ML 168732

ORDER NO. 86994

IN THE MATTER OF THE APPLICATION OF CHOPTANK ELECTRIC COOPERATIVE, INC. FOR AUTHORITY TO REVISE ITS RATES AND CHARGES FOR ELECTRIC SERVICE	* * * * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9368

Issue Date: May 21, 2015

On March 31, 2015, the Public Utility Law Judge ("PULJ") issued his Proposed Order ("P.O.") in this case, finding that Choptank Electric Cooperative, Inc. ("Choptank" or "Cooperative") should be authorized a base rate increase of $7,806,993. On April 27, 2015, the Office of People's Counsel ("OPC") and the Public Service Commission Staff ("Staff") filed Notices of Appeal and their Memorandums on Appeal ("OPC Appeal" and "Staff Appeal"). Choptank filed a Reply Memorandum ("Choptank Reply") on May 12, 2015. OPC raises four issues: "(1) the appropriate regulatory standard and burden of proof when setting rates for a public utility company; (2) the appropriate revenue requirement; (3) utilizing SOS rebalancing in the class revenue allocations; and (4) increasing the residential Consumer Charge to $17.00."[1] Although the Staff supports the PULJ's recommended revenue requirement, Staff also contests certain rate setting and burden of proof statements enunciated in the Proposed Order, the rate design that was

[1] OPC Appeal at 1.

adopted and the amount of the increases in customer charges.[2] Choptank replies that the Proposed Order "is thorough, consistent and supported by the record evidence and should be affirmed in all respects."[3]

I. Legal Standards[4]

The legal standards to be used in a utility rate proceeding are stated in the Public Utilities Article of the Annotated Code of Maryland ("PUA").[5] Section 4-201 provides:

> In accordance with the provisions of this article, a public service company shall charge just and reasonable rates for the regulated services that it renders.

Section 4-102(b) provides:

> The Commission shall have the power to set a just and reasonable rate of a public service company, as a maximum rate, minimum rate, or both.

A just and reasonable rate is defined in §4-101:

> In this title, "just and reasonable rate" means a rate that:
> (1) does not violate any provision of this article;
> (2) fully considers and is consistent with the public good; and
> (3) except for rates of a common carrier, will result in an operating income to the public service company that yields, after reasonable deduction for depreciation and other necessary and proper expenses and reserves, a reasonable return on the fair value of the public service company's property used and useful in providing service to the public.

Section 3-112(b) establishes the burden of proof thusly:

> In a proceeding involving a temporary or permanent new rate, or a temporary or permanent change in rate, the burden of proof is on the proponent of the new rate or change in rate.

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[2] Staff Appeal at 3.
[3] Choptank Reply at 1.
[4] *See* OPC Appeal at 1-5, Staff Appeal at 12-13 and Choptank Reply at 12-15. Since we apply the appropriate legal standards their arguments need not be repeated here.
[5] Statutory references are to the PUA, unless otherwise noted.

Based upon these statutory directives the Commission is required to establish just and reasonable rates for Choptank's services in this case. As the proponent of the rate increase, the burden of proof is upon Choptank. The Commission has historically applied these statutory mandates to cooperatives and investor-owned utilities alike and does so in this proceeding.

II. Choptank's Revenue Requirement

Choptank originally requested a $9.185 million rate increase in this case.[6] Choptank subsequently accepted Staff's position and is requesting an increase of $7.8 million, which will result in a modified debt service coverage ("MDSC") of 1.85.[7] OPC asserts that a MDSC of 1.80 is appropriate, which results in a revenue requirement increase of $6,870,000.[8]

According to OPC, the PULJ erred in adopting Choptank's test-year bush-hogging expenses, erroneously admitted the Goodwin Formula into the record and improperly adopted the Goodwin Formula as a basis for establishing Choptank's MDSC ratio. OPC also asserts that the determination of the revenue requirement is internally inconsistent and should be corrected.[9]

OPC states that over a four year period Choptank's bush-hogging expenses ranged from $19,000 to a test-year level of $339,000. OPC argued that Choptank's response – that the test-year level was due to increased costs to comply with Commission Rulemaking ("RM") 43 and new vegetation management regulations – is insufficient justification for the test-year expense to be fully included in rates. Consequently, OPC

[6] P.O. at 1.
[7] P.O. at 4.
[8] P.O. at 4.
[9] OPC Appeal at 5.

