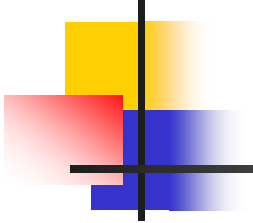


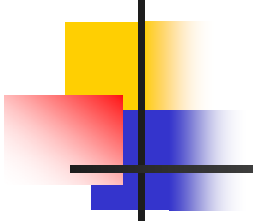
Accounting in the Rate Case Process

Scott A. Struck, CPA
Financial Analysis Division
Public Utilities Bureau
Illinois Commerce Commission



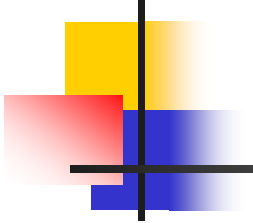
Overview

- General comments about the ICC's approach to determining rates.
- General comments about the legal framework.
- Step through the accounting aspects of the ICC's traditional process for determining rates.
- Please don't hesitate to ask questions as I go through this presentation.



The ICC's Rate Setting Approach

- Generally, rates are designed to recover the costs of providing utility service, including the cost of the capital invested.
- The ICC sets rates that are in effect for indefinite time periods.
- If the rates become insufficient, the utility files a rate case seeking to increase them.
- If the rates become excessive, the ICC initiates a rate case to consider reducing them.



Factors That Lead to Rate Changes

- Significant changes in operating expenses.
- New kinds of operating costs.
- Increased plant investment.
- Significant changes in the number of customers.
- Significant changes in the cost of capital.

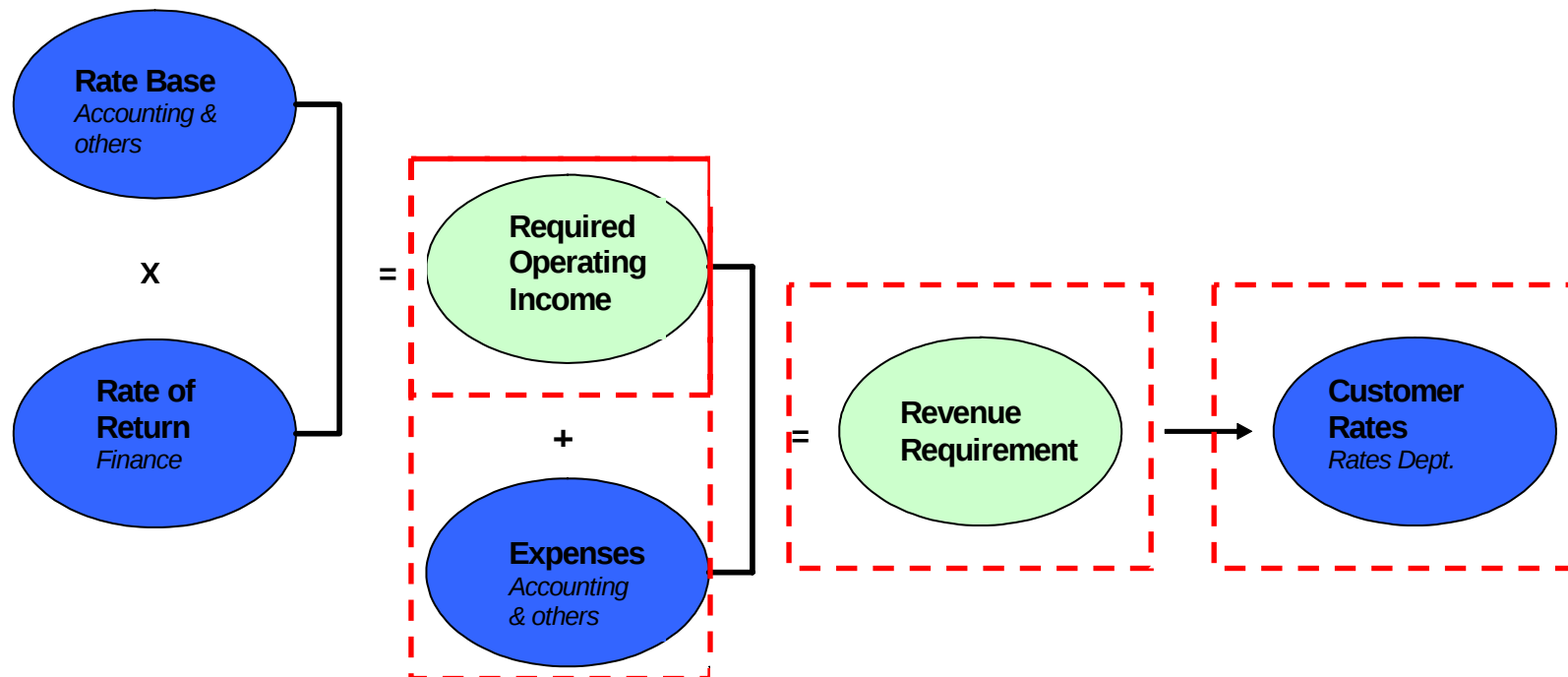
Legal Framework for Setting Public Utility Rates



