ML 237574

ORDER NO. 89971

In the Matter of the Application of The Potomac Edison Company for Adjustments to Its Retail Rates for the Distribution of Electric Energy	* * * * * * * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9490 PHASE II

Issue Date: October 26, 2021

ORDER DENYING APPEAL OF PROPOSED ORDER

1. On June 25, 2021, pursuant to § 3-113(d)(2) of the Public Utilities Article of the *Maryland Annotated Code*, and Section 20.07.02.13 of the Code of Maryland Regulations ("COMAR"), The Potomac Edison Company ("Potomac Edison" or "the Company") filed a timely Notice of Appeal of the May 26, 2021 Proposed Order of the Public Utility Law Judge ("PULJ"), which resolved certain Phase II issues related to Potomac Edison's request to increase rates. For the reasons discussed below, Potomac Edison's Appeal is denied.

I. PROCEDURAL HISTORY

2. Potomac Edison filed an application to increase its retail distribution rates on August 24, 2018, which was docketed as Case No. 9490 and designated to a Commission panel.[1] Following a fully litigated adjudicatory proceeding, on March 22, 2019, the Commission issued Order No. 89072, which approved an increase in Potomac Edison's

[1] The panel consisted of Commissioners Herman (Chair), O'Donnell, and Richard. *See* Case No. 9490, Designation of Panel, Maillog No. 223597 (Jan. 9, 2019).

electric service rates of $6,199,378. Because Potomac Edison had not conducted a depreciation study for approximately 25 years, the Commission directed Potomac Edison to file a new depreciation study within 18 months of the issuance date of Order No. 89072.[2] The Commission further stated that upon completion of a new depreciation study, the depreciation expense for the rate effective period of this case would be further adjusted in a Phase II proceeding.

3. On September 22, 2020, Potomac Edison filed a new depreciation study based on its plant as of December 31, 2019, and proposed new account level depreciation rates using the average service life procedure and remaining life technique.[3] Potomac Edison also filed the direct testimony of John J. Spanos, president of the firm Gannett Fleming Valuation and Rate Consultants, LLC, and Raymond E. Valdes, Director, Rates and Regulatory Affairs of FirstEnergy Service Company.

4. The Commission set the Phase II proceeding for hearing and delegated it to the PULJ Division on October 13, 2020.[4]

5. On January 29, 2021, OPC filed the direct testimony of James S. Garren, from the firm Snavely King Majoros & Associates, Inc. Staff filed the direct testimony and exhibits of Felix L. Patterson, a Utility Auditor in the Commission's Accounting Investigation Division, and the direct testimony of Drew McAuliffe, Director of the Commission's Electricity Division.

6. On March 2, 2021, Potomac Edison filed the rebuttal testimony of John J. Spanos and Raymond E. Valdes.

[2] Order No. 89072 at 2-3, 37-38. The Commission observed that Potomac Edison's depreciation study was for plant for the period that ended December 31, 1993. *Id*. at 34.
[3] Maillog No. 231901.
[4] Order No. 89649.

7. On April 2, 2021, OPC filed the surrebuttal testimony of James S. Garren. Also on that date, Staff filed the surrebuttal testimony of Felix L. Patterson and the surrebuttal testimony of Drew McAuliffe.

8. A Phase II evidentiary hearing was held virtually on April 12, 2021. Initial briefs were filed May 11, 2021, followed by reply briefs on May 25, 2021.

9. On May 26, 2021, the PULJ issued a Proposed Order approving new depreciation rates, adjusting the revenue requirement based on those rates, and directing Potomac Edison to file tariffs that decrease distribution rates by $2,102,725, within thirty days of the date of the Proposed Order.

