

ORDER NO. 87710

IN THE MATTER OF THE APPLICATION OF POTOMAC ELECTRIC POWER COMPANY FOR APPROVAL OF CHANGES IN ITS DEPRECIATION RATES <hr/>	* * * * * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND <hr/> CASE NO. 9385 <hr/>
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Issue Date: August 10, 2016

In this Order, the Maryland Public Service Commission (“Commission”) affirms the portion of the January 13, 2016 Public Utility Law Judge’s (“Presiding Judge” or “PULJ”) Proposed Order (“PO” or “Proposed Order”) which rejects the Potomac Electric Power Company (“Pepco”) request “to receive both a return of and a return on its capital costs related to legacy meters”¹ that were retired *en masse* to implement the Company’s Advanced Metering Infrastructure (“AMI”) deployment. For reasons discussed below, we grant that portion of Pepco’s Memorandum of Appeal that requests the amortization period for return of the legacy meters start at the conclusion of Pepco’s next base rate case² and affirm the rest of the PULJ’s Proposed Order.

I. Procedural History and Background

On June 29, 2015, Pepco filed its Application requesting approval of its depreciation rates in compliance with Order Nos. 83571 and 86441 in Case Nos. 9207 and 9336. In the case, Pepco also filed testimony addressing policy issues related to the recovery of Pepco’s legacy meters through the proposed depreciation rates and the

¹ PEPCO Memorandum of Appeal filed February 22, 2016 (“Pepco Appeal”) at 3-4.

² On April 19, 2016 Pepco filed a base rate case, Case No. 9418.

accounting treatment with respect to Pepco's retired legacy meters.³ On July 2, 2015, the Commission delegated Pepco's request to the PULJ Division. On September 18, 2015, the Commission Technical Staff ("Staff") and the Office of People's Counsel ("OPC") filed their direct testimony. On October 29, 2015, Pepco, Staff and OPC ("the Parties") filed a Partial Stipulation and Agreement settling all contested items including depreciation except the treatment of capital costs of Pepco's legacy meters.⁴ The Parties also agreed that AMI meters should have a depreciable life of ten (10) years. On October 28, 2015, the Presiding Judge conducted a hearing on the Partial Settlement and the disputed legacy meter issue.⁵ The parties filed their initial briefs on November 19, 2015, and OPC and the Company filed reply briefs on December 4, 2015. Staff filed a letter on December 4, 2015 stating that it would not file a reply brief and that it continued to support the alternative solutions proposed in its initial brief.⁶

On January 13, 2016, the PULJ issued the Proposed Order which directed that Pepco's legacy meter capital costs of \$84,670,768 remain in a regulatory asset and be amortized over a 15-year period with no opportunity to earn a return on the capital costs. The Proposed Order also directed that the amortization period start when the Proposed Order becomes a final order of the Commission.

II. Pepco's Appeal

In its Memorandum of Appeal, Pepco noted that "[a]fter approval of Pepco's

³ Pepco Appeal at 2

⁴ *Id.*

⁵ Proposed Order at 3.

⁶ Proposed Order at 3.

AMI business case by the Commission, capital recovery of the [legacy meters] was suspended when the meters were reclassified as a regulatory asset.”⁷ Prior to the reclassification of these meters, Pepco stated that the legacy meters were recorded as Electric Plant In Service for accounting purposes “and received approval to recover the costs of the investment; both return of and return on, in customer rates.”⁸ Pepco indicated that between 2011 to 2014 the Company retired its legacy meters with a total remaining net book value of \$84,670,768 after the cost of removal and salvage proceeds.⁹ Pepco argues that the Commission should reject the Proposed Order which denies the Company cost recovery “on” the legacy meters and only allowing cost recovery “of” the legacy meters by permitting the unrecovered cost to remain in a regulatory asset and be amortized over a period of 15 years.¹⁰

First, Pepco contends that the Commission should reject the Proposed Order because it is contrary to the Commission’s decision in Order No. 86757 in BGE’s Case No. 9355. Pepco notes that in Case No. 9355 “BGE sought to recover its capital costs related to its legacy meters that were dispersed due to the introduction of smart meters.”¹¹ Pepco points out that in that case, the parties entered into a “Unanimous Stipulation and agreement (Stipulation) that allowed BGE to receive both a return of and a return on its legacy meter capital costs in depreciation rates.”¹² Pepco noted that specifically in Order No. 86757, the Commission found that the “agreed-upon depreciation rates are based on Staff’s analysis, which was developed consistent with the Commission precedent,”

⁷ Pepco Appeal at 2.

