For example, imagine a utility that is subject to a 90% pass-through policy and that is expected to use 100 units of fuel at $5/unit. If this utility can find a way to spend $4/unit on fuel instead of $5/unit, it will earn a $10 reward for doing so (i.e., 100 units x $1/unit * 10%). If these are real savings that would not have occurred without the utility's effort, everyone wins: the utility gets its $10 reward and customers receive $90 of savings. However, if the utility can convince its regulator that the price of fuel is likely to be $6/unit instead of $5/unit, it will earn a $10 reward for doing nothing (i.e., for spending $5/unit) and then another $10 for reducing its spending to $4/unit. Either way, the utility earns the same incentive ($10) for reducing its fuel costs from $5/unit to $4/unit, so its marginal incentive to pursue this savings opportunity is the same. However, if the utility is able to inflate its forecast to $6/unit, its customers will pay an extra $10 incentive and receive nothing in return.

However, relying on historical spending could itself create an incentive problem under certain policy designs. When the utility's historical spending is used to set the baseline, reducing fuel costs in one year will reduce the expected-cost baseline in future years. This means that if the utility's reward for reducing fuel costs now is not large enough to offset the burden of operating under a lower baseline in the future, the utility will not be motivated to reduce its fuel costs. This situation is most likely to occur where an asymmetrical design is used that requires a utility to bear most of the cost when actual fuel prices are higher than expected, but which passes on most of the savings to customers when they are lower than expected.

Transparency

In many states today, the moral hazard problem created by FACs is compounded by a lack of visibility into fuel-supply contracts. While commission staff often have access to otherwise undisclosed contracts and key terms, they may not have the time or expertise to complete a thorough review on their own. When advocates and other stakeholders are barred from accessing key documents, they cannot identify potential prudency issues and flag them for the commission and its staff to consider. The end result is less regulatory scrutiny of utility fuel expenditures.

Though fuel-cost sharing addresses the moral hazard problem created by traditional 100 percent pass-through policies, transparency is still important. State lawmakers and utility regulatory commissions can take steps to ensure that the key terms of utility fuel-supply contracts are transparent to customers and other stakeholders, while protecting necessary trade secrets as appropriate. Such terms include (but are not limited to) pricing, annual escalators or other pre-determined price increases, minimum delivery amounts, and contract length.

Disallowance on Prudency Grounds

The purpose of fuel-cost sharing is to motivate the utility to seek ways to reduce its fuel costs. However, it is not the only policy tool available to accomplish this objective. Another option is to identify fuel-cost savings opportunities that are available to the utility and to disallow cost recovery if the utility fails to take advantage of these opportunities.

For example, a regulator might determine that a certain utility could reduce its reliance on natural gas for power generation by 5 percent a year if it aggressively pursues a demand-side portfolio of energy efficiency, demand response, and load-shifting measures. The regulator could then allow the utility to pass through all natural gas costs up to this level via the existing FAC, while disallowing any recovery of costs beyond this level on the grounds that they were imprudently incurred.[25]

As another example, a regulator could demonstrate a willingness to scrutinize all fuel costs presented for recovery and disallow any for which the utility cannot convincingly demonstrate prudency. This more rigorous prudency review could encourage the utility to pursue opportunities to reduce fuel costs, to be more transparent as a strategy to show the regulator that it has been making an effort, and to reduce its reliance on fuel-fired generation over time. For this strategy to be effective, however, it must be clear to the utility that disallowance is a real and substantive risk—simply

[25] The allowed level of natural gas usage could also be adjusted to reflect actual weather conditions. Such a normalization could reduce the risk of windfall losses or gains due to usage fluctuations driven by weather events, which are not under the control of the utility.

applying a slightly higher level of review to an existing FAC docket that currently functions as a rubber stamp is unlikely to be effective.

