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# Cost-Recovery for Pre-Approved Projects



Uncertainties remain,  
but recent cases provide guidance.

**BY PATRICIA D. GALLOWAY AND DAVID L. COUSINEAU**



utilities face numerous options as they modernize their baseload fleets: build new generating capacity, expand existing plants, refurbish and repower aging plants, and retire or decommission plants. Each of these options will require significant capital expenditures. Pre-approval of cost estimates for these types of projects—often called mega- or giga-projects—was intended to provide a buffer against the billions of dollars of cost disallowances that occurred in the 1970s and '80s. Recent experience suggests, however, that utilities continue to face numerous obstacles to achieving full cost recovery. Indeed, in the last six months alone, two state commissions approved settlements that required significant disallowances, reinforcing the need for utilities to consider carefully at every step of a project how cost-recovery issues affect the management and execution of projects. But all isn't grim. A careful reading of recent cases provides guidance for how utilities can increase the likelihood of recovering all their costs.

### The Prudence Standard

The prudence standard balances investor (utility) and consumer interests to achieve just and reasonable rates.<sup>1</sup> The utility is entitled to an opportunity to recover its cost of doing business; that is, operating expenses, capital costs, and financing costs. Ratepayers, on the other hand, can't be charged for costs that are wasteful or otherwise unnecessary.

The majority of jurisdictions that conduct prudence reviews have adopted a common test for prudence—the reasonableness of decisions based on all the circumstances known at the time.<sup>2</sup> The Federal Energy Regulatory Commission, for example, assesses whether the costs at issue result from decisions that “reasonable utility management (or that of another jurisdictional entity) would have made, in good faith, under the same circumstances, at the relevant point in time.”<sup>3</sup> The Missouri Public Service Commission applies a similar analysis:

“[The] company's conduct should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company. . .

1. See *FPC v. Hope Nat. Gas. Co.*, 320 U.S. 591, 603, 612 (1944).  
 2. P. Galloway, K. Nielsen, and C. Whitney, “New Day for Prudence,” *Public Utilities Fortnightly*, December 2009.  
 3. *New England Power Co.*, 31 FERC ¶ 61,047, at 61,084, *reh'g denied*, 31 FERC ¶ 61,112 (1985), *aff'd sub nom.*, *Violet v. FERC*, 800 F.2d 280 (1st Cir. 1986).

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### Commissions expect utilities to divulge the good, the bad, and the ugly—and then to explain why decisions were reasonable.

In accepting a reasonable care standard, the Commission does not adopt a standard of perfection. Perfection relies on hindsight. Under a reasonableness standard relevant factors to consider are the manner and timeliness in which problems were recognized and addressed. Perfection would require a trouble-free project.<sup>4</sup>

Importantly, as the Missouri commission noted, the analysis must eschew hindsight and a commission may not substitute its judgment for that of the utility.<sup>5</sup>

### Seeking Certainty

The legacy of the last significant build-out of baseload generation is billions of dollars of cost disallowances when plants were cancelled before going into service (*i.e.*, before becoming “used and useful”) or when commissions otherwise found imprudence. After this experience, utilities were understandably reticent to undertake the types of capital-intensive projects that are necessary to provide new, cleaner, and more efficient baseload power. Consequently, a number of states passed statutes and implemented accompanying regulations to mitigate the risks utilities assume for such projects. The purpose of Mississippi's “Baseload Act,” for instance, is to allow the commission to use alternative cost recovery mechanisms to “facilitate Mississippi electric utilities' ability to finance and construct baseload generation.”<sup>6</sup>

While regulations differ from state-to-state and resource-to-resource (*e.g.*, some are limited to specific technologies, such as renewables, nuclear, and integrated gasification combined cycle (IGCC)), the regulations generally include some or all

4. *Union Electric*, 1985 Mo. PSC LEXIS 54, \*28 (quoting *Consolidated Edison Co. of New York*, 45 PUR4th 331 (1982) (internal quotations omitted)).  
 5. See also *Southwestern Bell v. Public Serv. Comm'n.*, 262 U.S. 276, 289 (1923).  
 6. *Mississippi Power Co.*, 2012 Miss. PUC LEXIS 57, 69.

of the following elements: 1) pre-approval to construct the plant; 2) pre-approval of cost estimates; 3) ability to recover pre-construction costs; 4) ability to recover financing charges; 5) ongoing reporting requirements and prudence reviews; 6) no ability to revisit previous prudence determinations absent extenuating circumstances; 7) ability to recover costs before the plant goes into service; and 8) ability to recover costs if the plant is cancelled.