⁸ *Id.*

⁹ *Id.*

¹⁰ Proposed Order at 23.

¹¹ Pepco Appeal at 4.

¹² *Id.*

concluding that the “agreed-upon depreciation rates are just and reasonable.”¹³ Pepco argues that “those just and reasonable rates, approved by the Commission, allowed BGE the opportunity to earn a return on and a return of the legacy meters costs for BGE through the depreciation rates.”¹⁴ Pepco argues that the Commission had opportunity to reverse or modify the Proposed Order of the Chief PULJ in Case No. 9355 before Order No. 86757 became final; nonetheless, the Commission decided not to change the order or initiate further proceedings after reviewing the BGE Settlement.¹⁵

Pepco argues that by letting the Proposed Order in Case No. 9355 stand, the Commission found that BGE’s recovery of both a return of and a return on its legacy meter capital costs was consistent with the Commission’s statutory authority, was not contrary to its previous AMI orders for BGE, *e.g.* Order 83531 in Case No. 9208, and was just and reasonable.¹⁶ However, Pepco points out that in the Proposed Order in this case, the PULJ reaches a different conclusion “without any discussion as to why Pepco should be treated differently or why the Judge did not follow the decision in Order No. 86757.”¹⁷

Pepco contends that there is no material difference between its requested treatment of legacy meter capital costs and what was allowed for BGE.¹⁸ Therefore, to be

¹³ Pepco Appeal at 5.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Pepco Appeal at 5.

¹⁷ Pepco Appeal at 6.

¹⁸ *Id.*

consistent with that outcome Pepco is requesting that the Commission reverse the Proposed Order in this case.¹⁹

Second, Pepco argues that it should have the opportunity to receive a return on and a return of its investment in the legacy meter. Pepco Witness McGowan explained that “replacing the legacy meters with AMI meters does not extinguish the revenue requirements for capital recovery created when the legacy meters were first devoted to public service.”²⁰ Pepco argues that the investment in the legacy meters were prudently incurred costs critical to providing service to Pepco customers and that the treatment being requested is consistent with the early disposal of other assets due to damage or technological advances.²¹ Further, Pepco supports its rationale by citing Justice Brandeis in his separate opinion in *State of Missouri ex re. Southwestern Bell Telephone Company v. Missouri Public Service Commission* where he stated that “The thing devoted by the investor to the public use is not specific property, tangible or intangible but capital embarked in the enterprise. Upon the capital so invested the federal Constitution guarantees to the utility the opportunity to earn a fair return.”²² Here, Pepco seeks the opportunity to recover its capital invested in the legacy meters used to provide service to customers. The Company argues that, according to the Commission’s decision in *Re Maryland Marine Utilities, Inc. 78 Md. PSC 1, 2 (1987)*, whether the capital investment

¹⁹ We note that after the PULJ issued the Proposed Order, the Commission issued Order No. 87591 in Case 9406 – BGE’s rate case application that included a benefit-cost review of its AMI program. In that Order, the Commission found that BGE was not entitled to a return “on” its legacy meters. Order 87591 at 73-74.

²⁰ Pepco Appeal at 7.

²¹ *Id.*

²² Pepco Appeal at 7 citing 262 U.S. 276, 290 (1923).

is replaced early due to damage or new technology the capital investment is still entitled to recover over the life of the plant investment through depreciation.²³

Third, Pepco refutes the Proposed Order's statement that the legacy meters were retired "in response to perceived technology pressures."²⁴ Pepco noted that its proposal to implement its AMI was a response to federal and state policy directives. Moreover, Pepco points out that the Commission had approved the Company's request to remove its legacy meters and replace those meters with smart meters and found that Pepco's request to deploy AMI has the potential to deliver substantial benefits to its customers.²⁵ Therefore, Pepco argues that as a policy matter, the Company should not be penalized "when taking an action in response to federal and state policies directives, acting pursuant to Commission approval, and providing innovative technologies to its customers that advance the provision of safe and reliable service."²⁶