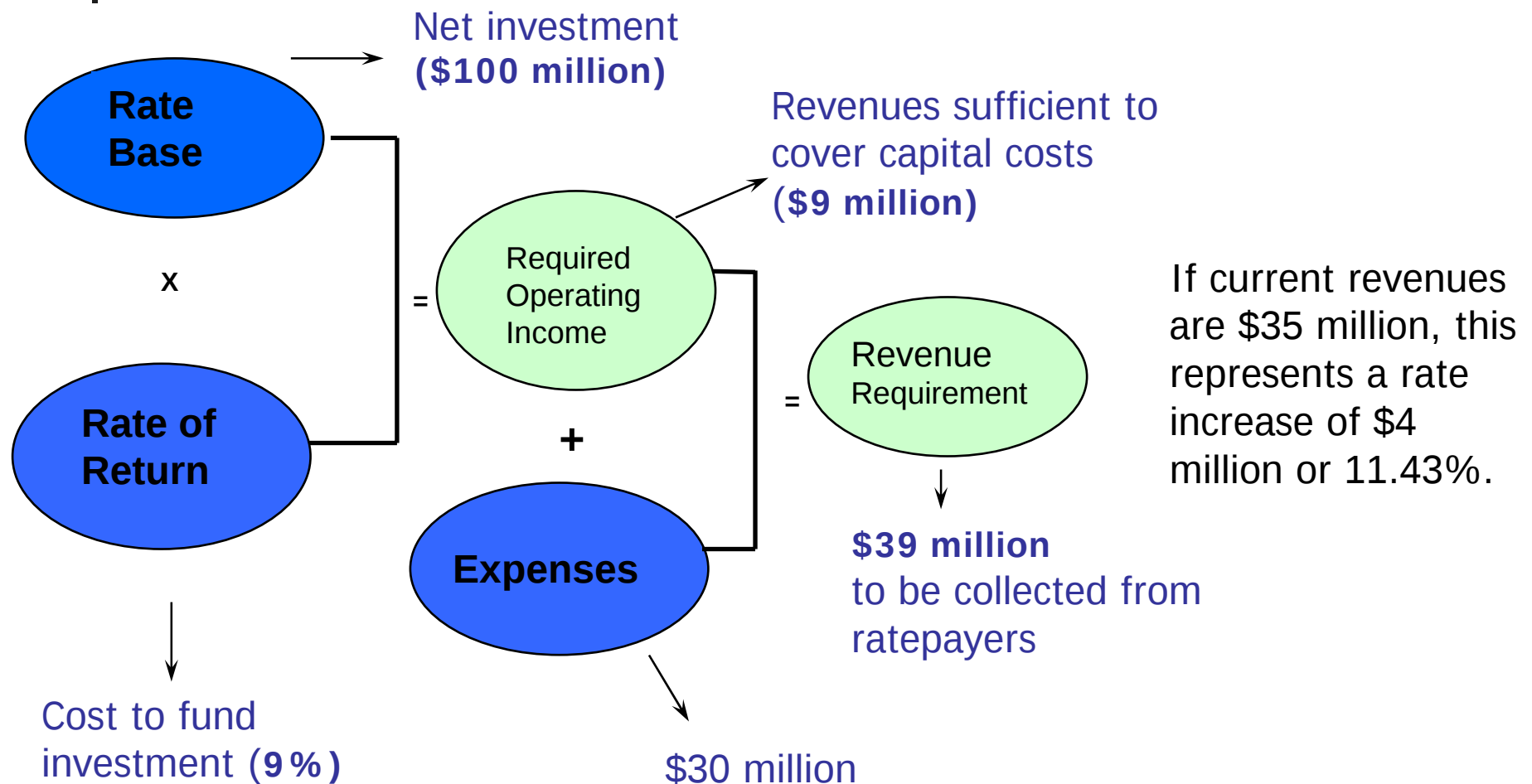
- The utility company is entitled to the opportunity to earn a fair return on its investment used to provide utility service to captive customers.
- The utility company's customers are entitled to safe, reliable service at just and reasonable prices.
- The ratemaking process seeks to balance these two interests.

