ML 223478

ORDER NO. 88975

IN THE MATTER OF THE APPLICATION OF BALTIMORE GAS AND ELECTRIC COMPANY FOR ADJUSTMENTS TO ITS GAS BASE RATES	* * * * * * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9484

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

Issued: January 4, 2019

APPEARANCES

Daniel P. Gahagan, Damon L. Krieger, Daniel W. Hurson, and Beverly A. Sikora for Baltimore Gas & Electric Company.

Margaret M. Witherup, David W. Beugelmans, and Chastity E.C. Threadcraft for the Maryland Energy Group and W.R. Grace & Co.

Leslie Romine, Kenneth Marc Albert, and Peter A. Woolson for the Public Service Commission Staff.

Paula M. Carmody, Theresa V. Czarski, and Patrick E. O'Laughlin for the Office of People's Counsel.

Scott H. Strauss, Jeffrey M. Bayne, Arlus J. Stephens, and Brian Petruska for the Baltimore Washington Construction and Public Employees Laborers' District Council.

May Va Lor for Laborers' International Union of North America.

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I. Background

On June 8, 2018, the Baltimore Gas and Electric Company ("BGE") filed an Application for Adjustments to its Gas Base Rates and Other Tariff Revisions ("Application") with Maryland Public Service Commission ("Commission"), pursuant to §§ 4-203 and 4-204 of the Public Utilities Article ("PUA"), *Annotated Code of Maryland*, seeking to increase its rates and charges for the retail distribution of natural gas in Maryland.[1] BGE's last gas rate increase request was in June 2016.[2] In the instant Application, BGE used a 12-month test year ending July 31, 2018, comprised of nine months of actual data and three months of projected data in support of an increase in its gas distribution revenue requirement of nearly $85 million.[3] BGE noted that its gas base rate revenues would only increase by $63.226 million, since the remaining $21.7 million of revenue is currently recovered through a Strategic Infrastructure Development and Enhancement ("STRIDE") surcharge.[4] Based upon updated actual data for the full test year filed on August 24, 2018, BGE lowered its requested revenue requirement to $82.781 million.[5] This Order approves BGE's Application, in part, and denies it, in part, as discussed below.

A number of parties filed written testimony in this proceeding. BGE sponsored the testimony of Mark D. Case, Vice President of Regulatory Policy and Strategy, who

[1] ML #220819.
[2] *In the Matter of the Application of Baltimore Gas and Electric Company for Adjustments to its Gas Base Rates*, Case No. 9406, Errata - Order No. 87591 (June 3, 2016).
[3] Application at 4.
[4] "As the $21.7 million is simply a transfer of the revenue requirement from the STRIDE recovery mechanism to base rates, customers' bills will increase by $63.3 million." *Id.*
[5] BGE Ex. 14, Prepared Supplemental Direct Testimony of Andrew W. Holmes ("Holmes Supp. Direct").

testified on a general basis for the rate increase;[6] Valencia A. McClure, Vice President of Governmental and External Affairs, testified on the Company's industry honors and recognition, diversity and inclusion, and community engagement;[7] Andrew W. Holmes, Vice President and Controller, testified on the revenue requirements and the Company's proposed capital structure and rate of return;[8] Lynn K. Fiery, Manager of Rate Administration, testified on the Calendar Year ("CY") 2017 Company Recommended Gas Actual Embedded Cost of Service Study;[9] Jason M.B. Manuel, Manager of Revenue Policy, testified on gas rate designs;[10] and A. Christopher Burton, Vice President of Gas Distribution, testified regarding gas meter installation and leak repair analysis.[11] Additionally, two other witnesses testified on behalf of BGE: Adrien M. McKenzie, President of Financial Concepts and Applications, Inc. ("FINCAP"), provided an assessment of BGE's rate of return on equity;[12] and Richard D. Huriaux, a consulting engineer specializing in gas and oil pipeline safety, regulations, standards, and new product innovation, testified regarding the Company's gas meter relocation program.[13]

The Office of People's Counsel ("OPC") presented the testimony of Allen R. Neale, a consultant with Daymark Energy Advisors, who testified regarding BGE's

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[6] BGE Ex. 17, Prepared Direct Testimony of Mark D. Case ("Case Direct"); BGE Ex. 18, Prepared Rebuttal Testimony of Mark D. Case ("Case Rebuttal"); BGE Ex. 19, Prepared Surrebuttal Testimony of Mark D. Case ("Case Surrebuttal").

[7] BGE Ex. 6, Prepared Direct Testimony of Valencia A. McClure ("McClure Direct").

[8] BGE Ex. 13, Prepared Direct Testimony of Andrew W. Holmes ("Holmes Direct"); Holmes Supp. Direct; BGE Ex. 15, Rebuttal Testimony of Andrew W. Holmes ("Holmes Rebuttal").

[9] BGE Ex. 7, Prepared Direct Testimony of Lynn K. Fiery ("Fiery Direct"); BGE Ex. 8, Prepared Rebuttal Testimony of Lynn K. Fiery ("Fiery Rebuttal").

[10] BGE Ex. 10, Prepared Direct Testimony of Jason M.B. Manuel ("Manuel Direct"); BGE Ex. 11, Prepared Supplemental Direct Testimony of Jason M.B. Manuel ("Manuel Supp. Direct"); BGE Ex. 12, Prepared Rebuttal Testimony of Jason M.B. Manuel ("Manuel Rebuttal").

[11] BGE Ex. 9, Prepared Rebuttal Testimony of A. Christopher Burton ("Burton Rebuttal").

[12] BGE Ex. 3, Prepared Direct Testimony of Adrien M. McKenzie ("McKenzie Direct"); BGE Ex. 4, Prepared Rebuttal Testimony of Adrien M. McKenzie ("McKenzie Rebuttal").

[13] BGE Ex. 5, Prepared Rebuttal Testimony of Richard D. Huriaux ("Huriaux Rebuttal").

proposed increase in revenue requirements;[14] Kevin W. O'Donnell, President of Nova Energy Consultants, Inc., who testified as to the Company's rate of return;[15] and Glenn A. Watkins, President and a Senior Economist with Technical Associates, Inc., who testified on the Company's cost of service studies, proposed distribution of revenues by customer class, and residential rate design.[16]

The Maryland Energy Group and W.R. Grace & Co. (collectively "MEG") presented the testimony of Richard Baudino, a consultant to J. Kennedy and Associates, Inc., who testified regarding the Company's rate design proposals;[17] Keith Cole, Vice President of Government Relations and Environment, Health, and Safety for W.R. Grace;[18] Kurt Krammer, the Environmental, Health, and Safety Officer for W.R. Grace;[19] Ted Lenski, Site Director for W.R. Grace's Curtis Bay Operations;[20] and Ali Gadiwalla, Manager for Special Projects for American Sugar Refining, Inc.,[21] all of whom testified regarding utility rates for large energy users.

The Baltimore/Washington Construction and Public Employees Laborers' District Council ("BWLDC") and Laborers International Union of North America ("LIUNA")

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[14] OPC Ex. 7, Prepared Direct Testimony of Allen R. Neale ("Neale Direct"); OPC Ex. 8, Prepared Rebuttal Testimony of Allen R. Neale ("Neale Rebuttal"); OPC Ex. 9, Errata to Rebuttal Testimony of Allen R. Neale ("Errata – Neale Rebuttal").

[15] OPC Ex. 5, Prepared Direct Testimony of Kevin W. O'Donnell ("O'Donnell Direct"); OPC Ex. 6, Revised Exhibits KWO-2 and KWO-4 to the Direct Testimony of Kevin O'Donnell ("Revised Exhibits – O'Donnell Direct").

[16] OPC Ex. 3, Prepared Direct Testimony of Glenn A. Watkins ("Watkins Direct"); OPC Ex. 4, Prepared Surrebuttal Testimony of Glenn A. Watkins ("Watkins Surrebuttal").

[17] MEG Ex. 4, Prepared Amended Direct Testimony of Richard Baudino ("Baudino Amended Direct"); MEG Ex. 5, Prepared Rebuttal Testimony of Richard Baudino ("Baudino Rebuttal").

[18] MEG Ex. 1, Prepared Direct Testimony of Keith Cole ("Cole Direct").

[19] MEG Ex. 2, Prepared Direct Testimony of Kurt Krammer ("Krammer Direct").

[20] MEG Ex. 6, Prepared Direct Testimony of Ted Lenski ("Lenski Direct"); MEG Ex. 7, Prepared Surrebuttal Testimony of Ted Lenski ("Lenski Surrebuttal").

[21] MEG Ex. 3, Prepared Direct Testimony of Ali Gadiwalla ("Gadiwalla Direct"). By ML #222478, MEG advised the Commission that Witness Gadiwalla's Direct Testimony is a re-assignment of the Testimony of Gary Lasako, ML #222249.

presented the testimony of David Allison, Business Manager for BWLDC, who testified regarding certain procurement conditions that BWLDC/LIUNA would like the Commission to consider imposing upon any approval of BGE's proposed rate increase.[22]

The Commission's Technical Staff ("Staff") presented the testimony of Juan Carlos Alvarado, Director of the Telecommunications, Gas, and Water Division, who testified regarding the concept of regulatory lag as it pertains to BGE;[23] Jason Cross, Regulatory Economist in the Telecommunications, Gas, and Water Division, who testified on BGE's gas cost of service study and the unbundling of the Company's Schedule C customers;[24] Jennifer Ward, Regulatory Economist in the Telecommunications, Gas, and Water Division, who testified regarding rate design;[25] Karen Suckling, Regulatory Economist in the Telecommunications, Gas, and Water Division, who testified regarding capital structure, rate of return, and return on equity;[26] Jamie Smith, Director of the Accounting Investigations Division, who testified regarding revenue requirement;[27] and Carlos Acosta, Pipeline Safety Engineer III in the Engineering Division, who testified on capital investments being made by BGE to its gas distribution system.[28]

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[22] BWLDC/LIUNA Ex. 1, Prepared Direct Testimony of David Allison ("Allison Direct").

[23] Staff Ex. 14, Prepared Direct Testimony of Juan Carlos Alvarado ("Alvarado Direct"); Staff Ex 16, Prepared Surrebuttal Testimony of Juan Carlos Alvarado ("Alvarado Surrebuttal").

[24] Staff Ex. 17, Prepared Direct Testimony of Jason Cross ("Cross Direct"); Staff Ex 18, Prepared Surrebuttal Testimony of Jason Cross ("Cross Surrebuttal").

[25] Staff Ex. 19, Prepared Direct Testimony of Jennifer Ward ("Ward Direct"); Staff Ex 20, Prepared Rebuttal Testimony of Jennifer Ward ("Ward Rebuttal"); Staff Ex 21, Prepared Surrebuttal Testimony of Jennifer Ward ("Ward Surrebuttal").

[26] Staff Ex. 15, Prepared Direct Testimony of Karen Suckling ("Suckling Direct").

[27] Staff Ex. 22, Prepared Direct Testimony of Jamie Smith ("Smith Direct"); Staff Ex 23, Prepared Surrebuttal Testimony of Jamie Smith ("Smith Surrebuttal").

[28] Staff Ex. 24, Prepared Direct Testimony of Carlos Acosta ("Acosta Direct"); Staff Ex 25, Prepared Surrebuttal Testimony of Carlos Acosta ("Acosta Surrebuttal").

The Company filed supplemental direct testimony on August 24, 2018, updating the Company's direct testimony for actual data for the full test year. OPC, MEG, BWLDC/LIUNA, and Staff filed direct testimony on September 14, 2018. Parties filed rebuttal testimony on October 12, 2018, and surrebuttal testimony on October 26, 2018. The Commission held public hearings throughout the Company's service territory in Howard County, Anne Arundel County, Baltimore City, Harford County, and Baltimore County on October 16, 18, 22, 24, and 30, 2018, respectively. The Commission conducted a trial-type evidentiary hearing on November 2, 7, 8, and 9, 2018. The parties filed Initial Briefs on November 30, 2018, and Reply Briefs on December 7, 2018.

On November 16, 2018, Staff filed, on behalf of the parties, a Revenue Requirement Comparison Chart (hereinafter, "the Chart").[29] The Chart reflects BGE's purported revenue deficiency of $82,781,000 inclusive of $21.7 million in STRIDE revenues for gas distribution operations. Staff's final position reflects a revenue deficiency of $59,636,000, while OPC's final position reflects a revenue deficiency of $47,832,000.

The Commission has reviewed the evidence and testimony presented, including the comments received at the public hearings in reaching the decisions in this Order. Based on the record, the Commission has determined that a total revenue increase of $64.915 million, inclusive of the investments ($21.7 million) currently recovered in the STRIDE surcharge, is warranted.

[29] ML #222936.

II. Discussion

A. Revenue Requirement

1. Regulatory Lag

BGE

BGE argued that the Company has experienced significant regulatory lag in recent years.[30] Witness Case explained that regulatory lag or "attrition" is created when a historical test year is used to set utility rates for the future while the utility is experiencing a combination of rate base growth and increasing O&M expenses.[31] Witness Case indicated that BGE has made significant investments in the gas distribution system and plans to continue to do so to provide safe and reliable gas distribution service to its customers. He noted that when a utility is experiencing growth in customers, the additional revenue from the new customers can typically offset attrition. However, Witness Case pointed out that often the customer growth is not enough to offset the increase in rate base and O&M expenses. Specifically, Witness Case testified that while BGE has experienced some growth in customers, it has not been nearly enough to offset the higher capital expenditures performed to replace aging assets and other gas distribution modernization initiatives.[32] Thus, the Company contends that it does not have a reasonable opportunity to earn a fair return on its investments, and will not be able to do so unless the Commission approves BGE's proposed adjustments to mitigate the adverse effects of regulatory lag.[33] Witness Case suggested that even with the implementation of the STRIDE cost recovery mechanism, the Company still has not been

[30] Case Direct at 21.
[31] *Id.*
[32] Case Direct at 22.
[33] *Id.*

able to achieve the Commission-authorized return on equity ("ROE") for its gas operations in any quarter since January 2014.[34] In the period between January 2014 and July 2018, the Company expects to have under-earned its authorized gas ROE by more than 20% overall and 46% during the test year."[35] To address the adverse effects of regulatory lag, the Company proposed the following adjustments:

- An upward adjustment to its ROE of 20 basis points to help address attrition;
- Rate Base Adjustment 3 ("RBA") and Operating Income Adjustment ("OIA") 16, which are forward looking adjustments that reflect non-STRIDE, non-revenue producing safety and reliability gas distribution investments between November 2018 to November 2019;
- Rider 6 to BGE's Gas Service Tariff, which would provide a customer protection crediting mechanism if the full amounts projected for RBA 3 are not invested; and
- Operating Income Adjustment 22, which adjusts for the impact of inflation on non-labor O&M expenses during the rate-effective period.[36]

Staff

Witness Alvarado explained that regulatory lag is not new to BGE or any other Maryland utility, noting that regulatory lag has been embedded in the regulatory process in Maryland since the introduction of rate of return regulation. Witness Alvarado contended that "regulatory lag ensures that customers pay rates that are just and reasonable" and that "more closely resemble the rates that would result from competitive pressures."[37] Witness Alvarado testified that although BGE views regulatory lag as a problem, Staff views it is an essential part of the regulatory process. Witness Alvarado

[34] Case Direct at 23.
[35] *Id.*
[36] BGE Initial Brief at 6.
[37] Alvarado Direct at 7.

concurred with the Company that inordinately high regulatory lag needs to be addressed but the "mere presence of regulatory lag is not a problem that needs to be solved."[38] He also noted that the Company bears the burden of proof to show that the regulatory lag faced by the Company is inconsistent with the purpose of regulatory lag, is inordinately high, or different from the lag faced by its peers.[39]

Witness Alvarado argued that BGE Witness Case does not present any evidence that the regulatory lag BGE is currently facing is larger than it has been in the past, different from that faced by other Maryland gas companies, or even that the inability of BGE to achieve its ROR can be directly and fully attributable to regulatory lag.[40] Witness Alvarado asserted that the "mere presence of regulatory lag is not a reason for action by the Commission."[41] Additionally, Witness Alvarado recommended that the Commission not grant any of BGE's proposed adjustments related to regulatory lag as the Company has not met its burden of proof that the regulatory lag faced by the Company is inconsistent with the purpose of regulatory lag, or inordinately high, or different from the regulatory lag faced by its peers.

OPC

OPC Witness Neale concurred with Staff Witness Alvarado in rejecting BGE's regulatory lag argument and contended that the Company has not demonstrated that it is unduly burdened by regulatory lag. In fact, OPC Witness Neale pointed out that the Company benefits from two regulatory provisions that mitigate regulatory lag risk. For instance, the Company has several riders in its tariffs that help align revenues with costs

[38] Alvarado Direct at 8.
[39] *Id.*
[40] Alvarado Direct at 12.
[41] Alvarado Direct at 8.

outside of a rate case such as (1) Rider 8 Monthly Rate Adjustment, the Company's decoupling mechanism, and (2) Rider 16, the Company's STRIDE investment cost recovery mechanism. With Rider 8, the revenue requirement collected from customers is normalized based on weather and growth, which are the two largest variables for utilities.[42] Additionally, the STRIDE surcharge provides for the accelerated recovery of costs outside of a traditional base rate case.

Commission Decision

The Commission finds that regulatory lag can help to ensure that rates are just and reasonable and encourage efficiency in the absence of competition. The Commission also finds that reviewing investments after they are made can minimize the tendency of rate of return regulation to encourage utility over-investment and encourages cost minimization.[43]

The Commission finds that regulatory lag does not prevent BGE from earning a just and reasonable return in this proceeding. It is within BGE's power to incorporate operational efficiencies and to control costs, and to the extent BGE 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 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, 87 (March 9, 2011) ("Moreover, the Commission concludes that regulatory lag alone is not a sufficient justification for approving adjustments to an

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[42] Neale Direct at 25.
[43] Alvarado Direct at 10.

average rate base."); *In re Delmarva Power & Light Co.*, 103 Md. P.S.C. 377, 388 (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.").

