Q&A – PSC Changes to Alabama Power's Rate Formula

On Aug. 13, 2013, the Alabama Public Service Commission tinkered with a formula it uses to calculate Alabama Power profits and ultimately customer rates, claiming falsely that doing so would lower bills. Residential and commercial customers in Alabama pay some of the highest electricity bills in the country, and Alabama Power is allowed by the PSC to earn some of the highest returns of any utility in the country. The end result of scrapping one formula and replacing it with an even more complex one, as the following Q&A describes, does little to fix this imbalance, which has plagued customers for years. In reality, this is simply an artful accounting trick that favors utility profitability and has dubious benefits for ratepayers.

How were Alabama Power's rates previously set?

By law, investors in regulated utilities are entitled to reasonable returns on their investment. Until the PSC scrapped its old approach, Alabama Power was allowed to charge customers rates that would give it a **Return on Equity,** or **ROE,** of 13-14.5%, a highly appealing rate for investors; first because rates regulated by utilities commissions are guaranteed, making them highly stable and secure; second, because the range allowed by the PSC was one of the most generous in the country. The industry average is closer to 10%.

Return on Equity (ROE)

There are various ways of calculating profitability, but one key measure, called **Return on Equity or ROE**, is used almost universally. **ROE** is determined by dividing profits (revenue after all costs, including taxes and interest, have been paid) by the amount of equity capital (stock ownership) in a company.

As an example: If rates are set so that the profit earned by a utility is $10 million/year and investors have provided $100 million of equity capital, the **ROE** is 10%.

How did the PSC alter Alabama Power's rate formula?

On Aug. 13, the PSC voted 2-1 to replace **ROE** with a new more complex rate formula, called **Weighted Cost of Equity. WCE** calculates a company's returns using the percentage of its assets held by stockholders vs. those held by creditors. This is called the **Equity Ratio**. The new system allows Alabama Power to earn a WCE between 5.75% and 6.21% (with a target of 5.98%). It also builds in a bonus of 0.07% if the company maintains an "A" credit rating.

Weighted Cost of Equity (WCE)

A far less common means of calculating profitability is through **Weighted Cost of Equity** or **WCE**, which is determined by multiplying **ROE** by a company's **EQUITY RATIO**, or the percent of assets owned by stockholders.

For 2014, without bonus

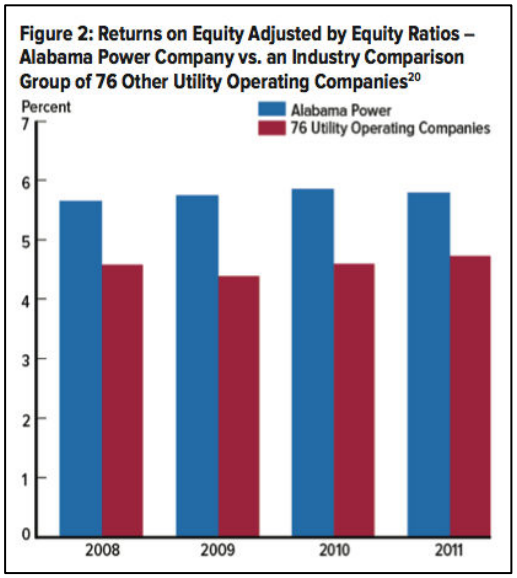
ROE = WCE (5.98%) ÷ 44.07% equity ratio = ***13.57%***

For 2014, with bonus

ROE = WCE (5.98% +.07%) ÷ 44.07% equity ratio = ***13.73%***

What does this mean for customers?

Alabama Power has already announced that the switch will not result in any immediate reduction in bills, exactly the opposite of what the two commissioners who voted for it promised.



Data Source: Institute for Energy Economics and Financial Analysis

What does this mean for company profits?

The WCE target of 5.98% for 2014 could very likely boost Alabama Power profits. Return on equity could rise to **13.73%**, a 3.1% increase from what it would have been under the previous formula (The target the PSC set for 2013 was **13.32%)**. Even though that may seem an inconsequential increase, it would translate to added profits of $13 million-$21.3 million, depending on the bonus. Contrary to claims that the switch to WCE lowers returns, Alabama Power profits will remain substantially higher than the industry average (graph at right).

The change also removes one of the PSC's only direct means of oversight. ROE provided a direct cap on returns. Under WCE, Alabama Power can adjust returns and the equity ratio in a way that allows it to mask profits. Even if the utility lowers its ROE, it could make the same profit in dollars by increasing the equity ratio, without any benefit to customers.