ML 223208

ORDER NO. 88944

IN THE MATTER OF THE APPLICATION OF WASHINGTON GAS LIGHT COMPANY FOR AUTHORITY TO INCREASE EXISTING RATES AND CHARGES AND TO REVISE ITS TERMS AND CONDITIONS FOR GAS SERVICE	* * * * * * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9481

Before: Jason M. Stanek, Chairman
Michael T. Richard, Commissioner
Anthony J. O'Donnell, Commissioner
Odogwu Obi Linton, Commissioner
Mindy L. Herman, Commissioner

Issued: December 11, 2018

APPEARANCES

Donald R. Hayes, Meera Ahamed, John C. Dodge, and Robert C. Cain, II for the Washington Gas Light Company

Gary L. Alexander and Joseph G. Cleaver for the Maryland Office of People's Counsel

Annette B. Garofalo, Lloyd J. Spivak and Michael A. Dean 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

James K. McGee for Prince George's County, Maryland

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I. BACKGROUND

On May 15, 2018, Washington Gas Light Company[1] ("WGL" or "the Company") filed with the Maryland Public Service Commission ('the Commission") an application for authority to increase its base rates by $56.3 million for natural gas distribution service in Maryland, representing an increase in Maryland annual base rates of 10.96%.[2] The revenue requirement was updated in the Company's supplemental direct filing to $56.6 million; however, the Company did not request a further increase in revenues from its original request of $56.3 million.[3] WGL asked for an overall rate of return of 7.60% and a return on common equity of 10.30%[4]

WGL stated that the request for an increase in base rates is driven by general cost increases in operation and maintenance expenses, growth in rate base, employee-related costs, a new billing system, higher leak management costs, and regulatory requirements.[5] Additionally, the Company observed that the transfer of STRIDE costs from the surcharge to base rates accounts for $15 million of the proposed total revenue increase. In particular, WGL's application for a rate increase highlights elevated costs the Company has experienced to address emergency odor call response and other leak mitigation activities, pursuant to the Company's Pipeline Safety, System Integrity goal.[6]

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[1] WGL, a domestic corporation of the District of Columbia and the Commonwealth of Virginia, provides natural gas retail sales and delivery services in Maryland to customers in Calvert, Charles, Frederick, Montgomery, Prince George's, and St. Mary's Counties. WGL also provides natural gas retail sales and delivery services to customers in the District of Columbia and Virginia. WGL has provided natural gas services to customers for 170 years. WGL Application at 4-5.

[2] WGL May 15, 2018 Application at 1. The Company noted that the proposed base rate increase includes $15 million currently being collected through surcharges associated with WGL's Strategic Infrastructure Development and Enhancement ("STRIDE") Plan. The Company observed that the incremental amount of the increase in base rates would therefore be $41.3 million, or 8.04%.

[3] WGL July 12, 2018 transmittal letter of Supplemental Direct Testimony at 1.

[4] Application at 5.

[5] Chapman Direct at 6.

[6] Chapman Direct at 8, 12.

In its application, WGL asked the Commission to accept its use of a partially forecasted test year, arguing that its use would reduce regulatory lag and more accurately depict the Company's expenses in the rate effective period. WGL last requested a general rate increase on April 26, 2013, in Case No. 9322.

The Commission has thoroughly reviewed WGL's Application and the evidence presented by all of the parties to the case, as well as the public's comments. After careful consideration, the Commission authorizes WGL to increase its Maryland natural gas distribution rates by $28,602,000, which will result in an increase to the average monthly residential bill of $4.08, or 5.69%. Part of that rate increase is attributable to a higher authorized return. After carefully considering WGL's request together with the evidence presented by the other parties related to the cost of capital, the Commission finds that an increased return on equity of 9.70% provides for a fair and appropriate return, and will allow WGL to obtain any necessary capital investment at reasonable interest rates. The Commission further finds that an overall rate of return of 7.30% is justified by the record in this proceeding.

As in prior WGL cases, the Commission has strived to limit rate impacts while allowing the Company to invest in safety and reliability and continue to modernize its distribution system for the benefit of its customers. The Commission has also acted to ensure that no costs associated with the merger of WGL Holdings, Inc. and AltaGas Ltd. are included in the rates that Maryland customers pay.[7]

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[7] *See In the Matter of the Merger of AltaGas Ltd. and WGL Holdings, Inc.*, Case No. 9449, Order No. 88631 (April 4, 2018).

II. DISCUSSION AND FINDINGS

A. Adjustments to Rate Base and Operating Income

Rate base represents the investment a company makes in plant and equipment to provide safe and reliable gas distribution service to its customers. Operating income is derived from the revenues the Company receives for gas 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. The Commission has reviewed the record and accepts the uncontested rate base and operating income adjustments, and resolves the disputed adjustments below.[8]

1. WGL Adjustment 12: Forecasted Revenues

WGL

WGL witnesses Robert B. Hevert, Partner at ScottMadden, Inc., Robert E. Tuoriniemi, Chief Regulatory Accountant for WGL, and Adrian P. Chapman, President and Chief Operating Officer of WGL, addressed regulatory lag. Mr. Hevert defined regulatory lag as the length of time between the investment of funds by the utility and the recovery of those funds through rates. Mr. Tuoriniemi testified that because rates are set prospectively based on a historic test year, regulatory lag may prevent the Company from earning its authorized rate of return. He stated: "Relying solely on a historical test period when the cost of service is subject to cost increases and inflation

[8] *See* Appendix I for the Commission's calculation of the appropriate rate base, operating income, and overall revenue requirement for rate making purposes.

every year will necessarily understate the cost of service in the rate effective period."[9] Mr. Chapman testified that regulatory lag is not limited to the length of time it takes for a public utility commission to process a rate case (which in Maryland is up to 210 days), but includes also Maryland's practice of requiring 12 months of historical data (the test year) to justify the utility's request for future revenues and costs.[10] Mr. Chapman further stated that regulatory lag in Maryland can reach two years in duration.

In order to reduce the negative impacts of regulatory lag, Mr. Tuoriniemi stated that WGL utilized a test year that is "as close as feasible as to when rates will go into effect."[11] Additionally, Mr. Tuoriniemi testified that the Commission should approve Company adjustments that update the historical test year ending March 31, 2018, to become a "rate year" utilizing projections through December 31, 2019. WGL witnesses made rate year adjustments for all major elements of the cost of service, including Revenues, Labor, Depreciation & Amortization, Gas Plant in Service, Construction Work-in-Progress, Reserve for Depreciation & Amortization, and Accumulated Deferred Income Taxes ("ADIT").[12] Mr. Chapman testified that the Commission allowed recovery for certain known and measurable safety and reliability expenditures incurred outside the test year in Case Nos. 8959 and 9267, and asked the Commission do the same in this proceeding.[13] Additionally, Mr. Chapman requested that the Commission consider opening a generic proceeding, open to all Commission-regulated utilities and

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[9] Tuoriniemi Direct at 7. Mr. Tuoriniemi explained that WGL has experienced continual increases in the cost of providing services to its customers, while at the same time experiencing new customer additions at just over 1% per year, resulting in new revenues that are not sufficient to offset increases in cost of service. Tuoriniemi Direct at 8-9.
[10] Chapman Rebuttal at 2-3.
[11] Tuoriniemi Direct at 7.
[12] Tuoriniemi Direct at 8.
[13] Chapman Rebuttal at 3.

stakeholders, to address the Commission's rate recovery practices and their contribution to regulatory lag. Without adjusting for regulatory lag, Mr. Tuoriniemi testified that WGL would be required to file rate cases more frequently.[14]

In its Adjustment 12, WGL updated its historical test year ended March 31, 2018, to reflect projected Revenue Growth and Purchased Gas Adjustment through December 31, 2019. That adjustment increased revenues by $8,419,173, which is partially offset by the corresponding increase in purchased gas costs of $4,525,305. That adjustment comprises post-test-year forecasted revenue growth through the rate effective period. The Company uses customer additions through March 2018 and then forecasted customer growth through December 2019. The adjustment comprises three pieces: 1) an adjustment to annualize customers in the test period, 2) an adjustment to add customers and their annual usage for the interim period between the end of the test year and when rates go into effect, and 3) an adjustment to add customers as they come on to the system in the rate year.[15]

Staff

Bion C. Ostrander, an independent regulatory consultant, testified on behalf of the Public Service Commission Staff ("Staff"). Mr. Ostrander recommended removal of WGL adjustments related to its rate year, which he testified were not known and measurable.[16] In particular, Mr. Ostrander made rate base adjustments related to Gas Plant in Service (WGL Adjustment 6), Construction Work in Progress (WGL Adjustment 7), Depreciation Reserve (WGL Adjustment 8), and Accumulated

[14] Tuoriniemi Direct at 9.
[15] WGL witness Tuoriniemi Direct at 60, lines 10-18.
[16] Ostrander Direct at 18.

Deferred Income Taxes (WGL Adjustment 11). Mr. Ostrander also made operating expense adjustments related to Depreciation Expense (WGL Adjustment 9).

Mr. Ostrander criticized the updated forward-looking test year (or rate year) utilized by Mr. Tuoriniemi as being excessively long, noting that WGL made projections through December 31, 2019, which is 21 months beyond the test period end of March 31, 2018. Mr. Ostrander observed that the Commission has typically adhered to a historical test year, with few exceptions. Additionally, Mr. Ostrander testified that operating income and rate base adjustments made beyond the test period end date of March 31, 2018 are not known and measurable, may result in plant additions that are not used and useful, and "do not have a reasonable degree of certainty and are too speculative."[17]

Mr. Ostrander also disputed WGL's argument that it cannot earn a fair rate of return under existing regulatory principles in Maryland given regulatory lag.[18] First, he noted that WGL's last rate case was filed five years ago in 2013. To the extent the Company was under-earning its authorized rate of return, it was within its power to file rate cases more frequently.[19] Additionally, Mr. Ostrander noted that WGL reached the limit of its five-year requirement for filing a rate case to recover its STRIDE investment, leaving unclear whether the Company would have filed without the STRIDE constraint. Additionally, Mr. Ostrander disputed that WGL has not been earning a reasonable return, noting that for FY 2017, WGL's Actual Utility return on equity ("ROE") of

[17] Ostrander Direct at 9.
[18] Case No. 9322, *In the Matter of the Application of Washington Gas Light Company for Authority to Increase Its Existing Rates and Charges and to Revise Its Terms and Conditions for Gas Service.*
[19] Ostrander Direct at 9.

9.48% slightly exceeded its Targeted ROE of 9.46%.[20] Similarly, for 2015, the Utility ROE of 10.5% exceeded the Target ROE of 9.57%. Third, Mr. Ostrander argued that WGL executives and other personnel have not incurred any decrease in base salary or incentive pay, indicating circumstantially that WGL has not under-performed.

Mr. Ostrander also criticized the manner in which WGL calculated its forecasted test year. He claimed that to have credibility, a utility would need to file adjustments even-handedly that both increase and decrease the revenue requirement, but that in this case, almost every Company adjustment increased the revenue requirement. In cases where the projected test year would have decreased the revenue requirement, Mr. Ostrander claimed WGL used a historic test year and did not project cost reductions forward to December 31, 2019. He concluded that "[t]his is not a fair and balanced approach to regulation or a forecasted test year concept."[21] Mr. Ostrander also argued that using a forecasted test year is risky for ratepayers because, to the extent the Commission over estimates future costs, and therefore allows the Company to over-recover, there is no remedy as the bar against retroactive ratemaking prevents any cure for the over-collection. Finally, Mr. Ostrander argued that WGL did not prepare a formal assessment of regulatory lag in the three jurisdictions (Maryland, the District of Columbia, and Virginia) in which it operates.

Because most of the adjustments related to WGL Adjustment 12 are not known and measurable, Mr. Ostrander recommended removal of that adjustment. In his Direct Testimony, Mr. Ostrander removed WGL's adjustment in total, noting that he planned to true up this adjustment when it would be possible to identify what amounts are related to

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[20] Ostrander Direct at 10, *citing* Staff DR 15-8.
[21] Ostrander Direct at 11.

the test period and what amounts are forecasted for the post-test period. Based on clarifying responses to Staff's data requests where WGL indicated that the entire adjustment is forecasted, Mr. Ostrander's surrebuttal testimony removed WGL's entire adjustment, disallowing forecasted amounts that are not known and measurable.[22]

Mr. Ostrander testified that WGL's estimated post-test period revenue and customer growth for the 21 month post-test period of April 2018 to December 2019 are not known and measurable because none of the primary underlying inputs (including rates, number of customers, and volumes) are knowable with any reasonable certainty at this time. He argued that the number of customers and related volumes could change based on a number of variables, including the rates to be set in this rate case, as well as future competitive alternatives, the future economy, and customers exiting the system.[23] Mr. Ostrander further stated that all major inputs are more speculative than known.

OPC

David J. Effron, a consultant specializing in utility regulation, testified on behalf of the Maryland Office of People's Counsel ("OPC.") He characterized WGL's rate year and comprehensive rate year update as, in substance, a future test year. He observed that the adoption of WGL's future test year would represent a significant departure from the Commission's long-established precedent of utilizing a historic test year and would affect all utilities within the regulatory authority of the Commission. He suggested that if the

[22] Staff Brief at 18-19.
[23] Ostrander Direct at 16.

Commission were to consider such a dramatic change in practice, it should do so in the context of a generic ratemaking investigation.[24]

Mr. Effron further argued that WGL has not established in this proceeding that regulatory lag has prevented the Company from receiving a just and reasonable return, noting that if STRIDE revenue is considered, WGL may have earned more than the authorized return on equity established in WGL's last rate case.[25] Additionally, OPC argued that the evidence the Company relied upon to justify a move away from a historic test year was lacking. Specifically, OPC stated that the calculations upon which WGL based its claim that it under-earned its return were misleading, because they were based on the Company's actual capital structure and not the hypothetical capital structure that the Commission imposed on WGL in Case No. 9322. Using the hypothetical capital structure, WGL over-earned its return for the majority of quarters from 2014 through 2017.[26]

Pursuant to the Commission's precedent regarding historic test years, Mr. Effron recommended that WGL's pro forma adjustments to reflect the future test year rate base, revenues, and expenses be eliminated. Mr. Effron delineated his adjustments to eliminate WGL's future test year rate base adjustments on Exhibit 14, DJE-1, Schedule B-1.[27]

[24] Effron Direct at 4.
[25] Effron Direct at 5-6.
[26] OPC Brief at 7-8, *citing* Arndt Surrebuttal at Exhibit MLA-1 SR.
[27] Mr. Effron's adjustments to remove WGL's future test year adjustments included (i) elimination of pro forma future test year adjustments to plant, accumulated depreciation, and ADIT, net of STRIDE and safety plant through December 2018, (ii) elimination of WGL's projected future growth of the deferred tenant allowance, (iii) elimination of WGL's adjustment to reflect growth in billing determinants in the future test year, (iv) elimination of the projected increase in the employee count in the future test year, (v) elimination of the effect of the pro forma wage rate increase forecasted to take place in 2019 and December 2018, (vi) elimination of certain post-merger related labor expenses expected to increase during the future test year, (vii) elimination of certain 401(k) benefits in the future test year, and (viii) adjustments related to certain taxes such as gross receipt taxes, FICA and Medicare, and property taxes. Effron Direct at 6-10.

His elimination of the Company's future test year revenue and expense adjustments is shown on Exhibit DJE-1, Schedule C-1 and C-1.1. The elimination of WGL's pro forma future test year rate base adjustments reduces the rate base by $66,161,000.

WGL Response

Mr. Tuoriniemi argued that relying exclusively on historical costs without recognizing known and measurable increases will necessarily understate the cost of service when rates go into effect.[28] Given that WGL is facing inflationary, not deflationary pressure, he indicated that WGL would be denied its authorized rate of return if the Commission adheres strictly to a historic test year. Mr. Tuoriniemi argued that a historic test year is not sacrosanct and that states like Virginia allow utilities to propose ratemaking adjustments that reach forward into the rate year. He further stated that FERC permits companies to use a test period consisting of a 12-month base period of recently available actual experience plus an adjustment period of nine months immediately following the base period.[29] Mr. Tuoriniemi disagreed with Staff witness Ostrander's characterization of WGL's rate year as lacking credibility because it failed to include adjustments that both decrease and increase the revenue requirement. Mr. Tuoriniemi argued that the Company's rate year did make both types of adjustments.

Mr. Tuoriniemi contested the adjustments of Staff witness Ostrander and OPC witness Effron regarding revenue growth, arguing that their methodologies and results were flawed.[30] For example, he charged that Mr. Ostrander selectively updated adjustments when they served to lower the revenue requirement and ignored them when

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[28] Tuoriniemi Rebuttal at 5.
[29] Tuoriniemi Rebuttal at 9.
[30] Tuoriniemi Rebuttal at 30-32.

they increased the revenue requirement. He also criticized Mr. Effron for using an outdated rate in setting late payment revenues and Mr. Ostrander for selectively revising the five-year net charge off ratio regarding the uncollectible accounts expense.[31]

Commission Decision

The Commission denies WGL's proposed future year adjustments. The extension of recovery to include costs 21 months beyond WGL's test year would be unprecedented and unwarranted for WGL or any other Maryland public service company. The Commission has been consistent in its adherence to a traditional test year that bases new rates on actual, not projected, data. WGL's proposal to use projections to create a test year that would incorporate forecasted costs through December 2019 stands in contravention to this longstanding Commission principle. Overall, WGL's forecasted test year would create adjustments that are not known and measurable, plant additions that are not used and useful, and adjustments that lack a reasonable degree of certainty and are speculative. Accordingly, although the Commission has statutory authority to consider alternative ratemaking proposals, such as a projected future test year, the Commission declines to deviate from its adherence to a traditional test year in this proceeding.

The Commission finds that regulatory lag does not prevent WGL from earning a just and reasonable return. It is within WGL's power to incorporate operational efficiencies and to control costs, and to the extent WGL faces a rising cost environment and decides to file a rate case, the Commission will objectively evaluate the Company's claims in that proceeding. Finally, this Commission has consistently rejected claims that

[31] Tuoriniemi Rebuttal at 34, 36.

regulatory lag justifies deviation from a historic test year as well as proposals to base future rates on a fully forecasted test year. *See In re Baltimore Gas and Elec. Co*., 102 Md.P.S.C. 74 (March 9, 2011) ("Moreover, the Commission concludes that regulatory lag alone is not a sufficient justification for approving adjustments to an average rate base."); *In re Delmarva Power & Light Co*., 103 Md.P.S.C. 377, (July 20, 2012) ("Except for these limited, purely reliability- and safety-related expenses, we have declined Delmarva's repeated requests that we deviate, in its favor, from our historic, average test year ratemaking principles.")

Accordingly, WGL's proposed adjustments related to the rate year in Adjustment 12 Forecasted Revenues are denied. Other proposed adjustments from the Company related to the rate year concept, including Gas Plant in Service, ("GPIS") are discussed in more depth in Section 18, Adjustment 13 GPIS – STRIDE and Safety Plant, *infra*.

2. WGL Adjustment 9: Depreciation Expense

WGL

Dr. Ronald E. White, of Foster Associates Consultants, LLC, testified on behalf of WGL in favor of the Company's request for revised depreciation rates. He recommended an overall composite deprecation rate of 2.42%, in lieu of the current composite rate of 2.33%.[32] His proposed depreciation rates produce an increase in depreciation expense of $3,088,087, based on the test year average plant balances ending March 2018.[33]

[32] White Direct at 4.
[33] WGL Brief at 67.

Dr. White sponsored WGL's 2017 Depreciation Rate Study in order to determine the appropriate recovery of plant investment and net salvage costs, which provides an examination of original investment based on the period ending December 31, 2016.[34] Dr. White conducted statistical life studies as well as a net salvage analysis for WGL plant and equipment.[35] He also performed an analysis of recorded depreciation reserves. Dr. White testified that he rebalanced depreciation reserves for WGL, stating: "Offsetting reserve imbalances attributable to both the passage of time and parameter adjustments recommended in the 2015 study should be realigned among primary accounts to reduce offsetting imbalances and increase depreciation rate stability."[36]

Dr. White testified that the Commission last examined WGL's depreciation rates in Case No. 9103. Based on the 2017 Depreciation Rate Study, he recommended the following changes in this proceeding:

	Accrual Rate			**2017 Annualized Accrual**		
Function	**Current**	**Proposed**	**Difference**	**Current**	**Proposed**	**Difference**
Storage	2.86%	2.64%	-0.22%	$713,626	$660,091	($53,535)
Transmission	1.87%	1.91%	0.04%	2,468,533	2,522,220	53,687
Distribution	1.54%	1.65%	0.11%	20,476,853	21,933,639	1,456,786
General	8.44%	8.45%	0.01%	15,025,806	15,044,987	19,181
Total	**2.33%**	**2.42%**	**0.09%**	**$38,684,818**	**$40,160,937**	**$1,476,119**

Staff

David L. Valcarenghi, Assistant Director of the Commission's Accounting Investigations Division, testified on behalf of the Commission's Staff regarding depreciation. Mr. Valcarenghi observed that WGL's depreciation rates were last

[34] White Direct at 8.
[35] White Direct at 9.
[36] White Direct at 10.

examined in 2011 in Case No. 9103, where the Commission determined that WGL's depreciation rates should reflect recovery of net salvage costs using the present value basis pursuant to Staff's SFAS 143 Present Value Methodology.[37]

Regarding depreciation rates in this proceeding, Mr. Valcarenghi testified that Staff conducted a life analysis of the plant accounts and determined that the parameters reflected in WGL's Depreciation Study are reasonable for use in the development of depreciation rates.[38] Nevertheless, Mr. Valcarenghi contested WGL's proposed depreciation rates. Mr. Valcarenghi's disagreement relates to WGL's recommendation that the rates applicable to individual plant accounts be developed through the use of redistributed depreciation reserves instead of utilizing book reserves for each account, as recommended by Staff.[39] Mr. Valcarenghi observed that although in total the depreciation reserve remains unchanged as a result of WGL's rebalancing, several individual accounts changed markedly. For example, the redistribution changes net unrecovered investment applicable to Account 376.10 (Mains) by lowering the applicable reserve, such that "rates for this account would be developed to recover an additional $22 million that has already been recovered from ratepayers."[40] Mr. Valcarenghi testified that it is contrary to the accurate development of depreciation rates to use a rebalanced reserve, especially with regard to remaining life statistics.[41] He further stated that using Book Reserves to calculate forward depreciation rates results in accruals that are $235,402 lower than those calculated with rebalanced reserves.

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[37] Valcarenghi Direct at 5.
[38] Valcarenghi Direct at 7.
[39] Valcarenghi Direct at 8.
[40] Valcarenghi Direct at 10.
[41] Valcarenghi Direct at 10.

Mr. Valcarenghi also testified regarding net salvage costs. He observed that Dr. White used a present value format consistent with the Commission's order in Case No. 9103. He also stated that Dr. White's present value rates follow a formulaic approach wherein an asset retirement obligation and accretion allowance are developed for each account that has net salvage based on estimated salvage percentages from the Depreciation Study. However, Mr. Valcarenghi testified that the development of the depreciation rate "tracks back to unverifiable data which the Company did not provide in either its supporting information or in response to data requests."[42] Mr. Valcarenghi contended that there are no workpapers or other supporting documentation to explain how the asset retirement costs, asset retirement obligation, or accretion portions of the rate were derived. Mr. Valcarenghi concluded that this "lack of transparency" demonstrates why the Company's net salvage rates "should be rejected for use in the development of pro forma depreciation rates."[43] In lieu of WGL's analysis, Mr. Valcarenghi proposed what he deemed a "transparent, verifiable analysis" that allows recovery of net salvage costs on a present value basis as illustrated in Mr. Valcarenghi's Exhibit DLV-4 (Direct).

Mr. Valcarenghi concluded that WGL should be authorized to accrue depreciation based on a composite depreciation rate of 2.37% based on original investment for the period ending December 31, 2016, pursuant to the following table:

[42] Valcarenghi Direct at 13.
[43] Valcarenghi Direct at 14.