In the instant case, the Company has not offered any evidence that would show that it is experiencing regulatory lag that is inordinately high or different from its peers. Accordingly, BGE's proposed adjustments in this case related to regulatory lag—forward-looking adjustments (RBA 3 and OIA 16), along with its Rider 6 and the attrition adder—are denied and will be discussed in detail below in Section II. A. 2b. Forward Looking Adjustment and Section II.B. Cost of Capital. Another proposed adjustment from the Company related to the regulatory lag includes an inflation adjustment for non-labor Operations and Maintenance ("O&M") expense (OIA 22), which is also discussed in more depth below in Section II. A. 2d. Inflation Adjustment for Non-Labor O&M Expense.

2. Rate Base and Operating Income Adjustments

Rate base represents the investments the Company makes in plant and equipment to provide safe and reliable utility service to its customers. Operating income is derived based upon the revenues the Company receives for utility service less the costs it incurs in providing service to customers. The parties proposed various adjustments to the Company's unadjusted rate base and operating income. The Commission has reviewed the record and accepts the uncontested rate base adjustments and operating income adjustments as set forth in the Chart and resolves the disputed adjustments, as discussed below. Briefly stated, the Commission finds that a total revenue increase of

$64.915 million, inclusive of the investments ($21.7 million) currently recovered via the STRIDE surcharge, to base rates is appropriate.[44]

a. Recovery of Plant (Rate Base Adjustments 1 & 2)

BGE

BGE proposed two separate adjustments to rate base to recover plant investments. BGE's proposed RBA 1 adjusts the test year plant from an average rate base during the test year to include the investment in safety and reliability investments through the end of July 2018 (also called terminal level of these investments). BGE's proposed RBA 2 is designed to include completed plant placed in service through the end of the evidentiary hearings in this proceeding (i.e., through October 2018).[45]

Staff

Staff Witness Smith noted that RBAs 1 and 2 are similar to adjustments proposed in prior rate cases, including Case No. 9406.[46] Witness Smith testified that Staff does not oppose BGE's proposed RBAs 1 and 2, noting that the Commission has allowed utilities to recover the terminal value of the actual prudently incurred costs for non-revenue producing safety and reliability investments through the evidentiary hearing in the rate case in an attempt to encourage the companies to make accelerated safety and reliability investments, including STRIDE investments.[47] Staff recommended that the Commission accept RBA 1. Witness Smith originally excluded investments discussed in RBA 2 as the amounts presented were estimates and thus not known and measurable. However, Staff

[44] *See* Appendix I for the Commission's calculation of the appropriate rate base, operating income, and overall revenue requirement for rate making purposes.
[45] Smith Direct at 8-9.
[46] Smith Direct at 8.
[47] Smith Direct at 9-10.

updated its position to reflect the inclusion of the post-test year plant through the date of the hearing.[48] In his Surrebuttal, Witness Smith testified that Staff has reviewed BGE's updated actual data through September 2018 and does not oppose inclusion of the related costs since they are known and measurable.

OPC

Witness Neale testified that OPC did not wish to disagree with Staff's initial approach of reversing BGE's estimated adjustments for RBA 1 and 2 in its direct testimony. Rather, OPC pointed out its decision to not disallow recovery of BGE's investments "was predicated on the fact that the Company's supplemental direct filing included actuals through July 31, 2018, and would be updated through the hearings, so they might come in lower or higher but likely not by enough merit a reversal."[49]

Commission Decision

The Commission finds that to ensure that Maryland utilities can provide safe and reliable service, recovery of known and measurable expenses for actual, prudently incurred costs, for non-revenue producing safety and reliability investments through the hearing date is appropriate. For this reason, the Commission will accept these two adjustments (i.e., RBAs 1 and 2).

b. Forward Looking Adjustments (RBA 3 & OIA 16)

BGE

BGE's proposed RBA 3 reflects the 13-month average amount of safety and reliability investments forecasted to be placed into plant in service from November 2018

[48] Smith Surrebuttal at 5.
[49] Neale Surrebuttal at 14.

through November 2019, less the investments expected to be recovered in STRIDE rates.[50] The period of November 2018 to November 2019 corresponds to the rate effective period in this proceeding.[51] Witness Holmes argued that the Company is proposing this adjustment to better align the matching of costs and revenues during the rate effective period.[52] Witness Holmes also noted that the proposed adjustment excludes amounts pertaining to gas safety and reliability investments that are anticipated to be recovered through BGE's STRIDE surcharge.[53] Similar to RBAs 1 and 2, this adjustment reflects net investments through offsetting adjustments to accumulated depreciation reserve and accumulated deferred income taxes. A companion adjustment Operating Income OIA 16 adjusts operating income to reflect additional depreciation expense related to the forward looking plant. BGE proposed a new rider (Rider 6) as a mechanism to reconcile and ensure that customers are only assessed the actual costs related to the plant investments.

Staff

Witness Smith recommended that the Commission disallow the forward-looking adjustment RBA 3 and its corresponding OIA 16. Witness Smith testified that "[t]he Commission has consistently rejected the estimated post-hearing safety and reliability plant addition adjustments in prior cases including the four most recently litigated rate cases of BGE's affiliated Maryland utility, Potomac Electric Power Company ("Pepco") (Case No. 9443, Case No. 9418, Case No. 9336, and Case No. 9311)."[54] Witness Smith

[50] Smith Direct at 9.
[51] *Id.*
[52] Holmes Direct at 35.
[53] *Id.*
[54] Smith Direct at 11.

argued that the estimated amounts are neither known nor measurable, nor are the capital investments used and useful at the time of the hearing.[55] Additionally, Witness Smith testified that RBA 3 does not give consideration for any adjustments, laws, regulations or other changes that may decrease costs or increase revenues and thus lower revenue requirement during the same period. Witness Smith maintained his recommendation to disallow the projected investments discussed in RBA 3 even though the Company conditioned the adjustment on the inclusion of Rider 6.[56]

OPC

Witness Neale also recommended excluding BGE's forward-looking adjustment RBA 3 and its corresponding operating income adjustment OIA 16. OPC opined that BGE is not unduly subject to regulatory lag,[57] which the Company offers as the basis for the need to include the forward-looking adjustment. OPC contended that this forward-looking adjustment amounts to the BGE "requesting recovery <u>for</u> and <u>on</u> investments that, by its own admission, are significantly beyond the test year and, by definition, neither used and useful nor known and certain."[58] OPC argued that "in some sense, the BGE proposal is similar to STRIDE, a statutory program in that customers would be required to pay in advance the estimated cost for projects that are not in service with a future reconciliation process to adjust [Rider 6] for the difference between the amount recovered and actual costs."[59]

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[55] Smith Direct at 11.
[56] Smith Direct at 12.
[57] OPC Initial Brief at 9.
[58] *Id.*
[59] OPC Initial Brief at 10.

OPC pointed out that BGE's proposal "is not only inconsistent with Maryland's approach to rate setting, it is unnecessary" because the Commission "has responded to arguments about regulatory lag by permitting recovery for 'terminal' safety and reliability net investment in rate base through the end of the hearings."[60] As noted above, OPC believes BGE is placed in a better position through the inclusion of plant investments discussed in RBA 1 and 2 and no further adjustment is warranted.

Commission Decision

The Commission has repeatedly rejected proposals to include post-hearing investments related to safety and reliability. As Staff noted in its Initial Brief, the Commission previously excluded the Company's proposal in Case No. 9326 to include in rate base BGE's forecasted upgrades after the hearing because the upgrades were not known and measurable, did not represent actual spending, and were dissimilar to other Commission-approved surcharges or riders.[61] Staff also pointed out that the Commission rejected a similar proposal in BGE's Case No. 9299 because the reliability plant additions were projected and not known and measurable.[62] For these reasons, the Commission rejected BGE's request to include projected investments, as proposed in RBA 3. In the instant case, BGE again proposed an increase to include a forward looking adjustment based on estimated costs of non-revenue safety and reliability investments based on a 13-month average basis for the twelve month period following the hearing. Based on the record, the proposed adjustment is not known and measurable and was not used and

[60] OPC Initial Brief at 9.
[61] Staff Initial Brief at 25.
[62] *Id.*

useful during the test year. Therefore, the Commission rejects BGE's proposed forward looking adjustment.

c. Gas Rider 6

BGE

To address the uncertainty inherent in RBA 3's projection of investments, BGE proposed Gas Rider 6, "which will ensure customers only pay the lower of the revenue requirement based on the forecasted investments or the revenue requirement based on the actual investments made during the period."[63] Witness Manual testified the Rider ensures customers will pay no more than actual costs and will only pay in rates for those investments that are known and measurable.[64] Witness Manuel explained that if the Commission approves RBA 3 and OIA 16, this revenue requirement will be included in gas base distribution rates.[65] Witness Manuel proposed an annual true-up process to compare the revenue requirement based on the actual known and measurable expenditures with the revenue requirement reflecting the inclusion of RBA 3 and OIA 16.[66]

"If the revenue requirement resulting from RBA 3 and OIA 16 and embedded in base distribution rates is *less* than the revenue requirement resulting from the actual expenditures made during the period at issue, no charge will be calculated under Gas Rider 6."[67] However, if the revenue requirement resulting from RBA 3 and OIA 16 and 19 embedded in base distribution rates is greater than the revenue requirement

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[63] Manual Direct at 19.
[64] Manual Direct at 20.
[65] Manuel Direct at 21.
[66] *Id.*
[67] Manuel Direct at 20.

resulting from the actual investments made during the period at issue, the difference in revenue requirements would be included in Rider 6 as a reduction to the distribution charge on customer bills.[68] Witness Manuel stated that Rider 6 will apply to all rate schedules except for Schedule PLG (i.e., private gas lighting), which is closed to new customers and contains a small number of legacy customers, almost all of whom also take service under Schedule D. In addition, Schedule PLG's contribution to total base revenue is less than one tenth of one percent.[69]

Staff

Witness Smith rejected BGE's proposed Gas Rider 6 and pointed out that BGE's proposal is similar to the Company's STRIDE mechanism and would result in simultaneous cost recovery for two gas safety and reliability initiatives. Witness Smith noted that BGE is proposing the adjustment and the accompanying Rider 6 to help mitigate regulatory lag; however, he concluded that the Company has not provided any evidence that BGE faces an inordinately higher regulatory lag than its peers.[70]

OPC

Witness Neale argued for the Commission to reject Gas Rider 6 along with RBA 3 and the corresponding OIA 16. Witness Neale opined that BGE's request for approval of a forward-looking adjustment along with Rider 6 appears analogous to a STRIDE rider for Transmission Infrastructure Management Plan ("TIMP") programs, rather than the

[68] Manual Direct at 20.
[69] Manual Direct at 21.
[70] Smith Surrebuttal at 7.

Distribution Integrity Management Plan ("DIMP") approved under STRIDE.[71] Witness Neale stated:

> [the] proposed Rider 6 is analogous to the STRIDE surcharge (Rider 16) because it would also allow for:
>
> - recovery from customers in advance of investment projects being completed and entered into service;
> - a rate of return on the estimated costs of these projects ;
> - a reconciliation process that adjusts the rider for the difference between the amount previously recovered and actual costs.[72]

Witness Neal also pointed out some differences between Rider 6 and STRIDE. Those differences include:

- no rate cap for Schedule D customers similar to the $2.00 cap under STRIDE;
- no assurances that the investments in the non-revenue producing safety and reliability projects will occur any faster than the current pace which is a benefit associated with STRIDE; and
- no provision for prior review and approval of the programs included in the forward-looking estimates of these investment projects to determine if costs for these projects are appropriately determined.[73]

Ultimately, Witness Neale concluded that Rider 6 is unnecessary for the purpose for which the Company purports it is needed; mitigating the regulatory lag experienced by BGE. Witness Neale asserted that BGE is already requesting a substantial amount for terminal safety and reliability net investments in rate base and that the Commission

[71] Neal Direct at 26.
[72] *Id.*
[73] Neale Direct at 26-27.

should deny the request for both the forward-looking adjustment and Rider 6 as inconsistent with developing just and reasonable rates.[74]

Commission Decision

In light of the Commission decision to reject proposed post-hearing safety and reliability investments under RBA 3, there is no need to approve Rider 6. The intent of this Rider is to protect customers from potentially paying projected investments that are not made in a timely fashion. If projected investments are not included in the revenue requirement, then the protection of the Rider is not necessary. Consistent with the decision to exclude forward-looking plant investment, the Commission declines to authorize BGE to implement Rider 6.

d. Inflation Adjustment for Non-Labor O&M Expense (OIA 22)

BGE

BGE proposed OIA 22 that increases test year expenses to reflect the impact of general inflation on non-labor O&M costs during the rate-effective period.[75] Witness Holmes testified that this adjustment addresses the regulatory lag "arising from having the level of non-labor O&M in the rate effective period being higher than the test year due to the impact of inflation."[76] Witness Holmes asserted that this mismatch hinders the Company's ability to earn its authorized rate of return.[77] Further, Witness Holmes explained that "[r]atemaking paradigms based on historical test years—like that used in Maryland—do not address systematic inflation. If a historical test year is used to set rates

[74] Neale Direct 28.
[75] Holmes Direct at 29.
[76] Holmes Rebuttal at 16
[77] *Id.*

in a period of rising costs, then by design the rates will not be sufficient to recover actual costs incurred during the rate effective period."[78] Witness Holmes argued that the most logical way for a regulator to address this lag would be to authorize an inflation ratemaking adjustment similar to what the Company proposes.[79] Witness Holmes refuted OPC Witness Neale's objection that this adjustment would allow recovery of O&M costs from customers in advance by arguing that this adjustment "would allow for recovery from customers concurrently with O&M spending during the rate effective period—not in advance of spending." This would merely serve to properly match revenues and expenses during the rate effective period."[80]

BGE proposed to use the inflation factor based on the Consumer Price Index ("CPI") per the U.S. Department of Labor, Bureau Statistics, which updates monthly.[81] In his Supplemental Direct, Witness Holmes proposed using the end of test year of July 2018 CPI inflation rate of 2.95% to calculate the non-labor O&M adjustment. Witness Holmes opined that it is a reasonable assumption that inflation will continue to rise given the historical trend. In his Rebuttal, Witness Holmes proffered a chart showing the levels of CPI since 2000 and in only one year (2009) was there a reduction in prices.[82] Witness Holmes stated that over the period 2000-2017, the average CPI inflation rate was 2.2%.[83] In its Initial Brief, BGE proposed that instead of using the end of test year CPI inflation rate as the basis for its recommended adjustment to operating income, the Commission

[78] Holmes Rebuttal at 17.
[79] *Id.*
[80] Holmes Rebuttal 18.
[81] Holmes Direct at 29.
[82] Holmes Rebuttal at 16.
[83] *Id.*

may also consider selecting a multi-year average CPI to capture the impact of inflation.[84]

In his Rebuttal, Witness Holmes addressed OPC Witness Neale's primary objection to the inflation adjustment, i.e., the volatility in the cost per leak repair as justification for rejecting this adjustment. Specifically, Witness Holmes noted that Witness Neale's analysis of leak repair costs shows that the general trend for total leak repair costs is up, which demonstrates the need to do something to mitigate the associated regulatory lag. Further, Witness Holmes also stated that BGE's proposed O&M inflation adjustment must be assessed in terms of total cost, not a particular item such as cost per leak repair.[85] Last, Witness Holmes argued that ignoring the existence of inflation, as Staff and OPC recommend, will undermine the Company's ability to earn its authorized rate of return. BGE Witness Case supported Witness Holmes' testimony by asserting that "[t]he use of a historical test year when inflation is causing costs to rise prevents rates from being sufficient to recover the actual costs incurred during the rate-effective period."[86]

Staff

Witness Smith testified that BGE's inflation adjustment (OIA 22) attempts to adjust for estimated future costs.[87] Witness Smith argued that the proposal is arbitrary and the estimated amounts are not known and measurable. Further, the proposal is one-sided since it does not account for any adjustments that may decrease costs or increase revenues during the same period.[88] Additionally, in his Surrebuttal, Witness Smith noted

[84] BGE Initial Brief at 10.
[85] Holmes Rebuttal at 18.
[86] Case Rebuttal at 6.
[87] Smith Direct at 18.
[88] *Id.*

that the CPI inflation rate is updated monthly and thus the related adjustment is a moving target based on the month that the test year ends. For instance, for the 12-month period ending September 2018, the CPI inflation rate is 2.3%. Witness Smith also cited Staff Witness Alvarado who explained in his direct testimony "that there is no evidence on the record that the regulatory lag BGE faces is inconsistent with the purpose of regulatory lag, inordinately high, or different from the regulatory lag faced by its peers."[89]

Therefore, Witness Smith recommended that the Commission disallow an adjustment to reflect potential impacts related to inflation.

OPC

Witness Neale recommended that the Commission disallow BGE's inflation adjustment (OIA 22). Witness Neale offered the following reasons to support disallowing this adjustment:

> "• First, the ability and responsibility to control operating expense is within the Company's control.
>
> • Second, while the Company acknowledges that leak rates have not improved it argues the cost of repairs have increased from $28.8 million and $29.1 million in 2013 and 2014 to $37 million in 2017.[90] But the Company's own data on leak repair costs suggest that rather than demonstrating an upward trend, operating expense, which along with capital costs is included in leak repair costs, has varied over time with cost per leak repair declining in 2016, as shown in the chart below. Exhibit ARN-4 Average Cost Per Leak Repair.

