Date Filed: October 05, 2026

Witness: Brendan J. O'Brien, Garrett J. Murray, Matthew Fallon and Jonathan Kallen
Request from: Office of Consumer Counsel

Question:

(Retained Earnings) Are ratepayers double paying for retained earnings because they paid the Company to create the earnings which were retained and later on pay a cost of equity on the retained earnings?

Response:

Please refer to the Company's response to OCC-758[i].

Prior Referenced Response:

[i] OCC-758 Question:

(Retained Earnings) Referring to OCC-518 Response. Are ratepayers paying a cost of equity outlay for retained earnings?

OCC-758 Response:

The Company provides this comprehensive response to questions raised in OCC Interrogatories 758 through 766. Where this response references those interrogatories, footnotes have been provided for ease of reference.

1. Fundamental Ratemaking Principles

Two fundamental ratemaking principles apply here.

First, retained earnings are not "included in rate base." Only infrastructure assets are included in rate base and the only equity return that customers pay is the return on rate base. The largest components of a utility company's rate base is the net balance of infrastructure investments that the Company has had to finance via a combination of long-term debt and equity (meaning that it reflects the gross value of plant additions, less accumulated depreciation on those additions, less the accumulated deferred income tax ("ADIT" [1]) benefit). The Company collects a return on rate base through rates equal to the weighted average cost of capital times rate base. The weighted average cost of capital ("WACC") in a rate case reflects the utility's cost of money associated with debt and equity capital used to fund rate base. In a rate case, utility rates are set to reflect the utility's cost of service including its WACC on rate base, such that rates are set to provide revenues that cover i) the utility's annual operating expenses (including taxes, depreciation, and other annually recurring expenses), ii) the utility's annual cost of debt service on rate base such that

[1] The largest driver of ADIT for utility companies is generally the different between book depreciation and tax depreciation. Because tax depreciation is typically accelerated relative to the level of book accounting depreciation, utilities are able to deduct more depreciation expense for tax purposes than they do for book accounting depreciation, creating an ADIT timing difference that serves as a source of capital over the term the ADIT balance 'turns around'.

iii) deducting the level of O&M and debt service from PURA-approved revenues results in a level of net income that reflects the authorized cost of equity (return on equity) established by PURA in the rate case. Customers pay only the return on rate base. There is no separate or additional payment by customers associated with retained earnings.

Second, retained earnings reflects the net income that the utility has earned but has not distributed as dividends. Net income is either returned to shareholders as a dividend, or is retained in the Company as retained earnings. In this manner, retained earnings represent owner's equity in the utility business, becoming part of the permanent capital supporting the Company's operations and investment in utility infrastructure assets. Retained earnings help to alleviate the need for incremental equity issuances (or contributions from the parent company, in the case of a regulated subsidiary) in order to finance ongoing investments.

2. Retained earnings are no different than other cash resources that investors contribute as equity; Ratepayers are not paying a separate (or second) amount for retained earnings (OCC-759)[2].

Customers pay rates designed to support the cost of providing utility service, including operating expenses, depreciation, taxes and the cost of capital (including the authorized return on equity) on the rate base invested in utility infrastructure. When earnings are retained in the Company rather than being distributed to investors as dividends those funds remain at risk to the investor and appropriately form part of the Company's equity capitalization, as "owner's equity."

Accordingly, equity derived from retained earnings is economically no different from other equity funds provided through direct investor contributions and, as such, its cost is the same authorized return on equity as all other sources of equity, when retained earnings are used to pay for utility infrastructure in lieu of other capital funding (OCC-759). In corporate finance, retained earnings come at the same cost, and thus have the same required return as externally supplied equity because investors retain ownership of those funds and continue to bear the same risks associated with the business. The source of the equity does not change the economic reality that investors have committed capital to the enterprise and could otherwise deploy that capital in competing investment opportunities were it not retained in the Company to fund additional infrastructure investments.

3. Retained earnings are not included in rate base; Retained earnings are invested capital that pays for rate base and must be repaid to investors, with a rate of return. (OCC-760)[3].

