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COST OF SERVICE INDEXING: AN ANALYSIS OF NEW MEXICO'S EXPERIMENT IN PUBLIC UTILITY REGULATION

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In April of 1975, the New Mexico Public Service Commission (hereinafter referred to as Commission) issued its decision in Case No. 1196 which established an innovative ratemaking methodology known as Cost of Service Indexing (hereinafter referred to as COSI) to be used in determining rates for the Public Service Company of New Mexico (PNM).[1] COSI provides for an automatic periodic adjustment to the rates of the Public Service Company of New Mexico when it is determined that earnings on the common equity investment are above or below a certain rate of return. The COSI methodology is viewed as an experiment in ratemaking.[2] The Order granting COSI contemplated a review of the methodology to assess its merits after a sufficient time had elapsed. In January of 1978, the Commission docketed an investigation of COSI.[3] In December of the same year, the Commission, after extensive hearings, decided that it would continue using COSI with certain modifications as a ratemaking methodology.[4]

COSI is a unique method of ratemaking with characteristics which make it justifiable only if the regulated utility meets certain criteria. The purpose of this article is to analyze the COSI experience in light of the regulatory lessons learned.

A public utility, as defined by New Mexico law, is a person who furnishes electricity, gas, water or steam to the public (with certain exceptions).[5] Such public utilities are regulated in New Mexico by the New Mexico Public Service Commission,[6] which has the principal

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1. *In re* Public Serv. Co. of N.M., 8 P.U.R. 4th 113 (1975).
2. *Id.* at 138.
3. *In re* Public Service Commission's Investigation into the Operation of Public Service Company's Cost of Service Indexing and Rate Treatment of Construction Work in Progress, N.M. Pub. Serv. Comm'n Case No. 1419 (1978-79), ____P.U.R. 4th ____ [hereinafter cited as Case No. 1419].
4. *Id.*
5. N.M. Stat. Ann. §62-3-3(F) (1978).
6. N.M. Stat. Ann. §62-6-4 (1978).

duties of setting or authorizing rates,[7] supervising standards of service,[8] allowing or disallowing the issuance of securities,[9] and issuing certificates of public convenience and necessity.[10]

Public utility companies, in this state and others, are in the position of having a potentially great bargaining power over the consumer of their services. Electricity or natural gas, and often both, has become a necessity to most people for light, heat and food preparation.[11] Commercial, industrial and agricultural enterprises obviously could not continue without an adequate energy supply.

Coupled with this extraordinary dependence by consumers upon the services of utility companies is the fact that these companies operate in an atmosphere relatively free from competition. The utilities have been allowed to be maintained as monopolies within their designated service areas because of the perception by lawmakers that consumers would not be benefited by direct competition among the companies.[12] Competition would cause an extreme waste of economic and capital resources. This is because competition requires that the consumer have access to more than one supply of goods and services, which would mean in the utility industry that each of the competing companies would have power lines or supply pipes running to each potential user. This duplication of services and goods would result in higher prices to the consumer and in decreased plant efficiency.[13] Utilities have also been described as "natural monopolies" because they are "industries in which the efficient scale of slant [sic] is so large, relative to the size of the market, as to permit the operation of only one plant of efficient scale."[14] In order to compensate for the lack of competition, public utilities are subjected to a high degree of regulatory control, including control over rates charged to consumers.[15]

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7. N.M. Stat. Ann. §62-8-7 (1978).

8. N.M. Stat. Ann. §62-6-19 (1978).

9. N.M. Stat. Ann. §62-6-6 (1978).

10. N.M. Stat. Ann. §62-9-1 (1978). N.M. Stat. Ann. §§62-3-1 to 62-3-4, 62-5-1, 62-5-3 to 62-5-11, 62-6-1 to 62-6-24, 62-8-1 to 62-8-9, 62-9-1 to 62-9-2, 62-9-4 to 62-9-6, 62-10-1 to 62-10-16, 62-11-1 to 62-11-7, 62-12-1 to 62-12-7, and 62-13-1 to 62-13-4 (1978) are known as the Public Utility Act provisions.

11. "Utility service is a necessity of modern life; indeed, the discontinuance of water or heating for even short periods of time may threaten health and safety. And the risk of an erroneous deprivation, given the necessary reliance on computers, is not insubstantial." Memphis Light, Gas & Water Div. v. Craft, 436 U.S. 1, 18 (1978) (footnotes omitted).

12. *In re* Public Serv. Co. of N.M., 8 P.U.R. 4th 113, 115-16 (1975).

13. *See* Parker, *The Regulation of Public Utilities,* 10 Nat. Res. J. 827 (1970).

14. *Id.* at 827.

15. Legislative authority to set maximum prices was held constitutional in Munn v. Illinois, 94 U.S. 113 (1876), but it cannot be arbitrary or irrelevant to the policy the legislature is free to adopt. Nebbia v. New York, 291 U.S. 502, 539 (1933).

THE DUTY OF THE PUBLIC SERVICE COMMISSION

Rapidly rising costs in the utility industry, resulting in higher rates to consumers, have caused ratemaking to become an even more critical concern of regulatory commissions. Setting rates is a difficult and complex task due to the competing interests, statutory obligations, market evaluations and business evaluations involved. Nonetheless, it is the Public Service Commission's duty to insure that rates charged by the utilities are just and reasonable:

> It is the declared policy of the state that the public interest, the interest of consumers and the interest of investors require the regulation and supervision of such public utilities to the end that reasonable and proper services shall be available at fair, just and reasonable rates, and to the end that capital and investment may be encouraged and attracted so as to provide for the construction, development and extension, without unnecessary duplication and economic waste of proper plants and facilities for the rendition of service to the general public and to industry.[16]

The Consumer Interest

The Commission, in arriving at just and reasonable rates, must balance the interests of consumers, of investors, and of the public as a whole. They are not necessarily at odds with one another but the balance is not always easy to achieve. Theoretically, an efficiently run business is in the interest of users as well as investors. The consumer benefits by receiving service at the lowest reasonable cost; the investor benefits by the availability of greater revenue for earnings and less revenues being expended for operations. The interests do conflict, however, if the utility charges an unreasonable amount for its services to the advantage of its investors. Generally, the consumer articulates his interest by demanding that the rates set be the lowest reasonable rates based upon a matching of the costs associated with present services. He is generally not concerned with the future availability and adequacy of utility service. He believes that his monthly bill should reflect only the cost of his current service and not the costs associated with the generation, transmission or distribution of future services. In his estimation, these are just concerns of the investor, who reaps a financial benefit in the form of dividends or stock appreciation in exchange for the risk he assumes in investing in the utility. Thus, the consumer interest in most cases is viewed as time limited—constrained by his current financial ability to pay his current or foreseeable utility bill.

16. N.M. Stat. Ann. §62-3-1(B) (1978).

The Investor Interest

The interests of investors are simply that they receive the greatest possible return on their investment for any given degree of risk. Their interests are constitutionally protected to some degree. If the company is not allowed to receive revenues which cover the cost of supplying the service, then the company and its investors are being deprived of their property by the state without just compensation.[17] Investors are also entitled to a reasonable return on the money which they have invested in the public utility. The United States Supreme Court in *Bluefield Waterworks & Improvement Company v. Public Service Commission*[18] has recognized the right to such a return:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[19]

This view was reiterated in *Federal Power Commission v. Hope Natural Gas Company:*[20]

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.[21]

This is consistent with the view that the investment returns which the company must pay out are part of the cost of doing business, and the company should receive revenues to cover these costs.

The Public Interest

The public interest is concerned with all present and future consumers and investors and the general citizenry of the state. This

17. *See* Smyth v. Ames, 169 U.S. 466, 521-26 (1898).
18. 262 U.S. 679 (1923).
19. *Id.* at 692.
20. 320 U.S. 591 (1944).
21. *Id.* at 603.

concern is predicated upon the duty of the Commission to assure that reasonable and proper services are made available now and in the future. Like the consumer interest, the public interest requires that rates be kept as low as possible, but the time orientation is somewhat different. It is in the public interest to assure the continuation of adequate service[22] in the foreseeable future, though it may mean paying higher rates in the present.[23] This requires a long-term view of a utility's ability to meet the energy demands of present and future consumers without unnecessary interruptions or cut-backs in service. The Commission must allow the utility to construct adequate utility plants or capacity to meet the demand of its service territory.