argues that the test-year expense should be normalized and the expense reduced by $221,000.[10]

Addressing the Goodwin Formula, OPC argued that it was improperly admitted into evidence and even if proper it was improperly applied.[11] Essentially, OPC argues that the Goodwin Formula is an equation used to derive a return on equity for a cooperative and because Choptank has no investors and does not pay dividends it is irrelevant in determining the Cooperative's debt reserve requirement.[12] Further, OPC stated that the record in support of the Goodwin Formula is weak as it results in a return on equity similar to investor-owned utilities with riskier investment profiles. Although Choptank stated that a MDSC of 1.8 to 2.0 was reasonable the Cooperative did not provide support for any specific MDSC other than the 1.85 supported by the Goodwin Formula. On the other hand, based upon Choptank's earlier stated reasonable range of 1.6 to 2.0 in Case No. 9146, OPC's witness recommended a MDSC value of 1.8 as a "reasonable mid-point."[13]

OPC also criticizes Staff's alternative method to determine an appropriate MDSC arguing Staff looked to years far beyond the test-year and used questionable assumptions in other parts of its analysis.[14] Finally, OPC asserts that based upon the methods used by Choptank, a revenue increase of $7,806,993 corresponds to a MDSC of 1.836 not 1.85 and therefore the MDSC authorized should be corrected to 1.84.[15]

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[10] OPC Appeal at 6-7.
[11] OPC Appeal at 7-11.
[12] OPC Appeal at 8-9.
[13] OPC Appeal at 10-11.
[14] OPC Appeal at 10-11.
[15] OPC Appeal at 11-12.

Choptank responds that in a data request from OPC it explained that the increase in test-year bush-hogging expenses was due to increased vegetation management requirements imposed by RM43, which took effect in May 2012. Choptank asserts that the test-year expense represents a "new normal", which can be expected for the foreseeable future. Moreover, Choptank states that there was "no evidence" that its bush-hogging expenses were imprudently incurred or artificially inflated.[16]

Choptank states that it explained why the Goodwin Formula is a useful tool for cooperatives to use to determine an appropriate level of operating margins that can be translated to an MDSC ratio.[17] Furthermore, only Choptank and Staff provided quantitative analysis to support their recommended MDSC ratios while OPC simply took the midpoint of the MDSC ratio range established in Choptank's last case over six years ago.[18] Finally, Choptank states that the 1.85 MDSC ratio is correct as OPC failed to include two items of additional revenue in its calculation.[19]

In its initial brief Staff stated that in recommending a 1.85 MDSC:

> Staff witness Currier considered the Cooperative's capital expenditure growth, anticipated growth in its margin, and cushions for unexpected expenses and revenue shortfalls based upon recent experience. As the result of this analytical approach, Staff's recommendations of 1.85 is superior to that of both OPC and Choptank.[20]

In the Proposed Order the PULJ stated that it "is undisputed that under the current rates Choptank's MDSC is low and at a level where it might fall out of compliance with

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[16] Choptank Reply at 3.
[17] Choptank Reply at 4-5.
[18] Choptank Reply at 5.
[19] Choptank Reply at 6.
[20] Staff Brief at 5, citations omitted. In footnote 41 Staff states that the Goodwin Formula, which it used, "is used by electric cooperatives in evaluating their cost of capital."

its loan agreements."[21] Furthermore, the MDSC ratio "must be high enough to show that Choptank has enough revenue to pay its debt service."[22] Choptank's loan obligation requires an MDSC above 1.35.[23]

The PULJ found Choptank's bush-hogging expenses "reasonable", based upon the Cooperative's "experience in managing its vegetation management programs [of which bush-hogging is a part] and upon [Choptank's] increased obligations under RM43."[24] Further, the PULJ found the Goodwin Formula "a reasonable method" to determine the appropriate MDSC and consequently a 1.85 MDSC "acceptable and appropriate."[25]

