

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

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DISTRICT OF COLUMBIA
PUBLIC SERVICE COMMISSION

OPINION AND ORDER

March 2, 2010

FORMAL CASE NO. 1076, IN THE MATTER OF THE APPLICATION OF THE
POTOMAC ELECTRIC POWER COMPANY FOR AUTHORITY TO
INCREASE EXISTING RETAIL RATES AND CHARGES FOR ELECTRIC
DISTRIBUTION SERVICE, Order No. 15710

Before the Commission:

Betty Ann Kane, Chairman
Richard E. Morgan, Commissioner
Lori Murphy Lee, Commissioner

Appearances:

Deborah M. Royster, Kirk J. Emge, Marc K. Battle, William M. Gausman, Anthony J. Kamerick, Arthur W. Adleberg, James W. Boone, Richard M. Lorenzo, Theodore F. Duver for Potomac Electric Power Company; Elizabeth A. Noel, Brian O. Edmonds, Sandra Mattavous-Frye, Karen R. Sistrunk, Barbara Burton, Laurence C. Daniels, Brenda K. Pennington, Jennifer L. Weberski, Maggie A. Sallah, Barry Cohen, Kevin J. Conoscenti, John Michael Adragna, James H. Boyd, Robert C. McDiarmid, Sharon Coleman, Jeffrey A. Schwarz, J.S. Gilbert, Stephen C. Pearson, Scott Strauss, Adrienne E. Clair, Dennie Lane, John E. McCaffrey, Douglas E. Micheel for Office of People's Counsel; Frann G. Francis, W. Shaun Pharr, Nicola Y. Whiteman for the Apartment and Office Building Association of Metropolitan Washington; Brian R. Caldwell for the District of Columbia Government; Leonard E. Lucas, III for the General Services Administration; Marc Biondi for the Washington Metropolitan Area Transit Authority; Nancy A. White, Robert I. White for the District of Columbia Water and Sewer Authority; Cathy Thurston-Seignious, Beverly Burke, Bernice K. McIntyre for Washington Gas Light Company.

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Attachment: SCHEDULES

I. BACKGROUND

1. On May 22, 2009, less than 16 months after an increase in its base rates, Potomac Electric Power Company ("Pepco" or "the Company") filed an Application with the Public Service Commission of the District of Columbia ("Commission") requesting a \$51.7 million increase in its retail service rates for distributing electricity in the District of Columbia.¹ The Company initially requested authority to earn an 8.88 percent rate of return, including a return on common equity of 11.50 percent. Subsequently, Pepco modified its request, seeking a \$44.514 million increase based on a rate base of \$1,020,095,000, an 8.53 percent overall rate of return and a 10.75 percent return on equity.² Pepco contends that its proposal for higher distribution rates is justified by higher costs (*i.e.*, the higher cost of capital, operations and maintenance expenses, and capital expenditures to maintain poles, wires, and critical equipment) as well as the need for Pepco to invest in new "smart grid" technology.

2. Pepco seeks approval of a surcharge to recover what it alleges are volatile pension-related, other post employment benefits ("OPEB"), and uncollectibles expenses based on a three-year rolling average (rather than actual test year costs); cost recovery for investment in advanced metering infrastructure ("AMI"); a new depreciation study filed December 31, 2008; and other cost of service items.

3. The Company states that current earned returns vary widely by customer class. It proposes to move gradually ("one-quarter of the way") toward equalizing class rates of return, by raising distribution rates (which are only one part of each customer's bill) more for residential than for commercial customers. Overall, Pepco proffers that an average residential customer's bill would increase by 6.1 percent or \$6.43 on the total bill under its proposals.³ Further, Pepco proposes a significant 211 percent increase in Street Light energy distribution rates. Other Pepco rate design proposals include replacement of its current Standby Rider with a new "GT-3A-S" tariff that would apply to customers with behind-the-meter generation that runs in parallel with the Company's delivery system; and a new Volatility Mitigation Surcharge (Rider "VM") to reflect changes in certain volatile expenses.

4. The Commission held a pre-hearing conference on July 2, 2009. By Order No. 15322 the Commission designated the issues for consideration and set the procedural schedule

¹ *Formal Case No. 1076, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, filed May 22, 2009 ("Formal Case No. 1076") ("Pepco's Application"). Pepco's Direct Testimony is hereinafter referred to as "Pepco ____"; its Supplemental Direct Testimony as "Pepco (2_)"; its Rebuttal Testimony as "Pepco (3_)"; its post-hearing initial brief as "Pepco Br."; and its post-hearing reply brief as "Pepco R. Br."

² See Tr. 1242.

³ Pepco (A) at 4 (Kamerick).

for this proceeding.⁴ We granted petitions to intervene by, among others, the Apartment and Office Building Association of Metropolitan Washington ("AOBA"), the District of Columbia Government ("DCG" or "District Government"); the District of Columbia Water and Sewer Authority ("WASA"); Washington Metropolitan Area Transit Authority ("WMATA"); and the General Services Administration ("GSA").⁵ The Office of the People's Counsel of the District of Columbia ("OPC") is a "party as of right."⁶

5. Pepco submitted supplemental direct testimony on July 27, 2009. Order No. 15540 directed the filing of additional testimony concerning Pepco's request for special regulatory asset treatment of its increased 2009 pension costs.⁷ OPC, AOBA, the District Government, WASA, WMATA, and GSA all submitted written testimony on September 17, 2009.

6. Rebuttal testimony was filed by all the parties on October 22, 2009. The Commission held evidentiary hearings on November 9, 10, 12, and 13, 2009. The Commission convened community hearings on October 24, November 19, and November 20, 2009. Over 125 community witnesses submitted comments or testified at the Commission's community hearings in this Pepco rate case. All the parties filed post-hearing initial briefs on December 9, 2009, and reply briefs on December 22 or 23, 2009.⁸

II. TEST PERIOD (Issue No. 1)⁹

7. Pepco's application reflects a test year of actual results for the twelve months ending December 31, 2008, adjusted for known and measureable changes, of the conditions which are expected to prevail during the rate-effective period.¹⁰ OPC does not challenge Pepco's

⁴ Order No. 15322 (July 10, 2009). The Commission's orders in this proceeding (*Formal Case No. 1076*) are hereinafter referred to as "Order No. ___ at (page or ¶ number) (Date)." Orders in other Commission proceedings are cited in the following format: "*Formal Case No. ___*, Order No. ___ (Date), ___ DCPSC ___ (Year)." Court decisions will be cited as "*[Case Name]*, ___ A.2d ___, ___ (D.C. (Year))." Transcripts of the Commission's evidentiary hearings are cited as "Tr. ___".

⁵ Order No. 15310 (June 24, 2009).

⁶ See D.C. Code § 34-804 (2009 Supp.) (OPC is a party, as of right, in any Commission investigation, valuation, reevaluation, concerning any public utility operating in District of Columbia). OPC's Direct Testimony is designated as "OPC ___"; its Rebuttal Testimony as "OPC (2___)"; its post-hearing initial brief as "OPC Br."; and its post-hearing reply brief as "OPC R. Br." The direct testimony of an intervenor is identified by party in the form (for example) "WMATA ___"; with rebuttal testimony denoted as (for example) "AOBA (2___)"; post-hearing initial briefs as (for example) "GSA Br."; and post-hearing reply briefs designated as (for example) "WASA R. Br."

⁷ Order No. 15540 (September 2, 2009).

⁸ The Commission grants the separate unopposed motions of AOBA and the District Government to file their reply briefs, out-of-time on December 23, 2009.

⁹ Designated Issue No. 1 asks, "Is Pepco's proposed test year ending December 31, 2008, reasonable?"

¹⁰ Pepco (A) at 10 (Kamerick); Pepco (C) at 3 (Hook); and Pepco (2C) at 2 (Hook Rebuttal).

use of a test year ending December 31, 2008.¹¹ No other party filed testimony on Pepco's proposed test year.

DECISION

8. The purpose of adopting a test year is to ensure that rate levels and the revenues they produce have a realistic relationship to the revenue requirements of the Company and to determine costs and investments as accurately as possible to allow the company a reasonable opportunity to recover its costs.¹² Pepco and OPC agree that the December 31, 2008, test year is a reasonable test year. The Commission concurs that Pepco's proposed test year ending December 31, 2008, is reasonable and an appropriate test year on which to review Pepco's Application.