Within the regulated utility ratemaking framework, retained earnings are not "included in rate base," as OCC-760 suggests. Rather, retained earnings are a source of investor-supplied capital, while rate base consists of prudently incurred assets that are used and useful in providing service to customers. Rate-base assets must be financed with a combination of long-term capital (long term debt and shareholder equity) and retained earnings are one, cost-effective source of that financing. To the extent retained earnings fund utility plant comprising rate base, the retained earnings become part of the capital structure supporting those investments. Regulatory ratemaking acknowledges the cost of equity capital and provides an opportunity to earn a return on invested capital regardless of whether the equity originated from stock issuances or accumulated retained earnings. From a financial perspective, utility assets are indifferent to the source of financing used to acquire them. A dollar of utility plant funded through retained earnings is economically identical to a dollar of utility plant funded through newly issued common stock. Both retained earnings, excluding issuance costs, and the funds from newly issued common stock represent investor dollars committed to utility operations which are exposed to investment risk and other forces that determine the cost equity investors demand in order to provide the utility with its capital to invest.

---

[2] OCC-759: (Retained Earnings) Referring to OCC-518 Response. Is the equity related to retained earnings eligible to earn the authorized return on equity?

[3] OCC-760: (Retained Earnings) Referring to OCC-518 Response. Why is retained earnings eligible to be included in rate base?

In addition, retained earnings differ fundamentally from items that reduce rate base, such as ADIT. As described previously, for utilities, ADIT arises primarily from timing differences between tax and book depreciation and represents taxes effectively paid for by customers in advance of the time that the Company pays out those taxes to appropriate governments. Because ADIT generated in this manner is generally viewed as cost-free capital supplied through the ratemaking process rather than by investors, it appropriately reduces rate base and correspondingly reduces the amount of investor-supplied capital upon which shareholders are permitted to earn a return. In this way, rate base is reduced by ADIT, such that the WACC applied to rate base reflects the cost of capital required to finance rate base, being sourced by long-term debt and shareholder equity.

By contrast, retained earnings ***belong to investors*** and represent earnings that have been reinvested in the business rather than distributed as dividends. In other words, retained earnings are investor capital that are used to fund new rate base assets rather than being distributed immediately as a dividend. This is economically equivalent to a circumstance where 100 percent of net income were to be distributed to shareholders as a dividend, and then reinvesting the portion that would otherwise have been retained as retained earnings back in the Company. Consequently, retained earnings are properly treated as investor-supplied equity capital and are eligible to earn the authorized return on equity when supporting utility investments.

The differing treatment of retained earnings and ADIT reflects a fundamental principle of utility ratemaking, which is that investor-supplied capital that remains at risk in the utility business comes at the cost of equity, and the utility is thus afforded an opportunity to earn a return on the balance of equity that is financing rate base, including retained earnings. Conversely, customer-supplied or cost-free sources of financing (such as ADIT) are generally used to reduce the amount of investor capital *upon which* a return may be earned. The regulatory ratemaking framework acknowledges that investors must be compensated for supplying capital and bearing financial risk and also that customers should not pay more than cost of capital that is required in order to finance rate base, by ensuring that cost-free funding sources, such as ADIT, lower rate base.

4. Ratepayers are not "double paying" for retained earnings (OCC-761).

For the same reason, ratepayers are not "double paying" for retained earnings, as contemplated by OCC-761[4]. The earnings that were "retained" in the utility were previously earned by investors through rates charges to customers and became investor property once earned. To articulate this point, it is important to point out that the amount of retained earnings in any given year has no impact on the value of rate base in that year. In general, utility rate base is a function of the net value of infrastructure (assets), whereas shareholder equity is a source of funds utilized to pay for those rate base assets. The dividend payout ratio (or the inverse being the retention ratio) has no direct bearing on rate base. As explained above, retained earnings as a source of capital to fund rate base is economically equivalent to an investor receiving a dividend and then choosing to purchase additional shares in the Company in the same amount. Both are shareholder equity used to finance rate base, and both come at the cost of equity.