Just how serious the MDSC issue is was summarized in Staff witness Currier's Exhibit JRC-2, which shows that Choptank failed to meet a MDSC of 1.35 in 2006, 2007, 2008 and 2012 and that the 2 of 3 years high average requirement was below a MDSC of 1.35 in 2008, (it was 1.15), and only 1.38 for 2009. Based upon this record we conclude that Staff's analytical approach, which Choptank has adopted, provides a reasonable basis to determine an appropriate MDSC for Choptank. Certainly it is preferable to OPC's use of a mid-point from a case (9146) that was decided in 2008.[26] Furthermore, we find that the test-year bush-hogging expenses are supported by the record, which recognizes heightened vegetation management standards we implemented in RM43. While the Goodwin Formula may not be a perfect analytical tool, we do find it is relevant, its use is supported by industry practice and that its use as part of Choptank's and Staff's analysis

[21] P.O. at 7.
[22] P.O. at 7.
[23] P.O. at 7.
[24] P.O. at 8.
[25] P.O. at 8.
[26] Order No. 82366 in Case No. 9146 was issued December 17, 2008.

superior to OPC's analysis. Lastly, we find that the MDSC was not miscalculated and that a MDSC of 1.85 for Choptank will provide an adequate cushion to meet its debt requirements.

For these reasons, we find that Choptank has sustained its burden of proof by more than a preponderance of the evidence and that a MDSC of 1.85 for Choptank will result in a just and reasonable revenue requirement, which will be used to develop just and reasonable customer rates as further explained below. Therefore, we affirm the PULJ's finding that Choptank should be authorized a base rate increase of $7,806,993.[27]

III. Rate Design

Both OPC and Staff are critical of the Cooperative's rate design, which the PULJ adopted.[28] The PULJ concluded that Choptank's computations and rebalancing (of Standard Offer Service, "SOS", rates) is a "better fit" to Choptank's circumstances than the "boilerplate formulations" of OPC and Staff.[29]

Staff argues that Choptank's rate design "is flawed by the use of rate base as the basis for allocating 75% of the proposed revenue increase, and by the commingling of SOS and distribution revenues to determine class rate[s] of return."[30] OPC concurs with Staff.[31] According to Staff, witness Norman began her rate design by recalculating the class relative rates of return ("RROR") developed in Choptank's cost-of-service study ("COSS") in order to isolate distribution revenues because the rate increase only applies

[27] To the extent the MDSC is rounded, we find that the revenue increase should be limited to $7,806,993.
[28] P.O. at 8-10.
[29] P.O. at 10. In this case Choptank seeks both to increase its distribution rates and to rebalance its SOS supply rates.
[30] Staff Appeal at 10.
[31] OPC Appeal at 12.

to distribution rates.[32] Because Choptank's distribution and power supply rates are required to be unbundled, Staff stated that the appropriate rates of return for setting distribution rates are the distribution-specific ones.[33] Staff concluded that its rate design is also superior to OPC's essentially similar proposal because in its first step Staff only allocates 20% of the required revenue increase to the under-earning classes as opposed to the 25% OPC applied and thus Staff's proposal represents a more gradual approach to remedying imbalances in class rates of return.[34]

Although Staff and OPC argue that Choptank should not have rebalanced SOS revenues <u>before</u> allocating any approved distribution revenue increase, Choptank replies that they misunderstood the Cooperative's reasons for doing so.[35] Choptank states that the first rate design step was to (re) balance the SOS revenues for each rate class to current costs and then offset any change in revenues on the distribution side, which is consistent with its past practice.[36] Choptank states that it was especially important to do so in this case because its power supplier Old Dominion Electric Cooperative ("ODEC") recently changed its FERC-approved wholesale rate structure. Therefore, Choptank asserts that the distribution revenue increase should be based upon distribution revenues <u>after</u> this rebalancing. Otherwise, the rebalancing of power supply costs, which are supposed to be a direct pass-thru, interferes with how the distribution increase is allocated, which could result in some rate classes not being moved closer to the system

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[32] Staff Appeal at 10.
[33] Staff Appeal at 11.
[34] Staff Appeal at 10.
[35] Choptank reply at 6.
[36] Choptank Reply at 6-7.

rate of return.[37] Choptank also states that OPC and Staff included SOS margins in distribution rates, however only Choptank included rebalanced SOS rates prior to allocating the distribution revenue increase, which reduces subsidies and excesses between rate classes. Choptank states that its SOS rebalancing method sets SOS rates that recover current supply costs for each customer so that no supply cost subsidization occurs.[38] Choptank concludes that the PULJ's recognition of the fact that it has no supply shopping customers provided a rational basis to conclude that Choptank's rate design method is appropriate.[39]

All parties agree that it is appropriate for Choptank to rebalance its SOS rates. What is in dispute is whether this should be done before (Choptank) or after (OPC and Staff) calculating new distribution rates as part of the rate design process. We find that Staff's and OPC's methodology is preferable because it avoids the commingling of SOS and distribution revenues, which is consistent with statutory unbundling requirements and Commission precedent. Furthermore, we find that Staff's methodology is the most appropriate in this case because it is a more gradual rate design approach than OPC's. Based upon the record herein, we will modify the Proposed Order and adopt Staff's recommended rate design.