Capital is commonly attracted through the issuance of debt, preferred stock and common stock. Though the attraction of capital is in the public interest, in order to construct plants to meet future demand, it is also in the public interest that it be done in the least costly manner possible.[24] This is tied very closely to the return on investment, for the higher the return is for a given amount of risk, the more likely it is that capital will be attracted. Therefore, a judgment must be made. The rate of return must be high enough to attract capital without being so high as to unjustly reward investors. The New Mexico Supreme Court has stated:

> The second concept may be simply stated: That, while the return for the utility should be sufficient to enable it to obtain funds in the

22. "Adequate service" is currently a hotly debated issue in regulatory circles. The issue concerns whether the utility planning is reasonable in light of present and foreseeable economic conditions; is it more costly for society to experience energy shortfalls or is it more costly for society to maintain our present posture of constructing reserve plants to avoid this potential?

23. The disparate time orientation of the public and consumer interest creates tensions and conflict in the regulatory process. For example, two principal issues confronting regulatory bodies today are "phantom taxes" and rate treatment of "construction work in progress." These issues in their simplest form confront the regulator with the question: "Should present ratepayers contribute additional revenues to the utility for the purpose of constructing additional utility plants to service future customers?" *See In re* El Paso Elec. Co., 23 P.U.R. 4th 131 (1977).

24. The capital structure of a typical utility includes debt, preferred stock and common stock. Common stock is the most expensive capital and debt the least expensive. A regulatory commission must be vigilant in assuring that a utility's capital structure is reasonable, *i.e.*, that the proportion of debt to equity is reasonable. Otherwise, the ratepayer may be forced to pay rates based upon an uneconomic capital structure. A rule of thumb is that an optimal capital structure consists of 50% debt, 35% equity and 15% preferred. Another issue that arises in rate cases concerns the appropriate capital structure for the utility operation of a parent company. This issue is resolved by a determination of whether the parent company's activities are more or less risky than utility operations. A more risky operation requires a greater amount of equity investment since bond holders require a greater degree of participation by junior securities. In such event, utility commissions have established hypothetical capital structures for the utility operation in order to assure that the ratepayers are not paying for the costs of non-utility related endeavors. *See, e.g. In re* Gas Co. of N.M., 21 P.U.R. 4th 159 (1977).

capital markets in competition with other businesses of like risk, that returns should be no greater than necessary for that purpose.[25]

This approach implies that if the return on investment is sufficient to attract necessary capital, then the return will also be sufficient to protect investors. This assumes, of course, that capital will not be attracted by issuing new stock at a price which would seriously dilute the value of old stock, which in the long run would be counterproductive.[26]

The Commission, then, must balance the interests of investors, consumers and the public in arriving at rates which are neither confiscatory nor extortionate, and which will allow the company to attract enough capital to meet the demands of the public.

THE TRADITIONAL RATEMAKING PROCEDURE

Normally, rate change proposals are brought to the Commission when the utility files a notice with the Commission which states the proposed rate changes and the intended effective date of such changes.[27] The Commission must be given this notice thirty days in advance of any intended rate change. The Commission may, after giving reasonable notice, investigate and hold hearings for the purpose of determining the lawfulness of the proposed rates. Until a decision is made, the Commission must suspend the operation of the proposed rates. The suspension may last for a period of not more than nine months after the proposed effective date. If the Commission has not determined whether the rates are lawful within the nine month period, it may suspend the rates for an additional three months. The utility, however, may during that time put the rates into effect under bond, insuring that any rates which are determined to be excessive will be refunded to the consumer.

If the Commission decides to have a hearing to determine whether the proposed rates are just and reasonable it follows a procedure which traditionally consists of four steps. First, a rate base is found, which is the measure of the current value of property owned by the utility or investments made by the investor in rendering service to the public. The threshold issue in determining the rate base is whether a particular piece of property or investment is to be included as

25. State Corp. Comm'n v. Mountain States Tel. & Tel. Co., 58 N.M. 260, 284, 270 P.2d 685, 701 (1954).

26. *See In re* Public Serv. Co. of N.M., 8 P.U.R. 4th 113, 128 (1975). It is argued that the dilution of stock below market value over an extended period of time would result in an inability to attract capital. The net result would be an inability of the utility to meet its statutory obligations at worst, or an inability to attract capital at reasonable costs.

27. Rate change procedures are governed by N.M. Stat. Ann. §62-8-7 (1978).

part of a utility plant for valuation purposes. Included in this consideration is whether the plant is "used and useful" in providing utility service.[28] Once a determination is made to include the plant in the rate base, the value of the plant must be ascertained. The Commission determines the original cost, and reproduction cost of equipment. In establishing this property valuation the Commission has utilized a ratio of the two valuations of equipment.[29] Recently, regulatory commissions have begun to utilize the end result method in determining property valuation.[30]

Second, a proper rate of return must be found. The rate of return on the property included in the rate base is arrived at through capital market evaluations, and the Commission must use its judgment in determining what a fair and reasonable rate of return is for each company.

Third, the Commission must determine the operating expenses of the company. Then the revenue requirement is found by multiplying the rate base by the rate of return and adding it in the operating expenses. The revenue requirement arrived at in this manner should give the company a reasonable return on its investment.

One writer has described the process as follows:

> ... [R]ate regulation can be expressed by the formula R=O+ (V-D)r, where R is the total revenue to be obtained, O is the operating costs, V is the value of the tangible and intangible property, D is the accrued depreciation of the tangible and reproducible property, and r is the rate of return. Establishment of the total revenue requirement thus involves three steps: (1) determination of the costs of operation, (2) determination of the value of the property minus accrued depreciation, known as the rate base, and (3) determination of the rate of return.[31]

Fourth, a proper rate design must be established. This is the process by which the total rate increase is allocated between the different classes of customers in order to satisfy the revenue requirement.

THE COST OF SERVICE INDEXING PROCEDURE

The Regulatory Procedure

As implemented by the Commission in Case No. 1196, the general procedures for setting rates for the Public Service Company of New

28. *See* Alto Village Serv. Corp. v. New Mexico Pub. Serv. Comm'n, 92 N.M. 323, 587 P.2d 1334 (1978).

29. *See, e.g., In re* El Paso Elec. Co., 23 P.U.R. 4th 131 (1977).

30. For a discussion of the end result method see text accompanying foonotes 38-50.

31. C. Phillips Jr., The Economics of Regulation 178 (rev. ed. 1972); *see also,* 1 A. Priest, Principles of Public Utility Regulation ch. 4-5 (1969).

Mexico were substantially modified. Under the 1196 Order, the Public Service Company of New Mexico would periodically submit accounting reports to the Commission. The reports were checked against the Company's books and records, and verified by Commission staff accountants.[32] The reports were used to determine from the preceding twelve-month accounting period the Company's earned rate of return on the book value of its common equity capital (ROE). If the return on common equity fell within the range of 13.5% to 14.5% then no adjustment in rates was made for the subsequent period. If, based upon the accounting report, the return on common equity fell below 13.5%, the company was allowed to increase its rates by a factor calculated to bring its return up to the 13.5% level. If the return on common equity was above 14.5% the Company had to decrease its rates by a factor calculated to bring its return down to the 14.5% level. Rate adjustments were by the kilowatt hour of consumption, and were applied to the energy charges for each class of service.[33]

This arrangement automatically passed the Company's business costs, including costs of capital, on to the consumer. Fuel costs and purchased power costs are passed on under a separate fuel adjustment procedure.[34] The adjustments under COSI were automatic in the sense that hearings were not held each time an adjustment was made, but the accounting reports of the Company were verified by the Commission accountants.

The Departure From Traditional Ratemaking

The COSI procedure departs from the traditional ratemaking processes in three ways. First and foremost, it allows rates to go into effect without a formal hearing. Thus, the adversary process is dispensed with in establishing rates. In justifying this departure from normal ratemaking processes the Commission stated in 1196:

> Yet the commisision [sic] has had very little opportunity, because it is always involved in rate cases and because its staff is always in rate cases, to inquire systematically into whether the company is being efficiently managed, whether its prospective growth in demand really justifies the construction program, whether appropriate adjustments in rate structures might temper the growth in demand and thereby reduce the need for construction and for further rate in-

32. Supplemental Order No. 1196, April 1, 1977. The Commission based its decision to modify the order on two grounds: (1) an increase in auditing staff; and (2) a savings of money.

33. *In re* Public Serv. Co. of N.M., 8 P.U.R. 4th 113, 122-24 (1975).

34. *Id.* at 122.

creases, whether the construction program has the mix of facilities which will result in minimum cost, whether the financing program will result in the lowest cost of capital. These are where the bodies are buried. These are where the real bucks are for a commission to get into to save the consumers some money and it can't do that while sitting in a rate case inquiring about line 6, column 9 from some very erudite accounting witness. It's in these neglected areas which the commission could, as its other choice, begin to exercise some control over events, or could at least get a reasonable assurance that the costs being incurred by the company, which costs after all in the long run are borne by the ratepayer, are no more than is necessary, and the inability of the commission, tied up in one case after another, one rate case after another, actively to inquire into such matters boils down to a simple formula: the situation is out of the control of the commission, faced with just a dreadful problem of a responsibility which it can't adequately exercise.