Function	Original Cost	Accrual Rate	Annual Accrual
Storage	$24,986,853	2.57%	$641,485
Transmission	$132,103,039	1.49%	$1,962,867
Distribution	$1,325,516,741	2.10%	$21,644,662
General	$178,027,566	8.44%	$15,025,959
Total		**2.37%**	**$39,274,973**

Accordingly, Mr. Valcarenghi does not propose any changes to the parameters that were used to develop rates, but recommends that rates be developed based on the use of book depreciation reserves and that net salvage costs be recovered based on Staff's SFAS 143 Present Value Methodology.[44]

<u>OPC</u>

David Garrett, managing member of Resolve Utility Consulting, PLLC, provided testimony on behalf of OPC addressing WGL's depreciation study as well as the Company's proposed depreciation rates. Mr. Garrett developed his estimations of the service life and net salvage of WGL's assets based on analysis of the Company's historical plant data, and use of actuarial analysis and survivor curve-fitting techniques. In analyzing WGL's depreciation rates, Mr. Garrett used the straight line method, the average life procedure, the remaining life technique, and the broad group model to analyze the Company's actuarial data.[45] Mr. Garrett testified that this depreciation system "is the system most commonly used by depreciation analysts in regulatory proceedings."[46]

In reference to Dr. White's manual reserve rebalancing, Mr. Garrett testified that "The authoritative texts are clear that when using the remaining life technique, no

[44] Valcarenghi Direct at 6.
[45] Garrett Direct at 10.
[46] Garrett Direct at 10.

separate reallocation of the theoretical reserve … is required or even necessary."[47] Mr. Garrett further stated that Dr. White's rebalancing of the reserve also impacted his proposed net salvage rates under the Present Value Method.

Mr. Garrett testified that WGL underestimated the service lives of its accounts and proposed excessive depreciation rates for its assets.[48] In particular, Mr. Garrett proposed service life adjustments to accounts 361 (Structures and Improvements),[49] 362 (Gas Holders), 363.5 (Other Equipment), 380.2 (Services-Plastic), and 390 (General Structures and Improvements) based on his Iowa curve fitting analysis.[50] For these accounts, Mr. Garrett concluded that WGL's proposed service life estimates were too short, resulting in inappropriately high depreciation rates and an unjustifiable expense for customers.

Regarding net salvage rates, Mr. Garrett observed that the Commission has followed the Present Value Method, whereby estimated future net salvage is discounted to present day value.[51] Because a dollar today is worth substantially more than one decades in the future, the Commission held in Case No. 9092 that estimated future net salvage must be discounted to ensure that present day ratepayers pay "only their fair share of recovery in 'real' dollars." In that way, the Present Value Method "strikes an appropriate balance between the interest of current and future ratepayers."[52] Although Mr. Garrett acknowledged that depreciation experts have utilized different approaches to

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[47] Garrett Direct at 12, 16. The NARUC manual also agrees that no separate reallocation of the theoretical reserve is required when using the remaining life technique. National Association of Regulatory Utility Commissioners, Public Utility Depreciation Practices n. 8 at 65 (1996).
[48] Garrett Direct at 5-6, 19.
[49] Mr. Garrett testified, for example, that Dr. White's curves do not track well with observed data and are not as good a mathematical fit as OPC's curves. Garrett Direct at 20-21.
[50] Garrett Direct at 19.
[51] Garrett Direct at 33.
[52] Garrett Direct at 33.

calculating net salvage rates under the Present Value Method, he testified that his method was consistent with Commission precedent. In particular, he testified that his methodology conforms to the depreciation rate methodology utilized by witness Charles King in Pepco Case No. 9286, which the Commission adopted in its rate order.[53] Mr. Garrett further testified that his proposed net salvage rates "reflect the balancing of cost responsibilities among generations of ratepayers the Commission is seeking to achieve."[54]

Mr. Garrett testified that after reviewing Dr. White's workpapers, he was not able to determine how his proposed net salvage rates were developed, though it appeared his net salvage rates "were influenced in part by his rebalancing of the depreciation reserve based upon his theoretical reserve estimation (the specifics of which are also not ascertainable from his workpapers.)"[55] Mr. Garrett concluded that Dr. White's manual rebalancing of the depreciation reserve and calculation of net salvage rates inappropriately "comingled two unrelated procedures," resulting in unnecessary complexity and confusion.[56]

In his surrebuttal testimony, Mr. Garrett stated that he was persuaded by arguments made by Dr. White and Mr. Valcarenghi regarding (i) reallocating the deprecation reserve, and (ii) removing the net salvage portion of the reserve from the plant-only depreciation rate calculation.[57] Mr. Garrett's recalculation of these two issues

[53] Garrett Direct at 34.
[54] Garrett Direct at 35.
[55] Garrett Direct at 36.
[56] Garrett Direct at 37.
[57] Garrett Surrebuttal at 3-4.

yielded proposed depreciation rates that are $607,000 less than his original recommendation.

WGL Response

On rebuttal, Dr. White opposed the adjustments of OPC and Staff. He argued that Mr. Garrett's adjustments replaced a widely accepted and Commission-approved rebalancing of depreciation reserves with his own version of reserve reallocation.[58] Dr. White further contested Mr. Garrett's statement that it is inappropriate to rebalance recorded reserves when the remaining life technique is used in the formulation of depreciation rates. Dr. White testified that his rebalancing of reserves did not impact proposed net salvage rates under the Present Value Method. He stated that depreciation reserves were rebalanced in the 2017 Depreciation Study to reduce offsetting imbalances and increase deprecation rate stability, as well as to account for neighboring jurisdictions. Dr. White claimed that Mr. Garrett also rebalanced depreciation reserves, though he labeled it reserve reallocation, which Dr. White argued was "a distinction without a difference."[59] Dr. White further stated that the Commission has previously approved the rebalancing of reserves used in the 2017 Depreciation Study — namely in Case No. 9286.

Dr. White criticized Mr. Garrett's estimations of service lives, particularly the visual curve fitting he relied upon in making his estimations. Dr. White testified that the statistical techniques he used in making his service life estimations were superior.[60] "Absent the use of more powerful statistical techniques … life analysis simply becomes

[58] White Rebuttal at 3.
[59] White Rebuttal at 5.
[60] White Rebuttal at 10.

an exercise in trying to visually fit a curve to an oddly shaped array of data points."[61] Dr. White also contested Mr. Garrett's estimations of service lives for certain accounts classified as storage and processing plant, because those accounts represent property in an integrated system that will likely be retired as a single unit.

Dr. White testified that the formulation of net salvage accrual rates contained in the 2017 Depreciation Study is the same as that adopted by the Commission in Case Nos. 9096 and 9103.[62] He also stated that the methodology for developing net salvage rates utilized by Mr. King in Case No. 9286 (upon which Mr. Garrett based his own analysis), was changed in response to criticism from Dr. White's firm, Foster Associates. Dr. White also noted that he used a discount rate of 7.7%, which was approved by the Commission in Case No. 9103. Dr. White criticized the rate of 7.15% used by Mr. Garrett, which is the weighted-average cost of capital recommended by OPC witness David Parcell in this proceeding.[63] Finally, Dr. White argued that Mr. Garrett failed to deduct net salvage reserves from the reserves used in deriving investment-only accrual rates.

Dr. White also contested the testimony of Staff witness Valcarenghi, asserting that Mr. Valcarenghi used a flawed formulation of the Present Value Method of accruing for net salvage. Additionally, Dr. White stated that Mr. Valcarenghi's use of a 7.30% overall rate of return recommended by Staff witness Alvarado was inappropriate because it would require Mr. Valcarenghi to recalculate his net salvage accrual rates after the Commission decides an authorized rate of return in this proceeding.

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[61] White Rebuttal at 10.
[62] White Rebuttal at 17.
[63] White Rebuttal at 17.

Commission Decision

The Supreme Court has defined depreciation as "the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence."[64] That Court further held:

> [T]he company has the burden of making a convincing showing that the amounts it has charged to operating expenses for depreciation have not been excessive. That burden is not sustained by proof that its general accounting system has been correct. The calculations are mathematical, but the predictions underlying them are essentially matters of opinion.[65]

OPC witness Garrett recognized that "depreciation is a cost of providing service, and that in addition to receiving a 'return on' invested capital through the allowed rate of return, a utility should also receive a 'return of' its invested capital in the form of recovered depreciation expense."[66] However, he cautioned that regulated utilities do not have the same incentive through natural competitive forces to operate with minimal capital costs. If a regulated utility is allowed to recover the cost of an asset before the end of its useful life (by using overestimated depreciation rates), it would be incentivized to unnecessarily replace the asset in order to increase rate base, resulting in economic waste.

As Staff witness Valcarenghi explained, historically, net salvage costs were recovered on a straight line basis in the development of depreciation rates. In other words, the deprecation rate would fund the recovery of the asset plus an estimate of necessary retirement costs on an equal basis over the remaining life of the asset.[67]

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[64] *Lindheimer v. Illinois Bell Tel. Co.*, 292 U.S. 151, 167 (1934).
[65] *Id.* at 169.
[66] Garrett Direct at 8.
[67] Valcarenghi Direct at 12.

However, in recent years, the Commission has recovered net salvage costs on a present value basis, such that the depreciation rates reflect the present value of amounts required to fund the retirement of plant investment. In Case No. 9092, for example, the Commission found that "[t]he Present Value Method strikes a balance between the straight line and historical recovery proposals. … [B]ecause future costs are discounted to a 'present value,' today's ratepayers will pay only their fair share of recovery costs in 'real' dollars rather than the inflated amounts under Straight Line Method." Accordingly, the Commission found that the Present Value Method "strikes an appropriate balance between the interests of current and future ratepayers."[68] The Commission sees no reason to depart from the Present Value Method in the present case.

The Commission accepts Staff's adjustments related to depreciation expense. Staff witness Valcarenghi reviewed the results of Dr. White's analysis and conducted his own, finding that the parameters such as plant service lives and remaining lives utilized by Dr. White were reasonable.[69] The record supports the finding that the parameters used in the 2017 Depreciation Study were reasonable.

However, Staff and OPC voiced strong disagreement with Dr. White regarding his rebalancing of depreciation reserves. Staff witness Valcarenghi opposed rebalancing of reserves, testifying that it is "contrary to the development of depreciation rates to reflect the use of a re-balanced reserve."[70] He further explained his opposition in the evidentiary hearing, stating: "Rebalancing the reserve should be an extraordinary event.

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[68] *In the Matter of the Application of Potomac Electric Power Company for Authority to Revise Rates and Charges for Electric Service and Certain Rate Design Changes*, Case No. 9092, Order No. 81517 at 31.
[69] Valcarenghi Direct at 7.
[70] Valcarenghi Direct at 10.

It shouldn't happen on an ongoing basis."[71] The reason is, according to Mr. Valcarenghi, that rebalancing entails shifting dollars between accounts, which can cause substantial fluctuations, such as Account 376.10-Mains — where Dr. White's rebalancing lowered the applicable reserve by $22 million.[72] As Mr. Valcarenghi explained, the reserve "tells you what has been the record of recovery for this particular account going back several years. And … if you start rebalancing, all that becomes kind of blurred and you're shifting the recoveries … unnecessarily."[73] OPC witness Garrett agreed that WGL should not have rebalanced reserves, stating "no separate reallocation of the theoretical reserve is required when using the remaining life technique."[74] The Commission agrees with Staff and OPC.

The Commission has previously stated that it "generally opposed rebalancing depreciation reserves unless there have been significant changes that have occurred in recent cases affecting both depreciation rate formulations and account reserves."[75] In the present record, the Commission finds insufficient evidence to justify rebalancing reserves and accordingly accepts Staff's adjustment with regard to this issue.

The Commission also accepts Staff's accrual rates. Mr. Valcarenghi used Dr. White's service lives, Iowa curves, and remaining lives for his net salvage/cost of

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[71] Tr. at 626 (Valcarenghi).
[72] Valcarenghi Direct at 10.
[73] Tr. at 635 (Valcarenghi).
[74] Garrett Direct at 12.
[75] Case No. 9424, *In the Matter of the Application of Delmarva Power and Light Company for an Adjustment to Its Retail Rates for Electric Servic*e, Order No. 88033 (Feb. 15, 2017), at 17. Mr. Valcarenghi acknowledged language in Case No. 9286, *In the Matter of the Application of Potomac Elec. Power Co. for Authority to Increase its Rates and Charges for Elec. Distribution Service,* where the Commission stated "it may not be necessary or appropriate in every instance to adjust account reserves." Mr. Valcarenghi concluded that the Commission's language "appears to convey examination on a case by case basis" and that "no standard or policy has been established." Valcarenghi Surrebuttal at 1-2. The Commission agrees with Mr. Valcarenghi that rebalancing should be examined on a case-by-case basis, but under the general standard of Case No. 9424 that rebalancing is appropriate only when there has been a significant change or other compelling reason.

removal analysis, which used the SFAS 143 Present Value Methodology to determine salvage and depreciation/amortization accrual rates, and resulted in a total overall accrual rate of 2.37%. Dr. White, however, disagreed with Staff's mathematical formulations used in its Present Value Methodology. Specifically, WGL argued that Mr. Valcarenghi miscalculated the present value Cost of Removal rates by incorrectly discounting future net salvage over the average service life of plant accounts, rather than the probable life of each plant account, as done by Dr. White.[76] Mr. Valcarenghi testified that the Commission has accepted Staff's methodology in previous rate cases, such as Columbia Gas of Maryland[77] and testified that "[t]he methodology employed by Staff … is precisely the same used in the development of depreciation rates for every major gas and electric utility in Maryland since the advent of present value calculations several years back."[78] The Commission agrees with Staff's calculations and accepts its proposed accrual rates.

OPC witness Garrett testified that the Commission should accept his proposed shorter service lives for certain WGL plant accounts. Dr. White and Mr. Valcarenghi agreed with the service lives proposed by the Company. In particular, Dr. White criticized the visual curve fitting employed by Mr. Garrett. Of the five plant accounts identified by Mr. Garrett for shorter service lives, the Company noted that three (Accounts 361, 362, and 363.5) are associated with the Company's Rockville gas propone storage facility. Dr. White suggested that these accounts would likely "be retired as a single unit" when the facility is retired, and that it was therefore inappropriate

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[76] WGL Brief at 70-71.
[77] Valcarenghi Surrebuttal at 3, *citing* Case No. 9480, *In the Matter of the Application of Columbia Gas of Maryland, Inc. for Authority to Increase Rates and Charges,* Order No. 88921 (Nov. 21, 2018).
[78] Valcarenghi Surrebuttal at 3.

for Mr. Garrett to estimate service lives based on actuarial techniques.[79] The Commission agrees with the Company that the service life estimates provided by Dr. White are reasonable and that OPC's alternative proposal has not been demonstrated to be superior. OPC's proposed shorter service lives for WGL plant accounts are therefore rejected.

Finally, Mr. Garrett formulated depreciation rates for WGL using the broad-group procedure, in lieu of the vintage-group procedure utilized by Dr. White.[80] The Company responded that the Commission has long approved of the vintage-group procedure. The Commission accepts the Company's position on this issue. Dr. White's analysis appears reasonable and OPC's use of the broad-group procedure has not been demonstrated to be superior. Accordingly, the Commission accepts the positions proposed by Staff with regard to WGL's Adjustment No. 9, including Depreciation Expense (Rate Year), Depreciation Expense, Amortization Expense – Capitalized Software (Rate Year), and Amortization Expense – General Plant (Rate Year).

3. WGL Adjustment 15: Depreciation Expense – STRIDE and Safety Plant

Because the Commission approved Staff's depreciation methodology, discussed above, conforming changes are made to Depreciation Expense that reduce operating income by $924,000 and increase revenue requirement by $1,314,000.

[79] White Rebuttal at 12.
[80] Garrett Surrebuttal at 11.

4. WGL Adjustment 10: Rent Expense and Deferred Tenant Allowance

WGL's Adjustment 10 (Rent Expense and Deferred Tenant Allowance) relates to the Company's entering into a new lease for two facilities WGL is currently occupying. The adjustment reflects the reduction in rent as well as the increase in the deferred tenant allowance deduction in rate base.[81] WGL stated that it included Adjustment 10 to fully match all components of the rate year cost of service. The adjustment recognizes the Company's move to 1000 Maine Avenue, SW Washington, D.C., and Tyson's Corner planned for July 2018. It reduces Rent Expense by $18,978 and increases Deferred Tenant Allowance by $2,216,097.[82]

OPC witness Effron eliminated the projected future growth of the deferred tenant allowance.[83] He stated that his adjustments to post-test year rent expense and deferred tenant allowance are internally consistent with other adjustments he made to remove post-test year expenditures, such as WGL Adjustment No. 7 regarding Construction Work in Progress, which he argued consists of forecasted expenditures subsequent to Test Year End ("TYE") March 31, 2018.[84]

WGL stated that if the Commission rejects its rate year plant adjustments, pursuant to principles of matching, the Commission should also disallow WGL Adjustment 10. In fact, the Company criticized Staff for preserving the Rent Expense –

[81] Tuoriniemi Rebuttal at 46.
[82] WGL Brief at 14.
[83] Effron Direct at 7.
[84] Effron Surrebuttal at 3.

Deferred Tenant Allowance Adjustment while eliminating WGL's rate year plant additions.[85]

To be consistent with the Commission's elimination of the increases proposed by the Company for the post-test period, the Commission eliminates the decreases for the post-test period as reflected in WGL's Adjustment 10. The Commission agrees with WGL that it is consistent with principles of matching to also disallow WGL Adjustment 10, which reflects projected decreases of expenses outside the test period.

5. WGL Adjustment 17: Property Tax

WGL witness Tuoriniemi increased the Company's test year property tax expense by $1,559,394. He computed ratemaking property taxes by applying a five-year average property tax growth rate factor to per book property tax expense.[86] Specifically, he computed an annual rate of 4.25% using the property tax rate growth rate for fiscal years 2013 through 2017. He applied this tax growth rate, compounded annually for 21 months which reflects the post-test period through December 31, 2019.

Consistent with his other post-test period adjustments, Staff witness Ostrander recommended removal of most of WGL's post-test period adjustment related to property taxes in the amount of $903,026 (Ostrander Adjustment 22).[87] He testified that he opposed these WGL post-test period adjustments because they are estimates and are not known and measurable.

[85] WGL Brief at 14.
[86] Tuoriniemi Direct at 71.
[87] Ostrander Direct at 57.

OPC witness Effron argued in his Direct Testimony that the average growth rate in property tax expense over the last five years does not represent a known and measurable change.

He stated that it would be appropriate to annualize property tax expense based on the latest known valuations and property tax rates. However, since WGL had not provided that information at the time of his Direct Testimony, he recommended removal of WGL's entire pro forma property tax expense adjustment of $1,557,000.[88] In its Rebuttal testimony, WGL updated the property tax adjustment for actuals. The Company calculated that the pro forma property tax expense would be $488,000 greater than the actual test year property tax expense. Accordingly, in his Surrebuttal Testimony, Mr. Effron eliminated only the Company's proposed pro forma property tax adjustment in excess of this amount, or $1,069,000.[89]

WGL opposed the adjustments recommended by Staff and OPC. In particular, the Company disputed Staff's adjustment because it "fails to recognize that property taxes increase based on actual plant growth."[90] The Company argued that at a minimum, property taxes should be increased by $488,000 to recognize WGL's actual Maryland property tax expenses as of June 30, 2018.

Commission Decision

The Commission agrees with Staff and OPC that using the average growth rate in property tax expense over the last five-year period to compute property taxes in the rate

[88] Effron Errata Direct at 9.
[89] Effron Surrebuttal, Exhibit DJE-2, Schedule C-1.
[90] WGL Brief at 19.

effective period does not represent a known and measurable change. It is instead a projection. WGL correctly argues, however, that Staff's adjustment goes too far because it does not recognize that property taxes increase based on actual plant growth. OPC witness Effron's adjustment, which acknowledges that WGL's pro forma property tax expense would be $488,000 greater than the actual test year property tax expense, properly accounts for known and measurable changes. Accordingly, the Commission accepts OPC's adjustment to Property Tax. This adjustment decreases operating income by $354,000 net of applicable tax and increases revenue requirement by $504,000.

6. WGL Adjustment 19: Labor Expense Operations and Labor Expense Maintenance

WGL proposed pro forma Adjustment 19 to labor expense in the amount of $6,958,813, which the Company stated reflects the best estimate of wages and salaries the Company will incur during the rate year. The Company stated that the adjustment (i) annualizes payroll increases that occurred in the test year, (ii) reflects wage increases for union employees, (iii) reflects wage increases for management that occurred in December 2017 and that are planned to occur in December 2018, (iv) reflects the average employee account in the rate effective period, and (v) accounts for nonrecurring merger-related work.[91]

Staff

Staff witness Ostrander proposed several adjustments to WGL's Wages and Salaries Adjustment 19. He testified that WGL used a similar method to calculate its

[91] Gibson Direct at 12.

payroll adjustment as its prior rate case (Case No. 9322), but observed that the resulting adjustment is much larger in the present case. In Mr. Ostrander's opinion, the reasons are because WGL's current adjustment includes (i) periodic pay raises that extend beyond the test period to December 2019, (ii) a substantial overtime component, (iii) a projected employee headcount factor that extends beyond the test period to December 2019, and (iv) a short-term incentive component (which is included in the merger-payroll component). Mr. Ostrander testified that the amount of the payroll adjustment has increased from $646,276 to $6,958,813, and that the overtime included in WGL's adjustment increased from $5,622,089 to $10,944,778.[92] Mr. Ostrander stated that a significant portion of the increase in this case is related to post-test period pay raises that are not known and measurable. For example, he testified that in the current case, WGL included pay raises for union employees occurring as far out as August 2019, with payroll annualized to December 2019. He raised similar issues with management employees and management pay raises, overtime, and other payroll components such as short- and long-term incentives.

As a result, Mr. Ostrander proposed to reduce payroll expense by a total amount of $3,859,920. That downward adjustment reflects reductions of $3,451,635 (Ostrander Adjustments 8a and 8b) related to the removal of pay raises and a true-up of the headcount factor. For example Mr. Ostrander found that certain management pay raises effective December 1, 2018, were "too far removed from the test period to be considered known and measurable, and there is no level of certainty."[93] He made similar adjustments for union raises. Mr. Ostrander also proposed a reduction of $408,285

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[92] Ostrander Direct at 28.
[93] Ostrander Direct at 32.

(Ostrander Adjustment 8c) related to the removal of the short-term incentive cost that was included in WGL's merger-payroll costs. Mr. Ostrander explained that in order to exclude merger costs from ratemaking, WGL had originally moved below the line certain internal employees who were working on merger activities. WGL then moved these merger-related payroll costs above-the-line to recover them in this rate case, because these same employees have returned to spending their time on non-merger related matters on a going-forward basis. Mr. Ostrander did not contest WGL recovering merger-related payroll, but he does contest inclusion of the short-term incentives that constitute "merger bonus." Mr. Ostrander stated: "To the extent the [short-term incentive] is related to the merger it is non-recurring and belongs below-the-line with all other merger-related costs that WGL states were reflected below-the-line in this case."[94]

Mr. Ostrander proposed a separate adjustment (Ostrander Adjustment 9) to revise the overall payroll costs included in this case. Mr. Ostrander adjusted WGL's overtime costs downward (from $10,944,778 to $9,565,214) based on the Company's revised data response showing lower overtime costs.[95] Mr. Ostrander offset this overtime balance by WGL's estimated Leak Management costs of $4,703,137, but provided WGL an allowance for these same costs as an offset to significant overtime costs.

