Group Exercise I: Calculating the Revenue Requirement

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Rates Recover Costs

- The utility's revenue requirement represents the total amount of money a utility must collect from customers to pay all costs including a reasonable return on investment
- The regulatory proceeding for determining the revenue requirement for an investor-owned electric utility in Colorado is the Phase I rate case





Revenue Requirement Formula

$$RR_t = (RB_t)R_t + OC_t + D_t + T_t + F_t$$

Where:

R

D

Т

F

t

RR =	Revenue requirement
------	---------------------

- = Rate of return
- RB = Rate base (Gross Investment Accumulated Depreciation)
- OC = Operating costs
 - = Depreciation expenses
 - = Taxes
 - = Other costs (Franchise Fees)
 - = Test year



Phase I Methods

- Surprisingly unsophisticated proceedings
- Operating costs- pass-through at cost
- Assets– book value; actual cost incurred at purchase
- Depreciation straight-line over useful life of asset
- Allowed rate of return
 - Weighted Average Cost of Capital
 - Price of debt– actual cost of bonds and other borrowing instruments
 - Price of equity- analysis (DCF) of returns of similarly situated companies (risk profile)



Test Year

- The foundation for developing Phase I rate case
- The test year is a measure of the operations and investment in some specified 12-month period
- A test year may be a recent historic 12-month period (historic test year)
- A test year may be a projected 12-month period (future test year)
- The financial statements in a test year are developed by the utility
 - Historic test years derive from the company's books and records
 - Future test years come from the utility's budget





Adjustments to the Test Year

- A test year is restated to the extent necessary (or permitted) to produce the data considered reflective of conditions during the period rates are to be in effect
- The adjustments that need to be made to the test year are generally classified as:
 - Commission prescribed adjustments
 - Accounting adjustments
 - Pro forma adjustments





Pro Forma Adjustments

- Made to reflect an ongoing change
- Typically made to historic test year data
 - Should be readily reconcilable to the test year without creating serious possibilities of distortion or mismatching
- Typical pro forma adjustments include:
 - Normalization restate the period data for abnormal conditions
 - Annualization extend over the period, or eliminate from the period, events that had partial period effects and are either recurring or have terminated
 - Out-of-period required when an event is recorded in one period but applies to another period
 - Reclassification add or remove items for purposes of rate recovery





Rules of Thumb

- Rates are set based on what will be reflective of the utility's financial operations in the future
- Adjustments generally not more that one year out of the test year
- Known, measurable, quantifiable or contracted
- In the historic test year framework, pro forma adjustments usually generate the most debate of any adjustments made to the test year data





Rate Base

- Rate base represents the investor-supplied plant facilities and other investments required to supply utility service to customers.
- Criterion for components to be included in rate base based on "used and useful" and "prudent investment" concepts
- The principal method for valuing rate base is original cost at the time plant is placed into service
- Categories of plant in rate base- production (generation), transmission, distribution, and general
- Includes franchises, rights-of-way, land, structures, wires, furniture, tools, equipment, vehicles, software development, etc.





Rate Base Components

- Plant in Service: land, land rights, infrastructure, etc. used to provide service to customers in the test period
- Utility Plant Held for Future Use: land, land rights, and complete units of property that have not yet been used or have been removed from providing service now to preserve them for later use
- Construction Work in Progress: work orders for electric plant under construction
- Cash Working Capital (CWC): average amount of capital provided by investors, over and above the investment in plant and other specifically measured rate base items, to bridge the gap between the time expenditures are required to provide services and the time collections are received for such services
- Prepayments: payments made in advance of the period to which they apply, such as prepaid rents, insurance, and taxes
- Utility Materials and Supplies: inventories of plant materials and operating supplies purchased primarily for use in the utility business for construction, operation and maintenance purposes such as poles, transformers, cables, etc.