Hedging

Fuel-cost sharing can reduce the risk posed by fuel-price spikes by encouraging the utility to secure more favorable fuel-supply contracts and reduce its reliance on fuel-based generation sources. However, another way to reduce the risk of price volatility is hedging. Hedging refers to the use of financial instruments to mitigate the risk of unexpected negative investment outcomes. Requiring that utilities hedge can reduce the risk of fuel-price spikes to customers, but hedging also means incurring an additional cost or risk that is then passed on to customers. Whether to encourage or require hedging (or particular kinds of hedging) is a question that should be considered whether or not fuel-cost sharing is in place.

Purchased Power

Fuel-cost sharing is only relevant for vertically integrated utilities that purchase fuel to generate power and then sell that power to customers. However, some regulated utilities do not own generation (these "wires only" utilities are the norm in restructured states), and even vertically integrated utilities may buy substantial amounts of power from other parties to serve their customers. These parties may include independent power producers, other regulated utilities, and unregulated affiliate companies of the purchasing utility.

Typically, the cost of purchased power is recouped in the same fashion that fuel costs are: as a 100 percent pass-through to customers. A sharing mechanism can be implemented for purchased power in the same way as for fuel costs, but whether this makes sense will depend on local circumstances.

In cases where a regulator is implementing fuel-cost sharing for a vertically integrated utility, applying an equivalent sharing policy to purchased power should be seriously considered—because without this, gaming may occur. For example, during a natural-gas price spike a utility that is subject to fuel-cost sharing but not purchased-power cost sharing could substitute spot-market purchases for its own generation. Such a move would likely raise rather than lower costs to customers, contrary to the goal of the fuel-cost sharing policy. Applying sharing to both fuel and purchased power could avoid this type of behavior.[26]

However, in cases where the utility does not own generation, the case for applying a sharing policy to purchased power is less clear. For a utility that has substantive opportunities to lower these costs through its own actions, a purchased-power sharing policy could make sense. For instance, a wires-only utility may be able to lower the cost of the power it purchases by aggressively promoting energy efficiency programs to its customers. It could also lower costs by negotiating better contracts, switching to different suppliers, or helping customers shift demand to lower-cost hours (e.g., via demand-response programs, managed EV charging, and time-varying rates). However, if a wires-only utility has limited control over purchased-power prices (e.g., because it purchases most of its power through wholesale markets where it acts as a price-taker rather than as a price-setter) and

[26] If a purchased-power sharing policy is adopted alongside a fuel-cost sharing policy, they should be equivalent—but this does not mean identical. Since fuel costs only make up a portion of purchased-power costs, the sharing factor for purchased power could be lower than the one applied to the utility's own fuel costs.

limited ability to influence customer behavior (e.g., because a separate state entity is responsible for administering demand-side management programs), it may make little sense to apply a sharing mechanism to its purchased power costs.

Stakeholders should also note that purchased power includes electricity generated from both fuel- and non-fuel resources. This means that purchased-power cost sharing will not necessarily drive decarbonization in the same way as fuel-cost sharing would be expected to. Where reducing carbon emissions is an important policy goal, additional strategies to accomplish this aim could be considered. For example, the sharing mechanism could be designed in a way that distinguishes between different types of generation resources (e.g., it could apply a higher pass-through percentage to renewables than to fossil fuel-fired generation).

Examples of State Fuel-Cost Sharing Policies

A few states have adopted fuel-cost sharing mechanisms to varying degrees, and interest in this neglected aspect of utility regulation has been growing in recent years. However, advocates should keep in mind that just because a particular design feature is common does not necessarily mean it is a good idea. Being familiar with existing forms of fuel-cost sharing policies but also willing to advocate for improvements to them is likely to result in the best outcome. Below we discuss a few examples of fuel-cost sharing policies that have been adopted by states.