Because investors continue to bear the risks associated with utility operations, retained earnings exist as investor-supplied capital supporting the rate base, on which the Company is entitled to earn a return on equity. The authorized return compensates investors for providing and maintaining that capital in the business, regardless of whether it originated from a stock issuance or retained earnings. Retained earnings are therefore properly treated as investor capital, unlike ADIT, which is generally considered customer-supplied, cost-free capital that reduces the amount of investor-supplied capital required to support utility operations. The use of retained earnings as opposed to new stock issuances is a slightly lower cost source of funds, as there are no issuance costs associated with the use of retained earnings to fund new investments.

---

[4] OCC-761: (Retained Earnings) Are ratepayers double paying for retained earnings because they paid the Company to create the earnings which were retained and later on pay a cost of equity on the retained earnings?

Characterizing retained earnings as a second payment by would miss the fundamental point that the opportunity to earn a return on invested capital and the passage of time are inextricably linked because capital that remains invested continues to have value to investors. Investors could have received those earnings as dividends and invested those dollars elsewhere and had those funds not been reinvested in the Company. As a result, retained earnings continue to represent investor capital that is contributed to the business, is at risk, and carries an ongoing opportunity cost, thereby remaining subject to the authorized return on equity.

Similarly, rate base would not be reduced by retained earnings simply because customers previously paid rates that enabled the Company to generate those earnings, as OCC-762 suggests[5]. Once earned, retained earnings belong to investors. The fact that those funds were retained in the business rather than being distributed as dividends does not change the fact that those funds remain investor-supplied capital supporting utility operations – just the same as any other contribution –with the contributions subject to continuing exposure to business risk and coming at the cost of equity.

As an example, consider a prudent, used-and-useful substation costing $50 million that is financed at the capitalization ratio proposed in this proceeding comprised of 53.86% equity. If the Company raises the equity through new share issuances, the substation would be financed with approximately $23 million of debt and $27 million of newly issued equity. Alternatively, investors could reinvest $27 million of previously earned profits rather than receive those funds as dividends. Under OCC-762's proposition, the second scenario would result in a lower rate base simply because those earnings were reinvested in the Company rather than being received first as a dividend and then reinvested through the purchase of newly issued shares. Yet, the underlying asset is identical; the service provided to customers is identical; and the investment decision facing investors is identical, i.e., ***choose*** to invest capital in the Company or ***choose*** to invest it elsewhere.

There is no economic or financial basis for treating these two financing sources differently (i.e., retained earnings versus investment in newly issued shared) for purposes of determining the financing costs associated with rate base assets providing service to customers. Relying on retained earnings is slightly lower cost since the use of these funds eliminates the need to go to market and the incremental costs associated with the issuance of new equity. Treating these two sources of funds differently would create a financing bias that favors externally raised equity over internally generated equity, even though both sources of capital reflect investment dollars provided by investors. Such a result would disconnect ratemaking outcomes from the financial principles used to set the return on equity. Establishing different returns for different sources of equity funding violates the basic financial principle that the return on an investment is based on the risk of the investment, not the source of the funding.

5. Retained earnings are an important source of internally generated capital (OCC-763).

Retained earnings are an important source of internally generated capital. Retained earnings strengthen the Company's financial position, support credit quality, reduce reliance on external financing, and help fund ongoing infrastructure investment. Recovery of financing costs does not eliminate the need for utilities to maintain adequate equity capital in the capital structure financing rate base. OCC-763 appears to imply that the Company merely serves as an intermediary between utility assets and the owners of those assets[6]. In reality, the owners of the Company and the owners of the utility assets are one and the same. Importantly, customers do not bear the risk of supplying capital to fund utility assets; investors do. Customers pay rates that include the cost of debt and equity capital; however, the capital itself is supplied by investors, not customers. Whether the source of equity capital is retained earnings or proceeds from newly issued shares does not alter this fundamental relationship and therefore does not change the cost of service because, in either case, investors have chosen to commit capital to utility operations and the return on that

[5] OCC-762: (Rate Base) Should the rate base be subtracted by amount of customer already paid for retained earnings?