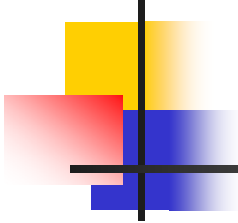
Rate Setting Formula

“...it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. (FPC v. Hope Natural Gas)

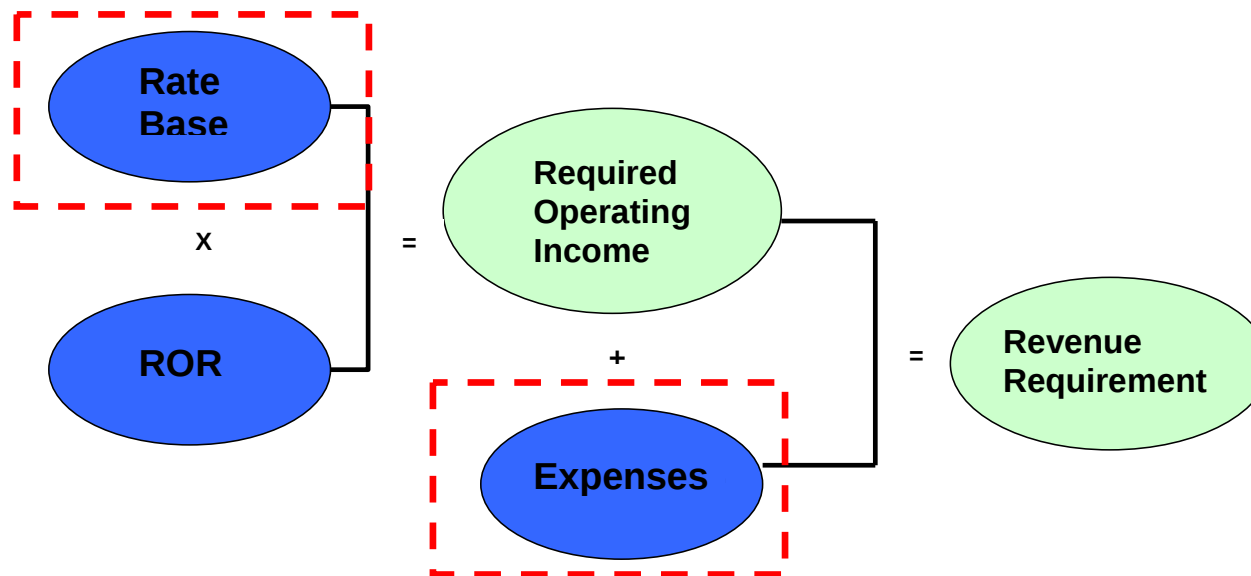


Revenue Requirement Calculation





Rate Base and Operating Expenses



Rate Base and Operating Income Statement



- We begin with the company's accounting records.
- Utility companies are required to keep their accounting records in accordance with the ICC's Uniform System of Accounts. (Corresponds to ERO's RAG's)
- Although the ICC requires utilities to maintain and present financial information in this way, the ICC also retains flexibility with respect to setting rates:

“The Commission does not commit itself to the approval or acceptance of any item set out in any account, for the purpose of fixing rates or in determining other matters before the Commission.”

When in Doubt...

as to USOA Interpretation

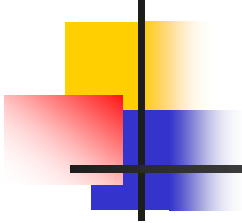


- To maintain uniformity of accounting, utilities shall submit questions of doubtful interpretation to the *Director of Accounting of the Commission* for consideration and decision.” *(General Instruction 5)*

Rate Base and Operating Income Statement



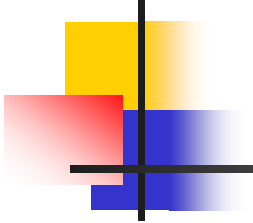
- We apply ratemaking principles to the company's accounting records to determine the revenue requirement.
 - Test Year
 - Rate Base (RAB_f)
 - Operating Income
 - Ratemaking Adjustments



Test Year



- A consecutive 12-month period of operations and investment.
- Adjusted to reflect conditions expected during the period of the new rates.
- 2 options are available in Illinois:
 - Historical test year – Based on 12 months of historical data (with *pro forma* adjustments)
 - Future test year – Based on 12 months of projected data (a *pro forma* test year)



Historical Test Year

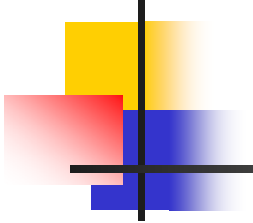


- Based on 12 consecutive months of historical data.
- Must begin no later than 24 months prior to when utility files the rate case and must end before the date on which the company files the rate case.
- *Pro forma* adjustments:
 - Known and measurable changes to the operating results of the test year.
 - Reasonably certain to occur within 12 months of the start of the rate case.
- Advantage – Historical data is objective and verifiable.
- Disadvantage – May not be forward looking in a rapidly changing environment.