IV. <u>Customer Charges</u>

The PULJ accepted Choptank's proposal to raise the residential customer charge from \$10 to \$17 per month as well as increases in non-residential customer charges

[37] Choptank Reply at 7.
[38] Choptank Reply at 7.
[39] Choptank Reply at 8.

ranging from 0% to 53.8%.[40] Staff proposed limiting customer charge increases to 25%.[41] OPC opposed any increase in the residential customer charge.[42] The PULJ concluded:

> Since Choptank gets 80% of revenue through a volumetric sale of electricity, the customer charge helps offset the revenue fluctuation caused by conservation efforts and weather changes. The $7 increase does not offend that concept of gradualism as it is only a small increase to the bill of an average customer.[43]

According to Choptank, customer costs (as opposed to volumetric-related costs) for residential customers are $29.54 per month while Staff asserts that they are $18.54 and OPC states that they are only $7.94 per month.[44] Choptank states that its proposed $17 residential customer charge is below the level of customer-specific costs calculated by Staff and the Cooperative, while OPC's calculation of such costs is flawed.[45] In its Reply Choptank states that Staff has correctly noted that recent literature suggests customers respond more to their overall electric bill than to individual bill components.[46] Moreover, Staff has concluded that recent research demonstrates that the correlation between low fixed customer charges and conservation is weak at best.[47] Choptank states no party claimed that the Cooperative's proposed overall revenue increase or its increase to a typical residential customer's bill offended the principle of gradualism.[48] For these reasons, Choptank states that its proposed customer charge increases, which were approved by the PULJ, should be affirmed.

[40] Staff Appeal at 5 and P.O. at 10-12.
[41] Staff Appeal at 5. *See also* Staff Appeal at 5-9.
[42] OPC Appeal at 12. *See also* OPC Appeal at 12-15.
[43] P.O. at 10.
[44] P.O. at 10-11.
[45] Choptank Reply at 10-11.
[46] Choptank Reply at 9, footnote 36.
[47] Choptank Reply at 9.
[48] Choptank Reply at 10.

In recent years we have limited or declined increases to customer charges as part of our effort to promote energy efficiency and conservation. When we have approved increases we have also limited those increases based upon notions of gradualism. In this case, we find Choptank's proposed 70% increase in the residential customer charge is too much and is inconsistent with recent precedent. Based upon this record, we find that the residential customer charge increase should be limited to $1.25 a month, which is more consistent with the principle of gradualism, falling between the recommendations of Staff and OPC. Additionally, we find that some of Choptank's proposed increases in non-residential customer charges are too large as well. Therefore, we will accept Staff's recommendation to limit these increases to 25%. These findings are more consistent with Commission precedent and Commission policy goals.

V. Conclusion

We find that the record reflects that Choptank's revenue requirement should be increased by no more than $7,806,993. Rate design should be based upon Staff's proposals. The monthly customer charge increase should be limited to $1.25 for residential customers and a 25% increase for non-residential customers. Additionally, we find that those aspects of the Proposed Order that were not appealed conform to the legal standards enunciated herein and therefore those decisions are affirmed.

IT IS THEREFORE this 21st day of May, in the year Two Thousand and Fifteen, by the Public Service Commission of Maryland,

ORDERED: (1) That Choptank's application for an increase in rates of $9.185 million is denied;

(2) That Choptank shall file Tariffs that result in a rate increase of no more than $7,806,993, which shall be subject to acceptance by the Commission with an effective date of May 21, 2015;

(3) That Choptank shall file Tariffs consistent with the rate design and customer charge findings herein; and

(4) That all motions not specifically granted herein are denied.

/s/ W. Kevin Hughes

/s/ Harold D. Williams

/s/ Lawrence Brenner

/s/ Kelly Speakes-Backman

/s/ Anne E. Hoskins
Commissioners