OPC

OPC witness Effron removed rate year expenses that occur in the rate year on the same basis as Mr. Ostrander.[96] He also eliminated WGL's pro forma adjustment to labor expense based on the Company's position that employee time charged to the merger

[94] Ostrander Direct at 34.
[95] Ostrander Direct at 35.
[96] Effron Direct at 9.

approval atypically reduced the time charged to normal utility operations in the test year.[97] He stated: "The Company has not established that a reduction in employee time charged to merger approval will necessarily lead to a concomitant increase in employee time charged to other activities; nor has the Company identified any specific areas or functions where the actual employee time was abnormally low in the test year."[98]

WGL Response

WGL opposes the adjustments of Staff and OPC. The Company stated that increases for union employees are known and measurable because they are referenced in the union contracts and wage schedules specified therein.[99] The Company further contended that management increases in December 2018 are known and measurable because they have been communicated to employees and they can be accurately estimated by using a historical average.[100] Regarding headcounts, WGE argued that its proposed headcount increase is consistent with its merger commitment to maintain and increase employment levels within five years.[101] The Company also opposed Mr. Ostrander's proposal to substitute an average headcount for the period ending June 30, 2018, stating that it bore "no relationship to what the Company will incur for compensation costs when rates go into effect."[102] With respect to merger-related payroll, WGL argued that Mr. Gibson demonstrated that his allocation of short-term incentives offset the clawback for Fiscal Year 2016 performance, which was included in the test

[97] Effron Surrebuttal at Exhibit DJE-2, Schedule C-1.1.
[98] Effron Direct at 8.
[99] WGL Brief at 20.
[100] Gibson Direct at 14.
[101] Gibson Rebuttal at 11, citing Case No. 9449, Order 88631 at Conditions 24 and 25.
[102] Gibson Rebuttal at 10.

year.[103] WGL opposed Mr. Ostrander's removal of overtime pay for leak management, claiming that there is no evidence that overtime costs are decreasing and arguing that new hires will not immediately replace existing personnel.[104] Regarding executive and non-executive bonuses, the Company disputed Mr. Ostrander's calculations pertaining to normalization.

Commission Decision

The Commission grants Staff's adjustments. WGL's projections of periodic pay raises extend well beyond the test year, into December 2019. The Company has also projected employee headcounts beyond TYE March 30, 2018 to December 2019. The Commission finds that these post-test period pay raises are not known and measurable. Mr. Ostrander's adjustments that reduce the Company's pay raises and other labor expense by removing post-test period projections are appropriate. The Commission also agrees with Mr. Ostrander that short-term incentives that constitute merger bonus should not be imposed on ratepayers. Those short-term merger bonus incentives should instead be paid for by shareholders. The merger bonuses are non-recurring events and properly belong below the line with other merger-related costs. WGL's clawback argument, which it raised on rebuttal, fails because the Company did not propose a specific rate case adjustment to normalize incentives for the clawback, and because the short-term incentive merger costs appear to serve as a mechanism to artificially raise

[103] Gibson Rebuttal at 17.
[104] Tr. at 168-69 (Gibson).

short-term incentive levels in this case.[105] The result of this decision for Labor Expense – Operations is to increase operating income by $200,000 and decrease the revenue requirement by $285,000. For Labor Expense – Maintenance, the decision decreases operating income by $1,645,000 and increases revenue requirement by $2,340,000.

7. WGL Adjustment 20: Short-Term and Long-Term Incentive Expense

WGL stated that it adjusted for short-term and long-term incentive expenses pursuant to its compensation philosophy to provide compensation that is competitive with the market.[106] WGL argued that its short-term and long-term incentives are consistent with the Commission's precedent in Order No. 84475, whereby the Commission removed 20% of the per book cost of short-term incentive expenses and removed 50% of per book long-term incentive expenses.[107]

Staff witness Ostrander and OPC witness Effron removed a portion of WGL Adjustment 20 to adjust for the rate year reduction.[108] WGL opposed those adjustments for the same reasons it opposes other Staff/OPC/AOBA adjustments that remove projected expenditures during the rate year. Staff witness Ostrander, however, makes an additional adjustment that is not opposed by the Company.

Mr. Ostrander stated that he was not opposed to WGL's adjustment to remove 50% of long-term incentives; however, in order to be consistent with his other adjustment to remove estimated post-test period costs, Mr. Ostrander proposed (Ostrander Adjustment 12-S) to remove WGL's adjustment and *increase* the revenue requirement by

[105] Ostrander Surrebuttal at 40-41.
[106] WGL Brief at 26.
[107] See Case No. 9267, Order No. 84475.
[108] Ostrander Direct at 28-32.

$466,969. Staff acknowledged that although this adjustment increases the revenue requirement in favor of WGL, "removing these amounts is consistent with Staff's approach of preserving an historical test period and removing adjustments that are not known and measurable."[109]

Commission Decision

The Commission rejects WGL's proposed Adjustment 20 and accepts the adjustments of Staff and OPC that remove projected expenditures outside the test year that are not known and measurable. Those adjustments are consistent with Commission precedent and the decision in this case to remove forecasted rate year amounts. Mr. Ostrander's corresponding adjustment in BCO-12-S is appropriate for the same reason. Accordingly, Staff's adjustment to WGL Adjustment 20 is accepted. This results in an increase in operating income adjustment of $1,992,000 and a decrease in rate base of $2,834,000.

8. WGL Adjustment 22: Pension and SERP Expense

WGL

WGL stated that Supplemental Executive Retirement Plans ("SERP") are mechanisms that provide individuals with salaries above the Internal Revenue Service ("IRS") limits for contributions to 401(k) plans a commensurate level of retirement

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[109] Staff Brief at 44, citing Ostrander Direct at 48.

benefits to standard retirement plans. They are typically offered to senior executives.[110] In WGL Adjustment 22, the Company removed 50% of the SERP expense from its pro forma test year operation and maintenance expenses, stating that this removal (and inclusion of the remaining 50%) "follows precedent from Case No. 9322," the Company's last rate case.[111] However, the Company retained the remaining 50% of SERP, despite the Commission's recent removal of 100% of SERP in other utility rate cases.

Staff

Mr. Ostrander observed that SERP is a non-qualified retirement plan for a limited number of key employees and executives that provides benefits above regular qualified pension plans that are limited in the amount of annual benefits that a participant can receive by the IRS Code pursuant to Section 415.[112] Although key executives can enjoy the benefits of both SERP and a regular retirement program, its costs are significant. Mr. Ostrander testified that WGL's total SERP cost for 2018 is $5.2 million (with $2.1 million allocated to Maryland). Mr. Ostrander acknowledged that the Public Utility Law Judge's order in WGL's last rate case, Case No. 9322, removed 50% of SERP. Nevertheless, he recommended in this case that 100% of SERP be removed, with a corresponding adjustment to the SERP ADIT (Ostrander Adjustment 20).

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[110] WGL Brief at 27.
[111] Gibson Direct at 23.
[112] Ostrander Direct at 54.

Mr. Ostrander argued that the Commission's policy has been clear since Case No. 9418 that 100% of SERP should be removed.[113] That policy decision is also consistent with the neighboring jurisdictions of D.C. and Delaware, where 100% of SERP has been removed in ratemaking cases involving electric companies. In that regard, Mr. Ostrander testified that "There appears to be a growing concern with significant SERP costs related to top hat benefits reserved exclusively for executives..."[114] Mr. Ostrander further testified that he is "not aware of any specific, quantifiable, or known meaningful benefits that accrue to customers because of the executive SERP, and [he has] not seen any costs versus benefit analysis that quantifies a net benefit to customers from this cost."[115] Accordingly, Mr. Ostrander recommended removal of 100% of SERP costs.

OPC

Mr. Effron argued that 100% of WGL's SERP expenses should be disallowed. He observed that recent Commission precedent has disallowed 100% of SERP expenses and that WGL has not presented any evidence that would distinguish its SERP expenses from those offered by Pepco and Delmarva, which were disallowed.[116]

WGL Response

Michael J. Halloran, Senior Partner at Mercer Human Resource Consulting, and Dori Ramsey, Chief Talent Officer, WGL, provided rebuttal testimony addressing short-term incentive compensation and benefits under WGL's SERP. Mr. Halloran and

[113] Pepco, Case No. 9418, Commission Order No. 87884, at 53-54.
[114] Ostrander Direct at 55, *citing* his earlier testimony in Case No. 9418 (regarding Pepco SERP).
[115] Ostrander Direct at 56.
[116] Effron Direct at 21.

Ms. Ramsey testified that WGL's compensation plans and practices, including short- and long-term incentives, represent market pay, are reasonable and competitive, and are consistent with general industry best practices.[117] They further stated that without appropriate competitive compensation, including short-term incentives, WGL would lack the critical means to attract and retain qualified employees and to incentivize the achievement of Company goals. Mr. Halloran/Ms. Ramsey stated that short-term incentive compensation is available to all employees at WGL.

Regarding SERP, Mr. Halloran and Ms. Ramsey testified that WGL must compete for executive talent with other utilities as well as employers in other industries, requiring the Company to offer competitive pay and benefits to attract and retain executives.[118] They stated that SERP provides additional retirement benefits above regular qualified pension plans, and that it is a standard component of a competitive executive compensation package. Over 90% of companies in the utility industry and corporate world provide SERP benefits. To the extent WGL is required to cease offering SERP as a benefit to its executives, WGL would be forced to increase the level of other components of the executive compensation package, such as long-term incentive compensation or base salary. Mr. Halloran and Ms. Ramsey concluded that SERP is a reasonable and prudent expense that is an integral part of WGLs compensation package for executives. Finally, Company witness Gibson noted that the states of Virginia and Pennsylvania recognize SERP benefits as a component of employee compensation in rates.[119]

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[117] Halloran / Ramsey Joint Rebuttal at 4.
[118] Halloran / Ramsey Joint Rebuttal at 6.
[119] Gibson Direct at 25.

Commission Decision

WGL correctly states that the Public Utility Law Judge's order in WGL's last rate case removed 50% of SERP. However, that case was decided in the year 2013. Since that time, the Commission's policy on SERP has changed. In Case No. 9418, decided November 15, 2016, the Commission disallowed 100% of Pepco's SERP expenses, finding that the company had provided no support for its claim that SERP benefits help the company attract and retain qualified executive level talent.[120] Similarly, in Case No. 9443, the Commission held that the SERP adjustment (which had been characterized as restoration benefits) represented "an attempt to provide retirement compensation to a limited number of employees above and beyond IRS limits, and the value of funding these expenses has not been proven."[121] The Commission further held finding that "ratepayers should not pay for pension benefits for company executives beyond the IRS limits."[122] The disallowance of 100% of SERP expenses in these and other cases reflects the Commission's consistent position that ratepayers should not pay for pension benefits for company executives beyond the IRS limits, absent clear proof of benefits.

In this case, the Commission agrees with Staff witness Ostrander that a SERP benefits a very small group of executives and WGL has not provided sufficient evidence to quantify or otherwise demonstrate any measurable benefit to customers from its provision of SERP to these executives. For example, WGL did not provide any studies

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[120] *In the Matter of the Application of Potomac Elec. Power Co. for Adjustments to Its Retail Rates for the Distribution of Elec. Energy*, Case No. 9418, Order No. 87884 (Nov. 15, 2016) at 54.
[121] *In the Matter of the Application of Potomac Elec. Power Co. for Adjustments to Its Retail Rates for the Distribution of Elec. Energy*, Case No. 9443, Order No. 88432 (Oct. 27, 2017) at 27.
[122] Case No. 9443, *Potomac Electric Power Company*, Order No. 88432 (Oct. 20, 2017) at 28.

or supporting documentation to support its claim that SERP is required to attract and retain executives, nor citation to specific examples in which the Company would have been unable to attract and retain executives absent SERP. The Company's generalized statement that it would be required to increase the level of other components of executive compensation, such as incentive pay or base salary, is not sufficient evidence upon which to grant the requested adjustment.[123]

The Commission therefore denies WGL's Adjustment 22 and approves Staff's adjustment. The Commission observes that the Staff adjustment also removes SERP-related ADIT. The effect of the Commission's decision decreases rate base by $5,283,000, increases operating income by $1,328,000 and decreases the revenue requirement by $2,438,000.

9. <u>WGL Adjustment 23: 401(k) Expense</u>

WGL Adjustment 23 adds $403,588 to its 401(k) plans for management and union employees.[124] WGL witness Gibson stated that the Company matches 100% of the first 4% of pre-tax contributions by its employees. Additionally, since January 1, 2009, the Company's 401(k) plan provides an additional benefit to management and Teamster Local 96 employees. The Company also makes an automatic contribution between 4% and 6% to eligible management and union employee based on years of service.[125] Mr. Gibson calculated Adjustment 23 by examining the growth rate of 401(k) expense for the last three Fiscal Years. He then applied the average growth rate compounded for

[123] The Commission notes, however, that nothing in this Order precludes WGL from providing SERP benefits.
[124] Gibson Direct at 24.
[125] Gibson Direct at 25.

1.75 years to the per book 401(k) expense. He determined that the Company would contribute an incremental amount of $1.3 million on a system-wide basis for 401(k) plans, which after applying O&M and Maryland labor allocation factors, resulted in an incremental 401(k) adjustment of $403,588.

Staff witness Ostrander removed $252,890 from Adjustment 23 to account for WGL's post-test period projections.[126] Similarly, OPC witness Mr. Effron reduced WGL Adjustment 23 by removing rate year expenses. Specifically, he analyzed the test year ratio of 401(k) benefits to labor costs and eliminated the remainder of the Company's adjustment.[127]

WGL opposed the adjustments of Staff and OPC, arguing that the increase in 401(k) expenses outside the test year are known and measurable. The Company stated that its 401(k) expense is growing at a rate faster than payroll growth because of the Company's transition of employees from the defined benefit pension plan to the Company's enhanced 401(k) plan. In particular, WGL stated that since the end of the test year, its 401(k) expense has increased from an average biweekly amount of $280,000 to $306,000 as of the last August payroll.[128] Company witness Gibson annualized the August payroll contributions to yield an annual contribution of $7,995,202, showing a 13.8% increase in 401(k) expense. WGL argued that since this increase is only five months after the test period, it demonstrates that the Company's adjustment is reasonable.

[126] Ostrander Direct at 58; Ostrander Surrebuttal at 65.
[127] Effron Direct at 8.
[128] Gibson Rebuttal at 26.

Commission Decision

The Commission accepts Staff's adjustments to WGL Adjustment 23. The increases in 401(k) expenses are beyond the test year. Mr. Gibson's annualization of the August payroll contributions represents a projection of 401(k) increases outside of the test year that are not known and measurable. The result of this decision is a decrease in operating income of $110,000 and an increase of the revenue requirement of $156,000.

10. WGL Adjustment 24: Medical Plans Inflation

WGL witness Gibson adjusted medical plan expenses by $35,741 based on his analysis of historical medical cost inflation.[129] He calculated an inflation factor for each plan based on cost growth over the last three years and then applied the inflation factor, compounded for 1.75 years, to the test year expense for each plan, to yield medical plan expense in the rate year.

Consistent with his other post-test period adjustments, Staff witness Ostrander recommended removal of most of WGL's post-test period adjustment related to medical plans in the amount of $11,221 (Ostrander Adjustment 24).[130] He testified that he opposed these WGL post-test period adjustments because they are estimates and are not known and measurable.

[129] Gibson Direct at 26.
[130] Ostrander Direct at 58.

Commission Decision

The Commission agrees with Staff that Mr. Ostrander's adjustment to remove projected increases in medical expenses outside the test year is appropriate. This adjustment results in a reduction in operating income of $11,000 and an increase in the revenue requirement of $16,000.

11. WGL Adjustment 26: FICA and Medicare Taxes

WGL Adjustment 26 increases Federal Insurance Contribution Act ("FICA")/Medicare Tax expense by $369,542.[131] The Company explained that it must adjust its payroll tax expense that is based on labor expense. Company witness Gibson determined the FICA wage base by calculating the ratio of Calendar Year 2017 Social Security Earnings to Calendar Year 2017 payroll. He then applied that factor to the ratemaking, incremental labor adjustment to calculate WGL's Social Security wage base. He then applied the tax rates to wages to determine the level of incremental FICA and Medicare taxes in the rate effective period.

Staff witness Ostrander reduced WGL Adjustment 26 by $294,000 (Ostrander Adjustment 13) to recognize the effect of his adjustments that impact payroll costs.[132] He stated that he used the same payroll taxes Excel worksheet used by the Company to calculate its payroll taxes in WGL Adjustment 26.[133] WGL responded that the Commission should reject Mr. Ostrander's adjustment because the Company's

[131] Gibson Rebuttal at 27-28.
[132] Ostrander Direct at 38.
[133] Ostrander Direct at 38.

FICA/Medicare tax expense is growing and the Commission has routinely granted this type of adjustment.

Commission Decision

The Commission accepts Staff's adjustment to the Company's FICA/Medicare tax expense. This adjustment is consistent with Commission's acceptance of Staff's position on Labor Expense, disallowing the post-test period labor/payroll increases. The FICA/Medicare taxes adjustment eliminates the proposed FICA/Medicare taxes increase for the post test period. The effect of this decision is to decrease operating income by $56,000 and increase revenue requirement by $80,000.

12. WGL Adjustment 27: Leak Management

WGL

WGL has indicated that over the last four years it has experienced a steady rise in odor complaint calls and leaks on its system. For 2018, the Company has been experiencing a significant and further increase in both odor calls and leak volumes. WGL witness Price testified that this spike in odor calls and leak volume represents the current condition of the system.[134] As a consequence, the Company is proposing to increase its existing workforce that deals with odor complaint calls and leaks. Specifically, the Company is proposing to increase its staffing to handle the increase in odor calls as well as leak repair, noting that the staffing and contract resources to address this issue will be further increased through the rate year 2019 over and above what has been experienced in

[134] Price Direct at 5.

the test year. The two groups that would need to be increased are the Service Operations Group and the Below Ground Operations Group. Additionally, the Company has proposed to adjust its operations and maintenance expense accounts to account for forecasted increases in leak management expenses. WGL witness Price testified that achieving the appropriate staffing levels for the elevated work volumes currently being experienced will, over the long term, provide ancillary benefits in the form of reduced levels of overtime and reduced fatigue of the workforce, which will ultimately enhance the personal safety of WGL's employees.[135]

Company witness Price also testified that the leak management costs presented by the Company are known and measurable because the significant increase in odor calls and leaks began prior to the test year and has escalated since the close of the test year.[136] Since the Company has been able to calculate that leaks have increased at a rate of approximately 4% per annum over the past ten years, utilizing a forecasting tool, Mr. Price was able to anticipate the year-over-year change for the next five years to be 3.8%.[137] Using the actual odor response and leak counts experienced during the test year and the actual number of resource hours used in the test year, Mr. Price formulated a rate period staffing plan that includes growth in full-time equivalents ("FTEs"), expanded use of contractors for emergency response and leak remediation, and use of alternative resources during peak periods and overtime.[138] Mr. Price also claimed that the Company's decades of experience in determining what resources are necessary to address any given amount of odor calls and leaks paired with other historical data, enables it to

[135] Price Direct at 6.
[136] Rebuttal Testimony of Stephen J. Price, September 13, 2018 ("Price Rebuttal) at 4.
[137] Price Rebuttal at 4.
[138] WGL Post Hearing Brief at 33

derive the number of crews required to meet the known and measurable leak trend.[139] Mr. Price determined that to adequately service the WGL territory during peak periods, the Company would need a total of 166 emergency-response qualified FTEs for above-ground operations and 70 emergency-response qualified crews for below-ground operations.[140] The total adjustment the Company has requested for leak management is $4,703,137.[141]

Staff

Staff witness John J. Clementson, Deputy Chief Engineer for the Commission's Division of Engineering, presented testimony addressing WGL's proposed leak management work requirements. He recommended that the Commission disallow certain costs associated with the growth of the Company's Service Operations Group[142] and Below Ground Operations Group[143] contained in WGL Adjustment 27, contending that they are not known and measurable.[144]

Mr. Clementson observed that WGL has proposed to increase staffing of its Service Operations Group from its current staffing level of 91 leak-qualified individuals to 106 by December 31, 2019. In addition to those 15 new employees, WGL indicated that it would hire three supervisors and seven individuals in its Dispatch and Workforce Planning office. Additionally, WGL proposed to expand the Below Ground Operations

[139] Price Rebuttal at 4-5.
[140] WGL Post Hearing Brief at 33
[141] WGL Post Hearing Brief at 32.
[142] WGL's Service Operations Group is responsible for operating and maintaining the above ground portion of the Company's distribution system and meeting safety standards for odor response, investigating, and leak grading. Clementson Direct at 7.
[143] WGL's Below Ground Operations Group is responsible for the response, investigation and repair of leaks on the Company's distribution system. Clementson Direct at 7.
[144] Clementson Direct at 2.

Group (currently comprised of 39 Company crews and 6 contractor crews) to reach a total of 70 crews (60 Company crews and 10 contractor crews).[145] Mr. Clementson testified that WGL intends to have 43 Company crews and 20 contractor crews by the end of 2018, with additional crews staffed as employees complete required training and field experience. The growth of the Below Ground Operations Group would also require five additional supervisors, two managers, two clerks, twenty mechanics helpers, and five operational assistants.

Although Mr. Clementson agreed that WGL has been experiencing a rise in the number of leaks on its mains and services since 2013 as a result of the age and condition of the pipes, he opposed the Company's decision to include the forecasted $4.7 million for its leak management program in its rate case because all the of the leak management program expenses are forecasted outside of the test year.[146] Because the expenses associated with WGL's planned staffing expansion fall outside the test year of April 2017 through March 2018 and are not known and measurable, Mr. Clementson concluded that they should not be recovered in this rate case.

Likewise, Staff witness Ostrander proposed to disallow the entire estimated costs of $4,703,137 related to WGL's Leak Management adjustment because they are outside of the test period, the costs are not known and measurable, and WGL has not yet incurred any actual costs related to this subject (Ostrander Adjustment 10).[147]

[145] Clementson Direct at 7-8.
[146] Clementson Direct at 8.
[147] Ostrander Direct at 37.

OPC

OPC witness Effron testified that WGL's adjustment for leak management expenses is not appropriate because it is not an adjustment for known and measurable changes to expenses actually incurred in the test year. "Rather, this is an adjustment to supplant actual leak management expenses incurred in the test year with the level of leak management expenses that the Company is projecting that it will incur in 2019."[148] Accordingly, Mr. Effron recommended elimination of WGL Adjustment 27.

AOBA

Bruce R. Oliver, President of Revilo Hill Associate, Inc. testified on behalf of the Apartment and Office Building Association of Metropolitan Washington ("AOBA"). Mr. Oliver stated that WGL overstated the number of FTEs it needed to support its Emergency Response and Leak Remediation activities.[149] Mr. Oliver argued that WGL witness Price projected that it would need 166 FTEs, but that the forecast was unreasonably inflated based on an unusually large Order Volume in January 2018 as well as a significant increase in the Contract Labor Hours reported for February 2018.[150] Mr. Oliver also criticized Mr. Price's calculation of labor hours, which was based on less than four months in 2018 and less than four months in 2017. Mr. Oliver prepared an alternative assessment of WGL's required FTEs, which compared data for two annual periods, namely the test year and the 12-month period preceding the test year. Mr. Oliver also evaluated WGL's customer call volume related to emergency response and found WGL's call volume calculations inflated.

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[148] Effron Direct at 23.
[149] B. Oliver Direct at 32.
[150] B. Oliver Direct at 32.

Mr. Oliver questioned the need for so many FTEs based on WGL's five-year STRIDE plan filed on June 15, 2018, which calls for acceleration of the Company's natural gas infrastructure replacement activities. He argued that WGL's accelerated infrastructure replacement under STRIDE should limit the need for further increases in Emergency Response activities.[151] To the extent it has not, Mr. Oliver suggested the Commission should question the efficacy (and approval) of WGL's new STRIDE program.[152] Mr. Oliver concluded that the Commission should find that WGL has failed to justify the reasonableness of the Company's presumption of continued growth in its Emergency Response order volumes.

WGL Response

WGL witness Price responded to the intervening parties by disputing that the leak management costs are not known and measurable.[153] He stated that over the last ten years, leaks have increased at a rate of approximately 4% per year, and that utilizing a forecasting tool, the Company "anticipates the year-over-year change for the next 5 years to be 3.8%."[154] Additionally, Mr. Price stated that the Company has decades of experience in determining what resources are required to address odor calls and leaks. Mr. Price argued that the 166 FTEs required to address the leak problems is known and measurable because WGL has executed a resource plan that provides for deployment of these resources.