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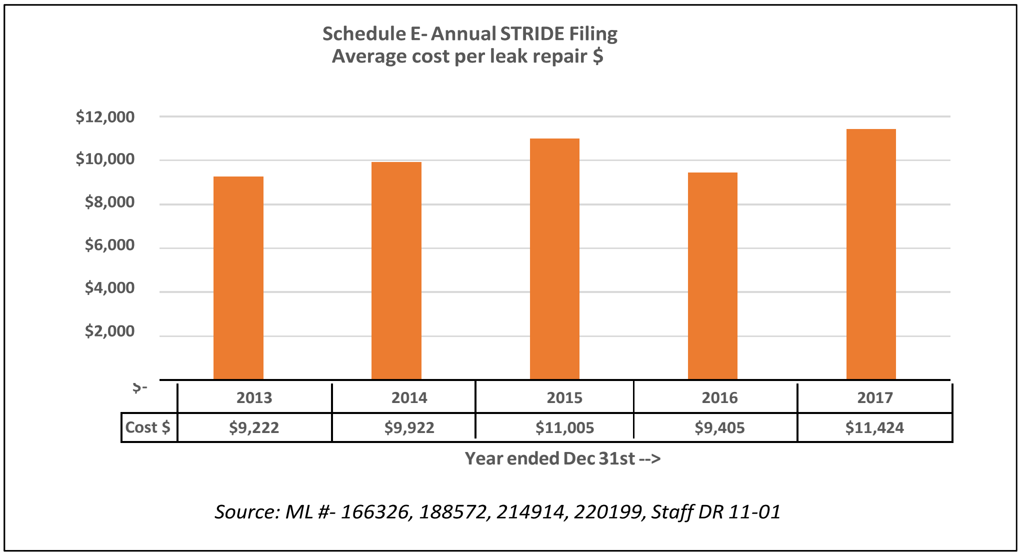
[89] Smith Surrebuttal at 9 *citing* Alvarado Direct at 3.
[90] Neale Direct at 29 *citing* Case Direct at 17, lines 1-7.



• Third, the Company maintains capital investments are driven by the need to modernize the gas distribution system and the associated operating expense growth. Yet the Commission recognized in the most recent STRIDE program review that a review of the O&M savings associated with STRIDE could be beneficial to the Commission during its examination of O&M costs in a future base rate case.[91]

• Fourth, the update for actuals through July 2018 shows a decrease in estimated project investments through the hearing for both STRIDE and non-STRIDE investments by several million dollars, as described above, which may indicate that the pace of investment may be falling behind.

• Fifth, while terminal STRIDE and safety and reliability net investments declined along with operating expenses with the update for actuals through July 2018, the inflation factor increased, which demonstrates that applying a positive adder to operating expenses would not be consistent with the requirement to rely on known and measurable costs.

• Sixth, the CPI is an historic index not a forward-looking inflation adjustment factor and as such is not in keeping with determining the level of costs that the Company may incur in the rate effective period."[92]

[91] Neale Direct at 30 *citing* Commission Order No.88714, Case No. 9468, (May 30, 2018), Slip Op. at 27.
[92] Neale Direct at 29-31.

Overall, Witness Neale concluded that "giving the Company authority to recover estimated costs in advance is a form of borrowing from customers who are not in a position to determine operating costs in lieu of financing through the debt and equity markets."[93]

Commission Decision

The Commission finds that BGE's proposal for a non-labor O&M inflation adjustment is warranted. As pointed out by the Company, "[r]atemaking paradigms based on historical test years—like that used in Maryland—do not address systematic inflation."[94] The Commission recognizes that inflation is measured by the U.S Department of Labor's Bureau of Labor Statistics and results in the Consumer Price Index. Staff and OPC recommend disallowance of OIA 22 primarily because the exact inflation rate is not known and measurable. While the data does not show that there is a steady rise in inflation—BGE points out that over the period of 2000 through 2017, the average CPI inflation rate was 2.2% with a sharp decline in 2009 as a result of a recessionary period—it does support positive growth in inflation over time. For this reason, the Commission finds inflation can be deemed known and measurable.

Additionally, OPC argues that the adjustment is not supported by evidence that BGE is experiencing an upward trend in expenses such as leak repair costs. In fact, OPC Witness Neale's analysis shows that the leak repair costs have varied and even declined

[93] Neale Direct at 31.
[94] Holmes Rebuttal at 17.

in a single year.[95] The Commission notes, however, that while exogenous factors may have lead to leak repair cost reductions, it does not change the fact that inflation exerts upward pressure on costs and should be considered in setting rates.

BGE developed its adjustment on a 2.95% inflation factor, which reflected the CPI for urban consumers on August 10, 2018.[96] Staff correctly argues that using the end of test year CPI inflation rate method proposed by BGE would be a moving target based on the month that the test year ended and would allow for potentially wide variance (especially when the test year occurred during a recessionary period).

The Commission finds that a more reasoned and accurate approach to assessing the impact of inflation is to use a five-year average of the CPI. This approach addresses the actual trend in inflation during the rate-effective period in a verifiable and measurable manner while accounting for variances. Based on Staff Exhibit 10, "CPI Historical Tables for Baltimore-Columbia-Towson MD per U.S. Bureau of Labor Statistics,"[97] the CPI for the period 2013 through 2017 reflects an average rate of inflation of 1.40%, which the Commission finds is an appropriate proxy for the rate of inflation for the rate effective period. Staff Exhibit 10 tracks changes in prices of goods and services for all urban populations for the Baltimore-Columbia-Towson Maryland area which corresponds to the BGE service territory. Adopting a CPI inflation rate of 1.40% corresponds to a reduction in operating income of $1,520,000, which the Commission finds to be a reasonable projection of inflation. The Commission also notes that an adjustment for inflation is not guaranteed in future cases, but will be examined on a case-by-case basis.

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[95] OPC Initial Brief at 12.
[96] BGE Initial Brief at 10.
[97] Staff Exhibit 10. CPI Historical Tables for Baltimore-Columbia-Towson MD. U.S. Bureau of Labor Statistics.

e. Supplemental Executive Retirement Program (OIA 4)

BGE

BGE proposed OIA 4 which provides for 50% of the Supplemental Executive Retirement Program ("SERP") as held in Case No. 9326, Order No. 86060.[98] Witness Case explained that "prior to Case No. 9326, filed in 2013, BGE recovered 100% of its SERP expenses. Witness Case pointed out, however, that in Case No. 9326, both Staff and OPC argued that SERP expenses should be shared equally between shareholders and customers and the Commission agreed.[99] Witness Holmes also noted that the Commission approved 50% SERP recovery in BGE's most recent fully adjudicated rate case in Case No. 9406 in June 2016.[100]

Staff

Staff Witness Smith testified that SERP is a non-qualified retirement plan for a limited number of executives that provides benefits above qualified retirement plans which are limited in the amount of annual benefits that a participant can receive by Internal Revenue Service ("IRS") Code Section 415.[101] Witness Smith pointed out that this is a benefit that is provided to a very limited group of senior employees. Witness Smith acknowledged that the Commission did adopt Staff's previous position to remove 50% of SERP costs in BGE's Case No. 9326 and that BGE had included an uncontested 50% adjustment in its two subsequent cases, Case No. 9355 and 9406. However, the Commission disallowed 100% of SERP costs in the most recent cases involving other Maryland utilities, including Pepco (Case Nos. 9418 and 9443) and

[98] Holmes Direct at 16.
[99] Case Rebuttal at 14.
[100] Holmes Rebuttal at 26.
[101] Smith Direct at 17.

Delmarva Power & Light Company (Case No. 9424).[102] Hence, Staff argued that the ratemaking decision related to the SERP benefit should be consistent among BGE's affiliated Maryland utilities.[103] Additionally, Staff asserted that BGE has not met its burden of proof that SERP is essential to attract and retain senior employees, and thus, providing a benefit to ratepayers.[104] Therefore, Staff recommended disallowance of 100% of SERP.

OPC

OPC did not contest BGE's OIA 4; consequently, OPC does not appear to oppose BGE continuing to recover 50% of its SERP expenses.

Commission Decision

BGE's proposed SERP adjustment, while consistent with the Commission's prior BGE decisions, is now inconsistent with more recent decisions that have not permitted the recovery of SERP-related expenses. Based on the record, BGE has not demonstrated that a 50% recovery of SERP expenses would be just and reasonable. However, in future rates cases, BGE may seek to introduce evidence to demonstrate that SERP yields quantifiable benefits for its customers.

f. Deferred Rate Case Expenses (OIA 17)

BGE

BGE Witness Holmes proposed a three-year recovery of rate case expenses incurred after the evidentiary hearing in Case No. 9406 and up to the start of the

[102] Smith Direct at 17-18.
[103] Smith Direct at 18.
[104] *Id.*

evidentiary hearing in this proceeding.[105] Witness Holmes stated that this adjustment will be updated through the hearing as actual expenses from the current proceeding are incurred consistent with Case No. 9406. BGE proposed to amortize these rate expenses over a three-year period, consistent with Case Nos. 9326 and 9406.[106]

In response to Staff Witness Smith's objections to allowing the unamortized balance of rate case expenses in rate base, BGE noted that contrary to Witness Smith's testimony these expenses have been included in the calculation of rate base since the Commission authorized the three year amortization of actual expenses in Case No. 9326. Specifically, BGE made similar adjustments in Case Nos. 9406 (to include Case No. 9355 expenses) and 9355 (to include Case No. 9326 expenses), which no party contested, and alleges that the Commission authorized the uncontested three-year amortization of actual rate case expenses in Case Nos. 9326, 9355, and 9406.[107] BGE Witness Holmes rebutted Witness Smith's recommendation as inconsistent with prior treatment of these costs as well as the appropriate standard for including costs in rate base.[108] BGE asserted that "[t]he standard for inclusion is not whether the cash outlay is extraordinary, but whether the costs were financed by investors. … As these expenses have not yet been fully recovered from customers, the deferred expense should be included in rate base to earn a return so that investors can be compensated for the use of their funds."[109] Therefore, BGE argued that the Commission should reject Staff's proposal.

[105] Holmes Direct at 26-27.
[106] Holmes Direct at 27.
[107] BGE Initial Brief at 24-25.
[108] BGE Initial Brief at 25.
[109] *Id.*

Staff

Staff Witness Smith supported the Company's amortization of the actual rate case expenses over three years, but did not agree with the inclusion of the unamortized balance of rate case expenses in rate base. Staff Witness Smith explained that in Case No. 9406, BGE proposed OIA 20, which only proposed to amortize the related costs over three years, but not require that the unamortized portion be included in rate base and earn a return.[110] Order No. 87591 did not authorize BGE to include the unauthorized balance of rate case expenses in rate base.[111] Witness Smith argued that "rate case costs are not extraordinary and should not earn a return. Thus, Staff proposes that BGE should not be allowed to include the unamortized balance of rate case expenses in rate base."[112]

OPC

OPC acknowledged that BGE correctly reduced operating income to reflect the amortization of rate case expenses incurred after the evidentiary hearing in Case No. 9406 as well as the rate case expenses for the present case which occurred during the test year. These rate case expenses have been amortized over three years in OIA 17. OPC pointed out that "without explanation, the Company included the unamortized amount of $310,000 as deferred rate case expense included in Rate Base."[113] OPC argued that "inclusion of that expense was improper because it is not a recurring expense"[114] and recommended that the Commission accept Staff's adjustment.

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[110] Smith Direct at 14.
[111] *Id.*
[112] *Id.*
[113] OPC Initial Brief at 16.
[114] *Id.*

Commission Decision

The Commission finds that, consistent with precedent, BGE properly adjusted operating income to remove rate case expenses in Case No. 9406 and the current rate case expenses through the hearing. However, the Commission does not accept the inclusion of unamortized post-hearing rate case expenses from Case No. 9406 in rate base, based on the arguments made by Staff and OPC. Post-hearing rate case expenses are not known and measurable for the present case and are not part of the test year in subsequent cases.[115] Further, layered amortizations between rate cases create generational issues; for this case, in particular, including post-hearing 9406 costs in rate base would make customers in years 2019-2021 responsible for costs incurred in 2016. However, the costs for the current rate case through the hearing are known and measurable and should be amortized over three years.

g. Amortize Gains and Losses on Real Estate (RBA 11 & OIA 24)

BGE

In June 2018, just one month prior to the end of the test year for the current proceeding, the Company sold a land parcel and realized a gain of $1.416 million. Witness Holmes in his Supplemental Direct proposed OIA 24 and corresponding RBA 11. OIA 24 amortizes the net gain for ratemaking purposes over a two-year period, as the Commission approved in Case No. 7695. RBA 11 reflects the unamortized portion to the June 2018 gain on the sale of real estate in rate base.

In response to Staff Witness Smith's recommendation to disallow the Company's adjustment of RBA 11 and OIA 24, Witness Holmes in his Rebuttal noted that

[115] *See* re *Potomac Electric Power Company*, 101 Md. P.S.C. 290, 307 (2010).

Witness Smith "does not object to deferring the gain and amortizing it over a two-year period, as a gain on the sale of real estate is not a usual or recurring item."[116] Rather, Witness Smith recommends that the Commission deviate from precedent of commencing the two-year amortization period on the sale date and, instead, amortizing the gain as if it occurred in the first month of the test year.[117] Additionally, Witness Holmes supported his position by pointing out that these adjustments are consistent with the Company's base rate filings in Case Nos. 8487, 9036, 9230, 9299 and 9406 (and as accepted in the respective Commission Order Nos. 70476, 80460, 83907, 85374, and 87591). In those cases, deferred gains and losses included in operating income were amortized over 24 months, commencing on the effective date of the gain or loss.[118]

In these cases, BGE consistently applied the same amortization schedule to real estate sales, regardless of when the 24-month amortization happened to commence. Changing this methodology would be changing precedent. In fact, in Case No. 9406, OPC Witness Effron made a similar proposal to change this precedent of commencing amortization on the effective date of the gain or loss (similar to Staff Witness Smith's recommendation in this case), and the Commission rejected this argument.[119] Furthermore, as noted in Order No. 87591 in Case No. 9406, the Commission held that "when utilities filed adjustments that involved real estate losses, the ratepayers would be disadvantaged."[120] Therefore, BGE argues that Staff Witness Smith's arguments are unpersuasive and should be rejected.

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[116] Holmes Rebuttal at 25.
[117] Holmes Rebuttal at 25.
[118] *Id.*
[119] Holmes Rebuttal at 25-26.
[120] Holmes Rebuttal at 26 *citing* Case No 9406, Order No. 87591 at 104.

Staff

Witness Smith opposed OIA 24 and RBA 11 proposed by BGE. Witness Smith noted that Staff understands that BGE has been amortizing gain and losses included in operating income over 24 months commencing on the effective date gain/loss and that in Case No. 9406, OPC Witness Effron proposed an adjustment similar to Staff's proposal which was rejected by the Commission. Nonetheless, Witness Smith testified that the adjustment in Case No. 9406 is distinguishable from the current case because in Case No. 9406, BGE included *three* months of amortization on the $1,007,212 gain on electric-related real estate in its operating income adjustment (resulting in a reduction of $526,000 to operating income and a $263,000 reduction to rate base) **versus** *one* month of amortization on the $1,416,366 gain in OIA 24 after the sale occurred in June 2018, which was one month prior to the end of the test year of July 2018 (resulting in a reduction of $984,000 to operating income and a $492,000 reduction to rate base), in RBA 11.[121] Witness Smith noted that "if the sale occurred during the last month of the test year, customers would get even a smaller benefit because the gain would not yet have begun to be amortized."[122] "In addition, including only one-month of amortization of the gain in connection with the real estate sale might provide an incentive for utilities to delay the sale of unneeded assets to exclude all or most of the revenue from being reflected in rates in connection with an upcoming rate case."[123] Witness Smith recommended that operating expenses be reduced by one year amortization of the

[121] Smith Surrebuttal at 11.
[122] Smith Surrebuttal at 11-12.
[123] Smith Surrebuttal at 12.

$1.416 million gain, which is equal to $708,000.[124] Alternatively, in its Initial Brief, Staff recommended that if the Commission does not accept Staff's proposal, then it requests that the Commission reduce rate base for the full 23-months of the unamortized gain amount (the terminal amount) of $1.357 million ($984 net of taxes), which is consistent with OIA 24."[125]

Commission Decision

Staff has recommended an alternative approach to the Commission's two-year amortization methodology used when adjusting for real estate gains and losses, primarily because the sale of land in the present case took place only *one* month prior to the end of the test year (in July 2018). Staff acknowledges that a similar real estate gain took place in Case No. 9406; however, in that case the sale occurred *three* months before the end of the test year. BGE correctly points out that its proposed accounting treatment of gains from real estate during the test period is consistent with Commission precedent in past cases. The Commission's precedent permits the amortization of deferred gains and losses included in operating income over 24 months commencing on the effective date of the gain/loss.[126] The Commission in this case will follow its precedent regardless of whether the effective date of the gain/loss occurred at the beginning of the test period or three months before the end of the test period.

The Commission rejects Staff's modification and allows BGE's OIA 24 and RBA 11, which reduces BGE's operating income by $984,000 and rate base by $492,000.

