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**ORDER NO. 88432**

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| 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<br><br>CASE NO. 9443 |

Before: W. Kevin Hughes, Chairman
Michael T. Richard, Commissioner
Anthony J. O'Donnell, Commissioner
Odogwu Obi Linton, Commissioner

Issued: October 20, 2017

APPEARANCES

Peter E. Meier, Douglas E. Micheel, Matthew K. Segers, and Kim F. Hassan for Potomac Electric Power Company

Theresa V. Czarski, Gary L. Alexander, Ronald Herzfeld, Molly Knoll, Jacob M. Ouslander, and Mikhail Raykher for the Maryland Office of People's Counsel

Lloyd Spivak, Annette B. Garofalo, Peter A. Woolson, and Leslie Romine for the Maryland Public Service Commission Staff

Frann G. Francis, Nicola Whiteman, and Excetral K. Caldwell, for the Apartment and Office Building Association of Metropolitan Washington

Lisa Brennan for Montgomery County, Maryland

Heather R. Cameron, for the United States General Services Administration

N. Lynn Board for the City of Gaithersburg, Maryland

James K. McGee and Jared M. McCarthy for Prince George's County, Maryland

Alexander Sanchez and May Va Lor, on behalf of Baltimore Washington Laborers and Public Employees District Council ("BWLDC")

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## I. INTRODUCTION AND EXECUTIVE SUMMARY

On March 24, 2017 Potomac Electric Power Company ("Pepco") filed with the Maryland Public Service Commission ('the Commission") a request to increase its rates for electricity in the amount of $68,619,000.[1] The revenue requirement was updated in the Company's supplemental direct filing to $68,634,000.[2]According to Pepco, the impact of this proposed rate increase on the typical residential customer would be $7.50 per month, or an increase of 5.61 percent.[3] Pepco last received a rate increase from the Commission in November 2016 of $52.5 million, primarily related to its capital investment over a six year period in Advanced Metering Infrastructure (AMI or 'smart meters') and continued reliability investments.[4] Prior to that, Pepco had last increased its rates in July 2014, prior to its parent, Pepco Holdings, Inc.'s merger with Exelon Corporation.

In this rate case, Pepco's application for an increase was predominantly driven by the Company's continued reliability infrastructure investments and an $18 million request related to a proposed change in the method of income tax accounting and allocation for the cost of removal ("COR") for electric plant acquired prior to 1981. As in the prior two rate cases, the Commission is granting a majority of Pepco's request related to actual reliability expenditures. The Commission did not, however, grant the Company's request related to the COR of its pre-1981 plant.

Over the past four years, Pepco has invested $908.6 million in the Company's distribution system in order to improve system performance and reliability. Since the

[1] Pepco March 24, 2017 Application at 3.
[2] Ziminsky Supplemental Direct at 1.
[3] Janocha Supplemental Direct at 3, Schedule (JFJ-SD)-2 at 2.
[4] *See* Case No. 9418, Order No. 87884.

creation of the Service Quality and Reliability Standards in 2012, Pepco has experienced a 22 percent improvement in the frequency of outages and a 35 percent improvement in the duration of outages through the end of 2016.[5] While continual improvement in Pepco's performance and reliability metrics is required in order for the Company to achieve first quartile performance, the Commission recognizes this improvement comes with a cost to customers. We are required to balance the Company's recovery of its expenses and capital investments with the requirement that its rates are "just and reasonable." To this end, we will continue to hold Pepco accountable for meeting its reliability commitments while providing service that is affordable to its customers.

Finally, the Company requested in its Application an increase in its authorized rate of return on equity from 9.55% to 10.10%. We carefully considered this request together with the evidence presented by the other parties. Based on the record in this case, we find that a reduced return on equity of 9.50% provides for a fair and appropriate return, and will allow Pepco to obtain any necessary capital investment at reasonable interest rates.

We have thoroughly reviewed Pepco's Application and the evidence presented by all of the parties to the case, as well as the public's comments. After careful consideration, we authorize Pepco to increase its electric rates by $33,967,000, which will result in an increase to the average monthly Standard Offer Service residential bill of $4.01, or 3.00%. As in prior Pepco cases, we have strived to limit rate impacts while

[5] Clark Direct at 3. Frequency of outages is measured by the System Average Interruption Frequency Index or "SAIFI" and duration of outages is measured by the System Average Interruption Duration Index or "SAIDI."

allowing the Company to invest in safety and reliability and continue to modernize its distribution system for the benefit of its customers.

## II. BACKGROUND

On March 24, 2017, Potomac Electric Power Company ("Pepco"), a subsidiary of Pepco Holdings LLC ("PHI"), formerly Pepco Holdings, Inc., filed an Application for Adjustments to its Retail Rates for the Distribution of Electric Energy ("Application") pursuant to §§ 4-203 and 4-204 of the Public Utilities Article of the Annotated, Code of Maryland ("PUA"), for authority to increase its rates and charges for electric distribution service in Maryland. The Application included supporting testimony and schedules, and was supplemented by supporting data on April 3, 2017. Pepco requested a rate effective date of April 23, 2017. On March 27, 2017, the Commission suspended the tariff revisions for a period of 150 days from April 23, 2017.[6] On May 1, 2017, the Commission extended the initial 150-day suspension period by an additional 30 days, or until October 20, 2017.[7]

In its Application, Pepco sought an increase of $68,619,000 in its Maryland distribution rates based on the partially-forecasted test year May 1, 2016 through April 30, 2017, as well as an authorized rate of return on equity of 10.10 percent.[8] The initial Application included eight months of actual results and four months of projected results. However, Pepco asked that in future rate cases it be relieved of the requirement to

[6] Order No. 88090 at 2.
[7] Order No. 88168 at 2.
[8] Pepco March 24, 2017 Application at 3.

provide no more than four months of forecasted data, and instead be authorized to submit up to six months of projections.[9]

Pepco asserted in its Application that at its current authorized rates, its adjusted return on equity for the test year is only 5.44 percent – a level well below its authorized rate of return. The Company stated that its revenue growth has been outpaced by growth in operating costs and rate base, a problem Pepco expects to grow as it continues investing to enhance the reliability of the distribution system.[10] Pepco further stated that if granted in full, the impact of the requested rate increase on the typical residential Standard Offer Service customer using 872 kilowatt-hours per month would be $7.37 per month, or an increase of 5.52 percent.[11]

On June 7, 2017, Pepco filed Supplemental Direct Testimony and Schedules, which updated the four months of projections with actual data.[12] Pepco's use of actual data caused its proposed increase in electric distribution base rates to rise slightly to $68.634 million, and the impact to the typical residential customer to increase to $7.50 per month, or an increase of 5.61 percent.[13] The rate increase was based on an adjusted rate base of $1.694 billion, adjusted net operating income of $131.11 million, and overall rate of return of 7.74 percent.[14]

On September 20, 2017, the Public Service Commission Staff ("Staff"), submitted a revised Comparison Chart reflecting the parties' revenue requirement positions, which

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[9] The Commission imposed a limit of no more than four months of forecasted data in Case No. 9311, Order No. 85724 at 164-65.
[10] Pepco March 24, 2017 Application at 3.
[11] McGowan Direct at 6.
[12] Pepco Exhibit 7 is the Company's June 7, 2017 Update to Actual Financials. Pepco Exhibit 8 is its August 18, 2017 Final Update to Actual Financials.
[13] Janocha Supplemental Direct at 3, Schedule (JFJ-SD)-2 at 2.
[14] Ziminsky Supplemental, Schedule (JCZ-SD)-1.

is appended to this Order as Appendix II. The Chart shows Pepco's final purported revenue requirement deficiency of $67,048,000; Staff's final proposed revenue requirement recommendation of $25,764,000; the final recommendation of the Maryland Office of People's Counsel ("OPC") of $9,954,000;[15] and the final recommendation of the Apartment and Office Building Association of Metropolitan Washington ("AOBA") of $24,757,000.

A number of parties filed written testimony in this proceeding. Pepco sponsored the testimony of Kevin M. McGowan, Vice President, Regulatory Policy and Strategy of PHI, who provided an overview of the Pepco's Application for an increase in base distribution rates, and described the infrastructure investments the Company has made to improve reliability and customer service.[16] Additionally, Bryan Clark, Director of Engineering at PHI testified regarding the investments that the Company has made in the infrastructure of its electric system in order to provide safe and reliable service to customers.[17] Donna J. Kinzel, Senior Vice President, Chief Financial Officer and Treasurer of PHI presented the side-by-side analysis of shared service costs, as required by Merger Condition 39 of Commission Order No. 86990[18] approving the merger between Exelon Corporation and PHI in Case No. 9361.[19] Jay C. Ziminsky, Director,

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[15] Alternatively, OPC recommended a revenue requirement of $13,439,000 based on a separate cost of capital analysis.
[16] Pepco Exhibit 3, Direct Testimony of Kevin M. McGowan ("McGowan Direct"); Pepco Exhibit 4, Supplemental Direct Testimony of Kevin M. McGowan ("McGowan Supplemental"); Pepco Exhibit 5, Rebuttal Testimony of Kevin M. McGowan (McGowan Rebuttal");
[17] Pepco Exhibit 21, Direct Testimony of Bryan Clark ("Clark Direct"); Pepco Exhibit 22, Rebuttal Testimony of Bryan Clark ("Clark Rebuttal").
[18] Case No. 9361, *In the Matter of the Merger of Exelon Corporation and Pepco Holdings, Inc*., Order No. 86990.
[19] Pepco Exhibit 9, Direct Testimony of Donna Kinzel ("Kinzel Direct"); Pepco Exhibit 10, Supplemental Direct Testimony of Donna Kinzel ("Kinzel Supplemental"); Pepco Exhibit 11 Rebuttal Testimony of Donna Kinzel ("Kinzel Rebuttal").

Regulatory Strategy and Revenue Policy, in the Regulatory Affairs Department of PHI provided testimony addressing Pepco's revenue requirement request; the Company's books and records; Pepco Holdings' costing and accounting procedures; Pepco's Cost Allocation Manual; electric distribution cost of service; and ratemaking adjustments.[20] Tyler W. Wolverton, Manager, Revenue Performance, in the Regulatory Affairs Department of PHI, presented testimony on certain ratemaking adjustments; the Cash Working Capital Lead/Lag Study; and the Jurisdictional Cost of Service Study ("JCOSS").[21] Brian M.W. Scheerer, Senior Rates Analyst for Baltimore Gas and Electric Company ("BGE"), testified on behalf of Pepco in this case regarding the Adjusted Maryland Class Embedded Cost of Service Study ("CCOSS") for distribution service.[22] Joseph F. Janocha, Manager of Retail Pricing for PHI provided the rate design supporting Pepco's proposed increase in distribution revenue, considering the unitized rate of return ("UROR") for each customer service classification in the allocation of overall revenue requirements among customer classes.[23] Robert B. Hevert, partner of ScottMadden, Inc., presented expert testimony on behalf of Pepco regarding the Company's return on equity

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[20] Pepco Exhibit 12, Direct Testimony of Jay Ziminsky ("Ziminsky Direct"); Pepco Exhibit 13, Supplemental Direct testimony of Jay Ziminsky ("Ziminsky Supplemental"); Pepco Exhibit 14, Rebuttal Testimony of Jay Ziminsky ("Ziminsky Rebuttal"), and Pepco Exhibit 15, Additional Supplemental Testimony of Jay Ziminsky ("Ziminsky Additional Supplemental"); Pepco Exhibit 16, Surrebuttal Testimony of Jay Ziminsky ("Ziminsky Surrebuttal").

[21] Pepco Exhibit 17, Direct Testimony of Tyler Wolverton ("Wolverton Direct"); Pepco Exhibit 18, Supplemental Direct Testimony of Tyler Wolverton ("Wolverton Supplemental"); Pepco Exhibit 19, Rebuttal Testimony of Tyler Wolverton ("Wolverton Rebuttal"); Pepco Exhibit 20, Surrebuttal Testimony of Tyler Wolverton ("Wolverton Surrebuttal").

[22] Pepco Exhibit 26, Direct Testimony of Brian Scheerer ("Scheerer Direct"); Pepco Exhibit 27, Supplemental Direct Testimony of Brian Scheerer ("Scheerer Supplemental"); Pepco Exhibit 28, Rebuttal Testimony of Brian Scheerer ("Scheerer Rebuttal").

[23] Pepco Exhibit 32, Joseph Janocha Direct Testimony ("Janocha Direct"); Pepco Exhibit 33, Supplemental Direct Testimony of Joseph Janocha ("Janocha Supplemental"), Pepco Exhibit 34, Joseph Janocha Rebuttal Testimony ("Janocha Rebuttal").

as well as an assessment of Pepco's capital structure.[24] Jonathan D. Weinstein, employed by Pay Governance, testified for Pepco on competitive practice information pertaining to nonqualified retirement plans and their use in the utility industry.[25] James I. Warren, a tax partner in the law firm of Miller & Chevalier Chartered, provided testimony addressing Ratemaking Adjustment ("RMA") 30, the Company's proposed change in its regulatory treatment of cost of removal ("COR") for assets acquired prior to 1981.[26] Finally, Denise H. Senecal, Principle Marketing Research Analyst in the Government Affairs & Public Policy Group at PHI, presented testimony on behalf of Pepco addressing OPC witness Alexander's claim[27] that Pepco's Root Cause Report is deficient.[28]

Staff also presented several witnesses to address the issues in this case. Drew McAuliffe, Regulatory Economist in the Commission's Electricity Division, discussed the CCOSS testimony provided by Witness Scheerer on behalf of Pepco.[29] Felicia L. Shelton, an Electrical Engineer in the Commission's Engineering Division, addressed Pepco witness Bryan Clark's testimony regarding Pepco's reliability program, associated reliability rate base adjustments, and vegetation management costs.[30] Felix L. Patterson, a Public Utility Auditor in the Commission's Accounting Investigations Division,

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[24] Pepco Exhibit 30, Direct Testimony of Robert Hevert ("Hevert Direct"); Pepco Exhibit 31, Rebuttal Testimony of Robert Hevert ("Hevert Rebuttal").
[25] Pepco Exhibit 29, Direct Testimony of Jonathon Weinstein ("Weinstein Direct").
[26] Pepco Exhibit 23, Direct Testimony of James Warren ("Warren Direct"); Pepco Exhibit 24, Supplemental Direct Testimony of James Warren ("Warren Supplemental"); Pepco Exhibit 25, Rebuttal Testimony of James Warren ("Warren Rebuttal").
[27] *See* Alexander Direct at 12.
[28] Pepco Exhibit 35, Rebuttal Testimony of Denise Senecal ("Senecal Rebuttal").
[29] Staff Exhibit 8, Drew M. McCauliffe Direct Testimony ("McCauliffe Direct"); Staff Exhibit 9, Drew M. McCauliffe Rebuttal Testimony ("McCauliffe Rebuttal"), Staff Exhibit 10, , Drew M. McCauliffe Surrebuttal Testimony ("McCauliffe Surrebuttal").
[30] Staff Exhibit 2, Felicia L. Shelton Direct Testimony ("Shelton Direct"); Staff Exhibit 3, Felicia L. Shelton Surrebuttal Testimony ("Shelton Surrebuttal").

provided analysis and recommendations regarding Pepco's revenue requirement.[31] Jamie A. Smith, Director of the Accounting Investigations Division for the Commission, addressed the revenue requirement sponsored by Pepco witnesses Jay Ziminsky and Tyler Wolverton.[32] Additionally, he responded to Company witnesses James Warren and Kevin McGowan. Phillip E. VanderHeyden, Director of the Commission's Electricity Division, addressed return on equity and overall rate of return for use in determining Pepco's electric distribution rates.[33] He also commented on the cost of capital testimony of Pepco witness Hevert. David Hoppcock, Assistant Director of the Commission's Electricity Division, analyzed the rate design testimony Pepco witness Janocha presented on behalf of Pepco and presented his own proposed electric distribution rate design testimony based on the Company's CCOSS and the revenue requirement proposed by Staff.[34]

The Maryland Office of People's Counsel ("OPC") offered five witnesses to address Pepco's rate case request. David J. Effron, an expert consultant specializing in utility regulation, testified regarding revenue requirement issues, rate base, and revenues and expenses.[35] His testimony included analysis of distribution plant, accumulated deferred income taxes, supplemental executive retirement plan, merger synergies, and the normalization of costs of removal. Karl Richard Pavlovic, Senior Consultant with and the

[31] Staff Exhibit 14, Direct Testimony of Felix L. Patterson ("Patterson Direct"); Staff Exhibit 15, Surrebuttal Testimony of Felix L. Patterson ("Patterson Surrebuttal").
[32] Staff Exhibit 16, Direct Testimony of Jamie A. Smith ("Smith Direct"); Staff Exhibit 17, Surrebuttal Testimony of Jamie A. Smith ("Smith Surrebuttal").
[33] Staff Exhibit 11, Phil VanderHeyden Direct Testimony ("VanderHeyden Direct"); Staff Exhibit 12, Phil VanderHeyden Surrebuttal Testimony ("VanderHeyden Surrebuttal").
[34] Staff Exhibit 4, David Hoppock Direct Testimony ("Hoppock Direct"); Staff Exhibit 5, David Hoppock Rebuttal Testimony ("Hoppock Rebuttal"); Staff Exhibit 6, David Hoppock Surrebuttal ("Hoppock Surrebuttal").
[35] OPC Exhibit 18, David J. Effron Direct Testimony ("Effron Direct"); OPC Exhibit 19, David J. Effron Surrebuttal Testimony ("Effron Surrebuttal").

Managing Director of PCMG and Associates LLC, provided testimony addressing electric class distribution costs of service, revenue requirement distribution, and rate design.[36] J. Randall Woolridge, Professor of Finance and the Goldman, Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration at the University Park Campus of the Pennsylvania State University, testified regarding the overall fair rate of return or cost of capital for the regulated electric distribution service of Pepco and he evaluated Pepco's rate of return testimony.[37] Peter J. Lanzalotta, Principal with Lanzalotta & Associates LLC, provided testimony addressing Pepco's distribution system planning and reliability matters.[38] Barbara R. Alexander, Barbara Alexander Consulting LLC, addressed Pepco's customer service performance in light of the merger commitments agreed upon in the Commission's approval of the Exelon-PHI merger in Case No. 9361, as well as the Company's compliance with the Service Quality and Reliability Standards adopted in Rulemaking 43.[39]

The Apartment and Office Building Association of Metropolitan Washington ("AOBA") presented two witnesses in this proceeding. Bruce R. Oliver, President of Revilo Hill Associates, Inc., addressed Pepco's use of a partially projected test year; the cost of equity; Pepco's actually achieved Synergy Savings; Pepco's claimed operating expenses, plant additions, and overall revenue requirement; and the Company's class cost

[36] OPC Exhibit 9, Karl L. Pavlovic Direct Testimony; OPC Exhibit 10, Errata to Karl L. Pavlovic Direct Testimony ("Pavlovic Direct"); OPC Exhibit 11, Karl L. Pavlovic Rebuttal Testimony ("Pavlovic Rebuttal"); OPC Exhibit 12, Karl L. Pavlovic Surrebuttal Testimony ("Pavlovic Surrebuttal").
[37] OPC Exhibit 6, Dr. J. Randall Woolridge Direct Testimony ("Woolridge Direct"); OPC Exhibit 7, Dr. J. Randall Woolridge Rebuttal Testimony ("Woolridge Rebuttal"); OPC Exhibit 8, Dr. J. Randall Woolridge Surrebuttal Testimony ("Woolridge Surrebuttal").
[38] OPC Exhibit 16, Peter Lanzalotta Direct Testimony ("Lanzalotta Direct"); OPC Exhibit 17, Peter Lanzalotta Surrebuttal Testimony ("Lanzalotta Surrebuttal").
[39] OPC Exhibit 13, Barbara R. Alexander Direct Testimony ("Alexander Direct"); OPC Exhibit 14, Barbara R. Alexander Surrebuttal Testimony ("Alexander Surrebuttal").

of service allocations.[40] Timothy B. Oliver, Project Manager and Senior Rate Analyst for Revilo Hill Associates, addressed the revenue increase distribution and non-residential rate design proposals that Pepco presented through witness Janocha.[41]

Finally, Montgomery County, Maryland presented the testimony of Eric R. Coffman, Chief of the Office of Energy and Sustainability within the Montgomery County Department of General Services. He discussed impacts of the proposed rate structure on customer classes; recommended adjustments to Pepco's Annual Incentive Plan; and other impacts to Montgomery County from Pepco's rate case requests.[42]

In addition to the parties that filed testimony, the following parties filed motions to intervene in this proceeding, which were granted by the Commission: United States General Services Administration; The City of Gaithersburg, Maryland; Prince George's County, Maryland; and Baltimore Washington Laborers and Public Employees District Council ("BWLDC").

The intervening parties to this proceeding filed their direct cases on June 30, 2017. Simultaneous rebuttal testimony was filed by Pepco and the intervening parties on August 1, 2017. Pepco and the intervening parties filed their surrebuttal testimony on August 24, 2017. Evidentiary hearings were conducted at the Commission's offices in Baltimore on September 5-8, and 11-13, 2017. Post-hearing briefs were filed by Pepco and the intervening parties on October 3, 2017. A public hearing for the purpose of receiving public comment on Pepco's Application was held on Monday, August 28, 2017

[40] AOBA Exhibit 57, Direct Testimony of Bruce R. Oliver ("B. Oliver Direct"); AOBA 58, Surrebuttal Testimony of Bruce R. Oliver ("B. Oliver Surrebuttal").
[41] AOBA Exhibit 56, Direct Testimony of Timothy B. Oliver ("T. Oliver Direct").
[42] Montgomery County Exhibit 37, Direct Testimony of Eric R. Coffman ("Coffman Direct"); Montgomery County Exhibit 38, Surrebuttal Testimony of Eric R. Coffman ("Coffman Surrebuttal").

beginning at 6:30 p.m. at the Prince George's County Community College in Largo, Maryland. An additional public hearing was held on Wednesday, August 30, 2017 beginning at 6:30 p.m. in the Montgomery County Council Office Building in Rockville, Maryland.

All of the evidence presented in this case, including the public's comments, has been thoroughly reviewed and carefully considered by the Commission in reaching the decisions in this Order.

## III. DISCUSSION AND FINDINGS

### A. Adjustments to Rate Base and Operating Income

Rate base represents the investment the Company makes in plant and equipment to provide safe and reliable electric service to its customers. Operating income is derived from the revenues the Company receives for electric service less the prudently incurred costs of providing service to customers. Adjustments to the Company's rate base request were offered, accepted or disputed by the various parties.[43] We discuss and resolve each of the disputed rate making adjustments below.

#### 1. ***RMA 2: Post Test Year Reliability Closings (May 2017 through June 2017)***

Pepco witness Wolverton explained that when a capital project commences to improve the Company's distribution system, the investment initially is considered Construction Work in Progress ("CWIP"). All capital expended on the project remains in

[43] *See* Appendix I for the Commission's calculation of the appropriate rate base, operating income and overall revenue requirement for rate making purposes. The list of contested and uncontested RMAs compiled by Commission Staff has been appended to this Order as Appendix II.

CWIP for accounting purposes until the project is in service and completed for accounting purposes. However, once the project begins providing service to customers, the capital expenditures residing in CWIP are transferred to Electric Plant in Service ("EPIS").[44] The Company's first adjustment, RMA 1, annualizes the effect of reliability projects that were added to EPIS during the test period. No party objects to this adjustment.

RMA 2 reflects the known and measurable effect of reliability projects that were closed to EPIS between May and June 2017, and for which actual plant closings data have been made available prior to the close of evidentiary hearings in this proceeding.[45] RMA 2 reflects in EPIS the full value of projects placed into plant in service, reduces average CWIP to the extent the projects were reflected in unadjusted average test-period amounts, and removes retirements from both EPIS and accumulated depreciation. The adjustment also includes the associated depreciation expense. Mr. Wolverton testified that RMA 2 is consistent with the Commission's treatment of reliability spend in Case Nos. 9336 and 9418, Order Nos. 86441 and 87884, respectively.[46]

Mr. Clark testified that the reliability projects included in RMA 2 support the reliability performance of the distribution system. Specifically, he testified that over the past four years, Pepco has invested $908.6 million in the Company's distribution system in order to improve system performance and reliability. Mr. Clark discussed Pepco's improving reliability through several metrics, including System Average Interruption Frequency Index ("SAIFI") and System Average Interruption Duration Index ("SAIDI").

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[44] Wolverton Direct at 3.
[45] Wolverton Direct at 3.
[46] Wolverton Direct at 4.

Mr. Clark testified that since the creation of the Service Quality and Reliability Standards in 2012, Pepco has experienced a 22 percent improvement in SAIFI and a 35 percent improvement in SAIDI through the end of 2016. Mr. Clark concluded that full and timely recovery of its reliability expenditures is necessary in order to meet or exceed the minimum performance obligations imposed by the Commission, to continue to modernize the grid by replacing aging infrastructure, and to meet the expectations of Pepco customers.[47]

In reviewing Pepco's reliability metrics over the past several years, Staff witness Shelton concluded that Pepco "demonstrates a trend of continued reliability improvement."[48] Additionally, Ms. Shelton observed that RMA 2 contains reliability projects that are similar to projects approved by the Commission in previous rate case orders.[49] Nevertheless, Staff recommends that RMA 2 be rejected in this case. Ms. Shelton testified that the reliability projects identified in RMA 2 are outside of Pepco's test year and therefore outside of traditional ratemaking practices. She observed that the Commission has approved reliability projects outside the test year in the past as an *exception* to traditional ratemaking practices in order to incentivize reliability investment and to improve reliability. However, in the present case, Ms. Shelton argued that because Pepco failed to meet all of its reliability targets, it should not receive the benefit of the exception.

[47] Clark Direct at 3, 19.
[48] Shelton Direct at 4.
[49] Shelton Direct at 9.

Specifically, Ms. Shelton noted that in the Exelon – PHI merger case,[50] Pepco committed as a condition of merger approval to improve SAIDI and SAIFI scores beyond what was otherwise required by the Code of Maryland Regulations ("COMAR"). Prior to the merger, COMAR 20.50.12.02D(1) specified that Pepco achieve a 2016 SAIFI of 1.25. However, as one of the purported benefits of the merger, Pepco committed to achieving a SAIFI of 1.05. That commitment was memorialized in the Commission's order approving the merger.[51] Despite its commitment to meet this merger target, however, Pepco scored a SAIFI of 1.08 for year 2016.[52] Accordingly, Ms. Shelton argued that Pepco should not receive the benefit of receiving an exception to the general policy of denying inclusion of reliability projects that are outside the test year.

In addition to Ms. Shelton's testimony, Staff witness Smith testified that from an accounting perspective, including post-test year plant in rate base violates the matching principle.[53] He explained that the matching principle is violated by allowing the capital investment costs to be recuperated without making similar offsetting adjustments for revenues and expenses that flow from those investments. In particular, Mr. Smith stated that when plant additions are placed in serve, the plant should result in increased operating efficiency and service reliability, thereby decreasing operations and maintenance ("O&M") expenses. However, Pepco did not present any corresponding adjustment to O&M expenses.

[50] Case No. 9361, *In the Matter of the Merger of Exelon Corporation and Pepco Holdings, Inc*.
[51] *See* Order No. 86990 at Appendix A, p. A-13. C.
[52] *See* Case No. 9353, *In the Matter of the Review of Annual Performance Reports on Electric Service Reliability Filed Pursuant to COMAR 20.50.12.11*, Order No. 88406 at 9.
[53] Smith Direct at 8.

OPC witness Effron also testified against granting RMA 2, stating that "[a]s a general rule, adjustments to annualize plant additions to their end of year level are not appropriate."[54] Mr. Effron stated that the Commission has traditionally used a test year average rate base in determining the utility's revenue requirement, which results in a proper matching of test year investment, revenue, and expenses. In contrast, allowing "selective adjustments" for certain elements of rate base to their end of year level does not result in a proper matching.[55]

Mr. Effron recognized that the Commission has granted exceptions to its general rule by allowing adjustments to restate plant related to distribution safety and reliability to the end of test year balances. However, he argued that RMA 2 is not entirely consistent with the allowance for post-test year reliability plant approved by the Commission in Case No. 9418. In that Case, Mr. Effron noted that the Commission limited the adjustments for post-test year reliability plant additions to the first three months after the end of the test year. He acknowledged that RMA 2, which includes plant additions in May and June of 2017, do take place within three months after the end of the test year, which ended on April 30, 2017. However, Mr. Effron observed that in Case No. 9418, the Commission implicitly limited plant additions to a point approximately three weeks prior to the date of Pepco's application. By contrast, in the present case, Pepco filed its application on March 24, 2017. Therefore, Pepco's RMA 2 includes post-test year additions that take place more than three months after the date of Pepco's application.[56] Mr. Effron therefore recommended denial of RMA 2.

[54] Effron Direct at 3.
[55] Effron Direct at 3-4.
[56] Effron Direct at 6-7.

In his rebuttal testimony, Pepco witness Clark testified that Pepco only narrowly missed the SAIFI standard set by Merger Condition 8.[57] He stated that because the District of Columbia Public Service Commission unexpectedly delayed approval of the merger, Pepco was unable to benefit from the Exelon best practices and merger operational synergies until well into the second quarter of 2016. He also testified that Pepco's failure to meet its merger SAIFI target was attributable to an increase in significant storms and a fire at a substation in Prince George's County. Mr. Clark argued that the recovery of the investments included in RMA 2 are directly related to Pepco's ongoing efforts to continue to improve reliability performance and meet the standards set out in Condition 8 of Commission Order No. 86990.

Pepco witness Wolverton testified that the recovery of the investments included in the Company's RMA 2 do not violate the matching principle. He stated that the Commission previously determined in Case No. 9192 that inclusion of post-test year reliability investment does not violate the matching principle "if the reliability investment is known and measurable and does not generate new revenue."[58] Mr. Wolverton further testified that the reliability plant additions in RMA 2 will be known and measurable before the close of the hearing and that such additions are similar to the post-test year reliability plant additions for which the Commission granted recovery in Case Nos. 9418, 9336, 9311, and 9286. Furthermore, Mr. Wolverton stated that the projects included in RMA 2 will not generate new revenue for Pepco.

Mr. Wolverton disagreed with Staff witness Smith regarding the application of the matching principle. Mr. Wolverton stated that the presentation of a corresponding

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[57] Clark Rebuttal at 2.
[58] Wolverton Rebuttal at 2, citing Order No. 83085 at 9.