Example Rate Base

	(thousands)
Plant in Service	\$2,200,000
Utility Plant Held for Future Use	500,000
Construction Work in Progress (CWIP)	100,000
Common Utility Plant in Service Allocated	75,000
Cash Working Capital (CWC)	15,000
Prepayments	75,000
Utility Materials and Supplies	50,000
Gross Rate Base at Original Cost	\$3,015,000
Less:	
Reserve for Depreciation & Amortization	\$2,000,000
Accumulated Deferred Taxes	150,000
Customer Advances for Construction	25,000
Customer Deposits	900
Allocated to FERC	24,100
Total Deductions	\$2,200,000
Net Rate Base	\$ 815,000



Public Service's Phase I Model

- Exhibit DAB-1 (May 1, 2009)
- Development of Rate Base
- Schedule 3
- Concepts:
 - Categories of Plant (Functionalization)
 - Uniform System of Accounts (FERC Accounts)
 - Jurisdictional Allocation (Retail Revenue Requirement)
 - Customer Deposits
 - Customer Advances for Construction





FERC Form 1 Plant Accounts

	5 /
1	1. INTANGIBLE PLANT
2	(301) Organization
3	(302) Franchises and Consents
4	(303) Miscellaneous Intangible Plant
5	TOTAL Intangible Plant (Enter Total of lines 2, 3, and 4)
6	2. PRODUCTION PLANT
7	A. Steam Production Plant
8	(310) Land and Land Rights
9	(311) Structures and Improvements
10	(312) Boiler Plant Equipment
11	(313) Engines and Engine-Driven Generators
12	(314) Turbogenerator Units
13	(315) Accessory Electric Equipment
14	(316) Misc. Power Plant Equipment
15	(317) Asset Retirement Costs for Steam Production
16	TOTAL Steam Production Plant (Enter Total of lines 8 thru 15)
17	B. Nuclear Production Plant
18	(320) Land and Land Rights
19	(321) Structures and Improvements
20	(322) Reactor Plant Equipment
21	(323) Turbogenerator Units
22	(324) Accessory Electric Equipment
23	(325) Misc. Power Plant Equipment
24	(326) Asset Retirement Costs for Nuclear Production
25	TOTAL Nuclear Production Plant (Enter Total of lines 18 thru 24)

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40 (343) Prime Movers		
41 (344) Generators		
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Phase I Cost Allocations

- Cost allocations between:
 - Separate corporate entities
 - Regulated and non-regulated activities
 - Different regulatory jurisdictions
- Allocators can evolve into a large and contested issue in a Phase I rate case





The "12CP-PROD" Allocator

Public Service Company of Colorado Revenue Requirements Calculation - Jurisdictional Allocators 12 Months Ended December 31, 2010 Exhibit No. DAB-1 Schedule 29 Page 1 of 2

Line	Description	Total	Jurisdictional	FFRC	CRIIC	
NO.	Description	Total	Anocator	FERG	CPUC	
1	Fundamental Allocators - Jurisdictional					
2						
3	Demand - 12 Coincident Peak - Production KW	6 202 442	12CP-PROD	13.84357868%	86.15642132%	
- 2		5,282,413		/31,2/5	4,551,138	
6	Demond - 12 Coincident Peak - Transmission KM		12CP-TRAN	28 04638838%	71 95361162%	
7	Demand - 12 Concount Fear - Transmission Key	6.473.518	120F-TRAN	1.815.588	4,657,930	
8		0,110,010		1,010,000	1001,000	
9	Demand - 12 Coincident Peak - Distribution kW		12CP-DIST	0.09609135%	99.90390865%	
10		4,354,190		4,184	4,350,006	
11						
12	Adjusted Annual Energy Sales - kwh		ENERGY	13.28246121%	86.71753879%	
13		34,350,420,208		4,562,581,238	29,787,838,970	
14						
15	CPUC Only		CPUC	0.0000000%	100.00000000%	
16		1		0	1	
1/	EEBC Only		EEDO	100.00000000%	0.00000000%	
10	PERC ONLY		FERG	100.00000000	0,000000000	
20					0	
21	No Allocation		N/A	0.0000000%	0.0000000%	
22	t the state of the	0		0	0	
		+				



CWIP in Rate Base

From 2008 Historic Test Year (Exhibit DAB-8)