Mr. Price disputed AOBA witness B. Oliver's statement that the STRIDE program has failed to replace the most leak prone pipes, stating that WGL's program

[151] B. Oliver Direct at 35.
[152] B. Oliver Direct at 40.
[153] Price Rebuttal at 2.
[154] Price Rebuttal at 4.

replaces eligible infrastructure based on risk, which is primarily weighted by the risk of leaking.[155] Mr. Price also disputed Mr. Oliver's contention that the STRIDE program should slow the pace of emergency response orders, at least in the short-term, because WGL's system continues to age. Nevertheless, Mr. Price stated that WGL's emergency response needs would be higher than they are today absent STRIDE.

Commission Decision

The Commission denies WGL's adjustments related to leak management. All of the leak management program expenses provided by the Company are forecasted, outside of the test year, and are not known and measurable. Additionally, as testified by Staff witness Ostrander, there is no certainty regarding when, if ever, these projected costs will begin.[156] WGL's adjustment attempts to replace actual leak management expenses incurred in the test year with the level of leak management expenses that WGL has projected it will incur in 2019. The Commission finds that replacing actual leak management expenses with future projected expenses is not appropriate in this situation. Moreover, nothing in the record related to this issue provides a reasonable justification for treating adjustments to leak management differently than the Commission has treated other expenses that are not known and measurable. Actual future leak management expenses will be reviewed for reasonableness and prudency in the next rate case.

Although WGL claimed late in the proceeding that the leak management costs were known and measurable (Tuoriniemi September 18, 2018 Rejoinder), that contention

[155] Price Rebuttal at 8.
[156] Ostrander Direct at 37; Clementson Direct at 8.

appears inconsistent with the testimony of other Company witnesses, such as Mr. Price, that WGL's leak management adjustment is based on forecasted amounts. The Commission finds that the Company has not provided sufficient documentation to demonstrate that its leak management costs are known and measurable.[157] Additionally, the Commission agrees with AOBA witness B. Oliver that the abbreviated periods of comparison used to project future leak management costs may have led to an overstatement of FTEs and related costs. Finally, WGL's accelerated STRIDE program should eventually lower the number of reported leaks and moderate the need for additional FTEs.

13. WGL Adjustment 29: BPO 2.0 Annual Amortization

WGL

In 2007, WGL entered into a 10-year Business Process Outsourcing ("BPO") agreement with Accenture, LLC ("Accenture"). The Company outsourced Consumer Services (call center operations, credit and collections, and back-office functions supporting meter reading), Billing (accounts payable processing, payroll administration, and cash receipts exception processing), Human Resources (payroll, compensation and benefits administration, recruiting/staffing administration, employee data management, and performance management administration), and Information Technology ("IT")Services (applications development and management, technology infrastructure management, technology help desk services, and support of end-user computing devices). In June 2017, after WGL's initial BPO agreement with Accenture expired, the Company

[157] See Tr. at 784 (Ostrander).

either extended the outsourced functions with Accenture, transitioned the outsourced functions to another service provider, or transferred the outsourced functions back in-house to WGL.

WGL describes three categories of costs to achieve ("CTA") associated with this transition, including Advisory, Transition and Transformation, and Wind-down. The $3.1 million in Advisory costs include "consulting and outside legal costs" associated with developing requests for proposals and negotiating the final vendor contracts for IT Infrastructure, Customer Services, and HR Benefits.[158] The Transition and Transformation category involves costs associated with transitioning functional areas from Accenture to new vendors. Company witness Walker testified that "the increase in the quality of service and the on-going cost reductions under new contracts supports the reasonableness of the CTA."[159] The Company is seeking $3.9 million in vendor transition costs, $2.6 million for Accenture's transition assistance, and $1.1 million for outside consultants and other support ($7.6 million in total Transition and Transformation costs).[160] Finally, WGL includes $764,000 in Wind-down costs consisting of money paid to Accenture and subcontractors for early contract termination.

Staff

Staff witness Jennifer A. Ward, Regulatory Economist in the Commission's Telecommunications, Gas, and Water Division, testified regarding the claimed financial and service benefits produced by WGL's BPO and the related costs incurred to achieve those benefits. Ms. Ward testified that WGL "has not demonstrated benefits that would

[158] Walker Direct at 13.
[159] Walker Direct at 15.
[160] Walker Direct at 14.

make the recovery of the CTA appropriate."[161] She testified that WGL's service quality performance showed marked decline, especially around May 2016, when most call center operations were transferred from Accenture to Faneuil, and January 2017, when additional services were transferred to Faneuil. Specifically, she pointed to WGL customer service reports that linked diminished service quality with the transitioning of functions such as call center. For example, the "transition of the Company's offshore Call Center" contributed to performance issues, including "customers' inability to make payments through the eService system" and "extended 'call wait' times."[162] Other customer service quality reports indicated that "customer satisfaction numbers continue to be lower than normal," due, in part, to "the transition of the Call Center to its new on-shore location in Virginia."[163] The reports further demonstrated a "payment processing issue," "longer-than-normal wait times," "slower speed-to-answer times," an "increase in the number of abandoned calls," an "increase in the number of rebills/cancellations," and a "decrease in timeliness of payment investigations as staff learns to perform new work flows in a new system."[164]

As a consequence of these performance issues, Ms. Ward concluded that WGL has failed to meet its burden of proof to show actual and verifiable service benefits resulting from BPO 2.0. Ms. Ward also contested WGL's projection that the BPO transition provides cost savings compared with the current Accenture contract over the lives of the new service provider contracts. Based on information that was deemed

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[161] Ward Direct at 9.
[162] Ward Direct at 11, citing WGL FY16Q3 Report (April – June 2016).
[163] Ward Direct at 12, citing WGL FY16Q4 Report (July – September 2016).
[164] Ward Direct at 12, citing WGL FY16Q4 Report (July – September 2016), FY17Q1 Report (October – December 2016), FY17Q2 Report (January – March 2017), and FY17Q3 Report (April – June 2017).

confidential, Ms. Ward concluded that the rates Accenture charged were above market and that WGL's subsequent outsourcing of certain functions to companies whose prices were more in line with market rates should not properly be deemed a "savings" to ratepayers for purposes of the Commission's test. Ms. Ward also criticized WGL's decision to renegotiate certain HR services with Accenture given Accenture's above-market prices.

Ms. Ward concluded that WGL had not demonstrated that the outsourcing arrangement has provided actual, verifiable, financial and service benefits. She therefore recommended that the Commission reject the Company's adjustment to recover CTA associated with BPO 2.0.[165] She further recommended that the Commission direct the Company to work with Staff and other interested parties to establish service quality metrics based on the current provider's capabilities. Finally, she recommended that if WGL requests recovery of CTA associated with BPO 2.0 in a future case, the Commission direct the Company to file information at the outset of a case showing all financial savings relative to typical or average market costs, by outsourced category that can be directly attributable to BPO 2.0, on a yearly basis.[166]

OPC

OPC witness Michael L. Arndt, a public utility rate consultant, similarly testified against WGL's proposed recovery of CTA related to Accenture, as well as costs related to the transition of services to new service providers and/or back in-house. He testified that the alleged savings WGL calculated appear to be overstated and are not known and

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[165] Ward Direct at 2, 19.
[166] Ward Direct at 18.

measurable. He further testified that WGL's claims of future savings and service quality projected through fiscal year 2021 are unknown at this time.

Mr. Arndt focused on WGL's request for recovery of costs associated with the migration of business away from Accenture. He observed that WGL was unsuccessful through multiple rate cases in proving to the Commission that the Company's contract with Accenture in 2007 resulted in cost savings to customers, even though that was the ostensible purpose of the contract. Mr. Arndt argued that it would be inappropriate to now award to WGL the costs to "achieve the 'savings' allegedly flowing from transitioning away from a contract whose purpose WGL has never been able to support."[167]

Mr. Arndt further testified that the multiple layers of management and oversight created by the Accenture contract "created inefficiencies and unnecessary costs" and that ratepayers, who did not make the decision to enter the contract, should not bear the costs associated with the Company's efforts to extricate itself from the contract.[168] Mr. Arndt additionally testified that the IT systems used by AltaGas and WGL do not appear to be compatible. He stated that based on WGL's testimony in the AltaGas merger proceeding, it appears that the IT systems used by WGL and AltaGas will remain separate for the "foreseeable future," but that the companies will consider integrating the systems at some point.[169] Mr. Arndt observed that the future costs to make AltaGas and WGL's IT systems compatible will likely be incurred in fiscal years 2019-2021 and as such are not known and measurable at this time. Additionally, he stated that WGL's alleged "savings"

[167] Arndt Direct at 7.
[168] Arndt Direct at 10.
[169] Arndt Direct at 13, *citing* Case No. 9449, Rebuttal Testimony of Luanne S. Gutermuth at pp. 2-3.

related to IT must be considered in the context of the AltaGas acquisition and are overstated.[170] Finally, Mr. Arndt testified that WGL has saved money by terminating inflated Accenture services and replacing them with less expensive providers, but he noted that these savings have not inured to the benefit of ratepayers to date.

Mr. Effron also testified on behalf of OPC related to Accenture. He testified that Company witness Walker acknowledged that the total CTA prior to allocation to Maryland are $11.4 million, that BPO transition savings of $7.4 million occurred in fiscal year 2017, and that BPO transition savings of $10.4 million occurred in fiscal year 2018.[171] Mr. Effron concluded that the cumulative savings in fiscal years 2017 and 2018 (which inure to shareholders, not to ratepayers) exceed the CTA incurred to achieve those savings.[172] Therefore, the CTA have been paid for and their inclusion in this rate case would constitute double recovery.

AOBA

AOBA witness Bruce Oliver testified that WGL has already experienced sufficient savings under its existing rates (which savings have benefited shareholders, not ratepayers) "to more than recover the entirety of its claimed BPO 2.0 costs to achieve."[173] He noted, for example, that many of the BPO 2.0 contracts have been in place for years, such as Businessolver for HR functions since January 2016; Cognizant Technology Solutions for IT Infrastructure since April and May 2016; and Faneuil, Inc., for Customer Services functions since June 2016.[174] Any savings claimed by WGL related to those

[170] Arndt Direct at 14.
[171] Effron Direct at 24.
[172] Effron Direct at 24.
[173] B. Oliver Direct at 6.
[174] B. Oliver Direct at 21.

contracts would have gone to shareholders and not ratepayers for the last two to three years, according to Mr. Oliver.

Mr. Oliver also testified that WGL significantly overstated benefits to ratepayers of the BPO 2.0 contracts and that the Company has not justified recovery of the BPO 2.0 CTA. He observed that WGL's early termination of a substantial portion of the functions outsourced to Accenture arguably denies Maryland ratepayers a portion of the benefits that the Company had earlier testified would be attributed to the Accenture contract when it was first presented to the Commission. Mr. Oliver also contested WGL's assertions that BPO 2.0 would yield improvements in service quality.[175] He further argued that because WGL has provided no evidence that the BPO 2.0 contracts were executed at below-market rates, the Company has no legitimate claim that the contracts achieved cost savings for ratepayers.[176] Likewise, he contended that any pricing under WGL's initial Accenture contract that might subsequently be characterized as above market should be treated as a deduction from the savings otherwise attributable to the original Accenture contract, not as the achievement of savings in a successor contract. Accordingly, Mr. Oliver concluded that WGL's Adjustment 29 should be eliminated in its entirety.

WGL Response

Mr. Walker disputed AOBA witness B. Oliver's testimony that the original Accenture MSA was above market.[177] He stated that the original Accenture MSA was developed through a competitive RFP process in 2006/2007 and that WGL did not obtain

[175] B. Oliver Direct at 29.
[176] B. Oliver Direct at 31.
[177] Walker Rebuttal at 2.

assessment reports identifying opportunities for cost savings until 2014. Due to the broad scope of the original contract, he argued "it would have been impractical and costly to test the market for new offerings early in the term of the Accenture agreement."[178] Mr. Walker further stated: "While it is true that the advisory firms indicated that the costs of selected functions serviced by Accenture were above market as of the time of the assessment, it is not reasonable to substitute actual costs with market benchmarks as the new cost baseline."[179] Accordingly, Mr. Walker argued that the original Accenture pricing should represent the cost baseline for comparisons against other vendors.

Mr. Walker disputed OPC witness Arndt's characterization that WGL "transition[ed] away from Accenture."[180] Mr. Walker stated that BPO 2.0 was not a transition away from Accenture, but merely a testing of the market as part of the comprehensive BPO 2.0 plan. Mr. Walker further contested Mr. Arndt's testimony that WGL employees are overseeing advisory consultants who are overseeing service providers. Mr. Walker stated that advisory firms assisted WGL only during the RFP and transition phases of BPO 2.0.

Tanya M. Hudson, Chief Customer Officer for WGL, submitted rebuttal testimony challenging Staff witness Ward's claims that the Company experienced declines in customer service metrics attributable to the transition of services from Accenture to new service providers through BPO 2.0.[181] Ms. Hudson testified that many of the negative quarterly service metrics arose prior to transitioning WGL's new service

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[178] Walker Rebuttal at 2.
[179] Walker Rebuttal at 6.
[180] Walker Rebuttal at 3, citing Arndt Direct at 9.
[181] Hudson Rebuttal at 1.

provider (eService) and therefore, were not the result of BPO 2.0.[182] She also stated that after WGL discovered problems with the eService system, it acted to mitigate the issues, and that customer satisfaction has subsequently improved. Ms. Hudson acknowledged that when WGL's new SAP billing system was launched, there was a reduction in performance. However, she attributed the dip in performance to agents learning the new system and severe weather at the time, rather than poor quality of the service provider.[183]

Commission Decision

The Commission has reviewed WGL's outsourcing efforts in several past regulatory proceedings. In Case No. 9104, the Commission stated that "any cost recovery must be offset by contract savings" and emphasized that "the Company retains the burden to prove the reasonableness of all Contract costs."[184] In WGL's next rate case (Case No. 9267), the Commission found that the Company had failed to demonstrate that its outsourcing initiative had resulted in a financial benefit to the Company and its customers. The Commission further held that "it is appropriate to match, to the degree possible, the costs incurred to achieve the Contract with the financial savings and service quality benefits it was intended to achieve."[185] Because the Commission found that WGL had failed to demonstrate those elements in Case No. 9267, it declined to approve recovery of the CTA. However, the Commission stated that WGL was not foreclosed

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[182] Hudson Rebuttal at 3.
[183] Hudson Rebuttal at 6.
[184] Case 9104, *In the Matter of the Application of Washington Gas Light Company for an Increase in Rates and Charges for Gas Service and to Implement a Performance Based Rate Plan*, Order No. 84277 at 17.
[185] Case No. 9267, *In the Matter of the Application of Wash. Gas Light Co. for Authority to Increase its Existing Rates and Charges and to Revise its Terms and Conditions for Gas Service*, Order No. 84475 at 57.

from presenting a more convincing case for recovery of such costs in the future. Similarly, in Case No. 9322, the PULJ rejected the Company's proposal to add the amortization of CTA to rate base, finding that WGL had not demonstrated "actual, verifiable evidence of the financial benefits."[186]

In the present case, the Commission agrees with witnesses from Staff, OPC, and AOBA that WGL has failed to show that the Accenture BPO 2.0 contracts have provided both financial and service benefits to WGL's customers. Indeed, intervenor witnesses demonstrated that the BPO 2.0 contracts failed both prongs of the test. As detailed above, WGL's quarterly service quality reports have shown significant diminished performance in several metrics, while others have failed to show improvement. Additionally, WGL has not demonstrated actual and verifiable evidence that its customers are obtaining financial benefits from its BPO 2.0 contracts. To the contrary, the evidence indicates that the original Accenture contract was above market and that WGL merely outsourced functions to new companies that charge a market rate, or perhaps a rate that, while still high, is not as above-market as the original Accenture contract. As Staff witness Ward stated, "showing a decrease in expenses from a contract that was well above market average cannot and should not be construed as savings to customers."[187] Finally, to the extent BPO 2.0 established contract savings with new vendors vis-à-vis the original Accenture contract, OPC and AOBA have provided

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[186] Case No. 9322, *In the Matter of the Application of Washington Gas Light Company for Authority to Increase its Existing Rates and Charges and to Revise its Terms and Conditions for Gas Service*, Proposed Order of PULJ at 41.

[187] Ward Surrebuttal at 3. See also OPC Brief at 16: "However, because the initial 2007 Accenture agreement unreasonably increased costs to customers, it is a mischaracterization to refer to the difference in price between the Accenture rates and those of the new vendors as "savings."

compelling evidence that those savings (recovered by Company shareholders, not ratepayers) may have exceeded the CTA.[188]

The Commission therefore denies WGL's adjustment that seeks recovery of the CTA for BPO 2.0. Nothing in this Order, however, precludes WGL from presenting in a future rate case proceeding actual and verifiable benefits to its customers resulting from BPO 2.0. The result of the Commission's decision is to increase operating income by $674,000 and decrease revenue requirement by $959,000.

14. WGL Adjustment 32: Regulatory Commission Expenses

WGL included rate case expenses through two adjustments. WGL Adjustment 32 includes all normal rate case costs for witnesses and public notices. WGL Adjustment 33 includes only the cost of preparing a depreciation study.

Staff witness Ostrander recommended a reduction of the expert witness fees of WGL's rate of return witness, Mr. Hevert, from $112,000 to $50,000 because of his concern that the fees were excessive and because WGL did not place sufficient attention to Commission concerns regarding rate case expenses from WGL's prior ratemaking proceeding.[189] Specifically, Mr. Ostrander testified that (i) Mr. Hevert's hourly rate exceeded WGL's approved contract level by 23%, (ii) Mr. Hevert's billings included hourly rates of other staff that significantly exceeded the ostensibly lower rates quoted by WGL in responses to Staff data requests, (iii) Mr. Hevert was assisted by as many as four

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[188] See, for example, OPC witness Effron (Direct at 24), stating "by the time that the rates in this case go into effect, those costs to achieve will have been recovered through the achievement of transition savings that have not been reflected in rates. Inclusion of the costs to achieve in the Company's revenue requirement for recovery in rates prospectively would result in a double recovery of those costs."

[189] Ostrander Direct at 38-39.

other high-cost professional witnesses to address the single issue of rate of return, (iv) WGL utilized an open-ended contract that should have contained a comprehensive "not to exceed" cap, and (v) Mr. Hevert's billing otherwise appeared excessive during certain periods. Accordingly, Mr. Ostrander's recommended adjustment (Ostrander Adjustment 14) reduces Mr. Hevert's fees from $112,000 to $50,000. Similarly, Mr. Ostrander recommended reducing the rate case costs of WGL's load study witness (Mr. Raab) from $50,000 to $40,000 based on the allegation that his contract does not fully relate to WGL rate case issues.

WGL witness Bonawitz opposed Mr. Ostrander's request for disallowance, arguing that it is arbitrary and unfounded.[190] Mr. Bonawitz testified that the contract executed between WGL and Mr. Hevert was the product of a competitive request for proposals where price was a factor. He also stated that in a rate case, the number of discovery requests, amount of rebuttal/rejoinder, hearing time, and post-hearing work is variable and cannot be predicted reliably, making a flat fee arrangement inappropriate. In contrast, the direct testimony can be reasonably estimated, and WGL required a set fee for that element of work.[191] Finally, Mr. Bonawitz argued that the outside expert fee charged by Mr. Hevert would be eclipsed by the costs of maintaining an internal staff fully versed in such issues for the years between rate cases.

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[190] Bonawitz Rebuttal at 6.
[191] Bonawitz Rebuttal at 7.

Commission Decision

The Commission approves WGL's adjustment, including its proposal to amortize current rate case expenses over two years. The Company has demonstrated that its contract with Mr. Hevert resulted from a competitive RFP and that the production of his direct testimony was subject to a flat fee. At the time of contracting, other aspects of Mr. Hevert's participation in this case, such as preparation of rebuttal and rejoinder testimony, were dependent on how other parties responded to Mr. Hevert and were not susceptible to a flat-fee structure. Finally, the Commission agrees that hiring full-time internal staff for rate cases could prove more costly than hiring outside expert witnesses as needed. The result of this decision is to decrease operating income by $83,000 and to increase the revenue requirement by $118,000.

15. WGL Adjustment 33: Depreciation Study

Staff witness Ostrander observed that WGL split its rate case related costs into two separate adjustments (Adjustments 32 and 33), and may have double counted certain portions of the Foster study relating to depreciation.[192] Mr. Ostrander proposed (Ostrander Adjustment 15) reducing depreciation study fees by $30,502 to ensure that no double recovery occurs, and to allow amortization over three years instead of the Company's two. He also reduced WGL's depreciation study fee cost of $103,000 to $85,578 based on Staff's receipt of WGL bills in response to Staff's data requests. WGL opposed Mr. Ostrander's adjustments, stating that they were unfounded and arbitrary.

[192] Ostrander Direct at 45.

Commission Decision

The Commission approves WGL Adjustment 33 and declines to accept Staff's adjustment. The Depreciation Study fees appear reasonable in amount and are well documented. The Commission sees no need in this instance to spread amortization over three years instead of the Company's proposed two. This decision decreases operating income by $37,000 and increases revenue requirement by $53,000.

16. WGL Adjustment 40: Income Tax Adjustments – COR Amortization

WGL recommended that the Commission authorize it to discontinue the flow-through treatment of Cost of Removal ("COR") for pre-1971 vintages and to normalize it by amortizing it over ten years.[193] Mr. Tuoriniemi explained that WGL has been accumulating a regulatory asset for COR that will need to be collected from future customers and which reached $5.1 million as of September 30, 2018.[194] He proposed that the Company stop treating pre-1971 COR as a flow-through item and stop further accumulation of the regulatory asset. All depreciation and COR would be normalized and the accumulated amount would be amortized over ten years. At the end of the ten-year period, the Company would be operating on a fully normalized basis for income tax in Maryland rates.[195] WGL discussed the benefits of normalization, including those referenced in FERC Order No. 144.[196] In that order, FERC found that tax normalization

[193] Tuoriniemi Direct at 100.
[194] Tuoriniemi Direct at 100, 105.
[195] Tuoriniemi Direct at 106.
[196] FERC Order No. 144, Docket No. RM80-42, *Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes* (May 6, 1981).

better matches tax benefits with cost responsibility than flow-through; is more likely to result in rates and revenues that are stable over time; and results in a more equitable inter-period allocation of tax costs to customers.[197]

Staff witness Ostrander opposed WGL's adjustment, citing Case No. 9443 as analogous to the current situation, in which the Commission rejected Pepco's request for normalization of COR. In Case No. 9443, the Commission found that Pepco had used an excessive allocation factor that had contributed to the company's accounting problem, that the accounting problem would resolve itself over time, and that Pepco had not provided sufficient information to the Commission to make a decision or to Staff to make a recommendation.[198] Mr. Ostrander argued that the instant case is analogous because WGL has not previously requested tax normalization of the COR deduction, there is no urgency to resolve the issue, and WGL has not provided Staff with sufficient information to verify the Company's assumptions and estimates. Consequently, Mr. Ostrander recommended reversal of WGL's adjustment, which would decrease income tax expense by an amount of $507,693 related to COR (Ostrander Adjustment 25).[199]

Commission Decision

The Commission denies Staff's proposed adjustment to remove WGL's Amortization of COR and accepts WGL's tax normalization Adjustments 40 in full, allowing WGL to adopt normalization of COR and to amortize the balance of $5.1 million over ten years, and a final reconciliation report at that time. In contrast to

[197] *Id*. at 11-12.
[198] Case No. 9443, Errata Order No. 88432 (Oct. 27, 2017) at 48-52.
[199] Ostrander Direct at 58.

Case No. 9443, WGL did not wait to bring this issue to the Commission's attention. To the contrary, the primary cause of the increased pre-1971 flow-through balance was the implementation of WGL's STRIDE Plan, and the present rate case is the first since WGL implemented its STRIDE Plan.[200] Additionally, WGL based the amount of flow-through COR on the vintage years of actual plant retirements, in contrast to Case No. 9443, where estimations were used. Finally, to the extent the Company's request for normalization is delayed, the tax effect of pre-1971 COR will likely continue to grow, creating an intergenerational inequity that may benefit ratepayers today, but at the expense of future customers.[201] Accordingly, WGL's proposal to discontinue the flow-through of income tax accounting and to normalize it through amortization of the prior flow-through balance of $5.1 million over ten years is approved and Staff's proposed adjustment is denied. The effect of this decision is to decrease operating income by $1,889,000 and to increase revenue requirement by $2,687,000.

