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Witness: Douglas P. Horton and Ann Bulkey
Request from: Public Utilities Regulatory Authority

Question:

(CAPITAL MARKETS) Explain how the Earning Sharing Mechanism (ESM), Revenue Adjustment Mechanism (RAM), revenue decoupling, and capital trackers each individually, and also collectively, impact the Company's revenue risk and the cost of capital? Explain.

Response:

This question indicates a fundamental conceptual error, which is that the Company's "risk" with and without a particular ratemaking mechanism can be discretely evaluated and keyed to a specific increment on the return on equity ("ROE") estimate, which would not be appropriate for the following reasons.

Cost of equity analyses rely on market data for the proxy group companies and the evaluation of a change in the Company's risk (and ultimately its ROE) is properly derived as a *comparison* to the proxy group. To the extent that the proxy group companies have similar mechanisms to those that the Company has, the effects of those mechanisms are reflected in the market data that has been used in the analysis.

As shown in Exhibit CLP-ROE-9, Ms. Bulkley conducted an analysis to determine whether the operating subsidiaries of the companies in her proxy group have one or more of three specific ratemaking mechanism in place, which are: (1) either a partially forecast or fully forecast Test Year; (2) a revenue decoupling mechanism or other clause mitigating volumetric risk; and/or (3) a form of capital cost recovery between rate cases. As discussed on page 67 of Ms. Bulkley's direct testimony, Ms. Bulkley concluded that the timeliness of CL&P's cost recovery through regulatory adjustment mechanisms is similar to the proxy group. Therefore, the existence of these mechanisms cannot be considered in isolation as evidence of lower risk or a lower cost of capital because comparable risk-mitigating mechanisms are already prevalent in the proxy-group market data used to estimate the Company's cost of equity.

Thus, the relevant question is not whether an individual mechanism mitigates a particular risk, but whether the Company's overall risk, after considering the operation of these mechanisms and the risks that remain, is materially different from the risks reflected in the proxy group.

As it relates to how the Earning Sharing Mechanism (ESM), Revenue Adjustment Mechanism (RAM), revenue decoupling, and capital recovery mechanisms, individually, and also collectively, impact the Company's revenues, please note the following:

- **Earnings Sharing Mechanism (ESM):** As proposed by the Company, the ESM can only serve to lower revenues in the future versus what revenues would otherwise be, in the absence of the ESM. Under the Company's proposal, the ESM will only be triggered in situations where the Company earns above (not below) its authorized return on equity. In this way the ESM does not decrease or mitigate revenue risk to the Company, but instead serves as a customer protection during the course of the PBMRP to ensure that rates are not inadvertently set too high during the course of the plan. Because the ESM does not provide corresponding protection when the Company earns below its authorized ROE, it does not mitigate the Company's downside revenue or earnings risk and therefore does not provide a basis for concluding that the Company's cost of capital is lower.

- **Revenue Adjustment Mechanism (RAM):** The RAM annually reconciles a number of reconciling rate components including the Non-bypassable Federally Mandated Congestion Charge (NBFMCC), the transmission adjustment clause (TAC), the system benefits charge (SBC), competitive transition charge (CTA), electric system improvement charge (ESI), and the revenue decoupling mechanism (RDM), which is described below. The vast majority of costs collected through the RAM are costs necessary to support state mandated public policy programs. The RAM ensures that customers pay no more and no less than the cost of these programs by annually reconciling rates to reflect the cost of the programs. These programs would not be able to continue in the absence of the RAM, requiring the state to decide to either abandon them or to identify an alternate funding source other than through electric rates. Therefore, the RAM does not mitigate the Company's downside Revenue of earnings risk and does not provide a basis for concluding that the Company's cost of capital is lower.

- **Revenue decoupling (RDM):** Revenue decoupling was enacted by the legislature in order to ensure that utilities as program administrators of Energy Efficiency programs do not have a financial disincentive to aggressively pursue energy efficiency programs. Without RDM, utility revenues would increase as customer usage increases-which means that the RDM is limiting upside and downside potential, symmetrically. The RDM serves to "decouple" the level of revenues from the level of underlying sales volumes so that -- in the end -- the utility recovers the level of revenues authorized by PURA, nor more and no less. The RDM provides a more predictable level of revenues annually than in the absence of decoupling for both the Company and its customers, but also means that revenue increases for any reason (weather, electrification, economic development, increased customer usage, or other factors) are subsumed by the RDM and returned to customers through operation of the mechanism, rather than being available to the Company as a revenue opportunity.

- Capital recovery mechanisms, like reconciling mechanisms for non-capital items, are utilized to provide support for the underlying capital program and are typically

implemented in lieu of sequential rate case filings. In the absence of a capital recovery mechanism, if the level of authorized revenues are insufficient to support the costs of incremental necessary capital requirements, the utility's recourse is to file a full distribution rate case in order to get the costs associated with the capital investment reflected in rates (i.e., depreciation, property taxes, and the cost of capital).

Collectively, these mechanisms reduce particular risks within the Company's regulatory framework, but these mechanisms do not convert the Company's operating revenues or earnings risk-free revenue streams. Instead, these mechanisms address different risks and operate differently than the base-rate construct. For example, the RDM mitigates volumetric revenue risk; the RAM reconciles imbalances between costs and revenues; capital recovery mechanisms account for the revenue requirement on capital investment between rate cases; and the proposed ESM limits the earnings available to the Company above its authorized ROE without providing corresponding protection against earnings below that level. The appropriate cost-of-capital question therefore is not whether these mechanisms provide any risk mitigation. Some clearly do. The question is -- after consideration of their design and operation together with the Company's remaining business, regulatory and financial risks – *whether the Company's overall risk is materially lower than the risks already reflected in the proxy-group market data.* Ms. Bulkley's analysis indicates that it is not, because comparable adjustment mechanisms and forms of timely cost recovery are prevalent among the proxy-group utilities.

The credit-rating agencies' reports and methodologies reinforce the importance of that distinction. Moody's recognizes revenue decoupling and timely capital recovery as credit supportive, but it also identifies the regulatory environment and financial performance as material credit considerations. Fitch likewise identifies the stability and predictability of earnings and cash flow, together with financial metrics, as relevant to CL&P's credit profile. Accordingly, these mechanisms should be evaluated as components of the Company's overall regulatory framework, not as isolated adjustments that can simply be translated adjustments to cost of capital.