35								
36	Construction Work in Progress:							
37	Steam Production		684,550,856	40,841,440	725,192,298	12C/P-PROD	122,628,874	602,563,424
38	Hydro Production		6,092,931	(9,365)	6,683,565	12CP-PROD	1,130,180	5,553,385
39	Combustion Turbine Production		101,056,709	(141,421)	100,917,288	12CP-PROD	17,064,954	83,852,334
40	Total Production		792,302,498	40,490,653	632,793,151		140,824,008	891,959,143
41	Transmission - System		77,972,850	23,777,538	101,750,386	12CP-TRAN	26,454,693	75,295,693
42	Transmission - Interconnect		0	0	•	12CP-PROD	0	0
43	Land Owned in Fee	360,1	2,297,368	(3,215)	2,294,153	12CP-DIST	1,930	2,292,223
44	Land and Land Rights	360.2	205,433	(287)	205,148	12CP-DIST	173	204,973
45	Structures & Improvements	361	641,229	(897)	640,332	12CP-DIST	539	639,793
46	Station Equipment	362	15,888,975	(22,235)	15,886,740	12CP-DIST	13,348	15,853,392
47	Towers and Fidures	364	3,266,298	(4,574)	3,263,724	12CP-DIST	2.746	3,260.978
48	Overhead Conductor - Primary	365	3,601,430	(5,040)	3,596,390	12CP-DIST	3,025	3,503,385
49	Overhead Conductor - Secondary	365	613,194	(050)	612,336	CPUC	0	612,335
50	Underground Conduit	365	8,371,162	(11,715)	8,359,447	12CP-DIST	7,082	8,352,415
51	Underground Conductor - Primary	367	25,164,208	(35,215)	25,128,993	12CP-DIST	21,140	25,107,853
52	Underground Conductor - Secondery	367	3,345,290	(4,681)	3,340,609	CPUC	0	3,340,609
53	Line Transformers	368	322,960	(452)	322,508	CPUC	0	322,508
54	Services	369	79,066	(111)	78,955	CPUC	0	78,955
55	Meters	370	7,979	(11)	7,965	CPUC.	0	7,965
56	Moters - AMR	370.5	0	0	0	CPUC	0	0
57	Inst. on Customer Premises	371	290,590	(437)	290,183	CPUC	D	290,183
58	Street Light / Signal Systems	373	4,325,388	(6,053)	4,319,333	CPUC	0	4,319,333
59	Total Distribution		88,422,568	(95,751)	68,326,017		49,933	68,276,664
60	General and Intargible		17,003,708	(23,795)	18,979,913	P18-SUBT	1,774,809	15,205,044
61	Common		19,857,567	(27,789)	19,829,778	PIS-SUBT	2,072,759	17,757,019
62	Total Construction Work in Progress		975,559,191	64,120,054	1,039,680,045		171,170,202	868,503,783





Capital Structure

- A utility's capital structure identifies the source of funds and the cost of those funds, *i.e.*, debt and equity
- The utility uses these funds to purchase assets for the provisioning of service
- Debt is where the utility has borrowed money and pays a interest rate on the amount owed
- Equity is where utility has gone to the market and sold shares of stock (ownership) of the company





Customer Deposits

- Customers, typically new customers, with a poor credit record or payment history pay a deposit with the electric utility
- Customers paid interest on deposit held by the utility; Commission sets interest rate
- Deposits considered a source of funds that the utility is free to use in support of rate base investment
 - Liabilities are treated as deductions to rate base
- Generally refunded after 12 months after good payment record



Customer Advances

- Payments to the utility from customers for utility investments needed to provide service
 - Line extensions
 - Transmission line
- Advances considered a source of funds that the utility is free to use in support of rate base investment
 - Liabilities are treated as deductions to rate base
- Customer advances for construction may be refunded to the customer either wholly or in part, generally over time





Other Exclusions from Rate Base

- Accumulated Depreciation: dollars invested in plant are depreciated (depreciation expenses) over the plant's useful life on a straight-line basis and accumulated as a reserve
- Accumulated Deferred Taxes: taxes that have been deferred as a result of revenues and expenses being recognized in different periods for book and tax purposes





Rate of Return

- Represents the amount allowed to be earned, expressed as a percentage of the utility's rate base
- The rate of return (ROR) is intended to allow the utility to:
 - Meet its obligations to present investors (interest and dividends)
 - Compete on reasonable terms in the financial markets for future capital requirements
 - Primarily consists of debt, preferred stock and common equity
- Often the most controversial component of the revenue requirement





Example Capital Structure





Public Service's Phase I Model

- Exhibit DAB-1 (May 1, 2009)
- Development of Rate Base
- Schedule 2





Operating Expenses

- Operating expenses comprise the costs of using and maintaining the utility's electric plant in providing utility service
 - For transmission and distribution, operating expenses primarily consists of labor, materials, supplies and other necessary expenditures
 - Fuel costs handled by fuel clause
- Expenses are presumed to be reasonable and necessary for efficient operation until proved otherwise
- Pro forma changes often include:
 - Salary and wage costs
 - Uncollectible expenses
 - Postage expenses
 - Rate case expenses
 - Pension costs
 - Depreciation expenses
 - Property taxes



