Test Year Methodology and Its Impact on Consumer Electricity Costs

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The Test Year Decision

Among the details of utility ratemaking is a decision on whether to base a rate application on a historical or a future test year. A test year is a period during which a utility's revenues and expenses are examined holistically to determine if a rate increase is warranted. Borrowing from accounting matching principles, the best profitability analysis results when expenses and revenues cover the same time period. This period can be completed at the time of the rate case application (historical test year) or in the future, typically when rates will go into effect. Some states allow hybrid test years based on historical data and some allow future projections.

Why Does This Matter

One would argue that in setting rates in the future, the test year should also be in the future to be the most meaningful and relevant.

Future test years require forecasting. These can be based on indices, negotiation, or utility forecasts.

Utility forecasts present challenges. A benefit of using utility budget forecasts is that one forecasting process is used for both financial and regulatory processes, saving time and resources for the utility. However, it is difficult for outside parties to judge the appropriateness of the forecast. This creates information asymmetry. Like taking your car to a mechanic, consumers must rely wholly on the utility’s expertise, and without competitive quotes (utilities are monopolies), there’s no easy mechanism to verify the forecast.

Instead, many regulators often require historical test years. This provides the most conservative approach and is easy to verify. However, it introduces regulatory lag. It makes utility investments unprofitable during periods of infrastructure ramp-up, either to finance an energy transition or growth in the region. Past financials are not necessarily the best predictor of future performance.

To be more balanced, regulators can make adjustments to either method. Most historical test year jurisdictions allow known and measurable adjustments, usually on plant balances, to make the test year more current. Many future test year jurisdictions have some kind of true-up or look-back provision to ensure that the money collected was indeed prudently spent as intended. Some allow hybrid test years, although others specifically disallow hybrids, as this encourages cherry-picking elements that could introduce bias.

The country is split on using historical versus future test years

We analyzed the rate impact of different test year types. We looked at the type of test year in each state jurisdiction, first checking whether there was any law or regulation mandating a certain type of test year. We examined one or two recent cases from the larger utilities to check against the literature on the subject. For multi-year plans that are indexed, we looked at the first year on how the initial rates were determined. For formula rate plans, we looked at the initial basis on how rates were developed. For jurisdictions with many variations, we identified the most commonly used method. We count 20 jurisdictions that favor historical test years, 26 jurisdictions with future test years, and 5 jurisdictions using hybrids.

	Historical		Hybrid	Forecast	
Defined or Usual	Alaska Idaho Kansas Montana Nebraska	Nevada North Carolina Oklahoma South Dakota Texas West Virginia	Ohio New Jersey	Indiana Iowa Kentucky Michigan North Dakota	Oregon Pennsylvania Tennessee Utah
Varying (Identified Most typical)	Delaware Colorado		South Carolina Missouri Wyoming	Illinois New Mexico	
Formula Rate Plans (Initial basis prior to look back)	Arizona Louisiana Virginia			Alabama Mississippi	
Multi-year plans, PBRs (First year)	Massachusetts New Hampshire Vermont Washington			Arkansas California Connecticut DC Florida Georgia Hawaii	Maine Maryland Minnesota New York Rhode Island Wisconsin

Figure 1: State Test Years and Regulatory Plans

Rates are 15% higher for future test year jurisdictions

We then compared jurisdictions with historical test years to future test years with residential rate data from EIA. On average, assuming equivalent value per kilowatt-hour, jurisdictions with future test years are 15% more expensive.

The 15% rate differential raises important questions: Are future test year jurisdictions achieving better reliability, faster infrastructure deployment, better customer satisfaction, or cleaner energy? Are utilities in historical test year jurisdictions struggling financially? If there is no difference in product or utility stability, then the higher rates represent a transfer of risk from shareholders to ratepayers with no corresponding public benefit.

	Residential rate (cents per kilowatt/hour)		
Census Division and State	**Year 2024**	**Year 2023**	**Type of Test Year**
New England	**27.68**	**28.73**	
Connecticut	28.75	29.88	Forecast
Maine	24.29	27.42	Forecast
Massachusetts	29.35	29.61	Historical
New Hampshire	23.40	28.15	Historical
Rhode Island	28.65	27.02	Forecast
Vermont	21.90	20.82	Historical
Middle Atlantic	**20.63**	**19.60**	
New Jersey	19.34	17.70	Hybrid
New York	24.43	22.24	Forecast
Pennsylvania	17.77	18.10	Forecast
East North Central	**16.48**	**16.19**	
Illinois	15.87	15.71	Forecast
Indiana	14.77	14.94	Forecast
Michigan	19.30	18.84	Forecast
Ohio	15.99	15.38	Hybrid
Wisconsin	17.18	16.88	Forecast
West North Central	**13.47**	**13.02**	
Iowa	13.40	13.31	Forecast
Kansas	14.15	13.38	Historical
Minnesota	15.45	14.73	Forecast
Missouri	12.91	12.58	Hybrid
Nebraska	11.53	11.20	Historical
North Dakota	11.51	11.01	Forecast
South Dakota	12.86	12.32	Historical
South Atlantic	**14.51**	**14.45**	
Delaware	16.57	15.73	Historical
District of Columbia	17.71	16.45	Forecast

Table 1: State rates and rate plans

Source: EIA, LaReg analysis

	Residential rate (cents per kilowatt/hour)		
Census Division and State	**Year 2024**	**Year 2023**	**Type of Test Year**
Florida	14.14	15.21	Forecast
Georgia	14.08	13.69	Forecast
Maryland	17.86	16.60	Forecast
North Carolina	14.13	12.93	Historical
South Carolina	14.23	13.68	Hybrid
Virginia	14.41	14.26	Historical
West Virginia	15.07	14.05	Historical
East South Central	**13.40**	**13.11**	
Alabama	15.18	14.63	Forecast
Kentucky	12.79	12.65	Forecast
Mississippi	13.39	13.23	Forecast
Tennessee	12.42	12.19	Forecast
West South Central	**14.04**	**13.68**	
Arkansas	12.32	12.25	Forecast
Louisiana	11.73	11.55	Historical
Oklahoma	12.24	12.08	Historical
Texas	14.94	14.46	Historical
Mountain	**14.12**	**13.68**	
Arizona	14.91	14.02	Historical
Colorado	14.92	14.30	Historical
Idaho	11.52	11.05	Historical
Montana	12.66	12.54	Historical
Nevada	15.00	16.67	Historical
New Mexico	14.20	13.85	Forecast
Utah	12.22	11.20	Forecast
Wyoming	12.47	11.46	Hybrid
Pacific Contiguous	**24.23**	**22.02**	
California	31.97	29.51	Forecast
Oregon	14.70	12.73	Forecast
Washington	11.90	10.98	Historical
Pacific Noncontiguous	**34.95**	**34.40**	
Alaska	24.82	23.90	Historical
Hawaii	42.86	42.39	Forecast
U.S. Total	**16.48**	**16.00**	

Table 1: State rates and rate plans

Source: EIA, LaReg analysis

Table 2: Type of Test Year	Year 2024	Year 2023	# of Jurisdictions
Historical	15.90	15.70	20
Hybrid	14.99	14.16	5
Forecast	18.35	17.95	26
Difference between forecast and historical	**15%**	**14%**	**51**

Table 2: Type of Test Year

Source: EIA, LaReg analysis

References

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