[124] Staff Initial Brief at 29.
[125] Staff Initial Brief at 32.
[126] Holmes Rebuttal at 25-26.

h. Reduction in Federal Corporate Tax Rate (RBA 8)

BGE

The Federal Tax Cuts and Jobs Act of 2017 ("TCJA") implemented a new 21% federal tax rate, which is lower than the prior federal tax rate of 35% on which BGE's existing rates (which were established in Case 9406) are based.[127] In a filing in January 2018, BGE reduced its electric and gas distribution rates on February 1, 2108 to adjust rates reflecting the lower tax rate. The Commission established a regulatory liability for the federal taxes collected during January 2018 that BGE will not be required to pay under the TCJA. This regulatory liability totals $1.7 million for gas distribution customers. BGE Witness Holmes proposed to return the gas portion of the deferred liability for January 2018 to customers by amortizing the established regulatory asset over five years.[128]

Staff

Staff Witness Smith advocated requiring BGE to immediately flow-through the $1.7 million liability as a one-time refund so that customers receive immediate return of the excess tax costs recovered in BGE's rates for January 2018 service.[129] Witness Smith argued that an immediate payback of the tax cut is especially needed for two reasons. First, over the next five years, some January 2018 customers are likely to relocate outside of BGE's service territory. Thus, if the payback is amortized over five years, the ratepayers who relocated would not receive the payback. Second, Staff calculated the

[127] Staff Initial Brief at 32.
[128] Holmes Direct at 22.
[129] Smith Direct at 20.

average refund will be $2.50 per customer, which Staff argues is a negligible amount that should not be amortized over five years.

<u>Commission Decision</u>

In Order No. 88860, the Commission observed that "one of the Commission's goals in addressing TCJA-related savings is to provide the benefits of this federal tax relief initiative to Maryland utility customers as quickly as possible."[130] BGE concedes that both the Staff and Company approaches for handling the January 2018 TCJA regulatory liability treat customers fairly and are reasonable. Therefore, the Commission accepts Staff's adjustment to provide the one-time bill credit to customers.

i. Riverside Environmental Remediation (RBA 6 & OIAs 18, 19)

<u>BGE</u>

Witness Case testified that "[i]n BGE's last base rate case, Case No. 9406, the Company informed the Commission that it was working with the Maryland Department of the Environment ("MDE") to investigate and remediate certain environmental issues at its Riverside site. Riverside was once the location of a natural gas purification plant but is currently used for both electric and gas operations at BGE."[131] In Case 9406, the Commission authorized BGE to establish a deferred charge account for the investigation and remediation costs associated with Riverside as they are actually incurred instead of authorizing the recovery of an accrual based upon an estimate of costs.[132] In the present case, BGE proposed that its actual Riverside investigation and remediation costs be

[130] In the Matter of the Federal Tax Cuts and Jobs Act of 2017 on Maryland Utility Rates, Case No. 9473, Order No. 888530 at 8 (Oct. 5, 2018).
[131] Case Direct at 27.
[132] *Id.*

recovered over ten years, identical to the ratemaking treatment authorized in Case No. 8697 for the environmental costs incurred at the Company's Spring Gardens campus. To date, BGE's actual costs for investigation and remediation at Riverside total approximately $650,000.[133] Thus, BGE seeks in this proceeding to recover $65,000 in annual amortization over ten years.

BGE also proposed that it continue to defer additional investigation and remediation costs in a deferred charge account, as was authorized by the Commission in Case No. 9406.[134] As with the ratemaking treatment for the Spring Gardens costs in Case No. 8697, the Commission would review these costs after they are actually incurred, and the Company would seek to recover—also based on a ten-year amortization—additional tranches of Riverside investigation and remediation costs through a pro forma adjustment in future gas base rate cases.

OPC

Witness Neale observed that BGE's proposed accounting treatment of the remediation costs is the same as was ordered for its Spring Garden environmental costs in Case No. 8697. However, OPC Witness Neale recommended that the Commission reject BGE's Riverside Remediation adjustment, because in Case No. 9406 the Order did not authorize a case-by-case portion of actual expenditures to be recovered from customers. Witness Neale noted that the expenses BGE seeks are not for work that has been completed.[135] Witness Neale claimed the Commission's directive was clear: the intent was to authorize recovery after the accrued funds were spent and the work completed.

[133] Case Direct at 27.
[134] Case Direct at 28.
[135] OPC Initial Brief at 13.

Witness Neale recommended that cost recovery should be considered only after the Riverside investigation is complete, consistent with the Commission's determination in Case No. 9406.[136]

Commission Decision

The Commission finds the Company's request is consistent with the ratemaking treatment for environmental remediation work at the Spring Garden facility. Therefore, the Commission accepts BGE's proposal to amortize its actual costs for environmental remediation over ten years. BGE is also permitted to continue to defer additional investigation and remediation costs in a deferred charge account, as previously authorized by the Commission in Case No. 9406.

j. Gas Meter Mitigation

Background

On September 23, 2015 an explosion occurred in the garage of a townhouse on Sleepy Horse Lane in Columbia, Maryland.[137] According to the Commission's Engineering Division's investigation, the homeowner damaged the natural gas piping while backing her car out of the garage. The homeowner indicated that the car door was open when the damage occurred, and she did not stop to check to see what was struck. As a result of the damage to the gas piping, natural gas leaked from the piping, filling the garage with gas and resulting in an explosion.[138]

[136] OPC Initial Brief at 13.
[137] Acosta Direct at 18.
[138] *Id. See also* Staff Exhibit 6.

The Commission's Engineering Division concluded that BGE failed to follow federal pipeline safety regulations and its own Gas Distribution Standards regarding meter location and protection against vehicular and other damages.[139] Staff issued a Notice of Probable Violation ("NOPV") citing two federal regulations under Title 49 of the Code of Federal Regulations: 49 CFR 192.13 (c) – General and 49 CFR 192.353 (a) and (c).

> **<u>49 CFR 192.13 (c) – General</u>**
>
> Each operator shall maintain, modify as appropriate, and follow the plans, procedures, and programs that it is required to establish under this part;
>
> **<u>49 CFR 192.353 (a) and (c) Customer Meters and Regulators: Location</u>**
>
> (a) Each meter and service regulator, whether inside or outside a building, must be installed in a readily accessible location and be protected from corrosion and other damage that may be anticipated. However, the upstream regulator in a series may be buried.
>
> (c) Each meter installed within a building must be located in a ventilated place and not less than 3 feet (914 millimeters) from any source of ignition or any source of heat which might damage the meter.

As a result of these probable violations the NOPV made three requests of BGE: 1) identify and protect its meters located inside garages over a five-year period in conjunction with its leak survey program; 2) provide protection for the remaining meters in the affected subdivision within 120 days; and 3) file a methodology to ensure new and renovated meters are installed with vehicular protection within 30 days.[140] In addition, BGE would pay a $25,000 civil penalty.[141] In response, BGE elected to accept the

[139] Acosta Direct at 18.
[140] Staff Exhibit 6.
[141] *Id*.

conditions outlined in the NOPV and pay the civil penalty, but did not admit to the alleged violations.[142]

<u>BGE</u>

To satisfy the conditions of the NOPV, BGE initiated a meter protection and relocation program. The BGE Gas Meter Relocation and Protection Program is focused on the relocation of gas meters from inside garages to the outdoors and the installation of concrete-filled bollards to protect the gas meters.[143] In this case, BGE seeks to recover $16,031,443 in capital costs and $656,013 in O&M costs for a combined total of $16,687,456 associated with the program.

BGE argued that the Commission should grant full recovery of the Gas Meter Relocation and Protection Program because it significantly benefits customers and the public by enhancing the safety and reliability of BGE's gas delivery system.[144] BGE asserted that the initial indoor meter locations were compliant with federal law at that time, consistent with long-standing industry practice, and BGE reasonably concluded that moving these particular meters outdoors now advanced the best interests of its customers by making the meters in question more accessible to BGE and first responders. BGE further stated that the move is consistent with BGE's current preference for outdoor meter locations.[145]

While the Company believes that relocating the meters enhances safety and accessibility, Company Witness Burton testified that, legally, BGE was, and currently is, following federal pipeline safety regulations. Specifically, Witness Burton noted that "in

[142] Staff Exhibit 7.
[143] Acosta Direct at 17.
[144] BGE Initial Brief at 10.
[145] *Id.*

1994 when the gas meter was installed within the garage at the affected home, 49 CFR 192.353 stated that meters 'whether inside or outside a building must be installed in a readily accessible location and be protected from corrosion and other damage.'"[146] He also noted that in 2013, the regulation was modified to include that meters "be protected from corrosion and other damage, including if installed outside a building, vehicular damage that may be anticipated." Witness Burton pointed out that "it is important to note that regardless of the version, the code does not contemplate protection of inside meters against vehicular damages."[147] Thus, BGE argued that it has always been and continues to follow applicable federal regulations regarding gas meter placement.

In reference to this single incident, Staff contends that BGE violated the requirements that a meter be (1) located in a ventilated space, (2) protected from "other damage," and (3) located not less than 3 feet from any source of heat which might damage the meter.[148] Staff conceded that if the Commission finds BGE in compliance with these three regulatory requirements, full cost recovery of the Gas Meter Relocation and Protection Program would be appropriate.[149] Company Witness Huriaux offered testimony to support the industry definition of ventilated space and explained that "[f]or purposes of pipeline safety regulation, garages and basements are considered ventilated spaces. … Within the meaning of regulation and the history of pipeline safety, [a garage] is a ventilated space."[150]

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[146] Burton Rebuttal at 6.
[147] *Id.*
[148] BGE Initial Brief at 12.
[149] Tr.541:18 to 542:1 (Acosta).
[150] Tr. 81:9-11, 102:15-17, and 106:3-5 (Huriaux).

Regarding the requirement that a meter be located not less than three feet from any source of heat which might damage the meter, Staff argued that the meter was located less than three feet from an ignition source because the car was parked in the garage. Witness Huriaux asserted that Staff's argument is misplaced because a car is not considered an ignition source, rather the regulations were referring to fixed ignition sources, i.e., hot water heater or space heater. Witness Huriaux testified that "a car is not considered an ignition source within the meaning of regulation. Sources of ignition are considered to be fixed sources within the building. Not a vehicle."[151]

BGE also notes that the federal regulations provides that the gas meter located inside a building be protected from corrosion and other damage. *See* 49 CFR 192.353(a). Company Witness Huriaux testified that "the common understanding in the industry is that protection is not required for any imaginable damage, but rather for damage that is anticipatable."[152] Staff claims that BGE did not adequately protect the meter at issue in the incident because the "wing wall"[153] in the garage was not sufficient to protect the meter.[154] BGE countered and testified that the wing wall was sufficient because the meter was effectively behind it, ensuring that a car driving into the garage or backing out would not ordinarily strike the meter.[155]

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[151] Tr.76:21 to 77:2 (Huriaux).

[152] Tr.99:8-15 (Huriaux) (explaining that protection from damage does not mean protection from all damage, but rather means protection from reasonably anticipatable damage).

[153] In this case, the wing wall is the small wall framing the sides of a garage or other doorway.

[154] BGE Initial Brief at 16.

[155] Tr.97:14-19 (Huriaux)

The Company argued that Staff's cost disallowance recommendation would impose an unjust, unfair, and arbitrary penalty upon BGE for reasonable actions taken to enhance and update the safety and reliability of the gas system.[156]

Staff

Witness Acosta recommended that BGE not be allowed to recover a portion of the expenses related to the Gas Meter Relocation and Protection Program because these expenses resulted from the Company's failure to comply with the federal pipeline safety regulations that were in place at the time the houses were constructed and the meters were installed by the Company.[157] BGE argued that these expenses should be granted full recovery by the Commission because the Company was directed by the Commission's Engineering Division to "identify and protect its meters located inside garages that are susceptible to vehicular and other damages and to ensure that every new and renovated gas meter, inside and outside of buildings is installed with appropriate protection against vehicular and other damages in accordance with 49 CFR 192.353."[158]

Witness Acosta recommended that the Commission grant 100% recovery for materials used under the program but only 50% recovery for direct labor for relocation and/or to provide protection for the meters and 50% recovery for direct costs for oversight of the program.[159] Witness Acosta argued that the percentages that he recommends for disallowance are reasonable because the program benefits customers and his proposed partial recovery would alleviate the expenses BGE is incurring to keep its

[156] BGE Initial Brief at 10-11.
[157] Acosta Direct at 21.
[158] Acosta Direct at 20.
[159] Acosta Direct at 21.

system safe and to remediate its lack of compliance.[160] Witness Acosta noted that since a portion of BGE's direct labor and program oversight would have been recoverable were the meters installed properly the first time, it is appropriate for the Company to recover only a portion of these costs.[161]

Staff also supported its position to disallow full recovery by pointing out that BGE agreed to a proposed compliance order and proposed civil penalty, issued along with the NOPV on February 24, 2016. Staff asserts that BGE agreed to the facts in the proposed compliance order and agreed to pay a civil penalty.

OPC

OPC Witness Neale stated in his Rebuttal testimony that he agreed with Staff's recommendation that the Company should be denied recovery of the capital costs associated with the Gas Meter Relocation and Protection Program; however, he initially disagreed with Mr. Acosta's proposed methodology.[162] Initially, Witness Neale proposed "an adjustment be made to the allowed rate of return for the duration of the five-year program or until all the identified meters and bollards have been addressed and approved for compliance in the next full rate case, whichever came first, provided the Company remains compliant with all other Federal and State safety programs."[163] Witness Neale argued that this method would have the benefit of tying a penalty to BGE's performance under the agreed upon Gas Meter Relocation and Protection Program, "while assuring that this goal is not reached at the expense of all other gas safety and reliability

[160] Acosta Direct at 21.
[161] Acosta Direct at 21-22.
[162] Neale Rebuttal at 6.
[163] *Id.*

objectives."[164] Witness Neale recommended a reduction of 20 basis points in the allowed rate of return.[165] In its Initial Brief, OPC ultimately agreed with Staff's Witness Acosta's recommendation.

Commission Decision

This is the first time any matter associated with the explosion at Sleepy Horse Lane in Columbia has been before the Commission. While evidence was presented regarding the explosion, the purpose of this hearing was not to determine whether BGE was or was not in compliance with the federal regulations. At this time, the Commission does not believe it necessary to decide the legal issue.

What the Commission has before it, is whether costs associated with the program that was initiated by the Commission's Engineering Division should be recovered in rates. BGE responded to an event and is in the process of moving meters outside of garages and installing barriers to the meters to protect them from being struck by vehicles. This is a safety program that the Commission's Engineering Division agrees is appropriate.[166] The Commission will not disallow these expenses that have been incurred. Therefore, Staff's adjustment is not accepted.

The Commission further notes that there is a potential conflict in this situation. If the program is mandatory in order for BGE to be in compliance with Pipeline and Hazardous Material Safety Administration regulations as Staff asserts, then BGE must be prepared to demonstrate why its shareholders should benefit from recovery "on" these capital expenditures. If, as BGE contends, it is in compliance with the federal

[164] Neale Rebuttal at 6.
[165] Neale Rebuttal at 8.
[166] *See* Staff Exhibit 6.

regulations, and always has been and the existing indoor garage configuration is and always has been consistent with the regulations, then BGE should be prepared to demonstrate that the costs associated with the program are prudent costs that all customers should bear, and customers should be compelled to participate in the program.

Therefore, the Commission grants BGE's requests to recover the Gas Meter Relocation and Protection Program expenses included in the instant case. However, BGE is directed to create a regulatory asset for the remaining costs of the Gas Meter Relocation and Protection Program and when that program is complete and BGE seeks to move those costs into rates, the Company shall demonstrate that such costs were prudently incurred.

B. Cost of Capital

The cost of capital is the rate of return ("ROR") that a utility must pay to investors in its common stock (equity) and bonds (debt) to attract and retain investment in a competitive market. The utility recovers its return on equity ("ROE") and return on debt through charges paid by its ratepayers. While the return on debt can be directly observed, as bonds are issued subject to specific interest rates, the ROE requires more analysis, as it is typically estimated based on market conditions and different analytical approaches. Once the return on debt and ROE are determined, they are weighted according to the percentage of debt and equity in the utility's capital structures. The sum of the weighted return on debt and ROE is the utility's overall ROR.

Although BGE is a subsidiary of Exelon and thus its stock is not publicly traded, the Commission must still examine BGE's level of risk and its financial capital structure to determine its cost of capital. In doing so, the Commission looks to the analyses of the parties comparing BGE to companies deemed comparable.