Public Service's Phase I Model

- Exhibit DAB-1 (May 1, 2009)
- Development of Expenses
- Schedule 4
- Concepts:
 - Removal of Fuel and Purchased Energy (Fuel Clause)
 - Labor and Non-Labor
 - Operations and Maintenance
 - Allocation of Service Company Expenses
 - Taxes





Depreciation

- Depreciation is the way in which the electric utility recovers its capital investment costs.
 - The recognition in financial statements that physical assets are consumed in the process of providing service.
 - Measures the loss in service value not restored by current maintenance
- Depreciation expense increases the revenue requirement, while accumulated depreciation is a deduction to the utility's rate base, reducing the revenue requirement
- Depreciable property groups can be defined in any convenient manner, but they are often the individual primary plant accounts specified by the Uniform System of Accounts
- Utilities prepare periodic depreciation studies measuring the mortality characteristics of plant and file for regulatory approval of book depreciation rates
- Book depreciation rates are applied to original cost plant balances
 to calculate the depreciation expense







- Taxes are a major component of a utility's cost of service for ratemaking purposes
 - Include federal and state income taxes, as well as many other taxes, such as property, payroll, franchise, gross receipts, excise and sales taxes.
 - However taxes that are based on the utilities gross revenues are usually not included in the revenue requirement formula
- "Gross-up Factor"
 - Used to calculate the pro forma adjustment to income taxes (and other costs that vary in direct proportion to changes in revenues) in determining the overall revenue requirement

Formula: 1 / (1 - Tax Rate) Example: 1 / (1 - 35%) = 1 / .65 = 1.53846

• To increase net operating income (return) by \$1,000, an increase of \$1,538.46 in gross revenues is required, because the utility's income tax expense will increase by \$538.46



Income Statement

- For ratemaking purposes, the income statement summarizes: (1) the funds collected by the utility from its customers; (2) the company's spending and its use of resources in providing service to customers; and, (3) the company's net operating earnings.
- The income statement includes:
 - Operating Revenues
 - Operating Expenses
 - Depreciation
 - Amortization
 - Taxes
 - Net Operating Earnings





Example Income Statement

Operating Revenue	(tł	nousands)
Sales of Electricity	\$	100,000
Other Operating Revenue		5,000
Total Operating Revenue	\$	105,000
Operating Expenses		
Fuel		1,000
Purchased Power		1,000
Production Expenses		2,000
Transmission Expenses		1,000
Distribution Expenses		1,000
Customer Operations Expenses		3,000
Administrative & General Expenses		<u>4,000</u>
Subtotal O&M Expenses	\$	13,000
Depreciation & Amortization	\$	15,000
Taxes other Than Income		500
Income Taxes		2,100
Total Expenses	\$	30,600
Net Operating Earnings	\$	74,400
AFDUC Addition		100
FERC Allocation Deduction		(500)
Total CPUC Jurisdictional Net Operating	¢	74 000
Earnings	Φ	74,000





Public Service's Phase I Model

- Exhibit DAB-1 (May 1, 2009)
- Development of GRSA
- Schedule 28
- Concepts:
 - Test Year Revenue
 - Billing Determinants
 - General Rate Schedule Adjustment (GRSA)





General Rate Schedule Adjustment

- In the absence of a Phase II rate proceeding, existing rates need to be adjusted up or down in order for them to recover the Phase I revenue requirement
- A percentage increase or decrease
- Sometimes there are multiple Phase I cases before there is a Phase II case





"Other Revenue" Reduction

Public Service Company of Colorado Net Operating Earnings - Electric Department 12 Nonths Ended December 31, 2010

