ORDER NO. 88177

IN THE MATTER OF THE APPLICATION OF POTOMAC ELECTRIC POWER COMPANY FOR ADJUSTMENTS TO ITS RETAIL RATES FOR THE DISTRIBUTION OF ELECTRIC ENERGY	*	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND
	*	CASE NO. 9418

ORDER ON PETITIONS FOR REHEARING

On December 15, 2016, pursuant to §3-114 of the Public Utilities Article, *Annotated Code of Maryland* ("PUA") and Code of Maryland Regulations ("COMAR") 20.07.02.08, three parties filed Petitions for Rehearing of Order No. 87884, which was issued by the Maryland Public Service Commission ("Commission") on November 15, 2016, in the above-captioned proceeding. The filings include the following: Potomac Electric Power Company ("Pepco" or "Company") filed a *Petition for Rehearing and Request for Clarification* ("Pepco Petition"); Office of People's Counsel filed *Request for Rehearing and Clarification* ("OPC Petition"); and the Healthcare Council of the National Capital Area filed a *Petition for Rehearing* ("HCNCA Petition"). This Order addresses the issues raised in the Petitions and affirms the Commission Order No. 87884 in its entirety, with certain clarifications.

I. Summary of Parties Petitions

A. Pepco Petition

In its Petition, Pepco asks the Commission to reconsider the Company's positions and the Commission's decisions on six adjustments: post-test year reliability plant

adjustment RMA [Ratemaking Adjustment] 2; return on equity; merger savings and costs to achieve; amortization of the tax compensation payment; treatment of the IRS tax settlement as known and measurable item for the entire test year; and outside legal services. Pepco's arguments for each of these positions are as follows:

1) Post-test year reliability plant adjustment RMA 2

Pepco argues that the Commission *sua sponte* (*i.e.*, on its own motion) disallowed recovery of Pepco's ratemaking adjustment RMA 2, which the Company argues met the known and measurable and used and useful criteria that the Commission has applied when approving similar ratemaking adjustments in previous cases. In RMA 2, Pepco requested recovery for post-test year reliability plant investment covering the period from January 2016 to August 2016. Pepco argues that the record evidence demonstrates that "these reliability plant investments were made *and will continue to be made* to ensure that Pepco meets or exceeds the stringent reliability standards adopted by the Commission."[1]

Rather than grant the requested eight months of post-test year reliability investment in its entirety, in its Order in this case, the Commission decided to limit recovery to the first three months after the test year (January 2016 through March 2016) and denied recovery of the remaining five months (April through August 2016). Pepco states in its Petition that the Commission's RMA 2 decision had the effect of disallowing $33.9 million of post-test year reliability plant that prior to the start of the hearing was known and measurable and providing service to customers."[2] Further, Pepco argues that the Commission's decision to allow three months of the reliability plant investments for RMA 2 is a departure from prior Commission precedent regarding recovery of post test-

[1] Pepco Petition at 6.
[2] *Id.* at 6.

year reliability plant investment that is arbitrary and capricious, and not supported by competent and substantial evidence.[3]

The Company points out that "[i]n Pepco's last three rate cases,[4] the Commission allowed Pepco to recover all of its known and measureable and used and useful post-test year reliability plant investments,"[5] and asserts that in Order No. 87884 the Commission changed the standard for recovery of post-test year reliability plant without prior notice.[6] Pepco also challenges the Commission's assertion in the Order that indicated that the Commission had departed from traditional ratemaking principles due to Pepco's poor reliability performance over the prior decade.[7] Pepco further indicates that the Commission "has consistently allowed Delmarva Power and BGE to recover their own post-test year reliability plant investment based on the standard developed in Case No. 9192,"[8] and notes that the Commission makes no mention of poor reliability in the Delmarva or BGE orders when approving recovery and argues that "poor reliability has not been a determining factor used by the Commission when determining recovery of post-test year reliability plant."[9] Instead, the Company proffers that the Commission allowed recovery of post-test year reliability investments in its previous three rate cases "due to its focus on improving reliability, including following the Commission's

[3] *Id.* at 6.
[4] Case No.9286, Order No. 85028 at 17 (2012), Case No. 9311, Order No. 85724 at 17 (2013) and Case No. 9336, Order No. 86441 at 18 (2014).
[5] Pepco Petition at 7.
[6] *Id.* at 11.
[7] *Id.* at 7.
[8] *Id.* at 10.
[9] *Id.* at 11.

promulgation of new reliability regulations in RM 43, factors that remain in effect today."[10]

Pepco also states that the second reason for departing from the Commission's precedent for RMA2 – namely, the significant rate increase requested by Pepco – has also never been a factor in the Commission's determination. The Company asserts that this rationale is antithetical to Md. Cod. Ann., Public Utilities Article ("PUA") § 4-101(3), which states that a utility should "receive a reasonable return on the fair value of the company's property used and useful in providing service to the public."

