

This summary is for your information and should not be considered a full and accurate depiction of all elements of a rate case. Three steps are used in determining rates under the rate of return regulation methodology:

1. DETERMINE REVENUE REQUIREMENT

The revenue requirement is the amount of annual revenue necessary to recover the annual cost of providing service and provide an opportunity for the utility to earn a reasonable return on its investment. The revenue requirement is based upon the formula:

$$R = E + (V-d) r$$

R represents revenue requirement. It is the amount of revenue required to generate a desired return on investment given a specified level of operating expenses and rate base.

E represents expense. This is the reasonable annual expense the utility incurs to provide utility service (also called the cost of service).

(V-d) represents the value of the utility's capital investment less its accumulated depreciation (and other required adjustments) necessary to calculate the utility's net plant in service. Working cash and materials and supplies inventory adjustments are then added to the net plant resulting in the utility's capital investment, called rate base.

r represents the rate of return that is achieved by adding the weighted cost of debt and the weighted cost of equity. The rate of return is then applied to the utility's rate base to produce a return on the utility's investment. The resulting amount is then included in the revenue requirement.

2. RATE SPREAD

Rate spread is the allocation of the revenue requirement to the various classes of customers (residential, commercial, etc.). Customers with common characteristics are grouped into customer classes. If it is possible to determine the costs associated with the different customer classes, the costs should be allocated to the customer class that incurs the cost.

3. RATE DESIGN

Rate design is the determination of the rate or price structure for each customer class. The revenue requirement has already been determined and divided among the different customer classes. Now the customer service rate must be designed to provide for the recovery of the allocated revenue requirement within each class. There are several different types of rate structures that can be used. Rate design is to determine the most appropriate rate structure for each customer class.