Exhibit No. DAB-1 Schedule 4 Page 7 of 7

							Adjusted			Adjusted	Adjusted
Line					Total		Total	Jurisdictional	Specific Assignments	Total	Total
No.	Description	Account	Labor	Non-Labor	Electric	Adjustments	Electric	Allocator	FERC CPUC	FERC	CPUC
	Other Bronour										
	Description for Data Balanti	440						8116			
	I ate Destroat Parence	450		4 970 444		u a	4 575 555	CRUC			4 1775 454
2	Late may note not durantic a	400		3,020,110	4,970,000	u sta ura	6,9/D,000	CPUC			4,970,000
	Mentel Turn-on and Succession	401		2,000,110	2,939,195	1,330,596	4,250,712	CPUC			4,209,112
2	Resolution de la companya de	401		(2/0,041)	(275,341)	9	(2/5,241)	TOTALV		(20,911)	(240,430)
	Other Merilan	404		294,000	294,000	0	294,000	PISHET		30.787	507,099
	Transformer Merses	404		220,595	220,595	0	220,595	PT8-P78		144	220,491
	FERG Assessment			340,400	348,480	0	348,450	FERC		348,480	0
	Automanistemer Capacity Charges	45609		366,400	368,400	0	368,400	12CP-TRAN		103,323	295,077
10	Facility Attachment Revenue	45628		4,998,008	4,998,868	0	4,556,866	PIS-DIST		18,143	4,952,725
11	Non-Gratuitous Revenue	45642		2,350,409	2,350,460	0	2,250,469	P18-018T		7,500	2,342,819
12	Demage Claim Revenue	45642		931,123	031,123	0	\$31,123	PIS-NET		97.278	833,645
13	PaofiCorp Exchange Fee	45842		3,600,000	3,600,000	0	3,600,000	12CP-PROD		495,309	3,101,631
14	Other Missellances Revenue	45842		4,340,456	4,340,455	0	4,340,456	TOTREV		424,228	3,910,225
15	Sub-Total	45642	a	11,222,048	11,222,048	0	11,222,046			1.027,466	10,194,683
16	Ancillary Service Revenue:										
17	Schedule 1 - Scheduling, System Control & Dispatch	45612		1,670,772	1,676,772	508,331	2,165,103	12CP-TRAN		612,842	1,572,281
18	Schedule 2 - Reactive Supply & Voltage Control	45614		1,305,498	1,385,488	41,252	1,426,750	12CP-PROD		197,513	1,229,237
19	Schedule 3 - Regulation & Frequency Response	45816		2.033,514	2,033,514	734,175	2,767,680	12CP-PROD		383.14T	2,384,542
20	Schedule 4 - Energy Imbalance	45819		0	D		0	ENERGY		0	á
21	Schedule 5 - Spinning Reserve	45822		2.471.952	2,471,952	0	2,471,952	12CP-PROD		342,207	2,129,745
22	Schedule 6 - Supplemental Spinning Raserve	45624		906,000	906,000	a	905,000	12CP-PROD		125,423	780,577
23	Schedule 7 & 8 - Transmission Service Revenue	45607		17,576,141	17,576,141	(15,724,317)	1,551,824	12CP-TRAN		519,370	1,332,454
24	Schedule 7 & 8 - Network Transmission Service Revenue	45509		10,383,059	16,383,059	(16.363.059)	0	12CP-TRAN		0	0
25	Interconnection Facilities Revenue	45509		286,560	286,550	a	266,590	12CP-TRAN		80.570	208,190
26	Total Ancillary Service Revenue			42,719,495	42,718,495	(30.623.016)	11,885,878			2 200 672	9,635,008
27	Joint Operating Revenue	45041		1 632 000	1,632,000	(1.632.000)	0	12CP-PROD		0	0
28	Ash Handling Beimbursement	45649		723,112	725,112	1.1.1.1.1.1.1.1.1	723.112	ENERGY		95.047	627.005
29	Provision for C/SP	45651		0	0	a		N/A		0	
90	Linkilled Transmission Revenue	45654		ő	õ	ā	ñ	NA		ő	ā
31	Renovable Energy Standard Adjustment (RESA)	45668		ň		ā	ñ	N/A		ň	ă
32	Internatible Service Ontion Cradit (150C)	45887		14 623 210	14 #23 210	/14 621 210	ő	RAMA .		ň	ž
33	OI & Gan Boyallias	1000		1.1464.618		650,000	850 000	1208-8800		117.670	772 773
34	Fighters Line Engranders					(1.633.644)	(1 652 644)	1208-8800		(200 105)	11 477 497
15	Total Other Revenue			B4 701 345	84 751 345	(46,523,044)	18 266 260	Internation of the second seco		3 747 630	11/40/ (002)
36	CANAN AND AND AND AND AND AND AND AND AND			01/101/060	04,701,040	(40,002,000)	30,200,200		5 D	3,147,036	34,511,622
37	Total Revenue Requirements						1.564.875.162			152,939,413	1411,935,749