1. <u>Return on Equity</u>

<u>Parties' Initial Positions</u>

<u>*BGE*</u>

Witness McKenzie performed several quantitative analyses to estimate the cost of equity: the discounted cash flow model ("DCF"), the Capital Asset Pricing Model ("CAPM"), and the empirical form of Capital Asset Pricing Model ("ECAPM"), an equity risk premium approach based on allowed equity returns and reference to expected earned rates of return for gas utilities.[167] Witness McKenzie also considered the current financial market, stock flotation expenses, and attrition,[168] and reviewed his quantitative analyses by applying the DCF model to a select group of low-risk non-utility firms.[169]

In his analysis of the current financial markets, Witness McKenzie testified that the markets continue to be affected by the Federal Reserve's unprecedented monetary policy actions, which were designed to push interest rates to historically and artificially low levels in an effort to stimulate the economy and bolster employment.[170] He further stated that investors have encountered renewed volatility due to uncertainties surrounding an expanding economy, price pressures and wage gains, the fiscal stimulus of the TCJA, and the Trump Administration's tariff policies.[171] According to Witness McKenzie, current market conditions are not representative of what investors and economic

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[167] McKenzie Direct at 2.
[168] McKenzie Direct at 2 and 3.
[169] McKenzie Direct at 3.
[170] McKenzie Direct at 15.
[171] *Id.*

forecasting services expect in the future, which is for interest rates to increase significantly from present levels.[172]

In order to develop a range of reasonableness for BGE's ROE, Witness McKenzie performed a quantitative analysis on a sampling of publicly traded companies that investors regard as risk-comparable to BGE, otherwise referred to as the proxy group.[173] This proxy group was compiled of nine publicly traded firms in Value Line's Natural Gas Utility industry group.[174] Witness McKenzie testified that BGE's adjustment mechanisms and cost trackers, such as the Company's STRIDE surcharge, had become increasingly prevalent in the utility industry in recent years and were comparable to those in his proxy group.[175]

Witness McKenzie applied the DCF model using his proxy group to estimate the ROE for BGE's gas operations. The DCF model is based on the assumption that the price of a share of common stock is equal to the present value of the expected cash flows (*i.e.*, future dividends and stock price) that will be received while holding the stock, discounted at investors' required rate of return.[176] Witness McKenzie specifically used the constant growth DCF model, which he asserted "provides a workable and practical approach to estimate investors' required return that is widely referenced in utility ratemaking."[177] Witness McKenzie explained that implementing the DCF model involves determining an expected dividend yield, estimating investors' long-term growth expectations, then adding the two figures together to find an estimate of the cost of

172 McKenzie Direct at 18, 20, and 21.
173 McKenzie Direct at 6 and 7.
174 McKenzie Direct at 7.
175 McKenzie Direct at 10 and 11.
176 McKenzie Direct at 27.
177 *Id*.

common equity.[178] Witness McKenzie stated that resulting estimates that are implausibly low or high should be eliminated so as to pass fundamental tests of reasonableness and economic logic.[179] After eliminating values he deemed illogical, Witness McKenzie's constant growth DCF model produced an ROE range of 8.6% to 10.8% for BGE's gas operations.[180]

Witness McKenzie also evaluated BGE's common equity requirements through the CAPM and ECAPM models. The CAPM model is a theory of market equilibrium that measures risk using the beta coefficient, with beta reflecting the tendency of a stock's price to follow changes in the market.[181] Like the DCF model, the CAPM is a forward-looking model based on expectations of the future.[182] Witness McKenzie utilized current bond yields as published by Value Line and found the ROE for his proxy group to be 9.9%.[183] After applying a size adjustment "because differences in investors' required rates of return that are related to firm size are not fully captured by beta,"[184] the adjusted ROE for the proxy group was 11.4%. Witness McKenzie also applied the CAPM using forecasted bond yields, which implied an unadjusted ROE of 10.3% and a size-adjusted ROE of 11.7%.[185]

Witness McKenzie testified that the CAPM model, which forms the foundation of the ECAPM,[186] tends to overstate the actual sensitivity of the cost of capital to beta, with low-beta stocks tending to have higher returns and high-beta stocks tending to have lower

[178] McKenzie Direct at 28.
[179] McKenzie Direct at 34 and 35.
[180] McKenzie Direct at 39.
[181] McKenzie Direct at 39 and 40.
[182] McKenzie Direct at 40.
[183] McKenzie Direct at 40 and 43.
[184] McKenzie Direct at 41 and 43.
[185] McKenzie Direct at 43.
[186] McKenzie Direct at 40.

risk returns than predicted by the CAPM. Witness McKenzie explained that this implies that cost of equity estimates based on the traditional CAPM would understate the cost of equity.[187] As such, the ECAPM employs weighting factors to correct for understated returns that would otherwise be produced for low-beta stocks.[188] Witness McKenzie's application of the ECAPM model implied an unadjusted ROE of 10.7% and a size-adjusted ROE of 12.1%.[189]

Witness McKenzie also utilized a utility risk premium approach to estimate BGE's common equity requirements. Under this approach, the ROE is "estimated by determining the additional return investors would require to forgo the relative safety of bonds and to bear the greater risks associated with common stock, then adding this equity risk premium to the current yield on bonds."[190] Unlike the DCF model, which indirectly imputes the ROE, risk premium methods directly estimate investors' required rate of return by adding an equity risk premium to observable bond yields.[191] Witness McKenzie's risk premium approach produced an ROE of 10.33%.[192]

Witness McKenzie also performed an expected earnings analysis to estimate the ROE. This method considers rates of return available from alternative investments of comparable risk and, Witness McKenzie testified, "Avoids the complexities and limitations of capital market methods and instead focuses on the returns earned on book

[187] McKenzie Direct at 44.
[188] McKenzie Direct at 45.
[189] McKenzie Direct at 47.
[190] McKenzie Direct at 47.
[191] *Id.*
[192] McKenzie Direct at 51.

equity, which are readily available to investors."[193] This analysis produced an average ROE of 11.0%, with a midpoint of 11.6%.[194]

Witness McKenzie also recommended that the Commission make an ROE adjustment based on flotation costs. When equity is raised through the sale of common stock, there are costs associated with "floating" the new equity securities. Witness McKenzie explained, "These flotation costs include services such as legal, accounting, and printing, as well as the fees and discounts paid to compensate brokers for selling the stock to the public."[195] Witness McKenzie observed that, while debt flotation costs are recorded on the books of the utility and amortized over the life of the issue, equity issuance costs are not.[196] He further alleged that, "Unless some provision is made to recognize these issuance costs, a utility's revenue requirements will not fully reflect all of the costs incurred for the use of investors' funds."[197] Witness McKenzie's ROE recommendations include a ten basis point adjustment for flotation costs.[198]

Finally, Witness McKenzie performed a DCF analysis on a select group of low-risk, non-utility firms. McKenzie testified that the non-utility DCF analysis is relevant when considering an appropriate ROE for BGE as, "Utilities must compete for capital, not just against firms in their own industry, but with other investment opportunities of comparable risk."[199] Witness McKenzie did not directly consider the analysis when

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[193] McKenzie Direct at 51.
[194] McKenzie Direct at 52.
[195] McKenzie Direct at 53.
[196] McKenzie Direct at 54.
[197] *Id*.
[198] McKenzie Direct at 57.
[199] McKenzie Direct at 59.

formulating his recommended ROE, but rather looked to the analysis for confirmation of the reasonableness of his recommendation.[200]

Witness McKenzie also testified about the risks of attrition,[201] which he defined as the "shortfall between a utility's actual return and the allowed return approved by regulators."[202] Witness McKenzie explained that attrition occurs when the assumptions regarding sales, costs, and rate base that are used to establish rates do not produce revenues that reflect the actual costs incurred to serve customers during the period that rates are in effect.[203] He characterized attrition as a constant issue for BGE and noted its consideration by investors when performing risk evaluations.[204] McKenzie argued that utility rates should be set at a level that considers the impact of attrition and allows a utility the opportunity to actually earn its authorized ROE.[205] He proposed setting the ROE at a higher level to offset the attrition,[206] specifically recommending that the Commission add 20 basis points to BGE's base ROE for this purpose.[207]

Witness McKenzie recommended a base ROE range for BGE of 9.6% to 10.9%, with a midpoint of 10.3%. To address the impact of attrition, he made the upward adjustment of 20 basis points to the midpoint, arriving at a recommended ROE of 10.5% for BGE's gas utility operations.[208]

[200] McKenzie Direct at 59.
[201] Attrition is referred to as "regulatory lag" by BGE. McKenzie Direct at 3.
[202] McKenzie Direct at 11.
[203] McKenzie Direct at 11.
[204] McKenzie Direct at 11 and 12. BGE Witness Case testified, "Even with the implementation of the STRIDE cost recovery mechanism, BGE has not achieved and is not projected to achieve the Commission-authorized ROE for its gas operations in any quarter since January 2014." Case Direct at 22 and 23.
[205] McKenzie Direct at 13.
[206] *Id.*
[207] McKenzie Direct at 13 and 14.
[208] McKenzie Direct at 3.

Staff

Witness Suckling calculated her recommended ROE using the traditional DCF and CAPM analyses.[209] Witness. Suckling adopted a similar proxy group to that used by Witness McKenzie in estimating the Company's ROE. She removed three of the nine companies used by Witness McKenzie, but retained the other six to form her proxy group.[210]

Witness Suckling explained in her written testimony that, under the DCF method, the ROE is equal to the sum of the expected dividend yield and the expected growth rate of future dividends.[211] To determine the expected growth rate for each company in her proxy group, Witness Suckling averaged the forecasted dividends per share, earnings per share, and cash flow per share as provided by Value Line.[212] She then averaged all of the proxy group companies' ROEs to arrive at an ROE of 9.46% for the DCF analysis.[213]

Witness Suckling also conducted a CAPM analysis, which she explained is predicated on the fact that common equity is riskier than debt to the investor; thus investors should be rewarded with a higher return for taking on the added risk associated with equity.[214] As such, the CAPM starts with a risk-free rate but adds on a risk premium to determine the expected return on equity of a company.[215] Witness Suckling testified that she did not believe the size adjustment made by Witness McKenzie in his CAPM analysis was necessary, given that the beta coefficient has a size adjustment embedded in

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[209] Suckling Direct at 10.
[210] Suckling Direct at 11.
[211] Suckling Direct at 13.
[212] *Id.*
[213] Suckling Direct at 14.
[214] Suckling Direct at 15.
[215] *Id.*

its use.[216] Based on her CAPM analysis, Witness Suckling arrived at an ROE of 10.11%.[217]

An ECAPM analysis was not performed by Witness Suckling, and she further stated that it was unnecessary for Witness McKenzie to do so because Value Line betas are adjusted, and by adjusting the betas again, the methodology will likely over-estimate the ROE result.[218] Witness Suckling also chose to not employ a risk premium method similar to Witness McKenzie's. "Authorized returns from a diverse group of Commissions often reflects issues specific to a particular utility, geographical area, or regulatory environment," thereby making previously awarded ROEs a poor proxy.[219]

With regard to Witness McKenzie's proposed upward adjustment for flotation costs, Witness Suckling recommended against it. In support of her position, Witness Suckling testified that BGE did not present evidence that it has incurred flotation costs.[220]

Witness Alvarado recommended that the Commission deny Witness McKenzie's adjustment for attrition.[221] Witness Alvarado testified that attrition is essential to the regulatory process, and while "the presence of inordinately high regulatory lag should be addressed, the mere presence of regulatory lag is not a problem that needs to be solved."[222] As support for his recommendation to the Commission, Witness Alvarado testified that BGE provided no evidence that the attrition it faces is inconsistent with the

[216] Suckling Direct at 18.
[217] Suckling Direct at 16.
[218] Suckling Direct at 19.
[219] Suckling Direct at 19 and 20.
[220] Suckling Direct at 20.
[221] Alvarado Direct at 4.
[222] Alvarado Direct at 8.

purpose of regulatory lag, inordinately high, or different from the regulatory lag faced by its peers.[223]

Witness Suckling recommended an ROE for BGE of 9.65%, which is equal to the average of her DCF and CAPM ROEs, with a downward adjustment to account for the risk reducing effect of BGE's STRIDE program.[224] She explained that, under STRIDE, BGE is allowed to accelerate cost recovery related to certain gas infrastructure investments, thereby reducing the Company's risk by improving cash flow as well as the safety of aging infrastructure.[225] Witness Suckling acknowledged that attributing an exact value to the impact of the risk reduction is difficult, and explained that her recommended ROE of 9.65% is equal to the first quartile of her range of reasonableness, rounded up to the nearest 0.05.[226]

OPC

Witness O'Donnell calculated his recommended ROE using the traditional DCF and CAPM analyses, as well as the Comparable Earnings Model.[227] Witness O'Donnell testified that he believes the most useful method is the DCF, but that the CAPM and Comparable Earnings Methods were performed as checks for his DCF results.[228] Witness O'Donnell adopted a similar proxy group to that used by Witness McKenzie in estimating the Company's ROE, only removing one of the nine companies used in Witness McKenzie's proxy group.[229]

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[223] Alvarado Direct at 13.
[224] Suckling Direct at 17.
[225] *Id.*
[226] Suckling Direct at 17.
[227] O'Donnell Direct at 14.
[228] *Id.*
[229] O'Donnell Direct at 13 and 14.

In performing the DCF analysis, Witness O'Donnell used several methods to determine the growth in dividends that investors expect.[230] Data used in Witness O'Donnell's DCF analysis included historical and forecasted growth in earnings, dividends, and book value.[231] He disagreed with Witness McKenzie's use of only forecasted earnings growth values, stating that doing so produces unrealistically high ROE numbers that cannot be sustained.[232] Witness O'Donnell's DCF analysis produced an ROE range of 8.0% to 9.0%.[233]

Witness O'Donnell also performed the CAPM analysis, but testified that he does not give the method much weight, as he has "[l]ong maintained the application of the CAPM can lead one to erroneous results when applied in an inaccurate manner, such as when 'forecasted' risk premiums or 'forecasted' interest rates are employed."[234] O'Donnell testified that McKenzie utilized "widely overblown market forecasts" in his CAPM and ECAPM analyses,[235] and inappropriately applied a size adjustment to the analyses, as well.[236] To further his point, Witness O'Donnell noted that, even without the size adjustment, Witness McKenzie's CAPM analysis produced an ROE range of 9.8% to 10.3%.[237] The results of Witness O'Donnell's CAPM analysis produced an ROE range of 5.5% to 7.6%.[238]

Witness O'Donnell also performed the Comparable Earnings Method, which he explained as involving an analysis of the returns on investments in other enterprises

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[230] O'Donnell Direct at 20.
[231] O'Donnell Direct at 48.
[232] O'Donnell Direct at 24.
[233] O'Donnell Direct at 25.
[234] O'Donnell Direct at 28.
[235] O'Donnell Direct at 47.
[236] O'Donnell Direct at 51.
[237] *Id.*
[238] O'Donnell Direct at 32.

having corresponding risks to that of BGE.[239] In performing the analysis, Witness O'Donnell reviewed the earned ROEs of a comparable group of gas utilities and Exelon over the period of 2016 through 2023 to provide the Commission with at least two historical returns and five years of forecasted returns.[240] Unlike Witness McKenzie, Witness O'Donnell did not use a non-regulated utility group. Witness O'Donnell explained, "Non-regulated companies are not truly comparable to BGE as none of those companies have the ability to seek regulatory relief as does BGE," thus they should not be examined in regard to the proper ROE to grant a regulated utility.[241] Witness O'Donnell's Comparable Earnings Method produced an ROE range of 9.0% to 10.0%.[242]

With regard to Witness McKenzie's proposed upward adjustment for flotation costs, Witness O'Donnell recommended against it. In support of his position, Witness O'Donnell testified that Witness McKenzie's adjustment would add approximately $1 million to the revenue requirements in this matter, which Witness O'Donnell considers to be a very large expense for legal, accounting, printing, and banking fees.[243] OPC Witness Neale recommended that the Commission deny Witness McKenzie's adjustment for attrition. Witness Neale testified that BGE is not unduly subject to regulatory lag,[244] but is well-insulated from risk due to several riders in

[239] O'Donnell Direct at 13.
[240] O'Donnell Direct at 25.
[241] O'Donnell Direct at 16.
[242] O'Donnell Direct at 28.
[243] O'Donnell Direct at 53.
[244] O'Donnell Direct at 9.

its tariff, including Rider 8, the Company's decoupling mechanism, and Rider 16, which allows recovery of future STRIDE investments.[245]

Witness O'Donnell recommended an ROE for BGE of 9.00%, which is at the upper range of his DCF results, is slightly lower than the range for the Comparable Earnings Method, and is well-above the CAPM results.[246] Witness O'Donnell testified that his recommendation was intended to reflect the strength of the stock market over the past two years, interest rates which have remained low relative to historic levels, and the fact that utility stock prices have soared in the past five years.[247]

Parties' Responses

BGE

Witness McKenzie submitted rebuttal testimony addressing what he characterized as a "downward bias" in Staff and OPC's capital structure, ROE, and ROR recommendations. Among the reasons given by Witness McKenzie as to why the recommendations were flawed was that Witness O'Donnell's ROE recommendation is below the reasonable range for BGE's gas operations, 65 basis points lower than the ROE currently allowed for BGE's gas utility operations,[248] and 65-80 basis points less than Staff's recommended ROE.[249] Witness McKenzie further took issue with the manner in which Witness O'Donnell performed his DCF, Comparable Earnings, and CAPM analyses, including, but not limited to, his use of historical rates of return.[250]

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[245] O'Donnell Direct at 24.
[246] O'Donnell Direct at 33.
[247] O'Donnell Direct at 33 and 34.
[248] McKenzie Rebuttal at 2.
[249] McKenzie Rebuttal at 3.
[250] McKenzie Rebuttal at 43, 47, and 49.