2) Merger savings and costs to achieve

Next, Pepco believes that the Commission erred in its treatment of merger synergy savings and costs to achieve. Specifically, Pepco argues that Order No. 87884 was inconsistent with the Commission precedent in Case No. 9299 where the Commission allowed recovery of the *costs to achieve* to be included in the regulatory asset over five years with an authorized rate of return and reiterated its preference for "symmetrical treatment of synergies and cost to achieve."[11] Additionally, Pepco states that the Commission's Order does not reflect all costs to achieve by adopting Staff Witness Ostrander's approach which excluded $4 million of costs to achieve that appears in the pre-close column of Schedule KMM-2 found in Company Witness Kevin McGowan's Direct Testimony.[12]

Pepco argues that the Commission's decision provides two mismatches for the Company. First, by adopting Staff Witness Ostrander's five-year averaging of the

[10] *Id.* at 7-8.
[11] Order No. 85374 at 15.
[12] Pepco Petition at 15.

merger-related savings, the Commission's decision would provide customers with the benefit of merger savings prior to the Company actually realizing the savings. Second, Pepco stated that exclusion of the $4 million of projected costs to achieve would cause it to incur a financial loss, as "the Company will incur all of the costs to achieve required to achieve the merger-related savings while only a portion of the costs to achieve are recognized rates."[13]

3) Amortization of the tax compensation payment

Thirdly, Pepco requests rehearing of the amortization period for the tax compensation carrying costs authorized by the Commission. Pepco argues that the Commission treated amortization of the tax compensation carrying costs of $3,169,000 and the amortization period for expiring storms differently by authorizing the full amount of the tax compensation payment to be returned to customers in one year versus its authorization to extend the storm amortization over a new three-year period although it was set to expire during the rate effective period. Pepco requested that at a minimum the Commission should authorize the Company to establish a regulatory asset to record amortization of the tax compensation costs in excess of $3,169,000 provided to customers, and the Company should be allowed recovery of the total amount of the regulatory asset, along with a return consistent with the return used to calculate the tax compensation benefit initially in a subsequent base rate case filing.

4) Treatment of the IRS tax settlement as known and measurable item for the entire test year

The Company also requests rehearing of the Commission's decision approving the use of "an average deferred tax balance but selectively treat [sic] one benefit – the

[13] *Id.* at 16.

IRS settlement – differently, without considering not only all other tax payments and benefits that flow through the deferred tax balance but other items associated with year-end rate base."[14] Pepco notes that the IRS settlement was recorded in December 2015, the last month of the test period. It states that "[a]s such this item could not have been recorded any earlier than December 2015."[15] Pepco argues as follows:

> It is inappropriate to conclude the IRS settlement refund, which was not known until it was recorded in December 2015, should be afforded special consideration and treatment since it is one of many items that flow through deferred taxes. The Commission should either approve the use of the average test year deferred tax balance in setting rates (as it has in the past), or approve the use of a year-end rate base which would reflect a year-end deferred tax balance.[16]

5) Return on equity

Next, Pepco requests rehearing of the Commission's authorized ROE at 9.55% and argues that the Commission failed to make the required factual findings or provide a reasonable explanation to support its departure from well-established precedent. Specifically, Pepco argues that the Commission's decision "fails to adequately explain the effect of the change in market conditions it cites as justification to lower Pepco's ROE."[17] Pepco contends that Order No. 87884 "lacks any specific explanation of how the alleged change in market conditions since the issuance of the Commission's order in Case No. 9299 has resulted in electric utilities no longer being riskier than gas utilities, nor does the Commission cite to any record evidence supporting such conclusion."[18]

[14] Pepco Petition at 17.
[15] *Id.* at 18.
[16] *Id.* at 18.
[17] *Id.* at 22.
[18] *Id.* at 22.