"beneficial" O&M adjustment is not the standard for recovery of post-test year reliability plant additions, nor has it been the standard in any of Pepco's four previous rate cases before the Commission.[59] Additionally, Mr. Wolverton argued that to the extent any O&M savings are created from new reliability plant investment, such potential savings would be realized in the future and therefore are not known and measurable at the time of this case. Mr. Wolverton also testified that exclusion of RMA 2 would be inconsistent with the Commission's past decisions to incentivize reliability spending, as well as the Company's demonstrated commitment to reliability and strong history of reliability improvements.[60] Mr. Wolverton concluded that the reliability plant additions in RMA 2 "are integral to Pepco's commitment to improve reliability and its ability to meet reliability performance standards in the future."[61] Finally, in its Brief, Pepco argued that the Commission should not adopt Staff's proposal to disallow RMA 2 because Merger Condition 8 already includes an applicable punitive mechanism should the Company not meet the SAIFI and SAIDI standards.[62] Specifically, the Commission's RM43 mitigation and penalty provisions apply, including the filing of a Corrective Action Plan, and the possible imposition of a civil penalty.[63]

In her surrebuttal testimony, Staff witness Shelton stated that Staff was not allowed sufficient time for discovery or to fully assess the sixty-four projects included

[59] Wolverton Rebuttal at 5, siting Case Nos. 9286, 9311, 9336, and 9418.
[60] Wolverton Rebuttal at 6.
[61] Wolverton Rebuttal at 7.
[62] Pepco Brief at 35.
[63] On January 31, 2017, Pepco filed a Corrective Action Plan, providing reasons why the SAIFI target was missed and how the Company plans to achieve its future SAIFI targets. The Commission accepted Pepco's Corrective Action Plan in Order No. 88406, and declined to penalize the Company for missing its SAIFI merger condition.

within RMA 2 given Pepco's August 18, 2017 update for actuals.[64] Additionally, she disputed Pepco's argument that her recommendation to disallow RMAs 2 and 3 constituted a penalty, stating "the grant of the [reliability] incentive initially should be viewed as an extraordinary benefit that was not set in place permanently, but was set in place temporarily for a finite duration of time."[65]

**Decision**

The Commission adheres to a historic test period methodology in setting rates. However, in past rate cases, we have recognized an exception to allow recovery of post-test year reliability plant investments made and placed into service prior to the evidentiary hearings, and generally including no more than three months of post-test year reliability plant additions. In order to accept a post-test year adjustment, the Commission has also required the Company to demonstrate that such investments meet objective standards for safety and reliability, have not generated additional utility revenues, and will provide service to existing rather than new customers.[66]

Pepco witness Wolverton provided testimony that the post-test year reliability plant additions contained in RMA 2 were known and measurable and would not generate new revenues for Pepco.[67] Additionally, he testified that all of the RMA 2 reliability projects have been closed to EPIS and are currently providing service to Pepco customers.[68] Pepco witness Clark further testified that Pepco's sizeable investments in its distribution system have improved system performance and reliability and have

[64] Shelton Surrebuttal at 2-3.
[65] Shelton Surrebuttal at 6.
[66] Case No. 9418, Order No. 87884 at 34.
[67] Wolverton Rebuttal at 3, Hearing Transcript September 5-8, and 11-13, 2017 (hereinafter "Hr'g Tr.") at 430.
[68] Hr'g Tr. at 444.

significantly elevated Pepco's performance with respect to reliability performance metrics. For example, since the inception of our Service Quality and Reliability Standards in 2012, Pepco has experienced a 22 percent improvement in SAIFI and a 35 percent improvement in SAIDI through the end of 2016.[69] For those reasons, we find approval of Pepco's RMA 2 appropriate.

We do not find that Pepco's inclusion of RMA 2 violates the matching principle, as argued by Staff. The Commission has found previously that inclusion of post-test year reliability investment does not violate the matching principle "if the reliability investment is known and measurable and does not generate new revenue," as the evidence supports here.[70] Consistent with Mr. Wolverton's testimony, we find that the reliability plant additions in RMA 2 were known and measurable before the close of the hearing and that the projects will not generate new revenue for Pepco. Additionally, the reliability plant additions in RMA 2 are similar to the post-test year reliability plant additions for which the Commission granted recovery in Case Nos. 9418, 9336, 9311, and 9286.

We will also decline Staff's proposal to disallow RMA 2 because of Pepco's failure to meet its SAIFI merger requirement, but will agree conceptually that disallowance of post-test year reliability plant additions does not constitute a penalty as the granting of post-test year reliability spending is an exception to the general rule. We remind Pepco of the public outcry over its industry-lagging reliability performance that prompted the inclusion of Condition 8 on "Reliability Performance" as part of the Exelon-PHI Merger Order. It was stated then that ratepayers can rightfully demand reliability as an "obligation of the incumbent utility to provide it" and that it was the

[69] Clark Direct at 3, 19.
[70] Case No. 9192, Order No. 83085 at 9.

Commission's statutory obligation to regulate public service companies in a manner that promotes adequate, economical, and efficient delivery of utility services in the State.[71] We take this opportunity to provide notice that this Commission takes the obligation seriously and it will be holding Pepco to its Parent Company's reliability commitments, with the budget caps agreed to, in Order No. 86990. In this case we find that Pepco's Annual Performance Incentive, where the Company rewarded certain employees for meeting reliability metrics, is the most appropriate area in which to address Pepco's failure to meet its merger SAIFI target, as discussed more fully below in Section III(A)(10).[72]

We do not find convincing OPC witness Effron's argument that the Commission should limit recovery of post-test year reliability plant additions based on the timing between the filing of the Company's base rate case and the plant additions. Neither do we find that the recovery of post-test year reliability plant additions should be limited to seven months before the start of the rate effective period. Our past decisions do not require this outcome[73] and we do not so require now.

In granting RMA 2, we do not deviate from our recent past decisions,[74] which stated that allowance of post-test period reliability expenses is an ***exception*** to the rule of allowing recovery only of reliability investments for historical test period. This exception was adopted in order to incentivize utilities to make accelerated reliability infrastructure investments by allowing recovery of the expenses without waiting for the

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[71] PUA § 2-113(a)(1).
[72] To the extent Pepco implied in its Brief (*see* pages 35-36) that the civil penalties contained in RM43 supplant the Commission's traditional ratemaking authority to disallow reliability spending that is imprudent, we disagree. The RM43 provisions add to the Commission's regulatory authority, they do not subtract from it.
[73] Hr'g Tr. at 1214 (Effron).
[74] *See*, for example, Case No. 9424, *Delmarva Power & Light Company*, Order No. 88033 at 15.

next rate case. We do not intend for this exception to be viewed as automatic or guaranteed. Instead, we will examine post-test year reliability spend on a case by case basis. We expect the utility companies, Staff and OPC to continue to scrutinize these adjustments.

Approving this adjustment decreases rate base by $1,722,000, decreases operating income by $2,872,000, and increases the revenue requirement by 4,705,000.

### **2**. ***RMA 3: Post Test Year Reliability Closings (July 2017 through December 2017)***

In RMA 3, Pepco proposes to include in rate base reliability projects currently in CWIP that are expected to be closed to plant in service from July 2017 until the end of the year in December 2017.[75] Mr. Wolverton testified that RMA 3 costs are known and measurable because these projects do not generate any new revenue and the associated construction costs will be spent before the rate effective period commences. Additionally, he claimed that the reliability projects will be providing service to customers for the majority of the rate effective period and that customers should pay for services they receive during the rate effective period.

Staff witness Shelton testified that the Commission should not approve RMA 3.[76] She observed that the approving the adjustment would depart from traditional ratemaking practices. Additionally, she testified that because Pepco missed its SAIFI target for 2016, it should not be allowed an exception to the general rule of disallowing reliability projects outside the test year. Staff witness Smith additionally testified that the Commission has rejected estimated post-hearing reliability plant additions in Pepco's three most recent

[75] Wolverton Direct at 5.
[76] Shelton Direct at 9.

rate cases, including Case No. 9418, Case No. 9336, and Case No. 9311.[77] Mr. Smith concluded that the estimated additions are not known and measurable and are not used and useful.

OPC witness Mr. Effron testified that the Commission should deny RMA 3. He argued that the adjustment is a clear departure from traditional ratemaking principles and that it is inconsistent with the criteria developed by the Commission in Case No. 9418 and prior cases for exceptions to the general rule of including only costs within the test year. Specifically, he testified that the Commission has departed from traditional ratemaking principles only with regard to known and measurable post-test year reliability plant additions and that RMA 3 includes additions that are not known and measurable.[78] In his surrebuttal testimony, Mr. Effron concluded that "the Company's Ratemaking Adjustment 3 is entirely inconsistent with the policies set forth by the Commission in its past orders."[79]

In his rebuttal testimony, Pepco witness Wolverton argued that the reliability plant additions in RMA 3 "will be used and useful, serving and providing benefits to customers before or during the first three months of the rate effective period in this case."[80] Mr. Wolverton claimed that the costs associated with the reliability projects included in RMA 3 will be known and measurable because Pepco is only proposing to recover costs that will have been incurred and will be in CWIP as of July 31, 2017.

[77] Smith Direct at 9. Mr. Smith observed that RMA 3 includes post-test year additions expected to be closed to EPIS from July through December 2017, with a portion of such additions representing projects to be placed in service after the evidentiary hearings in this proceeding.
[78] Effron Direct at 5.
[79] Effron Surrebuttal at 4.
[80] Wolverton Rebuttal at 9.

## Decision

The Commission disallows RMA 3. Approval of this adjustment would represent a clear departure from the traditional ratemaking principles that we have adhered to and it would represent a significant expansion of the exception to the rule of allowing only costs within the test year. Additionally, the Commission has rejected estimated post-hearing reliability plant additions in Pepco's three most recent rate cases, including Case No. 9418, Case No. 9336, and Case No. 9311. RMA 3 includes plant additions that are not known and measurable.

We find unconvincing Pepco's argument that EPIS included in this adjustment – some of which may close through December 31, 2017 – will nevertheless be known and measurable because the Company will only recover costs that have been incurred and will be in CWIP as of July 31, 2017. The fact remains that this adjustment includes plant that will not close for months beyond the publication date of this order, let alone the end of the hearing date in September, which represented the last time parties could challenge Pepco's evidence. Additionally, the sheer size of RMA 3 is extraordinary. It would increase rate base by $58.67 million and decrease operating income by $731,000.[81] Approval of this adjustment would be wholly inconsistent with the concept of a historical average test year. Accordingly, RMA 3 is denied.

### 3. *RMA 15: Reduction of SERP Expense and Liability*

In RMA 15, Pepco seeks to recover a portion of its Supplemental Executive Retirement Plan ("SERP") costs spent during the test year. Specifically, Pepco requests authorization to recover the portion of the SERP benefits related to salary, such that all

[81] Staff Brief at 13. The Comparison Chart at Exhibit II shows $56.68 million because of rounding.

employees in the Company (including executives and non-executives) receive the same benefit. Pepco refers to this portion of SERP as the "restoration amount."[82] Pepco witness Weinstein defined the restoration plan as "a type of nonqualified pension plan that 'restores' the benefits that are limited by the IRC [Internal Revenue Code]."[83] The restoration plan is based on the same formula as the qualified plan, but it provides benefits on earnings in excess of IRC limits. The IRC limit is $270,000 for 2017 and is increased by Internal Revenue Service on an annual basis for cost of living increases.[84]

Pepco witness Ziminsky testified that in order to be consistent with past Commission decisions denying SERP costs, RMA 15 removes from Pepco's O&M expense the portion of SERP expense attributable to bonus and other non-qualified benefits. The resulting O&M expense includes only the portion of SERP expense attributable to restoration benefits.[85] Pepco observes that unlike previous cases where it asked for 100 percent of SERP costs, in this case, Pepco is seeking to recover the restoration portion of SERP only, which amounts to 16.5 percent of the total SERP costs.[86]

Staff witness Patterson testified that the Commission should continue to disallow 100 percent of SERP expenses, including restoration benefits. He testified that SERP is unique from a ratemaking perspective because its costs are significant, despite that fact

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[82] McGowan Direct at 33.
[83] Weinstein Direct at 4. Mr. Weinstein defines a "nonqualified pension plan" as "an employer-sponsored pension plan that is not subject to IRC limitations and that can allow for benefits to be provided on income that is not subject to IRC limitations. Forms of nonqualified pension plans are restoration plans and supplemental executive retirement plans." *Id*. at 3-4.
[84] Weinstein Direct at 5. Mr. Weinstein explained that without a SERP restoration plan, a company pension plan that provides an annual benefit of 5 percent of compensation to its employees would contribute $13,500 to an employee earning $270,000, but would only be able to contribute the same dollar amount of $13,500 (or 4.5 percent) to an employee earning $300,000, because of the IRC cap. Weinstein Direct at 5.
[85] Ziminsky Direct at 17.
[86] Pepco Brief at 54.

that it provides benefits to a very limited number of employees.[87] He noted that key executives enjoy the benefits of both SERP and normal retirement programs. Mr. Patterson observed that Staff asked Pepco to provide additional documentation or quantifiable information supporting its position that SERP benefits are necessary to the retention (or hiring) of key executives. However, Mr. Patterson noted that Pepco merely responded that "[m]ost peer utility companies offer SERP benefits, so it is important that Pepco offers a comparable compensation and benefit package."[88] Pepco did not provide specific documentation or quantifiable information supporting its contentions and it acknowledged that it "has not performed any analysis on how employees or new recruits would react if certain benefits were offered by our competitors and no longer offered by Pepco."[89] Mr. Patterson further noted that restoration benefits were included in Pepco's SERP request in Case No. 9418, which the Commission denied. Accordingly, Mr. Patterson concluded that Pepco has not met the burden of proof required to be granted SERP restoration benefits.

Mr. Effron testified on behalf of OPC that Pepco's request to recover SERP restoration benefits should be denied. He noted that in Pepco's last rate case, the Commission disallowed 100 percent of the SERP costs. Additionally, he testified that Pepco has not provided information to support its claim that it could not retain nor attract qualified key executives if Pepco no longer offered SERP as part of its executive compensation package.

[87] Patterson Direct at 2.
[88] Patterson Direct at 3-4, citing response to Staff DR No. 12-16.
[89] Patterson Direct at 4, citing Pepco's Response to Staff DR No 12-16 a-d.

In his rebuttal testimony, Pepco witness McGowan emphasized that the SERP benefits Pepco is requesting in this case are very different from those proposed in prior cases. He reiterated that Pepco is seeking recovery only of the portion of SERP that relates to the restoration plan, which represents approximately 16.5 percent of the total SERP costs.[90] Mr. McGowan further testified that the restoration plan benefits are "reasonable and prudent" and are based on the idea of treating all employees equally and fairly. He further noted that such benefits are provided by 100 percent of the utilities that Pepco surveyed.

In his rebuttal testimony, Pepco witness Ziminsky disagreed with Staff's proposal to disallow 100 percent of SERP expense while concurrently including the associated SERP liability in rate base.[91] He argued that Staff's proposal does not properly match the SERP expense and the related liability, which should be treated symmetrically in his opinion. Mr. Ziminsky therefore recommended that *if* the Commission disallows 100 percent of SERP expense (a position Mr. Ziminsky opposes), then no SERP liability should be reflected in rate base.[92]

In his surrebuttal testimony, Staff witness Patterson disagreed that Pepco's restoration benefits were significantly different than what the Company had proposed in prior years, claiming: "Expenses that have been characterized as 'restoration benefits' are an attempt to provide retirement compensation to a limited number of employees above and beyond Internal Revenue Service ("IRS") limits."[93] He also testified that Pepco had not stated whether the companies referenced in its study have received authorization to

[90] McGowan Rebuttal at 9.
[91] Ziminsky Rebuttal at 11.
[92] Ziminsky Rebuttal at 11.
[93] Patterson Surrebuttal at 2.

recover SERP benefits in rates. Regarding the symmetry of SERP expenses and related liabilities, Mr. Patterson testified during the hearing that because the liability was not included in the test period, Staff is willing to accept that representation and agrees with Mr. Ziminsky that no SERP liability should be reflected in rate base.[94]

**Decision**

Despite Pepco's efforts to make these SERP benefits appear different in kind from its previous iterations of this issue, we do not find Pepco's arguments persuasive. In Pepco's last rate case, we disallowed 100 percent of the SERP expenses.[95] The restoration benefits sought in the instant case were contained in the SERP recently denied by the Commission. We agree with Staff that in this case, the expenses that have been characterized by Pepco as restoration benefits are an attempt to provide retirement compensation to a limited number of employees above and beyond IRC limits, and the value to ratepayers of funding these expenses has not been proven. As Staff testified, SERP benefits a very small group of executives and Pepco has not provided documentation to quantify any measurable benefit to customers from its provision of SERP to these executives.[96]

During the discovery in this proceeding, Staff asked Pepco to provide additional documentation or quantifiable information to support its position that SERP benefits are necessary to the retention or acquisition of key executives. However, Pepco did not provide the requested information and it acknowledged that it has not performed any

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[94] Hr'g Tr. at 1232.
[95] *See* Case No. 9418, Order No. 87884 at 54, disallowing 100 percent of SERP benefits because Pepco failed to meet its burden of proof and because the Delaware and District of Columbia Public Service Commissions had similarly disallowed 100 percent of SERP.
[96] Patterson Direct at 6.

analysis on how employees or new recruits would react if the SERP benefits were offered by the Company's competitors and no longer offered by Pepco.[97] The Company's statement that "[m]ost peer utility companies offer SERP benefits, so it is important that Pepco offers a comparable compensation and benefit package"[98] is insufficient evidence upon which to grant the requested adjustment. Furthermore, we note that our decision to disallow 100 percent of SERP expenses reflects the position we have taken in recent Pepco and Delmarva rate cases that ratepayers should not pay for pension benefits for company executives beyond the IRS limits.

We agree with Pepco that Staff's initial recommendation does not properly match the SERP expense and the related liability, which should be treated symmetrically. Staff appears to have conceded this point during the evidentiary hearings.[99] Accordingly, we disallow 100 percent of SERP expense, with the caveat that no SERP liability will be reflected in rate base.[100] We therefore deny Pepco's request through RMA 15 to decrease rate base by $1,979,000 and increase operating income by $846,000. The effect of the Commission's decision increases operating income by $1,014,000 and decreases revenue requirement by $1,739,000.

#### 4. ***<u>RMA 22: Add Back Test Period Merger Synergies</u>***

RMA 22, involving actual test period synergies, relates to two other (uncontested) ratemaking adjustments. RMA 20 reflects the five-year average of expected synergy savings in the Pepco Maryland territory stemming from the Exelon – PHI merger. RMA 20 passes through these average expected synergy savings consistent with the

[97] Patterson Direct at 4, citing Pepco's Response to Staff DR No 12-16 a-d.
[98] Patterson Direct at 3-4, citing response to Staff DR No. 12-16.
[99] Hr'g Tr. at 1232.
[100] Ziminsky Rebuttal at 11.

methodology prescribed by the Commission in Case No. 9418. RMA 21 reflects the amortization of the merger costs to achieve over five years. Finally, RMA 22 removes the actual merger synergies experienced in the test year (as calculated by Pepco) to avoid double counting merger synergies that are provided to ratepayers.[101]

Pepco proposes RMAs 20, 21, and 22 only as its second alternative. The Company explains that its preferred alternative is to remove RMAs 20 and 22 entirely. Pepco witness McGowan testified that Pepco included RMAs 20, 21, and 22 to comply with the methodology required by the Commission in Case No. 9418, but that passing through the five-year average of expected merger synergy savings creates a number of problems for the Company as well as future ratepayers. Specifically, Mr. McGowan stated that providing average expected savings (which will be higher than the actual synergy savings in Years One and Two), will have the effect of "effectively provid[ing] a loan to customers that must be later paid by future customers as actual synergies become higher than the average in Years Four and Five."[102] Achieving the result of providing synergy savings to customers before they are actually realized will require that rates be "artificially decreased in Years One and Two, and then artificially increased in Years Four and Five."[103] Mr. McGowan argued that such a result was not required or contemplated by the Commission's Order approving the merger. Mr. McGowan therefore recommended that the Commission eliminate RMAs 20 and 22 and instead flow through actual synergies as they are realized through cost of service. On that point, Mr.

[101] Pepco witness Ziminsky further explained how RMA 22 avoids double counting: "If realized test period synergy savings were not added back into O&M expense, customers would be receiving the same synergy benefits in two places; once through the five-year average reflected in RMA 20 (as approved by the Commission in Case No. 9418), and again through lower per books O&M expense in the unadjusted test period cost of service." Ziminsky Direct at 18.
[102] McGowan Direct at 28.
[103] McGowan Direct at 28.

McGowan observed that actual synergy savings already in the test year have been measured at $6.8 million.[104]

Pepco witness Kinzel testified regarding the level of actual synergy savings in the test year, which must be subtracted from average synergy savings, should the Commission deny Pepco's request to eliminate RMAs 20 and 22. She presented a side-by-side analysis of pre- and post-merger shared-services costs. She found that there are $9.3 million of realized synergy savings during the test period, $5 million of which are allocated to Maryland distribution.[105] She found that the synergy savings are driven by lower labor costs, stemming from the reduction of redundant positions in corporate areas, as well as non-labor synergy savings in the test period, such as lower bank fees and insurance premiums. In the future, Ms. Kinzel forecasts that corporate service costs will decline from the test year to the 2017 calendar year and continue to decrease significantly as additional synergies are realized.[106] Ms. Kinzel further testified that merger synergies not incorporated in the side-by-side analysis include procurement savings, synergies derived from reducing operating costs, and other avoided costs, which provide an additional $3.4 million of synergy savings, $1.8 million of which is allocated to Maryland distribution.[107] In total, Ms. Kinzel testified that $6.8 million of actual synergy savings exist in the test year for Maryland distribution.

OPC witness Effron agreed conceptually that actual synergy savings in the test year must be subtracted from the five-year average synergy savings in order to avoid

[104] McGowan Direct at 29. Mr. McGowan noted that there is not a huge disparity between actual synergy savings and the projected five-year average of approximately $9 million.
[105] Kinzel Direct at 6.
[106] Kinzel Direct at 8.
[107] Kinzel Direct at 9.

double counting; however, he argued that Pepco overestimated the actual synergy savings in the test year.[108] For example, he testified that of the $5 million in synergy savings identified in the side-by-side study, an actual comparison of before and after corporate service expenses shows a decrease of only $1.3 million from the 2014 base year to the test year.[109] Although Mr. Effron recognizes that Pepco attributes the difference between the quantified test year merger savings and the actual reduction in corporate service expenses to the addition of new or enhanced services, he testified that "it is not clear that these additional costs resulted in any actual benefits being provided to Pepco that would not have been available in the absence of the merger."[110] Mr. Effron also took aim at the $1.3 million in synergy savings Pepco attributed to redundant employee positions, arguing that if costs related to these savings appeared in the test year, then the savings associated with the elimination of the redundant positions were not in fact achieved by the end of the test year. In summary, Mr. Effron recommended that the add-back of test period synergies related to RMA 22 be reduced by $3.726 million and that pro forma test year O&M expense be reduced by the same amount.

AOBA witness B. Oliver testified that Pepco failed to clearly demonstrate synergy savings and that the Commission should therefore not allow the Company to add back claims of realized synergy savings. In particular, Mr. Oliver criticized Pepco's inability to demonstrate synergy savings through FERC accounts, stating: "If the Company cannot identify what it has saved, there is no basis for a savings claim. For a

[108] Effron Direct at 15.
[109] Effron Direct at 16.
[110] Effron Direct at 17.

regulated utility, any savings that cannot be identified by FERC account is strictly conceptual in nature and is not subject to verification."[111]

Mr. Oliver further disputed Ms. Kinzel's testimony that Pepco receives new or enhanced services that benefit the Company. Mr. Oliver indicated that the claim of new or enhanced services obfuscates the issue of actual synergy savings realized in the test year. He testified: "those increases suggest major additional expenditures that are not supported by any quantification of additional ratepayer benefits."[112] He suggested, for example, that replacement of Executive Management labor costs with substantially greater amounts of PHI Service Company and Exelon Business Service Company charges for Executive Management services should not be considered an achievement of synergy savings.

Mr. Oliver challenged several aspects of Ms. Kinzel's side-by-side analysis, including Ms. Kinzel's use of a 2.5 percent per year inflation rate, arguing that the rate overstates actual inflation since 2014.[113] Mr. Oliver argued that by overstating actual inflation, Pepco has incorrectly assessed that its test year costs have declined in terms of constant 2014 dollars, thereby making synergy savings appear larger than they really are.[114] Mr. Oliver also provided several examples of costs that do not reconcile between the data in Ms. Kinzel's side-by-side analysis and the data Mr. Oliver relied upon to independently determine synergy savings. As a consequence, Mr. Oliver recommended that the Commission find that Pepco's assessment of synergy savings is "inaccurate and

[111] B. Oliver Direct at 8, n. 1.
[112] B. Oliver Direct at 48.
[113] B. Oliver Direct at 50.
[114] B. Oliver Direct at 50. Mr. Oliver suggested that a more accurate measure of inflation would be the 1.6 percent annual price inflation as measured by the Gross Domestic Product Price Deflator.

unreliable and that Pepco has failed to demonstrate that any merger-related synergy savings have actually been achieved."[115] Accordingly, he testified that Pepco's RMA 22, which seeks an upward adjustment to the test year revenue requirement of $6.8 million, should be denied in its entirety.[116]

In her rebuttal testimony, Pepco witness Kinzel claimed that OPC and AOBA misunderstood her side-by-side analysis, which was not meant to be an assessment of synergy savings, but rather intended only to reflect the total actual historical corporate service costs billed to Pepco, in compliance with Condition 39 of the Merger Order.[117] She therefore testified that the critiques by OPC and AOBA of Pepco's merger savings were flawed.

Company witness Ziminsky testified that a detailed protocol is followed to ensure merger savings are accurately captured, including that each synergy initiative is assigned a business owner who is responsible for tracking implementation results; forecasted and achieved savings are tracked in a centralized tracking tool; a merger integration team validates implementation results; and executive leaders are briefed regularly on the status of implementation schedules.[118] Mr. Ziminsky also criticized the conclusions by OPC and AOBA that new or enhanced services should count against synergy savings. He stated that just because "other (justifiable) cost increases have been incurred in corporate service functions during that time frame ... does not mean the Company has not realized synergy savings. Rather, it means that without those realized synergy savings, the

[115] B. Oliver Direct at 55.
[116] B. Oliver Direct at 71.
[117] Merger Condition 39 provides in relevant part: "The Joint Applicants shall provide a side-by-side comparison by function of pre- and post-merger shared services cost allocations to Delmarva and Pepco for five pre- and post-merger years."
[118] Ziminsky Rebuttal at 13.

Company's costs would be higher than they actually were."[119] In their respective surrebuttal testimonies, Mr. Effron and Mr. Oliver maintained that Pepco had overstated actual synergy savings.

**Decision**

Nothing in the Merger Order required that Pepco pass through to ratepayers the five-year average expected synergy savings as Pepco has done in RMA 20. That requirement stemmed from the Commission's decision in Pepco's last base rate case, Case No. 9418, where the Commission determined that the benefits of the Exelon-PHI merger should be passed through to ratepayers as early as possible. In that case, the Commission reasoned that because merger synergy costs are front loaded and merger synergy savings are back-ended, net merger benefits would be relatively small in the first few years, but grow considerably by the fifth year. The Commission also expressed concern that the net merger benefits could be delayed if Pepco chose not to file a rate case annually, thereby preserving to itself – at least until the next rate case – the net synergy savings. Accordingly, the Commission accepted Staff's proposal to amortize total merger costs and savings over 5 years, effectively giving ratepayers the average net merger benefits in Year 1 of the merger.

Unfortunately, the current rate case has shed light on two significant problems associated with the Commission's decision. First, the requirement to pass through the five-year average synergy savings each year creates a multimillion dollar effective "loan" from Pepco to ratepayers that future ratepayers will be required to pay back in later

[119] Ziminsky Rebuttal at 22.

years.[120] Second, the measurement of actual synergy savings in each of the five post-merger years (a process all parties agree is necessary in order to avoid double counting) is less than certain and has a decided potential for error, as demonstrated by the parties' testimony in this proceeding.

Pepco witness McGowan correctly observed that by providing average expected savings to ratepayers, RMA 20 has the effect of providing an effective loan to current customers that must be paid back in the later years of the merger.[121] That is true because average synergy savings are expected to be higher than actuals for the first few years of the merger, and are projected to be surpassed by actual synergy savings in Years 4 and 5. In effect, therefore, Pepco is passing along to customers savings that have not yet been realized, which will require that rates be artificially lower in the early years of the merger and artificially higher in the later years. It is not clear at this time, however, what the burden will be to future ratepayers of paying back the "loan" granted to current ratepayers. If other ratemaking issues place a greater burden on future ratepayers, the requirement to repay the synergy savings "loan" may be especially inopportune. Other questions further cloud this issue, such as what the consequences are to ratepayers if synergy savings do not increase in future years as expected.

All parties agreed conceptually that actual synergy savings in the test year (RMA 22) must be measured and subtracted from the five-year estimated average synergy savings in order to avoid double counting. Nevertheless, the process of measuring actual synergy savings – by its nature, the absence of a cost – proved to be highly difficult, as demonstrated by the parties' substantial divergence on this issue. Pepco witness Kinzel

[120] *See* colloquy between Chairman Hughes and Mr. McGowan, Hr'g Tr. at 159-162.
[121] McGowan Direct at 28.

presented a side-by-side analysis of pre- and post-merger shared-services costs, and examined labor-related synergy savings, such as reducing redundant positions, and non-labor savings, such as lower fees and premiums. She also found procurement savings, reductions in operating costs, and other avoided costs. She concluded that $6.8 million of actual synergy savings exist in the test year for Maryland distribution.

Mr. Effron testified to a dramatically lower figure, however, finding that Ms. Kinzel's $6.8 million estimate should be reduced by $3.726 million. He also highlighted a particularly difficult issue – the extent to which new or enhanced services should count against claimed synergy savings. Pepco's response – that rising corporate costs do not necessarily mean that synergy savings do not exist – is conceptually accurate, but fully obfuscates the task of finding actual synergy savings. What becomes clear is that the more years that pass from the closing of the merger, the more difficult it may be to project what Pepco's costs would have been had the merger not happened.