To get out of that box, to get control of the situation again, it is necessary that the commission liberate itself from the tyranny of the rate case cycle. This it can do, I think, by the adoption of a cost-of-service adjustment clause constructed and supervised in such a way that ratepayers never pay for more than the cost truly incurred by the company, and the company is able to earn the rate of return to which the commission says it is entitled, but cannot earn an excessive rate of return by that standard. The rate case load might then become manageable, and the hands of the commission and its staff, freed to deal with the more important policy questions facing the company, the commission and above all, the consuming public. Only in that way can the commission begin to get the fullest understanding of, and control over, the factors which are giving rise to continually increasing costs.[35]

The Commission, however, withdrew its characterization of traditional ratemaking as "the tyranny of the rate-case cycle" in a subsequent case involving a request for COSI by Gas Company of New Mexico:

[T]he commission is compelled to modify our characterization of traditional rate cases in 1196 as the "tyranny of the rate case cycle." This should not be interpreted as a retreat from our position in 1196 that COSI promises to improve the efficiency and the input of this commission and staff. We are merely reconfirming our belief that the traditional rate case cycle has historically proven to be an excellent mechanism to assure the fair and complete presentation of differing points of view facilitating the achievement of regulatory objectives.[36]

35. *Id.* at 133-34.

36. *In re* Gas Co. of N.M., 21 P.U.R. 4th 159, 164-65 (1977).

The original COSI process for reviewing company costs and operations relied upon the skills of auditors. Under this procedure, the Company submitted accounting reports (COSI reports) to the Commission. The reports were checked against the books and records of the Company and verified by Commission staff auditors. The Order originally specified that the verification process would be conducted by certified public accountants under contract to the Commission. However, the 1196 Order was modified to allow staff to conduct the verification process, expressing the notion that trained auditors are all that is required to verify utility costs. It was felt that once a regulatory decision had been made regarding the appropriateness of general cost items, all the regulator needed to do was verify that the costs were actually incurred for utility operations.

Second, COSI established a certainty of time for a rate increase—every three months. Under traditional ratemaking a utility's rate increase request is subject to prolonged regulatory scrutiny—up to ten months in New Mexico. After a final order is issued by the Commission, additional time may elapse if the decision is appealed (up to two additional years). Since the utility's rate request is based upon its historical operating conditions as reflected by a test year at the time of filing its request, the rate relief which is ultimately granted by either the Commission or the courts is based upon stale economic data. Inflationary trends decrease the adequacy of the relief obtained thereby depriving utility investors of their ability to earn the return on the investment they are adjudged to deserve. This phenomenon is often referred to as "regulatory lag." COSI did not eliminate regulatory lag but made it predictable. It provided for a time certain when the investor could be assured of a final determination by the Commission of the rates to be charged.

Finally, COSI is a departure from the traditional method of setting rates because it is expressly an "end result" approach.[37] It focuses on the revenues received by the company, as determined from its return on common equity, rather than focusing on a property valuation of the company and the rate of return on that property.

THE LEGAL BASIS OF COST OF SERVICE INDEXING

"End Result" Doctrine

Cost of service indexing is based on the theory that the Public Service Commission need not follow any one method for examining

37. *See* Federal Power Comm'n v. Natural Gas Pipeline Co., 315 U.S. 575 (1942); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944); *In re* Permian Basin Area Rate Cases, 390 U.S. 747 (1968); State v. Mountain States Tel. & Tel. Co., 54 N.M. 315, 224 P.2d 155 (1950); Mountain States Tel. & Tel. Co. v. New Mexico State Corp. Comm'n, 90 N.M. 325, 563 P.2d 588 (1977).

or establishing rates, so long as the "end result" is just and reasonable.[38] The end result doctrine was enunciated by the United States Supreme Court in *Federal Power Commission v. Hope Natural Gas Company*[39] in 1944: "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling."[40] More recently, in *In re Permian Basin Area Rate Cases,*[41] the Court set out the standards by which the end result of the Federal Power Commission's orders should be measured:

> The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress. Accordingly, the "end result" of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they "maintain * * * credit and * * * attract capital."[42]

This language, though it requires that the public interest be considered by the Federal Power Commission, still focuses on the end result rather than the method used in arriving at rates. It is an indication, however, that the Court, when reviewing the end result, will expect an awareness by the Federal Power Commission of the consumer interests as well as the investor interest. It should be noted that *Hope* and the *Permian Basin Rate Cases* both involved questions concerning the Federal Power Commission and its authority under federal statutes. These statutes are similar but not identical to the New Mexico Public Utility Act. Nonetheless, the New Mexico Supreme Court has recognized the end result doctrine and has applied it in its review of the ratemaking functions of the State Corporation Commission[43] and the Public Service Commission.[44] In the 1977 case of *Mountain States Telephone and Telegraph Company v. New Mexico State Corporation Commission,*[45] the New Mexico

38. *Id.*
39. 320 U.S. 591 (1944).
40. *Id.* at 602.
41. 390 U.S. 747 (1968).
42. *Id.* at 791 (footnotes omitted).
43. The State Corporation Commission was created by the New Mexico State Constitution, N.M. Const. Art. 11, § 1. It has the duties, among others, of "fixing, determining, supervising, regulating and controlling all charges and rates of railway, express, telegraph, telephone, sleeping car and other transportation and transmission companies and common carriers within the state . . ." N.M. Const. art. 11, § 7. State v. Mountain States Tel. & Tel. Co., 54 N.M. 315, 224 P.2d 155 (1950); Mountain States Tel. & Tel. Co. v. New Mexico State Corp. Comm'n, 90 N.M. 325, 563 P.2d 588 (1977).
44. *See* Southern Union Gas Co. v. New Mexico Pub. Serv. Comm'n, 84 N.M. 330, 503 P.2d 310 (1972).
45. 90 N.M. 325, 563 P.2d 588 (1977).

Supreme Court stated that "[t]he [Corporation] Commission was not bound to the use of any single formula or combination of formulae in determining rates. The ratemaking function involves the making of pragmatic adjustments. It is the result reached, not the method employed which is controlling."[46]

The use of an "end result" approach to ratemaking, such as Cost of Service Indexing, does not change the statutory or constitutional limits on the Public Service Commission's exercise of its ratemaking authority. The resulting rates must still be within the "zone of reasonableness"[47] between confiscation and extortion, and by statute, must be "fair, just and reasonable" while protecting the interests of investors, consumers and the public.[48] Additionally, there is the requirement that determinations made by the Public Service Commission must be based on "substantial evidence."[49] The Commission has construed this to mean that the adoption of the cost of service indexing method itself must be just and reasonable as determined from substantial evidence.[50] If the resulting rates meet these tests, then it is probable that the end result doctrine would limit the court's scrutiny of the method used.

COSI As An Automatic Adjustment Clause

One possible criticism of cost of service indexing is that approval of the COSI rate adjustment does not require a public hearing. A hearing, however, may not be legally required. The applicable statute reads: "Whenever there is filed with the commission by any public utility a schedule proposing a new rate or rates, the commission *may*, either upon complaint or upon its own initiative, upon reasonable notice, enter upon a hearing concerning the lawfulness of such rate or rates."[51] This indicates that the holding of a public hearing is discretionary with the Commission. Even if the statute did not use discretionary language, a hearing may not be required for each rate adjustment so long as the indexing procedure itself was approved at a public hearing.[52] This is based on the justification that the formula

46. *Id.* at 338, 563 P.2d at 544.

47. State v. Mountain States Tel. & Tel. Co., 54 N.M. 315, 338, 224 P.2d 155, 170 (1950).

48. N.M. Stat. Ann. §62-3-1 (1978).

49. Llano v. Southern Union Gas Co., 75 N.M. 7, 399 P.2d 646 (1964); Alto Village Corp. v. Public Serv. Comm'n, 92 N.M. 323, 587 P.2d 1334 (1978).