Hawaii

The Hawaii Public Utilities Commission adopted fuel-cost sharing for the Hawaiian Electric Companies (HECO) in 2018.[27] The Energy Cost Recovery Clause (ECRC) utilizes a straight-sharing approach anchored to a forecast of fuel costs, in which the utility passes through 98 percent of fuel costs to customers regardless of whether its actual costs are above or below the forecast. HECO's annual financial exposure under the policy is capped at $2.5 million. In 2022, the Commission invited intervenors to consider proposals to modify the risk sharing component of the ECRC, signaling an openness to increase the sharing factor—though no decision to adjust it has yet been made.[28]

Idaho

The Idaho Public Utilities Commission adopted the Power Cost Adjustment (PCA) mechanism for Idaho Power in 1992 to share power supply costs between the utility and its customers. The mechanism features a straight sharing design, relies on forecasts, is symmetrical, and includes purchased power. The PCA initially passed through 90 percent of power supply costs, but in 2009 the commission increased this to 95 percent. In approving this change, it explained that "power supply cost volatility has increased significantly since the PCA was implemented, and that with increased volatility, a sharing percentage of 5% still provides strong incentive for the Company to make prudent power purchases."[29] In 2009, the commission also adopted a mechanism called the Energy Cost Adjustment Mechanism (ECAM) for Rocky Mountain Power. The ECAM features straight sharing with a 95 percent pass-through, has a symmetrical design, employs forecasts, and includes purchased power.[30]

Wyoming

In 2011, the Wyoming Public Service Commission adopted the Energy Cost Adjustment Mechanism (ECAM) for Rocky Mountain Power. The ECAM was a modification of a prior sharing policy called

[27] Hawaii Public Utilities Commission, Final Decision and Order No. 35545, Docket No. 2016-0328, June 22, 2018, https://puc.hawaii.gov/wp-content/uploads/2018/06/DO-No.-35545.pdf

[28] Hawaii Public Utilities Commission, Decision and Order No. 38429, Docket No. 2018-0088, June 17, 2022, pg. 56.

[29] Idaho Public Utilities Commission, Order No. 30715, Case No. IPPC-E-08-19, January 9, 2009, https://puc.idaho.gov/Fileroom/PublicFiles/ELEC/IPC/IPCE0819/OrdNotc/20090109final_order_no_30715.pdf

[30] Idaho Public Utilities Commission, Order No. 30904, Case No. PAC-E-08-08, September 29, 2009, https://puc.idaho.gov/Fileroom/PublicFiles/ELEC/PAC/PACE0808/OrdNotc/20090929final_order_no_30904.pdf; Idaho Public Utilities Commission, Order No. 35419, Case No. PAC-E-22-05, May 26, 2022, https://puc.idaho.gov/Fileroom/PublicFiles/ELEC/PAC/PACE2205/OrdNotc/20220526Final_Order_No_35419.pdf

the Power Cost Adjustment Mechanism (PCAM), which was created based on a statute that allowed the commission to use non-traditional rate tools to optimize outcomes.[31] The ECAM trues up the utility's actual net power costs (which include fuel, purchased power, and certain other costs) to its forecasted costs in a symmetrical fashion. The ECAM previously featured a 70 percent pass-through and it employs an 80 percent pass-through today.[32]

Missouri

In 2005, the Missouri legislature enacted Senate Bill 179, and the commission implemented the first fuel adjustment clause mechanism in 2007 (and the last one in 2015). In Missouri, these mechanisms are referred to as "fuel adjustment clauses" (FACs) even if they feature fuel-cost sharing.[33] The mechanisms in place for Ameren, Evergy, and Liberty Utilities all feature straight sharing with a 95 percent pass-through.[34] This legislation was codified as Section 386.266 of the Revised Missouri Statutes (RSMo) in 2005, and also granted authority to the commission to include an incentive for efficiency and cost-effectiveness as part of the mechanism.