17. <u>WGL Adjustment 6: GPIS – Rate Year; WGL Adjustment 7: CWIP – Rate Year</u>

WGL proposed to include a $152,863,954 adjustment for Gas Plant in Service ("GPIS") and Construction Work in Progress ("CWIP") through Adjustments 6 and 7, representing the cost of adding new customers, continuing the Company's program to replace its transmission and distribution mains, services, meters, and other property exclusive of STRIDE replacements, and addition software and general plant additions through the rate effective period. WGL witness Tuoriniemi derived the adjustments for

[200] Tuoriniemi Direct at 105.
[201] Tuoriniemi Rebuttal at 88.

GPIS and CWIP using monthly actual and forecasted capital expenditures for the period from March 1, 2018 through December 31, 2019.[202]

In WGL Adjustment 6, the Company also asked for recovery of the capital costs of certain information technology projects. WGL witness Tuoriniemi asked the Commission for authorization to apply cloud-based treatment for certain capital costs as recommended by the National Association of Regulatory Utility Commissioners ("NARUC"), Resolution Encouraging State Utility Commissions to Consider Improving the Regulatory Treatment of Cloud Computing Arrangements.[203] Specifically, he proposed including the costs of two information technology projects in rate base in this proceeding: Workday Human Capital Management ("Workday") and Oracle Enterprise Performance Management ("EPM.")[204] WGL stated that the "go live" dates for Workday and EPM are December 2018 and January 2019, respectively.[205]

Staff

Staff witness Ostrander recommended removal of WGL's adjustments related to estimated/projected post-test period plant additions that remain estimated and are not replaced by actual plant through the date of hearings. He also recommended removal of all estimated or actual plant additions that are post-hearing.[206] Mr. Ostrander argued that in recent history, the Commission has rejected the types of estimated/projected post-test period and post-hearing reliability plant additions contained in WGL's adjustments. Specifically, he stated that in WGL's two most recent rate cases (Case Nos. 9322 and

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[202] Tuoriniemi Direct at 45-46.
[203] Tuoriniemi Rebuttal at 14.
[204] Tuoriniemi Direct at 46-48.
[205] WGL Brief at 10-11.
[206] Ostrander Direct at 20.

9267), Pepco's four most recent rate cases (Case Nos. 9443, 9418, 9336 and 9311), and the two most recent rate cases of Baltimore Gas and Electric Company ("BGE") (Case Nos. 9326 and 9299), the Commission rejected the companies' adjustments because these estimated amounts were not known and measurable, the plant is not used and useful, and the companies were unable to accurately forecast these amounts. Mr. Ostrander further argued that in none of these cases was regulatory lag deemed an acceptable argument for including such amounts in rate base.

Regarding WGL's present rate case, Mr. Ostrander argued that the estimated/projected amounts requested by the Company are not known and measurable and have not been shown to be used and useful. He further argued that the Company has not made any showing that would justify a departure from Commission precedent.

Accordingly, Mr. Ostrander recommended removing all of WGL Adjustment 6 ($142,645,712) related to Other Gas Plant In Service. He testified that this period related to estimated post-test period (and part post-hearing) for the period March 31, 2018 to December 31, 2019. He observed that none of this plant was classified as "actual" at the time of WGL's filing. He further stated that this adjustment relates to estimated post-test period plant that is not known and measurable and not related to safety and reliability. Accordingly, Mr. Ostrander recommended that all of these plant additions be removed (Ostrander Adjustment 4a) because the adjustment represents post-test period plant that is not known and measurable and is not related to safety and reliability. Additionally, Mr. Ostrander contended that Workday and EPM are post-test period projects that should be removed from this case.[207]

[207] Ostrander Surrebuttal at 4.

OPC

OPC witness Effron recommended eliminating the pro forma test year adjustments to plant and the increase in CWIP from Adjustments 6 and 7. He also recommended removing certain expenditures related to leaseholder improvements from rate base.

Commission Decision

As discussed throughout this Order, the Commission will accept Staff's recommendation to eliminate certain post-test period plant that is not known and measurable. A further discussion of the Commission's rationale for accepting those adjustments is found *infra* in Section II A:1. Accordingly, WGL's proposed Adjustments 6 and 7 are denied. Acceptance of Staff's recommendation for CWIP (Rate Year) leads to a rate base increase of $6,009,000 and a revenue requirement increase of $624,000.

Regarding WGL's information technology projects, the Commission agrees with Staff that it is not necessary to make a policy decision regarding whether to include WGL's recommended cloud-based treatment of software in this proceeding.[208] Because the Commission has accepted Staff adjustments that remove forecasted post-test period plant additions, including computer software, this is an issue that should be addressed in a subsequent rate case proceeding.

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[208] Staff Brief at 13.

18. WGL Adjustment 13: GPIS – STRIDE and Safety Plant

WGL

WGL proposed adjustments for forecasted post-test period plant additions with corresponding adjustments for accumulated depreciation, accumulated deferred income taxes, and net operating loss for the categories of STRIDE, other reliability gas plant, other non-STRIDE and non-reliability gas plant, and Construction Work in Progress ("CWIP") through December 2018 in its proposed rate base. The Company argued that these post-test year plant additions, including plant additions that are not related to STRIDE or safety and reliability, should be recovered to offset regulatory lag (as discussed in Section II A.1. regarding Forecasted Revenues). Additionally, WGL witness Tuoriniemi stated that the Company will reach the $218.5 million STRIDE program total soon, with only $15.1 million remaining to be spent in the last four months of 2018.[209] Accordingly, Mr. Tuoriniemi recommended that the Commission include the full end of period amount in base rates to achieve a "clean cut-off" and to avoid having STRIDE costs in the Rider until the next base rate case filing.[210] Finally, although WGL recognized that the Commission has recently limited recovery of post-test year reliability plant spending, the Company argued that the Commission has never limited safety reliability plant.[211]

Staff

Staff witness Ostrander observed that WGL's adjustment concerns both STRIDE and reliability plant that is actual TYE March 31, 2018, while other plant is estimated

[209] Tuoriniemi Rejoinder at 4-5. See also Tr. at 186.
[210] Tuoriniemi Rebuttal at 52.
[211] Tuoriniemi Rebuttal at 52.

post-test period STRIDE. Mr. Ostrander made adjustments (Ostrander Adjustment 4b) to allow in rate base actual STRIDE/reliability plant at terminal levels. In contrast, he recommended disallowance (Ostrander Adjustment 4c) of estimated STRIDE plant for the post-test period and partial post-hearing period, as this plant was not known and measurable.[212]

Mr. Ostrander recommended disallowance (Ostrander Adjustment 4d) of non-STRIDE estimated post-test period plant for the period March 31, 2018 to December 31, 2018, noting that all of these plant additions are estimated and not known and measurable. However, he stated that he would recommend allowance in rate base of those actual plant additions that replace estimated plant additions through the date of the hearing if such actual plant is properly documented.[213] Mr. Ostrander similarly recommended disallowance (Ostrander Adjustment 4e) of non-STRIDE and non-reliability plant for the period March 31, 2018 to December 31, 2019, with the same caveat of allowing updates for actual plant additions through the date of the hearings. Finally, Mr. Ostrander recommended removal (Ostrander Adjustment 4f) of reliability-related and estimated plant for the period March 31, 2018 to December 31, 2019, but allowing for actual plant additions through the date of the hearings.

At the hearing, Staff accepted certain adjustments for actuals provided by WGL, resulting in a final Staff recommendation of $210.7 million for actual STRIDE plant additions incurred through the date of the hearings on September 30, 2018. Staff stated that the $210.7 million for actual STRIDE was based on WGL's response to Commission

[212] Ostrander Direct at 19.
[213] Ostrander Direct at 19.

Bench Request. No. 4.[214] Staff did not, however, accept the remainder of WGL's total STRIDE plant additions, arguing that they remained forecasted as of the date of the hearing.[215] Staff accepted other reliability plant additions through August 31, 2018 in the amount of $11,964,000. However, Staff removed (i) forecasted post-test period STRIDE and other reliability plant of $35,493,000, (ii) all forecasted post-test period non-STRIDE and non-reliability plant additions of $142,646,000, and (iii) CWIP of $4,209,000.

OPC

OPC opposed WGL's proposal to include STRIDE and safety plant additions through December 2018, noting that date is nine months after the end of the test year. Instead, OPC witness Effron argued that the Commission should authorize recovery of only two months of post-test year STRIDE additions in rate base (through May 2018). In support of that recommendation, Mr. Effron contended that authorizing WGL's Adjustment would "distort the relationship between plant in service and the other elements of rate base."[216] In particular, Mr. Effron argued that accepting WGL's plant adjustments would cause plant in service to reflect certain components as of the end of the test year, while all other elements of rate base would reflect average test year balances. OPC also argued that the Company's position was contrary to recent Commission precedent, which denied recovery of plant in service through the date of the hearing, and instead limited such recovery to two or three months after the test year.[217] Mr. Effron testified that WGL's proposal to include STRIDE and safety plant additions

[214] Tr. at 135-36.
[215] Ostrander Direct at 18.
[216] Effron Direct at 11.
[217] OPC Brief at 12.

through December 2018 "goes well beyond" that Commission precedent.[218] Accordingly, he proposed to limit the pro forma adjustment for post-test year STRIDE and safety plant additions to two months after the end of the test year (through May 2018).

Commission Decision

The Commission accepts Staff's position regarding WGL Adjustment 13. WGL's proposal to include recovery of plant beyond the hearing date and through December 2019 is inconsistent with Commission precedent. The Commission has rejected forecasted post-test period plant additions in a series of utility rate cases, including WGL's most recent rate proceedings (Case Nos. 9322 and 9267); Pepco's four most recent rate cases (Case Nos. 9443, 9418, 9336, and 9311); and BGE's most recent rate cases (Case Nos. 9326 and 9299). Simply put, forecasted post-test period plant additions not trued up for actuals by the time of the hearing are not known and measurable. Nor are they used and useful. Moreover, as stated in Case No. 9311: "The Commission has historically rejected this type of projected adjustment finding that it is not justified by regulatory lag arguments."[219]

OPC's position to limit post-test year plant additions to May, 2018 (two months beyond the test period) is on more solid ground. The Commission's recent orders have emphasized that recovery of post-test year rate base additions and reliability spending is

[218] Effron Direct at 15.
[219] *In the Matter of the Application of Potomac Elec. Power Co. for an Increase in its Retail Rates for the Distribution of Elec. Energy*, Order No. 85724, Case No. 9311 (July 12, 2013) at 14-15.

not guaranteed and should not be expected. Those cases also curtailed post-test period recovery to two to three months after the test period.

For example, during the recent Pepco rate case (Case No. 9418), the Commission allowed post-test period reliability investments three months after the end of the test year. The Commission explained that allowance of post-test period reliability plant additions is an "exception to the rule of allowing recovery only of reliability investments for the historical test period."[220] The Commission further stated that the exception was adopted several years ago "to incentivize the Company to make accelerated reliability infrastructure investments by allowing recovery of the expenses without waiting for another rate case."[221] The Commission reasoned that it had "departed from traditional ratemaking principles" in the past in order to improve Pepco's reliability performance, but "did not intend for this exception to become deemed as guaranteed or automatic."[222] The Commission explained that as Pepco's reliability performance improved, it became less necessary to incentivize further reliability spending through additional post-test year allowance, stating: "Given Pepco's improved performance and in light of the significant increase in rates the Company is requesting, we no longer find that Pepco needs this reliability exception in whole."[223] See also Case No. 9443, limiting post-test year plant additions to two months after the end of the test year.

In the present case, however, the record reveals an increasing leak rate problem for WGL. Company witness Chapman testified that there has been "a multi-year trend in

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[220] Case No. 9418, *In the Matter of the Application of Potomac Electric Power Company for Adjustments to its Retail Rates for the Distribution of Electric Energy*, Order No. 87884 (Nov. 15, 2016) at 35.
[221] *Id*.
[222] *Id*. (Internal citations omitted.)
[223] *In the Matter of the Application of Potomac Elec. Power Co. for Adjustment to its Retail Rates for the Distribution of Elec. Energy,* Case No. 9418, Order No. 87884 (Nov. 15, 2016) at 35-36.

the increase in the number of odor calls we have received, and a similar multi-year trend in the increase in the volume of leaks across our entire system."[224] Montgomery County stated that it is "particularly concerned about the increase in odor calls and leaks discussed throughout the duration of this proceeding," both relating to safety and environmental concerns related to the release of greenhouse gas emissions.[225] In order to address that problem, therefore, the Commission will authorize post-test year plant additions up to the hearing date, which is six months after the test period, as proposed by Staff. As stated in past rate case proceedings, the Commission will continue to address this issue on a case-by-case basis, with post-test year recovery viewed as an exception to the rule, and not intended to be deemed as guaranteed or automatic. The Commission's decision regarding WGL Adjustment 13 increases rate base by $56,213,000 and increases the revenue requirement by $5,838,000 for GPIS - STRIDE and Safety Plant. The decision also reduces rate base by $1,737,000 and reduces revenue requirement by $180,000 for CWIP – STRIDE and Safety Plant.

19. WGL Adjustment 8: Depreciation Reserve (Rate Year)

Staff witness Ostrander recommended removal of depreciation expenses related to forecasted plant. OPC witness Effron made an adjustment to his Direct Testimony to correct the double removal of post-test year period depreciation.

Consistent with other Commission adjustments to remove increases/decreases for the post-test period, the Company's Adjustment 8 for Depreciation Reserve for the rate

[224] Chapman Direct at 12.
[225] Montgomery County Brief at 3.

year is denied. This decision is consistent with Staff and OPC adjustments regarding WGL Adjustment 8.

20. WGL Adjustment 11: Accumulated Deferred Income Tax (Rate Year); ADIT Net Operating Loss – Federal (Rate Year); ADIT – Net Operating Loss – State (Rate Year)

WGL Adjustment 11 is a derivative adjustment that follows the Company's inclusion of adjustments for the post-test period. Pursuant to the Commission's decisions discussed above, the Commission accepts Staff's rate year related adjustments and denies WGL Adjustment 11.

21. WGL Adjustment 14: Depreciation Reserve – STRIDE and Safety Plant

WGL witness Tuoriniemi updated Adjustment 14 for the net operating income effects of the updated Plant in Service amounts he testified about. Pursuant to the Commission's decisions supra, WGL's Adjustment 14 is denied and Staff's adjustment is accepted. The effect of this decision is to reduce rate base by $2,186,000 and reduce revenue requirement by $227,000.

22. WGL Adjustment 16: Accumulated Deferred Income Tax – STRIDE and Safety Plant

WGL witness Tuoriniemi updated WGL Adjustment 16 by computing ADIT for the STRIDE and Safety Related plant by applying the tax rate to the book/tax timing differences related to depreciation pertaining to the incremental STRIDE and safety related additions. Pursuant to the Commission's other decisions regarding STRIDE and

Safety Plant, WGL's Adjustment 16 is denied and Staff's adjustments are accepted. This results in a decrease in rate base of $10,790,000 and a decrease in revenue requirement of $1,121,000.

23. WGL Adjustment 41: Accumulated Deferred Income Tax – MACRS; ADIT – NOL; ADIT – Non Plant; ADIT – Re-Acquired Debt

For Accumulated Deferred Income Tax – Modified Accelerated Cost Recovery System ("MACRS"), Staff recommended an adjustment to utilize a 13-month average through January 2019 rather than WGL's average ending December 2019. The Commission finds Staff's adjustment to be appropriate and accepts it. This results in a rate base decrease of $13,211,000 and a revenue requirement decrease of $1,372,000.

The other ADIT adjustments were uncontested and therefore accepted. WGL Adjustment 41 – ADIT - NOL results in a rate base reduction of $660,000 and a revenue requirement decrease of $69,000. WGL Adjustment 41 – ADIT – Non Plant results in a rate base reduction of $526,000 and a revenue requirement decrease of $55,000. WGL Adjustment 41 – ADIT – Re-Acquired Debt leads to a rate base increase of $414,000 and a revenue requirement increase of $43,000.

24. COMAR Advertising Expense

Staff

Staff witness Ostrander testified that certain promotional and institutional advertising expenses included by WGL should be disallowed.[226] He pointed to COMAR

[226] Ostrander Direct at 12.

20.07.04.08C, which provides in part that: "Expenditures for advertising and promotion other than that classified as informational will not be allowed for rate making purposes unless it is demonstrated to the satisfaction of the Commission in a subsequent rate proceeding that the expense is of direct benefit to the rate payer and in the public interest." Mr. Ostrander argued that WGL has not demonstrated that these advertising costs were beneficial to ratepayers and in the public interest as required by COMAR. Mr. Ostrander recommended removal of promotional and institutional advertising expenses of $1,170,294, but allowed informational-related expenses of $562,146.[227]

WGL

Nekole N. Johnson, Director of Marketing at WGL, filed rebuttal testimony regarding WGL's advertising expenses. She testified that the Commission approved similar marketing expenses in Case Nos. 9104, 9267, and 9322. Ms. Johnson testified that WGL acts as a conduit of information to assist customers in making energy decisions, including information related to the value of natural gas.[228] Ms. Johnson stated that WGL incurs marketing expenses to achieve four objectives, which are (i) meeting its public service responsibilities, (ii) retaining present business, (iii) obtaining new efficient business, and (iv) reducing costs to customers.[229] With respect to retaining and growing business, Ms. Johnson observed that WGL's product—natural gas—is in competition with electricity, propane, and oil, with electricity offering competition for the full product line that uses natural gas (such as space heating, water heating, cooking, clothes drying, and cooling).

[227] Ostrander Direct at 12.
[228] Johnson Rebuttal at 4.
[229] Johnson Rebuttal at 6-7.

Ms. Johnson testified that WGL's marketing programs include general residential awareness and education programs to educate customers about the environmental benefits and energy savings of natural gas appliances.[230] The Company's marketing programs also include targeted commercial advertisements, such as the Trade Relations Program, which provides to manufacturers and local HVAC contractors industry training and education as well as customer education materials regarding natural gas appliances. Ms. Johnson concluded that WGL's marketing program is in the public interest and directly benefits ratepayers because (i) it allows customers to make informed decisions that lead to more efficient use of WGL's gas distribution system, which in turn lowers unit costs of service; (ii) it promotes the national energy policy of reducing the nation's dependence on foreign oil; and (iii) it leads to improved environmental quality.[231]

Commission Decision

The Commission's regulations delineate four types of advertising expense, which include promotional, informational, community affairs, and institutional.[232] Promotional advertising is directed toward selling services, adding new customers, or encouraging the further use of utility services.[233] Informational advertising informs customers of "charges and conditions of service, safety precautions, energy conservation, temporary or emergency conditions, employment opportunities, rate cases, annual reports, and legal and financial matters."[234] Community affairs type of advertising attempts to influence

[230] Johnson Rebuttal at 10.
[231] Johnson Rebuttal at 14.
[232] COMAR 20.07.04.08D.
[233] COMAR 20.07.04.08E(1).
[234] COMAR 20.07.04.08E(2).

public opinion on a controversial issue or a legislative or administrative matter.[235] Institutional advertising seeks to establish a favorable image of the utility or its employees.[236]

The Commission's advertising regulations favor informational advertising over the other three forms. Informational advertising is presumed to be in the public interest and is recoverable unless it is demonstrated otherwise in the rate case proceeding.[237] In contrast, advertising expenditures other than informational "will not be allowed for rate making purposes unless it is demonstrated to the satisfaction of the Commission in a subsequent rate proceeding that the expense is of direct benefit to the rate payer and in the public interest."[238]

WGL's advertising campaigns appear to include a substantial amount of informational advertising. They include programs to educate customers about the environmental benefits and energy savings of natural gas appliances, as testified by Ms. Johnson. They also include educational programs directed toward manufacturers, HVAC contractors, and customers about natural gas appliances. These types of programs are informational and presumed to be in the public interest and the Commission so finds. Other WGL advertising may be more targeted toward promoting the Company's name and adding new customers and would be classified as promotional or institutional. Those types of advertising must provide a direct benefit to ratepayers and be in the public interest or they are excluded. The Commission will accept all of WGL's advertising

[235] COMAR 20.07.04.08E(3).
[236] COMAR 20.07.04.08E(4).
[237] COMAR 20.07.04.08C.
[238] COMAR 20.07.04.08F provides: "Unless a utility company demonstrates during a rate case proceeding before the Commission that a particular item of advertising or promotional expenditure was directly beneficial to the ratepayer and in the public interest, expenses classified as promotional, community affairs, and institutional shall be excluded as an expense for rate making purposes."

costs in this rate case proceeding. However, in the future, the Commission orders the Company to provide more information about the classification of each advertisement program, and to the extent it is not informational, testimony regarding why it is directly beneficial to ratepayers and in the public interest.

25. Executive and Non-Executive Bonuses

Staff witness Ostrander recommended removing $157,085 of normalized bonus costs for WGL Executives and Non-Executives (Ostrander Adjustment 11).[239] He later reduced that disallowance to $92,000.[240] He contended that it is reasonable to adjust these bonuses because of their significant increase in cost in recent years and because the larger bonuses for 2017 and 2018 may be related in part to the merger, which is not a recurring event. He also removed $104,000 non-executive discretionary bonus because it is related to the non-recurring merger event and $203,000 of non-executive retention bonus because these bonuses have not been paid consistently in recent years and are not proven to be recurring.

WGL witness Gibson challenged Mr. Ostrander's calculations, arguing that they were not properly normalized.[241] Mr. Ostrander responded by recommending removal of the amounts for discretionary and retention bonuses paid in the test year.

[239] Ostrander Direct at 37.
[240] Ostrander Surrebuttal at 46.
[241] Gibson Rebuttal at 21-22.

Commission Decision

The Commission accepts Staff's adjustments regarding executive and non-executive bonuses. The Commission agrees with Mr. Ostrander that the bonuses related to the merger are not a recurring event and that the other bonuses discussed have not been proven to be recurring. Mr. Ostrander has treated this adjustment appropriately. The effect of this decision is to increase operating income by $66,000 and to reduce revenue requirement by $94,000.

26. Fully Amortized Software

Staff witness Ostrander testified that WGL included ten-year and five-year amortizable software and assets that are either fully amortized or will be soon and for which amortization expense should not have been included.[242] Nevertheless, WGL included the related amortization expense in these fully amortized assets in this rate case through WGL Adjustment 9. Mr. Ostrander also testified that certain WGL software that is currently maintained on the books and being amortized is no longer used and useful and that certain costs related to WGL's replaced Customer Billing System may not have been removed from the accounting records. Accordingly, Mr. Ostrander recommended removal of amortization expense of $3,983,436 of software and amortizable assets (Ostrander Adjustment 16). That amount was subsequently amended downward to $1,634,000 upon learning that WGL's data request response had incorrectly provided

[242] Ostrander Direct at 46-47.

amounts on a total basis rather than a Maryland basis. The adjustment was also lowered to reflect this expense only through the period ending December 31, 2018.[243]

WGL opposed Staff's adjustments, arguing that Ostrander Adjustment 16 is one-sided because it failed to recognize increases in capitalized software and related amortization expense.[244] Additionally, WGL witness Tuoriniemi argued that it is not reasonable to remove amortization expense as proposed by Mr. Ostrander because retired assets are not tracked under amortization accounting. He stated that "the underlying premise of amortization accounting is to eliminate the need to track actual retirements and retirement units."[245]

Commission Decision

The Commission accepts Staff's adjustment to remove amortization expense on fully amortized software. Mr. Ostrander's adjustment appropriately removed amortization expense on software that was subsequently retired and fully amortized by December 31, 2018, for amounts that are known and measurable. There is no good justification to continue charging ratepayers during the rate effective period for assets that have been retired and are already fully amortized. The effect of this decision is to increase rate base by $167,000, increase operating income by $1,184,000 and reduce the revenue requirement by $1,667,000.

[243] Ostrander Surrebuttal at 53-54.
[244] WGL Brief at 13.
[245] Tuoriniemi Rebuttal at 96.