50. Case No. 1419 at 11.

51. N.M. Stat. Ann. §62-8-7 (1978) (emphasis added).

52. Consumer's Organization for Fair Energy Equality, Inc. v. Department of Pub. Utils., ____ Mass. ____, 335 N.E.2d 341 (1975); *Contra,* Wisconsin's Environmental Decade v. Public Serv. Comm'n, 81 Wis.2d 344, 260 N.W.2d 712 (1978).

for fixing the rates does not change from the form approved at the public hearing, only the numbers change.[53]

Courts have also held that the lack of a public hearing before rates are changed does not in itself violate the due process clause of the constitution.[54] This is based on the reasoning that consumers have no vested property rights in any fixed utility rates.[55]

Additionally, it has been argued that an automatic adjustment clause is an improper delegation of authority by the regulatory commission to the utility company. The argument has been rejected by several courts, the most recent being the Court of Appeals of Indiana in *Capital Improvement Board of Managers of Marion County v. Public Service Commission.*[56] Moreover, an automatic fuel adjustment clause was found lawful by the New Mexico Supreme Court in *Maestas v. New Mexico Public Service Commission,*[57] though the issue of delegation of authority was not squarely addressed. So long as the Commission retains proper oversight of the utility company and its rate changes, and has the power to prevent unjust rate changes from going into effect, it seems likely that there is no unlawful delegation of authority.[58]

The Public Service Commission, moreover, does not view COSI as a device which will do away with hearings, even if they are discretionary. The Commission has stated:

> We believe that hearings are a meaningful mechanism for achieving regulatory goals. In fact, under COSI, we do not expect that hearings are unnecessary. We fully anticipate that the hearing process will be utilized to resolve issues concerning such matters as rate design, construction programs, intra-corporate relationships, and energy conservation activities.
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> Finally, we believe that an essential ingredient in the traditional ratemaking process is intervenor input. Therefore, we fully expect that the monitoring of the COSI reports and the development of

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53. Consumer's Organization for Fair Energy Equality, Inc. v. Department of Pub. Utils., ——Mass. ——, 335 N.E.2d 341, 345-46 (1975).

54. Holt v. Yonce, 370 F. Supp. 374 (D.S.C. 1973), *aff'd*, 415 U.S. 969 (1974); Sellers v. Iowa Power and Light Co., 372 F. Supp. 1169 (S.D. Iowa 1974); Georgia Power Project v. Georgia Power Co., 409 F. Supp. 332 (N.D. Ga. 1975).

55. Sellers v. Iowa Power and Light Co., 372 F. Supp. 1169 (S.D. Iowa 1974); Georgia Power Project v. Georgia Power Co., 409 F. Supp. 332 (N.D. Ga. 1975).

56. Capital Improvement Bd. of Managers of Marion County v. Public Serv. Comm'n, —— Ind. App. ——, 375 N.E.2d 616 (1978); *see e.g.*, City of Norfolk v. Virginia Elec. and Power Co., 197 Va. 505, 90 S.E.2d 140 (1955); City of Chicago v. Illinois Commerce Comm'n, 13 Ill. 2d 607, 150 N.E.2d 776 (1958); Utilities Comm'n v. Carolina Power & Light Co., 250 N.C. 421, 109 S.E.2d 253 (1959).

57. Maestas v. New Mexico Pub. Serv. Comm'n, 85 N.M. 571, 514 P.2d 847 (1973).

58. *Id.* at 573, 512 P.2d at 849.

new reporting and procedural requirements will not only involve staff and PNM but other interested parties as well.[59]

The Burden of Proof on a Utility Company which Requests COSI

In late 1976, the Gas Company of New Mexico filed with the Public Service Commission a new rate schedule along with a petition requesting that the company be allowed to use cost of service indexing to set rates in the future.[60] The request for COSI was denied because the Gas Company was unable to overcome its burden:

> Since COSI represents a very substantial change in the methods and procedures historically followed for utility rate regulation, the commission believes that an additional burden for justifying the COSI procedure falls upon the utility desiring its implementation. The utility must show facts which establish that the "traditional" methods followed by this commission when applied to it are inadequate to ensure an end result commensurate with the public, consumer, and investor interests.[61]

The showings which a company requesting COSI must make are directly related to the purposes of the method. COSI's primary purpose is to allow a utility company to attract capital more readily, and less expensively than could be done using a traditional ratemaking method. Thus, the first, and probably most important, showing which a company should make is that it requires an extraordinary amount of new capital if it is to serve the public properly. Showing the need to raise vast amounts of capital is not enough, however, if the utility company can raise the capital through traditional ratemaking methods. The amount of capital needed in relation to the company's existing size of operation probably provides the standard by which a commission would determine the need for COSI. When the Public Service Company of New Mexico was granted COSI, it showed that it needed to raise enough capital to finance construction costs in the amount of approximately 250% of its undepreciated costs of current plant.[62] Compared to this is the showing which the Gas Company of New Mexico made when it was denied COSI:

> In the instant case, GASCO has failed to demonstrate its need for COSI rate relief in order to attract capital. Unlike PNM, the company has not presented us with any definite plans to be implemented which require the attraction of vast amounts of capital from potential investors. The company relies on its projected gas shortages to

59. Case No. 1419 at 60.
60. *In re* Gas Co. of N.M., 21 P.U.R. 4th 159 (1977).
61. *Id.* at 163.
62. *Id.* at 165.

> establish its need for COSI. Even the estimated capital expenditures for gas storage, liquified natural gas (LNG), and synthetic natural gas (SNG) projects are nowhere near the relative magnitude of capital requirements which PNM faced . . .[63]

The evidence should show, in short, that the utility requires an amount of capital that cannot be attracted at a reasonable cost if traditional ratemaking techniques are continued.[64]

The Public Service Company of New Mexico was able to meet the burden by showing that they were in jeopardy of losing their "AA" bond rating, which would mean that they would have to pay future creditors a higher interest rate in order to attract debt capital.[65] Moreover, because of extensive planning, the Public Service Company was able to show its expected savings. "PNM was able to quantify the money savings expected to be derived from COSI because PNM's plans were specific as to the projected time, cost, and capital needs required for their implementation."[66]

Unlike the Public Service Company in Case No. 1196, the Gas Company of New Mexico was not able to predict any such savings. In fact, their own witness for this issue stated that COSI would not reduce the company's cost of capital.[67] Relying on this expert testimony, the Commission found that one of COSI's primary purposes, the reduction of capital costs, would be unfulfilled.

The Public Service Company was able to show with "clear and convincing evidence on the record that without COSI PNM would helplessly suffer continued revenue deficiencies."[68] The Gas Company of New Mexico made no such showing:

> Indexing does speed up the process by which rate relief is granted and does involve some shortening of the time normally involved in implementing rate relief. However, GASCO has not established that its continued viability requires the extraordinary rate treatment of COSI. The record supports the conclusion that the traditional procedures of this commission are currently adequate to meet the stated needs of the company.[69]

Moreover, it follows that the company must also show that COSI will result in a reduction of capital costs. The Gas Company of New Mexico was unable to make this showing, primarily because of its

63. *Id.* at 166.
64. *Id.* at 167.
65. *Id.* at 165.
66. *Id.* at 165.
67. *Id.* at 166-67.
68. *Id.* at 165.
69. *Id.* at 165.

corporate structure. It is a vertically integrated natural gas utility and is a division of a larger company, Southern Union Company.[70] The cost of capital, therefore, is dependent on the activities of the parent company, and COSI may not influence it at all.[71] COSI's impact on cost of capital, if any, would be very difficult to measure in this situation because of this additional variable.

The Public Service Company, unlike the Gas Company of New Mexico, is in a better position to take advantage of COSI's equity capital cost reductions because it is less influenced by the activities of its related non-utility division. Changes in investor perceptions would, therefore, be more easily measured and influenced by the utility's operations under COSI.

The inability of the Gas Company to meet its burden of proof may also be due to the fact that two-thirds of its total cost of service is already passed on to the consumers under an automatic fuel adjustment clause.[72] The Commission believed it unlikely that the remaining one-third could not be dealt with by traditional ratemaking methods.[73]

THE GOALS OF COST OF SERVICE INDEXING

When the New Mexico Public Service Commission first implemented COSI in 1975, it delineated several goals which it hoped to achieve by using the new system. A discussion of each goal and how COSI was designed to realize each goal follows.