III. RATE BASE (Issue No. 2)¹³

A. Unopposed Adjustments (Ratemaking Adjustments Nos. 2, 3, 5, 12, 19, 20, 21, 22, 24, and 29)

9. Rate base represents the investment the Company makes in plant and equipment in order to provide service to its customers.¹⁴ The undisputed portion of the rate base including agreed adjustments, totals \$3.013 million and include Ratemaking Adjustment No. 2 ("RMA No. 2"), CWIP in Rate Base, RMA No. 3, Annualization of Northeast Substation, RMA No. 5, Exclusion of Supplemental Executive Retirement Plans, RMA No. 12, Reflection of FC 1076 Costs, RMA No. 19, Annualization of Software Amortization, RMA No. 20, Annualization of Deductible Mixed Service Cost Tax Method, RMA No. 21, Exclusion of Capitalized Portion of Disallowed Formal Case No. 939 Costs, RMA No. 22, Reflection of Disallowance of Incentive Plan Costs, RMA No. 24, Inclusion of Deferred Customer Education Costs, and RMA No. 29, Reflection of New Method-Repair Categorizations.

DECISION

10. Inasmuch as no party challenges these adjustments and as the Commission has reviewed them and independently found them reasonable, we approve the adjustments.

¹¹ OPC (A) at 10 (Ramas).

¹² See, e.g., *Washington Gas Light Co.*, 1 DCPSC 142 (1975).

¹³ Designated Issue No. 2 asks, "Has Pepco properly computed its proposed rate base?"

¹⁴ *Public Utilities Reports Guide, References*, 9-28 (2008).

B. Pepco's Proposed 13-Month Average Rate Base (Issue No. 2A)¹⁵

11. Pepco states that its proposed 13-month average rate base is reasonable, properly computed, and conforms to past Commission ratemaking determinations.¹⁶ The rate base proposed by Pepco is \$1,020,095,000.¹⁷ OPC, nor any other party, challenges the use of a 13-month average rate base. OPC does, however, recommend various adjustments (totaling \$212,109,000) to Pepco's proposed rate base which, if accepted, would result in a rate base of \$841.923 million.

DECISION

12. While OPC proposes certain adjustments to Pepco's test year rate base, neither OPC nor any other party objects to Pepco's use of the 13-month average rate base. Moreover, Pepco's use of a 13-month average rate base is consistent with Commission precedent.¹⁸ Therefore the Commission finds, subject to certain adjustments proposed by the parties and discussed below, Pepco's 13-month average rate base is reasonable and appropriate.

C. Construction Work in Progress ("CWIP") (Issue No. 2b)¹⁹

1. Benning Road Relocation Project

13. **Pepco.** Pepco states that RMA No. 4, the Benning Road Relocation Project ("Benning Road"), reflects a large, unique, one-time project that costs more than \$20 million and is part of the District's "Great Street Initiative." It required Pepco to relocate and reconstruct duct banks and manholes, and install electric and fiber optic cable along Benning Road.²⁰ The project is unique in that, under normal circumstances, reconstruction of ductwork and facilities would not have been necessary in a street modification and repaving project. Pepco indicates that the electric plant installation was energized and in service in February 2009,²¹ and the

¹⁵ Designated Issue No. 2a asks, "Is Pepco's proposed 13-month average rate base reasonable?"

¹⁶ Pepco (C) at 5 (Hook); Pepco (2C) at 2 (Hook Supp).

¹⁷ In its initial application, Pepco's proposed average rate base was \$1.054 million. Pepco (C)-1 at 1 of 33 (Hook). Pepco Br. 5.

¹⁸ See, e.g., *Potomac Electric Power Co., Formal Case No. 748*, Order No. 7457 at 410, 412-417 (December 30, 1981); *Potomac Electric Power Co., Formal Case No. 939*, Order No. 10646 at 54; *Formal Case No. 1053*, Order No. 14712, ¶ 62.

¹⁹ Issue No. 2b asks, "Is the construction work in progress that Pepco included in the rate base reasonable?"

²⁰ Pepco (D) at 11-12 (Gausman).

²¹ Pepco (C) at 8-9 (Hook); Pepco (D) at 12 (Gausman).

adjustment reflects a known and certain change which will take place within six months of the end of the test year, and prior to the end of the rate-effective period.²² Pepco contends that Benning Road is identical to the Northeast Substation cut-in project approved in Formal Case No. 1053.²³ Pepco proposes to increase rate base by \$19.794 million.²⁴

14. **OPC.** OPC recommends that the Commission exclude the Benning Road “Retirement Work In Progress” (“RWIP”) rate base portion which would reduce rate base by \$886,640 and the revenue requirement by \$113,000; and reflect the removal of the assets that have been or will be retired as a result of the relocation project.²⁵ Regarding the first adjustment, OPC argues Pepco failed to clearly demonstrate that the dollars associated with retiring the replaced assets should be included in “Electric Plant in Service” (“EPIS”).²⁶ Regarding the second adjustment, OPC contends that the costs of both the new and old assets being replaced are included in rate base. OPC contends that the Company’s filing does not reflect the removal of the replaced assets from rate base.²⁷

15. OPC recommends that EPIS and accumulated depreciation be reduced by \$1,051,000 to reflect the retirements booked by Pepco and that depreciation expense be reduced by \$28,000.²⁸ OPC contends that it does not have the accumulated depreciation balance for the test year associated with the retired assets, but assumed that the assets were close to fully depreciated. OPC also states that it needs additional information from the Company to determine the full extent of a reduction. Absent the removal from rate base of the assets being retired and removal of the associated depreciation expense, OPC asserts that Pepco’s CWIP adjustment associated with Benning Road EPIS and the resulting depreciation expense should be denied.²⁹ OPC concludes that to include the RWIP depreciation expenditures would result in double recovery.³⁰

16. **Pepco Rebuttal.** Pepco agrees with OPC that the retired assets should be removed from rate base.³¹ However, Pepco contends that because EPIS and accumulated

²² Pepco (C) at 8-9 (Hook).

²³ *Id.* at 8.

²⁴ Pepco (C)-1 at 7 (Hook).

²⁵ OPC (A) at 24-25 (Ramas); OPC Br. 41.

²⁶ *Id.* at 26.

²⁷ *Id.* at 27.

²⁸ OPC R. Br. 72.

²⁹ OPC (A) at 29 (Ramas).

³⁰ OPC Br. 40-41.

³¹ Pepco (4C) at 9 (Hook Rebuttal).

depreciation will be reduced by the same amount, there is no rate base impact.³² Therefore, Pepco submits it is proper to increase EPIS by \$18.9 million and the reserve by \$886,640 because the impact on rate base would be the same.³³ Pepco maintains that the costs are properly included in rate base.

DECISION

17. In response to cross examination by OPC, Pepco later verified in an exhibit filed with the Commission that the RWIP removal costs (\$886,640) had been recorded in the test year and should have been removed from rate base.³⁴ The impact of the correction is reflected in the Company's final proposed revised revenue requirement.³⁵ OPC's proposed adjustment to remove duplicative removal costs is therefore moot. OPC also contends that the costs of the new assets and the old assets being replaced are included in Pepco's proposed rate base. However, the plant-in-service assets (\$1.05 million) have been removed from service and do not impact rate base. Therefore, the additional adjustment proposed by OPC is unnecessary. Finally, OPC's proposed depreciation adjustment (\$28,000), which reduces depreciation expense, has been reflected in Pepco's revised revenue requirement.³⁶ With these changes, the Commission accepts Pepco's adjustment, as amended.

2. 69 kV Overhead Lines

18. **Pepco.** Pepco seeks to recover in rate base the D.C.-allocated portion of the Company's investment in the two temporary 69 kV emergency overhead lines used to provide service to the District of Columbia. Pepco indicates that a segment of the line over the National Park Service's Oxon Cove Park has been removed from service and retired on the Company's books with the remaining portion of the lines de-energized. Pepco represents that the lines were taken out of service in July 2009.³⁷

19. **OPC.** OPC contends that Pepco built the two overhead 69 kV lines to provide additional reliability to WASA's Blue Plains Wastewater Plant and that a significant segment of

³² *Id.* at 10.

³³ *Id.*

³⁴ Tr. 1356-1357; see Pepco Ex. 50 (filed November 11, 2009).

³⁵ Tr. 907. See *Formal Case No. 1076*, "Revised Revenue Requirement Schedules of OPC's witness Ramas," filed November 20, 2009.

³⁶ Tr. 1242, Pepco Attachment 9 of 34.

