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Ohio | Public Utilities Commission

Ted Strickland, Governor
Alan R. Schriber, Chairman

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Commissioners

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Cheryl Roberto

November 18, 2009

Alan R. Schriber, Chairman
Paul A. Centolella, Commissioner
Ronda Hartman Fergus, Commissioner
Valerie A. Lemmie, Commissioner
Cheryl L. Roberto, Commissioner
Public Utilities Commission of Ohio
180 East Broad Street
Columbus, Ohio 43215

Re: *In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to S.B. 221 for Electric Utilities*, Case No. 09-786-EL-UNC

To The Honorable Commissioners:

In accordance with the Commission Entry in this case dated September 23, 2009, Staff submits its recommendations regarding the development of the significantly excessive earning test (SEET).

The Staff's recommendations are intended to present for the Commission's consideration the Staff's recommendations. These recommendations do not reflect the view of the Commission.

Respectfully submitted

Jodi Bair

Jodi Bair, Director
Utilities Department

JB:djb

STAFF RECOMMENDATIONS

In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to S.B. 221 for Electric Utilities.	))))	Case No. 09-786-EL-UNC

Submitted
To
The Public Utilities Commission

INTRODUCTION

On May 1, 2008, Ohio's governor signed Amended Substitute Bill No 221 (SB 221), changing the law for Ohio's electric utilities. Senate Bill 221 revised the state energy policy to address electric service price regulation, established alternative energy benchmarks for electric distribution utilities, and established energy efficiency standards for electric distribution utilities. Pursuant to the amended law, electric utilities must provide consumers with a standard service offer (SSO), consisting of either a market-rate offer (MRO) or an electric security plan (ESP).[1]

On an annual basis, the Commission must determine whether the adjustments in the ESP or MRO resulted in significantly excessive earnings (SEET) for the electric distribution utility.[2] In order to make the SEET determination, the Commission concluded that certain aspects of the methodology for determining whether an electric utility has significantly excessive earnings should be determined within the framework of a workshop.[3] As ordered by the Commission, Staff conducted a workshop on October 5, 2009. Staff issued an Announcement that posed eleven questions for discussion at the workshop. Staff files its comments and recommendations in this docket in response to the Commission's directive set forth in its September 23, 2009 Entry.[4]

The Staff's recommendations respond to the eleven questions discussed at the workshop that were in the Announcement issued on September 23, 2009 in conjunction with the Commission's Entry.

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[1] Section 4928.142, Ohio Revised Code

[2] Sections 4928.142(D)(4), 4928.143(E) and (F), Ohio Revised Code.

[3] *In re Columbus Southern Power Company and Ohio Power Company*, Case No. 08-917-EL-SSO, et.al., Opinion and Order at 68. (March 18, 2009); *In re Ohio Edison Company, The Cleveland Electric Illuminating Company, and the Toledo Edison Company*, Case No. 08-935-EL-SSO, Opinion and Order at 64 (Dec. 19, 2009).

[4] *In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to S.B. 221 for Electric Utilities*, Case No. 09-786-EL-UNC at 2 (Sept. 23, 2009).

DISCUSSION AND RECOMMENDATIONS

1. Should off-system sales (OSS) be included in the significantly excessive earnings test (SEET) calculation?

OSS should be included in the net earnings used to calculate return on equity for the SEET. OSS are routine operating items and not one-time write-offs or non-recurring items. Inclusion of ongoing revenue and expense items for OSS would have a representative effect on the financials. Therefore, stated financial results without adjustment to OSS are appropriate for calculation of the return on equity.

2. Should the Commission determine SEET on a single entity basis or company-wide basis?

The SSO Applicant is a single entity that makes the SSO for the consideration of its customers. The Applicant has its own unique rate schedule. The Applicant would make restitution for its earnings deemed to be excessive. Therefore, the SEET should be calculated for the single entity, being the Applicant. According to Section 4928.143(F), Revised Code, "Upon termination of a plan under this division, rates shall be set on the same basis as specified in division (C)(2)(b) of this section, and the commission shall permit the continued deferral and phase-in of any amounts that occurred prior to that termination and the recovery of those amounts as contemplated under that electric security plan. In making its determination of significantly excessive earnings under this division, the commission shall not consider, directly or indirectly, the revenue, expenses, or earnings of any affiliate or parent company."

3. What adjustments should be included in the SEET calculation? and 11. How should write-offs and deferrals be reflected in the return on equity calculation for SEET?

In general, stated financial results without adjustment should be used for calculation of the SEET. Extraordinary items should be excluded. This provides a reasonable, representative, and consistent measure of return on equity. Extraordinary items could overwhelm normal levels of earnings and would not be pertinent to the SEET unless directly tied to an ESP or MRO. Where applicable, adjustments should be made to remove items associated with non-Ohio service areas.