10. The PULJ found that OPC witness Garren's proposed service lives "more closely align with actual data, both mathematically and visually" than Potomac Edison's proposed service lives.[5] Nevertheless, the PULJ observed that OPC witness Garren and Staff witness Patterson agreed that service life estimates between those proposed by Potomac Edison and those proposed by OPC would be reasonable. Upon request, Potomac Edison provided depreciation rates for service lives between those proposed by Potomac Edison and OPC for Accounts 362.00, 364.00, and 365.00, and the PULJ found those service life estimates "produce reasonable and appropriate depreciation rates that can be used to compute the appropriate depreciation expense for Potomac Edison."[6]

11. The PULJ found that Commission precedent is clear that the SFAS 143 / Present Value Method ("Present Value Method") should continue to be used to compute net

[5] Proposed Order at 14.
[6] *Id.* at 15.

salvage.[7] The PULJ discussed Potomac Edison's contention that continued use of the Present Value Method would result in a growing regulatory asset due to the Company incurring more in net salvage than it accrues under this method. However, the PULJ found that "the evidence presented in this case is insufficient to adopt a methodology other than the one currently used by other Maryland utilities based on past Commission decisions."[8]

12. The PULJ also discussed Potomac Edison's proposal to use a discount rate of 2.5% based on inflation, but rejected the proposal because of Commission precedent and record evidence. The PULJ observed that in Order No. 89403, the Commission determined that the utility's rate of return ("ROR") should be used as the discount rate.[9] However, that decision was "without prejudice to parties in future cases proposing a fully-supported [Present Value Method] discount rate that is supported by expert testimony of inflation rate forecasts."[10]

13. The PULJ found substantial evidence that the discount rate that should be used with the Present Value Method is a credit-adjusted risk-free rate, which "takes into account inflation, but it is not the same as inflation."[11] The PULJ stated that development of the credit-adjusted risk-free rate requires analysis of several variables, including the interest rate environment, the general state of the economy, a company's financial

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[7] *Id.* SFAS stands for Statement of Financial Accounting Standard. SFAS 143 is a Securities and Exchange Commission accounting direction that sets forth calculations to apply to legal asset retirement obligations ("legal AROs"). Potomac Edison argues that even though the Present Value Method has frequently been referred to as the "SFAS 143 Method," the Present Value Method "is not a precise application" of SFAS 143, "which is a valuation method." Potomac Edison Memorandum on Appeal at 1, n. 1.

[8] Proposed Order at 15,

[9] *In re Columbia Gas*, Order on Appeal, Order No. 89403, ___Md. P.S.C.___ (Case No. 9609, Order No. 89403 (2019) ("Order No. 89403.")

[10] Order No. 89403 at 15, n. 46.

[11] Proposed Order at 16.

condition, and a company's existing financing arrangements including associated interest rates. However, the PULJ found that "[n]o such analysis was performed in this case…. Without an expert qualified to opine on an appropriate credit-adjusted risk free rate for Potomac Edison, a credit-adjusted risk-free rate as might be appropriate to be used with the [Present Value Method] cannot be determined from the evidence in the record in this case."[12] Given the lack of evidence, the PULJ found that Potomac Edison's authorized ROR should continue to be used as the discount rate in the Present Value Method.

14. The PULJ declined Potomac Edison's recommendation that any change in depreciation rates resulting from the Phase II proceeding be included in customer distribution rates beginning after the Company's upcoming distribution rate case.[13]

15. The PULJ accepted the rate design recommendations of Staff witness McAuliffe, who recommended that no change in fixed monthly charges be made for any customer class, and that the capacity kW and energy kWh rates be adjusted to account for adjustments in the revenue requirement.[14]

16. The PULJ further found, consistent with Staff's recommendation, that revenue changes should be allocated to each rate schedule in the same manner as described in Order No. 89072, with 40 percent of any revenue increase or decrease first allocated to the residential and PH & AGS rate schedules based on their proportion of distribution revenue, and the final 60 percent allocated to all schedules based on their current share of total system revenue.[15]

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[12] *Id.* at 16-17.
[13] Potomac Edison witness Valdes testified that pursuant to the requirements of Order No. 89072, the Company would file a future distribution base rate case by the end of 2022 or early 2023. Proposed Order at 20, 24.
[14] Proposed Order at 19.
[15] *Id.* at 19-20, 25; McAuliffe Direct at 3.

17. On June 25, 2021, Potomac Edison filed a timely Notice of Appeal of the Proposed Order and a Memorandum on Appeal. Also on that date, Potomac Edison filed revised electric service tariffs and workpapers in accordance with the requirements of the Proposed Order, but asked that they be held in abeyance until final resolution of Potomac Edison's Appeal.