³⁷ There is conflicting testimony as to the exact length of the line and the segment removed from service. One Pepco witness testifies that approximately 4,600 feet of the 13,000 foot line was removed, while another states that 4,000 feet of the 16,000 foot line was removed. Pepco (4C) at 2-3 (Hook); OPC Cross Examination Ex. 100; Tr. 1329, 1422.

the lines were “physically removed” and “retired” on the Company’s books.³⁸ Based on these retirements, OPC argues that Pepco’s EPIS should be reduced by \$2.54 million (D.C.-allocated costs), with a corresponding reduction in depreciation expense of \$51,337,³⁹ and a resulting reduction to the revenue requirement in the amount of \$376,000.⁴⁰ OPC asserts that the Company has not demonstrated that the lines are abandoned, or that the investment should be included in rate base.⁴¹ To the extent the Commission is inclined to allow rate recovery for the lines, OPC maintains that WASA should be directly assigned the costs.⁴² OPC also claims that the dollar value of the portion removed from service should be approximately \$1 million, as Pepco witness Gausman testifies, and not \$61,529 as proffered by Pepco witness Hook.⁴³

20. **Pepco Rebuttal.** Pepco explains that the 69 kV overhead lines were used to provide emergency back-up support for the load supplied by the Potomac River station to the District of Columbia and Blue Plains in case Mirant’s Potomac River generating station shut down.⁴⁴ The Company acknowledges that a segment of the line which ran over the National Park Service’s Oxon Run Park has been removed from service, but maintains that the remainder is available to serve as back-up capacity. Pepco argues that the plans for the lines were approved by the Commission, the costs were prudently incurred, and, therefore, that cost recovery is appropriate.⁴⁵

21. Pepco indicates that, in order to replace dependence on the Mirant Potomac River generating station, two new 230 kV lines were being installed, and, pending installation, the Company needed the two 69 kV overhead lines to ensure public safety, protect the economic viability of the District and avoid a potential environmental failure.⁴⁶ Pepco transferred the load from the Potomac River station, which freed up capacity on the existing 230 kV lines to serve other customers within the District of Columbia.⁴⁷ Pepco asserts that it proceeded with the work

³⁸ OPC Br. 24.

³⁹ OPC (A)-15.

⁴⁰ OPC Br. 33; OPC (A)-3, Summary at 1 of 4.

⁴¹ OPC Br. 29

⁴² *Id.* at 24, n 58.

⁴³ *Id.* at 33.

⁴⁴ Pepco (4C) at 2 (Hook Rebuttal).

⁴⁵ *Id.*, Pepco (3D) at 16 (Gausman Rebuttal)

⁴⁶ *Id.* at 14-15.

⁴⁷ Tr. 905-906, 1425. At the time of *Formal Case No. 1044*, Potomac River served approximately 14,927 customers with approximately 11,000 being residential customers. See *Formal Case No. 1044, In the Matter of the Emergency Application of Pepco for a Certificate of Public Convenience and Necessity to Construct Two 69 KV Overhead Transmission Lines and Notice of the Proposed Construction of Two Underground 230 KV Transmission Lines*, Order No. 13895 (“*Formal Case No. 1044*”) (March 6, 2006).

based upon Order No. 13895 in Formal Case No. 1044, because neither the Commission nor any other party saw a quick, reasonable alternative to the problem. The issue of cost recovery and allocation was not addressed in Formal Case No. 1044.⁴⁸ Pepco acknowledges that the lines are not energized and are not “used and useful” and that the Oxon Run Park section was “physically removed” and retired on the Company records.⁴⁹ Pepco contends that the majority of the lines remains available to serve as back-up and can be reconnected, restoring service in five to seven days.⁵⁰ Pepco seeks full recovery for the lines, but, in the alternative, proposes that only the retired plant be excluded from rate base.⁵¹

DECISION

22. We agree with Pepco that its expenditure on the emergency overhead lines was prudent. Without the installation of the 69 kV and 230 kV lines, a major loss of power could have negatively impacted electric service to the District of Columbia and its utility customers.⁵² The lines were installed to ensure service reliability in light of the emergency that resulted from the potential closure of Mirant’s Potomac River Plant.⁵³

23. Pepco, PJM Interconnection, Inc. (“PJM”),⁵⁴ and OPC all agreed that the completion of the two 69 kV overhead lines and the two underground 230 kV lines were necessary to ensure service reliability to the areas served by the Potomac River Plant, and they all supported construction of the lines.⁵⁵ While acknowledging that Pepco’s actions were

⁴⁸ Pepco (3D) at 168. (Gausman Rebuttal).

⁴⁹ Tr. 1328, 1331-1334 (Hooks); Pepco (3D) at 17 (Gausman Rebuttal).

⁵⁰ Pepco (3D) at 19 (Gausman Rebuttal).

⁵¹ Pepco (4C) at 2-3 (Hook). Pepco witnesses have stated two different values for the costs of the retired plant. Pepco witness Hook estimates the total value for retirement purposes to be \$61,529, while Pepco witness Gausman estimates the value to be approximately \$1million. Tr. 1344.

⁵² In addition to Blue Plains, affected customers included, among others, all electric customers in Georgetown, Foggy Bottom, major portions of downtown Washington, numerous hospitals, schools, universities, the FBI, the U.S. Justice Department, the U.S. State Department, the Federal Emergency Management Agency, and the U.S. Departments of Interior and Energy. If power was lost, Blue Plains would have had to release raw untreated sewage directly into the Potomac River, which would have a significant adverse impact on the Potomac’s ecosystem as well as human health. See *Formal Case No. 1044*, Order No. 13895, ¶ 23. Pepco (3D) at 19 (Gausman); Pepco (4C) at 2 (Hook); Tr. 905-906.

⁵³ See *Formal Case No. 1044*, Order No. 13895.

⁵⁴ PJM is a regional transmission organization that coordinates the movement of wholesale electricity in all or parts of 13 states and the District of Columbia.

⁵⁵ *Id.*

prudent, OPC opposes cost recovery, arguing that the lines are no longer “used and useful” and that their costs were incurred outside the test year.

24. The Commission finds that cost recovery is warranted here. In fact, the Commission, by Order No. 13895, approved Pepco’s application to install the lines.⁵⁶ Without the lines, public health and safety, and national security might have been placed at risk. The emergency overhead lines significantly improved Pepco’s ability to provide safe and reliable service to District ratepayers. The out-of-period expenditure reflects costs that were justified and adequately supported by Pepco, and is therefore reasonable.

25. Out of test year adjustments have been routinely considered by this Commission on an item-by-item basis.⁵⁷ Neither the “out-of-test-year” objection nor the “no-longer-in-service” objection gives appropriate consideration to the emergency situation that was facing the District. Strict adherence to a particular set of general policies should not be pursued to the point where it has a “chilling effect” on the cooperation necessary when emergencies arise. “[T]he Commission may depart from the ‘used and useful’ standard if it takes into account the extent to which the risk that this particular plant [69 kV overhead lines] would become obsolete was borne by investors in the part and the extent to which they were compensated for it.”⁵⁸ In this instance, the Commission finds that a balanced decision will serve the best interests of the District of Columbia, Pepco investors, and Pepco ratepayers.⁵⁹

26. Approximately 25 percent of the 69 kV lines have been removed from service; therefore, we will deny Pepco cost recovery for 25 percent of the jurisdictional amount (\$2.54 million) that was included in EPIS.⁶⁰ Pepco should remove \$635,000 from rate base to reflect the full value of the “physically removed” and “retired” segment of the lines. The Commission will allow Pepco to include the remaining amount of the 69 kV lines in rates. To safeguard the safety and reliability of Pepco’s distribution system that serves the District of Columbia, the lines will serve as emergency back-up. The Commission is persuaded by Pepco’s testimony that it might be “better to leave [the 69 kV overhead lines] up and ready to use again if it were needed, than to tear them down”⁶¹ and that the lines, if needed, could be quickly reconnected.⁶² A major

⁵⁶ *Id.*, ¶ 25-29.

⁵⁷ Earlier case law provides ample precedent for allowing out-of-test-year adjustments, when known and definite deviations from the test year could be calculated with some precision. *See, e.g., OPC v. Pub. Serv. Comm’n*, 610 A.2d 240, 247 (D.C. 1992); *see also, OPC v. Pub. Serv. Comm’n*, No. 08-AA-947 at n. 5 (February 18, 2010).

⁵⁸ *See, e.g., Washington Gas Light Co. v. Baker*, 188 F.2d 11, 20 (D.C. Cir. 1951).

⁵⁹ “Neither regime [the prudent investment rule or the used and useful rule], mechanically applied with full rigor, will likely achieve justice among the competing interests.” *Jersey Central Power & Light v. FERC*, 810 F.2d 1168, 1191 (D.C. Cir. 1987).

⁶⁰ Tr. 1329.

⁶¹ Tr. 1337.

outage in the downtown area, where residents, business, essential governmental agencies and hospitals are located, could have catastrophic consequences. It is essential that Pepco be able to bring service back on line in an expedited manner. Pepco shall reclassify the lines in an appropriate account (e.g. "emergency capital spares") consistent with this Order. Pepco shall not remove the remaining portions of the 69 kV overhead lines without first obtaining the explicit prior approval of the Commission.