The adjustments created by the implementation of an ESP or MRO are what should be determined on a company specific basis. This is necessary only if financial results, as stated, are deemed to be excessive. If these adjustments, in total, are excluded from the earned return deemed to be excessive and, consequently, reduce that return to a level no longer deemed excessive, then it would be requisite to return the amount of the excess to consumers. If the return with the adjustments excluded is still excessive, then the adjustments cannot be at fault for excessive earnings, and no amount need be returned to the consumers.

Extraordinary items that are created as an adjustment in the ESP or MRO should be included for purposes of the SEET. Extraordinary items that are not created as an adjustment in the ESP or MRO should not be included for purposes of the SEET, both in earnings and as an adjustment.

Regarding OSS, only if OSS are included as an adjustment to an electric distribution utility's MRO or ESP, should OSS then be included as an adjustment in the SEET calculation. If OSS are not included as an adjustment to the MRO or ESP, then they should not be included as an adjustment in the SEET calculation. OSS are to be included in the earnings, in any case.

4. What is the precise accounting definition of "earned return on common equity" that should be used?

Earned return should be the net income for the year divided by the average common equity over all months of the year. Extraordinary items should be excluded. This is consistent with the use of stated financials with minimal adjustment.

5. What is the definition of "significantly in excess of the return on common equity"?

A return on common equity of the greater of 200 basis points above the mean or in excess of 1.28 (expressed as basis points) times the standard deviation above the mean of a comparable group of companies, should be defined as significantly in excess. Assuming a normal distribution, this would establish a level of return below which 90% of the sample of comparables would fall. This methodology was used by Michael J. Vilbert in direct testimony filed in the FirstEnergy companies' SSO cases and Staff believed the resultant level of return defined as significantly in excess to have been reasonable.[5] Two hundred basis points above the mean would act as a backstop when earnings are low.

6. How should companies "that face comparable business and financial risk" be determined? and 9. How should the earnings of a comparable company be adjusted to compensate for the financial risk difference associated with the difference in capital structures?

Staff believes it is appropriate that a comparable group sample be determined and utilized on a case-by-case basis, consistent with Section 4928.143(F), Revised Code. This prescribes a comparable group of "publically traded companies, including utilities, which face comparable business and financial risk." A mean value of return on common equity along with a standard deviation will be derived from this comparable group sample. A realized return that is 1.28 times the sample standard

[5] *In re Ohio Edison Company, The Cleveland Electric Illuminating Company, and the Toledo Edison Company*, Case No. 08-935-EL-SSO, Application., Ex. 8 at Appendix B-3, July 31, 2008

deviation above the group sample mean should be considered excessive. Assuming a normal distribution, this would establish a level of return below which 90% of the sample of comparables would fall. The factor of 1.28% will lend consistency and fairness to the process.

If the amount of 1.28 times the sample standard deviation above the group sample mean is lower than 200 basis points above the mean, then 200 basis points should be substituted. Two hundred basis points above the mean would act as a backstop and would keep the threshold for excess at a reasonable distance from the mean when earnings on an industry-wide basis contract. This approach will lend consistency and fairness to the process.

The method for comparable group sample selection should vary case to case, as different companies are structured differently and economic conditions will vary over time. While leverage can be used as a factor in group selection, Staff believes that not doing so and adjusting the resulting returns for the comparable group companies is preferable, as this enables a larger sample to be used. A larger sample enables greater validity for the results. Yet, Staff would leave this choice to the discretion of the Applicant companies as doing so would be consistent with the case by case group selection policy and the leverage consideration is of secondary significance.

7. How are "significantly excessive earnings" to be determined? (Located in the third sentence of Section 4928.143(F), Revised Code.)

Significantly excessive earnings are measured by whether the earned return on common equity of the electric distribution utility is significantly in excess of the return on common equity that was earned during the same period by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate. Staff endorses the concept that a return on common equity in excess of 1.28 times the standard deviation above the mean of a comparable group of companies should be defined as earnings significantly in excess, except in a low earnings environment when 200 basis points could be substituted.

8. What does "in the aggregate" mean in relation to the adjustments resulting in significantly excess earnings?

"In the aggregate" in relation to the adjustments resulting in significantly excess earnings means that the total of all the adjustments created by the implementation of an ESP is to be assessed for its impact in determining whether the company achieved a return on common equity significantly in excess.

10. What mechanism should be employed to return to customers the amount of excess earnings?

The Staff recommendation regarding the return mechanism should be decided on a case-by-case basis in each company's annual SEET proceeding. This would allow the Commission the discretion based on any unique situation or time sensitive circumstance to return the money to customers as they see fit. The Commission would also have the latitude to return the money in varying time periods and/or as reductions to other EDU imposed charges as they deem appropriate.