Fourth, Pepco contends that it is not seeking to recover expenses for property that is not "used and useful" as stated in the Proposed Order.²⁷ Rather Pepco argues that it seeks recovery on capital costs that supported used and useful property, *i.e.*, legacy meters, notwithstanding that this property is now retired. At the time of the investment in the legacy meters, Pepco argues, the investment was deemed prudent by the Commission and the meters were used to provide service to the customers. Pepco notes that the legacy meters were maintained in service until the Company deployed AMI meters. The Company also states that "[t]here has been no showing that Pepco's investment in legacy

²³ Pepco Appeal at 8.

²⁴ Pepco Appeal at 9.

²⁵ Pepco Appeal at 10.

²⁶ Pepco Appeal at 10-11.

²⁷ Pepco Appeal at 11.

meters was somehow imprudent, but absent such a determination, there is no basis to disallow the recovery of and on the costs of those meters.”²⁸ Pepco contends that the Proposed Order applies a rigid interpretation of the used and useful standard regarding legacy meters that should be rejected.²⁹

Pepco sets forth three additional arguments for the Commission to consider. Specifically, Pepco contends its treatment of the legacy meter costs will not result in over-recovery of costs because it would transfer the regulatory asset which contains the legacy meter capital costs into the reserve for Account 370.00 and rebalancing reserves across direct plant distribution accounts.³⁰ This would eliminate the regulatory asset and amortize the adjusted book values via conventional remaining-life accrual rates³¹ and prevent Pepco from recovering capital costs related to legacy systems in perpetuity. Additionally, Pepco argues that “the effect of the Proposed Order will be to discourage Maryland utilities from seeking to modernize their electric systems in ways that benefit customers.”³² Pepco cautions the Commission that a consequence of not allowing Pepco an opportunity to recover a return on its investment in the legacy meters would be a disincentive for utility companies from implementing new technology.³³ Lastly, Pepco argues that the Proposed Order directing the 15-year amortization period denies Pepco the opportunity to receive a return of Pepco’s capital costs related to its legacy meters and should be reversed. Pepco notes that if the Commission denies it an opportunity to earn a return on its legacy meters, then it reserves the right in its next base rate case to seek a

²⁸ *Id.*

²⁹ Pepco Appeal at 12.

³⁰ Pepco Appeal at 12-13.

³¹ Pepco Appeal at 13.

³² *Id.*

³³ *Id.*

shorter amortization period and to recover all costs of the legacy meters. Also, if the Proposed Order is allowed to stand, Pepco requests that the 15-year amortization should only start at the conclusion of Pepco's next base rate case.³⁴ Pepco argues that to uphold the Proposed Order and allow the 15-year amortization period to start when the Proposed Order becomes a final order would further erode Pepco's ability to recover full amount of its legacy meter capital costs.³⁵

III. OPC's Position

OPC opposes Pepco's appeal and refutes the Company's argument that the Proposed Order's decision to deny recovery to Pepco while awaiting a cost-effectiveness determination of AMI meters is an illegal taking. OPC explains that "nothing in the PO (if adopted) will in any manner prohibit, inhibit or limit Pepco from subsequently requesting both a return "of" and a return "on" the costs of these legacy meters when Pepco files its "business case" for a determination of whether this AMI program ultimately benefitted ratepayers."³⁶

OPC further argues that Pepco is only guaranteed under the Constitution the opportunity to earn a fair return on its capital costs and it "does not guarantee the opportunity to earn a return on the value of all items of property used by the utility..."³⁷ OPC points out that Pepco had the opportunity to earn a fair return on its legacy meters and indeed the legacy meters were earning a fair return until Pepco voluntarily chose to

³⁴ Pepco Appeal at 15.

³⁵ *Id.*

³⁶ Reply Memorandum On Appeal of the Office of People's Counsel filed march 14, 2016 ("OPC Reply") at 6.