In Florida, for instance, a utility must seek commission approval to construct a nuclear or IGCC plant and must also provide a nonbinding estimate of the costs to construct the plant. Once the commission issues a final order finding that the plant is needed, the utility is entitled to recover the estimated costs unless the commission finds imprudence based on a preponderance of the evidence. The utility also can recover its prudently incurred costs before the plant enters service, and may recover all prudently incurred costs if the plant isn't completed. Any costs that the commission finds were prudently incurred during interim reviews can't be challenged subsequently unless there was fraud, perjury, or intentional withholding of key information.

In exchange for these benefits, Florida utilities must provide significant information regarding their projects. For instance, the utility must provide all documents relied on by management to approve expenditures that it seeks to recover, a description of the technology selected, including the factors leading to its selection, and annual cost-variance explanations. Furthermore, the utility must submit to ongoing auditing and monitoring.

Kansas has similar reporting requirements for utilities that seek pre-approval and also presumes imprudence if costs exceed the approved estimate by 200 percent, at which point the utility must prove by a preponderance of the evidence that such costs were prudently incurred. If the utility completes construction within the estimate presented, however, the commission won't consider the prudence of the incurred costs absent fraud or other intentional imprudence.<sup>7</sup>

In South Carolina, the commission may grant a "base load review order" for any baseload plant. The order is a final and binding determination that a plant is "used and useful." After receiving a baseload review order, the utility must be allowed to recover its capital costs so long as the plant is constructed—or is being constructed—in conformance with the approved schedules, estimates, and projections. A utility also may submit revised rate requests before the plant enters service to collect part or all of its incurred costs and to earn financing costs on that portion of its costs for which it didn't seek recovery. The utility also must submit quarterly reports detailing the progress of the project, with the ability to recover its costs if it prudently abandons the project.

Overall, pre-approval statutes and regulations seek to properly balance ratepayer and utility obligations and risks. By making an early determination of need and reasonableness, a commission finds that a particular project benefits ratepayers at a defined cost, thereby providing a level of certainty to the utility that it will recover its costs and assisting in obtaining financing. Utilities aren't, however, given *carte blanche* to develop the project at any cost and are motivated through regular reporting requirements and ongoing prudence reviews to ensure that the project remains in ratepayers' best interests. Moreover, by allowing cost recovery if a project is prudently abandoned, regulators give utilities an incentive to cancel a project rather than continuing to pursue a project that has become uneconomic.

### Uncertainties Persist

Although utilities properly maintain a certain level of risk (e.g., responsibility for imprudently incurred cost increases), recent decisions indicate that the level of risk might be higher than anticipated. In late 2012, the Indiana Utility Regulatory Com-

## Even proceedings that haven't resulted in cost disallowances highlight the continued risks utilities face.

mission approved a contested settlement that requires Duke Energy Indiana to fund at least \$700 million of its incurred costs for an IGCC plant. Duke entered the settlement after protracted hearings in which intervenors claimed that the project was plagued by imprudence, gross mismanagement, concealment, and fraud going back as far as the initial certificate of need proceeding in 2007. In approving the settlement, the commission emphasized the utility's heightened disclosure obligations for pre-approved projects: "The regulatory bargain that is embodied in the [authorizing] statutes provides for a distribution of the company's project risk to its ratepayers in exchange for the company's reasonable management for the planning and provision of service. The efficient application of this risk transfer depends heavily on the [utility] to provide a reasonably complete picture of what was happening with the [project]."<sup>8</sup> The commission also expressed concerns about whether the company had sufficiently sought to hold its contractors responsible for cost increases before seeking recovery from ratepayers subject to refund. The commission ultimately found that the disallowance covered any alleged imprudence and that intervenors hadn't proven gross mismanagement, concealment, or fraud.

Just a few weeks later, Mississippi Power entered into a settlement agreement that capped the recoverable construction costs

7. *Kansas City Power & Light*, 2011 Kan. PUC LEXIS 817, \*80.

8. *Duke Energy Indiana*, 2012 Ind. PUC LEXIS 411, \*346.

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for its Kemper IGCC project at \$2.4 billion. The Mississippi Public Service Commission originally approved the project in April 2010 but required Mississippi Power to assume all risks and uncertainties, effectively making the project unfinanceable. The commission subsequently revised those conditions and, on remand in 2012, altered the conditions further. In its 2012 order, the commission stressed that Mississippi's statutory construct "is enabling and not mandatory."<sup>9</sup> Yet even that order didn't end the proceedings, and appeals continued. The settlement agreement gives Mississippi Power greater certainty, but requires it to absorb approximately \$700 million in costs that it received approval in March to finance through corporate bonds.