Mr. Oliver's testimony was even starker than Mr. Effron's, finding that Pepco should be given no credit for synergy savings during the test year. In challenging the accuracy of Pepco's measurement of actual synergy savings, he implicitly questioned the underlying premise of the Commission's decision in Case No. 9418 to pass through to ratepayers the projected five-year average of synergy savings. He stated: "In concept, Staff's recommendation in Case No. 9418 appears to achieve some measure of net benefit for Pepco's Maryland rate payers, but whether that savings is "real" will depend on how tightly Pepco's overall expenses are monitored and controlled. As demonstrated by Pepco's filing and data request responses in this proceeding, the Company retains substantial flexibility to move costs between categories of expenditures, and through the use of regulatory assets, move costs between periods. Although such flexibility may at times be appropriate, it erodes the confidence that can be associated with representation regarding actually achieved synergy savings."[122]

Because of the inherent difficulties of accurately measuring actual synergy savings, and the burden to future ratepayers of repaying a loan of synergy savings passed through prematurely, we find that RMAs 20 and 22 should be eliminated, as proposed by Pepco. The elimination of Pepco's RMA 20 decreases the operating income by $5,362,000 and increases the revenue requirement by $9,193,000. The elimination of Pepco's RMA 22 increases the operating income by $4,081,000 and decreases the revenue requirement by $6,997,000. The net effect of reversing Pepco's RMA 20 and 22 is an increase of $4,392,000 to revenue requirement. Finally, we note that this change in the treatment of synergy savings, while resulting in a one-time increase in the revenue requirement in this case, should result in significant savings to ratepayers over the next several years.

### 5. ***<u>RMA 26: Current Rate Case Expenses</u>***

In RMA 26, Pepco requests to recover $281,000 in rate case expenses amortized over three years.[123] Rate case expenses represent the costs for services related to the development and preparation of the rate case, including expert witness fees. Staff witness Patterson recommended that Pepco be allowed to recover only $145,000 in rate case expenses, also amortized over a three year period. In his direct testimony, Staff witness Patterson testified that the $281,000 requested by Pepco was an estimate, and that

[122] B. Oliver Direct at 74.
[123] Ziminsky Direct at 19.

Staff had not received any invoices or documentation to support actual rate case expenses incurred for the twelve-month period ending April 30, 2017.[124] He therefore recommended denial of RMA 26. He explained: "Rate case expenses should reflect only actual, prudently-incurred expenses. The use of actual costs is consistent with the regulatory principle of allowing recovery of costs that are known and measurable."[125] Nevertheless, Mr. Patterson testified that he would amend his recommendation upon receipt of additional supporting documentation by Pepco. He articulated the caveat, however, that Pepco should be allowed to include actual incurred expenses only through the end of the evidentiary hearings, so that Staff would have time to update its final position on the comparison chart, which is submitted to the Commission prior to the close of the record. During the evidentiary hearing, Staff witness Patterson testified that Pepco had updated its invoices and documentation to support actual rate case expenses of $145,000.[126] Staff's final position, therefore, is that Pepco should be allowed to amortize $145,000 of rate case expenses over three years.

AOBA witness B. Oliver testified that RMA 26 includes recovery only for Pepco's claimed "incremental costs" of the current rate case. The vast majority of Pepco's rate case expenses are recovered through test year expense in Account 992800, Regulatory Commission Expense, and related subaccounts.[127] He testified that the test year Regulatory Commission Expense for Maryland Distribution is $2.46 million.[128] He further testified that other parties to these rate cases, including AOBA, expend

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[124] Patterson Direct at 7.
[125] Patterson Direct at 7.
[126] Hr'g Tr. at 1232. (Patterson).
[127] B. Oliver Direct at 76.
[128] B. Oliver Direct at 76.

considerable resources in litigating the cases and that the Commission should consider certain alternatives to reduce the costs of litigation.

Specifically, Mr. Oliver recommended a significant and novel change in Commission treatment of rate case expenses in order to incentivize the Company to more accurately state its revenue requirement upfront and ultimately to reduce litigation expenses for all of the parties. He proposed that "the Company's allowed recovery of rate case expenses should be tied to the proportion of the Company's initial request that ultimately receives Commission approval… [w]ith the proviso that no disallowance would apply to approved amounts that are within 10% of the Company's initial request."[129] In other words, Pepco would be saddled with progressively larger rate case disallowance the higher its initial revenue requirement request was above the Commission's final determination of a just and reasonable rate.

In his rebuttal testimony, Pepco witness Ziminsky testified that the Company should be allowed to recover post-hearing rate case expenses, even if it is not able to produce actual bills prior to the evidentiary hearing for Staff review. He argued that Pepco's rate case expenses do not stop once the hearings begin. To the contrary, Pepco's expert witnesses often invoice the Company upon completion of services rendered – after the hearings have ended. Responding to AOBA's concerns, Mr. Ziminsky stated that Mr. Oliver's proposal was "arbitrary and results oriented," and that the Commission should evaluate each element of Pepco's rate increase request on its own merits, including the Company's request for rate case expenses.

[129] B. Oliver Direct at 78.

## Decision

The Commission has consistently found that rate case expenses known and measurable as of the date of the hearing are properly allowed expenses, so long as they are reasonable and do not result in the Company's total revenue requirement exceeding the amount requested initially.[130] We have also emphasized the importance of ensuring that ratepayer funds are expended only as necessary to facilitate efficient and fair rate case proceedings.

In this case, no party has offered testimony that Pepco expended rate case funds imprudently. However, Staff has limited its recommendation to allow recovery only of expenses that are known and measurable as of the end date of the evidentiary hearing. We agree with Staff and find, in accordance with our past decisions on this matter, that the submission of actual costs by the end date of the evidentiary hearing is consistent with the regulatory principle of allowing recovery of costs that are known and measurable.[131] Although Pepco argues that some expert witness bills may be submitted to it outside the end date of the evidentiary hearings, we find that adhering to the principle of allowing recovery only of known and measurable and prudently incurred costs outweighs the risk that some bills may not be submitted in time.

Regarding the amortization period, Pepco and Staff have each recommended a three-year amortization period and no party has offered an alternative period. Additionally, a three-year amortization period is consistent with the Commission's decision in Pepco's last rate case.[132]

[130] Case No. 9336, Order No. 86441 at 48.
[131] Case No. 9336, Order No. 86441 at 48.
[132] *See* Case No. 9336, Order No. 86441 at 51.

Although AOBA witness B. Oliver has submitted an original and innovative alternative to addressing rate case expenses, designed to reduce the costs of litigation in the long-run, we decline to adopt it at this time. Disallowing rate case expenses that are known and measurable and prudently incurred because the Company disagreed with parties (and ultimately the Commission) on other ratemaking issues would be contrary to the ratemaking principles this Commission has followed.

Pepco is granted authority to amortize the actual rate case expenses as calculated by Staff over three years. The effect of this decision is to decrease operating income by $29,000 and increase the revenue requirement by $50,000.

### 6. ***RMA 30: Pre-1981 Costs of Removal***

In RMA 30, Pepco proposes to change the method of income tax accounting from flow through to normalization for the cost of removal ("COR") for plant acquired prior to 1981. Currently, Pepco applies flow through accounting for assets placed in service prior to 1981 for COR. For assets placed in service after 1980 the Company applies normalization for COR.[133] Pepco witness Warren explained that COR is defined by the Federal Energy Regulatory Commission ("FERC") as "the cost of demolishing, dismantling, tearing down or otherwise removing electric plant, including the cost of transportation and handling incidental thereto."[134] The estimated COR for any particular

[133] Warren Direct at 3-4. Mr. Warren testified that utilizing normalization tax accounting, regulatory tax expense is calculated by reference to the receipts and expenditures that are recognized for ratemaking purposes. That is, tax expense is calculated by reference to book numbers regardless of how those items are reflected on the utility's tax return. Customers therefore receive the tax benefit commensurate with the expenses they fund. In contrast, using flow through tax accounting, the regulatory tax expense is calculated by reference to the receipts and expenditures that are reflected on the utility's tax return. That is, it is calculated by reference to tax numbers regardless of how those items are reflected for ratemaking purposes. Warren Direct at 6-7.

[134] Warren Direct at 3-4.

asset is charged as a cost over the asset's life, through reflection in the asset's depreciation rate. COR is accrued over the life of the asset for regulatory purposes, while it is deducted when incurred for tax purposes, thereby creating a "temporary difference" in treatment.[135]

Mr. Warren stated that the primary difference between normalization and flow through is in who holds the tax money that is generated by the temporary differences. "Applying normalization, the utility holds the tax money until it must be paid back to the government, at which time it simply pays it back. Applying flow through, customers hold the tax money and they must pay it back to the utility when the utility must pay it back to the government."[136]

Mr. Warren stated that Pepco requested and received approval to normalize the income tax consequences of COR related to post-1980 property in Case No. 7597, Order No. 65749.[137] Case No. 7597 commenced in 1981. However, for pre-1981 property, Pepco has consistently "flowed through" the income tax consequences. In 1998, Pepco requested full normalization of the COR in Case No. 8791 (including for pre-1981 property). However, prior to the Commission issuing an order, Pepco settled the case with the other parties to the proceeding. In the settlement, the Company agreed to withdraw its request to normalize the income tax consequences of pre-1981 property and it agreed not to submit another such proposal until such time as "all Pepco customers in Maryland have a choice of alternative energy suppliers."[138]

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[135] Warren Direct at 5.
[136] Warren Direct at 7.
[137] *Re Potomac Electric Power Co*. 73 MD PSC 256 (1982).
[138] *Re Potomac Elec. Power Co*., 89 Md. P.S.C. 250, 251 (1998).

Mr. Warren cited two primary reasons why Pepco has asked the Commission for authority to change the tax method of income tax accounting at this time. First, Pepco has placed in service significant amounts of Reliability Plant Additions in the past five years resulting in a significant increase to the amount of COR incurred. Second, Pepco has historically allocated (and continues to allocate) 85 percent of each year's incurred COR to pre-1981 property – a percentage that is now unreasonably high.[139] In Mr. Warren's opinion, the result of both of these factors is that the amount of allocated tax benefits inuring to customers significantly exceeded the incremental income taxes collected from the customers. If the Commission does not grant Pepco's adjustment, Mr. Warren testified that the distortion caused by flow through will be further exacerbated in future periods, leading to a greater imbalance that customers will ultimately need to address through higher rates.[140] Mr. Warren concluded that if the Commission approves normalization, incurred removal costs will no longer be flowed through, thereby preventing any increase in the regulatory asset caused by the larger than warranted tax benefit to customers. Under Pepco's proposal, the existing regulatory asset balance will be collected over the remaining useful life of the pre-1981 property.

Finally, Mr. Warren described an alternative proposal (referred to as the dispersion method) of allocating incurred COR to pre-1981 asset retirements. He testified that the Company could allocate removal costs to pre-1981 assets "based on the ratio of pre-1981 assets retired to total asset retirements (pre-1981 and post-1980)."[141]

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[139] Warren Direct at 15. Mr. Warren testified that Pepco will seek to reduce the percentage it uses to allocate incurred COR to pre-1981 asset retirements to a more appropriate percentage, regardless of whether or not the Commission approves the Company's normalization proposal. Warren Direct at 17.
[140] Warren Rebuttal at 3.
[141] Warren Direct at 18.

Mr. Warren explained that this approach would significantly reduce the amount of incurred COR allocated to pre-1981 assets. Additionally, the change to the revenue requirement would be less severe to customers, requiring a $15.4 million increase in the revenue requirement, in lieu of the $18 million increase required by the Company's preferred approach.[142]

Staff witness Smith agreed that Pepco has experienced large tax deductions related to pre-1981 COR in the last five years due to significant reliability plant additions as well as the historical allocation of 85 percent of annual COR to pre-1981 plant and 15 percent to post-1980 plant. He also acknowledged that Pepco discovered a tax regulatory asset[143] for COR a few years ago, meaning that customers received a larger tax deduction benefit with respect to pre-1981 plant than had been recovered from customers in rates.[144] Mr. Smith testified, however, that Staff does not support granting RMA 30 because the primary reason for the imbalance leading to the regulatory asset is Pepco's use of an 85 percent allocation for COR to pre-1981 plant. Mr. Smith stated that Pepco has been using the 85/15 percent allocation for years and that "Pepco had control over the allocation factor, not customers."[145] Mr. Smith further testified that Pepco's sister utilities – Baltimore Gas and Electric and Delmarva Power and Light – do not use an 85/15 percent allocation on pre-1981 and post-1980 plant COR and have not experienced similar problems to Pepco.[146] Staff concluded that the 85/15 allocation ratio "has not been remotely accurate in recent years" and that the regulatory asset that developed as a

[142] Warren Direct at 18; Tr. at 599, 613 (Warren).
[143] During the hearing, Mr. Ziminsky testified that this tax regulatory asset is not a Maryland Commission-approved regulatory asset (such as storm costs with a defined amortization period), but rather an asset that the Company has some certainty will be recoverable in later years. Hr'g Tr. at 318.
[144] Smith Direct at 13.
[145] Smith Direct at 15.
[146] Smith Direct at 15.

consequence can be viewed as the product of a "serious accounting error on the Company's part, for which ratepayers should not be asked to pay."[147]

Mr. Smith characterized the information submitted by Pepco in support of normalization as deficient at this time. He observed that Pepco's responses to data requests indicate that the Company was unable to track the book depreciation reserve by year and therefore the Company could not determine the value or remaining life of the un-depreciated pre-1981 plant.[148] Given that the majority of the distribution plant accounts have a service life of 40 to 60 years and that assets placed in service in 1980 have been in service for approximately 36 years, those assets could be in service for another 20 years or be retired in the next few years.[149] Mr. Smith testified that Pepco should be required to provide to the Commission in its next rate case the annual income tax impact of the COR allocation change and the annual balance of the tax regulatory asset.[150] Mr. Smith claimed this information is necessary in order to properly evaluate trends in Pepco's request. In the meantime, Staff recommends that the Commission deny RMA 30 and direct Pepco to continue utilizing flow through tax accounting and adjust its allocation for COR to pre-1981 plant to a more appropriate percentage based on the actual level.[151] Staff expressed a willingness to revisit Pepco's requested changes to COR in a subsequent rate case if Pepco can present more detailed information related to the annual tax effects of making such a change.

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[147] Staff Brief at 22.
[148] Smith Direct at 14.
[149] Smith Direct at 13.
[150] Smith Direct at 16.
[151] Given that in its dispersion method alternative, Pepco allocated approximately 20 percent to pre-1981 plant, Mr. Smith testified that the appropriate allocation for COR to pre-1981 plant "should be closer to 15 percent than 85 percent." Smith Direct at 16.

OPC witness Effron recommended that the Commission deny Pepco's normalization proposal as well as its dispersion method alternative, because they would "unnecessarily exacerbate rate increases being borne by Pepco's customers."[152] Mr. Effron testified that if the Commission finds that Pepco should be authorized to move to full normalization for income tax deduction for COR, then he would recommend that the shift be phased in to mitigate the immediate effect on rates paid by customers. Specifically, he recommended that the 85 percent assumption should be phased down by 8.5 percent per year, reaching zero in ten years. That is, in the first year of Mr. Effron's plan, 76.5 percent of the COR would pertain to pre-1981 vintages, while the percentage would drop to 68 percent in year 2, and by year 10, the percentage would be zero. The effect of this proposal would be to soften the impact of RMA 30, reducing Pepco's pro forma income tax expense by $10.24 million and decreasing Pepco's revenue requirement by $16.2 million.[153]

Although he preferred Pepco's initial proposal, Company witness Ziminsky testified that Mr. Effron's proposal to phase-in full normalization for COR deductions over 10 years is a "reasonable and pragmatic approach."[154] Mr. Ziminsky noted that for the rate effective date in this case, Pepco's revenues would align with the Company's income tax expense, such that there would be no mismatch or lag between the Company's revenues and expenses. However, in subsequent years, if Pepco did not file annual rate cases, Mr. Ziminsky testified that there would be potential for negative financial impacts as the COR deduction is decreased each year and rate revenues are not

[152] Effron Direct at 20.
[153] Effron Direct at 21.
[154] Ziminsky Rebuttal at 27.

updated to reflect such a decrease. Therefore, Mr. Ziminsky recommended that if the Commission accepts Mr. Effron's proposed adjustment, Pepco would track its financial losses and recover them in a future proceeding.[155]

Mr. Ziminsky opposed Staff's position on COR. Mr. Ziminsky testified that if it implemented Mr. Smith's proposal, the Company would reduce its Maryland COR flow-through from 85% to approximately 15 percent, resulting in increased income taxes. Nevertheless, the Company's revenues resulting from this rate case would not reflect the higher tax expense, thereby creating a mismatch between Pepco's expenses and revenues as of the rate effective date in this case.[156] Mr. Ziminsky concluded that "Staff's proposal would cause significant and undue negative financial impacts to the Company, particularly during 2017 and 2018."[157]

Pepco witness Warren disagreed with Mr. Smith's recommendation to defer the COR issue until the next rate case, stating that if the issue is not addressed in the current rate proceeding, "the distortion will be further exacerbated in future periods."[158] Regarding Mr. Effron's recommendation, Mr. Warren testified that Pepco's proposal is more appropriate, but he understands that Pepco finds Mr. Effron's phase-in proposal to be an "acceptable alternative."[159]

In his surrebuttal testimony, Mr. Smith stated that nothing in Pepco's responses changed his recommendation that RMA 30 should be denied at this time. Mr. Smith clarified that he did not recommend a specific figure of 15 percent, but rather, Pepco's

[155] Ziminsky Rebuttal at 28.
[156] Ziminsky Rebuttal at 30.
[157] Ziminsky Rebuttal at 30.
[158] Warren Rebuttal at 3.
[159] Warren Rebuttal at 4.

use of the dispersion alternative indicated that "the allocation should be closer to 15 percent / 85 percent rather than 85 percent / 15 percent."[160] Mr. Smith noted that this allocation could change when COR is allocated in a manner that more closely reflects the actual vintages of the equipment being removed. Regarding Mr. Effron's testimony, Mr. Smith stated that if the Commission believes an adjustment is warranted, then Mr. Effron's proposal to phase in full normalization for pre-1981 COR is "reasonable."[161]

In his surrebuttal testimony, Mr. Effron agreed with Mr. Ziminsky that the cost of removal deduction will decrease each year under the phase-in proposal. However, Mr. Effron stated that this decrease is only one of many changes affecting the Company's revenue requirements that take place from year to year. Other examples include the balances and amortization schedules of Pepco's regulatory assets, including merger costs to achieve and billing system transition costs. Mr. Effron observed that Mr. Ziminsky did not offer to track Pepco's financial gains from these expiring amortizations and refund them to customers in a future proceeding. Mr. Effron therefore testified it would be inappropriate for Pepco to treat COR asymmetrically.[162]

**Decision**

The Commission declines to accept Pepco's proposed adjustment at this time. As the record in this proceeding demonstrates, Pepco has a long history of utilizing flow through accounting for assets placed in service prior to 1981. Pepco witness Warren testified that Pepco requested approval to normalize the income tax consequences of COR related to post-1980 property in Case No. 7597, which was docketed in 1981.

[160] Smith Surrebuttal at 8.
[161] Smith Surrebuttal at 8.
[162] Effron Surrebuttal at 13.

However, Pepco did not request authority to normalize treatment of COR related to pre-1981 assets at that time. In fact, Pepco has flowed through the income tax consequences of pre-1981 assets since at least 1981.

Pepco points out that in 1998, it requested normalization of the COR in Case No. 8791 for pre-1981 property. However, before the Commission issued an order in the proceeding, Pepco settled the case with the intervening parties. In the settlement agreement, Pepco agreed to withdraw its request to normalize the income tax consequences of pre-1981 property and "the Company agree[d] not to again submit such a proposal to the Commission in any future proceeding until all Pepco customers in Maryland have a choice of alternative energy suppliers."[163]

Approximately 19 years have passed since the settlement in Case No. 8791 and over a decade has elapsed since customer choice became available to Pepco's Maryland customers.[164] The record demonstrates that all of Pepco's customers have had a choice of alternative electricity suppliers since at least 2004. Moreover, Pepco's rate freeze ended in 2006, and Pepco has filed frequent rate cases since then.[165] Nevertheless, Pepco has not proposed a change in its tax accounting method related to COR on pre-1981 plant in any case filed with the Commission since Case No. 8791.[166]

Given the amount of time that has passed since Pepco began using flow-through accounting regarding COR on pre-1981 plant, it is disturbing that Pepco has only now brought the alleged problem to the Commission's attention. The impacts of Pepco's proposed adjustment are huge. RMA 30 requires a revenue increase of $17,998,000, and

[163] *Re Potomac Elec. Power Co*., 89 Md. P.S.C. 250, 254 (1998).
[164] Hr'g Tr. at 585 (Warren).
[165] Hr'g Tr. at 585-586. (Warren).
[166] Hr'g Tr. at 584-586. (Warren).

is the single largest component of Pepco's proposed rate increase. It accounts for nearly 27 percent of the additional $67 million revenue requirement increase that Pepco seeks in this case.[167]

Another problem with Pepco's request is that the putative problem – that the amount of allocated tax benefits inuring to customers significantly exceeded the incremental income taxes collected from the customers – is largely of Pepco's own making. For years, Pepco has allocated its COR using a ratio of 85 percent to pre-1981 assets and 15 percent to post-1980 assets, even though this allocation ratio has become increasingly inaccurate.[168] Staff witness Smith testified that the correct allocation of COR to pre-1981 assets may be closer to the range of 15 to 20 percent. And as Mr. Smith stated, "Pepco had control over the allocation factor, not customers."[169] Indeed, other Maryland utilities, including specifically Baltimore Gas and Electric and Delmarva Power and Light, which do not use an 85/15 percent allocation factor on pre-1981 / post-1980 plant, have not experienced problems similar to Pepco. For these reasons, we are sympathetic to Staff's view that the regulatory asset can be viewed as the product of a "serious accounting error on the Company's part, for which ratepayers should not be asked to pay."[170]

Although Pepco brings COR to the Commission in this rate case as a pressing problem requiring immediate resolution, not all parties agree. Staff's testimony indicates that this problem will resolve itself over time, with Mr. Smith stating "COR income tax is

[167] Staff Brief at 20.
[168] Hr'g Tr. at 589-90.
[169] Smith Direct at 15. Indeed, Pepco witness Warren testified that Pepco will seek to reduce the percentage it uses to allocate incurred COR to pre-1981 asset retirements to a more appropriate percentage, regardless of whether or not the Commission approves the Company's normalization proposal. Warren Direct at 17.
[170] Staff Brief at 22.

a temporary difference. The book versus tax difference should reverse over time."[171] Pepco witness Warren appears to agree, stating: "As is the case with all temporary differences, the differences should reverse over time. … the total amount of the incremental tax imposed on customers during the depreciable lives of its pre-1981 assets should ultimately equal the actual tax benefit enjoyed by the Company when the COR associated with those assets is actually incurred."[172] Given the amount of time that Pepco has used flow through on pre-1981 COR assets, we also appreciate Staff's caution that

> the Commission should think very carefully about the advisability of changing the accounting methodology used for capital assets that are likely a minimum of 60% through their useable life. … If flow-through accounting has been used on pre-1981 assets for the last 37 years or more, why make the change to normalization accounting this late in the useful lives of the dwindling base of pre-1981 assets?[173]

The last significant problem with Pepco's RMA 30 proposal is that it does not provide sufficient information for the Commission to make an informed decision. Staff witness Smith enumerated several areas of concern that require additional information prior to the Commission making a decision on this matter. For examples, Staff indicated it would be unfair to customers to reflect an income tax change in this proceeding without further understanding how reflecting the proper allocation of COR between pre-1981 and post-1980 plant impacts the proposed income tax adjustment.[174] Additionally, Staff highlighted a deficiency of information regarding the value and the remaining life of pre-1981 plant, in order to better understand the related remaining COR.[175] Staff noted that it is not known what the actual amount of COR applicable to pre-1981 plant is currently.

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171 Smith Direct at 15.
172 Warren Direct at 15.
173 Staff Brief at 23.
174 Smith Direct at 13.
175 Smith Direct at 14.

Finally, Staff indicated that it needs more comprehensive and clear data demonstrating the alleged tax benefit customers received, and the consequences of changing the accounting for COR on pre-1981 assets to normalization, in order to make a final recommendation on the requested adjustment.

The Commission agrees that more information is needed in order to make an informed decision on this important, and costly adjustment. Accordingly, Pepco's RMA 30 is denied at this time without prejudice to the Company filing another similar proposal with more complete supporting information.

### 7. ***Deferred Storm Cost Amortization***

OPC witness Effron observed that the test year rate base includes a "Regulatory Assets" balance of $52.3 million, which includes unamortized deferred storm damage costs of approximately $8.3 million.[176] Pepco is currently amortizing these storm costs over the remaining terms extending from 2018 through 2021. Mr. Effron noted that amortization of Hurricane Sandy storm costs and the Derecho storm damage costs will be complete by July 2018, less than twelve months into the rate effective period.[177] Mr. Effron testified that Pepco did not adjust the amortization recorded in the twelve-month test year in order to reflect the completion of the amortization of these deferred storm costs in the rate effective period. Mr. Effron concluded that if the actual amortization recorded in the twelve months ending on April 30, 2017 is not modified, Pepco will over-recover the remaining balance of deferred storm damage costs. For Hurricane Sandy and the Derecho storm, the over-recovery will begin approximately nine months into the rate

[176] Effron Direct at 12.
[177] Effron Direct at 13.

effective period. Mr. Effron suggested that nothing in the record supports Pepco filing a new rate case within nine months or less.

In order to remedy this problem, Mr. Effron provided two alternative recommendations. First, Mr. Effron testified that Pepco could reduce the pro forma amortization of the deferred costs of Hurricane Sandy and the Derecho storm to the remaining balance as of September 30, 2017.[178] With that adjustment, these storm costs would be fully amortized at the end of the rate effective period. However, Mr. Effron clarified that if the rates established in this case are in effect for more than one year, the rates will continue to reflect this expense even after recovery is complete, leading to over-recovery of the costs Pepco was authorized to recover. For that reason, Mr. Effron's preferred alternative is that the balance of the deferred storm costs remaining as of September 30, 2017 be amortized over three years.[179]

Pepco witness Ziminsky disagreed with OPC's proposal to amortize the balance of the deferred storm costs remaining as of September 30, 2017 over three years. Mr. Ziminsky stated that Pepco has prudently incurred storm related expenses that are known and measurable and the Company has a right to recover those expenses over a reasonable time period.[180] Mr. Ziminsky stated that Mr. Effron's recommendation constitutes an unnecessary 26-month extension of the amortization period beyond the three-year amortization period previously deemed appropriate by the Commission. Mr. Ziminsky warned that granting OPC's request could lead to a significant number of amortizations

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[178] Effron Direct at 14.
[179] Effron Direct at 14.
[180] Ziminsky Rebuttal at 37.

continually being extended, "creating a seemingly never-ending series of amortization period extensions…"[181]

In his surrebuttal testimony, Mr. Effron retorted that while the Commission authorized recovery of these storm damage costs in a previous order over three years, it did not authorize over-recovery of the costs.[182] Mr. Effron reiterated his concern that "it is virtually certain that the rates in this case will remain in effect beyond July 2018," meaning that Pepco will over-recover if Mr. Effron's adjustments are ignored.[183] Mr. Effron further testified that in Case No. 9418, the Commission ordered the extension of the amortization period for deferred costs associated with three storms "because it will protect ratepayers from over-recovery."[184] Mr. Effron disagreed with Mr. Ziminsky's criticism that extension of the amortization period would lead to a never-ending cycle of amortization period extensions, stating that such adjustments should only be considered when there is a significant risk of substantial over-recovery, as with deferred storm costs in the present case. Finally, Mr. Effron stated that he has not proposed extending the amortization periods for any other deferred costs.

**Decision**

We agree with OPC witness Effron that the amortization of deferred storm costs recorded in the test year should be adjusted to avoid over-recovery of the remaining balance of deferred storm costs. Nothing in the record supports the proposition that Pepco will file another rate case as early as 9 months from the issuance date of this Order,

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[181] Ziminsky Rebuttal at 37.
[182] Effron Surrebuttal at 8.
[183] Effron Surrebuttal at 9.
[184] Effron Surrebuttal at 9, citing Case No. 9418, *Potomac Electric Power Company*, Order 87884, November 26, 2016, at 66.

the lack of which would lead to over-recovery of storm costs. However, under the facts of this proceeding, we find Mr. Effron's second recommendation, to amortize the storm costs over an additional 36 months, to be excessive. Instead, we will direct implementation of his first proposal, to reduce the pro forma amortization of the deferred costs of Hurricane Sandy and the Derecho storm to the remaining balance as of September 30, 2017 of $3,587,000[185] and authorize this balance be amortized over a 12-month period. That adjustment will ensure that the remaining storms balance will be fully amortized at the end of the rate effective period. While there is a risk that Pepco will over-recover those storm costs if it delays the filing of a new rate case by more than one year, the Company has indicated that it is "generally on a 12-month cycle" of filing rate cases.[186]

The Commission's adjustment to deferred storms for Hurricane Sandy and the Derecho storm reduces Pepco's pro forma test year operating expenses by $1,069,000, which increases its pro forma operating income by $638,000 and reduces the revenue requirement by $1,094,000.

### 8. ***Net Operating Loss Carryforward Adjustment***

OPC witness Effron proposed an adjustment to the balance of Pepco's accumulated deferred income taxes ("ADIT")[187] deducted from plant in service in the

[185] Mr. Effron's Exhibit DJE-2 Schedule C-1.1 Balance as of 09/30/2017 for Storm Sandy is $633,000 and for Storm Derecho is $2,954,000. The total balance for both storms is $3,587,000.
[186] Hr'g Tr. at 164 (McGowan).
[187] Mr. Effron defined ADIT as the cumulative effect of taxable temporary differences, such as the income tax effect of accelerated depreciation that is deductible for income tax purposes. As tax accelerated depreciation exceeds book depreciation, the amount of income taxes currently payable decreases. However, that reduction to current income taxes is not a permanent tax savings, but instead is treated as a deferred liability to be paid in the future when the deprecation "turns around" and book depreciation becomes greater than tax depreciation. Effron Direct at 8-9.

determination of rate base. He testified that the combination of Pepco's capital repair deductions and bonus depreciation has put the Company in a net operating loss ("NOL") position for income tax purposes in the last several years, meaning the Company has not been able to fully utilize the capital repair deductions and bonus depreciation.[188] However, the balance of ADIT reflects full utilization of the capital repairs deduction and bonus depreciation. Therefore, Mr. Effron stated that the gross balance of ADIT must be offset by a NOL deferred tax asset on Pepco's balance sheet.

Mr. Effron further testified that Pepco was included in the consolidated income tax return for Exelon Corporation and that Pepco's NOLs were used to reduce the taxable income of other corporate entities in the consolidated return. Pepco therefore increased the utilization of its NOLs, which was recognized in December 2016. Because the Exelon-PHI merger closed on March 24, 2016, Mr. Effron argued that Pepco's inclusion in Exelon's consolidated income tax return should be reflected for the whole test year (which began on May 1, 2016), rather than just a portion.[189] Moreover, Mr. Effron stated that Pepco will participate in the consolidated income tax return for Exelon Corporation for the full rate effective period, so the pro forma ADIT balance should reflect this fact. Mr. Effron recommended an adjustment of $18.51 million to the average test year rate base.