In response to Staff's ROE recommendation, Witness McKenzie noted Witness. Suckling's recognition that "current economic conditions have resulted in interest rates that are unusually low," and her consequent selection of a risk-free rate for her CAPM analysis. In response, Witness McKenzie argued that "Staff clearly recognizes that investors anticipate a substantial increase in future interest rates," and that Staff should have considered these expectations in evaluating a fair ROE for BGE.[251] Witness McKenzie also alleged that Ms. Suckling provided no evidence in support of her STRIDE adjustment,[252] and that she erred by failing to conduct an ECAPM analysis[253] and by removing three companies from his proxy group when conducting her analyses.[254] In response to Witness Alvarado's dismissal of BGE's proposed adjustment for attrition, Witness McKenzie agreed that BGE has regulatory mechanisms in place to address the impact of attrition yet, despite the mechanisms, BGE has been unable to earn its Commission-approved return.[255]

Staff

Staff Witness Alvarado filed surrebuttal testimony in response to the rebuttal testimony of BGE and OPC. In his testimony, Witness Alvarado adopted Witness Suckling's direct testimony as his own.[256] Witness Alvarado reiterated Staff's position that there is no evidence on the record that the regulatory lag faced by BGE is inconsistent with the purpose of regulatory lag, inordinately high, or different from the

[251] McKenzie Rebuttal at 15.
[252] McKenzie Rebuttal at 22.
[253] McKenzie Rebuttal at 33.
[254] McKenzie Rebuttal at 24.
[255] McKenzie Rebuttal at 63.
[256] Alvarado Surrebuttal at 3.

regulatory lag faced by its peers.[257] Witness Alvarado stated, "Other than the allowed and earned ROR since the last base rate case, [BGE] offers no robust data or rigorous empirical evidence" in support of its requested relief from regulatory lag.[258] Witness Alvarado also reaffirmed Staff's recommended ROE of 9.65%.[259]

In response to Witness McKenzie's characterization of Staff's STRIDE adjustment as a "penalty," Witness Alvarado reiterated Staff's position that, for various reasons, STRIDE reduces BGE's risk, but also noted that "Staff's recommended ROE takes into account STRIDE but cannot be construed to incorporate a specific reduction in the calculated ROE."[260] Witness Alvarado testified that STRIDE was one of many factors to demonstrate the reasonableness of his ROE recommendation, and that, even if BGE did not have a STRIDE mechanism, a 9.65% ROE as recommended by Staff would be reasonable.[261]

In its Initial Brief, Staff defended its proxy group and its decision to eliminate three utilities from the proxy group used by BGE. Specifically, Staff excluded Chesapeake Utilities Corporation because only 50% of Chesapeake's revenues in 2017 came from its regulated gas distribution service, and one of Staff's criteria for Proxy Group selection is that a company's regulated gas operations must equal or exceed 60% of the company's consolidated revenues.[262] Staff also excluded One Gas, Inc. because that utility was founded in 2014 and thus does not have five continuous years of financial

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[257] Alvarado Surrebuttal at 4.
[258] Alvarado Surrebuttal at 7.
[259] *Id.*
[260] Alvarado Surrebuttal at 10.
[261] *Id.*
[262] Staff Initial Brief at 12.

data available for review.[263] Finally, Staff excluded NiSource, Inc. for various reasons, including an unreasonably high DCF calculation and that its financial strength and beta are significantly lower than others in the proxy group.[264]

Staff noted that it utilized two equity return methods, the DCF and the CAPM, to develop its recommended ROE, and relied on the average of the two methods to arrive at its recommended ROE of 9.65%.[265] Staff pointed out that, as part of its DCF analysis, it considered actual growth by looking at a three-year historical period as well as forecasted growth for the three-year future period.[266] Conversely, BGE only considered the future growth component.[267] As a result, Staff contended that BGE's DCF analysis is flawed due to its failure to consider historical growth, which provides useful, known data pertaining to dividends, earnings, and cash flow, which are all factors considered by investors when evaluating a stock.[268] Similarly, when calculating the stock price component of the dividend yield portion within the DCF, Staff relied on stock prices for a 90-day period whereas BGE looked only to a 30-day period.[269] Staff contended BGE's analysis is thus performed using a much smaller window of data, thereby failing to capture the unpredictable nature of stock prices.

Staff took similar issue with BGE's CAPM analysis. For the market return component of the analysis, Staff used a historical market return, whereas BGE relied on a

[263] Staff Initial Brief at 12.
[264] Staff Initial Brief at 12 and 13.
[265] Staff Initial Brief at 13.
[266] Staff Initial Brief at 15.
[267] Staff Initial Brief at 15.
[268] Staff Initial Brief at 15 and 17.
[269] Staff Initial Brief at 19.

forecasted market return.[270] Again, Staff considered certain data whereas BGE's data can be considered speculative.[271]

In its Reply Brief, Staff took issue with BGE's use of a non-utility proxy group. Specifically, BGE applied the DCF equity return method to a proxy group of gas utilities, but also to a proxy group of non-utilities, as well.[272] BGE defended its application to non-utilities, stating, "[u]tilities must compete for capital, not just against firms in their own industry, but with other investment opportunities of comparable risk."[273] BGE contended that it is inappropriate for BGE to rely on non-utilities in its analysis, noting, "Unlike a company in a competitive industry, a utility faces no competitive risks, and enjoys significant protection from under-recovery of costs."[274]

Staff also reiterated its position against BGE's requested flotation adjustment. Flotation costs include legal, accounting, and printing services incurred in connection with the issuance of new stock, as well as fees and discounts paid to compensate brokers for selling stock to the public.[275] Staff pointed out that BGE concedes it does not issue stock and that the most recent stock issued by BGE's parent company was in 2014.[276] Staff also noted that BGE did not claim that there would be an upcoming stock issuance during the Rate Effective Period (calendar year 2019).[277] Given BGE's failure to provide evidence of costs associated with the issuance of stock, Staff asserted that the Commission must deny BGE's request for a flotation adjustment.

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270 Staff Initial Brief at 21.
271 *Id.*
272 Staff Reply Brief at 3.
273 McKenzie Direct at 59.
274 Staff Reply Brief at 3.
275 Staff Reply Brief at 6.
276 *Id.*
277 *Id.*

OPC

In its Initial Brief, OPC noted that, unlike Witness McKenzie, Witness O'Donnell did not use a non-regulated company proxy group, "as none of those companies have the ability to seek regulatory relief as does BGE."[278] OPC argued that such proxy group is not truly comparable to BGE and should not be included in determining an appropriate ROE for BGE.

OPC's Initial Brief took issue with elements of BGE's ROE analysis. Specifically, while both parties performed a DCF analysis, Witness McKenzie used only forecasted earnings growth values, whereas Witness O'Donnell used a broader array of data that includes historical and forecasted growth in earnings, dividends, and book value.[279] As to the CAPM analysis, Witness McKenzie's conclusion regarding market returns in the foreseeable future was far in excess of what other analysts are predicting.[280] Witness McKenzie further included a "size adjustment" to his CAPM results, which Witness O'Donnell testified served no purpose other than to increase the resulting ROE.[281]

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[278] OPC Initial Brief at 29.
[279] OPC Initial Brief at 33.
[280] *Id.*
[281] OPC Initial Brief at 34.

Commission Decision

A public utility must charge just and reasonable rates for the regulated services that it provides.[282] Pursuant to regulatory principles, these regulated utilities are allowed the opportunity to recover the costs of prudently incurred debt financing and to earn a return on equity financing. As testified to by all parties, long-standing Supreme Court opinions, primarily *Bluefield*[283] and *Hope Natural Gas,*[284] established a standard by which the Commission is to consider certain relevant factors when determining whether to allow a change in a utility's rates so as to allow the recovery of financing costs. In a proceeding involving a change in rate, the burden of proof is on the proponent of the change. Thus, in the instant matter, BGE bears the burden to support every element of its request for a rate increase.[285]

The parties in this rate proceeding have used a variety of models, methodologies, and assumptions to calculate BGE's ROE. Given that the cost of equity cannot be observed directly, we must carefully consider both our traditional methods and novel approaches, when justified. As a preliminary matter, certain aspects of the ROE analyses in this matter will receive little consideration by the Commission. For example, Witness McKenzie's use of non-utility companies as a proxy group is inappropriate. The Commission has previously noted its disapproval of the comparison between companies

[282] A "just and reasonable rate" is one that (1) does not violate any provision of the Public Utility Article of the Maryland Code; (2) fully considers and is consistent with the public good; and (3) will result in an operating income to the public service company that yields, after reasonable deduction for depreciation and other necessary and proper expenses and reserves, a reasonable return on the fair value of the public service company's property used and useful in providing service to the public. Public Utilities Article ("PUA") § 4-201.

[283] *Bluefield Water Works and Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923).

[284] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[285] PUA § 3-112.

subject to market risk and regulated monopolies.[286] Similarly, in performing certain analyses, Witness McKenzie used only forecasted earnings, which the Commission finds to be speculative when compared to the certainty provided by using historic data. However, the Commission finds every legitimate analytical tool helpful in its analysis and does not rely on any single tool to make its decision.

With respect to floatation costs, the Commission declines BGE's request for a specific upward adjustment. This decision is consistent with prior Commission decisions rejecting an adder for flotation costs.[287] The Commission agrees with Staff and OPC that BGE has not presented any evidence that it has incurred actual flotation costs and, therefore, does not warrant an upward adjustment to its ROE.

The Commission also denies BGE's request for a specific adjustment to counter the effects of attrition, finding its arguments unpersuasive. Throughout this proceeding, BGE has made references to its "chronic inability to earn its authorized rate of return." However, BGE fails to recognize that regulated utilities are not guaranteed to earn its authorized return, but rather a utility only has an *opportunity* to earn a maximum return. BGE has not shown any evidence to demonstrate that its financial health, credit rating, or ability to attract capital is at risk. Furthermore, all regulated utilities face some level of attrition risk, and such a risk may be apparent to investors when they choose to purchase a utility stock. In this instance, granting an attrition adjustment may over-compensate BGE for a risk that is already priced into its valuation.

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[286] Order No. 83907, Case No. 9230 (March 9, 2011).

[287] *See, e.g.,* Case No. 9406, *In the Matter of the Application of Baltimore Gas and Electric Company for Adjustments to its Electric and Gas Base* Rates, Order No. 87591, at 155 (June 3, 2016).

Finally, the Commission notes that the evidence presented by Staff in support of its request of a 9.65% ROE is but one of many factors considered by the Commission in arriving at a reasonable ROE for BGE's gas operations; however, the Commission declines Staff's request for a specific downward adjustment of 15 basis points to the ROE as a result of BGE's STRIDE mechanism. The evidence presented in this proceeding demonstrates that STRIDE-like mechanisms are now prevalent among gas utilities and that the reduced risk presented from the STRIDE mechanism is accounted for in the proxy group.

In conclusion, the Commission finds that a return on equity of 9.8% for BGE's gas distribution services complies with statutory standards and those established by *Bluefield* and *Hope Natural Gas*. This ROE is comparable to returns investors expect to earn on investments of similar risk as demonstrated through the use of the witnesses' proxy groups, is sufficient to assure confidence in BGE's financial integrity, and is adequate to maintain and support BGE's credit and attract needed capital. Further, 9.8% falls in the center of the ROE ranges recommended by the parties to this matter, and reflects both the changing markets and increasing interest rates testified to by witnesses.

2. Capital Structure

Parties' Initial Positions

BGE

BGE Witness Holmes testified that the 10.5% ROE recommended by Witness McKenzie is appropriate given current market conditions, investor expectations for the future, and the impact of attrition on BGE's ability to earn its authorized return.[288]

[288] Holmes Direct at 9.

Witness Holmes presented BGE's proposed ROR using its actual capital structure as of July 31, 2018.[289] Using that capital structure, Witness Holmes calculated a proposed ROR of 7.49% for BGE's gas operations as illustrated in this chart:[290]

Gas Rate of Return				
Type of Capital	**Capital Structure**		**Embedded Cost Rates**	**Weighted Cost**
Long-term debt	43.4%	x	4.02%	1.74%
Short-term debt	2.3%	x	2.25%	0.05%
Common equity	54.3%	x	10.50%	5.70%
Total	**100%**			**7.49%**

Staff

Staff Witness Suckling recommended that the Commission reject the capital structure proposed by BGE Witness Holmes because the common equity ("CE") proposed by Witness Holmes was significantly higher than CE ratios approved by the Commission in past BGE cases.[291] Witness Suckling further noted that the Company's proposed capital structure might result in rates that are unduly burdensome to rate payers.[292] Instead, Witness Suckling proposed that the Commission use the Company's average capital structure from its last base rate proceeding, which is 46.40% long-term debt ("LTD"), 0.88% short-term debt ("STD"), and 52.73% CE.[293] Using her proposed

[289] Holmes Supp. Direct at 2.
[290] Holmes Supp. Direct at 3.
[291] Holmes Supp. Direct at 7.
[292] Holmes Supp. Direct at 8.
[293] Suckling Direct at 2.

capital structure and recommended ROE of 9.65%, Witness Suckling recommended an ROR of 6.98% for BGE gas operations.[294]

OPC

Witness O'Donnell recommended that the Commission reject the capital structure proposed by BGE Witness Holmes, alleging that the Company provided no evidence to support an increase from the 51.90% equity ratio granted to it by the Commission in 2016.[295] Instead, Witness O'Donnell proposed the following:[296]

Gas Rate of Return				
Type of Capital	**Capital Structure**		**Embedded Cost Rates**	**Weighted Cost**
Long-term debt	43.83%	x	4.02%	1.76%
Short-term debt	4.27%	x	2.33%	0.10%
Common equity	51.90%	x	9.00%	4.67%
Total	**100%**			**6.53%**

Using his proposed capital structure and ROE of 9.00%, Witness O'Donnell calculated an ROR of 6.53% for BGE's gas operations.[297]

Parties' Responses

BGE

Witness McKenzie also took issue with Ms. Suckling's proposed capital structure, stating that it contradicts the Commission's practice to rely on a utility's actual test year-ending capital structure when determining the overall cost of capital in a base rate

[294] Suckling Direct at 2.
[295] O'Donnell Direct at 45 and 46.
[296] O'Donnell Direct at 46.
[297] O'Donnell Direct at 55.

proceeding.[298] Similarly, Witness McKenzie took issue with Witness O'Donnell's proposed capital structure, noting that, not only is it hypothetical rather than actual, but it is also "entirely predicated on what was granted in the Company's last rate case," thereby ignoring actual changes to BGE's financial position over the past nearly three years.[299]

Witness Holmes submitted rebuttal testimony stating that, on September 20, 2018, BGE issued an additional $300 million of long-term debt, the proceeds of which were used, among other things, to repay outstanding short-term debt.[300] As a result of the debt issuance in the post-test year period, the Company's actual capital structure as of the date of issuance reflects a lower equity ratio and thus a lower weighted cost and recommended ROR.[301] Witness Holmes therefore proposed using BGE's capital structure as of September 30, 2018, rather than that which was proposed in his Supplemental Direct Testimony.[302] Using that capital structure, Witness Holmes proposed an ROR of 7.46% for BGE's gas operations as calculated below:[303]

Gas Rate of Return				
Type of Capital	**Capital Structure**		**Embedded Cost Rates**	**Weighted Cost**
Long-term debt	47.15%	x	4.05%	1.91%
Short-term debt	0.0%	x	0.0%	0.0%
Common equity	52.85%	x	10.50%	5.55%
Total	**100%**			**7.46%**

[298] O'Donnell Direct at 6.
[299] McKenzie Rebuttal at 7.
[300] Holmes Rebuttal at 3.
[301] *Id*.
[302] Holmes Supp. Direct at 2.
[303] Holmes Supp. Direct at 3.

In its Initial and Reply Briefs, BGE again proposed that its overall ROR should be determined using the Company's actual capital structure and actual debt costs as of September 30, 2018.[304] BGE further stated that the 10.5% ROE recommended by Witness McKenzie is appropriate given current market conditions, investor expectations for the future, and the impact of attrition, and therefore requested that the Commission approve its overall ROR of 7.46% on its rate base for gas operations.[305]

Staff

Witness Alvarado modified his position on capital structure, finding that BGE's actual capital structure at September 30, 2018, as presented in Witness Holmes' rebuttal testimony, is appropriate for ratemaking purposes.[306] As a result of the changed capital structure, Witness Alvarado recommended an ROR of 7.0% for BGE's gas operations.[307]

OPC

OPC Witness Neale filed rebuttal testimony addressing, among other things, BGE's Gas Meter Relocation Program. Specifically, Witness Neale recommended that the Commission deny BGE the recovery of capital costs associated with the Program. Witness Neale therefore recommended a reduction of 20 basis points in the allowed ROR of 6.53% as proposed by Witness O'Donnell.[308]

Witness O'Donnell did not file an update to his direct testimony, which had examined BGE's projected capital structure at July 31, 2018, the end of the test year.

[304] BGE Initial Brief at 25; BGE Reply Brief at 24.
[305] BGE Initial Brief at 25; BGE Reply Brief at 27.
[306] Alvarado Surrebuttal at 5.
[307] Alvarado Surrebuttal at 6.
[308] Neale Rebuttal at 8.

Because his testimony was not updated, Witness O'Donnell did not offer an opinion on BGE's actual capital structure at July 31, 2018, or September 30, 2018.

In its Initial Brief, however, OPC did acknowledge BGE's actual capital structure at September 30, 2018, stating, "BGE's revised request for a Common Equity ratio of 52.85% is unreasonable."[309] OPC claimed that the capital structure proposed by BGE and adopted by Staff would "result in the transfer of excessive financial risk to ratepayers," given that its common equity ratio is significantly greater than 47.8%, the equity ratio of Exelon, BGE's parent holding company.[310] In its Reply Brief, OPC further opposed the use of BGE's capital structure at September 30, 2018, citing the Commission's "long-standing precedent of using the projected capital structure at the end of the test year."[311] OPC instead recommended that the Commission adopt the capital structure proposed by Witness O'Donnell, which includes the common equity ratio ordered by the Commission in Case No. 9406.[312]

Commission Decision

The total rate at which a utility is allowed to recover financing costs is the ROR, which is determined by summing the products of the long-term debt, short-term debt, preferred stock, and common equity. BGE and Staff agree that BGE's actual capital structure at September 30, 2018, is appropriate for ratemaking purposes. OPC does not agree, instead recommending that the Commission adopt the capital structure ordered by the Commission in BGE's most recent rate case, Case No. 9406. The Commission

[309] OPC Initial Brief at 21.
[310] OPC Initial Brief at 25.
[311] OPC Reply Brief at 5.
[312] OPC Initial Brief at 21.

recognizes the long-standing precedent in Maryland that a utility's actual test-year-ending capital structure should be used when determining its authorized rate of return in a base rate proceeding, absent evidence that the actual capital structure would impose an undue burden on ratepayers. The Commission does not find that use of BGE's September 30, 2018 capital structure would impose such a burden. Further, while the capital structure recommended by BGE and Staff extends slightly beyond the test-year, the Commission finds its use appropriate as it will allow for the most accurate analysis of the Company's current financial circumstances. The Commission therefore approves the use of BGE's actual capital structure, as of September 30, 2018, for ratemaking purposes in this proceeding. The Gas Rate of Return is thereby 7.09%.