³⁷ OPC Reply at 7.

retire them “about halfway through their useful lives and forecasted that the financial benefits to ratepayers would be sufficiently sound to justify Pepco’s choice.”³⁸

OPC also points out that the business risks that a utility’s investments will not earn a profit remains on the company.³⁹ Here, Pepco decided to remove an entire asset class which had an average remaining life of more than 15 years and whose individual meters were fully functioning and operational.⁴⁰ Pepco contends when seeking approval of the AMI project that the meters were outdated in terms of the future but could not with any degree of certainty predict when that future would actually arrive.⁴¹ Finally, OPC points out that even Pepco witness Linda Hook, when testifying in Case No. 9286, stated that “[a]s each legacy meter is pulled from service it must be written off in the financial records of the company; it cannot remain on the books and continue to be depreciated.”⁴²

OPC also argues that Pepco could not use “a settlement of a rate case by a different Maryland utility (*i.e.*, BGE) as a form of estoppel” in deciding the present case. In Case No. 9355, BGE sought a rate increase but after discovery and before the evidentiary hearings, the parties entered into a “black box” settlement. In Case No. 9355, the parties agreed to certain depreciation rates and provided an Exhibit 5 that indicated the retired legacy meters “will be amortized over a 10-year period.”⁴³ OPC points out that this is the only mention of legacy meters in the Settlement Agreement or the Commission’s Order approving the Settlement Agreement.⁴⁴ Although Pepco points out

³⁸ *Id.*

³⁹ OPC Reply at 8.

⁴⁰ OPC Reply at 9.

⁴¹ *Id.*

⁴² OPC Reply at 10 citing Order No. 86441 at p. 28.

⁴³ OPC Reply at 11.

⁴⁴ *Id.*

Case No. 9355 and Order No 86757 as the Commission's endorsement of the legacy meter treatment that Pepco seeks here, "the Order is silent as to legacy meter issues."⁴⁵

Finally, OPC notes that the PULJ understood and correctly applied the doctrine of "used and useful" in the Proposed Order. Specifically, OPC notes that "[w]hile no party has challenged the prudence of Pepco's investment in the legacy meters was prudent at the time the investment was made, it is yet undetermined whether Pepco's volitional and intentional premature retirement of the legacy meters *en masse* was prudent." OPC notes that the Commission's right and ability to make that determination in a future rate case is fully preserved by the Proposed Order.⁴⁶

IV. Staff's Position

With respect to the legacy meter issue, Staff supports the treatment proposed by Pepco. However, based on the testimony at the hearing, Staff indicates in its Initial Brief that "a reasonable compromise position would be to allow the Company to amortize the under-depreciated value of the legacy meters over a period of fifteen years, earning a return equal to the Company's cost of debt."⁴⁷ Staff states that it "does not believe the Company's investors should be punished by being completely deprived of a return on their investment in the legacy meters, simply because the Company sought the benefits of a new meter technology."⁴⁸ Nonetheless, Staff recognizes that such a position would mean that if the Company's proposed treatment of the legacy meters is allowed then ratepayers "will be paying the cost of, and returns on, two sets of meters for at least ten

⁴⁵ *Id.*

⁴⁶ OPC Reply at 12.

⁴⁷ Staff Initial Brief filed November 19, 2015 ("Staff Brief") at 2.

⁴⁸ Staff Brief at 6.

years.” Staff notes that while it may be able to accept that outcome, the PULJ and the Commission may wish to consider some limitations on the returns the Company may earn from the legacy meters.⁴⁹

Staff also suggests that the PULJ and the Commission could consider capping the overall legacy and AMI meter cost recovery and returns at the level of benefits to ratepayers that the Company can demonstrate when it files for AMI program cost recovery.

V. Commission Discussion and Findings

Pepco seeks to receive both a return “on” and a return “of” the capital costs related to the legacy meters that it voluntarily chose to retire *en masse* in order to implement a more advanced technology, the AMI meters. Pepco argues that it should be given a fair opportunity to receive a return on the capital invested in the legacy meters that were used in the public service.