D. Cash Working Capital (Issue No. 2c)⁶³

27. **Pepco.** Pepco proposes to include a \$12.194 million cash working capital ("CWC") allowance in rate base based on a net lag of 20.46 days.⁶⁴ Pepco represents that the revenue and expense lags used to determine the net lag were taken from the 2005 lead-lag study filed and approved in Formal Case No. 1053. Pepco indicates that CWC was determined by applying Pepco's net lag days to the average daily expense incurred in the test period, to which it made two adjustments. The first adjustment removes \$80,873 of District of Columbia-allocated withholding taxes and the second, includes \$183,038 for District of Columbia-allocated imprest funds.⁶⁵

28. **OPC.** OPC initially challenged but subsequently concurred with Pepco's CWC calculation.⁶⁶

DECISION

29. The Commission's independent review, finds that Pepco has properly reflected CWC in rate base. The Commission, therefore, accepts Pepco's CWC adjustment.

⁶² Pepco (3D) at 19 (Gausman Rebuttal).

⁶³ Issue No. 2c asks, "Is Pepco's proposed cash working capital allowance reasonable?" CWC is the amount of cash required by a utility to operate during the interim between when service is rendered and payment received. It is determined by multiplying the net lag days (difference between the company's revenue and expense lags) by the average daily expense incurred during a test year.

⁶⁴ Pepco (C) at 19-20 (Hook); Pepco (2C) at 2 (Hook Supp). The revenue and expense lags were determined based on the twelve months ended December 31, 2008.

⁶⁵ Pepco (C) at 20 (Hook).

⁶⁶ OPC Br. 43.

E. OPC's Proposed Offset to Rate Base for Ratepayer Funded Reserves

Self-funded Reserve Accruals

30. **OPC.** OPC recommends that the test year average balance of the self-funded reserve accruals for general and auto liability, and the incurred but not reported reserve ("IBNR") for health claims, be reflected as an offset to rate base in recognition that the funds are cost-free capital provided by ratepayers. OPC is concerned with the steady increase in, and size of, the reserve balances. These reserve accruals are included in the cost of service as an expense item.⁶⁷ OPC contends that these funds have been collected in advance from ratepayers, have not been paid out in claims and represent ready-available, ratepayer-supplied funds. The funds serve to offset the Company's working capital needs. OPC contends that because of the direct impact of the expense accruals on the reserve balance, it is appropriate to deduct the reserve balance from rate base for each of these non-cash expenses.⁶⁸ OPC recommends that the rate base be reduced by \$1.34 million for self-funded reserve accruals.⁶⁹

31. OPC also recommends that, in the next base rate case, Pepco be required to provide testimony: (1) describing each of its self-funded reserves; (2) identifying the target reserve balances; (3) explaining how the target reserve balances were determined; and (4) detailing how the expense amounts associated with the reserves were determined.⁷⁰

32. **Pepco Rebuttal.** Pepco testifies that it uses actuaries "in determining the liability balances for workers compensation, long term disability, surviving spouse welfare plan and IBNR."⁷¹ The Company also explains that it uses actuaries to provide a basis for determining probability and estimating accruals for automobile and general liabilities.⁷² Following SFAS 71 rules, the Company adjusts the self-funded expense accruals and records a regulatory asset for its workers compensation, long term disability, and surviving spouse welfare plan. Pepco represents that historically the Company has included an allowable cost for ratemaking on a pay-as-you-go basis. The difference between the actuarial accrual, as determined by the actuaries, and actual payment is recorded as a regulatory asset.⁷³

⁶⁷ OPC (A) at 18 (Ramas).

⁶⁸ *Id.* at 19.

⁶⁹ Tr. 865, OPC Br. 22. Originally OPC had proposed a reduction of \$14.45 million.

⁷⁰ OPC (A) at 21 (Ramas).

⁷¹ Pepco (3E) at 5 (White).

⁷² *Id.* at 5-6.

⁷³ *Id.*

33. Pepco maintains that it follows the guidelines outlined in SFAS 112 and SFAS 5.⁷⁴ The expense is based on probable and estimated liabilities and does not have a component for building and maintaining a reserve.⁷⁵ Pepco explains that the amount expensed pursuant to General Accepted Accounting Principles ("GAAP") is based upon estimates of future payments. The Company's rates have historically reflected pay-outs for the items included in self-funded accruals, and the difference between accruals and pay-as-you-go is included in the regulatory asset.⁷⁶ Pepco states that the amount included in Pepco's expense for cost of service purposes for worker's compensation, long-term disability, and surviving spouse welfare plan does not include a component associated with building up and maintaining the reserve balance. Further, Pepco contends that neither the liabilities nor the regulatory asset associated with it are included in rate base.⁷⁷

DECISION

34. The Commission has reviewed OPC's proposed adjustment, Pepco's response thereto, and the historical treatment of these self-funded reserve accruals. We are not persuaded that the self-funded reserve accruals should be adjusted and, therefore, OPC's proposed adjustment is denied. The Commission is satisfied that Pepco is following GAAP to estimate the expense for the various welfare plans and is recording the reserves properly.

IV. TEST YEAR SALES AND REVENUES (ISSUE No. 3)⁷⁸

A. Weather Normalization of Sales and Revenues⁷⁹

35. **Pepco.** Pepco proposes to reduce test year revenues by \$2.065 million (RMA No. 1).⁸⁰ Pepco calculates weather-corrected sales and revenues using a 30-year average (1978-2007) in accordance with Order No. 10646.⁸¹ Pepco indicates that to obtain weather corrected sales

⁷⁴ Pepco (3E) at 3-5 (White Rebuttal). SFAS 112 requires companies to accrue a liability for employee future absences when attributable to employee services already rendered. SFAS 5 requires an estimated loss be accrued by a charge to income if it is probable that an asset has been impaired or a liability incurred and the loss can be reasonably estimated.

⁷⁵ *Id.* at 5, Pepco R. Br. 8.

⁷⁶ Pepco (4C) at 8 (Hook Rebuttal).

⁷⁷ *Id.* at 8-9.

⁷⁸ Designated Issue No. 3 asks, "Are Pepco's test year-sales and revenues appropriate?"

⁷⁹ Designated Issue No. 3a asks, "Has Pepco properly weather-normalized its sales and revenue?"

⁸⁰ Pepco (F) at 20-21 (Browning), Pepco (2F) at 3 (Browning Supp). Pepco had proposed a \$2.196 million adjustment. However, in the November 20, 2009, filing, the update to the Company's revenue requirement model indicates an adjustment of \$2.065 million.

⁸¹ See Formal Case No. 939, Order No. 10646 (June 30, 1995).

and revenues, it ran regression analyses on daily degree day weather and daily sales to relate energy usage to heating degree days (HDD) and cooling degree days ("CDD").⁸² For the summer months, Pepco used a 65 degree base (65°F) and for winter months, both a 35 and a 65 degree (35° and 65°) base. The heating season covers October through March; while the cooling season includes May through October.⁸³ Pepco states that the weather coefficients developed for each class estimated the weather sensitivity of each class and were applied to the degree day differences from the 30-year average to develop the amount of kWh weather adjustment for the twelve months ending December 2008.⁸⁴

36. **OPC.** OPC proposes to decrease test year revenues by \$576,956.⁸⁵ OPC contends that Pepco should have used the most recent National Oceanographic and Atmospheric Administration ("NOAA") 30-year normal heating and cooling degree days (1971-2000). Further, OPC contends that Pepco improperly uses two balance points (65°F and 35°F) without providing justification, and uses a time period that is too short to capture changes in temperature and usage patterns.⁸⁶

37. OPC claims that its weather normalization adjustment is more appropriate because, among other things, it: (1) uses Pepco's daily temperature and retail sales data for the period 2005-2008 (which better captures the relationship between consumption and temperature); (2) uses the industry accepted single 65°F balance point,⁸⁷ and (3) reflects 1971-2000 30-year normal heating and cooling degree days. OPC argues the use of less than one year of data fails to accurately capture the relationship between electric consumption and temperature. OPC recommends that Pepco's sales revenues be adjusted by approximately \$1.62 million.⁸⁸

⁸² Pepco (F) at 20 (Browning).

⁸³ See Formal Case No. 1053, *In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, ("Formal Case No. 1053") Order No. 14712, ¶ 143. The Commission found Pepco's heating and cooling seasons reasonably designated.

⁸⁴ Pepco (F) at 20. (Browning); see also Pepco (F)-4, -5 and -6 (Updated).

⁸⁵ OPC (A) at 33 (Ramas).

⁸⁶ OPC (D) at 5-6, 13 (Mariam); OPC Br. 44. Balance point temperature refers to a point at which no additional heating or cooling is required when outdoor temperatures are higher or less than the balance point, respectively.