[6] OCC-763: (Retained Earnings) Should utility companies have any retained earnings if ratepayers are paying for the Company debt and equity costs on the entire rate base?

capital is based on the risk of the investment, not the source of the capital. Indeed, one purpose of maintaining a reasonable level of retained earnings is to preserve financial flexibility, support credit quality, and enhance access to capital markets. These attributes ultimately benefit both customers and investors by helping ensure that the utility can continue to attract capital at reasonable cost and provide safe and reliable service.

The Company does not distribute all earnings as dividends (OCC-764) because doing so would eliminate an important source of internally generated equity capital[7]. If retained earnings were fully distributed each year, the Company would need to replace that capital through additional common equity, debt, or both, in order to fund utility investments and maintain its target capital structure. This financing could be more costly and could expose both investors and customers to additional financing and market risks.

6. Retained earnings are a cost-effective financing resource.

Retained earnings provide financing benefits by avoiding flotation costs (OCC-766)[8], including underwriting, legal, registration, and administrative expenses associated with issuing new securities. Although the Company can elect to distribute 100% of earnings to investors and can subsequently raise replacement capital in the financial markets (OCC-765), doing so presents several drawbacks[9].

First, given the capital-intensive nature of the utility industry, replacement capital would likely be required almost immediately, exposing the Company to prevailing market conditions and unnecessary financing risk.

Second, retained earnings provide a financial cushion during adverse events, including market disruptions and broader economic downturns.

Third, if investors expected the Company to distribute all earnings as dividends, earnings volatility would translate directly into dividend volatility, including potential dividend reductions, which can be viewed negatively by capital markets.

Fourth, replacing retained earnings with externally raised equity would introduce flotation costs that could otherwise be avoided. From a capital formation perspective, retained earnings represent the most efficient source of common equity because they allow the utility to finance investment without incurring transaction costs, market issuance risk, or potential dilution associated with new share offerings.

By retaining earnings instead of issuing equivalent new equity, the Company obtains equity financing without incurring flotation costs. As a result, retained earnings are often a lower-cost source of equity capital than newly issued common stock.

7. Summary

In summary, retained earnings are investor-owned capital resources that remain invested in the utility business. The earnings constitute investor-supplied equity capital, are appropriately used to pay for utility infrastructure, while reducing the need for external financing and associated flotation costs.

In contrast, ADIT is generally treated as customer-supplied, cost-free capital and therefore serves to reduce the amount of investor-supplied capital upon which a return may be earned. This distinction reflects a foundational principle of utility ratemaking: customers should receive the benefit of cost-free sources of capital (ADIT), and only

---

[7] OCC-764: (Special Dividend) Why does the Company not pay out a special dividend every year to remove the retained earnings?

[8] OCC-766: (Retained Earnings) What is the relationship between retained earnings and lack of flotation costs for retained earnings?

[9] OCC-765: (Retained Earnings) If all retained earnings were paid out in the form of a special dividend yearly could the Company get the necessary common equity and debt investment to fund the Company?

pay the cost of capital necessary to finance rate base assets that in service, used and useful, and prudently incurred. The flip side of this same coin is that utility investors should have the opportunity to earn a fair return on capital they supply and place at risk, whether or not that equity capital is contributed in the form of a purchase of newly issued stock or in the form of retained earnings by the company. The treatment of retained earnings reflects the fundamental principle that capital left invested in the business continues to have value and an opportunity cost to investors, even when that capital originated from previously earned income. Fundamentally, retained earnings are the result of investment retained in the business rather than being distributed as dividends, and utility ratemaking has long recognized such retained earnings as investor-supplied equity, no different in substance from newly invested common equity.

Accordingly, retained earnings are not a source of customer-supplied capital, nor do they represent a basis for reducing rate base. Rather, retained earnings are investor-owned funds that are reinvested in utility operations and continue to perform the same economic function as any other form of common equity.