18. On July 15, 2021, OPC and Staff filed reply memoranda in opposition to Potomac Edison's Appeal.

II. <u>ISSUES ON APPEAL</u>

19. Potomac Edison raises two issues on appeal. First, Potomac Edison claims that the PULJ erred by adopting the Present Value Method over the Straight-Line Method. Potomac Edison contends that the record evidence shows the Present Value Method harms customers and the Company and that the Straight-Line Method would resolve those harms. Potomac Edison further argues that the PULJ was arbitrary in accepting the Present Value Method because it is not supported by the record and asks that the Commission re-adopt the Straight Line Method.

20. Second, Potomac Edison claims that the PULJ erred by adopting the Company's authorized ROR over an inflation-based discount rate. Potomac Edison argues that the PULJ failed to weigh any of the record evidence showing that use of the ROR as the discount rate causes Potomac Edison to under-recover its actual net salvage costs and artificially increases rate base, thereby harming customers.

III. DISCUSSION

A. Present Value Method vs. Straight-Line Method

1. Potomac Edison

21. Potomac Edison argues that although the Present Value Method reduces utility rates in the short-term, it ultimately harms customers and prevents utilities from recovering their prudently incurred net salvage costs.[16] The Company claims that the method reduces its depreciation expense to levels well below the actual net salvage costs incurred.[17] Potomac Edison contends that continued use of the Present Value Method will result in intergenerational inequity, where current customers fail to pay their fair share of net salvage costs, and future customers pay more.[18] In the long run, Potomac Edison argues that the Present Value Method will require utilities to form regulatory assets when utilities under-recover their net salvage costs, resulting in future customers paying for those regulatory assets, increasing rate base, and ultimately harming customers.[19]

22. Potomac Edison contends that over the last five years, the Present Value Method for net salvage recovery falls short of actual Company costs by more than 50% of the total incurred net salvage.[20] The Company claims that this problem will get worse as net salvage costs increase over time, driven by steadily increasing labor and environmental costs.

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[16] Potomac Edison Memorandum on Appeal at 2. Specifically, Potomac Edison claims that the Present Value Method harms customers by forcing them to pay for the costs of assets that have been long retired for which they have derived no benefit, and forcing them to pay for a return on a higher rate base. *Id.* at 11-12.

[17] *Id.* at 8.

[18] *Id.* at 8-9.

[19] *Id.* at 4, 8-9. Potomac Edison claims that a customer in 2068 will pay almost seven times as much as a customer in 2019, for the cost of removal of plant from which they did not benefit. Potomac Edison Memorandum on Appeal at 4, citing Spanos Rebuttal at 37; Table 3.

[20] Potomac Edison Memorandum on Appeal at 2, citing Spanos Rebuttal at 15.

23. In contrast, Potomac Edison argues that the Straight-Line Method provides numerous benefits, such as allowing customers to pay for the assets they use, ensuring that the full service value of a utility's assets is recovered through depreciation expense, and helping ensure intergenerational equity, by matching the recovery of investment with the customers who receive a corresponding benefit from the investment.[21]

24. Potomac Edison asserts that the majority of state public utility commissions employ the Straight-Line Method of calculating net salvage, and it notes that the Maryland Commission used it for years prior to adopting the Present Value Method in 2007 in Case No. 9092.[22]

25. Potomac Edison claims that no record evidence contradicts its claim that the Present Value Method harms customers, causes under-recovery of prudently incurred costs, and fails to match current ratepayers' net salvage recovery costs with their fair share of those costs in "real" dollars.[23] The Company concludes that the PULJ was arbitrary in ignoring this evidence.

2. <u>Office of People's Counsel</u>

26. OPC argues that the Commission has consistently chosen the Present Value Method over the Straight-Line Method to calculate the value of estimated future net salvage in an unbroken series of cases since 2007.[24] OPC asserts that the Commission's

[21] Potomac Edison Memorandum on Appeal at 8, citing Spanos Rebuttal at 56.
[22] Potomac Edison Memorandum on Appeal at 7, referencing Case No. 9092, *In the Matter of the Application of Potomac Edison Power Company for Authority to Revise its Rates and Charges for Electric Service and for Certain Rate Design Changes*.
[23] Potomac Edison Memorandum on Appeal at 9.
[24] OPC Reply at 3.

policy choice is reasonable because the Present Value Method ensures that ratepayers pay only their fair share of recovery costs in real dollars.[25]