Pepco witness Ziminsky disagreed with Mr. Effron's recommendation, arguing that Mr. Effron's proposed adjustment presumes wrongly that Exelon, and by extension Pepco, had the ability to utilize Pepco's net operating loss carryforward ("NOLC") as of

[188] Effron Direct at 9.
[189] Effron Direct at 10.

the first day of the merger, on March 24, 2016.[190] However, Mr. Ziminsky testified that Exelon and Pepco are only permitted to utilize the NOLC to the extent there is sufficient taxable income recognized in the taxable period. Because Pepco did not recognize an economic benefit related to the use of the NOLC until December 2016, Mr. Ziminsky argued that it would be inappropriate to reflect the reduction in the NOLC in a period earlier than that in which Pepco was entitled to the economic benefit.

Pepco witness Warren also criticized Mr. Effron's recommendation to adjust Pepco's ADIT, arguing that the proposal would conflict with the normalization requirements of the IRS and cause significant risk to the Company and to its ratepayers.[191] Mr. Warren testified that the benefit of accelerated depreciation (basically cost-free capital) was created by Congress as an incentive to promote certain investments by businesses (including utilities) in plant and equipment. In the case of a regulated utility, however, Congress was concerned that these incentives could be extracted from the utility and flowed directly to its customers through the rate-setting process, thereby interfering with Congress' purpose of promoting investment in plant and equipment.[192] In order to prevent this outcome, Congress created normalization rules, which were designed to allow access to accelerated depreciation only to utilities whose ratemaking is consistent with Congressional intent. Mr. Warren testified that the IRS normalization rules prohibit the direct flow-through of the benefit of cost-free capital to ratepayers by means of a reduction in the tax expense element of cost of service.[193] IRS rules do allow

[190] Ziminsky Rebuttal at 35.
[191] Warren Rebuttal at 4. Mr. Warren referred to a slightly different acronym – ADFIT – which refers to the Accumulated Deferred Federal Income Tax and does not include Maryland tax.
[192] Warren Rebuttal at 5.
[193] Warren Rebuttal at 8.

some sharing of benefits with customers, however. Specifically, Mr. Warren testified that the normalization rules permit sharing the benefit of accelerated tax depreciation with customers by recognizing the ADIT as zero-cost capital, which is usually effectuated by reducing rate base by the ADIT balance. Mr. Warren testified that this is what Pepco has done.

Mr. Warren described the penalty for violating the normalization rules as "draconian," stating that the utility would no longer be able to claim accelerated depreciation in its federal tax filings.[194] A non-compliant utility would not generate any additional interest-free, governmental loans and all outstanding federal government loans would have to be paid back more rapidly than would otherwise have been the case. Mr. Warren argued that ratepayers would also be negatively impacted by a violation of normalization rules. Because the non-compliant utility would not have access to cost-free capital, its ADIT balance would be significantly reduced, which in turn would produce a higher rate base and higher rates for customers.

Mr. Warren testified that Mr. Effron's recommendation would conflict with subsection (B) of section 168(i)(9) of the IRC (referred to as the "Consistency Rule.")[195] Specifically, he argued that by imposing the requirement that there be a consistent relationship between tax expense, depreciation expense, ADIT, and rate base, Congress precludes the "mixing and matching" of regulatory conventions that could result in a utility's rate base being reduced by an amount of ADIT that does not reflect the true tax

[194] Warren Rebuttal at 9.
[195] The Consistency Rule provides: (ii) Use of inconsistent estimates and projections. The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

economics of the situation. However, Mr. Warren claimed that Mr. Effron's proposal would mix and match by using a 13-month average for all elements of rate base except for the December ADIT increase. For that single component, Mr. Effron would use a different regulatory convention – "annualization."[196]

In his surrebuttal testimony, Mr. Effron stated that he did not propose to reflect the utilization of the NOL for any period prior to 2016. Instead, he recommended treating the reduction to the NOL recognized by the Company in December 2016 as if it had been available as of the beginning of the test year, on May 1, 2016.[197] Mr. Effron disagreed with Mr. Warren's testimony regarding inconsistencies with IRS normalization rules, stating that Pepco has proposed (and OPC has not opposed) stating test year reliability plant additions at their end of test year balances.

**<u>Decision</u>**

The Commission declines to accept OPC's adjustment to reduce Pepco's ADIT balance by $18.51 million. We agree with Pepco witness Ziminsky that Pepco was not necessarily able to use its NOLC against taxable income immediately upon the closing of the merger between Exelon and PHI. Rather, Pepco and Exelon are able to utilize the NOLC only to the extent that there is sufficient taxable income recognized in the taxable period. In the record before us, Pepco demonstrated that it adjusted the NOLC quarterly, with a significant decrease in NOLC in December 2016. We agree with Pepco that it would be inappropriate in this case to treat the reduction in the NOLC as having occurred before Pepco was entitled to the economic benefit.

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[196] Warren Rebuttal at 13.
[197] Effron Surrebuttal at 4.

We find Pepco's treatment of ADIT reasonable in this case. Pepco recorded an increase to its ADIT balance in December 2016 because of its utilization of the Company's NOLC.[198] Pepco reflected the December increase in its 13-month average computation. That is, it was included for five months of the 13-month average computation. Pepco's treatment provides a benefit to ratepayers. Exelon utilized Pepco's losses as a tax credit, which benefited customers by reducing the NOLC balance and thereby reducing rate base.[199] In contrast to Pepco's approach, Mr. Effron recommended reflecting the December ADIT increase for all 13 months of the 13-month average computation. While OPC's proposal would seemingly increase the benefit to customers, we are not convinced that that treatment can be reconciled with the actual use by Pepco and Exelon of Pepco's NOLC. That is, it is necessary to have taxable income against which Pepco's NOLC losses could have been utilized.[200]

Finally, we are reluctant to accept Mr. Effron's recommendation due to the risk that the IRS could view the action as a violation of the normalization rules. Pepco has raised valid concerns that the IRS could view Mr. Effron's recommendation to annualize one component of Pepco's ADIT as a violation of the Consistency Rule. As testified to by Mr. Warren, such a finding could have draconian effects on Pepco, which would

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[198] Pepco clarified that December was not the only month in which the NOLC balance decreased as a result of Pepco or Exelon utilizing Pepco's NOLC; however, there was a significant decrease in December. Hr'g Tr.at 311. (Ziminsky).

[199] Hr'g Tr. at 311 (Ziminsky). Mr. Ziminsky further testified that the merger accelerated the speed by which Pepco could utilize its NOLC (through Exelon), which benefited ratepayers. "I would say it's one of the merger benefits that Exelon is able to use these NOLC balances faster than PHI otherwise would have in a pre-merger world. In that Pepco's NOLC asset gets used faster, by having it used faster that lowers Pepco's rate base in this case so that customers get the benefits of those NOLCs being used by Exelon as opposed to waiting for a longer period of time under PHI…" Hr'g Tr. at 314.

[200] As Pepco witness Ziminsky testified, "What is known and measurable is when did Pepco's NOLC balances get used by Exelon. … And all of those are reflected in the NOLC balance that is in the test period in this case." Hr'g Tr. at 312.

ultimately hurt the Company's ratepayers.[201] Accordingly we decline OPC's recommendation on this issue.

### 9. ***Proposal to Remove Unexplained and Unjustified O&M Expense Increases***

AOBA witness B. Oliver testified that he observed a large percentage increase in a number of Pepco's operating expenses since the last rate case that have not been explicitly identified, explained or justified.[202] He located ten FERC operating expense accounts that showed cost increases of more than 25 percent in the sixteen-month period between the end of the test year in Case No. 9418 and the end of Pepco's test year in the current proceeding. Mr. Oliver explained that his primary concern was "Pepco's failure to systematically identify, explain and justify those cost increases as part of its direct case…"[203] Mr. Oliver acknowledged that some increase in a utility's annual expenses is expected from year to year for reasons such as annual wage adjustments, however, he argued that the O&M expense inflation reported by Pepco was unreasonable. He therefore recommended that the Commission allow Pepco a 3.0 percent per year increase over the level of expense Pepco reported in Case No. 9418 for each of the accounts Mr. Oliver identified in the exhibits to his testimony, and that the Commission disallow all increases in excess of that amount.

Pepco witness Ziminsky argued that the Company has made its prima facie case that its expenses are reasonable and it has presented direct and supplemental testimony containing all of the data at issue. Mr. Ziminsky claimed that AOBA, as an active party,

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[201] Warren Rebuttal at 9.
[202] B. Oliver Direct at 65-66.
[203] B. Oliver Direct at 66.

has utilized its rights to discovery to investigate all of the Company's expenses and has failed to present any evidence that the expenses incurred by the Company are imprudent.[204] Mr. Ziminsky also testified that in response to AOBA's discovery requests, the Company provided comprehensive variance analyses to explain any differences in O&M expenses between Case No. 9418 and the current proceeding. Mr. Ziminsky concluded that Mr. Oliver's recommendation to disallow any O&M expense increases above three percent is both contrary to the evidence and arbitrary.[205]

In his surrebuttal testimony, Mr. Oliver stated that Pepco's discovery responses were provided just three days prior to the June 30, 2017 deadline for intervenor direct testimony.[206] Mr. Oliver also stated that in addition to large unjustified cost increases since Pepco's last rate case, he objected to the large percentage increases in Pepco's overall test year costs that Pepco reported just recently through its updates for actuals to the four months of projected test year data.[207] AOBA concluded that Pepco "greatly delayed presentation of the data and explanations in the exhibits, greatly impeded intervenor review of, and response to, that information."[208] Mr. Oliver also asserted that the cost increases he identified may not be recurring costs, *i.e.*, they may not be reflective of the conditions that are expected to prevail during the rate effective period, and therefore may be excludable from the revenue requirement. AOBA concluded that Pepco's delay in providing critical information may deny due process to the intervenors and that the Commission should require an $18.1 million reduction to Pepco's claimed

[204] Ziminsky Rebuttal at 32.
[205] Ziminsky Rebuttal at 34.
[206] B. Oliver Surrebuttal Testimony at 32.
[207] B. Oliver Direct at 36.
[208] AOBA Brief at 16.

O&M expense, which in turn produces a $10.8 million increase in Pepco's operating income.[209]

In its brief, Pepco argued that AOBA has failed to identify any imprudent expenses in the information the Company has provided, but merely identifies variances in costs.[210] Pepco also contended that AOBA made this same argument to the District of Columbia Public Service Commission ("DC PSC"), which dismissed the claims as unsubstantiated.

**Decision**

The Commission appreciates the hard work of AOBA witness B. Oliver as well as that of the other intervenor witnesses in this proceeding who put countless hours into scrutinizing, verifying, and challenging utility rate case requests. The adversarial nature of our adjudicatory proceedings provides invaluable information to the Commission and greatly assists it in setting rates that are just and reasonable.

The Commission is sympathetic to Mr. Oliver's claims that Pepco's O&M expenses rose significantly in certain accounts, especially at the end of the test year when Pepco updated its four months of projected expenses for actuals. AOBA cited a dispute in Case No. 9418 where Mr. Oliver discovered nonrecurring costs that were subsequently removed from Pepco's revenue requirement. Although AOBA has alleged that there may be similar nonrecurring costs in Pepco's updates, as well as other costs that may be imprudent, AOBA has not made the allegations with sufficient specificity to disallow the expenses in this proceeding. We find – similar to the DC PSC's decision on this issue –

209 AOBA Brief at 17-18.
210 Pepco Brief at 62.

that the mere identification of variances in expenditures is not sufficiently probative to disallow Pepco's cost proposals. Without more evidence, we agree with Pepco that Mr. Oliver's proposal to simply disallow all expense increases in certain accounts above three percent would be arbitrary. We therefore deny AOBA's objection on this issue.

However, we agree with Mr. Oliver that the use of a partially projected test year can impose difficulties on parties trying to review the utility's data, including when the utility provides updates only a few days before testimony is due. Mr. Oliver's testimony on this issue informs the Commission's decision to deny Pepco's request for a partially projected test year beyond the 8 month actual, four month projected, which has been previously allowed by this Commission. That decision is discussed more fully in Section III(E)(1) below.

### 10. ***Merger SAIFI Reliability Commitment – AIP***

Montgomery County witness Coffman testified that the County has consistently advocated for enhanced reliability on Pepco's system, with the expectation that the Company would ultimately achieve first quartile performance.[211] He further stated that the County expected the Exelon-PHI merger to yield "accelerated improvements in reliability."[212] Mr. Coffman noted, however, that Pepco failed to meet its commitment to achieve a SAIFI of 1.05 in 2016 by 0.03, despite Exelon committing to that goal as a condition of merger approval. He also observed that Pepco's Annual Incentive Plan ("AIP") O&M expense attributable to SAIFI was $1.8 million for calendar year 2016. Mr. Coffman acknowledged that the Commission has found AIP to be an appropriate

[211] Coffman Direct at 3.
[212] Coffman Direct at 3, citing Case No. 9361, Post-Hearing Brief of Montgomery County, May 1, 2015 at 6.

method to encourage utilities to provide efficient and effective service, but only where the performance incentives "provide benefits to Maryland ratepayers."[213] As a consequence of the Company's failure to meet its merger target, Mr. Coffman testified that Pepco ratepayers should not be required to pay for all of the incentives received by Pepco personnel related to SAIFI performance. Specifically, Mr. Coffman argued that "a portion" of the proposed AIP should be disallowed.[214]

Pepco witness McGowan agreed that Pepco's incentive compensation programs help to incentivize and drive stronger performance, but he denied that Pepco's effort in this area has not provided benefits to Maryland ratepayers.[215] He testified that despite Pepco's failure to meet its SAIFI merger target, "the Company's positive performance trend over the last decade in terms of reliability is undeniable."[216] He concluded that Montgomery County's "proposal to disallow all of Pepco's AIP expense attributable to SAIFI is inappropriate and should be rejected."[217]

In his surrebuttal testimony, Mr. Coffman clarified that he recommended only that "a portion" of the AIP be denied, not the entirety of the incentive expense. He argued that "the total incentive should not be funded at the expense of ratepayers who have not received the anticipated full benefit."[218]

**Decision**

In past decisions, the Commission has found that "non-executive AIP is an appropriate method to encourage employees to achieve operational efficiency and

[213] Coffman Direct at 5, citing Case No. 9418, Order No. 87884 at 51.
[214] Coffman Direct at 4.
[215] McGowan Rebuttal at 17.
[216] McGowan Rebuttal at 18.
[217] McGowan Rebuttal at 18.
[218] Coffman Surrebuttal at 2.

promote quality customer service, which benefits ratepayers."[219] The Commission has clarified, however, that "the Company should only be allowed to recover non-financial-related goal expenses to the extent that the Company can demonstrate that they provide benefits to Maryland ratepayers."[220]

Montgomery County makes a compelling argument that ratepayers have not received the anticipated full benefits from the financial incentives paid by Pepco for meeting reliability targets. In Condition 8 of the Merger Order, Pepco committed to achieve a SAIFI of 1.05 for 2016. The language of Condition 8 expressly superseded the less stringent reliability metrics contained in COMAR.[221] As Pepco concedes, the Company failed to meet the SAIFI reliability commitments that it made in exchange for merger approval. As a consequence, the Commission has struggled with the paradox of requiring ratepayers to fund incentive rewards to Pepco employees for failing to meet reliability targets the Company committed to achieve.[222]

In order to improve its SAIFI and ensure future compliance with the stringent targets set through the merger case, Pepco filed a Corrective Action Plan on January 31, 2017.[223] In that Corrective Action Plan, the Company has promised to improve performance to a level which meets and/or exceeds the required reliability indices specified in the Merger Order. In this proceeding, the Company has blamed its failure to meet the SAIFI target on three primary factors: (i) several intense, local storms that impacted reliability but did not qualify as Major Outage Events under COMAR; (ii) a fire

[219] Case No. 9311, Order No. 85724 at 47.
[220] Case No. 9418, Order No. 87884 at 51.
[221] Prior to its new merger commitments, Pepco's SAIFI requirement contained in COMAR was 1.25. COMAR 20.50.12.02D(1).
[222] *See* Hr'g Tr. at 413 (Commissioner O'Donnell): "I'm just struggling with paying a reward for a merger commitment that wasn't met. And having the ratepayers pay for that."
[223] Mail Log No. 212198.

at the Oak Grove Substation in Prince George's County on February 28, 2016; and (iii) the delay by the Public Service Commission of the District of Columbia in approving the merger.[224] Nevertheless, we remind Pepco that the merger commitment restricted "the reasons for non-compliance to their experiencing a major outage event as defined in COMAR 20.50.01.03(27)(a)," and none of these factors change the fact that Pepco's ratepayers did not fully benefit from the incentive payments paid by Pepco to its employees related to reliability targets.[225]

The Commission agrees with Montgomery County that a portion of the $1.8 million AIP expense should be denied. An exchange between the Commission and Mr. Ziminsky during the evidentiary hearing provides a basis for determining the exact amount we will disallow. There, Mr. Ziminsky stated that Pepco's SAIFI performance in 2015 was 1.13 and its merger target goal for 2016 was 1.05. In reaching a SAIFI of 1.08 in 2016, Pepco "got about 63 percent of the way there. It didn't get the other 37 percent. So you could sort of take a reduction of that [$1.8 million AIP] based on the fact that we didn't get 100 percent of the way from '15 to '16 SAIFI."[226] Accordingly, the Commission will disallow $667,000 of Pepco's AIP expense, which represents 37 percent of Pepco's $1.8 million AIP expense. The effect of the Commission's decision increases operating income by $675,000 and decreases the revenue requirement by $1,157,000.

**11. *RM54 Purchase of Receivables Costs***

Pepco's proposed adjustments related to Purchase of Receivables ("POR") costs stem from the Commission's decisions in Rule Making 54, *Revisions to COMAR 20.32,*

[224] Clark Direct at 11.
[225] Order No. 86990 at 61.
[226] Hr'g Tr. at 412.

*20.51, 20.53, and 20.59 - Competitive Electricity and Gas Supply* ("RM54"). In order to comply with RM54 requirements, Pepco added additional capabilities to its billing system to allow customer accelerated switching between third party suppliers and Standard Offer Service. In an April 20, 2017 filing that came before the Commission in its July 5, 2017 Administrative Meeting, Pepco proposed to update its POR Supplier Discount Rate to include in its POR rates $868,343.88 for billing system software enhancements undertaken by Pepco in order to comply with the RM54 COMAR revisions.[227] On August 1, 2017, the Commission issued a Letter Order determining that the COMAR revisions adopted in RM54 provide a benefit to all customers, and that it would not be appropriate for utilities to recover RM54 program development costs through the calculation of the POR discount rate.[228] Instead, the Commission held that such costs should be recovered through a base rate case, where POR costs could be spread among all customers.

In response to the Commission's August 1, 2017 Letter Order, Pepco filed the Additional Supplemental Testimony of Jay C. Ziminsky. Mr. Ziminsky testified that he endorses two alternative proposals for addressing POR costs. First, he explained that Pepco retains a Supplier Liability Fund, which represents a liability on Pepco's balance sheet in the amount of $1.3 million, and constitutes the over-collection in the Purchase of Receivables primarily related to late payment revenues on behalf of third party suppliers.[229] Mr. Ziminsky testified that under this alternative, the Commission would remove the above referenced amounts from rate base and amortization expense, resulting

[227] *See* Pepco's August 9, 2017 Motion for Leave to File Additional Supplemental Testimony regarding Recovery of RM54 Program Development Costs at 2.
[228] Letter Order at 3.
[229] Ziminsky Additional Supplemental at 3.

in a $79,000 decrease to Pepco's revenue requirement. The Company would then reverse the amortization expense from Pepco Account 903 and record it as a reduction to the supplier liability fund. Finally, Pepco would no longer allocate the RM54 implementation costs as part of the net service company asset in its rate base. If the Commission adopts this option, Pepco requests that it grant explicit authorization for the use of the supplier liability fund to recover the RM54 implementation costs.[230] Second, if the Commission determines not to authorize the use of the supplier liability fund, Mr. Ziminsky testified that Pepco will collect RM54 implementation costs through the normal ratemaking process, over the life of the asset.

Staff witness Patterson initially recommended that Pepco recover RM54 POR costs through the Company's POR rates, amortized over two years, with certain adjustments to avoid double recovery.[231] However, in his Surrebuttal testimony, Mr. Patterson amended his recommendation to be consistent with the Commission's August 1, 2017 decision to include the costs of recent programming changes in base rates.[232] During the evidentiary hearing, Mr. Patterson discussed Pepco's proposal to recover RM54 POR costs through the Supplier Liability Fund. He clarified that "Staff has no problem with it going through a supplier liability fund as long as it reduces the revenue requirement."[233] In its brief, Staff observed that although RM54 POR costs are relatively small, recovering the costs through the Supplier Liability Fund "is the option that lowers

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[230] Ziminsky Additional Supplemental at 4.
[231] Patterson Direct at 9.
[232] Patterson Surrebuttal at 6.
[233] Hr'g Tr. at 1233.

costs to ratepayers" and it does so by tapping a fund that neither Pepco nor any other party is otherwise able to access.[234]

## Decision

In its August 1, 2017 Letter Order, the Commission directed that the costs associated with implementation of any changes required by RM54 should not be included in the POR discount rate, but rather should be considered in a base rate case where costs would be spread among all ratepayers. The Commission also stated in that order that it would evaluate the appropriateness of allowing RM54 cost recovery from the balance of the Supplier Liability Fund.

Pepco has demonstrated through Company witness Ziminsky that the costs expended related to RM54 POR were reasonable and necessary in order to add additional capabilities to the Company's billing system to allow customer accelerated switching between third party suppliers and Standard Offer Service. Accordingly, the Commission grants the Company's request for full recovery of RM54 costs.

Regarding the method of recovery, the Commission finds that tapping the Supplier Liability Fund is the optimal method of recovery at this time. As Staff explained, it is the option that lowers costs to ratepayers. Additionally, Mr. Ziminsky assured the Commission that there is sufficient balance in the Fund to recover RM54 implementation costs.[235] Pepco is therefore explicitly authorized to use the Supplier Liability Fund to recover RM54 implementation costs.

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[234] Staff Brief at 17-18.
[235] Hr'g Tr. at 380 (Ziminsky).

### 12. ***Cash Working Capital***

The Company proposed RMA 33 to adjust the Company's cash working capital allowance to reflect the use of adjusted cost of service amounts, including pro forma interest expense. Cash working capital is generally calculated with a lead lag study. The lead lag study is recognized as an accurate method of determining cash working capital because it is based on a detailed analysis of company specific data. This method estimates the timing difference between (1) when the Company renders and receives payment for its services (revenue lag), versus (2) when the Company incurs and pays its operating expenses (expense lag). In the present proceeding, we have determined that the recalculated cash working capital reduces the revenue requirement by $631,000.

### 13. ***AFUDC Synchronization***

Allowance for Funds Used During Construction ("AFUDC") is computed by multiplying the rate of return authorized by the Commission in this case by the average balance of test period Construction Work in Progress ("CWIP") accruing AFUDC. Accordingly, the Commission's adjustment to AFUDC decreases the operating income by $221,000 and increases the revenue requirement by $379,000.

### 14. ***Interest Synchronization***

Interest synchronization is the procedure that is used to adjust the Company's interest deduction for state and federal income taxes which results from various ratemaking decisions. Commission interest synchronization is calculated by multiplying the Commission's authorized rate base by the Commission's authorized weighted cost of debt. That amount is then compared to the Company's interest on debt. The difference between the two amounts is then adjusted for state and federal income taxes to arrive at the necessary operating income adjustment. The Commission's adjustment to interest synchronization increases the operating income by $353,000 and decreases revenue requirement by $605,000. The Commission's methodology is consistent with methodology used by Staff for calculating the interest synchronization adjustment.[236]

### B. Cost of Capital

A company's cost of capital, or overall rate of return ("ROR"), consists of its return on equity ("ROE") and return on the cost of long-term debt. The ROR is the rate at which the Company has an opportunity to earn a return on its investment in order to attract and retain investors in a competitive market. While the cost of debt can be directly observed, as debt instruments are generally issued subject to fixed, predetermined interest rates, the ROE for a company such as Pepco requires more analysis. Often, a company's ROE is calculated using several methodologies, some of which require the use of a group of companies deemed comparable in risk—*i.e.*, a proxy. The resulting ROE should comport with requirements of *Bluefield*[237] and *Hope*[238], wherein the Supreme Court ruled that a utility's rate of return on equity must be comparable to returns earned on investments of similar risk, sufficient to ensure confidence in the company's financial integrity, maintain and support the company's credit, and attract investment in its securities.

The Commission looks to the analyses of the parties, which vary in methodology and approach. OPC and Staff accepted the Company's proposed capital structure and weighted cost of debt, however AOBA raised various issues regarding the Company's

[236] Staff Brief at 19.

[237] *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923).

[238] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

capital structure. The parties presented differing estimations with regard to an appropriate ROE, and thus recommended differing RORs.

### 1. ***<u>Company Position</u>***

Pepco witness Hevert[239] proposed a return on Pepco's common equity ranging from 10.00% to 10.75%, with a final recommendation of 10.10%.[240] Mr. Hevert based his ROE recommendation, in part, on data from 22 proxy companies he selected from those identified as electric utility companies by the investment research firm, Value Line.[241] The list included both vertically integrated companies and companies that engaged only in electric transmission and distribution.[242]

In calculating Pepco's ROE, Mr. Hevert applied three analytical approaches, with variations to two of the three approaches: two variants of discounted cash flow ("DCF"); two variants of the capital asset pricing model ("CAPM"); and a "bond yield plus risk premium" ("RP") approach. He also considered additional factors, such as capital market conditions and Pepco's flotation costs.[243]

Mr. Hevert started with the constant growth DCF method. The DCF approach is based on the theory that a stock's current price represents the present value of all its expected future cash flows, and expresses the Cost of Equity as the sum of the expected

[239] Mr. Hevert previously testified on behalf of Pepco in the Company's last two rate cases, Case Nos. 9336 and 9418, regarding the Company's cost of capital.
[240] Direct Testimony of Robert B. Hevert ("Hevert Direct") at 6.
[241] Mr. Hevert excluded from his proxy list: companies that did not consistently pay quarterly cash dividends; companies whose regulated operating electric income over the three most recently reported fiscal years was less than 60% of total regulated operating income; and companies known to be involved in a merger or other significant transaction. He also expressly excluded Exelon Corporation, PHI's new parent company. Hevert Direct at 15.
[242] Mr. Hevert commented that there are no "pure play" state jurisdictional electric transmission and distribution ("T&D") companies to be used as a proxy for Pepco in Maryland. Hevert Direct at 16.
[243] Hevert Direct at 19.

dividend yield and long-term growth rate.[244] He used stock price data from multiple periods, expected dividend yield data, and earnings per share ("EPS") growth estimates from Zacks, First Call, and Value Line.[245] He reported the results from his calculations - a mean range of 8.84% to 8.89% and a mean high range of 9.80% to 9.85%.[246] However, Mr. Hevert concluded that the mean and mean low constant growth DCF results are "far-removed" from recently authorized returns and should therefore be given less weight than other methods in determining the Company's ROE.[247]

To address certain limiting assumptions underlying the constant growth form of the DCF model, Mr. Hevert applied the multi-stage DCF model to the same proxy group, which accounts for different growth rates over three distinct stages.[248] He calculated a long-term growth rate of 5.50% based on the real Gross Domestic Product (GDP) growth rate of 3.22% from 1929 through 2016, and an inflation rate of 2.21%.[249]

Mr. Hevert's unadjusted multi-stage DCF analysis resulted in a low growth range of 9.56% to 9.69%, a mean growth range of 10.20% to 10.33%, and a high growth range of 10.83% to 10.96%.[250]

Mr. Hevert performed a CAPM analysis, which estimates the Cost of Equity as a function of a risk-free return plus a risk premium, as well as an "empirical CAPM" analysis, or "ECAPM".[251] He used three different estimates of the risk-free rate, and

[244] Hevert Direct at 19.
[245] *Id.* at 22.
[246] *Id.* at 23.
[247] *Id.* at 24.
[248] Hevert Direct at 25.
[249] *Id.* at 27-28.
[250] *Id.* at 29.
[251] *Id.* at 29-31.

developed two forward-looking estimates of the market risk premium.[252] The result of Mr. Hevert's CAPM analysis is a ROE range of 9.08% to 12.10%.[253] The result of his ECAPM analysis is a ROE range of 10.01% to 12.89%.[254]

Lastly, Mr. Hevert applied the bond yield plus risk premium, or RP method. The equity risk premium is the difference between the historical Cost of Equity (authorized returns for electric utilities) and long-term Treasury yields.[255] Mr. Hevert used a base rate consisting of the current long-term 30-year Treasury yield and authorized returns for electric utilities from January 1, 1980 to February 28, 2017.[256] Mr. Hevert calculated an ROE range based on this method of 10.00% and 10.33%.[257]

Mr. Hevert discussed other considerations in determining cost of capital, including regulatory environment. He concluded that although Pepco has some rate mechanisms in place, it is not able to take advantage of other regulatory lag-reducing mechanisms. He believes his recommended ROE is reasonable given that the Company faces somewhat higher risks than others in its proxy group.[258]

Mr. Hevert calculated a flotation recovery adjustment of 0.12% (12 basis points) by modifying the DCF calculation to provide a dividend yield that would reimburse investors for issuance costs, *i.e.*, recognize the cost of issuing equity incurred by Exelon and the proxy companies in their most recent two issuances.[259] Mr. Hevert disagrees with

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[252] Mr. Hevert used (1) the current 30-day average yield of 3.03% on 30-year U.S. Treasury bonds, (2) the near-term projected 30-year Treasury yield of 3.40%, and (3) the long-term projected 30-year Treasury yield of 4.35%. *Id.* at 32.
[253] *Id.* at 34.
[254] *Id.* at 34.
[255] *Id.* at 35.
[256] *Id.* at 35.
[257] *Id.* at 37.
[258] *Id.* at 42.
[259] *Id.* at 43.

the Commission's position in Pepco's last rate case, Case No. 9418, that a flotation cost adjustment is only appropriate when new equity is issued.[260] He did not adjust his recommended ROE by 12 basis points; Mr. Hevert considered the effect of flotation costs, in addition to Pepco's other business risks in determining where the Company's ROE falls within the range of results.[261]

Mr. Hevert discussed the capital market environment, noting that it appears that the constant growth DCF results are at odds with market conditions.[262] He stated that interest rates have increased from the low levels experienced in early 2017, and that market-based data indicate investors' expectations of rising interest rates in the near and longer term.[263] As the economy grows and as interest rates continue to rise, Mr. Hevert believes it is reasonable to expect lower utility valuations, higher dividend yields and higher growth rates.[264] These variables would increase the COE arising out of the DCF model.[265] Thus, Mr. Hevert believes the DCF-based results should be viewed very carefully, with somewhat more weight given to the risk premium-based methods, hence his recommended ROE range of 10.00% to 10.75%.[266] Within that range, Mr. Hevert testified that an ROE of 10.10% is reasonable and appropriate.[267]

With regard to the Company's capital structure, Mr. Hevert calculated the average capital structure for each of his proxy companies over the last eight quarters. The overall mean common equity ratio for the proxy companies was 51.94% (with a range of 45.50%

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[260] *Id.* at 44.
[261] *Id.* at 45.
[262] *Id.* at 48-49.
[263] *Id.* at 56.
[264] *Id.* at 56.
[265] *Id.*
[266] *Id.* at 58.
[267] *Id.* at 60.

to 58.48%) and the mean long-term debt ratio was 48.06%.[268] He therefore concluded that Pepco's proposed common equity ratio of 50.15% was appropriate and consistent with the capital structures of the proxy companies.[269]

In his Rebuttal Testimony, Mr. Hevert updated his calculations for his DCF, CAPM, and RP cost of equity analyses with data through June 30, 2017. He applied those analyses to an updated proxy group which includes three additional companies.[270] He updated his analysis of the capital structures of his proxy companies and found that Pepco's capital structure remained consistent with the capital structures of the proxy companies.[271] He also refuted the analyses and recommendations of the other parties' witnesses.