Pro Forma Adjustments (?)



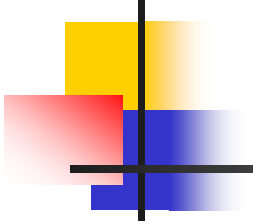
- Known and measurable changes to the operating results of the test year.
 - Known and measurable has been defined by the Commission as verifiable on the record and certain of effectuation. However, an adjustment should not be disallowed merely because it was based upon something less than absolute certainty.
 - A wage increase under a union contract would be considered known and measurable whereas the escalation of costs based on a general inflation factor would not.
- Reasonably certain to occur within 12 months of the start of the rate case.



Future Test Year



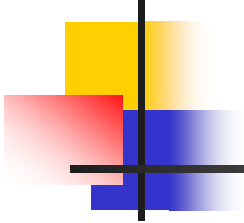
- Based on 12 consecutive months of forecasted data.
- Must begin after the date on which the rate case is filed and end no later than 24 months after the date on which the rate case is filed.
- Requires additional information to support the forecast.
- Requires certification of forecast from independent auditor.
- Advantage - More forward looking.
- Disadvantage – Forecast can be subjective.



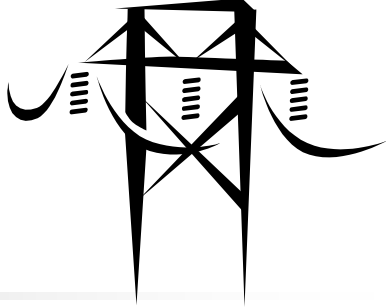
Rate Base



- The net investment used to provide utility service. (RAB_f)
- How to value the investment for ratemaking purposes?
 - Investment cost.
 - Fair value/replacement cost.
- Most jurisdictions in the USA use the investment cost approach.
 - Reflects cost recovery.
 - Assigns cost of investment to those who benefit from the investment.
 - Risk of value fluctuation stays with investors.
- Original cost – the cost to the entity first devoting the investment to public service.



Rate Base - Components



Utility Plant in Service (Net of Contributed Plant)

Less: Accumulated Depreciation

Plus: Working Capital Items

+ Cash Working Capital

+ Materials & Supplies

+ Fuel Inventory

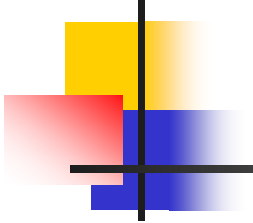
Less: Cost-Free Non-Investor Supplied Capital

- Accumulated Deferred Income Taxes

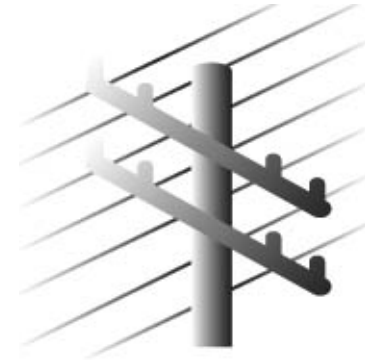
- Customer Deposits

- Customer Advances

Equals: Rate Base (RAB_f)