Pepco further insists that the Commission should grant a rehearing and grant Pepco a ROE of at least 9.75%, which it argues is consistent with the Commission's recent ROE determination in Case No. 9406 for BGE.

6) Outside legal services

Finally, Pepco claims that the Commission erred in disallowing $250,000 of outside legal service expense by concluding that Pepco failed to meet its burden of proof in recovering those legal fees in base rates. Pepco argues that the Commission's disallowance is a departure from Commission precedent regarding recovery of outside legal service expense, is arbitrary and capricious, and not supported by competent and substantial evidence.

B. OPC Petition

OPC's Petition for Rehearing addresses two areas. OPC seeks: 1) clarification of the Commission's treatment of Pepco's Legacy Meters as to disallow a return on Pepco's legacy meter regulatory asset; and 2) limited rehearing on newly discovered information regarding Pepco's Solution One customer information system which raises significant concern to justify disallowing recovery of transition costs.[19]

At the time Order No. 87884 was issued, there was a request for rehearing pending before the Commission in Case No. 9385, Pepco's depreciation case dealing

[19] OPC Petition at 1-2.

with the legacy meter issue, and the status of that request was not addressed in Order No. 87884.[20]

Additionally, OPC requested that the Commission reconsider its position on allowing recovery of $7.3 million of Pepco's Solution One Customer Information System (CIS) transition costs in light of new information provided by the Company in its November 10, 2016 filing in ML# 203902.[21] Specifically, Pepco reported a significant problem with the transition to the CIS. OPC's Petition stated that "[t]he system failed to provide appropriate notices of termination to customers between May 2015 and November 2016."[22] Further, OPC indicates that in a subsequent filing Pepco informed the Commission that over 148,000 customers received this defective notice and Pepco terminated service to approximately 42,600 customers who received the improper notice."[23]

OPC contends that "[t]his evidence of defective customer service termination notices, which omitted important consumer protection information about the Commission dispute process, energy assistance programs and additional requirements for customers with medial and other special needs," were it known, "would have strengthened Mr. Effron's position against allowing cost recovery for the transition at this time."[24] OPC argues that a rehearing would be appropriate because had the Commission been able to

[20] In the Commission's Order on Rehearing in Case No. 9385, the Commission resolved and clarified the legacy meter "return on" issue. Therefore, OPC's request for rehearing on this issue in this case is moot and is hereby denied.
[21] *Id.* at 4 citing fn 10.
[22] *Id.* at 4 citing fn 11.
[23] *Id.* at 4 citing fn 12.
[24] *Id.* at 5.

consider this information it could have led to a different decision regarding the inclusion of transition costs in the Company's rates.[25]

C. HCNCA Petition

HCNCA Petition for Rehearing requests that the Commission "reconsider and reverse its decision regarding Step One of the revenue allocation process by which a portion of the increase in [Pepco's] rate increase is allocated to under-earning classes."[26] HCNCA argues that the Commission's Order "failed to discuss or assess HCNCA's recommended 40% Step Allocation"[27] and that the "decision to allocate 18% of the increase to under-earning classes is contrary to existing precedent, arbitrary and capricious, and ignores substantial evidence in the record."[28]

II. Discussion and Finding

A. Post-test year reliability plant adjustment RMA 2

In Case No. 9311, the Commission clearly noted that its departure from traditional ratemaking principles to allow certain recovery of plant investment outside of the historic test year was a result of the Company's performance in preceding years. Specifically, the Commission stated, "We have been carefully monitoring Pepco's record of electric reliability for these past four years, and we demanded improvement."[29] In the same paragraph, the Commission indicated that Pepco was fined in 2011 due to its "failure to adequately maintain its distribution system over the prior decade,"[30] and that the

[25] *Id.*
[26] HCNCA Petition at 1.
[27] *Id.*
[28] *Id.*
[29] Order No. 85724, Case No. 9311 at 2.
[30] *Id.*

Commission disallowed $6.4 million in catch-up operations and maintenance expenses due to the Company's prior neglect.[31]