27. OPC objects to Potomac Edison's claim of under-recovery, particularly its claim that over the last five years, the Present Value Method for net salvage recovery falls short of actual Company costs by more than 50%. OPC argues that the five-year period chosen by Potomac Edison is an outlier and not indicative of future net salvage costs. OPC asserts that over the next five years, the Company's net salvage will likely revert to the average over the entire period, which is \$3.1 million.[26] OPC claims that over a longer period, the historical evidence of net salvage demonstrates that using Mr. Spanos' Straight-Line Method will cause Potomac Edison to over-recover rather than under-recover net salvage costs.

28. Even if Potomac Edison under-recovers, however, OPC asserts that there are mechanisms to adjust the Present Value Method to resolve the problem.[27] In particular, Mr. Garren testified that because the Present Value Method begins with a net salvage percentage estimated using a ratio on cost of removal over retirements, if net salvage begins to increase relative to the utility's net salvage accruals, in a subsequent depreciation study, the Company's expert can propose to increase the depreciation percentages.[28] OPC contends that such a proposal is in the Company's hands. OPC further observes that industry practice is to file a depreciation study every three to five

[25] *Id.* at 5.
[26] *Id.* at 7, citing Garren Surrebuttal at 2-5.
[27] *Id.* at 9-10.
[28] Garren Surrebuttal at 18-20.

years, in contrast to Potomac Edison's decision to wait 25 years to file a rate case without an updated depreciation study.[29]

29. OPC criticizes Potomac Edison's stated concern that the Present Value Method will require an increase in customer rates, arguing that customer rates would increase irrespective of which methodology is used. OPC argues that depreciation is based not on single assets, but on groups of assets in accounts, which expand over time due to increases in rate base and inflation. OPC asserts that Potomac Edison witness Spanos acknowledged this fact and conceded that even under the Straight-Line Method, every generation of ratepayers will pay more for these continually increasing groups of assets in depreciation accounts.[30] Similarly, OPC asserts that future ratepayers will also be current ratepayers in the future, and will therefore benefit from the application of the Present Value Method in the same way that current ratepayers do now.[31]

3. Staff

30. Staff recommends that the Commission reject Potomac Edison's appeal to return to using the Straight-Line Method when calculating net salvage, and continue using the Present Value Method. Staff argues that the concerns raised by Potomac Edison have previously been rejected by the Commission in multiple proceedings, including the Columbia Gas rate case.[32] Staff asserts that the Commission adopted the Present Value Method in 2007 "precisely because it addresses intergenerational concerns caused when the large future expenses of net salvage, which may take place decades from now, are

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[29] *Id.* at 10.
[30] *Id.* at 6, citing Hr'g. Tr. at 72-75 (Spanos).
[31] *Id.* at 6, citing Garren Direct at 46-47.
[32] Staff Reply at 3-4, n. 3, citing Case No. 9609, *In the Matter of the Application of Columbia Gas of Maryland, Inc. for Authority to Increase Rates and Charges*.

allocated using straight line methodology, so that ratepayers pay future costs using current dollars."[33] Staff contends that the Commission criticized the Straight-Line Method, which it utilized prior to 2007, because that method did not use a discount factor of the cash flows over the collection time, did not consider inflation or the time value of money, and thereby forced current ratepayers "to effectively over-pay for the recovery of future net salvage costs."[34] The Present Value Method appropriately discounts future costs to present value so that current ratepayers pay only their fair share, according to Staff.

31. Staff argues that Potomac Edison could mitigate potential under-collection problems, and keep rates current, by performing depreciation studies more regularly.[35] Staff asserts that performing depreciation studies at a regular frequency would reduce the variance between the calculated and actual plant service lives, depreciation, and net salvage. Nevertheless, Staff claims that "all methods of depreciation will fail to recover the exact costs of depreciation and net salvage" because "the selected depreciation curves, service lives, and net salvage rates are all estimates" and because the actual plant in service is often not removed from service at the exact time projected in the depreciation study.[36]

32. Staff asserts that use of the Remaining Life Technique will mitigate the financial impact from any inaccuracies in the calculated depreciation curves, service lives, net salvage rates, and equipment lives from the actual plant in service. Staff claims that Potomac Edison witness Spanos conceded that this technique incorporates a self-