Capital Costs and Attraction of Capital

COSI was designed to reduce simultaneously the Company's cost of capital and improve the Company's ability to attract new capital.[74] This result would be achieved by lowering the perceived degree of risk to the investor. Historically, regulated public utilities such as the Public Service Company of New Mexico have been able to obtain capital on the open market at lower costs than unregulated companies.[75] This was because of the relatively low risk to those who invested in the regulated companies. Changing economic conditions resulted in utilities having more difficulty in obtaining capital, and a rise in the costs of obtaining capital. Investors perceived that the risk of investing in utilities had increased, primarily because costs of

70. *Id.* at 162.
71. *Id.* at 166-67.
72. *Id.* at 164.
73. *Id.* at 164.
74. *In re* Public Serv. Co. of N.M., 8 P.U.R. 4th at 131 (1975).
75. *Id.* at 128-129.

doing business increased faster than revenues. Such cost increases were due to rapid inflation, growth in demand for services, and growth in capital intensity requirements. These include such things as fuel costs, wages and salaries, employee benefits, supplies, taxes, pollution controls and costs of capital. Electric utility companies are also having to switch from oil fired generators to coal fired generators and possibly to nuclear generating systems, all of which require an extraordinary amount of capital. With the changed economic circumstances, revenues were not keeping pace with capital needs and the traditional ratemaking methods and procedures further aggravated the electric utility companies situation. COSI was to remedy this situation, at least to some degree, by passing costs on to consumers without tedious intervening rate cases and their attendant uncertainties.

COSI supplies a greater certainty of earnings because the procedure is based upon a predictable regulatory lag. Regulatory lag is the amount of time between the actual increase in costs to the company and the time when the company is allowed to increase its revenues to cover the costs. Regulatory lag under traditional procedures is unpredictable. It is dependent upon the length of time between rate change requests by the company, the length of time allocated for hearings which have uncertain results, and the length of time necessary to render a decision. A utility which uses COSI can predict that rates will be changed on a regular basis to reflect cost changes. Predictability is a major factor in reducing the perceived risk of an investment.

If capital is attracted at a lower cost than would be possible with a traditional ratemaking procedure, then not only would a company be able to better serve the public interest, but the savings attributable to lower capital costs could be passed on to consumers. The Commission clearly recognized its obligations:

> The task here, as in any service rate proceeding, are [sic] to enable [the Public Service Company of New Mexico] to recover its current costs of service and also to enable it to better serve the public in the future. The principal requirement of both tasks is associated with capital. On the one hand, we should seek to devise a regulatory method that enables the public utility to recover its costs of capital and to create a regulatory climate that may result in a reduction of such costs; on the other, we should permit the company to attract the capital it must have in order to better serve the public in the future.[76]

76. *Id.* at 125.

COSI Would Not Reduce PNM's Incentives to Resist Cost Increases

The Commission apparently recognized that an automatic adjustment could be a disincentive to the Company's attempts to resist cost increases. Theoretically, automatic adjustment clauses act to recoup costs in a short period of time without tight regulatory scrutiny. Thus a utility may not feel compelled to be efficient since it knows that its cost increases will be covered in the near term through automatic rate adjustments. The Commission established two mechanisms to ameliorate this tendency—a so-called "rate of return band" and a moderate regulatory lag of three months between rate adjustments.

The Commission in Case No. 1419 described the operation of rate of return band:

> In Commission Case No. 1196 the Commission allowed PNM the opportunity (and not the guarantee) to earn in the 13½-14½% Return on Equity (herein named ROE) range. If PNM earned below 13½% ROE, it would be allowed to raise its revenue requirements to realize a 13½% ROE; if on the other hand, PNM earned more than 14½% ROE, the company would be required to reduce its ROE to 14½%. If PNM earned between 13½% ROE and 14½% ROE no adjustment would be required. The spread between the upper and lower limits of the ROE was to offer an incentive to PNM to use efficient methods and to increase its productivity so as to achieve a financial reward.[77]

In regard to the three month regulatory lag under COSI, the 1196 Order predicted that this lag would be a sufficient incentive to the Company to reduce costs and at the same time reduce investors' perception of risk in investing in the Company.

COSI Would Enable PNM to Implement Efficiencies Devised by Load Management

The Commission opined that COSI should maximize the Company's ability to plan and implement effective systems and methods for the generation, transmission, distribution, use and conservation of electric energy. It was believed that if management was provided with the means to attract capital cheaply, was provided with adequate incentives to resist cost increases, and was exempted from costly regulatory proceedings, it could maintain adequate services less expensively than under traditional ratemaking.

In essence, the Commission's decision in 1196 reflected a great

77. Case No. 1419 at 41.

degree of confidence in the Company's management abilities. It was premised on the belief that COSI's predicted attributes would allow management to excel with a concomitant benefit to the ratepayer.

Commission Oversight of the Company

Indexing, when implemented by the Commission in Case No. 1196, was perceived to be a method which would allow the Commission to increase its regulatory oversight of the Public Service Company. The traditional ratemaking method was becoming increasingly complex, leaving less time to inquire into issues concerning management efficiency, demand and growth forecasts, construction programs and the like. COSI, on the other hand, was designed to decrease hearing time, leaving the Commission free to conduct investigations into the operations of the utility. It was hoped that some of the more important policy questions could be dealt with because of a decrease in the work load associated with traditional rate cases. In this way, the Commission would be in a better position to protect the interests of consumers, investors and the public. The Commission stated in Case No. 1196:

> With the companies that come before us, we are reeling from one urgent revenue deficiency to the next, with no time to systematically investigate and reflect upon management efficiency, prospective growth in demand as a justification for new plant certification, service rate structuring as a method of more efficiently allocating and conserving resources, minimum cost financing programs and other matters which may result in cost savings, as well as increased reliability and quality of service.[78]

Toward that end, the Commission made it clear that it would not make any changes in either the "fundamental methods of calculation" of the indexing factor or in the allowed return on equity percentage without notice and a hearing.[79] The Commission however failed to define its use of the term "fundamental methods of calculation." Thus, the triggering device for hearings under COSI was vague and ambiguous.[80]

78. *In re* Public Serv. Co. of N.M., 8 P.U.R. 4th at 120 (1975).

79. *In re* Public Serv. Co. of N.M., N.M. Pub. Serv. Comm'n, Case No. 1196 at 48 (1975) (unreported portion of Order).

80. The Commission's failure to express a meaning of this language created a regulatory problem. PNM sent a letter to the Commission requesting an accounting modification to its calculation of its accumulated deferred investment tax credit under Sec. 46(f) of the IRS Code. PNM indicated that unless the Commission granted the company its request, PNM would lose the tax credit. The Commission granted PNM's request without a public hearing. In Case 1419 the intervenors argued that PNM's request amounted to a fundamental change in the method of calculating the rate of return. The company argued that the change was

Conservation

Cost of service indexing was also supposed to encourage energy conservation. By using an adjustment factor which applied to each kilowatt hour of consumption, regardless of the amount of consumption by each consumer, those who consume the most will bear the greatest portion of increased costs. This was intended to cut down on consumption increases by providing consumers with pricing signals which indicated the true cost of his consumption patterns. In other words, the COSI adjustment would be a contemporaneous indication to the consumer of the true costs of his utility uses. The consumer could then choose whether the value of the service received was equivalent to the price he had to pay for such service. Thus, he would be presented with an economic choice: Do I wish to spend my limited resources on utility service or on other goods available in the society?

THE REVIEW OF COST OF SERVICE INDEXING

Beginning in 1975, COSI was used by the Commission to set rates for the Public Service Company of New Mexico. In early 1978, the Commission issued an order of investigation which initiated a review of this ratemaking procedure.[81] The review addressed several issues: whether COSI accomplished the goals which it was designed to meet; whether COSI should be terminated or modified in light of its effectiveness in realizing its goals; whether COSI is consistent with the policies of the Public Utility Act and traditional regulatory goals; and, if COSI is continued, whether any of the modifications or recommendations proposed by any party to the proceeding should be adopted.[82] The Commission's conclusion concerning each goal previously discussed follows.

Cost of Capital and Attraction of Capital

As noted previously, a utility company such as Public Service Company raises capital through the issuance of three types of securities: equity capital, long-term debt, and preferred stock. The 1196 Order predicted that COSI would result in a reduction of equity

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not fundamental and that the Commission was acting in reliance on an information letter received from the IRS. The Commission ultimately ruled that the previously allowed treatment of the tax credit was inappropriate. Case No. 1419, Phase II Order 5-7.

81. Case No. 1419. The review was divided into two phases. The second phase was completed on May 1, 1979. References to the Phase II decision will hereinafter be noted as: Case No. 1419, Phase II.

82. Case No. 1419 at 5.

costs to the Company. The Commission concluded that a savings in Public Service Company's equity costs did occur.

> The Commission feels that the weight of the evidence in the record supports a conclusion that [COSI] has been a primary factor in reducing [Public Service Company of New Mexico's] cost of capital.
> In regard to equity savings, . . . testimony and analysis have indicated a decrease in equity capital costs from .85% to above 2%. . . . In the final analysis, [COSI] may not be a causal agent for the noted decrease, but it surely appears to have been a significant factor.[83]

The Commission was less convinced of COSI's impact upon the Company's ability to reduce its long-term debt and preferred stock costs.