Pepco argues in its Petition that contrary to Order No. 87884, "poor reliability has not been a determining factor used by the Commission when determining the recovery or post-test year reliability plant."[32] To support its position, Pepco notes that the Commission "has consistently allowed Delmarva Power and BGE to recover their post-test year reliability plant investment based on the standard developed in Case No. 9192[33]", which allowed recovery if post-test year reliability investments are known and measurable and do not generate new revenue. While the Commission did in fact first begin to allow post-test year reliability recovery for plant investments for Delmarva in Case No. 9192, it should be noted that in that case the Commission stated "[a]s a general rule, we are reluctant to deviate from the costs and revenues incurred in a test year," because "the revenues (and thus rates) ought normally to match the costs the Company incurs over the course of a year, and the test year should represent a fair snapshot of costs and revenues."[34] Additionally, it should be noted that Pepco failed to acknowledge that subsequent to Case No. 9192 the Commission denied Pepco a similar post-test year reliability adjustment in Order No. 83516 of Case No. 9217,[35] where Pepco had requested "an additional increase of $9,230,000 for reliability plant investments the Company made between January and March 2010 after the test year closed."[36] The Commission noted in its Rehearing Order for Case No. 9217 that Pepco argued that "its future level of

[31] *Id.*
[32] Pepco Petition at 11.
[33] *Id.* at 10. *See* fn 28.
[34] *Delmarva Power & Light Co.*, Order No. 83085 at 8 (December 30, 2009).
[35] *In the Matter of the Application of Potomac Electric Power Company for an Increase in its Retail Rates for the Distribution of Electric Energy*, Case No. 9217, Order No. 83516 (2010).
[36] Order No. 83516 in Case No. 9217 at 7.

reliability spending is not material to the question of whether to include end-of test year or post-test year investment in rate base."[37] However, in that case, OPC pointed out that in Case No. 9192, Delmarva "demonstrated that its particular construction spending for reliability purposes was continuing to increase at a significant pace *in response to past conditions* (italics added), and that it was targeted to address overload conditions that had developed over time."[38] By contrast to Case No. 9217, OPC indicated that in this case "Pepco conceded its reliability spending was neither new nor extraordinary and that the record also reflects that it was declining."[39] In the Case No. 9217 Rehearing Order (Order No. 84093), the Commission pointed out that OPC characterized as disingenuous Pepco's argument that trends in reliability spending are not a relevant consideration when deciding whether to include end-of-test year or post-test year plant adjustments in rate base.[40]

As determined in Case No. 9217, we should make a determination in the present case on the record "rather than blindly approve the same result"[41] just because it has been done in previous cases. In Case No. 9192, the Commission found that Delmarva's reliability spending was increasing at a significant pace in response to past conditions, which demonstrated the need for the Commission to grant Delmarva's request for the post-test year reliability investment spending exception at that time. On the other hand, in Case No. 9217 Pepco's spending had shown a decline and did not target specific

[37] Order No. 84093 at 2.
[38] *Id.* at 3.
[39] *Id.* at 3.
[40] *Id.*
[41] *Id.*

reliability system improvements.[42] Therefore, the Commission did not find granting the post-test year reliability investment spending exception justifiable. In the Case No. 9217 Rehearing Order (Order No. 84093), the Commission held that "[d]ifferent records justify different conclusions," and Pepco in Case No. 9217 had failed to meet the burden of proof to support exceptional ratemaking treatment.

Similarly, in July 2012 in Case No. 9286 (Order No. 85028), the Commission departed from traditional ratemaking principles to spur Pepco in addressing the need for significant reliability improvements.[43] The Commission also stated in Order No. 85724 in Case No. 9311 that:

> We have been carefully monitoring Pepco's record of electric reliability for these past four years, and we demanded improvement. In December 2011, we fined Pepco $1 million for its failure to adequately maintain its distribution system over the prior decade.[44] In its last rate case, we disallowed $6.4 million in "catch up" operations and maintenance expenses attributed to the Company's prior neglect, and reduced the Company's ROE from 9.83 percent to 9.31 percent. Recognizing the Company's need to increase reliability spending, we departed from traditional ratemaking principles and allowed end-of-test year reliability plant and three months post-test year reliability spending adjustments in rate base.[45] In May 2012, we adopted comprehensive electric reliability regulations in COMAR 20.50.12.02 (also referred to as Rule Making (RM) 43), providing specific SAIDI and SAIFI standards that will result in required annual reliability improvement for the Company from 2012 through 2015.[46]

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[42] *Id.* at 5-6.
[43] Order No.85028 at 17.
[44] *In the Matter of an Investigation into the Reliability and Quality of the Electric Distribution Service of Potomac Electric Power Company*, Case No. 9240, Order No 84564 (2011).
[45] Case No. 9286, Order No. 85028.
[46] *In the Matter of the Application of Potomac Electric Power Company for an Increase in its Retail Rates for the Distribution of Electric Energy*, Case No. 9311, Order No. 85724 (2013).