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[33] Staff Reply at 5.
[34] *Id.*
[35] *Id.* at 6.
[36] *Id.* at 6-7.

correcting mechanism that adjusts depreciation expense for any over- or under-recoveries that have occurred in the past.[37] Staff asserts that all parties used the Remaining Life Technique when computing their recommended depreciation rates, and that such use "will alleviate the claimed problems with the use of the [Present Value Method]."[38]

4. Commission Decision

33. There is no disagreement among the parties about how the Straight-Line Method and the Present Value Method function. Under the Straight-Line Method, "an estimate of future net salvage costs is made based on an informed judgment that incorporates a statistical analysis of historical net salvage data in which net salvage is expressed as a percentage of retirements. The estimated net salvage is then allocated on a straight-line basis over the service lives of the company's assets."[39] Under the Present Value Method, "net salvage can be estimated in a similar manner ... However, the [Present Value Method] does not allocate these costs on a straight-line basis, but instead uses a deferred method of recovery based upon a discount rate."[40]

34. The methodologies do not significantly differ in estimating net salvage. Instead, the difference lies in how the net salvage costs are allocated over time. The decision of how to allocate those costs over time requires the Commission to balance the interests of present and future ratepayers. As a matter of policy, the Commission has consistently found since 2007 that the Present Value Method appropriately balances the interests of current and future ratepayers.[41]

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[37] *Id.* at 7, citing Spanos Direct at 10-11.
[38] *Id.* at 8.
[39] Order No. 89403 at 10.
[40] *Id.* at 10-11.
[41] *See* Staff witness Patterson Direct at 5-6: "The Commission has repeatedly endorsed the SFAS 143 present value method for the determination of depreciation rates…"

35. The Commission first adopted the Present Value Method in 2007 and articulated the following rationale for doing so:

> The Present Value Method strikes a balance between the straight line and historical recovery proposals. It is a forward looking approach like the Straight Line Method and recovers projected costs over the life of the plant. However, because future costs are discounted to a "present value," today's ratepayers will pay only their fair share of recovery costs in "real" dollars rather than the inflated amounts under the Straight Line Method. In our opinion, the Present Value Method strikes an appropriate balance between the interests of current and future ratepayers.[42]

36. The Commission further elaborated that the Straight-Line Method would not result in a fair allocation of costs between current and future ratepayers. The Commission observed that under the Straight Line Method, the utility would recover "the same annual cost in nominal dollars from ratepayers today as it does at the time plant is removed from service."[43] However, because "a dollar is worth substantially more today than it will be 20 to 40 years from now," current ratepayers would pay more in "real" dollars under the Straight-Line Method for the recovery costs of the plant they consume than would future ratepayers. In effect, use of the Straight-Line Method would exacerbate the intergenerational inequities that Potomac Edison raises as a concern in its Appeal. As Staff asserts, the Present Value Method was adopted by the Commission in 2007 "precisely because it addresses intergenerational concerns."[44] Similarly, in Case No. 9609, the Commission held that its concerns about the Straight-Line Method "were based upon a perceived generational inequity whereby inflation-adjusted amounts paid by

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[42] *Potomac Electric Power Co*., 98 Md. PSC 228, 251 (2007). Order No. 81517, Case No. 9092.
[43] *Id.*
[44] Staff Reply at 5.

current ratepayers would exceed the inflation-adjusted amounts paid by future ratepayers."[45]

37. Since 2007, the Commission has consistently upheld the fairness of the Present Value Method against challenge.[46] See *In re Washington Gas Light Co.*, 101 Md. PSC 38, 42 (2010) ("We start from the premise, articulated in Case No. 9092, that the Present Value Method properly allocates the fair share of costs to today's ratepayers and thus we prefer it to the historical Straight Line Method.") The Commission has also rejected the types of criticisms of the Present Value Method that are articulated by Potomac Edison in its present Appeal. For example, in Case No. 9609, the Commission observed that certain parties objected to the Present Value Method because by deferring net salvage costs to the future, "the [Present Value Method] may result in a lower level of accumulated depreciation and therefore a higher rate base than would occur under the Traditional Method."[47] That concern is nearly identical to the one articulated by Potomac Edison in the present case. *See* Potomac Edison Memorandum on Appeal at 12 (The Present Value Method forces customers "to pay for a return on a higher rate base and caus[es] future distribution rates to be higher than they otherwise would be due to the compounding effect of increasing utility rate base beyond what would otherwise occur under the Straight-Line/Traditional Method of net salvage recovery.") Nevertheless, the Commission finds now as it did in the past that the Present Value Method strikes a fair balance between current and future customers by appropriately discounting future costs