27. Non-Recurring Leak Expense

Staff

Mr. Ostrander recommended removal of certain non-recurring costs and accruals of $874,968 pertaining to outside vendors addressing leak reports and related issues (Ostrander Adjustment 17).[246] He argued that these costs and accruals should be removed as one-time incidents. He noted that WGL labeled these events as "one-time accrual" costs that were paid to two other utilities, New Jersey Natural Gas Company and SEMCO Energy Gas Company, for providing assistance regarding leak reports.[247] Mr. Ostrander's adjustments also included removal of similar accruals for Precision Pipeline and Miller Pipeline leak repair costs. Staff concluded that WGL has not provided any forecasts to show that these one-time outside vendor costs related to leak management repairs will recur in the future.

WGL opposed Mr. Ostrander's adjustments. First, the Company disputed ever characterizing the costs as "non-recurring," stating that reporting them as a "one-time accrual" has a distinct meaning that does not foreclose the possibility that a similar cost will arise in the future.[248] Second, the Company argued that Mr. Ostrander's adjustments were not balanced because they failed to add back to the cost of service a dollar amount for either internal FTEs or other external contractors needed to address the leaks (in lieu of the mutual aid costs Mr. Ostrander removed). Third, WGL argued that the costs underlying the need for mutual aid and/or additional contractor costs demonstrated in the test year will continue in the rate effective period.

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[246] Ostrander Direct at 49-50.
[247] Ostrander Direct at 50.
[248] WGL Brief at 35.

Commission Decision

The Commission denies Staff's proposed adjustments regarding non-recurring leak management. It is true that non-recurring costs are customarily removed from test year expenses to ensure that ratepayers do not fund expenses in the future that are no longer incurred by the public service company. In this case, however, the record demonstrates that WGL's leak management accrued costs may indeed be recurring. Several witnesses addressed the significant and growing leak management problem faced by WGL. That condition is likely to persist into the rate effective period and the Company will have to respond to it, by utilizing additional mutual aid resources, or through other means such as hiring additional outside contractors or augmenting internal resources.

28. Uncollectible Expense

Mr. Ostrander testified that WGL utilized the same adjustment methodology in the present case that it used in Case No. 9322 to adjust for uncollectibles (a five-year average of net charge-offs to determine an uncollectible ratio that is applied to system revenues to produce an uncollectible expense). However, Mr. Ostrander contended that in this case, WGL used an artificially high charge-off ratio for TYE March 31, 2018, in that the bad debt recoveries in the formula are significantly understated compared to the amounts in the prior four years.[249] Based on WGL's responses to Staff data requests, Mr. Ostrander stated that WGL "admits that the recovery amounts are lower for TYE March 31, 2018 because WGL suspended the normal shut-offs and collection recovery

[249] Ostrander Direct at 52.

process from January 1, 2018 through July 31, 2018 to focus on billing and customer service during the period of introducing the new billing system."[250] Moreover, Mr. Ostrander stated that WGL recognizes that this is not a permanent situation and that the recoveries will increase. Accordingly, Mr. Ostrander recommended reduction of uncollectible expense by $131,450 to reflect a normalized level of recovery amounts for the 2018 period that is included in the five-year average formula (Ostrander Adjustment 19).

WGL witness Tuoriniemi opposed Mr. Ostrander's adjustment, stating that his adjustment was inconsistent with past Commission precedent.[251] He also stated that Mr. Ostrander's adjustment was excessive. "The Company's computation already reflects an average of five-year's worth of data. Staff witness Ostrander takes one component of the data, which is already included in Washington Gas's computation, averages it and then adds to the five-year computation where it is averaged again."[252] Mr. Tuoriniemi concluded that Staff has not made a compelling argument that demonstrates a need to deviate from existing precedent.

Commission Decision

The Commission finds that WGL's adjustment is reasonable. Mr. Tuoriniemi used a five-year computation to address an anomalous year, a methodology that the Commission approved in Case No. 9267. In that proceeding, the Commission held that using a five-year average to normalize an anomalous year was appropriate.

[250] Ostrander Direct at 52-53.
[251] Tuoriniemi Rebuttal at 36.
[252] Tuoriniemi Rebuttal at 38.

"The Commission's use of a recent average period is consistent with sound rate-making practices as it avoids basing rates on an anomalous year and smooths out yearly fluctuations."[253] Although Mr. Ostrander's proposal may also be reasonable, it has not been demonstrated to be superior to the Company's method. WGL's approach to normalizing the aberrant year appropriately resolves the problem and is accordingly accepted.

29. <u>AGA Dues</u>

<u>Staff</u>

Mr. Ostrander recommended removal of one-third of American Gas Association ("AGA") dues in the amount of $67,720 (Ostrander Adjustment 21). He contested full inclusion of AGA dues "because of excessive costs that the AGA appears to have spent on hosting a world conference in June of this year."[254] He argued that these costs are not beneficial to customers and resemble the "institutional" or "promotional" costs of COMAR 20.07.04.08, which are disallowed because they provide no proven direct benefit to ratepayers.[255]

WGL witness Tuoriniemi opposed Mr. Ostrander's adjustment, arguing that Mr. Ostrander's adjustment is speculative and that the Company's payment of dues and recovery thereof is consistent with Commission policy.[256] Mr. Tuoriniemi also stated that the AGA dues are not related to the AGA's hosting of the World Gas conference.

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[253] Case No. 9267, Order No. 84475 at 34-35.
[254] Ostrander Direct at 56.
[255] Ostrander Direct at 56.
[256] Tuoriniemi Rebuttal at 79-80.

Commission Decision

The Commission declines to adopt Staff's adjustment. There is insufficient record evidence to exclude Company costs that were paid to the AGA based on the premise that the AGA spent excessively on an annual conference. Additionally, when the Company's AGA dues were similarly challenged in Case No. 9267, the Commission authorized recovery, contingent on the Company removing any amount attributed to lobbying activities.[257] Mr. Tuoriniemi testified that the Company eliminated 6.40% of AGA fees for 2017 and 3.1% of AGA fees for 2018 from the Maryland cost of service based on the AGA's identification of those percentages of fees relating to lobbying expenses.[258] Because WGL's request for recovery of AGA dues is consistent with our precedent in Case No. 9267, Staff's proposed adjustment is denied.

30. Expensed Software Cost Amortization

Staff

Mr. Ostrander identified software expenses of at least $3,369,384 for TYE March 31, 2018, related to capitalized software purchases of $86.2 million for WGL's new Customer Information Billing System ("CIS") placed in service in January 2017.[259] The software expenses are related to data conversion, training, and change management for the related software.

[257] Case No. 9267, Order No. 84475 at 61.
[258] Tuoriniemi Direct at 96; RET-4, Schedule B, Adjustment 31.
[259] Ostrander Direct at 60.

Staff noted that the capitalized costs of this software are $70 million greater than any other software system on the Company's books.[260] WGL also implemented a Click software system with capitalized software costs of $11.2 million. Mr. Ostrander argued that these two software purchases are extraordinary and that the expenses justify some reasonable amortization to smooth the costs over a reasonable period of time. Accordingly, he took a portion of the CIS-related software expenses, capitalized them, and created a regulatory asset of $4,281,000 to amortize over five years (Ostrander Adjustment 27).[261]

WGL Response

WGL opposed Staff's adjustment. Company witness Tuoriniemi stated that the WGL followed Generally Accepted Accounting Principles ("GAAP") when it charged the software costs to expense.[262] During the hearing, Mr. Tuoriniemi acknowledged that these charges were "one-time expenses" for that billing system.[263] However, he also contended that the Company would soon replace its financial planning system, its property accounting system, and work management system, "so there's always a recurring level of operating expenses because of ongoing systems."[264]

[260] Ostrander Surrebuttal at 71.
[261] Ostrander Surrebuttal at 68.
[262] Tuoriniemi Rejoinder at 7.
[263] Tr. at 134.
[264] Tr. at 134.

Commission Decision

The Commission accepts Staff's adjustment to expensed software cost amortization.[265] It is appropriate to capitalize and amortize the test-period software costs because they are extraordinary in amount, arise from a unique project that will replace a 40-year old system, are non-recurring, and are likely to significantly decline in future years. It would not be reasonable to establish rates that would require customers to fund excessive test-period software expenses in all future years based on this extraordinary, non-recurring cost. Staff's proposal to amortize the expense provides a reasonable solution. This decision results in an increase to rate base of $4,150,000, an increase to operating income of $759,000 and a decrease to the revenue requirement of $649,000.

31. Late Payment Revenue

OPC

OPC witness Effron challenged WGL's calculation of its late payment charge ratio. WGL calculated the ratio of late payment charges to revenues for the year 2016, and then applied that ratio (0.6169) to test year revenues to calculate the pro forma test year late payment charges. The Company explained that it used calendar year 2016, in lieu of the test year, because after implementing its new billing system in January 2017, the Company discontinued late payment charges as it stabilized its new system, resulting in anomalous late fee collection numbers in the test year.[266] Mr. Effron argued that using

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[265] This decision is consistent with the Commission's order to amortize certain billing system transition costs over a five-year period in Case No. 9418. Order No. 87884 at 61–62.
[266] Tuoriniemi Rebuttal at 32.

2016 data is not a superior method than utilizing the actual experience in the test year.[267] To account for the anomaly, Mr. Effron recommended using the average ratio consisting of the twelve-month periods ending March 31, 2015, March 31, 2016, and March 31, 2018 to determine the normalized late payment ratio.[268] His calculation resulted in a ratio of 0.7181. Applying that ratio to the test year revenues from the sale of gas of $496,379,000 resulted in late payment revenue of $3,564,000, which is $559,000 higher than WGL's calculation.[269]

WGL opposed OPC's proposed adjustment. Mr. Tuoriniemi acknowledged that WGL's late payment percentage for the twelve months ending March 2017 was anomalously low.[270] However, he argued that WGL's approach was consistent with the methodology approved by the Commission in Case Nos. 9322, 9267, 9104, and 8959 where a single twelve-month period was used to set rates for late payment charges.[271] In his calculation, Mr. Tuoriniemi used the twelve months ending December 2016 late payment rate "because this was the latest twelve-month period that preceded the implementation of the new billing system and prior to the moratorium in charging late payment fees."[272] He then applied the resulting ratio (0.6169%) to test year revenues from the sale of gas to calculate the pro forma test year late payment charges. Mr. Tuoriniemi concluded that his approach of using 2016 data properly avoided the anomaly and that OPC's alternative proposal has not been demonstrated to be superior.

[267] Effron Direct at 19.
[268] OPC Brief at 25.
[269] Effron Direct at 19.
[270] Tuoriniemi Rebuttal at 32.
[271] Tuoriniemi Rebuttal at 34.
[272] Tuoriniemi Rebuttal at 33.

Commission Decision

The Commission declines to accept OPC's adjustment. WGL's approach of determining the late payment ratio by using 2016 late fee data, and thereby avoiding the anomalous 2017 late fee revenue numbers that were impacted by WGL's transition to its new billing system, is reasonable. Mr. Effron's proposal to normalize the data through a three-year average also represents a reasonable approach, but it has not been demonstrated to be superior to that offered by the Company.

32. Legal Expense

Mr. Ostrander recommended removal of legal costs of $311,437 associated with the National Transportation Safety Board's ("NTSB") investigation into the August 10, 2016 explosion and fire at an apartment complex on Arliss Street in Silver Spring, Maryland (Ostrander Adjustment 18).[273] Mr. Ostrander made this recommendation because (i) the amount of legal costs associated with the Arliss Street incident is unclear, (ii) the legal costs, including the hourly rates, are excessive, and (iii) WGL should have assigned a larger percentage of the Arliss Street legal issues to its sizeable internal legal department, rather than outsourcing the issues to outside legal counsel. Staff notes that WGL has a total budget for the WGL legal department of $2,953,406 for 2018.[274]

OPC witness Effron also testified against inclusion of WGL's legal expenses associated with the NTSB's investigation of the Arliss Street fire. He recommended removal of $187,000 in costs associated with the Arliss Street issue. He noted that

[273] Ostrander Direct at 51.
[274] Staff Brief at 38.

Company legal expenses increased from $1,471,000 in 2016 to $1,941,000 in the test year, with the NTSB investigation accounting for the increase.[275] He acknowledged that legal expenses can be reasonable and necessary costs incurred in the provision of utility service, but argued that the NTSB investigation relating to the August 10, 2016 explosion "should be eliminated as abnormal, non-recurring expenses."[276] Mr. Effron's elimination of these expenses reduces Maryland jurisdictional pro forma test year operation and maintenance expenses by $187,000.

WGL opposed the adjustments of Staff and OPC. The Company disputed Staff's claim that the amount of legal costs associated with the Arliss Street incident was unclear, noting WGL provided full, consistent answers to the extensive data requests Staff issued.[277] WGL also contested Staff's excessive cost allegation, noting that Mr. Ostrander has no expertise in reviewing legal invoices, cited no comparable legal projects, and failed to consider the highly competitive Washington, D.C. legal market. Finally, WGL disputed Staff's claim that the Company should have relied more on its internal legal department, noting that would have required the hiring of additional, highly specialized, internal legal staff, which would likely have been more expensive than hiring outside counsel with specialized skills on a temporary basis. WGL also contested OPC's adjustment, arguing at the hearing that Mr. Effron accepted that the NTSB investigation into the Arliss Street incident is on-going.

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[275] Effron Direct at 25-26.
[276] Effron Direct at 26.
[277] WGL Brief at 53-54.

Commission Decision

The Commission declines to accept Staff's adjustment to legal expense and accepts OPC's proposed adjustment. The amount of outside legal costs at issue does not appear uncertain, there is no persuasive evidence that the costs were excessive, and the hiring of outside counsel for this specialized, one-time litigation was not unreasonable. It does, however, appear to be non-recurring. The Arliss Street litigation is a one-time event unlikely to recur in the rate effective period. The hearing soliloquy referenced by the Company does not directly contradict the notion that the Arliss Street litigation is a non-recurring event. Mr. Effron answered that he "can't tell you for sure" whether the NTSB investigation was still open, but he would accept that premise, "subject to check."[278] Accepting his testimony that the NTSB investigation is still open, WGL should track such costs in a regulatory asset until such time as the litigation is completed and such costs are known and measurable and can be reviewed by the Commission for prudency. The effect of accepting OPC's adjustment is to increase operating income by $135,000 and reduce the revenue requirement by $192,000.

33. Compensation Deduction Limit TCJA

OPC witness Effron testified that the Tax Cuts and Jobs Act of 2017 ("TCJA") included certain new limitations on the deductibility of compensation for companies with publicly traded securities, such as WGL. Specifically, the TCJA eliminated deductions for all compensation to covered employees in excess of $1 million. In response to the new tax law, WGL increased its pro forma test year taxable income by $2,901,000 to

[278] Tr. at 712.

reflect the limitation on compensation deduction under the TCJA. Mr. Effron testified that it would not be appropriate to include the effect of the TCJA compensation limitation in the calculation of the pro forma income tax expense for ratemaking purposes because ratepayers did not make the decision to compensate these corporate executives "at levels deemed excessive by the TCJA."[279] Instead, the decision was made by representatives of the Company. Accepting Mr. Effron's adjustment would reduce pro forma taxable income by $2,901,000, and the pro forma Maryland state income tax expense by $239,000, and federal income tax expense by $559,000.

WGL opposes OPC's proposed adjustment, stating that OPC conflates tax policy with how the Company compensates its employees. The Company noted that Mr. Effron failed to produce any evidence that it is overly compensating its high-level employees or any testimony from a qualified tax expert on this subject. In that regard, Mr. Tuoriniemi testified that the TCJA does not use the term "excessive," much less in regard to limiting the deductions of certain publicly traded companies.[280] WGL further observed that it voluntarily petitioned the Commission to adjust downward its tariff rates to share with ratepayers the benefits of a lower TCJA tax rate.[281] The Company argued that "it would be inequitable to the Company and its shareholders if ratepayers received the benefit of the lower income tax rate when the Company alone bears the compensation deductibility limit."[282]

[279] Effron Direct at 28.
[280] Tuoriniemi Rebuttal at 81-82.
[281] WGL Brief at 45.
[282] Tuoriniemi Rebuttal at 82-82.

Commission Decision

The Commission declines to adopt OPC's adjustment regarding the TCJA. WGL correctly observes that it petitioned the Commission on January 8, 2018, to flow through to its ratepayers the reductions in federal income taxes attributable to the TCJA[283] and that the Commission accepted those tariff changes.[284] It would be inequitable to flow through to ratepayers the benefits of WGL's lower tax rate while imposing on the Company alone the consequences of a lower compensation deductibility limit arising from the same tax law. Additionally, OPC did not provide evidence that specific WGL salaries are excessive (or should now be considered excessive as a result of the TCJA).

34. Fee Free Credit Card

Mr. Bruce Oliver contested WGL's Fee Free Credit/Debit Card Payment Program. He stated that the Maryland portion of the program's costs have escalated significantly, from $60,266 approved in the Company's last rate case (Case No. 9322) to $637,015 requested in the current rate case.[285] Additionally, the average cost per transaction for the Fee Free program has risen by approximately 228% to $1.69 per transaction. Mr. Oliver testified that other forms of payment are much less expensive. For example, ACH transactions, which include payments arranged through customer banks, cost less than $0.01 per transaction, while mailed checks cost approximately $0.16 per transaction. Mr. Oliver stated that only about 6.5% of WGL customers pay

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[283] Mail Log No. 218464, *Notice of Intent to reduce natural gas distribution rates resulting from the Tax Cuts and Jobs Act of 2017.*
[284] January 31, 2018 Administrative Meeting #12; Mail Log Nos. 218520 and 218665.
[285] B. Oliver Direct at 41.

their bills with credit/debit cards, but that WGL incurred the cost equivalent of over 25% of its total Test Year Customer Collection Expense to pay for processing fees related to the Fee Free program.[286] He concluded that it is inappropriate for the Company to require that the vast majority of its customers who pay by ACH or mailed check payments subsidize the much more costly credit/debit card payments. Accordingly, Mr. Oliver argued that the Commission should direct WGL to terminate its Fee Free Credit/Debit Card Bill Payment program and remove the costs of that program from the Company's revenue requirement.

WGL opposed AOBA's proposal to remove costs related to the Company's credit card payment program. WGL observed that the program was approved by the Commission in 2011 in Case No. 9267 and subsequently affirmed in 2013 in Case No. 9322, without change to the original 2011 tariff language.[287] Company witness Tuoriniemi testified that the use of a credit or debit card represents "a customer choice and convenience issue," with the increase in usage of the program demonstrating that certain customers have a strong preference for this alternative.[288] Additionally, Mr. Tuoriniemi testified that it is important for the Company to facilitate payment by customers, and that the program could help prevent the write off of some otherwise unpaid bills.

[286] B. Oliver Direct at 45.
[287] WGL Brief at 56.
[288] Tuoriniemi Rebuttal at 102.

Commission Decision

The Commission declines to accept AOBA's adjustment. As WGL observed, the Commission approved the Fee Free Credit/Debit Card Payment Program in previous Company rate cases. The WGL program was also recently referenced in a Commission letter order denying a proposal of BGE to allow residential bill payment through credit/debit card without a transaction fee.[289] The Commission distinguished WGL's program because, at the time, it imposed on typical residential customers only 11 cents per month and because WGL (unlike BGE) waives fees only for customers who receive paperless or electronic bills. The increasing costs of the Fee Free Credit/Debit Card Payment Program may cause the Commission to reconsider the merits of this program in the future. As additional customers elect to pay their bills with a credit or debit card, the burden imposed increases proportionally on the remaining customers to subsidize the fees increases. However, WGL's requirement that customers who pay their bills with a credit or debit card use electronic billing is also an important element of the program that has not been explored in this proceeding. Cost savings stemming from paperless bills may mitigate the costs of the program.

35. Cash Working Capital

Cash working capital ("CWC") represents the amount of investor supplied cash a company requires in order to provide the funds necessary to operate the business on a day to day basis. The amount of CWC required by a utility is frequently determined by a lead/lag study, which measures the difference between the company's revenue lag and its

[289] May 29, 2018 Commission Letter Order, addressing Mail Log Nos. 217635 and 219243.

expense lag. The revenue lag measures the average number of days from the date service is rendered to the date payment for such service is received. The expense lag represents the number of days from the incurrence of an expense to the date the company pays the expense. Once the revenue and expense lags are determined, the CWC requirement is calculated by applying the net lag to the average daily amount of operating expense.

In this case, the methodology used and the calculations made by WGL to determine CWC were not disputed by the parties. However, CWC is affected by other operating income adjustments being contested. Based on the Commission's determinations in the other sections of this Order, WGL's CWC requirement will result in an increase of rate base of $3,001,000 and an increase in the revenue requirement of $311,000.

36. <u>Interest Synchronization</u>

Interest synchronization refers to the procedure whereby the interest deduction used for Federal income tax treatment is synchronized with the interest component of the return on rate base to be recovered from ratepayers. The interest deduction is calculated by multiplying the rate base by the weighted cost of debt. The resulting interest is then multiplied by the State and federal income tax rates to arrive at the operating income adjustment. In this case, the parties do not contest that an interest synchronization adjustment is necessary to reflect the tax effect of pro forma interest. Furthermore, the calculation is uncontested as to methodology, cost of debt, and WGL's capital structure. Therefore, utilizing the final rate base of $1,011,585,000, the Commission finds that the

appropriate interest synchronization results in an operating income increase of $58,000 and decreases in the revenue requirement of $83,000.

B. <u>Cost of Capital</u>

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 debt.[290] The ROR is the rate at which the Company has an opportunity to attract capital on reasonable terms and earn a return on its investment in order to attract and retain investors in a competitive market.[291] While the cost of debt can be directly observed, the ROE is determined by comparison to other investments of comparable risk. Usually this is done by comparison to "proxy" companies based on characteristics reasonably similar to the utility in question, and examining their ROEs as guidance for determining the appropriate ROE for the utility in question. The Commission looks to the analyses of the parties, which vary in methodology and approach. OPC, AOBA, and Staff all agree that the Company's proposed capital structure of 41.86% Long Term Debt, 5.40% Short Term Debt, 1.05% Preferred Stock, and 51.69% Common Stock is appropriate for ratemaking purposes. The parties' ROE analyses differed, however, which led them to recommend varying RORs.

[290] The cost of capital is a utility's overall rate of return , which is the sum of the weighted returns the utility must earn on its stock (equity) and bonds (debt) to attract investors in those securities. Unlike return on debt, return on equity is not directly observable and must be estimated based on market data.
Order No. 85374, (Feb. 2013).
[291] See *Bluefield Water Works and Improvement Co. v. PSC of West Virginia,* 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591 (1944).

Party Positions

1. WGL

WGL witness Hevert proposed a return on equity ranging from 10.00% to 10.50%, with a final recommendation of 10.30%.[292] Mr. Hevert based his ROE recommendation, in part, on data from eight proxy companies he selected from those identified as natural gas utilities by the investment research firm, Value Line.[293] Mr. Hevert used three primary analytical approaches to calculate WGL's ROE: discounted cash flow ("DCF") two variants of the capital asset pricing model ("CAPM") and a "bond yield plus risk premium" ("RP") approach.

Mr. Hevert first discussed the constant growth DCF method, which posits 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 dividend yield and the expected long-term annual growth rate.[294] He used stock price data from three averaging periods, annualized dividends per share, and growth terms using growth estimates from Value Line, Zacks, and First Call, as well as estimates based on a Retention Growth model.[295] The results from his calculations indicated a mean low range of 7.85% to 8.15%, a mean

[292] Direct Testimony of Robert B. Hevert ("Hevert Direct") at 72.

[293] Mr. Hevert stated that he excluded from his proxy list companies that did not consistently pay quarterly cash dividends, companies with less than 60% of total regulated operating income derived from regulated natural gas utility operations, companies that are not covered by at least 2 utility industry equity analysts, companies that do not have investment grade senior unsecured bond and/or corporate credit ratings from S&P, and companies known to be involved in a merger or transformative transaction. Hevert Direct at 16-17. Mr. Hevert included South Jersey Industries ("SJI"), even though in October 2017 it agreed to acquire Elizabethtown Gas and Elkton Gas from Southern Company Gas, because he did not consider the proposed acquisition to amount to a transformative change in SJI's operations. Hevert Direct at 18.

[294] Hevert Direct at 18.