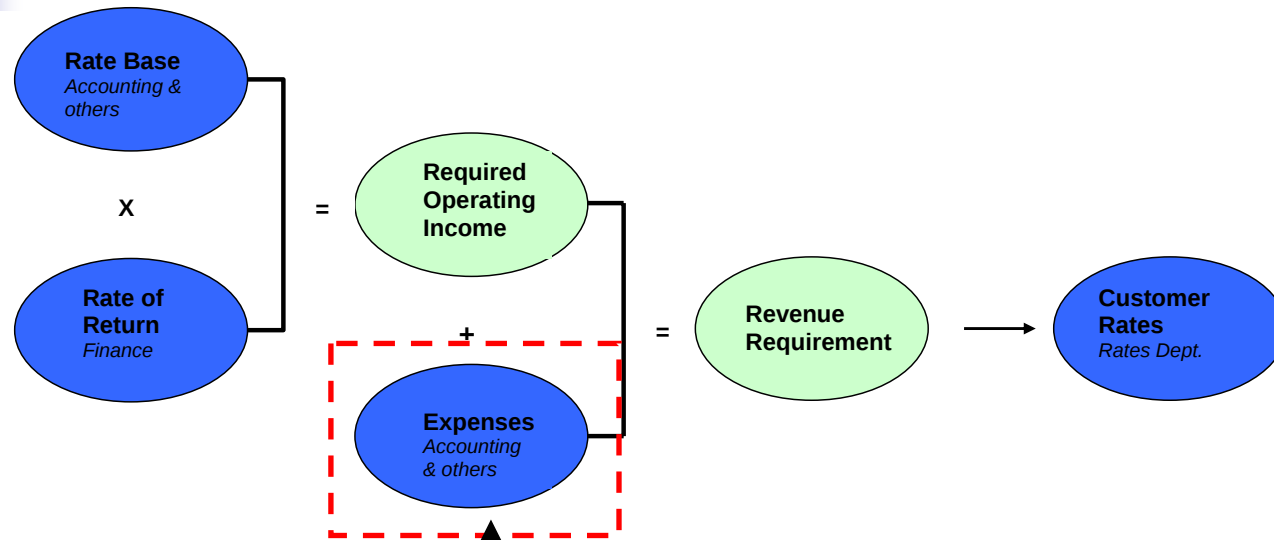


Rate Base - Issues

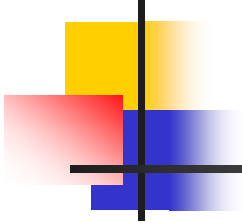


- Used and Useful – The investment is necessary to meet customer demand or economically beneficial in meeting such demand.
- Prudent Investment – The investment will be used and useful in providing service to customers at the time of its completion.
- Reasonable Cost - A utility's decisions, construction, and supervision resulted in efficient, economical and timely construction considering the knowledge and circumstances prevailing at the time of each relevant utility decision or action.
- Shareholder Investment – The item is supported by investor capital.

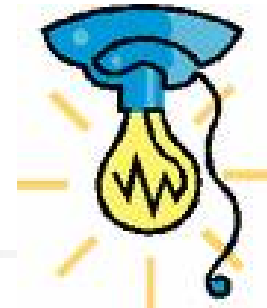
Re-Cap: **Rate Base** is multiplied by **ROR** to calculate the **Required Operating Income**.



Next, we will examine the determination of **Expenses** to add to the **Required Operating Income** in order to calculate the **Revenue Requirement**. (Allowed Revenues)



Operating Expenses

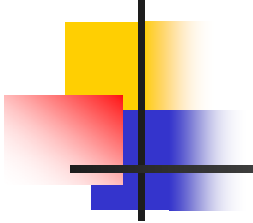


- Cost of operating the system to provide service to customers for a given period, usually 1 year.
- The cost of activity over a given period rather than and amount of investment.

Operating Expenses - Components

- Operation and Maintenance Expenses
- General and Administrative Expenses
- Depreciation
- Income Taxes (including tax effect of interest expense)
- Other Taxes





Operating Expenses - Issues



- Cost of Service – Is it a cost of providing utility service?
- Reasonable Amount – Is the amount excessive?
- Policy Concerns – Is the item treated consistent with Illinois Policy as set forth in statute, rules, and prior decisions?
- Normal Level – Is it a normal recurring level that is expected to continue?

Operating Expenses – Issues (Continued)



- Annual Amount – Are more than 12 months worth included?
- Out of Period – Does the item belong to another period?
- Pro Forma Amount – Do *pro forma* adjustments reflect changes that are known and measurable and reasonably certain to occur within the required time frame?
- Forecast Reliability – Are there concerns about the test year forecast based upon the accuracy of past forecasts? Are the assumptions reasonable?

Operating Income Statement



Utility Operating Revenues (Revenue Requirement)

Less: Utility Operating Expenses

- Operation and Maintenance
- Depreciation
- Income Taxes
- Other Taxes

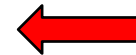
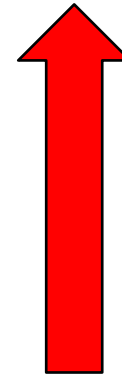
Equals: Operating Income (Rate Base x ROR)

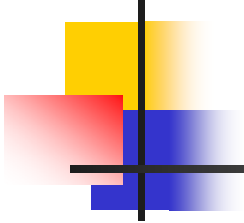
Plus: Total Other Income and Deductions

Less: Interest Expense

Less: Dividends Paid on Preferred Stock

Equals: Net Income Available for Common Stock





Rate of Return (WACC)