[45] Order No. 89403 at 11-12.
[46] *See* Staff witness Patterson Surrebuttal at 2, stating: "The Commission has considered these arguments and has consistently rejected the traditional method in favor of the present value method proposed by Staff."
[47] Order No. 89403 at 12.

to present value, thereby ensuring that all customers pay for their fair share of net salvage costs.

38. The Commission rejects Potomac Edison's assertion that the Present Value Method is unfair to future ratepayers. First, the allocation of future net salvage costs among ratepayers should consider the time value of money, as the Present Value Method does. Second, as OPC witness Garren testified, future ratepayers will also be current ratepayers in the future and will benefit from the application of the Present Value Method in the same way that current ratepayers do now.[48] The Commission likewise finds no injury to Potomac Edison from use of the Present Value Method. The Company is correct that as a matter of regulatory law, it is entitled to recover its prudently-incurred costs, including the costs of net salvage. Regardless of the method used, however, such costs involve estimations. As acknowledged by Potomac Edison,[49] to the extent it under-recovers net salvage costs, it may form a regulatory asset and later request Commission approval to recover such costs in the future.

39. The Commission finds unpersuasive Potomac Edison's claim that the selective application of the Present Value Method will cause the Company to fall "short of actual Company costs by more than 50% of the total incurred net salvage."[50] As noted by OPC, the five-year period chosen by Potomac Edison appears to be an outlier and not indicative of future net salvage costs. Potomac Edison's most recent five-year average of net salvage costs is $5,473,629, its average for the period from 2001 to 2019 is $3,164,687,

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[48] Garren Direct at 46-47. *See also* Order No. 89403 at 13-14: "Current customers are future customers from a past perspective, and they are clearly still benefiting from application of the [Present Value] Method."
[49] Potomac Edison Memorandum on Appeal at 4.
[50] *Id.* at 3.

and the highest net salvage cost it incurred in a single year was $11,614,708.13.[51] Those figures make Potomac Edison's proposal to collect net salvage under the Straight-Line Method at approximately $12.7 million annually unreasonable. Under its proposal, Potomac Edison would over-recover net salvage costs.

40. Staff and OPC correctly state that no net salvage method can estimate with perfect accuracy future net salvage costs, given that selected depreciation curves, service lives, and net salvage rates are all estimates. However, the Commission finds that Potomac Edison can mitigate the risks of error by performing depreciation studies on a more frequent and regular basis than it has in the current proceeding. Performing more frequent depreciation studies will reduce the variance between the calculated and actual plant service lives, depreciation, and net salvage. Additionally, use of the Remaining Life technique will mitigate the financial impact from any inaccuracies in the calculated depreciation curves, service lives, net salvage rates, and equipment lives from the actual plant in service. Potomac Edison witness Spanos acknowledged as much, when he testified that the Remaining Life technique "incorporates a self-correcting mechanism that will adjust depreciation expense for any over- or under-recoveries that have occurred in the past [and] … therefore, ensures that the full service value of the Company's assets is recovered through depreciation expense – no more, no less."[52]

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[51] OPC Reply at 8-9; Garren Surrebuttal at 5-6.
[52] Spanos Direct at 10. *See also* Case No. 9092, Order No. 81517 at 5 (the Remaining Life technique allows a "true-up of recovery amounts").

B. Discount Rate

1. Potomac Edison

41. Potomac Edison argues that the use of a utility's ROR as the discount rate results in current customers paying far less than their fair share of net salvage costs, which will cause rate base to increase over time, further increasing future customers' rates.[53] Potomac Edison claims that neither Staff nor OPC put forth any substantive evidence to support the use of Potomac Edison's ROR as the discount rate in this case.