⁸⁷ OPC Br. 49. OPC also states it prefers to include additional appropriately chosen balance point temperatures in order to capture the non-linear relationship between energy consumption and temperature. OPC (D) at 8, n.4. (Mariam).

⁸⁸ OPC (D) at 18 (Mariam).

38. **Pepco Rebuttal.** Pepco states that NOAA publishes new 30-year normal weather data only once a decade and that NOAA, citing climate change (warming trend), is developing alternatives to the 30-year normal temperatures.⁸⁹ Pepco argues that it uses the 35 degree threshold as a variable because the engineering characteristics of electric heat pumps, a major heating technology, imply an inflection point in the relationship between temperature and electricity use. Moreover, regression statistics support its use in many of the rate cases studied.⁹⁰ Pepco argues that OPC's approach, among other things, blends data from several years and mixes the heating and cooling seasons, which can muddy the estimation of the relationship between weather and usage.⁹¹

DECISION

39. The Commission, in past rate proceedings, determined that it would review the issue of weather normalization on a case-by-case basis.⁹² Regarding the data to be used to calculate normalization, the Commission determined that "[t]he appropriate data set for a method that uses daily sales and weather shall encompass the most recent twelve-month period."⁹³ The Commission also determined that "the use of a 30-year period to determine average or normal weather was appropriate."⁹⁴ Here, as in prior proceedings, the Commission is interested in the continual refinement and improvement of the analyses that goes into determining normal weather.

40. OPC challenges Pepco's selection of a 30-year period (1978-2007) to determine normal weather. OPC proposes that end of the decade data published by the NOAA, following standards established by the World Meteorological Organization ("WMO"), be used to determine the thirty-year period. However, using the 30-year period (1971-2000) suggested by OPC would lead to weather normals that drop 10 years of data at a time as a result of moving from one decade to the next. For example, during 2011, the WMO normal will change from 1971-2000 to 1981-2010, effectively dropping ten years of data (1971-1980) at one time. By contrast, if the Company were to file a rate case in 2011, its methodology would move the period from 1978-2007 to 1980-2009, thus dropping only two years of data (1978-1979). This is consistent with the Commission's desire for more recent and stable data.

⁸⁹ Pepco (3F) at 5-6 (Browning Rebuttal).

⁹⁰ *Id.* at 6-7.

⁹¹ *Id.* at 7-8.

⁹² *Formal Case No. 939*, Order No. 10646 at 73 (June 30, 1995), citing *Formal Case No. 929*, Order No. 10387 at 76.

⁹³ *Id.* at 73.

⁹⁴ *Id.* at 75.

41. The Commission also finds that Pepco's use of two balance points (65 and 35 degrees) is consistent with what we have permitted in the past.⁹⁵ OPC's own witness has recommended multiple balance points in other proceedings.⁹⁶ The Commission finds that Pepco has established that the 35 degree threshold as a variable is reasonable because of the engineering characteristics of electric heat pumps. Moreover, regression statistics support its use.⁹⁷

42. Last, the Commission's stated preference is for daily sales and weather that encompass the most recent twelve-month period.⁹⁸ OPC has not shown that the use of a 12-month period is too short to capture changes in temperature and usage pattern. OPC has not convincingly shown why the Commission should depart from this established precedent. The methodology used by the Company is reasonable and consistent with our past orders. Therefore, we accept the revenue adjustment as proposed by Pepco. This weather normalization adjustment will reduce test year revenues by \$2.065 million.

V. RATE OF RETURN/COST OF CAPITAL
(Issue No. 4)⁹⁹

43. As in all base rate proceedings, the Commission must determine a reasonable rate of return including capital costs and the appropriate capital structure for Pepco. We need not discuss in great detail the legal standards and guidelines governing our responsibility to determine a fair and reasonable rate of return and the purpose of that determination. Our continuing basic reliance on *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187 at 1209-1215 (D.C. 1982) (review of Formal Case No. 686) is amply described in many of our discussions of rate of return in rate cases. In this decision also we will adhere to the standards derived from the Supreme Court's decisions in *Bluefield* and *Hope*,¹⁰⁰ as set forth in *Washington Gas Light Co. supra*.

44. With these standards forming the backdrop for our consideration of Issue No. 4, we turn to its various components and the evidence presented on the record of this proceeding by the parties.

⁹⁵ *Id.* at 72.

⁹⁶ Tr. 1021.

⁹⁷ Pepco (3F) at 6-7 (Browning Rebuttal).

⁹⁸ Order No. 10387 at 73.

⁹⁹ Designated Issue No. 4 asks, "Are Pepco's requested cost of capital and capital structure reasonable?"

¹⁰⁰ *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923); *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 590 (1944).

a. Overall Cost of Capital

45. The overall costs of capital recommended by the parties to this proceeding are as follows:

Pepco.

<u>Capitalization</u>	<u>Ratio</u>	<u>Cost Rates</u>	<u>Return</u>
Long-Term Debt	53.82%	6.63%	3.57%
Common Equity	<u>46.18</u>	10.75%	<u>4.96</u>
	100.00%		8.53%

OPC.

<u>Capitalization</u>	<u>Ratio</u>	<u>Cost Rates</u>	<u>Return</u>
Short-Term Debt	4.30%	1.35%	0.06%
Long-Term Debt	51.51	6.63	3.41
Common Equity	<u>44.20</u>	9.00	<u>3.98</u>
	100.00%		7.45%

AOBA.

<u>Capitalization</u>	<u>Ratio</u>	<u>Cost Rates</u>	<u>Return</u>
Long-Term Debt	56.00%	6.11%	3.42%
Common Equity	<u>44.00</u>	9.40	<u>4.14</u>
	100.00%		7.56 %

b. Cost of Common Equity (Issue No. 4a)¹⁰¹

46. **Pepco.** Pepco recommends a return on equity ("ROE") of 10.75 percent, including a Bill Stabilization Adjustment ("BSA"), discussed below.¹⁰² Initially Pepco recommended an ROE of 11.25 percent, with the BSA adjustment. However, during the hearings, Pepco revised its recommended ROE to reflect the improvement in financial conditions and the abatement of the financial crisis.¹⁰³ Pepco's revised ROE is based on a cost of equity range of 10.75 to 11.25 percent, without a BSA adjustment and without any adjustment to reflect

¹⁰¹ Designated Issue No. 4a asks, "What cost of common equity should Pepco be allowed to earn?"

¹⁰² Tr. 239-243.

¹⁰³ Tr. 239. Although Dr. Morin updated his DCF, CAPM, and Risk Premium calculations during the hearing to reflect changes in market conditions, he did not update the analyses he provided as support for his returns on equity.

Pepco's proposed surcharge related to pension, other post-employment benefit ("OPEB"), and uncollectible expenses (the Company's surcharge/deferral mechanism), discussed below.

47. Pepco Witness Kamerick testifies that the Company's proposed ROE is the minimum necessary for the Company to attract capital on reasonable terms in the current capital markets.¹⁰⁴ Witness Morin originally testified that capital markets were in a state of turmoil, extremely volatile and unpredictable,¹⁰⁵ but appeared to be improving.¹⁰⁶ During the hearings, he revised his recommended ROE downward, stating that the "financial crisis has abated, and there had been some significant improvements in the capital markets and stability."¹⁰⁷

48. To determine the cost of common equity, witness Morin employs three market-based methods: the Capital Asset Pricing Model ("CAPM"), Risk Premium, and Discounted Cash Flow ("DCF") methods. He contends that reliance on a single methodology or preset formula would be inappropriate when dealing with investor expectations because of possible measurement errors and vagaries in individual companies' market data. Dr. Morin uses two proxy groups in his analyses: investment-grade dividend-paying combination electric and gas utilities from AUS Utility Reports (Pepco's Combination Utility Group),¹⁰⁸ and electric utilities in the S&P Electric Utility Index.¹⁰⁹

CAPM

49. According to witness Morin, the CAPM approach to estimating the cost of common equity is a form of risk premium analysis that is based on the principle that risk-averse investors demand higher returns for assuming additional risk, and higher-risk securities are priced to yield higher expected returns than lower-risk securities. The CAPM quantifies the additional return, or risk premium, required for bearing incremental risk. The CAPM provides a formal risk-return relationship anchored on the basic idea that only market risk matters. Market risk is measured by a firm's "beta."¹¹⁰ The return expected by investors is equal to the risk-free

¹⁰⁴ Pepco (A) at 13 (Kamerick).

¹⁰⁵ Pepco (B) at 5 (Morin).

¹⁰⁶ Tr. 239.

¹⁰⁷ Tr. 239-242.

¹⁰⁸ These companies allegedly possess large amounts of energy distribution assets, are investment grade, pay dividends, have a market capitalization of more than \$500 million, and derive more than 50% of their revenues from regulated utility operations. See Pepco (B)-7.

