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Witness: Brendan J. O'Brien and Garrett J. Murray
Request from: Office of Education, Outreach, and Enforcement

Question:

(EARNINGS SHARING MECHANISM-ESM) Discuss the method or methods used by the Company to calculate the ESM results (e.g., cost of capital method) and explain how the Company accounts for estimated activity, including revenue that would be subject to annual true-up within the RAM dockets.

Response:

Under the terms of the Settlement Agreement approved in Docket No. 17-10-46, earnings at the end of each calendar year above the distribution company's authorized ROE of 9.25% must be shared with customers and shareholders on a 50/50 basis.

As such, the Company performs a calculation that divides the operating income of the distribution company by the rate base of the distribution company to calculate a rate of return ("ROR") for the distribution company. The cost of debt is then subtracted from the ROR and the resulting percentage is divided by the equity ratio to arrive at the actual earned ROE for the distribution company. This method is referred to as the cost of capital method.

Generally speaking, the activity that flows through the RAM does not have an impact on the above calculation. This is because the rate components that make up the RAM are fully-tracking reconciling rate mechanisms that collect revenues for the distribution company, with deferrals of over or under collections to the next rate period. Due to the deferrals, there is no impact to the operating income of the distribution company from most RAM activity.

The exception to this is the revenue requirement calculations for capital items placed in service that are included for recovery in the ESI, NBFMCC and SBC. These revenue requirement calculations include the recovery of a return on investment that is not deferred. Since this return on investment is not deferred, it flows into the operating income of the distribution company, which is the numerator of the ROR calculation that the ESM is based on. Further, all plant additions, accumulated depreciation and accumulated deferred income taxes on those plant additions that are part of the revenue requirement calculations that are included for recovery in the ESI, NBFMCC and SBC are included in the rate base of the distribution company, which is the denominator of the ROR calculation that the ESM is based on. In this way, the ROR contribution of the plant investments that are recovered through the ESI, NBFMCC and SBC are included in the overall ROR of the distribution company that is calculated for ESM purposes.

Lastly, the RAM rate mechanisms are fully reconciling mechanisms based on actual costs and any differences between estimates of expense items are deferred. To the extent a RAM rate mechanism's rate was based on the prior period's historical costs, that rate will produce revenues that either over or under collect that period's actual costs. Such over or under collections are deferred in accordance with Generally Accepted Accounting Principles ("GAAP") (meaning they do not produce excess operating income or an operating income deficiency) and refunded or recovered in the next rate period.