In live rejoinder at the hearing in this case, Mr. Hevert continued to defend his recommended ROE and his use of the multi-stage DCF and empirical ECAPM methods.[272] On cross examination by Staff, Mr. Hevert stated that the fundamental difference between the present case and Pepco's most recent rate case, Case No. 9418, is that during Case No. 9418 central banks were still taking a very active role in managing capital markets.[273] He stated that we are not in that condition anymore, such that although there have been a series of geopolitical events, changes in interest rates have not been as abrupt or acute.[274] Despite this "fundamentally different market now" and the fact that the 30-year treasury yield has increased about 60 basis points since last year, the range of results from his analyses in this case is not very different from his range of

[268] *Id.* at 59.
[269] *Id.* at 59.
[270] Rebuttal Testimony of Robert B. Hevert ("Hevert Rebuttal") at 5-6.
[271] Hevert Rebuttal at 99-100.
[272] Hr'g Tr. at 718-724.
[273] Hr'g Tr. at 744.
[274] Hr'g Tr. at 744-45.

results in the most recent Pepco and Delmarva rates cases in which he testified, Case Nos. 9418 and 9424.[275]

Pepco witness Kevin M. McGowan filed supplemental direct testimony to update the Company's requested rate of return (ROR) based upon its most recent long-term debt issuance on May 22, 2017.[276] The overall cost of long-term debt decreased from 5.45% to 5.35% because of the lower 4.15% interest rate on the newly issued debt. Applying the Company's pro forma capital structure as of March 31, 2017, consisting of 49.85% long-term debt, and Mr. Hevert's cost of capital analysis, the ROR decreased from 7.79% to 7.74%.[277]

Pepco Witness McGowan submitted testimony to rebut Mr. Oliver's testimony and recommendation as to capital structure. Mr. McGowan acknowledges that the long-term debt issuance and related equity contribution both occurred after the April 30 test period, however, he opined that both are equally known and measurable changes to the test period data and should be used when setting rates.[278] Mr. McGowan contends that if the post-test period debt financing is included in the pro-forma capital structure, then the associated equity contribution must also be included.[279] He argues that instead of exposing ratepayers to a higher overall cost of capital as suggested by AOBA Witness Oliver, the inclusion of the post test period long-term debt issuance and equity contribution reduces the revenue requirement by $1.5 million and thus provides a cost

[275] Hr'g Tr. at 745.
[276] Supplemental Direct Testimony of Kevin M. McGowan, June 7, 2017 ("McGowan Suppl. Direct") at 1.
[277] McGowan Suppl. Direct at 2.
[278] Rebuttal Testimony of Kevin M. McGowan ("McGowan Rebuttal") at 5.
[279] McGowan Rebuttal at 6.

savings to ratepayers.[280] Moreover, Mr. McGowan contends that the Commission approved a similar approach in Case Nos. 9311 and 9336.[281]

At the hearing in this case, on rejoinder, Mr. McGowan clarified the basis of Pepco's proposed capital structure. He explained that the proposed capital structure is based on "the historic March 31, 2017 capital structure modified for the $200 million debt issuance and the equity contribution needed to maintain the Company's equity ratio after the debt was issued."[282] On cross-examination, Mr. McGowan admitted that the Company estimated its post-test year equity infusion in an amount that would keep its capital structure the same - 50.15% common equity and 49.85% long-term debt – after its May 22, 2017 debt issuance.[283] Mr. McGowan stated that the modifications, including the equity contribution in June, are now, as of the date of the hearing, known and measurable.[284] He stated that the actual capital structure as of June 30, 2017 has an equity ratio of 50.17% (as opposed to the 50.15% reflected in the Company's supplemental direct testimony).[285]

### 2. <u>Other Parties' Positions</u>

#### *a. AOBA*

AOBA witness Bruce Oliver recommended that the Commission amend the capital structure presented in Company Witness McGowan's Supplemental Direct Testimony to eliminate the proposed $174 million pro forma addition to common equity

[280] McGowan Rebuttal at 6.
[281] McGowan Rebuttal at 8.
[282] Hr'g Tr. at 15.
[283] Hr'g Tr. at 68.
[284] Hr'g Tr. at 16.
[285] Hr'g Tr. at 17.

because it is not "known and measurable."[286] Mr. Oliver contends that the Company's request for a significant unexplained and unsupported pro forma increase in its common equity exposes Maryland ratepayers to higher than appropriate overall costs of capital.[287] Mr. Oliver recommended adoption of a capital structure for ratemaking purposes of 51.65% long-term debt and 48.35% common equity.[288]

Mr. Oliver testified that Pepco's requested returns significantly overstate the Company's required returns.[289] He noted that the majority of Witness Hevert's ROE estimates are lower in this case than the estimates he presented in Case No. 9418, yet his suggested ROE range is the same as he offered in that case.[290]

Mr. Oliver criticized Mr. Hevert's proxy group as being comprised almost exclusively of holding companies, most of which have substantial investment in vertically integrated utility operations, and/or non-regulated utility business ventures, and, as such, have risk and return requirements that are not similar to those for Pepco.[291] Mr. Oliver also testified that Mr. Hevert's ROE recommendations have exceeded regulator's authorized returns in cases in which he presented an ROE recommendation by an average of 77 basis points.[292]

With regard to Mr. Hevert's DCF analysis, Mr. Oliver chided Mr. Hevert for his use of a terminal price/earnings (P/E) ratio of 24.76 which Mr. Oliver stated drives Mr. Hevert's multi-stage DCF results to much higher levels for all scenarios.[293] Mr. Oliver

[286] Direct Testimony of AOBA Witness Bruce R. Oliver ("Oliver Direct") at 18.
[287] Oliver Direct at 18.
[288] Oliver Direct at 18.
[289] Oliver Direct at 19.
[290] Oliver Direct at 20.
[291] Oliver Direct at 21, 23.
[292] Oliver Direct at 22.
[293] Oliver Direct at 28-29.

believes use of the 24.76 terminal price/earnings (P/E) ratio is inappropriate because it is not reflective of the price/earnings ratio that would be applicable to a stand-alone distribution utility, which would typically be less than 20.[294] Mr. Oliver also criticized Mr. Hevert for his use of 30-day, 90-day, and 180-day average periods for stock prices, and for asymmetrically removing his "mean low" and "median low" ROE estimates from his results, which biased his ROR recommendation upward.[295]

Mr. Oliver also criticized Mr. Hevert's CAPM and ECAPM analyses, and criticized his bond yield plus risk premium analysis as well. Mr. Oliver found no support for Mr. Hevert's flotation cost adjustment to his cost of equity estimates.[296]

Mr. Oliver finds Witness Hevert's flotation cost adjustment inappropriate for three reasons, because (1) the proposed flotation cost adjustment is within the margin of error for Mr. Hevert's cost of equity estimates; (2) as a subsidiary of Pepco Holdings and now Exelon, Pepco has not issued publicly-traded equity for years and is far removed from Exelon's issuance of equity; and (3) the application of the flotation cost adjustment in perpetuity can be expected to over-recover the flotation costs actually incurred, and with gross-up for taxes, results in an expensive burden to ratepayers.[297] Mr. Oliver recommends an amortization approach whereby specific amounts of issuance expenses for which ratepayers are responsible are identified and those costs are amortized over an appropriate time period.[298] Mr. Oliver recommends that no equity flotation costs be recovered from Pepco's Maryland ratepayers in the absence of a reasonable and

[294] Oliver Direct at 29-31.
[295] Oliver Direct at 32-33.
[296] Oliver Direct at 39-42.
[297] Oliver Direct at 41.
[298] Oliver Direct at 41-42.

documented assessment of the Company's share of any actual equity issuance costs incurred.[299]

Mr. Oliver recommends approval of a 9.10% ROE in this proceeding based on cost of equity estimates computed using three methods: (1) constant growth DCF, (2) CAPM, and (3) the Regulators Adjustment Method ("RAM").[300]

Pepco Witness Hevert responded to Mr. Oliver's Direct Testimony disagreeing with: (1) the reasonableness of his "Regulator Adjustment Method"; (2) the risk-comparableness of the proxy group; (3) the application of the DCF model; (4) the application of the CAPM, in particular Mr. Oliver's market risk premium estimates as unsupported; and (5) the need to consider flotation costs.

Mr. Hevert stated that the premise of Mr. Oliver's Regulator Adjustment Method is that regulatory commissions arrive at ROE determinations by making a downward adjustment to a subject utility's proposed return, a premise for which Mr. Hevert contends there is no evidence, and which would have negative policy implications.[301]

Mr. Hevert noted that Mr. Oliver was the only witness to rely on an annual stock price averaging period, while OPC Witness Woolridge relied on the same averaging periods as Mr. Hevert and Staff Witness VanderHeyden relied on six-month averaging periods.[302]

Mr. Hevert surmised that Mr. Oliver used Equity Risk Premia based on utility stock returns, not Market Risk Premia based on market returns in his CAPM analyses.[303]

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[299] Oliver Direct at 42.
[300] Oliver Direct at 42.
[301] Rebuttal Testimony of Robert B. Hevert ("Hevert Rebuttal") at 24.
[302] Hevert Rebuttal at 28.
[303] Hevert Rebuttal at 34.

Mr. Hevert calculated that including Mr. Oliver's corrected Market Risk Premia into his analysis would increase his CAPM results from a range of 8.01% to 10.24% to a range of 9.86% to 12.35%.[304]

Mr. Oliver submitted Surrebuttal Testimony addressing, among other things, (1) Witness McGowan's rebuttal on capital structure issues; and (2) Mr. Hevert's rebuttal with respect to the terminal P/E ratio used in his multi-stage DCF analyses.

Mr. Oliver argues that although Pepco witnesses refer to the Company's equity contribution as being associated with its debt issuance, nothing necessitates a link between the debt issuance and a specific amount of equity contribution.[305] Mr. Oliver notes that Pepco did not receive an equity infusion of $174 million as indicated in the schedules attached to Witness McGowan's Supplemental Direct Testimony.[306] According to Mr. Oliver, the actual equity infusion received by Pepco from PHI, as reported in the PHI SEC 10-Q for the quarter ended June 30, 2017 was $161 million.[307] Mr. Oliver thinks that Pepco's final capital structure is unclear given, among other things, the differing amount of equity infusion, a dividend payment made one day after the Company's filing of Supplemental Direct Testimony, and retained earnings.[308] Mr. Oliver observed that the computed revenue requirement reduction of $1.5 million would be substantially greater if Pepco's new long-term debt issuance was not linked to an equity infusion.[309]

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[304] Hevert Rebuttal at 35.
[305] Surrebuttal Testimony of Bruce R. Oliver ("Oliver Surrebuttal") at 15-16.
[306] Oliver Surrebuttal at 16.
[307] Oliver Surrebuttal at 16.
[308] Oliver Surrebuttal at 17-19.
[309] Oliver Surrebuttal at 20.

Mr. Oliver maintains that his 77 basis point adjustment under his Regulators' Adjustment Method is valid.[310] Mr. Oliver reiterated that the results of Pepco Witness Hevert's multi-stage DCF analyses are inappropriately driven by short-term market price and short-term earnings considerations when terminal P/E ratios should reflect more stable long-term considerations.[311]

***b. OPC***

OPC witness Dr. Woolridge adopted Pepco's proposed capital structure and long-term debt cost rate.[312] His main issue was with the Company's proposed common equity cost estimate. Dr. Woolridge applied the DCF and CAPM methods to his proxy group of electric utilities arriving at a recommended ROE of 8.75%, which was at the upper end of his equity cost rate range of 7.6% to 8.85%.[313] Using Pepco's proposed debt cost rate and capital structure, Dr. Woolridge calculated an overall ROR of 7.06%.[314]

Dr. Woolridge selected 30 electric utilities as his proxy group (the "Electric Proxy Group"), using different criteria than Pepco witness Hevert used to select his 22 utilities.[315] Dr. Woolridge relied primarily on the DCF model to estimate the cost of equity capital, finding that the DCF model provides the best measure of equity cost rates for utilities.[316] In Dr. Woolridge's opinion, the constant-growth DCF model in particular is appropriate for public utilities because of their relative stability and regulated status.[317] Dr. Woolridge did not rely exclusively on EPS growth rate forecasts for his DCF model

[310] Oliver Surrebuttal at 21.
[311] Oliver Surrebuttal at 22.
[312] Direct Testimony of J. Randall Woolridge ("Woolridge Direct") at 3-4.
[313] Woolridge Direct at 4.
[314] Woolridge Direct at 4.
[315] Woolridge Direct at 28-29.
[316] Woolridge Direct at 38.
[317] Woolridge Direct at 41.

growth rates because long-term EPS growth rate forecasts of Wall Street securities analysts are "overly optimistic and upwardly biased" and will produce an overstated equity cost rate.[318] Dr. Hevert determined that the appropriate projected growth rate for his Electric Proxy Group was 5.25%.[319] Dr. Woolridge determined that the appropriate projected growth rate for the Hevert Proxy Group was 5.5%.[320] For the Electric Proxy Group, the resulting equity cost rate was 8.65%, and for the Hevert Proxy Group is was 8.85%.

Dr. Woolridge also performed a CAPM analysis but gave these results less weight because he believes that risk premium studies provide a "less reliable indication of equity cost rates for public utilities."[321] Using standard CAPM components, Dr. Woolridge determined an equity cost rate of 7.6% for the Electric Proxy Group and 7.9% for the Hevert Proxy Group.[322]

Given the results of his DCF and CAPM analyses, Dr. Woolridge calculated an ROE range of 7.60% to 8.95% for both proxy groups. Because he relied primarily on the DCF model, he recommended an ROE of 8.75% as his primary recommendation.[323] If the Commission were to apply the concept of gradualism to this case, Dr. Woolridge would offer an alternative ROE of 9.0%.[324]

Dr. Woolridge believes an ROE of 8.75% (or 9% applying gradualism) is appropriate for several reasons including that capital costs for utilities, as indicated by long-term bond yields, are still at historically low levels, interest rates are likely to remain

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318 Woolridge Direct at 48-49.
319 Woolridge Direct at 52.
320 Woolridge Direct at 52.
321 Woolridge Direct at 38.
322 Woolridge Direct at 63.
323 Woolridge Direct at 64.
324 Woolridge Direct at 64.

at low levels for some time, and authorized ROEs for electric utility and gas distribution companies have declined in recent years.[325] Citing Regulatory Research Associates, Dr. Woolridge testified that "authorized ROEs for electric utilities have declined from 10.01% in 2012, to 9.8% in 2013, to 9.76% in 2014, to 9.58% in 2015, and to 9.60% in 2016."[326]

Dr. Woolridge criticized Mr. Hevert's DCF equity cost estimates for: (1) his exclusive use of earnings per share growth rates of Wall Street analysts and Value Line; (2) his use of an inflated terminal GDP growth rate of 5.50% in his multi-stage DCF model; and (3) his inclusion of flotation costs.[327] Dr. Woolridge also disagreed with the base interest rate and market or equity risk premiums in Mr. Hevert's CAPM and Bond Yield Risk Premium ("BYRP") approaches.[328]

Pepco Witness Hevert submitted rebuttal testimony including in response to Dr. Woolridge's testimony. In reviewing Dr. Woolridge's ROE analysis, Mr. Hevert challenged the reasonableness of OPC's recommendation, pointing out that Dr. Woolridge's recommended ROE is 80-125 basis points lower than the recent average returns for electric utilities and up to 100 basis points lower than the ROEs recently authorized by the Commission.[329] Mr. Hevert also disagreed with Dr. Woolridge's proxy group selection and argued that the companies were not sufficiently comparable to Pepco.[330]

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325 Woolridge Direct at 65.
326 Woolridge Direct at 65-66.
327 Woolridge Direct at 70.
328 Woolridge Direct at 70.
329 Hevert Rebuttal at 41.
330 Hevert Rebuttal at 42-43.

Mr. Hevert criticized Dr. Woolridge's DCF analyses and results as incompatible with current market conditions and inconsistent with the practical interpretation of the model's results.[331] Mr. Hevert argued that Dr. Woolridge's equity cost rates were subjective, and took issue with Dr. Woolridge's calculation of sustainable growth.[332] Mr. Hevert claimed that Dr. Woolridge's constant growth DCF model is flawed because of the high P/E ratios for utility stocks, and took issue with Dr. Woolridge's assessment of analysts' long-term EPS growth rates.[333] Mr. Hevert then addressed in detail Dr. Woolridge's criticism of his CAPM and bond yield plus risk premium analyses. Mr. Hevert disagreed with Dr. Woolridge's position on Pepco's request for flotation costs.[334] He rejected Dr. Woolridge's argument that flotation costs for electric utility companies could result in a reduction to the equity cost rate, countering that flotation costs are "true and necessary costs to the issuer" and that denial of their recovery would deny the Company a portion of its expected return.[335]

Dr. Woolridge provided Surrebuttal Testimony, responding to Mr. Hevert's Rebuttal Testimony, addressing DCF and CAPM issues and Mr. Hevert's assertion that OPC's ROE recommendation is unreasonable.[336] Dr. Woolridge defended his application of the DCF model, and acknowledged that both he and Mr. Hevert use subjective judgment in estimate equity cost rates.[337]

In oral testimony, Dr. Woolridge reiterated his written testimony that authorized returns are slowly coming down to reflect the level of the historically low interest

[331] Hevert Rebuttal at 44.
[332] Hevert Rebuttal at 42-48.
[333] Hevert Rebuttal at 49-60.
[334] Hevert Rebuttal at 95.
[335] Hevert Rebuttal at 95-96.
[336] Surrebuttal Testimony of J. Randall Woolridge ("Woolridge Surrebuttal") at 1.
[337] Woolridge Surrebuttal at 6.

rates.[338] He agreed that interest rates have varied quite a bit between 2012 and 2016, going up and down.[339] He noted that "equity cost rates generally move with interest rates, but it's not a one-for-one movement."[340]

Dr. Woolridge explained that he relies on the DCF method primarily because of the difficulty in estimating the rate of return in the market as required with the CAPM method.[341] Dr. Woolridge testified as to the difficulty in forecasting interest rates, stating that "economists have been forecasting interest rates going up for ten years and they've been wrong."[342] He noted that an increase in short-term rates does not mean that long term rates will increase, which are a function of GDP growth, and expected inflation.[343] He stated that GDP growth has been slow and is projected to stay low.[344]

#### *c. Staff*

Staff witness VanderHeyden recommended that Pepco's cost of equity should be 9.39% and its overall rate of return should be 7.38%.[345] He accepted Pepco's proposed capital structure.[346]

Regarding proxy groups, he testified that a utility's return should be comparable to other companies of similar risk. Mr. VanderHeyden observed that Pepco, as an electricity provider, was solely a distribution company, devoid of any generation or transmission assets in its rate base.[347] Mr. VanderHeyden included in his proxy group

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338 Hr'g Tr. at 867.
339 Hr'g Tr. at 868.
340 Hr'g Tr. at 868.
341 Hr'g Tr. at 870.
342 Hr'g Tr. at 896.
343 Hr'g Tr. at 896-97.
344 Hr'g Tr. at 897.
345 Direct Testimony of Phillip E. VanderHeyden ("VanderHeyden Direct") at 2.
346 VanderHeyden Direct at 11.
347 VanderHeyden Direct at 8.

companies from Value Line's Electric East, Central, and West groups, removing from this group companies that are not comparable, retaining all companies that pay a dividend and for which Value Line provided a financial strength rating of at least B++. Mr. VanderHeyden agreed with Pepco Witness Hevert that it is inappropriate to include Pepco's parent company, Exelon, in a proxy group for Pepco.[348] In total, Mr. VanderHeyden's proxy group consisted of 31 companies.[349]

Mr. VanderHeyden's estimated ROE is the average of his DCF and CAPM results.[350] He also calculated a result based on the Internal Rate of Return ("IRR") method, however he excluded this result because it was below Pepco's cost of debt.[351] For his DCF analysis, Mr. VanderHeyden used closing stock prices as reported by Google Finance for the six months prior to the filing of this case, and annual earnings growth data from Value Line for the period ending in 2020 to 2022, as well as Value Line-reported dividends for the twelve months ending March 31, 2017.[352] He did not use dividends to estimate growth as part of his DCF calculation because in his opinion, many utilities would be unable or unwilling to increase dividends while spending heavily on reliability improvements.[353] Mr. VanderHeyden's DCF analysis resulted in an individual ROE of 9.14%, which reflected the proxy group average.[354] For his CAPM analysis, Mr. VanderHeyden calculated an ROE of 9.63% for Pepco.[355]

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[348] VanderHeyden Direct at 9.
[349] *See* VanderHeyden Direct at 40.
[350] VanderHeyden Direct at 9.
[351] VanderHeyden Direct at 9-10.
[352] VanderHeyden Direct at 12.
[353] VanderHeyden Direct at 13.
[354] VanderHeyden Direct at 15.
[355] VanderHeyden Direct at 15.

Mr. VanderHeyden did not include an adjustment for flotation costs in his ROE estimate in this matter. He testified that the Commission clearly instructed in previous orders that an award for flotation costs would be granted only based on verifiable costs of issuing new stock; Pepco Witness Hevert's testimony documented only the cost of PHI flotation costs, not flotation costs incurred by Pepco.[356] Averaging his DCF and CAPM results, Mr. VanderHeyden applied an ROE of 9.39% to the Company's capital structure to arrive at his recommended 7.38% ROR.[357]

Mr. VanderHeyden explained that the reason the result of his DCF analysis differs from that of Pepco Witness Hevert is because of Mr. Hevert's use of the multi-stage growth model as part of his DCF method. Mr. VanderHeyden testified that his own DCF results fell within Mr. Hevert's results under constant growth DCF but not under Mr. Hevert's multi-stage analysis.[358] Similarly, Mr. VanderHeyden did not use the ECAPM method as Mr. Hevert did, noting that Mr. Hevert's ECAPM results were approximately 100 basis points higher than the corresponding CAPM results, and above the range of returns authorized by the Commission in the last several years.[359] In his opinion, use of the ECAPM is not necessary to compensate investors with higher returns that reflect non-utility risk, and using the ECAPM method with the Value Line beta would be an over-adjustment.[360]

Mr. VanderHeyden also criticized Mr. Hevert's application of the bond yield plus risk premium method, stating that there is no connection between country-wide historic

[356] VanderHeyden Direct at 19-20.
[357] VanderHeyden Direct at 20.
[358] VanderHeyden Direct at 21-22.
[359] VanderHeyden Direct at 22.
[360] VanderHeyden Direct at 24.

commission–awarded ROEs and investors' expectations; other considerations may be incorporated into the setting of an ROE.[361]

Dr. Woolridge in his Rebuttal Testimony raised two purported errors by Mr. VanderHeyden: (1) asymmetrical elimination of low-end observations in his DCF results; and (2) inflated risk-free interest rates and a flawed measure of equity risk premium for his CAPM analysis.[362]

Mr. Hevert presented criticisms of Mr. VanderHeyden's ROE testimony in his Rebuttal Testimony. He objected to Mr. VanderHeyden's proxy group selection and challenged his DCF and CAPM calculations. Furthermore, Mr. Hevert faulted Mr. VanderHeyden for not including in his ROE analysis an ECAPM model as previous Staff witnesses have done in past rate cases.[363] With regard to flotation costs, Mr. Hevert disagreed with Staff's reasoning that Pepco's recent acquisition by Exelon negated the need to adjust for flotation costs because in his opinion that acquisition did not restore the permanent reduction in equity caused by Pepco's prior equity issuances.[364]

In his Surrebuttal Testimony, Mr. VanderHeyden responded to Dr. Woolridge's concerns with regard to his DCF results including: (1) his use of Value Line EPS as the growth rate; and (2) his elimination of unrealistically low ROE results (less than 7%).[365] Mr. VanderHeyden stated that Dr. Woolridge did not provide a reason to symmetrically remove outliers, and that outliers should be removed only when it makes sense to do

361 VanderHeyden Direct at 26.
362 Woolridge Rebuttal at 2.
363 Hevert Rebuttal at 14-15.
364 Hevert Rebuttal at 21.
365 Surrebuttal Testimony of Phillip E. VanderHeyden ("VanderHeyden Surrebuttal") at 5-9.

so.[366] Mr. VanderHeyden also responded to Dr. Woolridge's criticism of his CAPM results including: (1) his use of a projected 30-year treasury rate of 4.10%; and (2) his use of a historical market risk premium ("MRP").[367] Mr. VanderHeyden maintained his preference for the use of historical data to determine the MRP as a typical approach.[368]

Mr. VanderHeyden also provided surrebuttal in response to Mr. Hevert's rebuttal of his testimony. Mr. VanderHeyden testified that the difference between his results and Mr. Hevert's are due to Mr. Hevert's use of a multi-stage DCF, ECAPM with CAPM, and his use of a risk premium method based on awarded returns.[369] Mr. VanderHeyden testified that Staff's and Pepco's results are similar if flotation costs are not taken into account, and the ECAPM and comparable earnings methods are removed from consideration, and then if Mr. Hevert's constant growth DCF results are averaged with Mr. VanderHeyden's CAPM.[370]

Mr. VanderHeyden explained that he relies on a constant growth DCF method that utilizes EPS forecasts for the upcoming three to five year period because Pepco has been filing frequent rate cases, and that short-term growth rates best reflect the growth rate that investors will consider in evaluating Pepco's capital stock.[371] Mr. VanderHeyden believes there is no justification for a three-stage DCF methodology.[372]

Mr. VanderHeyden summarized the parties' ROE recommendations in the following table:[373]

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366 VanderHeyden Surrebuttal at 6-8.
367 VanderHeyden Surrebuttal at 9-11.
368 VanderHeyden Surrebuttal at 9-10.
369 VanderHeyden Surrebuttal at 11.
370 VanderHeyden Surrebuttal at 12.
371 VanderHeyden Surrebuttal at 13-14.
372 VanderHeyden Surrebuttal at 15.
373 VanderHeyden Surrebuttal at 3.

| Table 1 – Summary of ROE Calculations | | | | |
|---|---|---|---|---|
| **Method and Adjustments** | **PEPCO** | **Staff** | **OPC** | **AOBA** |
| | | | | |
| **DCF** | 8.74%-9.54% | 9.14% | 8.40%-8.70% | 8.95% |
| **DCF Multi-Stage** | 9.07%-10.61% | n/a | n/a | n/a |
| **CAPM** | 8.91%-12.90% | 9.63% | 7.90%-8.00% | 9.06% |
| **ECAPM** | 9.94%-13.63% | n/a | n/a | n/a |
| **RAM** | n/a | n/a | n/a | 9.21% |
| **Utility RP** | 10.06%-10.39% | n/a | n/a | n/a |
| **RAF** | n/a | n/a | 9.71% | n/a |
| **Flotation Adj.** | 12 bp | n/a | n/a | n/a |
| | | | | |
| **ROE Recommendation** | **10.10%** | **9.39%** | **8.75% (9.0%)** | **9.10%** |
| **ROR** | **7.79%** | **7.38%** | **7.06%(7.18%)** | **7.19%** |

In oral testimony, Mr. VanderHeyden explained why his recommended ROE in this case of 9.39% is less than his recommendation in Pepco's most recent case, Case No. 9418, of 9.57%. He explained that his DCF result decreased from a year ago because stock prices for utility stocks have increased significantly in the past year, so the dividend yield has dropped.[374] So even using a slightly higher growth rate, his DCF result was lower than in Case No. 9418.[375] At the same time, Mr. VanderHeyden's CAPM result increased because his risk-free rate input, which is related to interest rates, was higher than what he used a year ago.[376]

[374] T at 1157-1159.
[375] T at 1158-1159.
[376] T at 1159-1163.

### 3. Commission Decision

#### *a. Capital Structure*

Pepco's overall cost of long-term debt decreased from 5.45% to 5.35% because of a lower 4.15% interest rate on debt issued on May 22, 2017. No party raised an issue with regard to the cost of long-term debt and we will adopt Pepco's 5.35% cost of long-term debt.

However, with regard to capital structure, Pepco Witness McGowan revealed that the $174 million pro forma addition to common equity was an estimate of what the company would need to maintain its capital structure as of its initial filing.[377] Mr. McGowan initially testified that the Company would update its capital structure as of March 31, 2017 in rebuttal testimony, "once the audited financials for the first quarter are released."[378] In supplemental direct testimony, the Company submitted a projected capital structure based on its actual capital structure for the quarter ending March 31, 2017 updated for what the Company referred to as two "known and measurable changes."[379] However, from Mr. McGowan's oral testimony we know that the two changes were not both known and measurable at the time of Pepco's filing of supplemental direct testimony. Instead, the Company estimated the post test-year equity infusion in an amount that would keep its capital structure the same - 50.15% common equity and 49.85% long-term debt – after its May 22, 2017 debt issuance. This estimate

[377] The Company calculates its capital structure on a quarterly basis (T at 62); as of the date of its filing of this case (March 24, 2017), the reported capital structure was the Company's actual capital structure as of December 31, 2016 of 50.15% common equity and 49.85% long-term debt.
[378] McGowan Direct at 23.
[379] It appears from Page 2 of Schedule (KMM-SD)-1that the Company's actual capital structure as of March 31, 2017 was 50.45% common equity and 49.55% long-term debt, however, the Company did not propose this capital structure and the record does not contain any discussion of it.

of the equity infusion, as estimates often do, differed slightly from what actually occurred in June, subsequent to the Company's filing of supplemental direct testimony.