42. Potomac Edison asserts that in Order No. 89403*,* the Commission rejected Columbia Gas's proposed 2.5% inflation rate as unsupported by the record, but left open the possibility of evaluating a new depreciation methodology.[54] In the present case, Potomac Edison argues that it presented extensive expert evidence to show "that 2.5% is an accurate estimate of the inflation rate."[55] Potomac Edison claims that the PULJ ignored this evidence in adopting an ROR discount rate. Specifically, Potomac Edison argues that the PULJ was arbitrary in ignoring Mr. Spanos' undisputed analysis of Consumer Price Index ("CPI") data from the U.S. Bureau of Labor Statistics, which shows annual 10-, 20-, and 30-year changes in the CPI over different periods of time, and which supports an inflation rate of 2.5%.[56]

2. Office of People's Counsel

43. OPC asserts that the Commission should affirm the PULJ's determination that Potomac Edison's overall ROR should be used as the discount factor in applying the Present Value Method. OPC acknowledges that Order No. 89403 left open the

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[53] Potomac Edison Memorandum on Appeal at 4, 13, citing Spanos Rebuttal at 20:1-4 & 56:4-5.
[54] *Id.* at 14.
[55] *Id.* Potomac Edison also claims OPC conceded that 2.5% is a reasonable inflation estimate. *Id.* at 5.
[56] Potomac Edison Memorandum on Appeal at 14, citing Spanos Rebuttal Testimony, Exhibit JJS-6RP; Spanos Rebuttal at 53-54.

possibility for a party to propose a fully-supported Present Value Method discount rate that is supported by expert testimony of inflation rate forecasts, "including evidence of inflation and risk-free rates."[57] However, OPC argues that Potomac Edison failed to heed the requirements of Order No. 89403 by neglecting to include any evidence of risk-free rates and asset retirement obligations – an omission noted by the PULJ.[58] Additionally, OPC asserts that no party to the case presented a witness qualified to testify regarding risk-free rates. In light of the lack of evidence concerning an appropriate risk-free rate, OPC contends that the PULJ properly found that Potomac Edison's authorized ROR should continue to be used as the discount rate.[59] Additionally, OPC argues that even if Potomac Edison had provided evidence regarding a credit-adjusted risk-free rate, there would still be a dispute about whether it would be appropriate to apply such a rate to non-legal asset retirement obligations, especially since those were the only obligations involved in this proceeding.[60]

44. OPC argues that an unreasonably low discount factor – such as Potomac Edison's 2.5% inflation rate – can harm ratepayers.[61] OPC also claims that the two hundred categories that comprise the CPI include categories such as food and beverages, housing, apparel, transportation, medical care, recreation, education, and communication, which have little relevance to utility plant and should be given minimal weight.

[57] *Id.* at 10.
[58] *Id.*, citing Proposed Order at 16, n. 62.
[59] *Id.* at 15.
[60] *Id.* at 13-14.
[61] *Id.* at 11.

3. Staff

45. Staff argues that the discount rate used for the Present Value Method of determining net salvage should be the approved ROR from Phase I of the Potomac Edison rate case proceeding. Staff argues that using the utility's ROR is clearly consistent with Commission precedent, in particular, the Columbia Gas rate case in Case No. 9609.[62] Additionally, Staff asserts that "it is appropriate to use the ROR as a discount rate in rate proceedings to ensure that cash flows received over time and cash balances in various accounts are treated equivalently regardless when received."[63]

4. Commission Decision

46. The Commission has consistently used the utility's ROR as the discount rate for making the Present Value Method calculations regarding net salvage. *See e.g.*, Proposed Order in Case No. 9316: "I reject the Company's present value methodology calculation because it uses a 2.5 % discount rate rather than a discount rate approximately equivalent to the Company's existing overall rate of return, which has been the discount rate methodology approved by the Commission in prior cases."[64] The Commission most recently confirmed that practice in Case No. 9609. There, the Commission reviewed a proposed order that used a 2.5 percent discount factor based upon the CPI. On appeal, the Commission reversed the proposed order, noting that "[t]he Commission has affirmed the company's ROR as the discount factor in multiple cases since 2007."[65]

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[62] Staff Reply at 9.
[63] *Id.* at 10.
[64] *In re Columbia Gas of Md.*, Case No. 9316, Aug. 9, 2013 Proposed Order of PULJ at 52; affirmed in Order No. 85858, 104 Md. PSC 487, 519 (2013).
[65] Order No. 89403 at 12. *See also* Staff witness Patterson Direct at 6: "For those accounts that have an expectation of net salvage costs, the Commission has historically discounted future net salvage / removal costs based on the utility's authorized rate of return."