> In regard to [COSI's] impact upon preferred and long-term debt, we are less confident of its past impact on reducing costs and even less confident of its future impact on these costs due to [Public Service Company of New Mexico's] current financial parameters.[84]

Yet the Commission determined that COSI did enhance the utility's present and past ability to maintain an advantageous bond rating.[85]

In sum, the Commission found that COSI achieved its capital savings goal and enhanced the Company's ability to attract capital. An independent analysis of COSI conducted by the National Regulatory Research Institute, a federally funded institute providing technical assistance and research for state utility commissions, arrived at the same basic conclusions as the Commission.[86] However, in their opinion, COSI's continued success in reducing capital costs and attracting capital is doubtful. In fact, they concluded that COSI's benefits were temporary and now seem to be past.[87] This conclusion is attributed to the Company's inability since the inception of COSI to earn its allowed rate of return. In their opinion the investors are more impressed by the "bottom line"–amount earned–than the regulatory methodology employed.[88]

Cost Increases

The Commission determined that COSI did not provide adequate incentives to the Public Service Company of New Mexico to resist

83. *Id.* at 36.
84. *Id.* at 36.
85. *Id.* at 71.
86. A. Kaufman & R. Profozich, The New Mexico Cost of Service Index–An Effort in Regulatory Innovation (1979) (Report for the National Regulatory Research Institute).
87. *Id.* at V.
88. *Id.* at 48.

cost increases.[89] COSI was designed to supply these incentives by the use of two devices. One device was the allowed return on equity range between 13.5% and 14.5%, the theory being that the Company would try to increase its chances of earning the higher rate of return (14.5%) by striving to keep its costs down. But in the three years between 1975 and 1978, the Company was able to achieve a return within the allowed range only once.[90] The Commission did not offer an explanation for this result, but decided that the device was obviously not having the desired effect. Indeed, the Commission ultimately discarded the rate of return band entirely. This was due in part to the Commission's adoption of an annual COSI adjustment. The Commission allowed PNM to set rates based upon a fixed return on equity of 13.5%.

The other device which was to supply an incentive to keep costs down was the use of regulatory lag. As explained earlier, this is the time lapse between the periodic rate adjustments. Once rates have been adjusted, based on the accounting report of the previous period, the Company must keep costs down to the same levels as were recorded in that accounting report for it to meet the allowed return. The methodology prescribed in Case No. 1196 called for rate adjustments every three months.

The Commission, in its review of COSI in Case No. 1419, concluded that "regulatory lag theoretically is the strongest incentive in the regulatory environment to reduce costs"[91] and decided that it should be lengthened to twelve months.

The decision to increase regulatory lag appears to have been based in part upon the Company's inability to demonstrate that it had resisted cost increases under COSI. The Company relied upon a management audit to justify a claim of increased efficiencies under COSI. However, this claim was discounted since the Company was unable to establish a causal relationship between COSI and the alleged efficiencies. The Commission also gave little weight to other evidence submitted by staff, intervenors, and the Company which attempted to measure pre- and post-COSI productivity. The Commission was critical of the evidence since it was based upon unreliable tools and techniques for productivity measures.

It would seem that the Commission's determination to increase regulatory lag resulted from a combination of factors. First, the Commission was unconvinced that the evidence supported its prediction that the Company would resist cost increases. It seems that the

89. Case No. 1419 at 71.
90. *Id.* at 41-42.
91. *Id.* at 46.

Commission expected a convincing demonstration of the fact by the Company. When the Company failed to meet this burden, the Commission relied upon the incentives inherent in regulatory lag as a cost resister. Second, as noted above, the Commission appears to have been motivated to increase regulatory lag on the basis of its prediction that it would not seriously diminish COSI's ability to enhance the Company's ability to attract capital at lower costs. Finally, the Commission seems to have lost some confidence in Public Service Company management's motivation to resist cost increases.

> The prudence of PNM's construction program has been severely challenged by the parties to this proceeding. Dr. Halvorsen has criticized the company's load forecast. The company's failure to maximize efforts in this area of energy conservation has been raised. Professor Gordon suggests that the company has been overly aggressive in obtaining the rights to serve the growing mining load in the northwest portion of the State, thereby undertaking the construction of plant for a large, undiversified and risky load. Dr. Gordon also questions the prudence of PNM's management decision to construct plant to serve wholesale customers who may choose to take service from other sources at some future time. In addition, it is alleged that PNM's ambitious investment program is predicated upon management's own ambitions rather than on the public, investor and consumer interests. These allegations are based upon Gordon's expert analysis and cannot be ignored in our consideration of the appropriate action to take in regard to PNM's cash flow problems. The stakes are enormous. The public interest of the State is at the heart of the issue. *If* PNM's construction program is prudent under present and future economic conditions we must be willing to assure PNM the ability to attract the necessary capital to continue its current construction programs. In providing this assurance, we must determine the least burdensome means upon the ratepayer to achieve this result. We are not confident from our review of the evidence in this case of either the prudence of PNM's construction program or that assuming its prudence, PNM's proposed modification to COSI are [sic] the cheapest means available to the ratepayer to achieve the goals.[92]

In sum, the Commission in 1419 has substantially retreated from its optimistic viewpoint on management's good faith activities to resist cost increases under COSI. The 1419 Order reflects a significant regulatory attitude change toward Public Service Company's activities. The Commission's confidence in the utility's operations and planning abilities has apparently diminished. Indeed, the Commission

92. Case No. 1419, Phase II at 11.

indicated its intention to conduct a full review of the Company's construction program and method for financing it.[93]

COSI Does Not Guarantee that Management Will Implement Efficiencies

The Commission found that its earlier prediction that COSI would enable Public Service Company to plan and implement measures to reduce customer costs and increase efficiencies is contingent upon good management planning.[94] In other words, COSI's positive impact upon the Company's ability to attract capital, to reduce capital costs, to resist cost increase, and to maintain adequate regulatory oversight does not guarantee that management will take advantage of these attributes. COSI will provide an opportunity to meet the above-noted objectives.

Again, these findings by the Commission appear to reflect its disenchantment with the Company's management. They depict a Commission attitude that utility management is not infallible and may require more regulatory scrutiny than previously thought. The Commission seems to be indicating a belief that it must be more active in evaluating the reasonableness and prudence of the Company's plans and operations.

Commission Oversight of the Company

As previously stated, the 1975 COSI procedure gave the Commission ten days after an accounting report was filed to determine whether the report was proper and whether the rate change should be allowed.[95] It was hoped that COSI would give the Commission more time to investigate Company management decisions and expenditures. It was found, however, to have exactly the opposite effect.[96] The Executive Director for the Commission stated that "less time is available to the staff for other than verification or straight auditing functions. Those 'other' functions might include the monitoring of management efficiency, the monitoring of the capital expansion program, analysis of planned generations mix, etc."[97]

The Commission also determined that COSI had imposed an undue burden upon its staff to discover regulatory problems associated with Company operations. Once an expenditure was questioned, how-

93. *Id.* at 16.
94. Case No. 1419 at 72.
95. *In re* Public Serv. Co. of N.M., N.M. Pub. Serv. Comm'n Case No. 1196 at 41 (1975) (unreported portion of Order).
96. Case No. 1419 at 49-50.
97. *Id.* at 50.

ever, the burden of showing its reasonableness shifted back to the Company. Under traditional ratemaking procedures, the utility has the burden to go forward with evidence to support its rate increase request.

The result of the short time frame and shifted burden was that it placed "an extremely difficult, if not impossible burden on . . . the staff. . . . [The staff] is reduced to the role of being a rubber stamp, and the frequency with which it must rubber stamp COSI reports for the companies under this jurisdiction seriously limits its time for more useful endeavors."[98]

An example of a questionable expenditure by Public Service Company, which was not discovered by the Commission's auditors, is the Company's purchase of a Learjet in 1977. The Company did not clearly notify the Commission of its purchase,[99] nor did the Commission staff have time to "go behind the books" to determine the existence of the purchase.[100] The Commission learned of the purchase, after the fact, from an outside source. Hearings on the reasonableness of the purchase were then held in early 1978, and the Commission found that the expenditure was "unreasonable and imprudent" in light of its costs and benefits.[101]

The Commission held, in its 1978 review, that these procedural problems could be overcome by use of new Company reporting methods, new time frames, such as annual adjustments rather than quarterly adjustments, and longer times for analysis and review by the accountants. The Commission further withdrew its confidence in the auditor verification process:

> Finally, we no longer believe that only an auditor's review is a sufficient means to regulate utility operations. It is only one function among many that must be performed. The verification of the COSI report is not the type of regulation which will assure a just and reasonable end result.[102]

Impact Upon Conservation

Contrary to the 1196 Order, the Commission decided that imposing the COSI factor as an adjustment applied equally to each kilowatt hour of electricity consumed, regardless of the total amount consumed by an individual customer, did not provide proper price signals to consumers.