Also last year, the Louisiana Public Service Commission denied Entergy Louisiana the benefit of the protectionist provisions of the state's Nuclear Incentive Rule. The commission

stressed that the rule "requir[es] the utility's transparency and compliance with the Rule's provisions in exchange for fewer risks, a high degree of regulatory certainty, and the opportunity for beneficial rate treatment."<sup>10</sup> Entergy, the commission found, had incurred costs without seeking the required authorization, hadn't submitted to the heightened reporting requirements, and therefore couldn't recover its incurred costs.

Even proceedings that haven't resulted in cost disallowances highlight the continued risks utilities face. In 2011, Florida Power & Light (FPL), like Duke, faced claims that it withheld key information when it didn't disclose an updated, higher cost estimate at the time of the initial need hearings.<sup>11</sup> FPL responded that the disputed estimate was still in flux, hadn't been fully vetted, and therefore wasn't suitable for public release. The

9. *Mississippi Power Co.*, 2012 Miss. PUC LEXIS 57, 71.

10. *Entergy Louisiana*, 2012 La. PUC LEXIS 129, 60.

11. *Florida Power & Light*, 2011 Fla. PUC LEXIS 392, \*165-183.

commission ultimately found that no necessary information was withheld, in part because FPL had provided sensitivities showing that the project remained economic even at increased costs. While not specifically disallowing costs, in 2011 the Kansas Corporation Commission imposed a heightened burden on Kansas City Power & Light that requires it to prove the prudence of any costs incurred above the approved estimate.<sup>12</sup>

As these recent decisions demonstrate, utilities continue to face great uncertainty on cost recovery issues. The Duke and Mississippi Power settlements alone disallowed almost \$1.5 billion in costs for projects that will provide extensive benefits to ratepayers for decades.

### Creating Partnerships

Perhaps the biggest take-away from these decisions is that commissions expect utilities to treat large construction projects as a close partnership. To a certain extent, this represents a fundamental change in the relationship between utilities and commissions—a change that utilities must understand and appreciate. Absent pre-approval, commissions assess a utility's overall prudence at the end of a project. To recover costs before a plant goes into service, however, the utility must submit to regular prudence reviews and allow the commission much greater access to its decision-making process. Commissions expect utilities to divulge the good, the bad, and the ugly and then to explain why the utility's decisions were reasonable, including providing full documentation on how and why decisions were made. While this greater commission participation might be a burden on the utility, it's an objectively reasonable imposition for the resulting benefits—*e.g.*, ratepayer-backed funding and recovery of costs before the plant is placed in service or if the plant never becomes used and useful. Moreover, it's an efficient method to incentivize the development of new beneficial technologies while protecting against extravagant or wasteful costs.

When one thinks of these projects as partnerships, numerous strategies for minimizing cost disallowances become apparent. While regulators might know the energy industry very well, they rarely have engineering or construction backgrounds that would prepare them to play a partnership role in major new projects. Early proceedings, therefore, provide a strategic opportunity to educate commissions about the pros and cons of different types of technologies, contracting and general project management strategies, as well as the potential risks that could be faced throughout the project's design and construction phases. By making expansive, on-the-record presentations early in the process—before pressure to disallow higher-than-anticipated costs mounts—utility witnesses can become trusted commission

advisors, guiding them through this unfamiliar enterprise.

In this regard, it's important to choose appropriate witnesses who will educate and inform the commissioners and their staffs. While senior managers can present the tone from the top and establish the project's framework, early testimony from witnesses who actually live and breathe the project could prove to be strategically more advantageous. These are the witnesses who truly understand the project and who will make the majority of decisions that intervenors might later challenge. If the commission already trusts these witnesses as knowledgeable and capable experts, it will be more likely to credit their explanations when their actions are challenged. Because these witnesses will be crucial in helping the commission understand important engineering, construction, and management issues, witnesses who can present technical issues in easy, straightforward terms will be most helpful in building the trusted partnership.

Recently decided cases also teach that transparency is essential, thereby putting a premium on brutally honest presentations. A comprehensive presentation that explains the benefits of and the challenges to the project—both known and

### The settlement agreement gives Mississippi Power greater certainty, but requires it to absorb \$700 million in costs.

unknown—as well as how the utility addressed the challenges, the assumptions used in developing the cost estimate and in comparing available technologies, and the status of work performed to develop the cost estimate, will make clear the seriousness with which the utility approaches the project. These are generally the types of questions that the utility's management will answer internally before senior management or the board of directors approve a project. Providing the same level of detail to a commission doesn't take significantly more effort and will demonstrate the utility's transparent approach to the project.