C. Cost of Service Study

BGE

BGE Witness Lynn Fiery, presented the results of BGE's Recommended Gas Cost of Service Study ("GCOSS"), which identifies the distribution costs embedded in the 12 months ending December 31, 2017.[313] Following cost causation principles, Witness Fiery stated that these costs are broken down into three main categories: gas plant in service ("GPS"); depreciation expenses; and O&M expenses. The allocation of these three categories flows into many of the other allocations in the GCOSS. The proposed GCOSS utilizes two different demand and throughput allocator methods—a five-year average allocator for Schedule D and C, and a single year (2017) allocator for Schedules IS and ISS.[314]

[313] Fiery Direct at 6.
[314] Fiery Direct at 6.

BGE's recommended GCOSS followed the same general process used by the Company in prior base rate cases.[315] In fact, the only changes from the previous GCOSS presented by the Company in Case No. 9406 pertain to the allocation methodologies used by the Company. First, Witness Fiery testified that the Company has changed the allocation method for FERC Account 903 (Customer Records and Collection Expenses). "In prior cases, the Company used a study to calculate the allocation percentages; however, the results of that study in the Company's most recent rate cases resulted in allocation percentages that were approximately the percentages of customer counts by class. Therefore, in the GCOSS performed for this case FERC Account 903 is allocated based on customer counts, which is an appropriate representation of cost causation, as Customer Records and Collections costs vary proportionately with the number of customers in each class."[316] Second, the Company eliminated the separate allocators for advanced metering infrastructure ("AMI") and non-AMI, since AMI has now been deployed.[317] Finally, Witness Fiery proposed to use a combination of the five-year average demand and throughput allocators for Schedule D and C; and the single year demand allocators for Schedules IS and ISS.[318] Witness Fiery believes that her combination method is more accurate representation of the demands on the Company's

[315] BGE Initial Brief at 37.
[316] Fiery Direct at 8-9.
[317] Fiery Direct at 9.
[318] Fiery Direct at 10. Witness Fiery provided the background for her recommendation by noting that "In Order No. 87591 in Case 9406, the Commission directed the Company to continue to present cost of service studies with single year demand allocators while still providing the five year demand allocator study for both electric and gas in future rate cases."

distribution system. "Based on heating degree days (HDD[319]), 2017 was over 10% milder than normal weather, whereas the average Heating Degree Day for the last five years is within 1% of normal weather. Demands on Schedule D and C are weather dependent and will vary significantly with changes in weather."[320] Witness Fiery argued that using a five-year average will decrease the volatility from year to year and provide a stable demand allocation that is more representative of the cost causation of the demand-related elements for Schedules D and C. Due to decoupling, revenues derived from Schedules D and C are not driven by weather, so it is only reasonable that the demand should not be as well.[321] For non-decoupled classes (Schedule IS and ISS), Witness Fiery indicated that single year (2017) demands are used since revenue from these classes are impacted by weather, although demand by these two classes are generally less weather sensitive than other classes.[322]

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[319] Cross Direct at 11, fn 15 defines HDD: "HDD is a measure designed to quantify the energy needed to heat a building, usually measured as the difference between 65 degrees (the temperature at which most people begin to heat) and the observed temperature. For example, if the observed temperature is 55 degrees then 65 – 55 = 10 HDDs. In a footnote on page 10 of Direct Testimony, Witness Fiery notes that normal HDDs are calculated based on 30-year average of historical weather data."
[320] Fiery Direct at 10
[321] Fiery Direct at 10.
[322] *Id.*

The results of BGE's cost of service study are provided in the following Table 1:[323]

Table 1
Comparison of Rate Base Dollar Allocations and Class Rate of Return Ratios[324]

2017 GCOSS		
Rate Schedule	**Rate Base** **($ in millions)**	**Relative Return**
D (Residential)	917.3	1.08
C (General Service)	392.9	0.80
ISS (Interruptible-Small)	6.9	0.97
IS (Interruptible-Large)	75.1	1.11
PLG (Private Lighting)	0.02	9.76
System Total	**1,392.2**	**1.00**

The GCOSS showed that Schedule D (including Grantors of Rights-of-Way) rate of return is within the system average return band width of +/- 10% at a relative rate of return of 1.08. Schedule C is earning a rate of return of 0.80. Schedule ISS is earning a rate of return within the system average return band width of +/- 10% at a relative rate of return of 0.97. Schedule IS is earning a rate of return slightly above the system average band width of +/- 10% at a relative rate of return of 1.11. Schedule PLG is earning a return well above the system average return band width of +/- 10% at a relative rate of return of 9.76. It should be noted that Schedule PLG has not historically received a revenue increase and it is closed to new customers.[325]

[323] BGE Initial Brief at 38.
[324] Fiery Direct at 6 *citing* BGE Exhibit LKF-1.
[325] Fiery Direct at 16.

Company Witness Jason Manuel used the GCOSS to develop the proposed rate design and resulting tariffs.

Staff

Staff supported BGE's GCOSS except for one difference.[326] Staff recommended using the traditional single year Non-Coincident Peak ("NCP") method to determine the allocator for all four of customer classes,[327] while BGE advocated a change from past Commission practice for two of the four classes which determine the class allocator by class NCP. Instead of using only the NCP from the most recent year (2017) available as the allocator, BGE used a five-year NCP average for Schedule D and Schedule C and used the traditional single year NCP allocator for Schedule IS and Schedule ISS.

Staff stated that while BGE's theory for the five-year NCP average seems attractive on the surface, it is not supported by the data.[328] Staff Witness Cross argued that there is no direct correlation between NCP and a measure of yearly temperature like HDD. Witness Cross showed in Table 1 of his Surrebuttal that both the NCP allocators and the class Relative Rates of Return ("RROR") remain relatively stable over the five years that BGE averages the NCP despite widely varying HDD.[329] Witness Cross concluded that "BGE's use of the five year average NCP allocator is unproven and contradicted for the last five year period."[330] Staff Witness Cross testified that Staff is unable to ascertain "whether (1) the NCP calculations and resulting class RROR's are weather sensitive, (2) any perceived benefits of the modified allocators are permanent or

[326] Staff Initial Brief at 46.
[327] Staff Initial Brief at 47.
[328] *Id.*
[329] Staff Exhibit.18, Cross Surrebuttal at 8-9.
[330] Cross Surrebuttal at 8-9.

are simply the result of these particular test years, (3) any perceived effect is the result of weather or another exogenous factor, (4) there are any unidentified weaknesses to the methodology, (5) this methodology is preferable to the traditional one year allocator or any other available methodologies."[331] Witness Cross pointed out that in Case No. 9406, BGE proposed the same five-year averaging method but applied more broadly to electric service and to interruptible classes for gas that it excludes here.[332] The Commission rejected BGE's proposed new method then, stating the Company did not provide sufficient evidence for the Commission to abandon the traditional one year demand allocator for the five year average demand allocator.[333] Witness Cross argued that the Commission should reject BGE's approach in this proceeding for the same reason as BGE has not provide any compelling reason or proof that its method is superior to the single NCP allocator traditionally used by the Commission.[334]

OPC

OPC Witness Watkins found the class cost allocations submitted by BGE were reasonable and consistent with Commission precedent. However, the Company relied upon a class NCP study which Witness Watkins considered to be inflexible and "mechanical."[335] Witness Watkins believes that the Peak and Average ("P&A") approach is the most reliable, fair, and equitable method to allocate natural gas mains.[336] Witness Watkins recommended an alternative class revenue allocation that considers both

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[331] Cross Direct at 19.
[332] *See* 106 MD PSC 206, 290-291.
[333] *See* 106 MD PSC 206, 295.
[334] Staff Initial Brief at 50.
[335] OPC Initial Brief at 37.
[336] Watkins Direct at 2.

the Company's class NCP study as well as the P&A study.[337] Witness Watkins recognized that different cost allocation methodologies conducted for the same utility and time period can and often do yield different results. For that reason, Witness Watkins advised that "regulators should consider CCOSS only as a guide, with the results being used as one of many tools to assign class revenue responsibility."[338]

Witness Watkins testified that the majority of a natural gas distributions company's ("NGDC") plant investment serves all customers in a joint manner:

> If all customers were the same size and had identical usage characteristics, cost allocation would be simple (even unnecessary). However, in reality, a utility's customer base is not so simple. Customers (or customer groups) tend to vary greatly in the amount of service required throughout the year such that there are small usage and large usage customers. Therefore, differences in usage should be considered. Because different groups of customers also utilize the system at varying degrees during the year, consideration should also be given to the demands placed on the system during peak usage periods.[339]

Witness Watkins noted that for every NGDC the largest single rate base item is distribution mains. Therefore, any COSS must take a focused review of the allocation of distribution mains to classes. Witness Watkins opined that the P&A approach[340] is the most fair and equitable method to assign natural gas distribution mains costs to the various customer classes. This method recognizes each class's utilization of the Company's facilities throughout the year yet also recognizes that some classes rely upon the Company's facilities (mains) more than others during peak periods.[341]

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[337] Watkins Direct at 2.
[338] Watkins Direct at 4.
[339] Watkins Direct at 5.
[340] Quoting Watkins Direct at 8, "The P&A method is also referred to as the Demand/Commodity method."
[341] Watkins Direct at 8.

Witness Watkins noted that the BGE's method "allocated production and storage plant based on class contributions to coincident peak day demands and allocated distribution mains and related equipment based on class non-coincident peak hour demands."[342] Witness Watkins acknowledged that while the Company's approach does assign some cost responsibility to interruptible customers, it has over-assigned costs to the small interruptible class and under-assigned costs to the large interruptible class.[343] Therefore, OPC recommended an alternative class revenue allocation be used that takes into consideration the averaged results of the Company's study and Witness Watkins's recommended Peak and Average methodology.[344] If the GCOSS is revised using Witness Watkins recommended P&A method to allocate mains related costs, there is no significant change to the relative rates of return for Residential and General Service Classes but it becomes apparent that the Small Interruptible class is significantly over contributing to system profits while the larger Interruptible class's system profit contribution is deficient.[345]

Commission Decision

The Commission finds that BGE's recommendation to use a combination of the five-year average demand and throughput allocators for Schedule D and C and the traditional single year demand allocators for Schedules IS and ISS may be a reasonable approach to be explored in future rate cases provided that the Company can provide more substantial evidence that the five-year average NCP allocator is a more accurate predictor

[342] Watkins Direct at 13.
[343] Watkins Direct at 15.
[344] Watkins Direct at 14.
[345] Watkins Direct at 18.

than traditional single year NCP allocator used by the Commission. Therefore, for this case, the Commission will accept the Staff's approach and its recommended GCOSS, and will discuss its application in the rate design section below.

D. Rate Design

BGE

Based upon the Company's recommended GCOSS prepared by Witness Fiery, Company Witness Jason Manuel presented the proposed rate design for each customer class that would produce the requested increase in gas revenues proposed by the Company.

Witness Manuel explained that "an effective rate design incorporates principles such as cost causation, price signaling, reasonableness, gradualism, and both inter-class and intra-class equity."[346] These principles are thoroughly documented by experts within the utility ratemaking field and have been employed by the Commission in prior rate cases.[347] Company Witness Manuel opined that BGE's proposed two-step revenue allocation methodology in this proceeding is an example of how cost causation is addressed by using the results of a cost of service study to move customer class returns closer to the system average return and thereby having costs be borne by the appropriate customers.[348] Additionally, Witness Manuel noted:

> the Company's rate design should be consistent with the nature of the costs incurred in providing service to customers. In other words, fixed and demand-related costs (or costs that do not vary with the total amount of gas delivered) should be recovered through fixed monthly rates

[346] Manuel Direct at 4.
[347] *Id*.
[348] *Id*.

> and rates that reflect a customer's demand on the system, respectively, and variable costs (or costs that increase or decrease as the total amount of gas delivered changes) should be recovered through rates that do vary based on the total amount of gas delivered to a customer.[349]

BGE's basic rate structure includes the use of a Customer Charge, a Demand Price, and a Delivery Price. The Customer Charge is the fixed monthly charge on a customer bill that is intended to recover those operating costs that are caused by customers connecting to the gas distribution system.[350] The Demand Price is a charge for certain rate schedules based on the maximum load over a measured period of time that is designed to recover the costs driven by customer class's peak loads.[351] The Delivery Price is a volumetric charge meant to recover the costs caused by customers' usage (or those costs which vary as the customer usage vary).[352]

Customer Charge

Witness Manuel testified that all BGE gas customers currently have a Customer Charge and while the charge for the residential class recovers a portion of the fixed costs incurred in serving these customers, it is not set at a level to recover all the fixed costs.[353] Witness Manuel explained that he is "proposing to increase the fixed Customer Charge for the Schedule D gas rate class to $15.00, in order to gradually move the fixed cost recovery for this class closer to the $23.02 supported by the 2017 GCOSS."[354] He noted that the Customer Charge for Schedule D has not been changed since 2005 in

[349] Manuel Direct at 5.
[350] Manuel Direct at 7.
[351] *Id*.
[352] *Id*.
[353] Manuel Direct at 8
[354] *Id*.

Case No. 9036 when it was increased from $12.25 to the current charge of $13.00.[355] Witness Manuel made clear that his proposal to increase Customer Charge for Schedule D only takes the fixed cost recovery for Schedule D *closer* to the level supported in the 2017 GCOSS to better align rates with cost causation, it does not cover all of the fixed costs for this class.

Witness Manuel explained that at an average consumption of 55 therms per month, increasing the Customer Charge for Schedule D customers would yield the same increase to a residential bill whether the proposed Customer Charge and volumetric Delivery Price rate design is accepted or whether the full increase was assigned to volumetric Delivery Price.[356] Witness Manuel asserted that his proposed Customer Charge increase should work towards reducing the intra-class inequities between the recovery of fixed and variable costs.

Gas Revenue Allocation

Witness Manuel proposed to utilize a two-step approach to apportion the proposed revenue increase to each customer class of service.

In step one, he proposed "to move Schedule C to a RROR of 0.90 from 0.80 to reach the lower band around the system average" and "to move Schedule IS to a RROR of 1.10 from 1.11 to reach the upper band around the system average."[357] Consistent with the Company's proposed approach for Schedule PLG in every BGE as rate case since Case No. 9230, Witness Manuel did not propose a revenue reduction for Schedule PLG due to its limited size.

[355] Manuel Direct at 8 *citing* Case No. 9036, Order No. 80460 at 86 (Dec. 21, 2005).
[356] Manuel Direct at 9.
[357] Manuel Direct at 11.

Table 2
2017 Gas Cost of Service Study Results[358]

Tariff Class	GCOSS RROR
D	1.08
C	0.80
ISS	0.97
IS	1.11
PLG	9.76
System Total	**1.00**

In step two, the remaining proposed revenue increase was allocated to the customer classes in proportion to the adjusted test year base distribution revenues, with one exception. As Schedule PLG is closed to new customers and continues to significantly over-earn the system average, Witness Manuel proposed that none of the revenue increase be allocated to that schedule.

For the Schedule D (Residential) customers, Witness Manuel proposed to recover the proposed revenue increase through an increase in the Customer Charge and the remaining revenue increase through the Delivery Price.[359] The Customer Charge increase from $13.00 to $15.00 would account for $15.1 million of the $57.7 million total proposed revenue increase for this schedule. The remaining revenue increase would be recovered "through the Delivery Price of $0.5598 per therm, which is an increase from the current effective rate of $0.4457 per therm."[360] In his Supplemental Direct,

[358] Manuel Direct at 11 *citing* Company Exhibit LKF-2.
[359] Manuel Direct at 15.
[360] Manuel Direct at 16.

Witness Manuel indicated that "for the average combined gas and electric service residential customer, the increase amounts to $5.67 per month or about 3.39%.[361]

Staff

Based upon the Staff's recommended GCOSS prepared by Witness Cross, Staff Witness Ward presented the proposed rate design for each customer class that would produce the increase in gas revenues proposed by Staff. Staff Witness Cross recommended the use of a GCOSS using 1-year allocators which result in URORs (unitized rates of return) for each customer class shown in the chart below. Staff Witness Cross's GCOSS showed Schedules C, IS, and ISS are under-earning while Schedules D and PLG are over-earning.[362]

Table 3
Staff Recommended 2017 Gas Cost of Service Study Results[363]

Rate Schedule	GCOSS UROR
D	1.14
C	0.70
IS	0.96
ISS	0.85
PLG	9.25
Total System	**1.00**

Staff Witness Ward, similar to the Company, used a two-step approach for rate design. The first step allocated a portion of the revenue increase to the classes that are under-earning. Based on Staff's recommended GCOSS, Schedules C, IS, and ISS are

[361] Manuel Supp. Direct at 4.
[362] Ward Direct at 7.
[363] Ward Direct at 8.

under-earning and therefore included in Step 1 allocation.[364] Witness Ward recommended allocating 7%[365] of Staff Witness Smith recommended revenue requirement in the first step, which ensures that no under-earning class is assigned revenue that would result in a UROR greater than 1.0.[366] Next, in the second step Witness Ward allocated the remaining revenue increase to all classes, except PLG. Witness Ward agreed with the Company's exclusion of PLG from revenue allocation.