98. *Id.* at 51.
99. *In re* Public Serv. Co. of N.M.'s Purchase of a Learjet 35-A, N.M. Pub. Serv. Comm'n Case No. 1408 at 7 (1978) (hereinafter Case No. 1408).
100. Case No. 1419 at 56.
101. Case No. 1408 at 12.
102. Case No. 1419 at 56-57.

By applying the indexing factor equally to large and small consumers, the Commission found that the Company was charging large consumers more than their actual cost of service while charging small consumers less than the actual cost of supplying the service.[103] The effect may be that while large consumers are encouraged to use less, small consumers may be encouraged to use more electricity. The Commission suggested that the underlying rate design be changed, possibly to reflect actual costs at various times of day and in various seasons.[104] By giving consumers a better "price signal," that is by fixing rates as closely as possible to the actual cost of supplying the electricity, which would theoretically reduce peak load consumption, conservation of energy as well as lower costs may result.

In sum, the Commission raised doubts that COSI had the beneficial impact on conservation originally conceived. It reserved final judgment on this matter until it completed a total review of the Company's rate structure.

THE COMMISSION'S MODIFICATION OF COSI

After analyzing the evidence presented in Case No. 1419, the Commission concluded that COSI should be modified. The modifications included:

1. elimination of the quarterly adjustment and institution of an annual adjustment based upon year end common equity.
2. the development of specific procedures governing the Commission's monitoring analysis, evaluation and enforcement under COSI.
3. elimination of the rate of return band on common equity.

The Commission's decision to modify COSI in this manner was based upon the following:

> COSI has met its two primary objectives–reduction of capital costs and the enhancement of PNM's ability to attract capital. Thus, COSI has benefited the ratepayers of New Mexico. In addition the record reflects that PNM's growth in customer rates has not been unreasonable when compared to other growth utilities.
>
> As constituted in its present form, COSI does not appear to provide PNM's management with sufficient incentives to reduce cost increases and inefficiencies. It also does not provide adequate regulatory oversight of PNM's operations and public input into the ratemaking process since it shifts the burden to staff and intervenors to discover potential problems. These deficiencies do not warrant a

103. *Id.* at 57-58.
104. *Id.* at 58.

termination of the COSI experiment. They do require that the Commission undertake modifications to the COSI methodology in order to assure that its end results are just and reasonable and consistent with the goals of the Public Utility Act § 67-3-1.

The modifications we will attempt to devise have the following goal: To maximize the continuation of COSI's positive impact upon the reduction of PNM's capital costs and capital attraction and to minimize the negative impact of COSI upon (1) PNM's incentives to keep costs down and (2) the Commission's ability to adequately regulate PNM's rates.[105]

Annual Adjustment in Year End Equity

The Commission reasoned that the institution of an annual adjustment would not reduce COSI's positive impacts on Public Service Company's capital costs and attraction attributes since the modification maintains the predictability and certainty of a modest regulatory lag—the main reason found by the Commission to result in capital cost savings and attraction.[106] Further, the Commission reasoned that the annual adjustment would provide the Commission staff with more time for an in-depth review of the Company's operations and performance under COSI.[107] Moreover, the Commission concluded that the ratepayers would be benefited by a less frequent rate adjustment since they would anticipate a fixed utility charge for a reasonable planning period.[108] Finally, the Commission expressed its belief that an annual adjustment would shift the burden of inflation from the ratepayers back to the stockholders.[109] It is anticipated that since the stockholders would have to wait longer for a rate change, they would pressure management to be more vigilant in reducing costs. The negative impact of inflation would provide an incentive to the Company to reduce costs by tightening its operating and construction budget.

The annual adjustment is to be made on year-end equity. As noted previously, the 1196 Order mandated a quarterly adjustment based upon the average twelve month equity investment.[110] In making this modification, the Commission stated:

105. *Id.* at 62-63.
106. *Id.* at 63.
107. *Id.* at 66. Case No. 1419, Phase II at 8-9.
108. *Id.* at 66-67.
109. *Id.* at 67.
110. For purposes of illustration, the impact of year-end vs. 12-month average equity investment is as follows. If PNM were to invest a total of 3 million dollars in a given 12-month period, and in the beginning of the period it had a $1 million investment, under the 1196 Order, it could only earn its allowed rate of return $2 million; however, under the 1419 Order, it can now earn its allowed rate of return on the year-end investment of $3 million.

> First, our decision to allow a return on year-end common equity is governed by the fact that the company will now operate on an annual adjustment rather than a quarterly adjustment. Under the quarterly adjustment the Commission only allowed the index to be computed on the company's twelve month average equity. This proviso was perceived as a cost reducing incentive in the Order in 1196. However, with the elimination of the quarterly adjustment and the institution of an annual adjustment this incentive is no longer appropriate. As noted in our December 29, 1979 Order, the annual adjustment should afford PNM the desirable cost reducing incentive.[111]

The Commission also recognized a potential problem inherent in the year-end equity approach.

> We are cognizant that the return on year-end equity may provide the company with an incentive to increase its equity portion of its capital structure at the close of each year. We do not believe that the company would engage in such activity. However, in order to provide PNM with adequate notice of the Commission's concern over the existence of such a circumstance in the future, the continued allowance of year-end equity will require that the amount of year-end equity reflected in future COSI reports must be consistent with a prudent capital structure. Thus, the Commission reserves the right to apply the COSI adjustment to a hypothetical capital structure, 12 month average equity experience, or other reasonable method to correct any future problems which might arise under a year-end equity approach.[112]

In sum, the Commission decision to go to an annual adjustment based upon year-end equity investment is an attempt to maintain COSI's benefits and reduce its regulatory costs. This modification should result in a narrowing of the gap between traditional rate-making and the automatic nature of COSI. It implies a shift in Commission philosophy regarding utility costs. The Commission has departed from the philosophy that costs cannot be controlled by management to the philosophy that the utility can reduce costs if it is provided sufficient incentives.

In anticipation of an allegation that this modification would destroy the COSI methodology, the Commission Order cited the following testimony in opposition:

> Q. In your recommendations finally, you have in a sense devised a new "indexing system" where you do not have quarterly adjustments but yearly, an annual adjustment; is that correct?

111. Case No. 1419, Phase II at 9.
112. *Id.* at 9.

A. *I wouldn't call it a new system. That is just a very modest modification, just doing the report once a year instead of once a quarter.*

Q. I guess that's my question.

Do you consider that still to have all the benefits of COSI and to be essentially a COSI method?

A. In the case leading up to the adoption of COSI, I believe that company witness indicated that some regulatory lag is desirable. Going from quarterly to annual adjustments increases the regulatory lag slightly.

I believe it is a reasonable and sound solution to the problem. I don't advocate going back to the old system. This system relieves the company and in particular staff with an impossible burden of report reviewing and also achieves the essential benefits of having a predictable, modest regulatory lag.

Q. How does that differ from having a yearly rate case?

A. It differs in that the procedure is less formal and is more automatic and therefore deals with the regulatory lag. It does not deal with all the problems of regulations as Mr. Swartwout pointed out. Outside of COSI, the regular regulatory procedure, you will have problems of rate design, any changes in how COSI is implemented in terms of such things as say the treatment of deferred income taxes would be outside of the COSI reports; but to go to a regular annual calculation of revenue requirements would first of all require an annual hearing which is more time consuming and burdensome, and there's no guarantee the hearing would have a duration of–First there's no guarantee it would be annual, and there's no guarantee that the hearing would generate a solution in two to three months whereas here you guarantee that once a year there will be an adjustment in the rates for certain prescribed changes in conditions which I believe is desirable.[113]

Whether this COSI modification will have its intended results must be measured by time and experience. If the Commission's perception is correct, the modified COSI methodology may become more acceptable to other Commissions.

Modifications in Reporting Procedures

The Commission, because it found that COSI had increased its workload, and because it found that verification of Public Service Company's quarterly reports was difficult and time consuming, has undertaken to modify the existing reporting and procedural require-

113. Case No. 1419 at 64-65.

ments. The Commission has required its staff to develop procedural and specific functional reporting requirements governing COSI. The purpose of the modifications is to insure that the COSI privilege will not be abused by the Company and to increase regulatory oversight of the Company.