[295] Hevert Direct at 26. The Retention Growth model assumes that a firm's growth is a function of its expected earnings, and the extent it retains earnings to invest in the enterprise, and as applied by Mr. Hevert is meant to reflect growth from internally generated funds and equity issuances, based on data from Value Line. *Id*. at 26-28.

range of 9.3% to 9.59%, and a mean high range of 11.99% to 12.29%.[296] Mr. Hevert asserted, however, that the Constant Growth DCF model assumes returns that do not reflect the likelihood of increasing interest rates, and that the model's low mean results are well below reasonable ROE estimates as well as ROEs awarded since 1980.[297] As a result, he afforded the low DCF results less weight than other methods.[298]

Mr. Hevert next used a CAPM analysis, which estimates the Cost of Equity as a function of a risk-free return plus a risk premium,[299] and a second form of the CAPM, the Empirical CAPM ("ECAPM"), to address the asserted tendency of a traditional CAPM analysis to underestimate the Cost of Equity low-Beta coefficient companies like regulated utilities.[300] The CAPM analysis resulted in a ROE range of 11.06% to 13.19%.[301] Mr. Hevert's ECAPM analysis produced an ROE range of 11.94% to 14.09%.[302]

Mr. Hevert's bond yield plus risk premium, or RP method, resulted in an ROE of 9.93% to 10.19%. Risk premium approaches estimate the Cost of Equity as the sum of the equity risk premium and the yield on a class of bonds.[303] Using natural gas rate cases from January 1, 1980 to March 29, 2018, Mr. Hevert defined the risk premium as the difference between authorized ROEs for natural gas utilities and 30-year Treasury yields,

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[296] Hevert Direct at 28.
[297] Hevert Direct at 28-29.
[298] Hevert Direct at 29-30.
[299] Hevert Direct at 30.
[300] Hevert Direct at 32. Both analyses were based on three different estimates of the risk-free rate, two forward-looking estimates of the market premium, and two different sets of Beta coefficients from Value Line and Bloomberg. *Id*. at 33-34.
[301] Hevert Direct at 34.
[302] Hevert Direct at 34.
[303] Hevert Direct at 37.

and used regression analysis to model the relationship between interest rates and the equity risk premium.[304]

Mr. Hevert also considered other factors in assessing his analytical findings, including the company's size, its regulatory environment, differences in authorized returns for electric and natural gas utilities, and flotation costs.[305] Contending that smaller companies like Washington Gas[306] face increased liquidity and fundamental business risks which affect the return required by investors, Mr. Hevert determined that Washington Gas's "size premium" was 50 basis points higher than the proxy group's, and considered Washington Gas's size in his assessment of business risks in order to determine where the Company's ROE appropriately falls.[307]

Mr. Hevert also maintained that Maryland's regulatory environment was perceived negatively from an investor viewpoint, and that Washington Gas faced more regulatory lag than other companies in the proxy group, due to policies like a historical test year.[308] Mr. Hevert concluded that the higher regulatory risks he identified further supported his recommended ROE.[309]

Mr. Hevert next addressed recent Commission orders concerning differences in authorized returns for gas and electric utilities, in which the Commission stated that differences between returns for electric and natural gas utilities were case-specific.[310] As

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[304] Hevert Direct at 38-39.
[305] Hevert Direct at 41.
[306] Mr. Hevert estimated that, if one treats Washington Gas, a subsidiary of WGL Holdings, as a stand-alone, publicly traded entity, its Maryland jurisdictional implied market capitalization would be $1,076.39 million, which is 32.8% of the proxy group. Hevert Direct at 42.
[307] Hevert Direct at 41-44.
[308] Hevert Direct at 45-49.
[309] Hevert Direct at 49.
[310] Hevert Direct at 49-50.

a result, because Washington Gas has no electric operations in Maryland, he did not consider electric ROEs to set a limit on his ROE recommendation.[311]

Mr. Hevert then addressed flotation costs, which are associated with the sale of new issuances of stock.[312] He contended that flotation costs merited consideration even for wholly owned subsidiaries like Washington Gas, because they receive equity capital from their parents and provide returns to the parent, which must raise capital based on those returns,[313] and even when new equity is not issued, because equity is perpetual in nature.[314] Although Mr. Hevert calculated a flotation cost adjustment of 10 basis points, rather than adjusting his recommended ROE by that amount, he instead considered the effect of flotation costs along with the Company's other business risks in determining where the Company's ROE appropriately falls.[315]

With regard to the capital market environment, Mr. Hevert stated that higher economic growth and higher interest rates may lead to lower utility valuations, higher dividend yields, and higher growth rates, which would indicate increases in the Cost of Equity in the context of the DCF model.[316] Mr. Hevert also addressed the *Tax Cuts and Jobs Act of 2017*, concluding that it likely has increased cash flow-related risks for natural gas utilities, which risks have been reflected by natural gas utilities' underperformance in the market at large and by rating agency commentary.[317] This effect would also suggest focusing on the upper end of the range of DCF-based results.[318]

[311] Hevert Direct at 50.
[312] Hevert Direct at 51.
[313] Hevert Direct at 51.
[314] Hevert Direct at 53.
[315] Hevert Direct at 55.
[316] Hevert Direct at 63.
[317] Hevert Direct at 70.
[318] Hevert Direct at 71.

Considering all of the capital market factors, Mr. Hevert recommended taking a cautious approach with DCF-based results, and giving somewhat more weight given to the Risk Premium-based models.[319]

Mr. Hevert applied updated DCF, CAPM, ECAPM, and bond yield risk premium analyses to his proxy group in his rebuttal testimony, refuted other party witnesses' testimony, and maintained his recommended ROE of 10.30%.[320]

On cross examination, Mr. Hevert maintained that although he respected the importance of gradualism, his analysis focused on estimating the return investors require, and also that changing market conditions supported his decision not to focus on the Company's existing ROE when determining the WGL's Cost of Equity.[321] In response to various questions from Commissioners concerning the analyses underlying the regulatory environment rankings of Regulatory Research Associates, Mr. Hevert generally indicated that although he did not know the details of all their reviews, his understanding was that the firm investigated policy issues and policy decisions from a regulatory body in determining the likelihood that regulated entities would be able to meet their obligations; he did, however, concede that a national consumer group might have an opposite perspective about the general regulatory environment in Maryland.[322]

[319] Hevert Direct at 72.
[320] Rebuttal Testimony of Robert B. Hevert ("Hevert Rebuttal") at 2-4; 100-104.
[321] Transcript at 266-283.
[322] Transcript at 329-341.

2. Other Parties' Positions

a. *AOBA*

Although AOBA witness Bruce Oliver[323] expressed concerns that WGL failed to provide satisfactory quantitative evidence of ratepayer cost minimization relative to its capital structure, he nevertheless found that the Company's proposed structure struck a reasonable balance between shareholder and ratepayer interests.[324] Mr. Oliver did, however, object to the Company's proposed Cost of Equity, maintaining that a 10.30% ROE would be much higher than what the Company requires, and that Mr. Hevert's recommendation does not reflect comparably risky investments.[325]

Mr. Oliver objected to Mr. Hevert's inclusion of South Jersey Industries in his proxy group in spite of screening criteria that eliminated from consideration companies that were a party to a merger or other transformative transaction.[326] Mr. Oliver found the companies Mr. Hevert selected for his proxy group more risky than WGL, and maintained that the risk premium measures Mr. Hevert used for his Risk Premium, CAPM, and ECAPM analyses were based on returns for investments that do not reflect WGL's risks.[327]

Mr. Oliver further criticized Mr. Hevert's decision to use shorter averaging periods to calculate the dividend yields in his DCF analyses, arguing that the practice left

[323] Although AOBA witness Timothy Oliver pre-filed written testimony in this case, due to his unavailability at the evidentiary hearing, his testimony was adopted by AOBA witness Bruce Oliver. Tr. at 734-35.
[324] Direct Testimony of AOBA Witness Timothy B. Oliver ("T. Oliver Direct") at 14-16.
[325] T. Oliver Direct at 17-18.
[326] T. Oliver Direct at 18-20.
[327] T. Oliver Direct at 20-21.

less protection against anomalous data.[328] He also maintained that the Commission should not give weight to Mr. Hevert's mean high and mean low results, because they relied on segmented proxy results, which provide less protection against anomalous results.[329]

Ultimately, Mr. Oliver recommended an ROE of 9.30% and an ROR of 7.09%, based on the same proxy group as WGL, except without South Jersey Industries, using DCF and CAPM analytical methods.[330] (Although that approach produced an ROE of 8.51%, Mr. Oliver noted that the Commission had previously found a five-basis points per year adjustment gradual and reasonable, and thus recommended a 20 basis point reduction to the Company's current 9.50% ROE down to 9.30%, since it had been between four and five years since WGL's last rate case.)[331]

WGL Witness Hevert responded to Mr. Oliver's Direct Testimony, contesting Mr. Oliver's assumptions that 8.99% would be a reasonable ROE, and that falling capital costs since 2014 warrant a downward adjustment.[332] Mr. Hevert expressed methodological concerns about whether Mr. Oliver's Regulator Adjustment Method was reasonable, Mr. Oliver's proxy group composition, his DCF and CAPM applications, and his Bond Yield Plus Risk Premium analysis application and relevance.[333]

Mr. Hevert defended his Bond Yield Plus Risk Premium Analysis, maintaining that Mr. Oliver mistakenly confuses the market risk premium with the equity risk premium, which reflects compensation for risk and is not a measure of expected market

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[328] T. Oliver Direct at 22.
[329] T. Oliver Direct at 22-23.
[330] T. Oliver Direct at 23-24.
[331] T. Oliver direct at 24-25.
[332] Rebuttal Testimony of Robert B. Hevert ("Hevert Rebuttal") at 83.
[333] Hevert Rebuttal at 83.

returns.[334] Mr. Hevert found that if he applied Mr. Oliver's risk-free rate, the implied ROE would be 9.91%, and to the extent gradualism was applied, it would be related to an increase in the Company's ROE.[335]

In his Surrebuttal Testimony, Mr. Oliver addressed earnings growth estimates used in Mr. Hevert's DCF model and the exclusion of South Jersey Industries from the proxy group. Mr. Oliver continued to maintain that South Jersey Industries should be excluded from the proxy group based on unique, increased earnings growth estimates that he attributed to the merger.[336]

Mr. Hevert responded to Mr. Oliver's surrebuttal in Rejoinder Testimony. Mr. Hevert maintained that to the extent DCF results rely on outlier data, the median results mitigate their effect.[337] Mr. Hevert maintained that although South Jersey Industries' growth rate increased, the Company's returns made it appear more like its peers, and that it had a minimal effect on the CAPM results.[338]

b. OPC

OPC witness Mr. Parcell applied the DCF, CAPM, and Comparable Earnings (CE) methods to the same proxy group used by Mr. Hevert, and recommended an ROE of 9.4%, which was in the middle of his range of 9.3% and 9.5%, based primarily on the DCF and CE results.[339] Mr. Parcell calculated an overall rate of return of 7.15%.[340]

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[334] Hevert Rebuttal at 99.
[335] Hevert Rebuttal at 98-99.
[336] T. Oliver Surrebuttal at 36-38.
[337] Rejoinder Testimony of Robert B. Hevert ("Hevert Rejoinder") at 13.
[338] Hevert Rejoinder at 14. Mr. Hevert added that Mr. Alvarado and Mr. Parcell both included SJI in their proxy groups. *Id.*
[339] Direct Testimony of David C. Parcell ("Parcell Direct") at 2-3, 26.
[340] Parcell Direct at 3.

Before addressing his analytical methods, Mr. Parcell discussed general economic conditions, emphasizing that the costs of capital for regulated utilities have declined in recent years, along with the results of traditional ROE models and the ROEs authorized by state regulators.[341] Mr. Parcell also discussed WGL's operations and risks, noting that WGL's downgraded credit rating will likely mean higher costs on its debt,[342] and maintained that WGL has agreed its ratepayers should be held harmless from any negative consequences of its merger with AltaGas.[343] Mr. Parcell also cited WGL's favorable regulatory mechanisms, including the Revenue Normalization Adjustment and the STRIDE program, which reduce WGL's risks,[344] and underscored his recommendation that WGL's return on equity be no higher than the mid-point of the Cost of Equity for the proxy companies.[345]

Mr. Parcell used the constant growth DCF model, combining the current dividend yield for the proxy utility stocks with several indicators of expected dividend growth.[346] The resulting DCF rates ranged from 6.8% to 9.4%, with the highest rates at 9.2 and 9.4%; Mr. Parcell found that the 9.2 to 9.4% range represented the current DCF-derived ROE.[347] For his CAPM analysis, Mr. Parcell used three-month average yields from May to July of 2018 to calculate the risk-free rate, and used the most recent Value Line betas for each company in the proxy group.[348] Mr. Parcell calculated a 6.0% risk premium

[341] Parcell Direct at 11.
[342] Parcell Direct at 15.
[343] Parcell Direct at 16.
[344] Parcell Direct at 16-20.
[345] Parcell Direct at 21. Mr. Parcell also found that WGL should continue to be considered, post-merger, as a below-average risk natural gas utility. *Id*. at 22.
[346] Parcell Direct at 27.
[347] Parcell Direct at 29.
[348] Parcell Direct at 30-31.

using three different approaches, which resulted in an ROE of 7.2 to 7.5 percent.[349] Mr. Parcell's CE method, which is designed to measure expected returns on the original cost book value of similar risk enterprises, examined realized ROEs for the proxy group, as well as unregulated companies, and also evaluated investor acceptance of the returns via market-to-book ratios ("M/Bs").[350] Using recent ROEs and M/Bs, Mr. Parcell found that the ROE for the proxy group ranged between 9.0% and 10.0%, with a 9.5% mid-point.

Although the results of the three analyses Mr. Parcell employed resulted in a 7.2% to 10.0% range, Mr. Parcell recommended a range of 9.3% to 9.5%, which included the mid-point of the DCF and CE results, and a specific ROE recommendation of 9.4%.[351] Mr. Parcell maintained that his recommendation was consistent with the Commission's endorsement of the concept of gradualism.[352]

Mr. Parcell maintained that Mr. Hevert's methods, and their inputs, are systemically biased upward, and as a result significantly overstate WGL's Cost of Equity.[353] Mr. Parcell dismissed the four factors Mr. Hevert argues create more risk for WGL, noting that ratings agencies already consider size, regulatory environment, returns for electric versus natural gas utilities, and flotation costs.[354] Mr. Parcell further emphasized that WGL does not have greater risk than the proxy group, citing rating

[349] Parcell Direct at 31-32.
[350] Parcell Direct at 32-33.
[351] Parcell Direct at 36. Mr. Parcell also considered the lower CAPM results as a factor in his recommendation. *Id*. at 36-37.
[352] Parcell Direct at 37-38.
[353] Parcell Direct at 40. Mr. Parcell maintains that Mr. Hevert's ROE recommendation would result in the highest authorized cost of equity in the United States in recent times. *Id*. at 40.
[354] Parcell Direct at 46.

agencies, cost recovery mechanisms, and WGL's higher credit rating.[355] Mr. Parcell also dismissed the need to consider flotation costs, because WGL and several other affiliate entities will no longer issue new shares, and it would be difficult to attribute costs (as well as infusions of equity versus debt) to WGL.[356]

WGL Witness Hevert disagreed with Mr. Parcell in seven principal areas: "(1) the effect of current market conditions and its relation to current authorized returns on WGL's Cost of Equity, (2) WGL's risk relative to the proxy group, (3) the growth rates used in [their] respective DCF analyses, (4) the application of the CAPM and ECAPM, (5) OPC Witness Parcell's application of the CEM, (6) OPC witness Parcell's response to his Bond Yield Plus Risk Premium Analysis, (6) OPC Witness Parcell's dismissal of WGL's increased risk due to size, and (7) the recovery of flotation costs."[357]

In his Surrebuttal Testimony, Mr. Parcell maintained the recommendations he made in his Direct Testimony.[358] Mr. Parcell reiterated that he believed the Company's capital costs had declined, citing actual and current costs of WGL's long-term debt, declining authorized ROEs, and the Company's lower ROE request relative to its last rate case before the Commission.[359]

In Rejoinder Testimony, Mr. Hevert argued that the Company's embedded cost of debt is not relevant to a marginal cost rate like the Cost of Equity, and that since the current cost of debt falls within one standard deviation of the 2013 average, it cannot be

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[355] Parcell Direct at 47.
[356] Parcell Direct at 49-50.
[357] Hevert Rebuttal at 29.
[358] Surrebuttal Testimony of David C. Parcell ("Parcell Surrebuttal") at 3.
[359] Parcell Surrebuttal at 3-5. Mr. Parcell also emphasized that market volatility had a less significant impact on utilities and their cost of equity than it did for most firms. *Id*. at 5.

considered indisputably lower.[360] Mr. Hevert found that ROEs had not fallen since 2014, and that comparing results from different economic periods did not provide useful information.[361]

Mr. Hevert argues that he did not misrepresent Mr. Parcell's method, pointing to his acknowledgement that Mr. Parcell does not assume the market/book ratio is related only to ROE, and noting that he had not stated that there was no relationship between the two.[362] Rather, Mr. Hevert maintained that there are other variables at play, and that if one attempts to quantify the relationship between market/book ratios and ROEs, Mr. Hevert's recommended ROE appears reasonable.[363]

c. Staff

Staff witness Alvarado found the range of reasonableness for WGL's ROE to lie between 9.45% and 10.17%, with a recommended Cost of Equity of 9.7% and an overall rate of return of 7.3%.[364]

Finding Mr. Hevert's approach to selecting a proxy group generally reasonable, Mr. Alvarado used Witness Hevert's approach as a starting point, but excluded two companies: Chesapeake Utilities Corporation ("Chesapeake") and ONE Gas.[365] Mr. Alvarado eliminated Chesapeake because it derived less than 60% of its operating income from its regulated natural gas distribution business, which he found to make its

[360] Hevert Rejoinder at 7-8.
[361] Hevert Rejoinder at 8-9. Mr. Hevert also found that market volatility is relevant to utility investors, especially when the volatility is elevated. *Id*. at 9-10.
[362] Hevert Rejoinder at 12.
[363] Hevert Rejoinder at 12-13. Mr. Hevert defended his reference to the S&P 500 by citing Mr. Parcells reference to it, and concluding that his ultimate recommendation would remain the same without it. *Id*. at 13.
[364] Direct Testimony of Juan Carlos Alvarado ("Alvarado Direct") at 4.
[365] Alvarado Direct at 12.

risk profile too dissimilar from WGL's.[366] Mr. Alvarado eliminated ONE Gas because it did not have five years of financial data available for review.[367] The resulting six companies represented, to Mr. Alvarado, an appropriate risk profile for a utility like WGL.[368]

Mr. Alvarado used a traditional DCF analysis, a build-up method risk premium analysis, and a CAPM analysis to recommend an ROE.[369] Mr. Alvarado's DCF analysis used a proxy group's forecasted growth dividends and cash flow to reach an average ROE of 9.45%.[370] Mr. Alvarado chose to use multiple growth rates to avoid misrepresenting investors' long run growth expectations by relying on limited sources of information.[371] Mr. Alvarado's RP method used a risk free rate of return, equity risk premium, and industry adjustment to reach a 10.17% ROE.[372] The build-up RP method he employed added a natural gas distribution industry adjustment and a micro-cap size adjustment to the equity risk premium.[373] Mr. Alvarado's CAPM analysis resulted in an ROE of 9.93%.[374]

Mr. Alvarado adjusted his ROE recommendation to reflect reduced risk from WGL's Strategic Infrastructure Development and Enhancement ("STRIDE") mechanism, which he found to allow the Company to more quickly recover infrastructure expenses while improving safety.[375] Although Mr. Alvarado found it to difficult to assign a

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[366] Alvarado Direct at 12.
[367] Alvarado Direct at 12-13.
[368] Alvarado Direct at 13.
[369] Alvarado Direct at 11.
[370] Alvarado Direct at 11.
[371] Alvarado Direct at 14-15.
[372] Alvarado Direct at 16-18.
[373] Alvarado Direct at 17.
[374] Alvarado Direct at 19-20.
[375] Alvarado Direct at 22.

specific value to the risk reducing effect of STRIDE, he incorporated the effect by recommending an ROE of 9.70%, equal to the first quartile of Mr. Alvarado's range of reasonableness, rounded up to the nearest .05%.[376]

Mr. Alvarado disagreed with Mr. Hevert's DCF calculation on several bases, principally on Mr. Hevert's decision to discount his mean low results as anomalously low without accounting for his mean high results, which appear similarly anomalous.[377] Mr. Alvarado therefore accepted Mr. Hevert's mean 30-day average result of 9.59% as an appropriate finding.[378] Mr. Alvarado also disagreed with Mr. Hevert's use of an ECAPM analysis, because he found the methodology Mr. Hevert employed to overstate the ROE result.[379] Mr. Alvarado further found Mr. Hevert's CAPM calculation to be too high based on an inflated market risk premium, and accepted instead a CAPM estimate of 9.53% based on publicly available market returns.[380] In sum, Mr. Alvarado recommended disregarding the ECAPM analysis and correcting the DCF and CAPM results, which if combined with Mr. Hevert's highest bond yield premium result would ultimately lead to the same recommendation reached by Mr. Alvarado.[381]

Mr. Alvarado also addressed Mr. Hevert's treatment of regulatory lag, noting that regulatory lag can help regulators ensure that rates are just and reasonable by allowing time for retrospective reviews, foster market efficiency in the absence of competition by encouraging utilities to reduce costs, and, due to the prospect of retrospective rate review,

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[376] Alvarado Direct at 22-23.
[377] Alvarado Direct at 24-25.
[378] Alvarado Direct at 25.
[379] Alvarado Direct at 25.
[380] Alvarado Direct at 26.
[381] Alvarado Direct at 26.

reduce incentives for utilities to make imprudent over-investments.[382] On the other hand, Mr. Alvarado acknowledged that it is important to realize that too much regulatory lag could increase utility risks observed by the markets and cause financial hardships.[383] Ultimately, finding that Mr. Hevert failed to produce evidence that the Company faced a different amount of regulatory lag than its peers, Mr. Alvarado recommended that the Commission dismiss the argument that Mr. Hevert's recommended ROE is supported by risks to the Company from regulatory lag.[384]

Mr. Hevert disagreed with Mr. Alvarado on several fronts in his Rebuttal Testimony. Mr. Hevert also disagreed with Mr. Alvarado's determination that the risk reducing effect of STRIDE justified a downward adjustment in the Company's ROE.[385] Mr. Hevert maintained that Mr. Alvarado had not demonstrated a risk reduction as a result of STRIDE, and pointed out that infrastructure recovery mechanisms like STRIDE were common among natural gas utilities.[386] Further, in response to Mr. Alvarado's discussion of regulatory risk, Mr. Hevert pointed out that there was a limit to the gains a utility could make from increased efficiencies under rate of return regulation.[387] Mr. Hevert concluded by focusing on a few areas of disagreement, finding that if he accepted Mr. Alvarado's convention of using the bottom 25% of the ROE range for his ECAPM and Build-Up methods, the adjusted ROE result would increase to 9.80%.[388] He added that if he accepted Mr. Alvarado's argument that STRIDE required an ROE

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[382] Alvarado Direct at 28-29.
[383] Alvarado Direct at 30-31.
[384] Alvarado Direct at 31-32.
[385] Hevert Rebuttal at 23.
[386] Hevert Rebuttal at 23-27.
[387] Hevert Rebuttal at 27-28.
[388] Hevert Rebuttal at 28.

below 50th percentile of the range, Mr. Hevert's low end, 10.0%, would lie in the 37th percentile of adjusted results.[389]

In his Surrebuttal Testimony, Mr. Alvarado continued to maintain that the findings made in his Direct Testimony were appropriate.[390] Mr. Alvarado also defended his conclusions about STRIDE, reiterating his argument that STRIDE reduces risk and regulatory lag by accelerating cost recovery, and maintaining that the proxy group does not capture STRIDE's risk reducing effect in its entirety, as many jurisdictions only use trackers for future cost recovery, which do not eliminate the carrying costs like STRIDE.[391]

On cross-examination, Mr. Alvarado acknowledged that, unique from his practice in the prior two WGL rate cases, he made an adjustment due to STRIDE that resulted in his ROE recommendation not being a measure of central tendency relative to his range of results.[392] Mr. Alvarado acknowledged, however, that the members of his proxy group have an infrastructure replacement mechanism that is similar to STRIDE.[393] On redirect, Mr. Alvarado also clarified that many of the other proxy companies' infrastructure mechanisms are merely trackers, which do not allow up front recovery, and hence a reduction in carrying costs, like STRIDE.[394]

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[389] Hevert Rebuttal at 28. More likely, in Mr. Hevert's opinion, was that STRIDE has no effect on the cost of equity, and the 50th percentile result – 10.20 percent -- would be the most reasonable. *Id*. at 29.