¹⁰⁹ Pepco (B) at 57-58 (Morin).

¹¹⁰ *Id.* at 25. Beta is a measure of the volatility, or systematic risk, of a stock or a portfolio in comparison to the market as a whole. A beta of 1 indicates that the stock's price will move with the market. A beta of less than 1 means that the stock will be less volatile than the market. A beta of greater than 1 indicates that the stock's price will be more volatile than the market. Many utilities stocks have a beta of less than 1.

rate (witness Morin uses the current interest rate on 30-year Treasury bond) plus the risk premium. In his analysis, Dr. Morin relies on average betas for his proxy groups and forward-looking and historical studies of long-term risk premiums.¹¹¹ Witness Morin also uses an empirical version of CAPM ("ECAPM") because, he contends, CAPM-based estimates of the cost of capital underestimate the return required from low-beta securities and overstate the return required from high-beta securities.¹¹²

Risk Premium

50. In his historical risk premium analysis, witness Morin estimates the cost of common equity by comparing returns earned by the Standard & Poor's Utility Index and the yield on A-rated utility bonds. Morin states that an historical risk premium was estimated based on an annual time series analysis applied to the utility industry as a whole over a 1930-2007 period. The risk premium is calculated by computing the actual realized return on equity for the S&P Utility Index for each year, using the actual stock prices and dividends of the index, and then subtracting the utility bond return for that year. Dr. Morin then added the average risk premium for the 1930-2007 period to the current risk-free interest rate.¹¹³ Dr. Morin believes that, in the current financial markets, it is more appropriate to use utility bond yields as opposed to government bond yields, as he has previously, because the trends in utility cost of capital are directly reflected in the cost of debt and not by a risk premium estimate tied to government bonds.¹¹⁴

Discounted Cash Flow

51. Dr. Morin's DCF analysis is based on the proposition that the value of any security to an investor is the expected discounted value of the future stream of dividends or other benefits.¹¹⁵ According to Dr. Morin, the standard DCF model assumes a constant average growth trend for both dividends and earnings, a stable dividend payout policy, a discount rate in excess of the expected growth rate, and a constant price-earnings multiple, which implies that growth in price is synonymous with growth in earnings and dividends. It also assumes that dividends are paid at the end of the year, when in fact, dividends are paid on a quarterly basis.¹¹⁶

52. As proxies for the expected dividend growth component of the DCF model, witness Morin uses the consensus growth estimates developed by Zacks Investment Research,

¹¹¹ *Id.* at 31.

¹¹² *Id.* at 36-40.

¹¹³ *Id.* at 44.

¹¹⁴ *Id.* at 43-46.

¹¹⁵ *Id.* at 48.

¹¹⁶ *Id.* at 50.

Inc. ("Zacks") and Value Line. Morin rejects the uses of historical growth rates to estimate expected future growth because several electric utility companies have experienced negative growth rates, and, he believes, historical growth rates have little relevance as proxies for future long-term growth. Witness Morin also rejects OPC's use of the sustainable growth/retention growth method of estimating future growth because, he testifies, this approach assumes that the ROE is constant over time and no new common stock is issued (and, if so, at book value), the method requires an estimated ROE, and this method is not as significantly correlated to measures of value (such as stock prices and price-earnings ratios) as analysts' forecasts.¹¹⁷

53. Dr. Morin rejects the use of dividend growth estimates in DCF analysis, because some utilities will continue to lower their dividend payout ratios and so their dividend growth rates are not likely to provide a meaningful guide to investors' growth expectations. Investors, he contends, are more focused on earnings, and earnings growth provides a more meaningful guide to investors' long-term growth expectations. Growth in earnings will support future dividends and share prices. Moreover, dividend growth forecasts are not readily available.¹¹⁸ In his DCF studies, Dr. Morin increases the current dividend used in calculating the dividend yield component of the DCF model by the expected growth rate, to adjust for the quarterly payment of dividends.¹¹⁹

54. Dr. Morin argues that investors must be compensated for flotation costs on an on-going basis, to the extent that such costs have not been expensed in the past, in order for investors to have the opportunity to earn the ROE set by the Commission. He includes a flotation cost adjustment in his estimates of the cost of common equity.¹²⁰

55. Dr. Morin's revised cost of equity results, including flotation costs are:¹²¹

<u>Study</u>	<u>ROE</u>
CAPM	9.4%
Empirical CAPM	9.8
Historical Risk Premium	10.9
DCF Combo. Elec. & Gas Utilities – Value Line Growth	11.6
DCF Combo. Elec. & Gas Utilities – Zacks Growth	10.4
DCF S&P Electric Utilities - Value Line Growth	11.2
DCF S&P Electric Utilities – Zacks Growth	11.4

¹¹⁷ *Id.* at 51-54.

¹¹⁸ *Id.* at 55-56.

¹¹⁹ *Id.* at 49-50.

¹²⁰ *Id.* at 62-67.

¹²¹ Pepco witness Morin updated his analysis in light of the changes in market conditions. Tr. 239-243.

56. Based on his revised data, Dr. Morin's range for Pepco's ROE, including floatation costs, is from 10.75 percent to 11.00 percent.¹²² As discussed below, with the BSA, Dr. Morin contends Pepco's risk will be reduced and the cost of common equity lowered by some 25 basis points. With a BSA adjustment, his recommended ROE is 10.75 percent.¹²³ He recommends no surcharge/deferral adjustment.

57. **OPC.** OPC proposes a cost of equity of 9.0 percent for Pepco, with a BSA adjustment and no adjustment to reflect Pepco's surcharge/deferral mechanism. This is a revision of Dr. Woolridge's recommended cost of equity incorporated in the testimony of OPC witness Ramas, which reflects OPC's changed position on the appropriate BSA adjustment.¹²⁴ OPC witness Woolridge states that the worst of the credit crisis appears to be over.¹²⁵

58. OPC, like Pepco, utilizes the DCF and CAPM approaches in estimating the cost of common equity.¹²⁶ However, OPC witness Woolridge relies primarily on the DCF approach. He employs two proxy groups – his own group of electric companies ("OPC's Electric Group") and Dr. Morin's S&P Electric Group.¹²⁷ Dr. Woolridge argues that, based on various financial metrics, Pepco's electric group is slightly riskier than OPC's.¹²⁸

DCF

59. OPC criticizes Dr. Morin's DCF analysis on three bases: dividend yield adjustment, use of the forecasted EPS growth rates from Zacks and Value Line (to estimate the growth rate to be used in the DCF model), and his floatation cost adjustment. Woolridge argues that witness Morin's quarterly timing adjustment to the dividend yield component of the DCF model overstates the equity cost rate. Dr. Morin's approach presumes that investors require additional compensation because their dividends are paid out quarterly instead of in one lump sum. For the dividend yield component of the DCF model, OPC adjusts the dividend yield by one-half ($\frac{1}{2}$) the expected growth rate to reflect the growth over the coming year.¹²⁹

¹²² Tr. 241.

¹²³ Pepco states that, should the Commission decide to deviate from the capital structure, with each reduction in common equity ratio of 1%, the return on equity would increase by approximately 10 basis points.

¹²⁴ Tr. 865-866.

¹²⁵ OPC (B) at 12 (Woolridge).

¹²⁶ OPC (B) at 25 (Woolridge). OPC primarily relies on the DCF model and gives little weight to the results obtained using the CAPM. Pepco utilized the ECAPM and Risk Premium approaches as well.

¹²⁷ *Id.* at 14-15. See OPC (B)-4.

¹²⁸ *Id.*

¹²⁹ OPC (B) at 31 (Woolridge).

60. Dr. Woolridge states that the primary difficulty with the DCF model is estimating expected dividend growth rates. For the dividend growth rate component of the DCF model, OPC contends investors use a combination of historical and projected growth rates for earnings per share ("EPS"), dividends per share ("DPS"), and internal (retention rate) or book value per share growth ("BVPS") to assess long-term potential.¹³⁰ To obtain the appropriate growth rate, OPC indicates that it reviewed Value Line's historical and projected growth rate estimates for EPS, DPS, and BVPS. It also utilizes the average EPS growth rate forecasts of Wall Street analysts as provided by Yahoo First Call, Zacks, and Reuters. Nevertheless, OPC contends that Wall Street analysts' EPS growth forecasts are overly optimistic and upwardly biased. Thus, OPC contends that using these growth rates exclusively as a means of estimating a DCF growth rate will overstate the equity cost rate.¹³¹ Based on his analysis, Dr. Woolridge contends that the DCF-based cost of common equity is 9.8 percent for OPC's Electric Group and 10.6 percent for Pepco's S&P Electric Group.