Wisconsin

The Wisconsin Public Service Commission was authorized by Wisconsin Statute § 196.20(4) to establish automatic adjustment clauses for regulated utilities, and the commission codified the rules for doing so as Wisconsin Administrative Code § PSC 116.03.[35,36] Under these rules, each of the state's five major investor owned electric utilities (Wisconsin Electric Power Company, Wisconsin Public Service Corporation, Madison Gas & Electric, Wisconsin Power and Light, and Northern States Power – Wisconsin) are required to file fuel cost plans.[37] Each plan includes a forecast of the utility's expected costs for fuel, purchased power, and related expenditure categories to be collected from customers. Once the utility's actual fuel (and related) costs are known, the commission can approve a true-up to collect or refund any difference that represents 2 percent of the forecasted amount. In other words, there is a 2 percent deadband where no sharing occurs and a 100 percent pass-through outside this deadband. The commission has the authority to rule on whether or not the utility's actions were prudent when determining the extent of cost recovery to be allowed. The true-up occurs through a fuel adjustment which appears on customers' bills.[38]

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[31] Wyoming Public Service Commission, Memorandum Opinion, Findings, and Order, Docket No. 20000-368-EA-10, February 4, 2011, https://pscdocs.utah.gov/electric/09docs/0903515/71051ExhibitA2-9-11.pdf

[32] For the present 80% pass-through policy, see the current version of Sheet No 95-6 (P.S.C. Wyoming No. 17, Original Sheet No. 95-6). For the previous 70% pass-through policy, see P.S.C. Wyoming No. 16, First Revision of Amended Original Sheet No. 95-6 Canceling Amended Original Sheet No. 95-6. Source: Rocky Mountain Power, Energy Cost Adjustment Mechanism, Schedule 95, (current tariff) https://www.rockymountainpower.net/content/dam/pcorp/documents/en/rockymountainpower/rates-regulation/wyoming/rates/095_Energy_Cost_Adjustment_Mechanism.pdf

[33] This is different from how we use this term in this primer, where we define FAC as a 100% fuel-cost pass-through mechanism.

[34] Lena M. Mantle, Electric Utility Fuel Adjustment Clause in Missouri: History and Application Whitepaper; Office of the Public Counsel, Revised January 14, 2022, https://efis.psc.mo.gov/mpsc/commoncomponents/viewdocument.asp?DocId=939661980

[35] Wisconsin Statutes, https://docs.legis.wisconsin.gov/statutes/statutes/196/20

[36] Wisconsin Public Service Commission, Chapter PSC 116, March 15, 2023, https://docs.legis.wisconsin.gov/code/admin_code/psc/116.pdf

[37] Wisconsin Public Service Commission, Final Decision, Docket 6680-ER-103, December 13, 2022,

[38] Alliant Energy, RE: Wisconsin Power and Light Company Electric Tariff for Fuel Adjustment, Docket No. 6680-ER-103, December 21, 2022, https://apps.psc.wi.gov/pages/viewdoc.htm?docid=455114

Conclusion

Many Americans today struggle to pay their electric bills. Fuel costs often represent a large share of customer bills, and unlike most rate components these charges can vary substantially from month to month. Reducing fuel costs—as well as fuel-cost volatility—is imperative to ensuring that electricity is affordable and accessible to all.

Fortunately, electric utilities have more ways to reduce fuel costs today than ever before. These opportunities exist on both the supply and demand side (e.g., increasingly cheap solar and wind generation, distributed energy resources that shift load to lower-cost hours), and they are enhanced by supportive federal policies like the Inflation Reduction Act (IRA). However, these opportunities have not spurred a utility rush to decrease fuel costs. Why?

The answer is that most states pass 100 percent of fuel costs through to customers, which gives utilities no financial incentive to reduce these costs. If a utility finds any savings, customers reap all the benefits—and if it spends more than necessary, customers pick up the bill.

It is time for these outdated policies to change, and advocates can play important roles in this process. This primer has described the problems created by existing 100 percent pass-through policies, explained how fuel-cost sharing reforms can produce better outcomes, and provided tools that advocates can leverage to encourage reforms in their states. If these reforms are well designed, they will result in lasting benefits for customers, utilities, and the environment.