47. Nevertheless, Potomac Edison correctly observes that in Case No. 9609, the Commission left open the right of parties in future proceedings to present evidence on the appropriate discount rate, "including evidence of inflation and risk-free rates."[66] In this case, however, Potomac Edison did not present any material evidence on the risk-free rate. Instead, it presented evidence exclusively on the rate of inflation, which Mr. Spanos testified was 2.5%, based on the federal CPI.[67] As the PULJ stated: "Exactly how a credit-adjusted risk-free rate is calculated went beyond the expertise of any of the witnesses in this Phase II proceeding…. Although witness Valdes agreed that Potomac Edison could have consulted with an expert to ascertain whether a credit-adjusted risk-free rate could be estimated for Potomac Edison, the Company did not do so."[68] Additionally, the PULJ found that "[a] credit-adjusted risk-free rate takes into account inflation, but it is not the same as inflation."[69] Developing a credit-adjusted risk-free rate requires analyzing market data such as the interest rate environment and the general state of the economy, as well as a company's financial condition, including financing arrangements.[70] As the PULJ observed, however, no such analysis was performed in this case.

48. Potomac Edison claims that its estimation of the inflation rate was uncontested. However, as the PULJ observed, "Staff and OPC argued that the inflation rate that Potomac Edison proposed does not necessarily relate to inflation experienced by

[66] Order No. 89403 at 15.
[67] Hr'g. Tr. at 46-47 (Spanos).
[68] Proposed Order at 11, citing Hr'g. Tr. at 170.
[69] *Id.* at 16.
[70] *Id.*

utilities."[71] Staff witness Patterson, for example, testified that "the CPI reflects 'the prices paid by urban consumers for a market basket of consumer goods and services,' the CPI is not directly tied to any utility industry standards and does not reflect the costs incurred by [Potomac Edison] or other utilities."[72]

49. Irrespective of the actual rate of inflation, however, the Commission finds that the inflation rate is too low to serve as the discount rate for purposes of the Present Value Method. The Commission agrees with Staff that "it is appropriate to use the ROR as a discount rate in rate proceedings to ensure that cash flows received over time and cash balances in various accounts are treated equivalently regardless when received."[73] The inflation rate proposed by Potomac Edison would not achieve that goal. Staff and OPC depreciation witnesses used Potomac Edison's ROR of 7.15% as the discount rate, which the Commission finds is appropriate and consistent with its precedent.[74]

IT IS THEREFORE, this 26th day of October, in the year of Two Thousand Twenty-One, by the Public Service Commission of Maryland,

ORDERED: That the Proposed Order of the Public Utility Law Judge is affirmed.

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[71] *Id.* For example, OPC asserted that multiple categories that comprise the CPI have little relevance to utility plant and should be given minimal weight by the Commission. OPC Reply at 12. *See also* Hr'g. Tr. at 46 (Spanos).

[72] Patterson Surrebuttal at 4, quoting Bureau of Labor Statistics.

[73] Staff Reply at 10. As a fall back position, Staff witness Patterson testified that "if the Public Utility Law Judge and Commission accept a discount rate lower than the utility's authorized rate of return, it should not be lower than [Potomac Edison's] highest asset retirement obligation ("ARO") credit adjusted risk-free rate ..." Patterson Surrebuttal at 5-6. However, as discussed above, Potomac Edison did not present material evidence relative to a credit adjusted risk-free rate.

[74] OPC witness Garren testified that Potomac Edison's ROR was the appropriate discount rate and that a credit-adjusted risk free rate may be inappropriate. *See* Garren Surrebuttal at 23: "In this matter, without [a] high degree of certainty that these removal costs will be incurred at close to the amount recorded, it is inappropriate to use the credit-adjusted risk-free rate as the discount factor."

/s/ Jason M. Stanek

/s/ Michael T. Richard

/s/ Anthony J. O'Donnell

/s/ Odogwu Obi Linton

/s/ Mindy L. Herman
Commissioners