Although in recent Pepco rates cases we have gotten away from it, the Commission's practice is to utilize a utility's actual test year-ending capital structure when determining its authorized rate of return in a base rate proceeding unless there is evidence that the actual capital structure would impose an undue burden on ratepayers.[380] This practice is not immutable and the Commission has required the use of a hypothetical capital structure when the circumstances have warranted it.[381]

The Company reported its capital structure when it filed this case as being comprised of 50.15% common equity and 49.85% long-term debt. Company Witness Hevert calculated the average capital structure for each of his proxy companies and concluded that Pepco's proposed capital structure was consistent with the capital structures of the proxy companies and therefore appropriate. He does not mention Pepco's actual capital structure as of March 31, 2017, only the capital structure proposed by the Company, which is the same as the capital structure in the Company's initial filing. AOBA proposes a different capital structure but not based on evidence that a capital structure of 50.15% common equity and 49.85% long-term debt would impose an undue burden on ratepayers. We find the Company's capital structure as initially filed reasonable. We are not convinced that the circumstances presented in this case warrant using a capital structure other than that which was reported with the Company's initial filing.

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[380] Case No. 9311, *In the Matter of the Application of Potomac Electric Power Company for an Increase in its Retail Rates for the Distribution of Electric Energy*, 104 MD PSC 292, 347 (2013).
[381] *See* Case No. 9406, Order No. 87591 at 166-170.

### *b. Return on Equity*

The Supreme Court set forth the fundamental elements for determining a fair return on the investments of a regulated utility in the cases *Bluefield Waterworks*[382] and *Hope Natural Gas*.[383] In those cases, the Court found that a return on equity should be: (i) comparable to returns investors expect to earn on investments of similar risk; (ii) sufficient to assure confidence in the company's financial integrity; and (iii) adequate to maintain and support the company's credit and to attract capital.[384] After having reviewed and considered the witnesses' testimony in view of the *Bluefield* and *Hope* decisions, we find that an ROE of 9.50% is a fair and appropriate return.

The parties' final ROE recommendations in this case range from 8.75% to 10.10%, with Pepco proffering the highest ROE and OPC the lowest. In reviewing the parties' proposed ROEs, we note that they are supported by extensive analysis applying, in some cases, multiple methodologies. As we have said in prior rate cases, this subject is far too complex to reduce to a single mathematical formula. The parties' witnesses have relied on subjective judgment not only as to the methodologies performed, but also the quantitative inputs into the respective models. Judgment was again applied to interpret the results obtained from the different methods employed; in some cases the witnesses decided to exclude specific results from their own preferred methodologies.

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[382] *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923).
[383] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).
[384] *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923); *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

In each of its four prior rate cases,[385] the Company requested an ROE of 10.10% or greater. Each time we declined to adopt the Company's recommendation in view of the economic and risk factors faced by the Company at the time. This time is no different.

As part of our decision, we consider the low risk facing the Company's electric distribution operations in Maryland. The Company is a monopoly provider of electric distribution service in in an economically stable service territory in Maryland which allows several utility-friendly policies (e.g. customer charges, decoupling, etc.).[386] Pepco has a heavily residential customer base, and does not own generation. We are also mindful of investor perception of utilities constituting low-risk investments. Thus, we are once again presented with the question of what has changed since we last established a just and reasonable ROE for Pepco that would now justify a higher return.

As we noted in Pepco's last rate case, interest rates have generally declined over the past decade. Once again, the Company predicts that interest rates will increase, however, as OPC Witness Woolridge noted, economists have been forecasting that interest rates would increase for the past ten years, and they have been wrong. Dr. Woolridge believes that authorized returns have slowly been coming down to reflect the level of the historically low interest rates. Interest rates have fluctuated, but they remain

[385] *See In the Matter of the Application of Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service*, Case No. 9286; *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; *In the Matter of the Application of Potomac Electric Power Company for Adjustments to its Retail Rates for the Distribution of Electric Energy*, Case No. 9336; *In the Matter of the Application of Potomac Electric Power Company for Adjustments to its Retail Rates for the Distribution of Electric Energy*, Case No. 9418.

[386] Pepco witness Hevert acknowledged that decoupling is "constructive" from an investor's point of view, though he testified that it has become "fairly prevalent." *See* also Hr'g Tr. at 894 (OPC witness Woolridge, noting that the BSA helps ensure timely recovery of expenses).

low. Moreover, despite the fluctuation in interest rates between 2012 and 2016, Dr. Woolridge's recommended ROEs have only ranged between 8.5 and 9.2 percent.[387] And in this case, the small increase in the 30-year treasury yield and the fluctuating interest rates over the past year have not necessarily resulted in higher recommended ROEs than a year ago; Staff recommends a slightly lower ROE than it did in Case No. 9418 for example.

Pepco argues in its Brief that no party has provided any credible evidence to rebut Mr. Hevert's assessment that the current market conditions have changed in the last year, and interest rates have increased.[388] The first part of Mr. Hevert's assessment was based on his direct testimony that "inflation expectations had risen significantly following the U.S. presidential election in November 2016."[389] However, in oral testimony, Mr. Hevert testified that the expectation was inflation in the two percent (2%) range. He stated that it had been somewhat volatile in the near term, that it had moved up over the past year, but that it had moved back down, such that the market expectation is "still in the roughly 2% range."[390] With regard to interest rates, Mr. Hevert testified that "interest rates will go up and they'll go down and they'll react to a number of events, often geopolitical. That can be in response to expected inflation." Thus, although Mr. Hevert found that long-term interest rates have increased since the Company's last rate case, with the 30-day average of the 30-year Treasury yield more than 30 basis points higher,[391] his own oral testimony

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[387] Hr'g Tr. at 864.
[388] Brief of Potomac Electric Power Company ("Pepco Brief") at 19. No party seems to dispute that over the past year, market conditions have changed with interest rates going up, then back down. The assessment that market conditions have changed does not need to be rebutted. The relevant question is whether the Company's ROE is appropriate given market conditions
[389] Pepco Brief at 19.
[390] Hr'g Tr. at 755-756.
[391] Pepco Brief at 19.

at the hearing regarding anticipated inflation would seem to rebut the assessment Pepco references from Mr. Hevert's direct testimony that "investors have higher return requirements than when the Company last filed a rate case."[392]

Pepco describes the change in capital market conditions over the past year as significant.[393] Indeed, Pepco Witness Hevert testified that we have a fundamentally different market now than we did when the Company filed its last rate case in 2016.[394] However, Pepco then quotes Mr. Hevert's direct testimony in an attempt to correlate his oral testimony regarding this fundamental change in the market to a fundamental change, *i.e.*, significant increase, in interest rates. But what Mr. Hevert explained in his oral testimony is that the fundamental difference is that in Case No. 9418, "central banks were still taking an active role in managing the capital markets." Noting that we are not in that situation anymore, he went on to say that as we have experienced a series of geopolitical events in the past year, "the change in interest rates has not been nearly as abrupt or as acute."[395] In reality, interest rates went up and down between Case No. 9418 and this case, and are now somewhat higher. This resultant increase however cannot be correctly described as significant. Moreover, despite whatever change in market conditions occurred over the past year, including an increase in interest rates, Mr. Hevert's range of results from his analyses in this case is not very different from his range of results a year ago. Thus, although market conditions may have changed, they do not support an increase in authorized ROE.

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[392] Pepco Brief at 19.
[393] "[C]apital market conditions have significantly changed since the Company filed its last rate case on April 19, 2016 and when the Company filed this rate case on March 24, 2017." Pepco Brief at 26.
[394] Pepco Brief at 27.
[395] Hr'g Tr. at 744-745.

Instead of justifying the higher return Pepco seeks in this case, current market data supports an ROE of 9.50% for the Company's electric distribution operations.[396] We note that an ROE of 9.50% falls within the DCF, DCF Multi-Stage, and CAPM ranges reported by Pepco witness Hevert, and, in particular, falls towards the upper end of his constant growth DCF range.[397] The ROE of 9.50% that we authorize in this Order is both adequate and appropriate for Pepco, considering the low level of risk associated with its electric distribution service in Maryland and the current capital market environment. This ROE further complies with the standards under *Bluefield* and *Hope*. It is comparable to the returns investors expect to earn on investments of similar risk in the current market. It is sufficient to assure confidence in Pepco's financial integrity and enable the Company to receive a fair return commensurate with its risk.

Despite its own witness' testimony that Pepco's level of risk has not changed,[398] the Company contends in its Brief that it faces risk related to its capital investment plan.[399] According to Pepco Witness Clark, over the past four years, 2013 through 2016, the Company made capital investments of $877.2 million in its distribution system which serves Pepco's Maryland territory.[400] Pepco states that over the next five years it projects the need for approximately $1.016 billion to meet future reliability requirements, to

[396] As Staff points out in its Brief, the Commission suggested in Order No. 87884 in Case No. 9418 that but for application of the principle of gradualism the Commission might have reduced Pepco's ROE even more than it did. Staff Brief at 31. Thus, an authorized ROE of 9.5% actually reflects an increase in equity costs found to be supported by market data.

[397] As Staff points out, Witness Hevert arrives at a much higher recommendation by giving his DCF results almost no weight. Mr. Hevert's recommended ROE of 10.10% is 47 basis points above the upper limit of his reasonable range for his DCF analysis. Staff Brief at 28.

[398] Hr'g Tr. at 757.

[399] Pepco Brief at 20 *et seq.*

[400] Direct Testimony of Bryan Clark ("Clark Direct") at 8; Hr'g Tr. at 455.

replace aging infrastructure, and to accommodate customer load.[401] We are not convinced that Pepco's projected level of reliability spending will subject the Company to an unusual level of perceived risk. We find that an ROE of 9.50% is adequate to sustain Pepco's credit so that the Company can continue to attract needed capital in a low-interest rate environment and provide safe and reliable service to its customers.

There is no clear evidence that interest rates will increase significantly during the rate effective period. However, to the extent interest rates surge, the Company may file a new rate case to address the changed environment. Especially given Pepco's recent predilection for filing rate cases so frequently, we see no value in awarding a higher ROE during a time of relatively low interest rates because of the chance that interest rates could increase several years in the future.

As we said in Case No. 9418, relative stability in rates is an important ratemaking goal – for ratepayers and utilities alike.[402] Gradualism prescribes that sudden and dramatic shifts in rate design should be avoided. We look to authorize ROEs that change gradually, instead of attempting to respond immediately to intermediate market changes. A five-basis point downward adjustment from Pepco's currently approved ROE comports with the principle of gradualism. This slight movement in one year's time maintains an environment that does not surprise investors with changes that impact them adversely. We believe this ROE is sustainable. Dr. Woolridge testified that authorized returns have slowly come down to reflect the historically low interest rates, to an average authorized

[401] Pepco Brief at 20. Pepco describes this as "an extended period of capital spending," which is an exaggeration if not a mischaracterization.
[402] Order No. 87884 at 101.

ROE for electric utility and gas distribution companies of 9.60% in 2016;[403] about 30 basis points lower for delivery-only electric utilities such as Pepco.[404] It is unlikely that the slightly lower ROE we authorize today will scare investors or hurt Pepco's access to credit. In fact, as Dr. Woolridge testified, even with ROEs of 9 percent, stock prices for utilities are up 16 percent this year, outperforming the market.[405]

Pepco urges us to ignore the recommendations of Staff, OPC, and AOBA because they purportedly do not respond to the questions posed by the Commission in Order No. 88177 in Case No. 9418. In that Order, the Commission "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."[406] The Commission stated that it "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."[407] Pepco contends that "the parties' proposals to reduce the Company's ROE fail to take into account the Company's risks associated with operating an electric distribution company in a perceived unsupportive regulatory environment, and the Company's risks related to the Company's investment plan, as well as the changes in the capital market environment." For this assertion, Pepco cites again to Order No. 88177 in Case No. 9418. However, contrary to finding that Pepco faced risks related to investments in an

[403] 9.61% through the first two quarters of 2017. OPC Brief at 23.
[404] Hr'g Tr. at 862-863.
[405] Hr'g Tr. at 901.
[406] Order No. 88177 at 18.
[407] Order No. 88177 at 18.

unsupportive regulatory environment, the Commission "concluded that Pepco remained a low-risk monopolistic provider of electric distribution service, operating in a capital market environment with historically low interest rates."[408] Here too, we conclude that Pepco remains a low-risk monopolistic provider of electric distribution service, operating in a State with utility-friendly policies, and operating in a capital market environment that is still experiencing historically low interest rates. Accordingly, we find an ROE of 9.50% is appropriate and reasonable at this time.

When applied to its capital structure, Pepco's overall rate of return will be 7.41%, as shown in the following chart:

| **Type of Capital** | **% of Total Capital** | **Embedded Cost Rate** | **Weighted Cost Rate** |
|---|---|---|---|
| Long-Term Debt | 49.85% | 5.35% | 2.67% |
| Common Equity | 50.15% | 9.50% | 4.76% |
| Total/Overall ROR | 100.00% | | 7.43% |

### C. Cost of Service

Pepco provides electric distribution services to customers in Maryland and the District of Columbia. Hence, Pepco first allocated the Company's rate base, revenues, and expenses in a Jurisdictional Cost of Service Study ("JCOSS"), which reflects the costs of providing this service to customers in each jurisdiction. Pepco then used a Class Cost of Service Study ("CCOSS") to assign and allocate its Maryland-specific distribution costs to its customer classes in Maryland, based upon the principles of cost causation and revenue responsibility. As a general principle, costs in a cost of service

[408] Order No. 88177 at 18.

study can be assigned directly to specific customer classes or allocated using various allocation methodologies. Once costs are distributed appropriately, they can be used to develop jurisdictional and individual class rates of return, which are then used to design customer rates. The Commission views these studies as guidelines for setting customer rates in a sound and reasonable way.

### *1. The Parties' Positions*

#### *a. Pepco*

Pepco states that the methodologies of the instant JCOSS and CCOSS are consistent with those previously accepted by the Commission in Pepco's prior rate cases.[409] Company Witness Wolverton presented Pepco's JCOSS and explained that the Company directly assigned the majority of its distribution Electric Plant In Service ("EPIS"), which consist of primary- and secondary-voltage systems, to the jurisdiction in which the plant is located. Pepco then allocated the lesser portion of its EPIS—namely, its subtransmission facilities—between Maryland and the District of Columbia using the Average and Excess Demand Non-Coincident Peak ("AED-NCP") allocation method.[410] Mr. Wolverton stated that distribution and general depreciation expenses were assigned based on Company records, while O&M expenses were either directly assigned or allocated using corresponding plant ratios.[411] Other expenses were assigned or allocated using various allocators and methods previously approved by the Commission.[412]

[409] Pepco Wolverton Direct at 11; *see* Scheerer Direct at 8.
[410] Wolverton Direct at 12.
[411] Wolverton Direct at 13.
[412] *See* Wolverton Direct at 11-13.

Pepco Witness Scheerer presented Pepco's CCOSS and testified that Pepco followed a three-step approach in developing its CCOSS. First, Pepco "functionalized" the Company's rate base and expenses into components based on the operational characteristics of those components.[413] For purposes of this rate case, the Company did not consider functions of generation, purchase of power and transmission. Instead, Witness Scheerer identified two main functional categories in Pepco's CCOSS—subtransmission and distribution.[414] Next, Pepco "classified" its rate base and expense components by further separating the functionalized costs based whether they were demand-related (*i.e.*, necessary to meet the demand of the Company's electric distribution system) or customer-related *(i.e.*, associated with the number of customer served by Pepco), or both.[415] Lastly, Pepco "allocated" the functionalized and classified costs to the Company's multiple customer classes either directly, if costs were known and assignable to specific customer classes, or using methodologies that "best replicate[] the cost causation principles of those elements."[416] Pepco then determined each class's respective rate of return for use in rate design.[417]

Except for AMI meter costs, Pepco maintains that the allocation methodologies used in this CCOSS are consistent with those accepted in Case No. 9418.[418] Pepco used AED-NCP for its subtransmission-related plant facilities and Non-coincident Area Peak ("NCAP") and/or the sum of customer maximum demand ("NCD") for its primary- and

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413 Scheerer Direct at 6.
414 Scheerer Direct at 6.
415 Scheerer Direct at 6.
416 Scheerer Direct at 7.
417 *See* Scheerer Direct at 5.
418 Scheerer Direct at 11.

secondary-voltage level facilities.[419] Pepco also assigned and allocated its customer-related distribution EPIS FERC accounts in the same manner as in the last rate case. For AMI, Pepco states that it followed the Commission's directive in Commission Order No. 87884 and used a weighted average approach to allocate AMI meter costs. ("WAVGAMI").[420] Apart from these costs, Mr. Scheerer stated there were no other changes to the allocation methodologies in the CCOSS compared to its last rate case.[421]

*b. AOBA*

AOBA offers no position on the JCOSS. Instead, AOBA challenges Pepco's allocation of AMI meter costs in the CCOSS, arguing that the new "hybrid" allocation method is neither reasonable nor consistent with the Commission's expectations in Case No. 9418 when it approved the methodology.[422] In his direct testimony, AOBA Witness Bruce Oliver quoted Order No. 87884 as follows: "To the extent that AMI costs are allocated based on demand or energy volumes, costs will rise for smaller customers and decline for larger customers."[423] According to Mr. Oliver, the Commission expected the hybrid method would result in lowered costs for commercial customers. However, Pepco's implementation of this method yielded the opposite —an increase in the allocated costs for medium and large commercial customers.[424] These results notwithstanding, AOBA further objects to this benefits-based approach to allocating AMI meter costs as premature insofar as the Company has yet to quantify AMI's actual

[419] Scheerer Direct at 8-9.
[420] Pepco incorporated three (3) different allocators in its AMI allocator: (1) CUST3701-AMI Meters; (2) NCAP (Primary Substations); and (3) Total kWh Sales@Meter. Scheerer Direct at 10.
[421] Scheerer Direct at 11.
[422] AOBA Brief at 24.
[423] B. Oliver Direct at 82 (quoting Case No. 9418, Order No. 87884 at 105).
[424] B. Oliver Direct at 82-83.

benefits.[425] Accordingly, AOBA recommends that the Commission move back to a cost-based approach to allocating AMI meter costs.[426]

*c. OPC*

OPC alleges five points of error in Pepco's JCOSS and CCOSS. Those alleged errors include: (1) use of the AED-NCP method in the JCOSS and CCOSS to allocate subtransmission costs instead of a single system coincident peak demand ("1CP") method; (2) use of proxy demand allocators in the CCOSS for primary and secondary EPIS; (3) use of a single demand allocator in the CCOSS for both underground and overhead EPIS; (4) functionalization of AMI meters in the JCOSS as distribution plant in service, instead of common plant, and allocating them to transmission and distribution functions; and (5) functionalization and classification of AMI meters in the CCOSS as distribution plant, instead of common plant, and allocating them using the hybrid allocator.[427] OPC therefore recommends rejection of both studies because they allegedly fail to accurately reflect the cost of serving Maryland customers.[428]

According to OPC Witness Pavlovic, Pepco's system is characterized by a single summer peak, and system coincident peak is the cost driver of the Company's subtransmission facilities. Dr. Pavlovic therefore recommended 1CP as the proper allocation method for subtransmission costs.[429] He warned that using AED-NCP could lead to erroneous over- or under-allocation because it features both demand and

[425] B. Oliver Direct at 84.
[426] B. Oliver Direct at 89.
[427] OPC Brief at 39.
[428] OPC Brief at 39.
[429] Pavlovic Direct at 11-12.

volumetric measures to allocate costs.[430] Dr. Pavlovic also believed that Pepco should have used diversified coincident peak demand instead of the proxy demand allocators for primary and secondary EPIS, arguing that AMI allows the Company to measure actual differences in diversity and develop accurate allocators reflecting various class demands.[431] He similarly explained that AMI enables Pepco to develop separate allocators that distinguished class demand differences between underground and overhead facilities, given that those facilities have different cost characteristics.[432]

Lastly, Dr. Pavlovic criticized Pepco's classification of AMI meter costs strictly as customer-related costs when the benefits of AMI are both customer- and demand-related.[433] He further noted that Pepco has incorporated its AMI meters and software into the Company's Supervisory Control and Data Acquisition (SCADA) system, which costs Pepco records in its General Plant and Intangible Plant accounts. According to Dr. Pavlovic, Pepco should functionalize AMI meters in General Plant and then allocate the costs as common plant to the rate classes.[434] By using the hybrid method, he argued that Pepco over-allocated AMI meter costs to the distribution function and the distribution costs to the class customer costs.[435]

Responding to OPC's critique, Pepco points out that the Commission has historically approved the AED-NCP method for sub-transmission costs, beginning with Case No. 9286, when the Commission specifically directed the Company to use the

[430] Pavlovic Direct at 11-12.
[431] Pavlovic Direct at 14.
[432] Pavlovic Direct at 14-15.
[433] Pavlovic Direct at 16-18.
[434] Pavlovic Direct at 17-18.
[435] Pavlovic Direct at 18.

AED-NCP allocation methodology.[436] In his rebuttal, Company Witness Scheerer disagreed with Dr. Pavlovic's characterization of Pepco's subtransmission system and recommendation of the 1CP method. He also explained that coincident peak demand on the system does not drive the Company's sub-transmission investments.[437] Rather, Pepco's subtransmission system is designed to meet non-coincident peaks, thus making AED-NCP the appropriate method for allocating subtransmission costs.[438] Whereas NCP demands "appropriately reflect each rate class's contribution to the capacity needs for which the plant is designed,"[439] Mr. Scheerer reasoned it was also appropriate to use non-coincident peak and the sum of customer maximum demands for allocating primary and secondary EPIS. Mr. Scheerer further noted that these methods are consistent with the NARUC Electric Utility Cost Allocation Manual ("NARUC Manual").[440]

Mr. Scheerer defended Pepco's use of a single allocator for its overhead and underground facilities, pointing out that Pepco operates a single integrated distribution system whereby customers are served by both underground and overhead facilities.[441] He explained that these facilities are not designed such that equipment is necessarily either overhead or underground. Many of Pepco's distribution feeders have both overhead and underground segments.[442] And while Pepco's AMI system yields many benefits, it is not capable of determining if a customer is served by overhead facilities, underground facilities, or some combination of the two.[443]

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[436] Scheerer Rebuttal at 7.
[437] *See* Scheerer Rebuttal at 8.
[438] *See* Scheerer Direct at 8-9.
[439] Scheerer Rebuttal at 9.
[440] Scheerer Rebuttal at 9.
[441] Scheerer Rebuttal at 10.
[442] Scheerer Rebuttal at 10.
[443] Scheerer Rebuttal at 10.

With regard to the allocation of AMI meter costs, Pepco states that it allocated AMI meters as directed by the Commission in Order No. 87884.[444] Mr. Scheerer explained that while the Commission previously directed Pepco to allocate AMI meter costs based on customer, energy, and demand-related allocators, meter costs themselves only serve the end user and do not vary with demand or energy.[445] As such they properly remain classified as customer-related.[446] He further opined that classifying a portion of AMI meter costs as demand-related would not significantly impact the customer charges supported by the CCOSS.[447]

d. *Staff*

Staff recommends that the Commission accept Pepco's JCOSS and CCOSS without modification.[448] Staff Witness McAuliffe confirmed that the instant JCOSS is consistent with the methods and used and relied upon by the Commission in Pepco's prior rate cases, including Case No. 9418.[449] He similarly agreed that the CCOSS is consistent with the methods accepted in Case No. 9418, including Pepco's use of AED-NCP for its subtransmission costs.[450] He concluded that Pepco's CCOSS details the total costs of serving each customer class such as to allow the Company to directly assign or allocate each item of its rate base, revenues, and operating expenses to the respective customer classes based upon cost causation and revenue responsibility.[451] He described the allocators in the CCOSS, noting that except for the AMI meter costs, the Company

[444] Pepco Brief at 68.
[445] Scheerer Rebuttal at 12.
[446] Scheerer Rebuttal at 12; Pepco Brief at 73.
[447] Scheerer Rebuttal at 12.
[448] Staff Brief at 37.
[449] McAuliffe Direct at 2, 8.
[450] *See* McAuliffe Direct at 6-7.
[451] McAuliffe Direct at 5.

retained the same allocation methodologies used in Case No. 9418.[452] Specifically with regard to AMI meter costs, Mr. McAuliffe stated that the Company complied with the Commission's AMI allocation directive in Order No. 87884.[453]

Notwithstanding Staff's approval of the cost of service studies, Staff further recommends that Pepco study class demand trends prior to the Company's next rate case "to better understand why some classes' demands are increasing as a proportion of the total, even as overall demand growth remains low."[454] Mr. McAuliffe stated that Pepco should be directed to provide the following prior to its next rate case: (a) monthly non-coincident peak data for all customer classes; (b) monthly coincident peak data for all customer classes; (c) historical coincident and non-coincident peak data; (d) kWh sales data; (e) historical demand allocator ratios; and (f) analysis of allocators using multi-year data.[455]

In response to Staff's recommendation of further study, Pepco Witness Scheerer stated that the Company will agree to provide the following data prior to its next rate case filing: (a) five years of annual coincident peak demand by class; (b) five years of annual non-coincident peak demand by class; (c) five years of kWh sales data for Maryland cost of service classes; (d) cost of service allocation ratios from filed Maryland rate cases during the past five calendar years; and (e) percentage change in Maryland cost of service class demand allocators from filed Maryland rate cases during the past five calendar years.[456] Mr. Scheerer noted, however, that Pepco does not track monthly demand data

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[452] McAuliffe Direct at 6-7.
[453] McAuliffe Direct at 7.
[454] Staff Brief at 37.
[455] McAuliffe Surrebuttal at 2-3.
[456] Hr'g Tr. at 644-645.

for all customer classes. On brief, Pepco argues that to do so "would require significant analysis and program changes…."[457] Consequently, the Company would not be in a position to provide this data by its next rate case, which Pepco has indicated could be filed as early as next year.[458]

### 2. ***Commission Decision***

We begin with the observation that apart from specific objections raised by OPC and AOBA, the other parties—Staff and Montgomery County—do not oppose Pepco's JCOSS and CCOSS. Furthermore, only OPC recommends that we reject both studies in their entirety. Meanwhile, Staff recommends that we accept both studies without modification. For the reasons that follow, we find that the data and allocation methods used in Pepco's JCOSS and CCOSS provide an acceptable guide for allocating the Company's revenue requirement increases among the various rate classes in this proceeding. We turn to address the specific issues concerning the allocation of Pepco's distribution plant in service and AMI meter costs.

#### a. *Distribution EPIS Cost Allocation*

Pepco and Staff agree that the Company's AED-NCP allocation method used here in its JCOSS and CCOSS is consistent with our precedent. Upon examination of Pepco's last four rate cases, we concur. In Case No. 9286, we directed the Company to prepare a cost of service study using the AED-NCP method and compare it to a coincident peak-driven method it had traditionally used.[459] Subsequently in Case No. 9311, we found the

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[457] Pepco Brief at 69.
[458] Hr'g Tr. at 644:9-13.
[459] Case No. 9286, Order No. 85028 at 118.

AED-NCP method appropriate for use in the Company's future rate cases.[460] Our decision was based in part on Staff's conclusion that the AED-NCP approach was more consistent with cost causation.[461] Since then, we have accepted Pepco's jurisdictional cost of service studies using the AED-NCP method in the Company's last two rate cases.

OPC raises the same objections here as it did in Pepco's last rate case, which we declined to follow. We find no compelling reason now to deviate from our prior holdings and adopt an alternative allocation method for the Company's subtransmission costs. OPC has not persuaded us in this instance why the 1CP allocation method is applicable, let alone superior, to the AED-NCP approach. Specifically, we do not agree with OPC's characterization of the Pepco's distribution system but, instead, find Pepco's own description to be more correct. Ergo, we understand Pepco's distribution system to be comprised of many subtransmission systems designed to meet the expected loads for that localized area. And as Pepco Witness Clark indicated, where each sub-system may peak at different times and dates, the calculated system peaks would sum to a non-coincident system peak. We observe that this description is further consistent with the NARUC Electric Utility Cost Allocation Manual, which approves AED-NCP as a reasonable method to allocate subtransmission costs and notes that "peak responsibility method based on coincident demands is used for the higher order transmission facilities."[462]

We find that Pepco's use of non-coincident peak and the sum of customer maximum demands for allocating primary and secondary EPIS is also consistent with the NARUC Manual, which provides that "the normal practice is to use non-coincident peak

[460] Case No. 9311, Order No. 85724 at 122.
[461] *See* Case No. 9311, Order No. 85724 at 120, 122.
[462] Witness Scheerer Rebuttal at 7-8 (quoting NARUC Manual at 83).

allocators to approximate the amount of load diversity at the primary, secondary, and line transformer facilities level of an electric utility system…."[463] The Manual further states, "Local area loads are the major factors in sizing distribution system. Consequently, customer-class noncoincident demands (NCPs) and individual customer maximum demands are the load characteristics that are normally used to allocate the demand component of the distribution facilities."[464]

Lastly, with respect to OPC's criticism against using a single demand allocator for its underground and overhead EPIS, this too is not a new argument. What is new, however, is the availability of AMI's technological advances. Despite the many perceived benefits of AMI, Pepco explains that AMI does not have the granular capability of determining whether a customer is served by overhead or underground facilities (or both). No one has offered evidence that proves otherwise. According to Mr. Scheerer, in order to assign each customer as being served by overhead or underground facilities, it would need to make and rely on impractical assumptions, which can be inaccurate.[465] We find no fault with this reasoning.

b. *AMI Meter Costs*

The Parties agree that Pepco complied with our directive in Case No. 9418 and used a "hybrid" of customer, demand and energy allocators to allocate AMI meter costs. Nevertheless, AOBA and OPC seek reversal of our decision in Case No. 9418 to adopt this hybrid allocation methodology. AOBA argues mainly that the results of the CCOSS are inconsistent with our expectation in Order No. 87884 that costs would rise for smaller

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[463] Witness Pavlovic at 10 & n.28 (citing NARUC Manual at 97).
[464] Witness Pavlovic at 10 & n.29 (citing NARUC Manual at 97).
[465] Pepco Brief at 72.

customers and decline for larger customers. Moreover AOBA believes that because the actual benefits of AMI have not been assessed, such a benefits-based approach of allocation of AMI costs is premature at this time. OPC objects to Pepco's classification of AMI meter costs strictly as customer-related and, instead, argues the costs should be classified as both customer-related and demand-related and functionalized as common plant.