As demonstrated in the decisions highlighted above, we base our decisions on the facts and evidence present in each record and should never blindly follow a previous decision if it is not warranted by present evidence and circumstances. In the present case, Pepco witness Gausman testified that the Company is now meeting and exceeding the reliability metrics established by the Commission in RM 43, which indicates less of a need for us to depart from traditional ratemaking principles at this time.[47] Therefore, we affirm our decision not to grant a post-test year reliability spending exception.

B. Merger Savings & CTA

We agree with Pepco that in prior decisions the Commission has stated a preference for symmetry in the treatment of costs to achieve merger synergy savings.[48] However, we find that the approach proposed by Staff Witness Ostrander satisfies the asymmetric concerns expressed in Case No. 9406 and would have been present if Pepco's approach in the present case were adopted. In Case No. 9406, OPC had expressed a concern with the asymmetric approach proposed by BGE "to recover all of its merger costs dollar for dollar regardless of when BGE filed its next rate case (because it established a regulatory asset to be amortized), while some merger savings that should be passed through to ratepayers may slip between rate cases and go to shareholders."[49] One of the key reasons that the Commission approved the Exelon-PHI merger was because the merger savings that Exelon projected would pass through to the Pepco and BGE

[47] Gausman Direct at 11 noting that "Pepco's reliability performance continues to show improvement and exceeds the current COMAR requirements. In fact, Pepco's reliability performance exceeded the annual COMAR requirement each year since the regulations went into effect in 2012."
[48] McGowan Rebuttal at 49.
[49] Ostrander Direct at 40.

customers.[50] The Commission adopted OPC's approach in that case as a fair and equitable compromise because it was concerned that the timing of BGE's next rate case filing would jeopardize synergy savings that would be passed on to ratepayers.[51]

Staff witness Ostrander explained that Pepco's approach in the present case would result in the same asymmetric treatment. First, Pepco also proposes to establish a regulatory asset in which amortized merger costs would be recouped regardless of when rate cases are filed. Second, Mr. Ostrander explained that "because Pepco offsets specific annual merger savings each year (and does not average these savings over 5 years against average merge[r] costs), if Pepco elected not to file a rate case in Years 3, 4, or 5 when merger savings are at their highest levels, both Pepco and its shareholders would receive a windfall benefit and these merger savings would not flow through to customers."[52] Mr. Ostrander argues that his proposed approach addresses the asymmetry issue "because [it] levelizes and averages 'both' merger savings and costs over 5 years, so regardless of whether Pepco files a rate case in a particular year the same average net savings of $6.4 million[53] (before allocation to Maryland) that is built into Year 1 in this rate case would also be the same net savings reflected in all years."[54] Mr. Ostrander further points out that the only way that net savings to customers can be changed under his approach is if Pepco files a rate case and seeks to change its estimated merger savings or costs.[55]

[50] *Id.*
[51] *Id.*
[52] *Id* at 41.
[53] *Id* at 41 fn 47 "This is before allocating 90% of these amounts to Maryland and before any tax impacts."
[54] *Id* at 41.
[55] *Id* at 41.

Pepco's merger adjustment in this case is based entirely on estimated merger costs and savings.[56] As Staff Witness Ostrander indicated in his direct testimony "it is necessary to make an exception to include certain reasonable estimated merger costs and savings in the revenue requirements because there is no other good alternative that will provide some immediate and deserved benefit to customers as a result of the merger."[57] Nonetheless, witness Ostrander eliminated $4 million of "pre-close" merger costs which should not have been included in the merger costs estimates. We find that this approach explains the difference between Pepco's proposal on page 15 of its Petition and the five-year average of synergy benefits net costs to achieve included in the Order. Therefore, we affirm the decision adopting Staff's approach for treatment of merger synergies and merger costs.