The staff's proposals, which have not yet been adopted or rejected by the Commission, include a three-month time period for staff and intervenors to review the Company's COSI reports.[114] Challenges to the reports by the staff or intervenors may be made during that time period. If the Commission decides that any challenges are for good cause, a formal, public hearing shall be conducted. If there are no challenges for good cause, or the Commission determines at a hearing that the accounting reports are proper, the COSI factor as determined from the accounting report will become effective.

Another proposal is to review each year or two, the rate of return on equity.[115] If it is found that the cost of capital to the Company has increased or decreased, the allowed rate of return will be adjusted accordingly. The proposed procedure calls for a formal public hearing to the appropriate rate of return.

The staff has also proposed that a capital expansion program review be conducted.[116] This would allow the Commission to scrutinize Company construction plans and its financing of new facilities. Questions concerning the Company's forecast of future demand for their services and the Company's need to attract new capital can be explored.

The staff would also have perpetual reporting requirements whereby the Commission and its staff would have access to the basic information and data necessary for regulatory review on a continual basis.[117] It is thought that this procedure will provide enough information to allow the reviewer to make informed judgments as to where and when further investigation is warranted.

The proposed procedural reforms are designed to subject the operations of Public Service Company to considerable scrutiny. The proposed time frames will allow the Commission and its staff adequate time to properly review information. In fact, the proposed procedures may well subject the Company to greater regulatory oversight than was done under traditional ratemaking methods. It is

114. R. Swarthout, Memorandum to the Commission on Staff Recommendations for Procedural and Specific Functional Reporting Requirements Governing COSI–Pages 67 and 68 of the December 29, 1978 Order of the Commission in Case 1419 re: Public Service Company of New Meixco (PNM) at 5-7 (Feb. 28, 1979).

115. *Id.* at 10.

116. *Id.* at 12.

117. *Id.* at 14.

hoped that this will allow the Commission to get to the real "bread and butter" issues.

The Commission also made a specific finding that "unlike traditional ratemaking methods, COSI does not allow adequate participation of interested parties in the ratemaking process."[118] This conclusion might be interpreted to mean that the Commission not only supports the active participation of consumers in the ratemaking process, but recognizes this participation as a real contribution to the process. In fact, the Commission instructed its Staff to actively involve intervenors in the process of developing rules governing reporting and procedures under COSI.

In the final analysis, the Commission appears to have recognized that the 1196 Order failed to provide adequate measures to monitor and evaluate PNM's performance under COSI and failed to create sufficient enforcement procedures to safeguard the consumer, investor and the public interest from management deficiencies.

Elimination of the ROE Band

The Commission reasoned that under an annual adjustment, the return on equity band was no longer appropriate.

> Upon reflection of the impact of a change from the quarterly to annual COSI adjustment, we do not believe that a [13.5% to 14.5% return on equity] band is necessary. As noted in our previous order, the band has not achieved its desired result of providing PNM with an incentive to keep its costs down. Additionally, an annual adjustment should provide the Commission with sufficient time to evaluate PNM's capital costs in a timely fashion. Thus, the Commission in this Order will eliminate the [return on equity] band and set the company's [return on equity] on an annual basis and review the level of [return on equity] for each succeeding annual index adjustment.[119]

THE COSI EXPERIENCE AND THE COMMISSION

Aside from the expressed findings of the Commission in its 1419 Order in support of its modifications to COSI, the COSI experience in New Mexico provides the electric utility regulatory environment with a less obvious finding. An experiment by its nature stems from an hypothesis which it seeks to test. As expressed in 1196, COSI was to reduce capital costs and enhance capital attraction to a highly capital intensive industry in general and to the Public Service Company in particular without damaging the fragile balance between the

118. Case No. 1419 at 73.
119. Case No. 1419, Phase II at 9.

often competing interests which the Public Utility Act mandates the PSC to preserve. In essence, the Commission in Case 1419 determined that the experiment did not achieve all the desired results envisioned in the 1196 Order. It did not preserve the balance. Yet, the Commission did not discard COSI. It concluded that COSI does have the potential elements to become a more efficient and acceptable regulatory methodology through the imposition of specific modifications designed to achieve its fundamental goal—to assure the provision of adequate electric utility service at a just and reasonable price under dynamic economic conditions.

There is a very important lesson to be learned from COSI. The lesson does not relate to obvious facts noted in the Order, but rather must be discerned from unarticulated circumstances. The lesson stems from the source of a regulatory commission's duty to balance competing interests in an environment made adversarial by economic circumstances largely beyond the control of any parties to the process. The lesson concerns risk-taking; the willingness to step forward into an uncertain and opaque future. The risk taker in this case is the New Mexico Public Service Commission, but also may apply, in our opinion, to any public service commission.

A public service commission exists in a legal and political environment. Its members are acutely aware of the conflicting interests that are impacted by its decisions. These interests more often than not resort to political and/or legal means to express their pleasure or displeasure with commission decisions. In such an environment, a commission tends to hold on to traditional techniques to accomplish its function. Tradition provides safety. It is a shield against unpleasant accusations and innuendos. Yet, tradition may not be responsive to changing times. Indeed, it may exacerbate the effects of hard times. The COSI experience does provide us with some insight into risk-taking and its consequences in the regulatory world.

It must be noted that COSI as a concept was presented to the Commission as the result of an out-of-court settlement of an earlier case.[120] The COSI methodology, when inaugurated, was endorsed by almost all parties to the proceeding—residential consumers, the Attorney General, the Commission staff, and the Public Service Company. The adversaries agreed to the institution of the experiment and apparently recognized its potential benefits. Thus, COSI was a product of a compromise not only among competing interests, but also among adversarial interests. Aside from the merits of the COSI proposal, the compromise itself lessened the political-legal risk associated with the experiment. Thus, the regulatory environment, in this

120. *In re* Public Serv. Co. of N.M., 7 P.U.R. 4th 166 (1974).

instance, was conducive to change. The Commission was free to break from the past and assume a risk. In fact, the risk was shared among all the parties to the process. And so, an important precondition to regulatory change by a Commission may be the existence of agreement among the parties to the process.

The COSI experience also teaches us about the importance of mutual trust and understanding among the Commission, the utility, and the consumers. It is trust and understanding which appear to be the fulcrum point of the COSI experiment. Both the utility and the Commission had to be perceived by the consumers as worthy of their trust. Two things appear to have eroded that trust: (1) the ever-increasing COSI adjustment factor;[121] and (2) Public Service Company's purchase of a Learjet 35-A.[122] The Learjet case highlighted a perception by consumers that the Company was abusing its privilege and the Commission was incapable of monitoring Company activities under the automatic adjustment clause. Rather than responding to the erosion of public trust, the Company argued that it was in the purview of its management discretion to purchase the plane. It ignored and was insensitive to public sentiment. The upshot of the dispute was a Commission finding based upon the record that the purchase was unjust and unreasonable.[123] As a result of this episode, all of the Company's expenses and investment became suspect. The ring of trust had been broken.[124] The eventual restoration of the hearing process and total elimination of COSI, whatever its benefits, was advocated by consumers in 1419. Although, the Commission in 1419 did not eliminate COSI, it did eliminate the quarterly adjustment because it found it to be too difficult to monitor and enforce. The Commission instructed its staff to develop report and procedural requirements to assure effective monitoring, evaluating, and enforcement of the adjustment clause.

Thus, the second lesson on regulatory commission risk-taking to be derived from this history relates to utility company sensitivity and concern for the risk-taker commission. A utility must recognize that it and the Commission operate in a fishbowl. A utility granted a special privilege has a duty to avoid any appearances of unwarranted or unreasonable expenses or investments.[125] If public trust and confidence erodes, the risk-taker may reconsider its posture.

121. The COSI Adjustment factor rose from .002688 PKW in May of 1975 to .013944 PKW in March of 1979 or approximately an increase of 519%.

122. Case No. 1408.

123. Case No. 1408 at 12.

124. In Case No. 1419 intervenors and staff opposed the continuation of COSI as it was developed and implemented under Case No. 1196.

125. In Case No. 1419 at 71, the Commission stated "COSI is a privilege, not a right or entitlement."

CONCLUSION

The New Mexico Public Service Commission's decision in Case 1419 makes significant modifications to COSI as it operated under the Commission's Order in 1196. These modifications may or may not correct the regulatory deficiencies noted in the Commission's review. Ultimately, the modified COSI's success or failure will be determined by: (1) Public Service Company's continued ability to attract capital at low costs; (2) the Commission's ability to develop reporting and procedural requirements which will assure effective regulatory oversight over the Company; and (3) future actions taken by the Company and the Commission to restore public confidence in the COSI methodology. The Commission has pledged to review COSI in another two years. Additional regulatory lessons are sure to be learned in this bold experiment.