In Case No. 9418, we recognized that traditional cost causation principles would lead to over-allocation of AMI costs to metered customers, particularly the residential class. We determined that Staff's weighted average allocation proposal would more equitably distribute AMI costs across all rate classes receiving benefits from AMI, while weighting more heavily those classes that share additional benefits exclusive to receiving an AMI meter.[466] Staff explained then that "to the extent that the incremental costs of AMI meters are incurred to support load shaping and conservation programs and goals, they could be classified and allocated accordingly."[467] We anticipated, as Staff did, that costs would rise for smaller customers and decline for larger customers if AMI costs were also allocated based on demand or energy volumes.[468] That is, the relative rates of return for smaller customer classes would shift upward while those of larger customer classes would shift downward.[469] We find that the CCOSS reflects these expected shifts in class URORs.[470] As shown in the following Table 2, these shifts are consistent with those calculated by Staff in Case No. 9418, which are based on alternate demand and energy

[466] Order 87884 at 105.
[467] Order 87884 at 105.
[468] Order 87884 at 105 (citing Case No. 9418, Staff Witness Shelley Norman Direct at 21).
[469] *See* Case No. 9418, Staff Witness Shelley Norman Direct at 21.
[470] AOBA Witness B. Oliver's Schedule (BRO)-13, exhibit to B. Oliver Direct.

allocators.[471] Accordingly, we see no reason to reexamine our determination in Case No. 9418 with respect to the hybrid allocation methodology.

| **Table 2 – Class Relative Rates of Return for Alternative Allocation of AMI Meter Costs** | | | | |
|---|---|---|---|---|
| Class | 9418 Pepco Supplemental (as filed) | 9418 Staff Demand Based | 9418 Staff Energy Based | 9443 Pepco Supplemental (as filed) |
| R | 0.59 | 0.64 | 0.65 | 0.63 |
| RTM | 0.69 | 0.69 | 0.70 | 0.82 |
| GS-LV | 0.70 | 0.79 | 0.79 | 1.36 |
| MGT-LV | 1.53 | 1.46 | 1.45 | 1.46 |
| MGT-HV | 1.36 | 1.24 | 1.22 | 0.66 |
| GT-LV | 2.01 | 1.91 | 1.88 | 1.80 |
| GT-HV-69 KV | 8.59 | 8.60 | 6.11 | 6.93 |
| GT-HV-69 Other | 1.27 | 1.13 | 1.10 | 1.00 |
| Metro | 1.56 | 1.41 | 1.39 | 0.99 |
| SL-E | 1.37 | 1.26 | 1.28 | 0.92 |
| SL-S | 1.03 | 1.03 | 1.03 | 1.42 |
| TN | 4.71 | 4.50 | 4.33 | 3.32 |

Regarding the classification of AMI costs, the NARUC Manual provides that classification of costs in a CCOSS as demand-related, customer-related or some combination of both "depends upon the analyst's evaluation of how the costs in these accounts were incurred."[472] Under the FERC Uniform System of Accounts, meter costs are traditionally classified as customer-related. And as Pepco Witness Scheerer stated during these proceedings, Pepco's meter costs are currently incurred "based on the number of meters, which is directly related to the number of customers on Pepco's system."[473] While there are system-wide benefits of AMI, at this time there is no analysis

[471] *See* Case No. 9418, Staff Witness Shelley Norman Direct at 22, Table 11.
[472] Pavlovic Surrebuttal at 14 (quoting NARUC Manual at 89).
[473] Hr'g Tr. at 642-43.

that places a dollar-value on those benefit, and Mr. Scheerer testified that "those benefits do not change the magnitude of the cost associated with the AMI meters..."[474] By contrast, the NARUC Manuel explains classification of demand-related costs as follows: "Classifying distribution plant as a demand cost assigns investment of that plant to a customer or group of customers based upon its contribution to some total peak load. The reason is that costs are incurred to serve area load, rather than a specific number of customers."[475] OPC has not established which incremental portions of AMI meter costs were incurred to serve area load, nor has it provided a dollar amount.[476] We therefore accept at this time the Company's reasoning that AMI meters are fixed costs and, as such, should be reflected in the customer charges supported by the CCOSS. We note that Staff does not disagree.

We find Pepco's jurisdictional cost of service study and class cost of service study to be reasonable in this case. As we have stated in prior rate cases, we use the CCOSS as a guide for rate design for the purpose of reducing interclass subsidies and bringing class unitized rates of return closer to 1.0. It need not be perfect to be serviceable. Based on the record before us, we find no reason in this instance to reject the study altogether. Thus, we accept the two studies without modification. And pursuant to Staff's recommendation, to which the Company does not object, we direct Pepco to further examine customer demand trends and provide the following data and analyses in its next rate case: (1) historical coincident and non-coincident peak data; (2) kWh sales data; (3) historical demand allocator ratios; and (4) analysis of allocators using multi-year data.

[474] Hr'g Tr. at 643.
[475] NARUC Manual at 90.
[476] However, the Commission could derive value from an analysis that would monetize the future incremental system wide benefits from AMI.

Pepco shall also provide monthly coincident and non-coincident peak demand for each customer class as soon as it can reasonably do so.

### D. Rate Design

Rate design serves two important functions: (1) to establish rates between the various customer classes (*i.e.,* inter-class rates) by assigning the adjusted revenue requirement between the classes; and (2) to establish rates within each customer class (*i.e.,* intra-class rates) by designing the manner in which the class revenue requirement will be collected from customers. Since we have approved a $33,967,000 million revenue increase for Pepco, we must determine how much of this additional revenue should be assigned to each customer rate class. We look to the Company's jurisdictional cost of service study and class cost of service study to obtain individual rates of return for Pepco's rate classes which are then translated into a relative or unitized rate of return, or UROR, for each rate class. The UROR measures as a mathematical ratio an individual class rate of return compared to the utility's system average rate of return.[477] A UROR of 1.0 signifies that a rate class has a return equal to the utility's system rate of return. Thus, a UROR greater than 1.0 indicates that the class has a return (or contribution) greater than the system average, while a UROR less than 1.0 indicates that the class is providing less than the system average. If all customer rate classes have URORs of 1.0, it means that each class is contributing equally to the utility's overall rate of return based upon its cost of service. As a matter of policy, the Commission strives to bring all rate classes closer to a UROR of 1.0. We temper this goal, however, with notions of gradualism in order to avoid rate shock to the customers of any particular rate class. Utility rates are therefore

[477] Case No. 9418, Order No. 87884 at 106; *see* Janocha Direct at 3.

designed to be consistent with traditional rate-making principles as well as our policy priorities and those of the State of Maryland.

Once the revenue requirement is apportioned among the various rate classes, intra-class rates may be designed. Almost all rate classes have a customer charge, which is designed to recover fixed utility costs that do not vary with the amount of electricity used, such as the cost of meters. Additionally, Pepco customers have an energy charge, which is aimed at recovering the utility's variable costs. And some non-residential customers also have a demand charge, which is designed to recover the utility's capacity costs. In sum, each customer's bill will have a fixed, monthly charge as well as variable or "volumetric," per-kilowatt hour charge components. Intra-class rate design is also guided by important policy considerations, such as gradualism, energy conservation, economic impacts, and cost causation.

### 1. ***Revenue Allocation***

The Commission has regularly used a two-step process for allocating rate increases and determining inter-class rates. As a first step, a portion of the approved revenue increase is allocated to those under-earning rate classes withURORs below 1.0, to move them closer toward 1.0, the system average. In the second step, the remainder of the revenue increase is apportioned to all customer classes, based upon the proportion of their class revenues compared to overall system revenues. Classes that are significantly over-earning may be excluded from this second step.

### a. ***The Parties' Positions***

#### *i. Pepco*

Pepco Witness Janocha presented the Company's rate design, which follows the Commission's two-step revenue allocation process approved in Pepco's last four rate cases.[478] In the first step, Pepco proposes to allocate 19% of the total revenue increase to under-earning classes, which include rate classes R, RTM, MGT-3A, GT-3A, TM-RT, and SL.[479] Mr. Janocha described three objectives that guided this decision:

> (1) Limit the maximum percentage increase to any one of these four rate schedules to 1.5 times the overall average percentage increase;
>
> (2) Ensure that the final proposed UROR for a rate class with an existing UROR above 1.0 does not increase, nor move to a level below 1.0;
>
> (3) Ensure that the final proposed UROR for a rate class with an existing UROR below 1.0 does not decrease nor move to a level above 1.0.[480]

Subsequently in step two, Pepco would allocate the remaining level of the revenue increase to all rate classes, except classes GT-3B and TN, based on their level of current annualized distribution revenue.[481] Indeed, Pepco proposes no increase for these GT-3B and TN because their URORs are already significantly higher than the system average, at 6.93 and 3.32, respectively.[482] Mr. Janocha observed that this approach is

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[478] Janocha Direct at 2; *see* Pepco Brief at 73.

[479] In his direct testimony, Mr. Janocha initially proposed allocating 24% of the proposed revenue increase to the following under-earning rate classes: R, RTM, GS-LV, and GT-3A. Later, based on the updated results of the CCOSS, Mr. Janocha reduced the first-step allocation from 24% to 19% and removed Schedule GS-LV from this first-step allocation while adding Schedules MGT-3A, TM-RT, and SL. Janocha Supplemental Direct at 2.

[480] Janocha Direct at 5-6.

[481] Janocha Direct at 6. All parties characterize classes GT-3B and TN as significantly over-earning classes.

[482] Janocha Direct at 5-6; *see also* Janocha Supplemental Direct at 2.

consistent with the methods previously approved by the Commission in Pepco's last three rate cases, Case Nos. 9311, 9336, and 9418.[483]

### *ii. AOBA*

AOBA Witness T. Oliver offered a different three-step revenue allocation approach with some similarity to Pepco's two-step method. Mr. Oliver's allocation methodology is based on a +/- 10% band on system average rate of return intended to ascertain the reasonableness of allocating the proposed revenue increase to each rate class.[484] Mr. Oliver noted that BGE currently employs this band for the purpose of achieving reasonable inter-class equity and has successfully used this approach in its last three rate cases.[485] As a preliminary matter, AOBA does not propose any revenue increase for rate classes GT-3B and TN.[486] In the first step, rate classes GT-3A, TM-RT, and SL would receive the system average increase because their rates of return already fall within the +/- 10% band range.[487] In step two, 24% of the total revenue increase would be applied to rate classes R, RTM, and MGT-3A. And in the last step, the remainder of the total revenue increase would go to the remaining classes (GS-LV, MGT-LV, GT-LV, and SSL).

AOBA does not oppose Pepco's favored two-step revenue allocation approach and, alternatively, suggests that a first-step allocation of 30% of the approved revenue requirement to under-earning classes would facilitate greater incremental progress

[483] Janocha Direct at 5.
[484] T. Oliver Direct at 10-11.
[485] T. Oliver Direct at 10.
[486] T. Oliver Direct at 12.
[487] T. Oliver Direct at 11.

towards inter-class equity, moving all classes to within +/- 10% of the system average rate of return.[488]

iii. *OPC*

OPC Witness Pavlovic objected to Pepco's rate design and reasoned that the inaccuracies of the Company's CCOSS call into question the individual class and unitized rates of return for all rate classes.[489] He explained that because the CCOSS is defective, "Pepco knows neither what the class returns are nor how much to adjust the class revenue requirements in order to move the classes toward parity."[490] OPC therefore recommends that the Commission reject Pepco's proposed rate design and allocate any revenue increase proportionally across the rate classes, except for GT-3B and TN, based on current revenue levels.[491]

*iv. Staff*

Staff proposes a revenue allocation approach that is identical to Pepco's favored two-step allocation method, which Staff acknowledges has been approved by the Commission in prior cases.[492] Staff Witness Hoppock testified that in this case a first-step allocation of 19% to under-earning classes is equitable.[493] And he identified the same under-earning classes as Pepco for its first step. In the second step, the remaining 81% of the revenue requirement would be allocated to all rate classes, except rate classes GT-3B and TN.[494] Mr. Hoppock explained that in selecting 19% for step one, he "ran 50

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[488] AOBA Brief at 27.
[489] Pavlovic Direct at 21.
[490] Pavlovic Direct at 21.
[491] Pavlovic Direct at 21
[492] Staff Brief at 34.
[493] *See* Hoppock Direct at 14-15.
[494] Hoppock Direct at 14.

scenarios varying the size of Step 1 . . . [and] selected 19 percent because it gradually moves the rate classes closer to a UROR of 1.0" while avoiding rate shock to any individual class as a result of the revenue requirement increase.[495] Pepco agrees that Staff's revenue allocation proposal is not unreasonable.[496]

**Commission Decision**

This Commission has typically favored rates that are designed to move rate classes closer toward a UROR of 1.0 while avoiding rate shock. Most recently, in Case No. 9418, we explained that our two-step approach serves the purpose of balancing the actual rates of return reflected in the Company's cost of service studies and the principle of gradualism.[497] This approach affords us flexibility in achieving system parity while tempering rate increases to mitigate adverse impacts on customers.

All of the Parties, except OPC, propose revenue allocation processes consistent with the above method. OPC recommends instead that we allocate revenue proportionally to all the rate classes based on current revenue levels. Pepco does not object to any other party's proposal, except for OPC's, arguing that "it fails to make any progress in eliminating inter-class subsidies in . . . class revenue requirements."[498] We agree. For the above reasons, we will again utilize our two-step rate design method in this case.

We adopt the 19% first-step allocation recommended by Pepco and Staff, which we believe represents an optimal, gradual movement toward a UROR of 1.0 without simultaneously causing financial harm to customers. Pepco is therefore directed first to

[495] Hoppock Direct at 15.
[496] Janocha Rebuttal at 4.
[497] Case No. 9418, Order No. 87884 at 107.
[498] Janocha Rebuttal at 4.

apply 19% of the authorized revenue increase in this Order to the above-referenced under-earning classes in proportion to their current distribution revenue. Then, the Company shall distribute the remaining 81% of the revenue increase among all the rate classes—except GT-3B and TN—based on their current distribution revenues.

### 2. ***<u>Customer Charges and Intra-Class Rate Design</u>***

Customer charges are intended to cover the costs incurred by the utility for fixed charges. As with allocating costs between rate classes, determining the proper ratio between customer, volumetric, and demand charges requires the balancing of many competing variables. And while it is important that customers who cause certain costs incur those costs, the principle of gradualism also applies. Additionally, policy concerns must also guide the Commission, such as energy conservation incentives and the effect of an increased surcharge on low income customers. With these principles in mind, we believe the record in this case supports a gradual increase in the customer charges.

#### **a.** ***The Parties' Positions***

##### *i. Pepco*

Pepco proposes to increase the customer charge for residential customers from its current \$7.60 to \$8.78, which represents a 15.53% increase, in proportion to the average percentage increase for the rate class. Pepco seeks to make this adjustment in view of the rate design efforts currently underway in PC 44 and with the intention of minimizing variability between current and proposed rates.[499] Alternatively, Pepco agrees to increase the residential customer charge by 2.84%, to \$7.82, which is consistent with the customer

[499] Janocha Direct at 6-7.

charge increases granted by the Commission in Case No. 9418.[500] For each of the remaining rate classes, except GT-3A and GT-3B, Pepco proposes to take the difference between the current customer charge and the customer-related costs from the CCOSS and add 25% of that difference to the customer charge for that class.[501] This according to Mr. Janocha would bring rates closer in line with cost causation while recognizing gradualism.[502]

Pepco agrees with Staff's rate design proposal for volumetric charge increases for residential classes and class GS-LV, resulting in the same percentage increase for summer and winter rates.[503] For commercial classes MGT-LV, GT-LV, GT-3A, and GT-3B, Pepco proposes to increase both demand charges and volumetric charges proportionally.[504] Specifically, the percent increase in revenue from the demand charge would increase by the same amount as the percent increase in revenue from the volumetric charge increase, relative to pre-normalization and pre-Bill Stabilization Adjustment ("BSA") revenue, and vice versa.

ii. *AOBA*

AOBA objects to Pepco's intra-class rate designs and argues that they are neither reasonable nor appropriate.[505] AOBA observes that, contrary to Pepco's stated objective in rate design, the Company's proposed increases in the customer charges for rate classes GS-LV, MGT-LV, MGT-3A and GT-LV are not gradual.[506] AOBA further avers that

[500] Pepco Brief at 73.
[501] Janocha Direct at 8-9.
[502] *See* Janocha Direct at 8.
[503] Janocha Rebuttal at 4-5.
[504] Janocha Direct at 9-10; Hoppock Direct at 11-12.
[505] AOBA Brief at 28.
[506] T. Oliver Direct at 18.

Pepco's proposed rate designs do not provide for continuity in rates, and do not support customer initiated energy efficiency in the State of Maryland."[507] Instead, AOBA proposes to increase all cost components within each commercial rate class—GS-LV, MGT-LV, MGT-3A, and GT-LV—by the combined percentage increase of the rate increase and the BSA assignment.[508] This in AOBA's view would result in reasonable increases for each bill component—customer charge, demand charge, volumetric rate.[509]

*iii. OPC*

OPC opposes any increase to the residential customer charge.[510] Even a modest 2.84% increase would in OPC's view "distort price signals, frustrate investments in energy efficiency and distributed resources, and inequitably burden low-usage customers."[511] Instead, OPC proposes to recover the approved revenue requirement increases through the volumetric charge.[512] Dr. Pavlovic reasoned that increasing the monthly customer charge is contrary to the Commission's stated desire to avoid hindering the customers' ability to control their electric bills.[513] He further dismissed any residential customer charge increase in this case on the basis of his belief that Pepco's CCOSS contains errors in the allocation of customer and demand costs.[514]

iv. *Staff*

For residential rate classes, Staff and Pepco are in agreement regarding intra-class rate components. Staff proposes a 2.84% increase to the residential customer charge,

[507] AOBA Brief at 32.
[508] AOBA Brief at 32; T. Oliver Direct at 22-23.
[509] T. Oliver Direct at 23.
[510] OPC Brief at 47; Pavlovic Direct at 24.
[511] OPC Brief at 48.
[512] Pavlovic Direct at 25.
[513] Pavlovic Direct at 24.
[514] Pavlovic Direct at 24-25.

which is the same percentage approved by the Commission in Pepco's last rate case, Case No. 9418.[515] Pepco does not object.[516] Staff and Pepco further agree to use an allocation for the Bill Stabilization Adjustment revenue annualization between summer and winter seasons, which will produce identical percentage increases in summer and winter energy rates.[517] Staff Witness Hoppock indicated that this too follows the Commission's order in Case No. 9418. Under this rate design, the monthly impact on the distribution portion of a residential SOS customer's bill for an average monthly usage of 863 kWh would increase $4.46 during the summer (5.97%) and $2.31 during the winter (4.66%).[518]

For the commercial rate classes, Staff proposes to increase customer charges by approximately the same percentage as recommended for the residential class. For commercial classes with energy and demand components, Staff adopts Pepco's formula for volumetric and demand rates. Except for class MGT-3A, this approach yields similar percentage increases in volumetric and demand rates.

**Commission Decision**

As we have stated in the past, determining the appropriate increase in customer charge is not an exact science, but rather involves balancing many considerations. In arriving at a modest increase, we place emphasis on Maryland's public policy goals that intend to encourage energy conservation. Maintaining relatively low customer charges provides customers with greater control over their electric bills by increasing the value of volumetric charge, which is variable and directly tied to a customer's consumption behavior. Thus, conservative energy usage will lead to smaller volumetric charges and

[515] Hoppock Direct at 2.
[516] Staff Brief at 34.
[517] Staff Brief at 34.
[518] Staff Brief at 34.

lower energy bills. By contrast, fixed customer charges cannot be reduced no matter how diligently a customer might attempt to conserve energy or respond to AMI-enabled peak pricing incentives. Additionally, lower customer charges provide more value to net metering customers. The terms of most utility tariffs typically require a customer to pay the monthly customer charge regardless of the amount of energy produced. For energy billed, however, the customer pays only for the energy he or she used, netted against any generation produced by that customer.

We believe an increase in residential customer charge slightly lower than Staff's recommendation of 2.84% is appropriate in this case and consistent with our recent precedent. Staff recommends that we increase the residential customer charge from $7.60 to $7.82, explaining that the increase is gradual, encourages energy conservation, and would allow customers to maintain control over their bills through their energy consumption. Pepco accepts this recommendation. We agree in principle with Staff's proposal, but for reasons of administrative simplicity, we round the proposed rate down 2 cents to $7.80, which now equates to an increase of 2.64%. As the table below demonstrates, the residential customer charge approved in this Order remains comparable to those paid by similarly situated customers of other Maryland electric utilities:

| **Table 3 – Residential (R) Customer Charges in Maryland** | |
|---|---|
| **Company** | **Monthly Customer Charge** |
| Choptank | $11.25 |
| SMECO | $9.50 |
| **STATEWIDE AVERAGE** | **$8.27** |
| Delmarva | $8.17 |
| BGE | $7.90 |
| Pepco (new) | $7.80 |
| PE | $5.00 |

Pepco responds to the Parties' criticisms of its commercial customer charges and argues that its proposed increases do not promote excessive rate impacts when viewed in the context of the overall bill impact to the commercial classes.[519] We agree with Staff and AOBA that Pepco's proposed increases to the commercial class customer charges are not gradual. Indeed, the customer charges for four of the five commercial classes increase by more than 35%. Thus, for the same reasons that support our residential customer charge increase, we counterbalance the increases in the commercial class customer charges against the need to avoid rate shock to the commercial classes. This too is consistent with our determination in Case No. 9418.

Our ruling will result in the following changes in customer charges for the rate classes:

[519] Janocha Rebuttal at 6.

| **Rate Class** | **Current Customer Charge** | **New Customer Charge** | **Percent Increase (Decrease)** |
|---|---|---|---|
| R | $7.60 | $7.80 | 2.64% |
| RTM | $16.31 | $16.77 | 2.84% |
| GS-LV | $11.32 | $11.64 | 2.84% |
| MGT-LV | $42.51 | $43.72 | 2.84% |
| MGT-3A | $40.37 | $41.52 | 2.84% |
| GT-LV | $345.42 | $355.23 | 2.84% |
| GT-3B | $313.08 | $313.08 | -- |
| GT-3A | $324.33 | $333.54 | 2.84% |
| TM-RT | $3,583.34 | $3,863.66 | 7.82% |

After we allocate the revenue requirement for each class and set the customer charge, the utility recovers the remainder of the approved revenue increase through the class's energy and demand charges. In the Company's last rate case, we held that for those rate classes with three rate components, energy and demand charges should be increased equally.[520] We find that Pepco's proposal in this case comports with our directive.

Applying these principles, the typical residential Standard Offer Service (SOS) customer using an average of 872 kWh per month will see a 3.00% increase in their monthly bill, or approximately $4.01. We believe this is reasonable in light of the capital investments made by Pepco to improve overall system reliability. This increase advances our strong policy of placing control over monthly bills within the customers' hands by balancing the extent to which customers are subject to fixed monthly charges—over

[520] Case No. 9418, Order No. 87884 at 113.

which they have no control—with the Company's right to recover its fixed customer costs.

Finally, we are cognizant of AOBA Witness T. Oliver's criticism of Pepco's continued reliance on unbundled customer components as the "foundation for the Company's assessment of fully allocated customer cost targets…."[521] He explained that the unbundled cost components by rate class have changed dramatically over last two rate cases and this case.[522] Hence, Mr. Oliver opined that these components should no longer be used as a benchmark for setting customer charges.[523] This argument has some merit, warranting further inquiry. To that end, we direct the Company to explain in detail in its next rate case: (1) how the unbundled customer component is calculated; (2) whether the calculation method has changed over time; and (3) the variability between rate cases for each customer class, as observed by Mr. Oliver.[524]

### 3. ***LED Streetlights***

#### a. *The Parties' Positions*

##### i. *Pepco*

Pepco proposes to change the current fixed charge rate structure for LED streetlights in Rate Schedules SSL-OH-LED and SSL-UG-LED to a lower, flat rate structure that purportedly reflects the underlying costs associated with LED streetlight installations.[525] According to Pepco, this reduced flat rate aims to encourage future

[521] T. Oliver Direct at 21.
[522] T. Oliver Direct at 15.
[523] T. Oliver Direct at 15-16.
[524] *See* T. Oliver Direct at 15-16.
[525] Pepco Brief at 76.

conversion to LED streetlights.[526] Pepco explains that the fixed rates proposed for overhead LED streetlights are lower than the fixed charges for comparable overhead high pressure sodium ("HPS") lights. And the proposed flat rate for underground-fed LED streetlights is lower than nearly all of the fixed charges for more conventional HPS equivalents, except for the 70-watt lamp.[527] As proposed, the LED flat rate for all underground-fed LED streetlights, regardless of size, is $2.17. The proposed variable rate structure for HPS fixed charges is as follows: $2.01 (70-watt); $2.37 (100-watt); $4.57 (150-watt); $8.17 (250-watt); and $13.46 (400-watt).[528]

Pepco contends that its revised LED rate structure is intended to incentivize installation of both overhead and underground-fed LED streetlights, which according to Pepco is consistent with Maryland's energy efficiency goals.[529] During the proceedings, Mr. Janocha stated that the HPS fixed charges are tied to a historic, scaled rate structure for streetlights born out of a settlement in Case No. 9217, between the Company and several municipalities. He further explained that the fixed charges relate to the cost of the lights as well as serving the fixtures.[530] He also referenced an economic incentive to LED conversion insofar as corresponding reductions in energy consumption would be reflected in the customer's overall bill.[531]

Mr. Janocha stated that while the Company could consider restructuring the conventional lighting tariff to a more fixed level, the change would have to be gradual in order to avoid unintended detrimental effects on municipalities that have been operating

[526] Janocha Direct at 10.
[527] Pepco Brief at 76 & n.425.
[528] Janocha Supplemental Direct, Schedule (JFJ-SD)-1 at 15-16.
[529] Pepco Brief at 76.
[530] Hr'g Tr. at 815.
[531] Hr'g Tr. at 816.

under the existing rate structure for several years.[532] Presently, Pepco maintains that it would be improper to lower the fixed charge for underground LEDs artificially, given that the flat rate already reflects the true cost of underground-fed LEDs.[533]

ii. *Montgomery County*

Montgomery County supports Pepco's proposed streetlight tariffs with modification. The County explains that the proposed LED rate structure would allow customers to begin conversions to LEDs over time and, ultimately, reduce their conventional lighting portfolios.[534] The County believes this is true for most lamp wattages, except for the 70-watt HPS streetlight.[535] The County cautions that the tariff structure could have the opposite effect and incentive jurisdictions to retain their inefficient equipment.[536] In this regard, the County recommends equalizing the customer-supplied maintenance charges between LED and conventional lamps and suggests that the LED flat rate should be lower:

> If possible, any effort to ensure the fixed charge for the 70 watt LED is equal or less than the rate for the equivalent HPS lamp could help Montgomery County and others move their projects more quickly or avoid picking and choosing of the larger wattage 'energy hog' lamps, as opposed to upgrading streetlights as a portfolio."[537]

Mr. Coffman disclosed that the County "is in the process of developing a program to replace approximately 28,000 owner operated underground fed predominantly high

[532] Hr'g Tr. at 783-84.
[533] Pepco Brief at 77.
[534] Montgomery County Brief at 9.
[535] Montgomery County Brief at 9.
[536] *See* Montgomery County Brief at 8.
[537] Montgomery County Brief at 9; *see also* Hr'g Tr. at 1077.

pressure sodium ("HPS") with high-efficiency light emitting diode ("LED") lamps."[538] On brief, the County states that this project is "inviable" under Pepco's current tariff structure, even after considering the energy cost and maintenance savings associated with LEDs.[539] However, the County would not support a comprehensive levelizing of fixed charges because it "could lead to rapid and unexpected 'rate shock' to local government budgets…."[540] Instead, the County would favor a more gradual shift of costs to the conventional "consumptive" lamps over multiple years, which would allow the County and other municipalities time to upgrade their lighting to LEDs.[541]

iii. *Staff*

Staff agrees with Pepco and Montgomery County that O&M costs for LED streetlights and customer-maintained O&M rates for corresponding non-LED streetlights should be the same.[542] Staff Witness Hoppock stated in his surrebuttal testimony that under Pepco's proposed rate structure for LED streetlights Montgomery County would save money on these specific costs if it converted its existing underground-served HPS streetlights to LEDs.[543] And if the Commission adopts Staff's recommendation to equalize O&M costs between LED and HPS streetlights, the County would realize greater savings.[544] He observed that converting overhead-served streetlights to LED alone would yield significantly savings because the fixed costs for overhead LED lights are substantially lower than those for overhead-served HPS.[545] He did not observe a

[538] Coffman Direct at 5.
[539] Montgomery County Brief at 8.
[540] Montgomery County Brief at 8-9.
[541] Montgomery County Brief at 10.
[542] Hoppock Surrebuttal at 5.
[543] Hoppock Surrebuttal at 5.
[544] Hoppock Surrebuttal at 5.
[545] *See* Hoppock Rebuttal at 16.

significant difference between the flat and fixed charges for underground served LED lights and HPS equivalents.[546] Accordingly, Staff does not support lowering the flat charge for LED streetlights below the fixed charges for all HPS lights absent evidence that subsidizing LEDs in this manner is justified on a cost causation basis.[547]

**Commission Decision**

LED lighting is more efficient technology compared to conventional lighting.[548] And for the purposes of our discussion, we note that most non-LED streetlights covered under Pepco's SSL-OH and SSL-UG tariffs are HPS lights.[549] LED streetlights utilize light emitting diodes instead of chemicals such as mercury or vaporized sodium found in HPS lights, thus making LEDs better for the environment and more sustainable. They also depreciate more slowly over time. As Mr. Coffman stated, the service life of an underground fed LED streetlight can be between 16-19 years.[550] Additionally, LED lights have a lower wattage consumption compared to conventional lights, which would result in reduced energy consumption and, consequently, lower energy and distribution charges.[551] It would appear then that LED streetlights comport with several key policies and programs in our state, including energy efficiency goals advanced through EmPOWER Maryland and other programs, the guiding principles of PC44, environmental sustainability, and the Greenhouse Gas Reduction Act.[552] Those policies would all favor future conversions to LED street lighting.

[546] Hoppock Rebuttal at 16.
[547] Hoppock Rebuttal at 16; Staff Brief at 35-36.
[548] Hr'g Tr. at 1077.
[549] Hoppock Rebuttal at 11 n.28.
[550] Hr'g Tr. at 1080.
[551] Hr'g Tr. at 815, 985.
[552] *See* Hr'g Tr. at 814-15.