Regarding the Customer Charge, Staff Witness Ward agreed that a modest increase is reasonable and appropriate at this time. In her Surrebuttal, Staff Witness Ward recommended a customer charge of $14.00 as reasonable.[367] Staff Witness Ward noted that "an average residential customer's bill would increase by $5.21 or 7.75%," which holds STRIDE at the current $2.00.[368] Witness Ward acknowledged that there will be a change in the STRIDE surcharge as result of the transfer into base rates of some portion of STRIDE investments, but the STRIDE surcharge would not be reduced to $0.00. At a minimum, the STRIDE charge would be updated for the Company's STRIDE 2 plan, as described in Case No. 9468.[369]

Finally, with respect to the TCJA tax credit, Staff Witness Ward recommended allocating the regulatory liability proposed by Staff Witness Smith in the manner that base rate reductions were allocated in Case No. 9473.[370] Witness Ward recommended that the Commission should direct the Company to return the regulatory liability associated with the TCJA to customers, excluding the PLG class customers, as a one-time

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364 Ward Direct at 9.
365 Ward Surrebuttal at 2 (updating the initial recommendation of a 9% step one allocation).
366 Ward Direct at 9.
367 Ward Surrebuttal at 4.
368 Ward Surrebuttal at 5.
369 *Id.*
370 Ward Direct at 14.

credit within 60 days of the Commission's final order in this proceeding and be distributed according to Staff's rate design allocation per customer class.[371]

OPC

OPC Witness Watkins used the P&A method to allocate mains related costs. If BGE's GCOSS was revised using this method, then "there is no significant change to the relative rates of return for the Residential and General Service Class but it becomes apparent that the Small Interruptible class is significantly over contributing to system profits while large Interruptible class' system profit contribution is 'deficient.'[372] OPC's Initial Brief noted:

> [a]pplying … Witness Watkins' preferred Peak and Average Class cost of service study would result in slightly less of an increase being allocated to residential customers. The decrease in allocation to the residential class will not create any subsidization issues as claimed by MEG Witness Baudino because, under Witness Watkins' approach, the Residential class produces a larger rate of return than the system average. Even under BGE's cost allocation study, at current rates the residential class rate of return is above system average.[373]

OPC Witness Watkins also opposed the proposed increase in BGE's Customer Charge from $13.00 to $15.00 per month. Witness Watkins disagrees that fixed costs should be recovered through fixed charges and states that "efficient pricing results from the incremental variability of costs even though a firm's short-run cost structure may include a high level of sunk or 'fixed' costs or be reflective of excess capacity."[374] Witness Watkins also identified potential conflict between higher customer charges and

[371] Ward Direct at 15.
[372] OPC Initial Brief at 38.
[373] OPC Initial Brief at 38-39.
[374] Watkins Direct at 23.

conservation policies.[375] Under his own direct customer cost analysis, including only "those costs required to connect and maintain a customer's account," Witness Watkins calculated a customer charge in the range of $11.93 to $12.56 per month.[376]

MEG

MEG's stated in its Initial Brief that its "consistent position in BGE rate cases is that its members should only pay the costs for which they are responsible."[377] However, many of the cost of service methodologies and rate design proposals advanced by Staff and OPC would increase the rates paid by Schedule C and IS customers and reduce rates paid by Schedule D customers. In this case, MEG recommended that the Commission adopt BGE's proposed Cost of Service Study using the 1-year NCP allocation factors for Schedule IS and ISS and 5-year NCP allocation for Scheduled C and D.[378] MEG believes this proposal more accurately represents the demands of each customer class on BGE's distribution system.[379] MEG argued that there is "strong evidence that it is unreasonable to utilize 1-year allocation factors for Schedules C and D and that use of Staff's proposal in setting rates would be an implicit approval of a subsidy for residential customers by commercial and industrial customers in this case."[380] MEG supported BGE's proposed customer class revenue allocation, which moves Schedules C and IS to a relative rate of return within 0.90 and 1.10 of the system average in Step One. MEG allocated the remainder of the proposed revenue increase to all classes in proportion to each class's share of test year revenues (except Schedule PLG) in Step Two. Lastly, MEG supported

[375] Watkins Direct at 24-28.
[376] Watkins Direct at 31.
[377] MEG Initial Brief at 8.
[378] MEG Initial Brief at 8.
[379] *Id.*
[380] MEG Initial Brief at 11.

BGE's proposed rate design for Schedule C. For Schedule IS, however, BGE proposed no increase in the customer charge and information fee, a 9.4% increase in the demand price and a 33.0% increase in the delivery price.[381] MEG recommended that the Commission reject this proposed rate design because it collects too much of IS revenue in delivery price, while collecting too little in demand price.[382]

Commission Decision

Consistent with decisions in previous BGE rate cases, the Commission adopts a two-step process to allocate increased gas revenues. The first step moves under-earning classes closer to the system average, while the second step allocates the remainder of the gas revenue increase to customer classes in proportion to the adjusted test year revenues.

In the present case, the Commission adopts Staff's proposed cost of service study using the traditional one-year NCP allocator and therefore finding that Schedules C, IS, and ISS are under-earning while Schedules D and PLG are over-earning. In order to move the under-earning classes closer to a UROR of one, the Commission allocates 15% of the approved revenue requirement in step one to the under-earning classes of Schedules C, IS, and ISS, and allocates the remaining revenue increase across all classes, except PLG. Seeing that no party objected, the Commission accepts the miscellaneous "housekeeping" revisions in reflected in Company Exhibit JMBM-3.[383]

Regarding the Customer Charge, both Staff and BGE recommended an increase in the fixed monthly charge in order to collect a portion of rate increase outside of

[381] MEG Initial Brief at 15.
[382] Baudino Direct at 5.
[383] Manuel Direct at 23.

volumetric charges and partially address fixed costs.[384] Staff recommended a $1.00 increase which would raise the current Customer Charge from $13.00 to $14.00[385] versus BGE's recommended $2.00 increase which would result in a Customer Charge of $15.00. The Commission finds that Staff's proposal would be more gradual than BGE's request to increase the Residential Customer Charge.

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."[386] The Commission finds that $14.00 is the correct and balanced amount.

Based on the Commission-approved revenue requirement of $64.915 million, this rate design results in an average residential customer gas bill increase of approximately $5.40 per month (8.04%).

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[384] Ward Surrebuttal at 4; Manuel Direct at 8.
[385] Ward Surrebuttal at 4.
[386] Order No. 88944, *In the Matter of the Application of Washington Gas Light Company for Authority to Increase Existing Rates and Charges and Revise Its Terms and Conditions for Gas Service*, Case No. 9481, Slip Op. at 127.

E. Miscellaneous

1. <u>BGE's RM54 Related Adjustments</u> (RBA 10 & OIA 23)

In his Direct, Company Witness Holmes proposed two adjustments, Operating Income Adjustment 23 and its companion Rate Base Adjustment 10, associated with "capitalized software changes to BGE's billing system which were necessary to allow for customer accelerated switching between third party suppliers and BGE commodity service, as required by COMAR revision adopted in Rulemaking 54 ("RM54")."[387] Operating Adjustment 23 eliminates from operating income the gas portion of the amortization related to capitalized software changes. Second, Rate Base Adjustment 10 removes the capitalized costs of the RM54 software changes from the gas rate base.

The Company requested that the Commission grant explicit authorization to recover the RM54 costs through the supplier liability fund consistent with Order No. 88432 and accept its proposed adjustments, if it agrees the RM54 costs can be recovered in such manner. Company Witness Holmes pointed out that Commission has addressed this issue previously in Order No. 88432 in Case No. 9443, a Potomac Electric Power Company rate case, which stated, "the Commission finds that tapping the Supplier Liability Fund is the optimal method of recovery …" and "as Staff states, it is the option that lowers costs rate payers."[388] BGE pointed out that no party in the instant case has objected to either adjustment or to the use of the supplier liability fund to recover the RM54 implementation costs.[389]

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[387] Holmes Direct at 29.
[388] Holmes Direct at 22 *citing* Errata Order No. 88432, Case No.9443, at 70.
[389] BGE Initial Brief at 44.

Commission Decision

The Commission accepts BGE's proposed RM54 related adjustment, finding it to be just and reasonable. The Commission also finds that using the Supplier Liability Fund is an appropriate method to recover RM54-related costs, consistent with Order No. 88432.

2. BWLDC Requests for BGE's Contractor Procurement Practices

The Baltimore Washington Construction and Public Employees Laborers' District Council ("BWLDC") requested that the Commission condition approval of rate relief in this case on the submission of BGE's contractor procurement practices that embody BGE's understanding of "best value" concepts.[390] BWLDC requested that the submission contain the Company's general contractor prequalification standards—particularly those which state or relate to safety and reliability, including minimum outside contractor employee training thresholds.

Commission Decision

The Commission has sufficiently addressed BWLDC's request in its responses to BWLDC's two separate Motions to Compel where it denied BWLDC's discovery requests regarding BGE procurement practices, stating that the request has no relevance to the Commission's review of BGE's base rate application.[391] The Commission therefore declines to take any additional action on BWLDC's request.

[390] BWLDC Initial Brief at 1.
[391] Case No. 9484, Order No. 88859.

3. W.R. Grace Interruptible Service Proposal

W.R. Grace requested that the Commission find that BGE's tariff does not preclude it from using, at its Curtis Bay facility, the natural gas from Schedule C Meter #24G to serve its Poly production line, which is currently served by Schedule IS Meter #34G, in the event of system interruptions called by BGE for Schedule IS meters. BGE supplies W.R. Curtis Bay facility with both firm and interruptible gas service under multiple meters. The facility's FCC/Hydro line is connected to Meter #24G which is on firm service Schedule C meter. The facility's Poly production line is connected to Meter #34G, which is on an interruptible service Schedule IS meter.

W. R. Grace noted that BGE can interrupt Schedule IS customers for any reason with only a six-hour notice. In contrast, BGE is not able to interrupt Schedule C service. Therefore, W.R. Grace proposed to use up to the total connected load allowed under Meter #24G to enable it to take gas from the Schedule C meter that normally supports the FCC/Hydro production.

W.R. Grace believes that Commission approval of its proposal would assist it in avoiding the negative impacts of prolonged periods of system curtailment by BGE as occurred during this past winter. Witness Ted Lenski testified that during a cold spell in January 2018, BGE called for a curtailment of interruptible lines for multiple days.[392] As required by Schedule IS, W.R. Grace had to cease all operations above the Optional Firm Delivery Service ("OFDS") option on its Schedule IS lines for the duration of the curtailment. At the time W.R. Grace had significant demands for its Poly products, which run on Schedule IS, and lower demand for its hydro products on its Schedule C.

[392] Lenski Direct at 4.

W. R. Grace argued that because it was unable to connect to the gas supplies from its Schedule C line, it could not meet current demand.

BGE opposed W.R. Grace's proposal by stating that its tariff requires "separation" of facilities[393] and W.R. Grace's proposal would violate the Gas Service Tariff Section 2.2(b) and Section 5.5(b) of Schedule IS. BGE argued that W. R. Grace's lines would be separated as required by Section 5.5(b) of Schedule IS and a single production line would simultaneously be supplied with gas from two different schedules in violation of Section 2.2(b) of its General Terms of Conditions.[394]

W.R. Grace responded that it has clearly articulated to BGE how it intends to keep the production lines separate at all times in compliance with the tariff provisions. First, during a system interruption initiated by BGE, W. R. Grace "would turn off gas supply from Meter #34G to the Poly production line and physically separate Meter #34G from its Poly production line. Second, W. R. Grace would connect its Meter 24G gas supply to the Poly production line, so that Meter #24G is serving the Poly line and the FCC/Hydro line. The two production lines would be separated by mechanical valves or blanks to ensure compliance with Section 5.5(b) at all times."[395]

BGE also asserted that W. R. Grace is attempting to receive firm service at interruptible service rates. To that, W. R. Grace responded that BGE gets it completely backwards as "the Poly production line is normally priced cheaper at Schedule IS interruptible prices."[396]

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[393] Burton Rebuttal at 20-21.
[394] Burton Rebuttal at 20-21.
[395] MEG Initial Brief at 21.
[396] MEG Initial Brief at 22.

Commission Decision

W. R. Grace's proposal is focused on a solution that will help it avoid major productions disruptions caused by a BGE interruption in gas service while continuing to take service on an interruptible rate. W.R. Grace asserts that its proposal will not violate the tariff provision requiring separation of facilities, that it will not use any additional gas supply than already contracted for in its Schedule IS, and that it will not benefit from lower prices by being allowed to connect to Schedule C. BGE argued "the proposal offered by W. R. Grace is contrary to the Company's Gas Service Tariff and could detrimentally impact the safety and reliability of the Company's gas system as well as the gas service provided to other customers." [397] BGE Witness Burton explained that the Company had been working very closely with W. R. Grace to address its concerns and offered several options to increase W. R. Grace's flexibility. The Commission rejects W.R. Grace's proposal and directs BGE and W. R. Grace to continue to work together to come up with a more flexible solution agreeable to both parties.

4. TCJA-Related to Bonus Depreciation

BGE Witness Holmes in his Supplemental Direct noted that one event had occurred since the Company's original filing of its Application on June 8, 2018. Specifically, Mr. Holmes stated that on "August 8, 2018, after the test year ended, the IRS proposed regulations that provide guidance regarding changes to bonus depreciation as a result of the 2017 Tax Cuts and Jobs Act (TCJA)."[398] The IRS invited comments on the proposed regulations to be submitted by October 9, 2018, with no defined date for the

[397] BGE Initial Brief at 46.
[398] Holmes Supp. Direct at 6.

issuance of final regulations.[399] For the most part, BGE testified that the proposed regulations were consistent with the Company's expectations. However, the proposed regulations included language that could be interpreted to allow certain plant placed in-service during the fourth quarter of 2017 to be eligible for 100% bonus depreciation.[400] Witness Holmes explained that "up until this point, the Company has assumed that bonus depreciation ended with the TCJA starting in the fourth quarter of 2017."[401] BGE Witness Holmes proposed that consistent with the Company's February 15 filing in Case No. 9473, the Company will track any additional tax savings that may accrue as a result of this IRS proposed guidance so that those amounts can ultimately be reflected in rates.

In his Direct, Staff Witness Smith recommended that when final IRS regulations are issued that result in "bonus" depreciation for certain assets, the Commission should require BGE to reflect the reduction in rates immediately.[402] During the hearing, Witness Smith responded to BGE Witness Holmes rejoinder testimony on this subject stating, "I agree that Staff does not want to cause an IRS normalization violation. So in this proceeding we wish to not continue that recommendation. It will be, if in fact the IRS does accept to use bonus depreciation for the property at the end of 2017, in a future proceeding that bonus depreciation would be reported in rate base and customers will get a benefit then."[403]

[399] Holmes Supp. at 6-7.
[400] Holmes Supp. at 7.
[401] Holmes Supp. at 7.
[402] Smith Direct at 22.
[403] Tr. At 512 (Smith); BGE Initial Brief at 44.

Commission Decision

The Commission finds that BGE's and Staff's decision to take no action at this time to address the proposed IRS regulation regarding any benefits from the TCJA related to bonus depreciation for fourth quarter 2017 is prudent. The Commission fully expects that BGE will continue to track all benefits arising from the enactment of the TCJA and bring them to the Commission's attention when discovered so that the appropriate treatment can be determined.

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

ORDERED (1) That the Application of Baltimore Gas and Electric Company, filed June 8, 2018 (as supplemented by BGE over the course of this proceeding), seeking an increase in its gas distribution revenue requirement of $82.8 million inclusive of $21.7 million STRIDE revenue requirement to be transferred in to rate base, is denied;

(2) That Baltimore Gas and Electric Company is authorized to increase gas distribution rates no more than $64.915 million inclusive of $21.7 million STRIDE revenue requirement to be transferred into rate base, for service rendered on or after January 4, 2019, consistent with the findings in this Order;

(3) That Baltimore Gas and Electric Company is directed to provide within 60 days of the date of this Order a one-time credit created by the Tax Cuts and Jobs Act to customers classes, as discussed in the body of this Order;

(4) That Baltimore Gas and Electric Company is directed to file tariffs in compliance with this Order with an effective date of January 9, 2019, subject to acceptance by the Commission; 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

Appendix I

Case No. 9484
Baltimore Gas and Electric Company
For the Twelve Months Ended June 30, 2018

Development of Awarded Revenue Requirement
($ Thousands)

Adjusted Rate Base	$ 1,646,011
Rate of Return	7.09%
Required Operating Income	$ 116,702
Adjusted Operating Income	$ 70,927
Operating Income Deficiency	$ 45,775
Conversion Factor	1.41813
Revenue Requirement	$ 64,915

<u>Rate Base</u>	
Per Book Unadjusted Rate Base	$ 1,492,971
Uncontested Adjustments	871
Total Before Contested Adjustments	$ 1,493,842
Contested Adjustments	
Reflect Terminal Level of Safety and Reliability Investments	$ 71,858
Reflect Terminal of STRIDE Investments	78,945
Reflect Forward Looking Plant Investments	-
Reflect Actual Riverside Environmental Costs	344
Reflect Unamortized Gains on Sale of Real Estate	(492)
Reflect Removal of January 2018 TCJA Regulatory Liability	904
Deferred Rate Case Expenses	-
Cash Working Capital	610
Remove Gas Meter/Mitigation Program Capital Expenditures	-
Contested Adjustments	$ 152,169
Total Rate Base	$ 1,646,011

Operating Income		
Per Book Unadjusted Operating Income	$	92,104
Uncontested Adjustments		(19,413)
Adjusted Income Before Contested Adjustments	$	72,691
Contested Adjustments		
Eliminate 100% of SERP Costs		586
Annualize Safety and Reliability Net Depreciation Expense		(1,484)
Annualize STIDE Net Depreciation Expense		(1,000)
Reflect Forward Looking Plant Net Depreciation		-
Eliminate Estimate Riverside Environmental Costs		1,765
Amortize Actual Riverside Environmental Costs		(45)
Reflect Inflation on Non-Labor O&M Expenses		(1,520)
Amortize Gains on Sale of Real Estate		(984)
Recover Gas Meter/Mitigation Program Costs		-
Annualize AFUDC		(58)
Interest Synch		976
Total Contested Adjustments		(1,764)
Adjusted Operating Income	$	70,927