C. Amortization of the tax compensation payment

Pepco requests symmetrical treatment of the amortization period applied to the tax compensation carrying payment related to RMA 9 and the amortization of storm costs. However, as pointed out in Order No. 87884 (at page 46) we did, in fact, apply symmetry, albeit not between the amortization periods sought by Pepco's Petition. Rather, we found and "likewise sees no reason to amortize the carrying charge amount, as Pepco requests, as Pepco received the full benefit of PHI's payment at one time, and equal treatment of ratepayers is appropriate."[58] We granted ratepayers the same treatment Pepco received when it received the full benefit of PHI's payment at one time and therefore, affirm our decision and make no change to our ruling on this issue first

[56] Ostrander Surrebuttal at 29.
[57] Ostrander Direct at 37.
[58] Order No. 87884 at 46.

adopted in Case No. 9336 (where RMA 9 was accepted as far as total carrying costs but the Commission declined Pepco's proposed three-year amortization period).

D. Treatment of the IRS tax settlement as known and measurable item for the entire test year

Subsequent to filing its Petition, the Company on February 2, 2017, filed a *Motion for Leave to Supplement the Petition for Rehearing of Potomac Electric Power Company ("Pepco Motion")* "to explain why annualization of the non-recurring Internal Revenue Service (IRS) global settlement violates the Normalization Rules of the Internal Revenue Code (Code)."[59] In Pepco's Motion, the Company noted that "after consulting with tax counsel and further understanding the implications of the Commission decision and its interaction with tax laws, particularly the portion of the Normalization Rules established by Subsection (B) of Section 168(i)(9) of the Code, the very inconsistency identified by Pepco both in testimony and in its briefs and then again in the Petition for Rehearing is the factual basis for Pepco's concern with respect to those tax rules" and if not addressed our decision would contravene the Normalization Rules.[60]

On February 6, 2017, we granted Pepco's Motion and provided parties an opportunity to file responsive comments to Pepco's supplemental information. OPC filed a response to Pepco's request for supplemental information on February 21, 2017, arguing that we should disregard the filing because it is procedurally inappropriate and that Pepco had the burden of proof and should have raised any potential normalization issues during the proceeding. Staff also filed a response to the Pepco's request for supplemental information, suggesting that Pepco's request should not be *simply*

[59] *Motion for Leave to Supplement the Petition for Rehearing of Potomac Electric Power Company* in Case No. 9418 filed February 2, 2017 at 1.
[60] *Id* at 2.

dismissed. Rather, Staff recommends that we "require Pepco to seek a private letter ruling from the IRS to determine whether treatment of the IRS global settlement revenues in the Commission's Order would in fact violate Normalization Rules, as was done in Case No. 9311." However, Staff suggests that the Commission, Staff and OPC be allowed to review Pepco's requests before it is filed and be permitted to suggest changes.

We find that Staff's response is reasonable and would offer the best approach to determining if our decision implicitly violates of the IRS Normalization Rules as suggested by Pepco. We therefore direct Pepco to prepare its request for a Private Letter Ruling from the IRS to seek guidance on our decision's treatment of the IRS tax settlement issue, and direct that Pepco's PLR request be shared with the Commission, Staff and the Maryland Office of People's Counsel for review and comment by these parties before it is officially filed with the IRS.

E. Return on equity

Next, Pepco argues that the Commission erred in setting Pepco's return on equity ("ROE") at 9.55% without making the required factual findings to support its conclusions or providing a reasonable explanation for deviating from purported Commission precedent. The real gravamen of Pepco's objection is that we set an ROE for the Company that is lower than the one recently authorized for BGE's gas utility operations in Case No. 9406,[61] which according to Pepco contravenes our prior comments in Case No. 9299[62] regarding the relative risks of electric utility operations as compared to gas

[61] *In re the Application of Baltimore Gas and Electric Company for Adjustments to its Electric and Gas Base Rates*, Case No. 9406, Order No. 87591 (Errata) (June 6, 2016). In Case No. 9406, the Commission set an ROE of 9.65% for BGE's natural gas operations. *See* Order No. 87591 at 152.
[62] *In re the Application of Baltimore Gas & Electric Company for Adjustments to its Electric and Gas Base Rates*, Case No. 9299, Order No. 85374 (Feb. 22, 2013).

operations.[63] Given the dual-industry context of our comments in Case No. 9299 and in subsequent decisions concerning BGE's ROEs, Pepco's reliance on our comparative risk observations is misplaced. Simply put, Pepco has no gas operations. Likewise, Pepco's steadfast adherence to our stated policy that we endeavor to treat utilities the same unless facts and circumstances warrant different treatment is also untenable. Pepco has not pointed us to, nor are we aware of, any rule or regulation that would require us to grant Pepco the same ROE as BGE. Rather, as we stated in Order No. 87884, we must address Pepco as an individual company on the specific facts in evidence.