CAPM

61. OPC alleges that there are two flaws in Pepco witness Morin's CAPM analysis: the equity risk premium and his use of the ECAPM approach. In regard to the equity risk premium relied on by Pepco, Dr. Woolridge contends that the Ibbotson's historical returns, relied on by Pepco, are poor measures of the expected market risk premium. According to OPC, leading financial practitioners conclude that the financial crisis has not significantly changed the long-term estimates of the equity risk premium, which is in the 3.5 to 4.0 percent range.¹³² Past market conditions do not give a realistic or accurate reading of the expectations of the future.¹³³ According to OPC, historical bond returns are biased downward because of the past losses suffered by bondholders. Also, because Pepco's study covers more than one period and makes the assumption that dividends are reinvested, the use of geometric means, instead of the arithmetic means used by Dr. Morin, better captures investment performance. OPC contends that the upward bias of the arithmetic means overstates the return experienced by investors.¹³⁴

62. According to Dr. Woolridge, Dr. Morin's use of the ECAPM is inappropriate because Dr. Morin uses Value Line betas in his CAPM, and those betas are adjusted to reflect the fact that, historically, betas tend to regress toward 1.0 over time. Using adjusted betas increases the return for stocks with betas less than 1.0, and decreases the returns for stocks with a beta greater than 1.0. Suggesting that the ECAPM accomplishes the same thing, Dr. Woolridge testifies that Dr. Morin's ECAPM approach makes "two adjustments to the expected return."¹³⁵

¹³⁰ *Id.*

¹³¹ *Id.* at 33, 77 -78.

¹³² *Id.* at 49. Tr. 223- 224.

¹³³ *Id.* at 58.

¹³⁴ *Id.* at 59.

¹³⁵ *Id.* at 66.

63. OPC states that its CAPM analysis relies on three procedures (historic returns, surveys, and expected return models) to arrive at its equity risk premium. OPC maintains that its equity risk premium is consistent with the risk premium found in recent academic studies by leading financial scholars, and employed by leading investment banks and management consulting firms. OPC uses the yield on 30-year U.S. Treasury bonds as the risk-free rate of interest in the CAPM. It relies on average betas, as provided by Value Line, for OPC's Electric Proxy Group and Pepco's S&P Electric Group.¹³⁶ In estimating the equity risk premium, OPC is not convinced that using historical stock and bond returns to measure the market's future expected return is appropriate. First, historical returns are not the same as forward looking expected returns. Secondly, market risk premiums can change over time. Lastly, market conditions can change such that historical returns are a poor indication of future expected returns.¹³⁷ According to Dr. Woolridge, the equity cost rates indicated by the CAPM are 7.5 percent for OPC's Electric Group and 7.8 percent for Pepco's S&P Electric Group.¹³⁸

Risk Premium

64. OPC maintains that Pepco's risk premium analysis includes an "inflated based interest rate" and an excessive risk premium which is based on the historical relationship between stock and bond returns.¹³⁹ OPC concludes that the appropriate equity cost rate for Pepco is in the range of 7.5 percent to 10.6 percent, with a midpoint of 9.1 percent. OPC believes this wide range reflects the uncertainty and volatility in the capital markets and that, in recognition of this volatility and uncertainty, an equity cost rate at the upper end of that range is appropriate. Further, OPC believes that it is appropriate to give primary weight to OPC's Electric Group results. Therefore, OPC recommends an equity cost range of 9.50 percent to 10.0 percent, with a midpoint of 9.75 percent. Within this range, Dr. Woolridge proposes an ROE of 9.50 percent, which reflects a 25 basis point reduction for Pepco's poor service and system reliability.¹⁴⁰ When the BSA adjustment is included, OPC's recommended ROE is 9.25 percent. This ROE does not include OPC's recommended surcharge/deferral adjustment. During the hearings, OPC witness Ramas adopted the 50 basis point BSA adjustment determined by the Commission in Formal Case No. 1053, Phase II, producing an OPC-recommended ROE of 9.00 percent.¹⁴¹

¹³⁶ *Id.* at 40, OPC (B)-11 at 3.

¹³⁷ *Id.* at 41.

¹³⁸ *Id.* at 51.

¹³⁹ *Id.* at 69.

¹⁴⁰ *Id.* at 52.

¹⁴¹ Tr. 865-866.

65. **AOBA.** AOBA argues that the ROE Pepco requests substantially overstates current market requirements and contends that investors have experienced significant declines in returns since the last rate case. Additionally, AOBA asserts that Pepco does not appropriately account for the influence of non-utility risks and returns on holding company financial results. According to AOBA, Dr. Morin's results reflect a significant upward ROE bias as a result of his use of comparables and industry groups without risk profiles comparable to that of Pepco's. The data used by Dr. Morin are for the parent holding companies, many of which have substantial investments in generation assets and/or are significantly diversified and, therefore, face much greater risk than Pepco.¹⁴² According to AOBA, of the 27 companies included in Pepco's Electric Group, 15 are assessed by Edison Electric Institute as having either 20 percent to 50 percent unregulated activities or greater than 50 percent unregulated activities. AOBA avers that Pepco's Electric Group of electric companies includes some of the largest generation portfolios in the U.S. and Pepco's "combined gas and electric companies" group is likewise heavily influenced by substantial generation ownership and diversified operations.¹⁴³

66. Witness Oliver states that the bias found in Pepco's DCF analyses also is found in its CAPM and risk premium analyses. As in his DCF analysis, Morin's risk premium does not differentiate between electric distribution utilities and electric utilities holding substantial generation portfolios or utility holding companies that have significant non-regulated activities. It makes no attempt to account for biases that are introduced as a result of reliance on electric utility stock price data that incorporate information for generation activities and non-regulated activities. Last, he fails to account for, or make any adjustment to reflect, the influence of changes in the composition of the industry over time, including industry consolidation and diversification experienced over the last two decades.¹⁴⁴ According to AOBA, the standard deviations associated with Pepco's annual risk premium estimates are roughly three to four times the magnitude of witness Morin's computed average for those risk premiums. The comparatively large standard deviations render Pepco's computed equity risk premiums, at best, very poor and unreliable indicators of future equity risk premiums.¹⁴⁵

67. Further, AOBA contends Morin's CAPM and ECAPM are biased because the proxy group he employs to estimate a beta for Pepco includes PHI as well as a number of large utility holding companies.¹⁴⁶

68. Witness Oliver recommends an ROE of not greater than 9.9 percent, including floatation costs. He considers his own DCF analyses; witness Morin's CAPM, ECAPM, and historical risk premium analyses, which he gives little weight; and the ROEs allowed in other

¹⁴² AOBA (A) at 16-19 (Oliver).

¹⁴³ *Id.* at 19-22.

¹⁴⁴ *Id.* at 23-24.

¹⁴⁵ *Id.* at 25.

¹⁴⁶ *Id.* at 27-28.

electric utility rate proceedings in 2008 and the first half of 2009. Witness Oliver uses two proxy groups in his DCF analysis, one a group having substantial electric distribution operations and the other a group of gas distribution utilities. In his DCF studies, witness Oliver relies on projected earnings growth rates from Thompson Financial Network and Zacks Investment Research to estimate expected future growth.¹⁴⁷ Witness Oliver averages the composite of his DCF results for gas and electric utilities with his computed average of recent commission ROE determinations for electric utilities.¹⁴⁸ This results in an ROE of 9.9 percent, before any BSA or surcharge/deferral adjustments. With a BSA adjustment, AOBA recommends an ROE of 9.4 percent.¹⁴⁹

69. **WMATA.** Dr. Foster contends that the Commission should “keep Pepco’s ROE at the current authorized level (10 percent before the BSA adjustment) if there is no BSA or Rider VM (surcharge/deferral mechanism).”¹⁵⁰ Dr. Foster states that he reviewed 126 cases that involved electric utilities and natural gas companies for the period 2007-2009. The average allowed return over the three year period was 10.34 percent. Dr. Foster maintains that Pepco is less risky than most of the utilities in the group he analyzed because, unlike Pepco, the electric companies in the group have extensive generation and, therefore, face more risk due to competition.¹⁵¹ Further, Dr. Foster believes PEPCO faces less risk than other utilities because: (1) natural gas utilities face greater business risk than electric distribution companies; (2) PEPCO’s customer profile is less risky than that of other utilities, and its service territory is more affluent; and (3) the Washington Metropolitan Area has a stronger economy than the U.S. as a whole.¹⁵²

¹⁴⁷ *Id.* at 28-29. AOBA (A)-1.