Pepco claims its new rate structure for LED streetlights, which features a flat rate fully reflective of underlying costs, is designed to promote future LED conversions. Equalizing the maintenance charges for LED and conventional HPS streetlights will certainly further this objective. But our analysis cannot end there. Although we observe that the proposed $2.17 flat rate for all LEDs is lower than the fixed charges for nearly all of the HPS equivalents, this is not true for the 70-watt HPS light, which has a fixed charge of $2.01—*i.e.*, 16 cents lower than the LED flat rate. We can decipher no clear reason why this specific HPS fixed charge must remain lower than its LED equivalent, other than the fact that it tracts with a variable rate structure that was established by settlement in 2012.[553] Whereas the price for LEDs may have been high then, they have since come down.[554] We find that the lack of parity concerning this single component of Pepco's underground LED streetlight tariff is sufficient to be a disincentive to future conversion to LED at this bulb size.

We commend the Company for taking this step towards advancing the energy efficiency goals of local governments and our state. Nevertheless, this particular element of the proposed rate structure, if left unresolved, creates incongruities with other state programs, such as EmPOWER Maryland, the guiding principles of PC 44, and our Greenhouse Gas Reduction Act. We are mindful of the potentially dangerous impact a rapid and comprehensive restructuring or leveling of conventional fixed charges could have on local government budgets. Accordingly, we find that specifically raising the

[553] In response to a bench data request, Pepco explained that the cost components comprising the LED flat charge include: cables; duct construction; manholes; brackets; and posts, while the fixed charge for the 70-watt HPS light consists of the same components plus additional costs related to the recovery of all light fixtures. Case No. 9443, D.E. 62, Pepco Response to the Commission's Bench Data Request , ML #216936 (Sept. 19, 2017).

[554] Hr'g Tr. at 819. Mr. Janocha admitted that it may be appropriate for the Company to reexamine its conventional lighting rate structure more closely. Hr'g Tr. at 815.

fixed charge for underground-fed 70-watt HPS streetlights from $2.01 to $2.17 is both necessary and reasonable in this instance to introduce parity within this lighting class and eliminate the disincentive against LED conversion. Furthermore, by equalizing the maintenance costs for LED and HPS streetlights as described and equalizing the fixed charge for 70-watt HPS lamps and their LED equivalents, we eliminate the above-mentioned incongruities and bring Pepco's LED rate structure in line with our energy efficiency policies and objectives.

We will approve Pepco's streetlight tariffs, subject to the following modifications: (1) the fixed charge for the underground-fed 70-watt high pressure sodium streetlight shall be raised from $2.01 to $2.17; and (2) the customer-supplied maintenance charges for conventional streetlights shall be equalized with the O&M costs for LED streetlights. We further direct Pepco to adjust its tariff as necessary, consistent with the variable rate structure for underground-fed HPS streetlights, while ensuring that the overall approved class revenue requirement remains unchanged.

### E. Miscellaneous

#### 1. ***Partially Projected Test Year***

Pepco witness McGowan asked that the Commission allow the Company either to allow known and measurable adjustments to the test period through at a minimum the start of evidentiary hearings or, in the alternative, to authorize the Company to file proposed rates based on a test period consisting of at least six months of forecasted data. Mr. McGowan argued that these measures are necessary in order to reduce regulatory lag.[555]

[555] McGowan Direct at 21.

Staff opposes the expansion of forecasted data beyond the four months of projections currently authorized by Commission precedent, which are adjusted for actuals in the utility's supplemental testimony prior to the hearing. Staff finds the current 8 months actual / 4 months forecasted to be reasonable, but argues that any expansion of forecasted data would deprive the parties of the ability to analyze a utility's rate request while complying with the time frame set out in § 4-204 of the Public Utilities Article.[556]

AOBA states that it finds Pepco's use of a partially projected test year in this proceeding "highly problematic" and argues that acceptance of Pepco's request for authorization to use up to six month of projected data would further exacerbate the problems. As discussed in Section III(A)(9) above, AOBA witness B. Oliver provided testimony that Pepco's last-minute adjustments to the four months of projected data led to discovery problems and constrained the ability of parties to scrutinize the Company's data. AOBA further asserted that Pepco's use of a partially projected test year does not necessarily provide a clearer or more accurate assessment of costs for the rate effective period.[557] Accordingly, AOBA recommended that the Commission reject Pepco's request for authorization to use more projected data. Additionally, AOBA argued that the Commission should consider requiring Pepco to utilize fully historic test periods in future base rate proceedings.

We deny Pepco's request for authorization to use test years in subsequent proceedings that reflect six months of actual data and six months of projected data. The discovery problems in this proceeding have demonstrated that parties need time to respond to updated actuals in order to properly scrutinize the data and make a

[556] Staff Brief at 25.
[557] AOBA Brief at 10.

recommendation on the appropriate treatment of ratemaking adjustments. Expanding the amount of projected data to more than four months would exacerbate those problems. The Commission has been consistent in its preference for using actual data when establishing new rates, as well its reliance on a historic test year.[558] Expanding the test year projections would be inconsistent with those principles.

We also decline to require Pepco to utilize a fully historic test period in future rate proceedings. We find that the use of 8 months actual data, four months projected when filing a rate case strikes the correct balance between Company and intervenor interests.

### 2. ***Trail Workgroup – Interim Report***

Merger Condition 43 requires Pepco to collaborate with the Maryland Department of Natural Resources, Montgomery County, Prince George's County, and the Maryland National Capital Park and Planning Commission to establish a public-use trail pilot in the Company's service territory. Pepco witness McGowan testified that the Company has engaged with these stakeholders on the initial portion of the pilot project – a trail between Quince Orchard Road and the Soccerplex in Germantown, Maryland. The remainder of the pilot project includes an 11-mile paved trail from Westlake Drive to Quince Orchard Road.[559] Pepco seeks recovery of the costs it has incurred in the amount of $157,000 for its work on the design of the trial.[560]

[558] See, for example, Case No. 9311, Order No. 85724 at 164-65: "Providing eight months of actual data initially, thereby limiting time required to update forecasted data for actual results, should enable parties to make more thorough and professional presentations and avoid many of the unnecessary disruptions experienced in this proceeding. Consequently, we direct Pepco in future rate case proceedings to limit its test year data to no more than four months of forecasted data."
[559] McGowan Direct at 35.
[560] Pepco Brief at 79.

No party opposes Pepco's request for recovery of the costs it has incurred so far regarding the design of the trail. In fact, Montgomery County has stated that it finds the costs incurred so far to be "reasonable."[561] However, Montgomery County witness Coffman expressed concerns regarding the scope of additional expenditures to complete the project, such as for final engineering and permits.[562] Accordingly, Montgomery County has asked that Pepco be directed to file an interim report to the Commission summarizing the efforts of the workgroup and discussing the scope and costs to complete the pilot project.

The Commission finds Montgomery County's request reasonable and directs that Pepco file an interim report on the scope and costs of the trail pilot project.

### 3. ***Root Cause Analysis Report***

Merger Condition 11 required that Pepco prepare and file a root cause report that addresses Pepco's customer satisfaction scores. OPC witness Alexander testified that Pepco's Root Cause Analysis Report (filed on September 22, 2016) is defective because it fails to examine any indicia except a statistical analysis of its customer survey results.[563] She further argued that the Company's Action Plans do not include any measurable outcomes, timetables, budgets, or reporting and performance mechanisms. Accordingly, she recommended that the Commission open a proceeding to examine the reasonableness of Pepco's Root Cause Analysis Report and require it to consult with stakeholders and prepare a proper report. She also urged the Commission to require Pepco to meet its

[561] Montgomery County Brief at 10.
[562] Coffman Direct at 8.
[563] Alexander Direct at 2.

2017-2018 call answering performance equal to or better than its 2016 performance to prevent further degradation of service.

Pepco argued that its Root Cause Analysis Report adhered to the requirements of Merger Condition 11 and identified and defined key drivers of customer satisfaction; identified the root causes of the problems and issues; identified corrective actions and action plans; implemented solutions; and monitored customer satisfaction.[564] Pepco further professed that it is committed to improving customer satisfaction and has a number of short and long-term initiatives to improve it.[565] Accordingly, Pepco asked that the Commission dismiss Ms. Alexander's criticisms of the report. Additionally, the Company opposed Ms. Alexander's recommendation to impose a new customer communication standard specific to Pepco.

The Commission considers customer satisfaction an important issue, and vital to the trust between the customer and the utility. Pepco's performance relative to its customer communication standards is strongly correlated with customer satisfaction. The Commission therefore appreciates Ms. Alexander's testimony on this topic. Although we do not find Pepco's root cause report deficient in this proceeding, we welcome her input in Case No. 9353, regarding the annual performance reports filed by the electric companies related to electric service reliability.[566]

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[564] Pepco Brief at 82.
[565] Pepco Brief at 84. The Company discussed reliability enhancement projects, implementing a new customer information system, a new integrated voice response system, and installing smart meters and an AMI network.
[566] Case No. 9353, *In the Matter of the Review of Annual Performance Reports on Electric Service Reliability Filed Pursuant to COMAR 20.50.12.11*.

### 4. ***Proposal to Reclassify Certain Projects From Load to Reliability***

OPC witness Lanzalotta testified that certain load-related capital spending by Pepco should be considered reliability-related capital spending subject to the caps imposed by Merger Condition 8.[567] Merger Condition 8 sets annual reliability performance targets for Pepco and provides that "Exelon shall achieve the proposed reliability standards … without exceeding the annual capital and O&M spending levels set forth below, absent a major outage event …"[568]

Although Pepco claims that increases in load-related spending are attributable to new loads currently under development, Mr. Lanzalotta does not agree. He observed that Pepco increased load-related capital spending from $4.2 million in 2012 to $48.9 million in 2016, even though the Company has experienced declining summer peaks.[569] Mr. Lanzalotta concluded that certain projects categorized as "load-related" actually function to support increased system reliability and should be subject to the Merger Order restrictions on reliability spending. Specifically, he testified that projects undertaken to address load switching by distribution automation schemes should be considered reliability-related and subject to Merger Condition 8. He therefore recommended that the Commission require Pepco to separate load spending into two categories: load growth due to distribution automation and load growth due to increases in customer loads. The former would be subject to the limits of Merger Condition 8. Alternatively, Mr.

[567] Lanzalotta Direct at 2.
[568] Merger Order, Order No. 86990, Appendix A, at A-14.
[569] Lanzalotta Direct at 7.

Lanzalotta argued that any annual load-related spending by Pepco in excess of $82.8 million should be considered as reliability-related and subject to the cap.[570]

Pepco opposes both of Mr. Lanzalotta's recommendations. Company witness Clark responded that its budgeting process classifies projects based on their scope of work and purpose served.[571] He denied that Pepco is undertaking certain load projects solely because of the Company's implementation of distribution automation. Although he acknowledged that installation of automated devices in the course of completing a load transfer do provide an ancillary reliability benefit going forward, he insisted that the installation of automated devices as part of a project to relieve load does not change the reason why the project is being done, which is for load relief.[572] Mr. Clark further asserted that "each and every one of those projects … [was] driven first and foremost and in most cases solely by a load problem. And a load problem isn't exacerbated, caused, or otherwise created because of [distribution automation]."[573] He concluded that the projects would be undertaken irrespective of whether or not Pepco had installed automated devices. Finally, Mr. Clark testified that Mr. Lanzalotta's focus on overall load projections is misplaced because it ignores the fact that Pepco is experiencing heavy load growth on specific parts of its system, for which it has an obligation to serve.[574]

The Commission will vigorously uphold the requirement that Pepco meet its merger reliability Condition 8 according to the budget caps set in that commitment. We welcome the scrutiny given the Company's capital spending, but in this circumstance

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[570] Lanzalotta Direct at 12.
[571] Clark Rebuttal at 9.
[572] Clark Rebuttal at 9.
[573] Hr'g Tr. at 500 (Clark).
[574] Hr'g Tr. at 462 (Clark).

decline OPC's recommendation to reclassify certain load-related projects as reliability-related projects, as well as OPC's alternative proposal to reclassify any annual load-related spending by Pepco in excess of $82.8 million as reliability-related. We do not find sufficient evidence in the record to support the contention that Pepco has improperly labeled reliability-related projects as load-driven in order to avoid the ceiling imposed by Merger Condition 8. Nor do we find that the load-related projects are primarily reliability-driven.

## IV. CONCLUSION

Based upon our review of the record in this case, we find that the Application filed on March 24, 2017, by Potomac Electric Power Company for a rate increase of $68,619,000 (updated to $68,634,000 on June 7, 2017) will not result in just and reasonable rates and is therefore denied. Instead, we find that based on a test year of the twelve months ending April 30, 2017, as adjusted above, the Company is authorized to file revised rates and charges for an increase in revenues of $33,967,000, which amount will result in just and reasonable rates to the Company and its customers. As allocated, the increase in the overall residential bill of a typical customer will be approximately 3.00%, which is $4.01 per month on average. The Company shall file revised tariffs for such increase in accordance with the rate design and other decisions in this Order.

**IT IS THEREFORE**, this 20th day of October, in the year Two Thousand Seventeen, by the Public Service Commission of Maryland,

**ORDERED** (1) That the Application of Potomac Electric Power Company, filed March 24, 2017, seeking to increase distribution rates for electric service by

$68,619,000 in its Maryland service territory (updated to $68,634,000 on June 7, 2017), is hereby denied;

(2) That Potomac Electric Power Company is hereby authorized, pursuant to § 4-204 of the Public Utilities Article, Annotated Code of Maryland, to file base rate tariffs for the distribution of electric energy in Maryland, which shall increase rates by no more than $33,967,000, and which shall otherwise be consistent with the findings of this Order;

(3) That such tariffs shall be effective for service rendered on and after October 20, 2017, subject to acceptance by the Commission;

(4) That Potomac Electric Power Company is hereby directed to file an interim report on the Montgomery County public-use trail pilot project as provided herein; and

(5) That all motions not granted within the body of this Order are denied.

*W. Kevin Hughes*

*Michael T. Richard*

*Anthony J. O'Donnell*

*Odogwu Obi Linton*
Commissioners*

* Commissioner Mindy L. Herman did not participate in this decision.

# Appendix I

**PEPCO Case No. 9443**

| **Revenue Requirement ($000's)** | | **Amount** |
|---|---|---|
| Adjusted Rate Base | $ | 1,638,159 |
| Rate of Return | | 7.43% |
| Required Operating Income | $ | 121,715 |
| Adjusted Operating Income | $ | 101,904 |
| Operating Income Deficiency | $ | 19,811 |
| Conversion Factor | | 1.71455 |
| Revenue Requirement | $ | 33,967 |

| | | **Rate Base ($000's)** | | **Operating Income ($000's)** |
|---|---|---|---|---|
| Per books | $ | 1,642,238 | $ | 103,043 |
| Uncontested and agreed on adjustments | $ | 2,597 | $ | (4,804) |
| Total uncontested | $ | 1,644,835 | $ | 98,239 |

| **Uncontested Company-Proposed Ratemaking Adjustments** | **Adj #** | | **Rate Base ($000's)** | | **Operating Income ($000's)** |
|---|---|---|---|---|---|
| Annualization of Test Year Reliability Plant Closings | 1 | $ | 7,852 | $ | (999) |
| Annualization of MD Case No. 9418 Revenue | 4 | $ | - | $ | 18,076 |
| Annualize Case 9418 Depreciation Rates | 5 | $ | (3,418) | $ | (6,818) |
| Annualize Regulatory Asset Amortization | 6 | $ | (1,799) | $ | (9,337) |
| Annualize Re-Stated Storm Deferrals | 7 | $ | - | $ | 1,139 |
| Annualization of 2017 Pension Expense | 8 | $ | - | $ | 1,072 |
| Annualization of 2017 OPEB Expense | 9 | $ | - | $ | 63 |
| Reflection of Uncollectible Write-Offs | 10 | $ | - | $ | (1,252) |
| Annualization of Wage Increases | 11 | $ | - | $ | (485) |
| Reflection of Employee Health & Welfare Cost Increases | 12 | $ | - | $ | (313) |
| Reflection of 3-Year Average AIP Costs | 13 | $ | - | $ | 758 |
| Exclusion of Executive Incentive Costs | 14 | $ | - | $ | 1,509 |
| Reflection of 3-Year Avg Auto & General Claim Payments | 16 | $ | - | $ | (441) |
| Exclusion of Institutional & Promotional Ad Expense | 17 | $ | - | $ | 222 |
| Exclusion of 50% Employee Activity Costs | 18 | $ | - | $ | 58 |
| Reflection of 3-Year Avg Overtime Expenses | 19 | $ | - | $ | 352 |
| Reflection of 5 Year Average Synergies | 20 | $ | - | $ | (5,362) |
| Annualization of CTA Regulatory Asset | 21 | $ | (825) | $ | (4,470) |
| Removal of Benning Environmental Remediation Cost | 23 | $ | - | $ | 310 |
| Inclusion of Commission Authorized Interest Expense | 24 | $ | - | $ | (338) |
| Remove Expiring Regulatory Asset Amortization | 25 | $ | - | $ | (777) |
| AMI Regulatory Asset (1/1/16 - 11/15/16) | 27 | $ | 1,780 | $ | (611) |
| Eliminate Impact of Re-Connection Fees Refund | 28 | $ | - | $ | 962 |
| Outside Contractors/Legal | 29 | $ | - | $ | 112 |
| Remove Aged Capital Work Orders Charge | 31 | $ | (1,387) | $ | 1,839 |
| Winter Storm Stella | 35 | $ | 394 | $ | (73) |
| **Total Uncontested Adjustments before AFUDC Offset** | | **$** | **2,597** | **$** | **(4,804)** |
| **Contested Company-Proposed Ratemaking Adjustments:** | | | | | |
| Post Test Year Reliability Closings (May thru June 2017) | 2 | $ | (1,722) | $ | (2,872) |
| Post Test Year Reliability Closings (July thru December 2017) | 3 | $ | - | $ | - |
| Reduction of SERP Expense and Liability | 15 | $ | - | $ | 1,014 |
| Add Back Test Period Synergies | 22 | $ | - | $ | 4,081 |
| Current Rate Case Costs | 26 | $ | - | $ | (29) |
| Pre-81 Removal Costs Flow Through | 30 | $ | - | $ | - |
| **Additional Intervenor-Proposed Ratemaking Adjustments:** | | | | | |
| Deferred Storm Cost Amortization | | $ | - | $ | 638 |
| NOLC Adjustment | | $ | - | $ | - |
| Remove Unexplained & Unjustified O&M Expense Increases | | $ | - | $ | - |
| Merger SAIFI Reliability Commitment - AIP | | $ | - | $ | 675 |
| RM 54 POR Costs a/ | | $ | - | $ | - |
| **Synchronization of Ratemaking Adjustments:** | | | | | |
| AFUDC Synchronization | 32 | $ | - | $ | (221) |
| Adjustments to Cash Working Capital Allowance | 33 | $ | (4,954) | $ | - |
| Tax Effect of Proforma Interest Expense | 34 | $ | - | $ | 353 |
| **Updated Company-Proposed Adjustment:** | | | | | |
| Case No. 9444 Expenses | | $ | - | $ | 26 |
| **Adjusted Rate Base and Operating Income** | | **$** | **1,638,159** | **$** | **101,904** |

Appendix II

**POTOMAC ELECTRIC POWER COMPANY**
**CASE NO. 9443**
Analysis of Proposed Rate Increase - Position by Party
Twelve Months Ended April 30, 2017

| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) | (13) | (14) | (15) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | **PEPCO (Hearings Update)** | | | **STAFF (Hearings Update)** | | | **OPC (Surrebuttal)** | | | **AOBA (Surrebuttal)** | | |
| Line No. | RMA | (Thousands of Dollars) | Rate Base | Operating Income | Revenue Requirement | Rate Base | Operating Income | Revenue Requirement | Rate Base | Operating Income | Revenue Requirement | Rate Base | Operating Income | Revenue Requirement |
| 1 | | Unadjusted Amounts | $ 1,642,238 | $ 103,043 | | $ 1,642,238 | $ 103,043 | | $ 1,642,238 | $ 103,043 | | $ 1,642,238 | $ 103,043 | |
| 2 | | Revenue requirement at Party's proposed rate of return | | | $ 41,263 | | | $ 31,126 | | | $ 21,978 | | | $ 24,932 |
| 3 | | | | | | | | | | | | | | |
| 4 | | **Uncontested Company-Proposed Ratemaking Adjustments** | | | | | | | | | | | | |
| 5 | 1 | Annualization of Test Year Reliability Plant Closings | 7,852 | (999) | 2,755 | 7,852 | (999) | 2,706 | 7,852 | (999) | 2,663 | 7,852 | (999) | 2,677 |
| 6 | 4 | Annualization of MD Case No. 9418 Revenue | - | 18,076 | (30,992) | - | 18,076 | (30,992) | - | 18,076 | (30,992) | - | 18,076 | (30,992) |
| 7 | 5 | Annualize Case 9418 Depreciation Rates | (3,418) | (6,818) | 11,236 | (3,418) | (6,818) | 11,257 | (3,418) | (6,818) | 11,276 | (3,418) | (6,818) | 11,270 |
| 8 | 6 | Annualize Regulatory Asset Amortization | (1,799) | (9,337) | 15,770 | (1,799) | (9,337) | 15,781 | (1,799) | (9,337) | 15,791 | (1,799) | (9,337) | 15,788 |
| 9 | 7 | Annualize Re-Stated Storm Deferrals | - | 1,139 | (1,953) | - | 1,139 | (1,953) | - | 1,139 | (1,953) | - | 1,139 | (1,953) |
| 10 | 8 | Annualization of 2017 Pension Expense | - | 1,072 | (1,838) | - | 1,072 | (1,838) | - | 1,072 | (1,838) | - | 1,072 | (1,838) |
| 11 | 9 | Annualization of 2017 OPEB Expense | - | 63 | (108) | - | 63 | (108) | - | 63 | (108) | - | 63 | (108) |
| 12 | 10 | Reflection of Uncollectible Write-Offs | - | (1,252) | 2,147 | - | (1,252) | 2,147 | - | (1,252) | 2,147 | - | (1,252) | 2,147 |
| 13 | 11 | Annualization of Wage Increases | - | (485) | 832 | - | (485) | 832 | - | (485) | 832 | - | (485) | 832 |
| 14 | 12 | Reflection of Employee Health & Welfare Cost Increases | - | (313) | 537 | - | (313) | 537 | - | (313) | 537 | - | (313) | 537 |
| 15 | 13 | Reflection of 3-Year Average AIP Costs | - | 758 | (1,300) | - | 758 | (1,300) | - | 758 | (1,300) | - | 758 | (1,300) |
| 16 | 14 | Exclusion of Executive Incentive Costs | - | 1,509 | (2,587) | - | 1,509 | (2,587) | - | 1,509 | (2,587) | - | 1,509 | (2,587) |
| 17 | 16 | Reflection of 3-Year Avg Auto & General Claim Payments | - | (441) | 756 | - | (441) | 756 | - | (441) | 756 | - | (441) | 756 |
| 18 | 17 | Exclusion of Institutional & Promotional Ad Expense | - | 222 | (381) | - | 222 | (381) | - | 222 | (381) | - | 222 | (381) |
| 19 | 18 | Exclusion of 50% Employee Activity Costs | - | 58 | (99) | - | 58 | (99) | - | 58 | (99) | - | 58 | (99) |
| 20 | 19 | Reflection of 3-Year Avg Overtime Expenses | - | 352 | (604) | - | 352 | (604) | - | 352 | (604) | - | 352 | (604) |
| 21 | 20 | Reflection of 5 Year Average Synergies | - | 5,362 | (9,193) | - | 5,362 | (9,193) | - | 5,362 | (9,193) | - | 5,362 | (9,193) |
| 22 | 21 | Annualization of CTA Regulatory Asset | (825) | (4,470) | 7,555 | (825) | (4,470) | 7,560 | (825) | (4,470) | 7,564 | (825) | (4,470) | 7,563 |
| 23 | 23 | Removal of Benning Environmental Remediation Cost | - | 310 | (532) | - | 310 | (532) | - | 310 | (532) | - | 310 | (532) |
| 24 | 24 | Inclusion of Commission Authorized Interest Expense | - | (338) | 580 | - | (338) | 580 | - | (338) | 580 | - | (338) | 580 |
| 25 | 25 | Remove Expiring Regulatory Asset Amortization | - | (777) | 1,332 | - | (777) | 1,332 | - | (777) | 1,332 | - | (777) | 1,332 |
| 26 | 27 | AMI Regulatory Asset (1/1/16 - 11/15/16) | 1,780 | (611) | 1,284 | 1,780 | (611) | 1,273 | 1,780 | (611) | 1,263 | 1,780 | (611) | 1,266 |
| 27 | 28 | Eliminate Impact of Re-Connection Fees Refund | - | 962 | (1,649) | - | 962 | (1,649) | - | 962 | (1,649) | - | 962 | (1,649) |
| 28 | 29 | Outside Contractors/Legal | - | 112 | (192) | - | 112 | (192) | - | 112 | (192) | - | 112 | (192) |
| 29 | 31 | Remove Aged Capital Work Orders Charge | (1,387) | 1,839 | (3,337) | (1,387) | 1,839 | (3,329) | (1,387) | 1,839 | (3,321) | (1,387) | 1,839 | (3,323) |
| 30 | 35 | Winter Storm Stella | 394 | (73) | 177 | 394 | (73) | 175 | 394 | (73) | 173 | 394 | (73) | 174 |
| 31 | | | | | | | | | | | | | | |
| 32 | | Subtotal Adjustments before AFUDC Offset | 2,597 | 5,920 | (9,804) | 2,597 | 5,920 | (9,821) | 2,597 | 5,920 | (9,835) | 2,597 | 5,920 | (9,829) |
| 33 | | | | | | | | | | | | | | |
| 34 | | **Contested Company-Proposed Ratemaking Adjustments** | | | | | | | | | | | | |
| 35 | 2 | Post Test Year Reliability Closings (May thru June 2017) | (1,722) | (2,872) | 4,696 | - | - | - | - | - | - | (1,722) | (2,872) | 4,713 |
| 36 | 3 | Post Test Year Reliability Closings (July thru December 2017) | 58,679 | (731) | 9,040 | - | - | - | - | - | - | 58,679 | (731) | 8,457 |
| 37 | 15 | Reduction of SERP Expense and Liability | (1,979) | 846 | (1,713) | - | 1,014 | (1,739) | (1,979) | 1,013 | (1,976) | (1,979) | 846 | (1,693) |
| 38 | 22 | Add Back Test Period Synergies | - | (4,081) | 6,997 | - | (4,081) | 6,997 | - | (1,859) | 3,187 | - | - | - |
| 39 | 26 | Current Rate Case Costs | - | (56) | 96 | - | (29) | 50 | - | (56) | 96 | - | (56) | 96 |
| 40 | 30 | Pre-81 Removal Costs Flow Through | (11,378) | (11,378) | 17,998 | - | - | - | (1,138) | (1,138) | 1,813 | (11,378) | (11,378) | 18,111 |
| 41 | | | | | | | | | | | | | | |
| 42 | | **Additional Intervenor-Proposed Ratemaking Adjustments:** | | | | | | | | | | | | |
| 43 | | Deferred Storm Cost Amortization | - | - | - | - | - | - | - | 2,064 | (3,539) | - | - | - |
| 44 | | NOLC Adjustment | - | - | - | - | - | - | (15,480) | - | (1,873) | - | - | - |
| 45 | | Remove Unexplained & Unjustified O&M Expense Increases | - | - | - | - | - | - | - | - | - | - | 10,823 | (18,557) |
| 45 | | Merger SAIFI Reliability Commitment - AIP | - | - | - | - | - | - | - | - | - | - | - | - |
| 46 | | RM 54 POR Costs a/ | - | - | - | - | - | - | - | - | - | - | - | - |
| 47 | | | | | | | | | | | | | | |
| 48 | | **Synchronization of Ratemaking Adjustments** | | | | | | | | | | | | |
| 49 | 32 | AFUDC Synchronization | - | 29 | (50) | - | (262) | 449 | - | 29 | (50) | - | 29 | (50) |
| 50 | 33 | Adjustments to Cash Working Capital Allowance | (5,028) | - | (667) | (4,859) | - | (615) | (5,028) | - | (608) | (5,028) | - | (617) |
| 51 | 34 | Tax Effect of Proforma Interest Expense | - | 444 | (761) | - | 372 | (638) | - | (470) | 806 | - | 444 | (761) |
| 52 | | | | | | | | | | | | | | |
| 53 | | **Updated Company-Proposed Adjustment** | | | | | | | | | | | | |
| 54 | | Case No. 9444 Expenses | - | 26 | (45) | - | 26 | (45) | - | 26 | (45) | - | 26 | (45) |
| 55 | | | | | | | | | | | | | | |
| 56 | | | | | | | | | | | | | | |
| 57 | | Total Revenue Requirement | $ 1,683,407 | $ 91,190 | $ 67,048 | $ 1,639,976 | $ 106,003 | $ 25,764 | $ 1,621,210 | $ 108,572 | $ 9,954 | $ 1,683,407 | $ 106,094 | $ 24,757 |
| 58 | | Alternative Total Revenue Requirement | | | | | | | | | $ 13,439 | | | |
| 59 | | Gross Up Factor | 58.3244% | | | 58.3244% | | | 58.3244% | | | 58.3244% | | |
| 60 | | | | | | | | | | | | | | |
| 61 | | Capital Structure | | | | | | | | | | | | |
| 62 | | Long Term Debt | 49.85% | 5.35% | 2.67% | 49.85% | 5.35% | 2.67% | 49.85% | 5.35% | 2.67% | 51.65% | 5.35% | 2.76% |
| 63 | | Common Stock | 50.15% | 10.10% | 5.07% | 50.15% | 9.39% | 4.71% | 50.15% | 8.75% | 4.39% | 48.35% | 9.10% | 4.40% |
| 64 | | Proposed Rate of Return | | | **7.74%** | | | **7.38%** | | | **7.06%** | | | **7.16%** |
| 65 | | | | | | | | | | | | | | |
| 66 | | Common Stock (Alternative) | | | | | | | 50.15% | 9.00% | 4.51% | | | |
| 67 | | Alternative Proposed Rate of Return | | | | | | | | | **7.18%** | | | |
| 68 | | | | | | | | | | | | | | |

69 Note: Montgomery County did not file written testimony regarding specific ratemaking adjustments or revenue requirements, but reserves the right to adopt adjustments proposed by other intervenors in this proceeding in its Brief.

70 a/ Per Pepco's Additional Supplemental Testimony filed August 9, 2017, if the Commission elects to use the supplier liability fund for the POR programming costs, then that would result in a rate base reduction of $110,000 and operating income increase of $39,000, as shown on Exhibit FLP -5.

71 Updated