[390] Surrebuttal Testimony of Juan Carlos Alvarado ("Alvarado Surrebuttal") at 11.

[391] Alvarado Surrebuttal at 9-10. Mr. Alvarado also noted that he did not make a specific reduction in his calculated ROE for STRIDE, and that he would be comfortable with his recommendation even in STRIDE's absence. *Id*. at 10.

[392] Tr. at 550-563.

[393] Tr. at 564. Counsel for the Company did not ask for an explanation of the acknowledgment. *Id*. at 564. On redirect, Mr. Alvarado agreed with Mr. Hevert's prior statement to the effect that opinion plays a role in ROE recommendations. *Id*. at 567-568.

[394] Tr. at 571-573.

Responding to questions from Commissioners, Mr. Alvarado explained that regulatory lag is a natural part of regulatory review, which can benefit ratepayers by discouraging imprudent investments.[395] He further stated that it may be useful for the Commission to study issues related to regulatory lag, but that it should do so with knowledge that it may affect all the companies that the Commission regulates with regard to rates, and in a setting that is conducive to achieving good results via informal exchanges of information and analysis.[396]

Commission Decision

There being no dispute as to WGL's capital structure as of March 31, 2018, the Commission adopts WGL's weighted average costs of capital. In keeping with precedent, the Commission again declines to adopt a single methodology, but rather uses all of the witnesses' methodologies to establish a range of reasonableness for an ROE.[397] Here, the results range from a low of 8.00% (AOBA witness Oliver) to a high of 10.50% (WGL witness Hevert), with Staff and OPC in the middle (recommending 9.70% and 9.40%, respectively). This approach also makes it unnecessary to adopt any particular proxy group.

The Commission also considers the economic conditions since it last set WGL's ROE at 9.50% in 2013.[398] After several years of low interest rates, this year has seen a strong economy accompanied by a gradual rise in interest rates. Considering all of the

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[395] Tr. at 579-580.
[396] Tr. at 578-582.
[397] *See* e.g. *In Re Baltimore Gas and Electric Company,* 104 MD PSC 653, 695 (2013).
[398] *In Re Washington Gas Light Company,* 104 MD PSC 576 (2013).

factors, the Commission finds a modest increase in WGL's ROE is appropriate which it sets at 9.70%, resulting in an ROR of 7.30%.[399]

The Commission declines to make a downward adjustment for STRIDE as recommended by Staff, and likewise declines to make an upward adjustment for regulatory risk as recommended by the Company. As WGL is now a wholly owned subsidiary of AltaGas, it will no longer be issuing stock and there is no evidence in this record of when or how much such costs would be, or how such flotation costs would be apportioned among the subsidiaries.[400] Finally, while the Commission recognizes that regulatory lag poses challenges to the operation of a utility, the Commission agrees with Staff witness Alvarado that regulatory lag has both benefits and drawbacks, and that WGL is no different from any other utility with regard to the challenges it poses. Consequently, the Commission declines to adjust the ROE upward due to this consideration as Company witness Hevert had recommended.

C. <u>Cost of Service</u>

WGL presented its cost of service study ("COSS") and its class cost of service study ("CCOSS") through the testimony of Mr. Gibson. On May 15, 2018, Mr. Gibson presented direct testimony that described and supported WGL's Normal Weather Study, labor and labor-related accounting adjustments to the test year, the Per Book Jurisdictional Cost of Service Allocation Study, and the Class Cost of Service. On July 12, 2018, Mr. Gibson submitted Supplemental Direct Testimony that described the

[399] The Commission notes that this ROE is supported by Staff witness Alvarado, who testified he was comfortable with this ROE even without a STRIDE adjustment.
[400] See Case No. 9336, Order No. 86441 at 88 ("We have consistently awarded flotation costs based on the verifiable costs of issuing new stock.")

updated per book amounts for the one month forecasted in his direct testimony. On July 31, 2018, Mr. Gibson corrected two errors in his prior exhibits. Finally, on September 13, 2018, Mr. Gibson filed Rebuttal Testimony and fifteen exhibits setting forth WGL's final proposed CCOSS. Pursuant to our order in Case No. 9322, WGL submitted fully allocated non-coincident peak and coincident peak CCOSS studies which utilize statistically valid demand studies.[401]

Although WGL revised its CCOSS several times, WGL maintains that Mr. Gibson's rebuttal testimony contains sufficient information to develop class-specific rates.[402] Mr. Gibson recognized that he had previously over-stated the meter count for WGL's GMA class of customers.[403] His rebuttal testimony therefore calculated the impact of this data correction both for normal weather therms and customers.[404] He also testified that he had inadvertently excluded Frederick, Maryland, from the number of customers in the services allocation and that "the count of services inadvertently included all service segments for 1.25" services."[405]

AOBA agrees with WGL, asserting that Mr. Gibson's rebuttal testimony corrected the errors identified during the course of this proceeding. AOBA concludes that Exhibits ABG-R8 and ABG-R9 attached to Mr. Gibson's Rebuttal Testimony provide reasonable assessments of class rates of return using coincident peak and non-coincident peak allocation methods.[406] WGL based both allocation methods upon its

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[401] Order No. 86013 at 23.
[402] WGL Brief at 76-77.
[403] Gibson Rebuttal at 3.
[404] Gibson Rebuttal at 3.
[405] Gibson Rebuttal at 29.
[406] AOBA Brief at 6-7.

Demand Study, which the Commission directed WGL to undertake in Case No. 9322, and AOBA supports either allocation method for purposes of designing rates.[407]

According to AOBA, the problems that required substantial revisions to the results of WGL's CCOSS in this proceeding were not the result of problems in the structure or programming of WGL's CCOSS, but rather the data used.[408] AOBA witness Oliver testified that he had reviewed WGL's rebuttal CCOSS and determined that WGL had made all appropriate corrections.[409]

Staff urges that the Commission reject WGL's cost of service studies and order that WGL hire a third-party contractor to perform the cost of service study in WGL's next rate case. Staff concludes that the multiple changes made to the data within studies create a sufficient lack of confidence in the cost allocations that the Commission should allocate the approved revenue increases to customer class by some other means.[410] Staff points out that the changes incorporated within Mr. Gibson's rebuttal testimony were significant, particularly involving Non-Firm Interruptible customers, whose unitized rate of return ("UROR") increased from -0.531 to 0.41. Mr. Gibson's rebuttal testimony also reduced the operating income attributed to the Residential Class by \$5.5 million and increased the rate base allocated to that class by approximately \$63 million.[411]

Staff also contends (as it has in prior rate cases) that a non-coincident peak study better reflects the costs that the different rate classes impose upon the system.[412] Staff

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[407] AOBA Brief at 18.
[408] AOBA Brief at 7.
[409] Tr. at 739-740.
[410] Cross Direct at 3; Bonikowski Direct at 1-2.
[411] Cross Surrebuttal at 5.
[412] Cross Surrebuttal at 10-11.

therefore asks the Commission to continue to require WGL to provide a non-coincident peak study in its COSS going forward.[413]

Because Staff expresses no confidence in the cost studies provided by WGL, it concludes that the Commission should allocate any approved rate increase evenly across all rate classes.[414]

OPC also expresses frustration with the number of iterations of the cost of service studies that WGL has provided the Commission in this case. Most concerning to OPC is the effect the various changes have had on residential customers' URORs which went from over-earning to under-earning.[415] OPC Witness Mierzwa testified:

> I am not aware of another gas or water utility that uses the customer/capacity approach to the allocation of services investment. The need to significantly revise the results of the customer/capacity approach to the allocation of services investment to one class raises concerns as to whether the approach provides a reasonable basis for the allocation of services investment to all customer classes. Given these concerns and the significant impact the allocation of services investment has on CCOSS study results, I recommend that the Commission not place significant reliance on the results of the Company's CCOSS study in setting rates in this proceeding.[416]

Like AOBA, OPC also recommends that the Commission require WGL to provide a statistical sampling approach to determine the allocation of services to customer class in future proceedings.[417] Like Staff, OPC contends that the Commission should discard

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413 Staff Brief at 58.
414 Bonikowski Direct at 1-2.
415 OPC Brief at 75.
416 Mierzwa Surrebuttal at 5.
417 Mierzwa Surrebuttal at 5.

WGL's allocation studies in their entirety and allocate any rate increase evenly across all rate classes.[418]

Commission Decision

The Commission notes the frustration expressed by OPC and Staff that has resulted from WGL's submission of multiple versions of its cost of service studies. However, the Commission concludes that the record supports the reliability of the final study that WGL provided in Witness Gibson's surrebuttal testimony. The Commission agrees with Witness Oliver that the record supports the conclusion that WGL properly corrected the undisputed errors contained within its earlier CCOSS versions. Neither Staff nor OPC provided its own proposed CCOSS, and they premise their ongoing objections mostly upon the lateness of WGL's final submission rather than a specific objection to WGL's methodology. In fact, the only other party that performed a CCOSS was Mr. Oliver, and while his results were similar to those contained in WGL's rebuttal testimony, Mr. Oliver stated that the WGL CCOSS was the best available in this proceeding.

The Commission therefore adopts WGL's Non-Coincident Peak CCOSS for purposes of allocating rates. The Commission will not require WGL to hire a third-party contractor as requested by Staff. Such an expense would only impose higher costs on ratepayers without any demonstrable improvement in accuracy. Staff made several recommendations as to how to improve WGL's submission of CCOSS in future proceedings. The Commission will continue to require that WGL provide

[418] Unlike Staff, OPC recommends that the Interruptible Class receive an increase 1.5 times the overall approved rate increase due to its significant under-earning (0.41). Mierzwa Surrebuttal at 6.

Non-Interruptible Peak studies. Otherwise, the Commission will not require WGL to provide its studies through a third-party contractor or a statistical sampling methodology. As the applicant, WGL may present its service studies in a manner that it believes best reflects its provision of service as long as there is a reasonable basis upon which the Commission may trust its accuracy.

D. <u>Rate Design</u>

Rate Design involves two functions: (1) the design of inter-class rates, which involves the assignment of revenue requirement between the various customer classes, and (2) the design of intra-class rates, which involves the manner in which the class revenue requirement will be collected from customers. In order to determine how much of any rate increase (or decrease) should be assigned to a particular customer rate class, the Commission begins with the actual rates of return reflected in the jurisdictional cost of service ("COSS"). These results are then translated into a relative rate of return, which measures as a percentage the actual individual customer class rate of return compared to the utility's system average or overall rate of return.[419] This percentage is then compared with the actual earnings provided by that rate class, resulting in a UROR for each class.

A UROR of 1.0 signifies that a rate class has a return equal to the utility's overall rate of return. A UROR that is higher than 1.0 indicates that the class has a return (or contribution) that is greater than the system average, and a UROR that is lower than 1.0 indicates a class return that is less than average. If all customer rate classes have an UROR of 1.0, then each class is contributing equally to the utility's overall rate of return

[419] *In the Matter of the Application of Baltimore Gas and Electric Company for Adjustments to its Electric and Gas Base Rates*, Case No. 9326, 104 Md. P.S.C. 653, 699 (2013).

based upon its cost of service. As a matter of policy, the Commission strives to bring all classes closer to an UROR of 1.0 in each rate case, to reflect the cost causation from each class. However, this goal is also tempered with notions of gradualism in order to avoid rate shock from the customers of any particular rate class.

Once the revenue requirement is apportioned among the various classes, intra-class rates may be designed. Almost all rate classes have a service charge, which is designed to recover fixed utility costs, such as the cost of meters. Additionally, WGL customers have a distribution charge, which is designed to recover variable costs. That is, each customer's bill has a fixed, monthly customer charge and a volumetric, per-therm charge. Intra-class rate design is guided by important policy considerations, including gradualism, energy conservation, economic impacts, as well as cost causation.

1. Revenue Allocation

The Commission has regularly employed a two-step process for the determination of inter-class rates. The two-step approach intends to balance the actual rates of return reflected in the company's COSS and the principle of gradualism. The Commission has described this process as follows:

> We have developed a general policy of allocating rate increases using a two-step approach. *First*, a portion of the increase is allocated to under-earning classes to move their rates of return or URORs closer to the system average. In the second step, the remainder of any increase is apportioned to all customer classes based upon the proportion of their class revenues compared to overall system revenues.[420]

[420] Case No. 9286, *In Re Potomac Electric Power Co., 103 Md. PSC 293, 352 (2012).*

For the first step, WGL has not provided a specific rate design proposal, but simply contends that its CCOSS is sufficient for this Commission to allocate rates in a reasonable fashion. WGL initially proposed to allocate approximately $3.6 million to the classes by increasing revenue for classes with URORs below 1.0 and decreasing revenue for classes with URORs above 1.0.[421] In the second step, it then proposed to allocate the remaining revenue increase to all classes based upon each class' share of base rate revenue.[422]

However, following submission of the final version of its CCOSS, WGL requests the Commission to assign revenue decreases to all classes with an RROR greater than 1.0 and decreases to all classes below 1.0.[423] AOBA proposes an initial assignment of 15% to classes with RRORs below the system average with the remainder assigned to all classes.[424]

As noted, Staff and OPC would not allocate any revenue in the first step, but rather contend that the Commission impose all revenue increases across the board. The Commission has already concluded that it will rely upon WGL's CCOSS for purposes of rate allocation, so the Commission rejects an across-the-board approach.

[421] Wagner Direct at Ex. JBW-1.
[422] Wagner Direct at Ex. JBW-1.
[423] WGL Brief at 76-77; Wagner Rebuttal at 11.
[424] AOBA Brief t 24.

Decision

1. Distribution Charges

a) Step One

The Commission concludes that a first-step allocation of 15% to the two customer classes with a current UROR below 1.0 — RES Heat/Cool and Interruptible customers - represents a fair balance between the policies discussed above.

b) Step Two

The remaining 85% of the awarded revenue requirement increase should be allocated to all classes, except "C&I Non-Heat/Non-Cool" and "GMA Non-Heat/Non-Cool" as these classes are significantly over-earning.

This two-step allocation increases the UROR of the Interruptible Class by a small amount and only increases the Residential Class UROR by an even lesser amount. Based upon WGL's CCOSS and the rate adjustments described above, the Commission concludes that this allocation of distribution charges reflects the best balance between moving all rate classes toward 1.0 without any significant rate shock to under-earning classes.

2. Service Charges

Service charges intend to cover the costs incurred by a utility for fixed charges. As with allocating costs between rate classes, determining the proper ratio between customer and volumetric charges requires balancing many competing variables. It is important that customers who cause certain costs incur those costs, but the principle of gradualism applies here as well. 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, the Commission believes the record in this case supports a gradual increase in the customer charges.

WGL proposes to increase the fixed charge for its residential customers from its current $10.20 per customer to $11.75.[425] This would represent an increase of 15% across all rate classes. OPC recommends that the Commission increase the residential fixed customer charge from $10.20 to $10.50, an increase of approximately 3%.[426] OPC's position reflects its preference to allow customers "a better opportunity to control their monthly bills by controlling their usage, and is consistent with the State's EmPOWER Maryland goals, which encourage energy conservation and efficiency."[427]

Staff and AOBA recommend an increase of 8%, which results in a residential fixed charge of $11.00.[428]

Commission Decision

Determining the appropriate increase in this rate case is not an exact science, but rather the balancing of many considerations. In arriving at this increase, the Commission places 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 heating bills by increasing the value of volumetric charges. No matter how diligently customers might attempt to conserve energy or respond to pricing incentives, they cannot reduce fixed service charges.

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[425] Wagner Rebuttal at 11.
[426] OPC Witness Mierzwa Direct at 12
[427] OPC Witness Mierzwa Direct at 12.
[428] AOBA Exhibit 68; Staff Response to AOBA Data Request 1-8; AOBA Brief at 24.

Staff Witness Bonikowski testified that the non-coincident peak COSS submitted by WGL indicates that the fixed cost for serving an R-HC customer is $18.16.[429] Therefore, WGL's current fixed charge recovers 56.2% of fixed costs. Despite the principle of cost causation, the Commission agrees with Staff that WGL's proposed 15% increase is inconsistent with the principle of gradualism, which also guides our analysis. The Commission therefore believes that an increase closer to OPC's recommendation is appropriate in this case, and concludes that residential customer fixed charges should increase to $10.70 per customer, which reflects an increase of approximately 5%. The Commission also concludes that the rates of other classes should increase by a similar percentage. This increase will result in the following charges for each rate class:

Rate Class	**New System Charge**
R-HC	$10.70
R-NH/NC	$10.70
CI (below 3k)	$19.05
CI (above 3k)	$38.05
GMA – HC	$49.45
Interruptible	$120.75

Overall, the average residential ratepayer will see an increase of $4.05 on their heating bill, or approximately 5.67%.[430] The overall result of the Commission's decisions regarding the appropriate rate design in this case results in the following outcomes for each customer class:

[429] Bonikowski Direct at 7.
[430] Ex. JBW-2.

Proportion of Distribution Revenues

	Distribution Revenues ($)	Distribution Revenues (%)
R·HC	$171 ,773,078	70.1%
R-NH/NC	$975,606	0.4%
Cl<3K	$9,769,449	4.0%
Cl>3K	$38,316,158	15.6%
Cl-NH/NC	$2,607,734	1.1%
GMA-HC	$11,812,649	4.8%
GMA-Nl-1/NC	$2,067,769	0.8%
Interruptible	$7,816,175	3.2%
Total	$245,138,618	100.00%

System Charge Increase

	Current	New	Difference (%)
R-HC	$ 10.20	$ 10.70	4.9%
R-NH/NC	$ 10.20	$ 10.70	4.9%
CI<3K	$ 18.15	$ 19.05	5.0%
CI>3K	$ 36.25	$ 38.05	5.0%
CI-NH/NC	$ 15.00	$ 15.75	5.0%
GMA-HC	$ 47.10	$ 49.45	5.0%
GMA-NH/NC	$ 17.50	$ 18.40	5.1%
Interruptible	$ 115.00	$ 120.75	5.0%

Distribution Charge Comparison

Class	Distribution Charges ($/therm)	
	WGL Current	New Charges
R-HC		
0-45 therms	$0.3903	$0.4528
46-180 therms	$0.2869	$0.3329
> 180 therms	$0.2180	$0.2529
R-NHC		
0-45 1henns	$0.3578	$0.4139
46-1 80 therms	$0.2587	$0.2993
> 180 them1s	$0.1934	$0.2237
C1<3K		
0-300 therms	$0.3647	$0.4123
301-7,000 therms	$0.2167	$0.2450
> 7,000 therms	$0.1536	$0.1736
Cl>3K		
0-300 therms	$0.3647	$0.4034
301-7,000 therms	$0.2167	$0.2397
> 7,000 therms	$0.1536	$0.1699
CI-NH/NC		
0-300 Lhem1s	$0.2925	$0.2905
301-7,000 therms	$0.2002	$0.1988
> 7,000 therms	$0.1471	$0.1461
GMA-HC		
0-300 therms	$0.3238	$0.3583
301-7,000 therms	$0.2247	$0.2487
> 7,000 therms	$0.1666	$0.1844
GMA-NH/NC		
0-300 therms	$0.2924	$0.2884
301-7,000 therms	$0.2020	$0.1992
> 7,000 therms	$0.1501	$0.1480
Interruptible		
0-75,000 therms	$0.1000	$0.1127
> 75,000 therms	$0.0582	$0.0656

Bill Impact

	Current Avg. Bill	Increase	Resulting Avg. Bill	Difference (%)
R-HC	$ 71.49	$ 4.05	$ 75.54	5.67%
R-NH/NC	$ 40.02	$ 2.21	$ 42.23	5.52%
C1<3K	$ 111.41	$ 5.52	$ 116.93	4.95%
C1>3K	$ 1,288.60	$ 40.73	$ 1,329.33	3.16%
Cl-NH/NC	$ 448.22	$ (0.14)	$ 448.08	-0.03%
G MA-HC	$ 1,509.42	$ 47.44	$ 1,556.86	3.14%
GMA-NH/NC	$ 243.94	$ (0.12)	$ 243.82	-0.05%

Interruptible Revenue Margins

Finally, both AOBA and OPC ask the Commission to abolish WGL's participation in the sharing of Interruptible (Non-Firm) revenue margins. AOBA claims that WGL's participation in this program has become outdated. Begun in the 1980s, AOBA contends that value of service pricing was intended to respond to the potential loss of fixed cost recovery if non-firm customers switched to fuel oil alternatives.[431] As AOBA argues:

> By providing utilities the ability to flex their charges for interruptible service along with an incentive to maximize interruptible margin revenue, the hope was that the interests of the Company and its firm ratepayers would be aligned in a manner that would benefit both….
>
> However, energy markets and regulatory paradigms have changed dramatically, negating the need for such practices. Retail markets have been opened to the competitive provision of natural gas supply services for nearly two decades, and competition from alternative fuels, to the extent such exists, is met by the competitive market for natural gas supply services, not by local gas distribution utilities.[432]

[431] AOBA Brief at 26.

[432] AOBA Brief at 26; *See* Oliver Surrebuttal at 41.

Based upon its position that margin sharing has outlived its usefulness, AOBA argues that the 9.1% of revenues not credited to firm customers simply provides WGL with earnings without any evidence that it attracts customers under its Gas Expansion program.[433]

OPC agrees with AOBA, and OPC Witness Mierzwa reaches the same conclusion as Mr. Oliver:

> If the sharing of interruptible margins is eliminated, firm customers would receive credit for 100% of these margins in a base rate case and rates would be set according. Between rate cases, WGL would retain 100 percent of interruptible customer margins, thereby providing WGL a significant incentive to increase and maximize these margins.[434]

WGL disagrees and claims that this margin sharing still provides the incentives for which it was created, particularly in light of its recent acquisition by AltaGas, Ltd. WGL contends that its obligation to commit half of its $30 million investment in natural gas development in Maryland pursuant to that acquisition offers an opportunity for margin sharing to attract businesses to interruptible service within its territory.[435]

Commission Decision

The Commission agrees with AOBA and OPC. There is nothing in the record to suggest that margin pricing provides any tangible incentive for customers to adopt interruptible service, and the Commission sees no reason to believe that the commitments within our approval of the acquisition of WGL by AltaGas changes this analysis. The

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[433] AOBA Brief at 29-30.
[434] Mierzwa Surrebuttal at 7.
[435] Wagner Rebuttal at 10-11.

Commission therefore directs WGL to amend its tariff accordingly.

IT IS THEREFORE, this 11th day of December, in the year Two Thousand Eighteen, by the Public Service Commission of Maryland,

ORDERED (1) That the Application of Washington Gas Light Company, filed on May 15, 2018 (as supplemented by the Company over the course of this proceeding), seeking an increase in its Maryland distribution rates of $56.3 million, is hereby denied, as discussed in the body of this Order;

(2) That Washington Gas Light Company is hereby authorized to increase its Maryland distribution rates by no more than $28,602,000 for service rendered on or after December 11, 2018, consistent with the findings in this Order;

(3) That Washington Gas Light Company is directed to file tariffs in compliance with this Order with the effective dates prescribed herein, subject to acceptance by the Commission;

(4) That Washington Gas Light Company's uncontested request to change First Revised Page No. 47a, paragraphs 6 and 9 as well as First Revised Page No. 57, paragraph 4d of its tariff is hereby granted; and

(5) That all motions not granted herein are denied.

/s/ Jason M. Stanek

/s/ Michael T. Richard

/s/ Anthony J. O'Donnell

/s/ Odogwu Obi Linton

/s/ Mindy L. Herman
Commissioners