OPC rightly points out that Pepco was given an opportunity to receive a fair return on and of the legacy meters while they were in service to the public. However, Pepco chose to remove these legacy meters that were still operating and which had an average remaining life of more than 15 years. And, this decision was made because Pepco believed that the AMI meters would eventually be more cost effective and beneficial to ratepayers. Pepco argued that the Commission should treat the legacy meter issue similar to its treatment of damaged wood poles that are allowed full cost recovery with both a return on and a return of the capital costs. Pepco asserts that “[t]he treatment

⁴⁹ Staff Brief at 6-7.

being requested here for legacy meter capital costs is *entirely* consistent with the early disposal of other assets by the Company due to damage or technological advances.”⁵⁰ (italics added)

We reject Pepco’s argument analogizing the damaged wood poles to the legacy meters because, as pointed out by OPC, the legacy meters had an average remaining useful life of more than 15 years. The Company made a calculated business decision to retire a class of assets not because they were inoperable or became damaged due to storm or some unforeseen circumstance, but rather the Company believed the anticipated long-term financial and other benefits from deploying the AMI meters would be greater than the alternative benefits related to continuing use of the existing legacy meters and earning the authorized return *on* and return *of* these assets in rate base. Thus, we find that the primary motivation for Pepco to switch to the AMI technology was to achieve greater business returns, which is reasonable and to be expected; however, this business choice bears a certain level of business risk as well as the opportunity cost of forgoing present benefits. We do not find in this case that the opportunity cost of the foregone present benefit of receiving a return *on* the capital cost of legacy meters should be passed on to ratepayers. As explained below, the Proposed Order preserves the Company’s ability to earn a fair return on its capital investment.

Here, Pepco argues that according to Justice Brandeis’s opinion in *State of Missouri ex re. Southwestern Bell Telephone Company v. Missouri Public Service Commission* the federal Constitution “guarantees to the utility the opportunity to earn a

⁵⁰ Pepco Appeal at 7.

fair return”.⁵¹ We do not disagree and find that during the period that the legacy meters were used in service to Maryland customers those meters were included in rate base and earned the authorized rate of return. Had the Company kept the legacy meters in operation Pepco would have continued to earn a fair return on its capital investment by including the legacy meters in rate base. OPC noted that even the Company’s witness Linda Hook in Case No. 9286 indicated that removing legacy meters from rate base was appropriate if they are no longer used in service. Specifically, she stated “[a]s each legacy meter is pulled from service, it must be written off in the financial records of the company; it cannot remain on the books and continue to be depreciated.”⁵² We thus find that disallowing the Company to receive a return *on* the capital costs related to the retired legacy meters would not be confiscatory because: 1) as noted in Case No. 9336, Order No. 86441, “the Company will have an opportunity to recover the value of stranded legacy meters, currently in a regulatory asset, through a full depreciation proceeding,”⁵³ which is the present proceeding; and 2) “[a]llowing the cost of the AMI meters to be placed in a regulatory asset accruing a return negates the arguments that there must be a meter in the current revenue requirement for each customer; provided the Company proves cost effectiveness, the Company will eventually recover its investment fully.”⁵⁴ And as OPC Witness Ramas stated in that proceeding “[i]t’s just a matter of timing when this is passed to the customers.”⁵⁵

⁵¹ Supra fn. 20 at p. 6.

⁵² OPC Reply at 10.

⁵³ Order No. 86441 at 29.

⁵⁴ *Id.*

⁵⁵ *Id.*

However, we agree with Pepco that if the amortization of the return of the legacy meters begins with the effective date of this Order, before the rates from Case No. 9418 go into effect, the amount amortized in the interim would never be recovered by Pepco. We agree with Pepco's position on appeal that the 15 year amortization period for the return of the legacy meters should start with the effective date of the rates granted in Case No. 9418.

For these reasons, we therefore find that the Proposed Order strikes the appropriate balance between the ratepayers and the shareholders in allocating the costs of Pepco's AMI and the costs of the legacy meters. Therefore, we uphold the decision of the Proposed Order in all points except we also grant Pepco's request to allow the 15-year amortization to start at the conclusion of Pepco's next base rate case, Case No. 9418

IT IS, THEREFORE, this 10TH day of August, in the year Two Thousand Sixteen,

ORDERED: 1) That the Proposed Order of the Public Utility Law Judge be, and it is hereby, affirmed in part; and

2) That Pepco's request to allow the 15-year amortization to start at the conclusion of Case No. 9418 is granted.

By Direction of the Commission,

/s/ David J. Collins

David J. Collins
Executive Secretary