In this matter, we determined that an ROE of 9.55% was adequate and appropriate for Pepco after considering: 1) the risks associated with the Company's electric distribution operations in the State; 2) the current capital market environment; and 3) the fact that Pepco had not issued any new stock since its last rate case. We framed the general question of what had changed since Pepco's last rate case in 2014 and applied the above three factors to the question. We made factual findings under each factor to reach the answer. In sum, we concluded that Pepco remained a low-risk monopolistic provider of electric distribution service, operating in a capital market environment with historically low interest rates. The fact that Pepco's parent company, PHI, will no longer issue stock post-merger with Exelon Corp. further justified the removal of the flotation cost adjustment awarded in Pepco's last rate case. The final ROE of 9.55% clearly fell within Pepco's DCF, CAPM and ECAPM ranges and, in particular, toward the upper end of the Company's constant growth DCF range. Maryland law requires only that the ROE fall

[63] Pepco Pet. for Reh'g at 19. Pepco relies on the Commission's statement in Case No. 9299 that "a utility's electric operations present a slightly elevated risk to investors compared to natural gas operations, and investors in the electric utility will therefore require a slightly higher return to compensate for that risk." Order No. 85374 at 77.

within "the zone of reasonableness" to withstand judicial scrutiny.[64] We have met that burden here and therefore affirm our return on equity decision in Order No. 87884.

F. Outside legal services

Pepco requests that we reverse our decision adopting Staff Witness Ostrander's removal of $250,000 of outside legal expenses. In his Direct Testimony, Mr. Ostrander indicated that he believed that it was reasonable to believe that Pepco used some outside legal services regarding the significant merger transaction, yet Pepco had not reflected these costs in this rate case.[65] Witness Ostrander continued to have this belief and did not remove this $250,000 placeholder reduction, citing the Company's failure to provide requested information in its initial response to Staff DR 17-14, where Staff asked Pepco to provide the amount of outside and in-house legal expense by account number and broad categories. The Company did provide an updated response to Staff DR 17-14, wherein it stated that the Company did not have any Merger Condition 36 transactions to report during the test period.[66] Nonetheless, in his Surrebuttal Testimony, Staff Witness Ostrander indicated that he would not make any revisions to his adjustment to remove $250,000 of legal expenses.[67] We affirm our decision on this adjustment and note that the Company has the responsibility of meeting its burden of proof that it complied with Merger Condition 36 by providing detailed accounting information rather than a

[64] *Md. Office of People's Counsel v. Md. Pub. Serv. Comm'n*, 226 Md. App. 176, 221 (2015) (citing *Potomac Edison Co. v. Pub. Serv. Comm'n*, 279 Md. 573, 582-83 (1977)). "Whether a rate of return is reasonable depends on many circumstances, including the money market, business conditions, and the amount of risk involved." *Id.* at 220 (citing *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 693 (1923)).
[65] Ostrander Direct at 65.
[66] Pepco letter filed with the Commission in Case No. 9418 on July 29, 2016.
[67] Ostrander Surrebuttal at 54.

summary denial that these prohibited expenses were not included in its expenses in this case.

G. Customer Information System

In light of the new information about the defective customer service termination notices, which became known after the conclusion of the rate case, OPC argues that we should rehear that portion of Order No. 87884 because a full review of the functioning of the system and the prudency of Pepco's actions during the transition "goes to the heart of whether any portion of those costs should be disallowed."[68] OPC bases its request on PUA § 114(a)(1), which permits the Commission to "consider facts not presented in the original hearing, including facts arising after the date of the original hearing."[69]

On January 9, 2017, Pepco filed a *Response in Opposition to the Office of People's Counsel's Request for Rehearing and Clarification* ("Pepco's Opposition").[70] In Pepco's Opposition, the Company argued that OPC's request for rehearing in this matter should be dismissed on several grounds. First, OPC Witness Effron in his Direct Testimony did not attack the prudency of Pepco's customer relationship management and billing system as a reason to disallow cost recovery. OPC noted that "[i]nstead, he sought to disallow the transition costs only due to the fact that the transition costs were non-recurring costs associated with the implementation of a new customer information system."[71] We find it disappointing to learn of the system defect reported by the Company after the conclusion of the rate case. This defect should have been tested and