This open dialogue has the additional benefit of making future concealment-type claims more difficult to prove. Both Duke and FPL, for example, faced allegations that they had withheld relevant information from commissions and intervenors. Indeed, in Duke's case, some witnesses argued that the company concealed information even if the information had been provided but not specifically highlighted in Duke's filings. While such claims ultimately were rejected, they require significant time and effort to rebut and have the potential to produce severe cost disallowances because they often target the initial approval proceedings. If the alleged information had been provided in that proceeding, the argument goes, the commission wouldn't have approved the project and the utility therefore shouldn't now be able to recover most of

12. *Kansas City Power & Light*, 2011 Kan. PUC LEXIS 817, \*84.

the incurred costs. Those claims might be blunted by early comprehensive disclosures that demonstrate the utility's intent to keep the commission informed of both positive and negative developments.

Once a project has been approved, commissions will expect a utility to demonstrate that it prudently addressed issues that arose. Infrastructure projects such as these are hugely expensive—indeed often cost-prohibitive for anyone but a regulated utility—and typically face opposition at each step of the process. As costs increase, so does the pressure for a commission to disallow costs above the pre-approved estimate, thereby enhancing the utility's need not only to make prudent decisions but to document them in anticipation of future challenges. In the crush of managing a megaproject, the cost-recovery labyrinth is easy but foolhardy to forget, especially as it focuses on basic management precepts: careful consideration of options, engaging in accepted management procedures, and documenting decision-making processes. Utilities also would be well advised to conduct an independent GAPP review or similar type of analysis to determine whether its policies, procedures, project controls, and management organization are consistent with best industry and prudent utility practices. Independent prudence advisors could add significant value by assessing decisions contemporaneously, assuring adequate documentation, and evaluating the likelihood that decisions will survive a prudence review. Ultimately, this level of analysis not only protects the utility but also provides the greatest likelihood of completing the project reasonably, efficiently, and at the lowest cost. In short, a utility can benefit by making prudence an everyday consideration.

Finally, demonstrating that the utility has taken appropriate account of ratepayer interests will enhance the likelihood of recovering costs. For instance, a project that was reasonable at its inception could become unreasonable if costs increase materially or if key assumptions change. Regular assessments of the reasonableness of continuing the project will help show that the project remains in the public interest. A detailed explanation early on of the project's non-cost benefits will also help demonstrate the prudence of continuing the project even if other options become more economical as the project progresses. Of course, any changes to the assumptions about the non-cost benefits (e.g., environmental, economic, or efficient use of local resources) will affect the project's continued reasonableness.

In the same vein, commissions expect utilities to manage contractors with a view to protecting ratepayers. Indeed, many

of the cost disallowances in the 1970s and 1980s resulted from contractor, not utility imprudence. No particular type of contract (e.g., turnkey, cost-reimbursable, or target price with incentives) will always provide the best protection to ratepayers. For instance, a turnkey contract might be appropriate in some instances, and might generally appear to be the best option to non-engineers, but it also might be unreasonable for untested projects or if the contractor demands an unreasonable contingency to compensate for perceived risks. A careful explanation of the pros and cons of different contracting strategies, and why the chosen approach provides the best value based on current market conditions, will assist the commission in understanding why a particular strategy is reasonable even if it imposes certain risks on the utility and, therefore, on ratepayers. Regardless of the pursued contract, the utility will be expected to monitor its contractors closely while not giving them excuses to demand unwarranted change orders.

## Commissions expect utilities to treat large construction projects as a close partnership.

The utility also might need to demonstrate that it has enforced its legal remedies for contractor misfeasance. Commissions will be unlikely to approve full cost recovery if they believe the utility hasn't made a reasonable attempt to recover increased costs from its contractors, even if the utility itself was prudent. Of course, contract limitations or the facts of a particular increase could preclude recovery, but a well-planned prudence strategy will already have laid the foundation for demonstrating that the contractual provisions that preclude recovery were prudent at the time the contract was signed. Again, the foundations for such a showing are best laid early in the proceedings so that regulators appreciate the risk-reward tradeoff before allegations of imprudence arise.

These lessons as well as many others emerge from understanding and appreciating the role expected of utilities for pre-approved projects. Ninety years ago, Justice Brandeis described utilities as "the substitute for the state in the performance of the public service, thus becoming a public servant."<sup>13</sup> By taking that role to heart and treating mega- or giga-projects as partnerships with commissions, utilities can enhance their ability to recover all their costs. ■

13. *Southwestern Bell*, 262 U.S. at 291 (Brandeis, J., dissenting).