[68] OPC Petition at 6.
[69] *Id.* at 3.
[70] Potomac Electric Power Company's Response in Opposition to the Office of People's Counsel's Request for Rehearing and Clarification filed on January 9, 2017.
[71] Pepco Opposition at 3.

known prior to the end of the rate case but we find, as noted in Pepco's Opposition, that "the disclosure of a programming issue has no bearing on OPC's argument that these costs should be disallowed for being non-recurring costs."[72] Nonetheless, we conclude that PHI's replacement of a two legacy system with a single solution customer relationship management and billing system is a more optimal and sustainable solution, and therefore we continue to maintain our conclusion to allow cost recovery of the $7.3 million over five years with the unamortized costs placed in regulatory asset. OPC's request for rehearing on this matter is denied.

H. Rate Design

Regarding HCNCA's petition for rehearing, we affirm our decision to allocate 18% of Pepco's rate increase to under-performing classes. Although we did not expressly address HCNCA's proposed 40% allocation, we did explain why we believed Pepco's proposed 25% allocation was too high, relying largely on Staff Witness Blaise. It naturally follows from our conclusion that a proposed 25% allocation was excessive that a 40% allocation would be even more excessive.

Witness Blaise explained that he recommended an 18% increase after running "over fifty different scenarios" to determine the best allocation approach, and 18% "provided a balanced set of RRORs and allocation proportions. That is, it doesn't unduly strain any one class by allocating too much revenue towards any one class in an excessive manner."[73] We concluded that this expert recommendation was persuasive after listening to extensive testimony.

[72] *Id.*
[73] Blaise Direct Testimony at 17-18; Order No. 87884 at pg. 108.

We have previously allocated lower and higher percentages in applying "Step One" to determine appropriate inter-class rates. However, each case is based upon its own extensive record, and on our attempt to balance the utility's actual rates of return with the principle of gradualism. After reviewing the testimony submitted by the parties and HCNCA's petition for rehearing, we affirm our prior conclusion that Witness Blaise's testimony best achieved this balance.

III. Clarifications

Rebalancing Depreciation Reserve Accounts. While we believe it may be appropriate that the Company rebalance its depreciation accounts to reflect the approved depreciation treatment adopted in Case No. 9385, there was no opportunity in the present case for other parties to review such adjustments. Therefore, we direct the Company to propose an appropriate adjustment in its next rate case giving all parties an opportunity to review the proposed realignment.

Benning Environmental. In Case No. 9286, in which this issue first arose, the Commission directed "the Company to provide more information about the Benning Road property, particularly information that addresses the concerns raised by Staff and that delineates the potential impact on Maryland ratepayers so that we may determine whether creation of a regulatory asset is appropriate for a future proceeding." No additional information, evidence or discussion was presented in the present case. Therefore, we clarify that the Company does not have authority to record a regulatory asset related to the Benning Road Environmental project.

Merger Synergies. We agree that the Company may propose a merger synergy tracking mechanism in the next rate case for Commission review.

Vegetation Management Quarterly Reporting. We clarify and agree that Pepco's quarterly vegetation management reports, beginning in 2017, are due sixty days after the close of the quarter.

Test Year. During the present case, the Company offered no discussion or review of its request to have the Commission revise or remove its test year restrictions. Pepco requests that we remove its restriction limiting the Company's test year to no more than four months forecasted data (imposed in Case No. 9311) and clarify that in the future Pepco has the discretion to use a test year consisting of six months of actuals and six months of forecasted data. Absent any new evidence or discussion in the present case, we are not inclined to remove the test year restrictions imposed in Case No. 9311 at this time.

IT IS THEREFORE, this 4th day of May, in the year of Two Thousand Seventeen, by the Public Service Commission of Maryland,

ORDERED:

(1) That the Petitions for Rehearing filed by Potomac Electric Power Company, Office of People's Counsel and Healthcare Council of the National Capital Area are hereby denied; and

(2) That Potomac Electric Power Company request a Private Letter Ruling from the Internal Revenue Service to clarify the impact of the Tax Normalization Rule within the context of the Commission's Order No. 87884, and that the Company is directed to share the draft with the Commission, Staff and the Maryland Office of People's Counsel before it is officially filed with the IRS.

/s/ Chairman W. Kevin Hughes

/s/ Commissioner Harold D. Williams

/s/ Commissioner Michael T. Richard

/s/ Commissioner Anthony J. O'Donnell
Commissioners