¹⁴⁸ During the hearing, Pepco witness Morin attempted to update AOBA witness Oliver’s ROE testimony. Having reviewed the exhibits, it is apparent that Pepco is seeking to introduce new testimony that will enhance its case without the data’s undergoing appropriate scrutiny. Although Pepco contends that the testimony and evidence address witness Oliver’s direct testimony, the testimony is nevertheless new. The cost of capital, and in particular the return on equity, is an important component in rate proceedings, requiring careful and fair consideration and weighing of the evidence. Fairness requires that the parties be given an opportunity to examine the new data and to challenge it, if they so desire. The parties were not afforded that opportunity. Procedural due process outweighs any probative value the testimony might possess. The scope of rebuttal is within the discretion of the Commission. The Commission hereby grants AOBA’s motion to exclude Pepco Cross Examination Exhibit Nos. 11, 12, and 13 and to correct the transcript to show that these exhibits were never formally admitted into evidence.

¹⁴⁹ *Id.* at 29 -30.

¹⁵⁰ WMATA (A) at 4 (Foster).

¹⁵¹ *Id.* at 6-9.

¹⁵² *Id.* at 5-6.

DECISION

70. In its decisions, the Commission has relied primarily on the DCF method to determine a utility's cost of common equity because the Commission consistently has found that the DCF method produces more reasonable results than those of other calculation methods. Nevertheless, the Commission's preference for the DCF method does not preclude consideration of other methods for calculating the cost of equity. The Commission has taken into account the results of the various approaches (DCF, CAPM, and Risk Premium) in estimating the ROE in this proceeding. The Commission, however, will focus on the DCF model (relying primarily on forecasted growth rates) to determine the appropriate ROE.

71. In the application of the DCF model, the Commission implicitly has given considerable weight to forecasted earnings growth rates (estimates of earnings growth over the next approximately five years) in the recent past, as opposed to historical growth rates in earnings, dividends, and book value and retention growth rates. Although the expected dividend growth rate is one of the components of the DCF model, earnings growth rates often are used as a proxy. Arguably, based on the uncertainty and volatility in this economy, the forecasted earnings growth rates may overstate the long-term expected dividend growth rate to be used in the DCF model at this time, since, if earnings are unusually low when the estimates are made, this would produce unusually high estimates of expected growth in the roughly 5-year period covered by projected rates. However, some of this effect is captured in Pepco's updated ROE estimate.

72. Pepco recommends a ROE of 10.75 percent including a flotation adjustment, which, according to Pepco witness Morin, represents approximately 30 basis points. The Commission traditionally excludes flotation costs from its ROE calculation, since flotation costs are treated as an expense item. Pepco's proposed 10.75 percent ROE also reflects its BSA adjustment. This recommendation is based on a range of reasonable returns of 10.75 to 11.00 percent, before any BSA or surcharge/deferral adjustments. In other words, to incorporate its BSA adjustment, Pepco adopted the lower end of its range of reasonable returns. Further, historically, in its application of the DCF model, the Commission has projected the dividend yield component of the DCF model forward by one-half the expected growth rate, rather than the growth rate which is Pepco's approach. Pepco alleges that using one-half the growth rate understates the dividend yield by 10 basis points.¹⁵³ Finally, in Formal Case No. 1053, the Commission concluded that Pepco's ROE results for its electric proxy group overstated Pepco's required return on its distribution operations due to the inclusion of companies that have risk profiles different from that of Pepco, i.e., the inclusion of companies with greater risk due to generation and unregulated operations. The Commission continues to believe that this is a consideration in estimating Pepco's ROE.¹⁵⁴

¹⁵³ Pepco (3B) at 13 (Morin).

¹⁵⁴ Order No. 14712, ¶ 33.

73. OPC recommends a ROE of 9.50 percent, before BSA or surcharge/deferral adjustment, but including a 25 basis point reduction adjustment for poor performance. In that the Commission has deferred the issue of the reliability of service to another docket, it would be inappropriate to adjust the Company's ROE for reasons of poor performance when reliability is not an issue for determination in this proceeding.¹⁵⁵ Without this adjustment, OPC's ROE figure is 9.75 percent. Additionally, OPC's recommendation understates the return required by investors because of its partial reliance on historical growth rates to estimate expected future growth. OPC's Exhibit B-10 (at page 3) shows that the historic returns relied on by OPC include numerous negative growth rates which most likely do not reflect investor's expectations going forward. With its revised BSA adjustment of 50 basis points, OPC recommends an ROE of 9.00 percent.

74. AOBA's recommended ROE, without a BSA adjustment, is 9.9 percent. This ROE is based in part on returns allowed in other jurisdictions in 2008 and the first half of 2009, 10.37 percent. As for WMATA, it simply states that the risks of providing transmission and distribution service have not increased since the Commission's decision in F.C. No. 1053, and the starting point for the ROE allowed in this proceeding should be the 10.0 percent ROE (without a BSA adjustment) allowed in that proceeding. With its recommended BSA adjustment of 50 basis points, AOBA's proposed ROE is 9.5 percent.

75. The Commission finds that the parties' recommendations establish parameters that, when narrowed by the considerations above, support our informed determination that a reasonable range for Pepco's allowed ROE is 10.0 percent to 10.25 percent. Based on this range, the Commission finds that an ROE of 10.125 percent, before BSA or surcharge/deferral adjustment, is appropriate at this time. This allowed return on common equity reflects the interests of the community and the Company in the receipt and provision of safe and dependable electric distribution service at reasonable rates. Moreover, it will allow Pepco to raise capital on reasonable terms.

76. As discussed below, the Commission adopts a BSA adjustment of 50 basis points in this proceeding and does not adopt the Company's proposed surcharge/deferral mechanism. When the 50 basis point BSA adjustment is included, Pepco's allowed return on common equity capital is 9.625 percent.

c. Cost of Debt (Issue No. 4b)¹⁵⁶

77. **Pepco.** Pepco calculates its cost of long-term debt to be 6.63 percent.¹⁵⁷ This cost rate was obtained by examining Company-specific contractual interest payments. Dr. Morin

¹⁵⁵ *Formal Case No. 1076*, Order No. 15322, ¶ 8 (July 10, 2009).

¹⁵⁶ Issue No. 4b asks, "Has PEPCO properly determined its cost of debt?"

¹⁵⁷ Pepco (B)-18 (Morin).

contends that Pepco's calculation methods are consistent with the methods approved in previous rate proceedings.¹⁵⁸

78. **OPC.** OPC adopts Pepco's long-term debt cost rate of 6.63 percent. OPC, in addition, calculates a short-term debt rate by adding the average yield on 1-month, 3-month, and 12-month LIBOR rates in 2009 of 1.0 percent plus an additional 35 basis points,¹⁵⁹ for a cost rate of 1.35 percent.¹⁶⁰

79. **AOBA.** AOBA witness Oliver challenges Pepco's cost of debt on two grounds. First, he states, Pepco's calculation includes a computational error which overstates the cost of debt. He contends that Dr. Morin incorrectly subtracted the Unamortized Loss on Debt Reacquisition from the Company's Long-Term Debt balance when he should have added it. If Dr. Morin had added, the cost of debt would be 6.30 percent, not 6.63 percent, he states. Second, according to AOBA, the Company's issuance of \$250 million of first mortgage bonds in December 2008 was imprudent because the cost rate is 140 basis points greater than that of any of Pepco's other bonds. Further, the need for the issuance did not emanate from the financing requirements of the Company's distribution operations, and the issuance should have been deferred. The need for the funding was related to the Mid-Atlantic Power Pathway ("MAPP") project. AOBA recommends that Pepco's cost of long-term debt be set at 6.11 percent.¹⁶¹

80. **Pepco Rebuttal.** Regarding the treatment of the Company's Unamortized Loss on Debt Reacquisition costs, Pepco witness Kamerick argues that Pepco witness Morin did add this amount to the Company's Long-Term Debt balance; it was AOBA who subtracted. He states that the Net Outstanding Long-Term Debt balance of \$1.54 billion is a liability, a credit balance, while the Unamortized Loss on Debt Reacquisition of \$38.89 million is a debit on the balance sheet. Adding the two items together results in a net credit balance of \$1.50 billion.¹⁶²

81. Regarding the Company's first mortgage bonds issued in December 2008, Pepco contends that market conditions warranted the issuance of long-term debt at that time; short-term credit was tight; banks and other liquidity-constrained companies were being downgraded; commercial paper market was severely constrained; and Pepco could not issue commercial paper. Pepco also contends that the duration and the severity of the liquidity crisis were unknown, and the Company did not know if it could secure financing in 2009. Because the outlook for the capital markets was highly uncertain, Pepco made the decision to pre-fund its anticipated 2009 funding needs when the markets allowed, in December 2008. Contrary to

¹⁵⁸ Pepco (2B) at 2 (Morin Supp).

¹⁵⁹ OPC alleges that Pepco was borrowing from its credit facility at 35 basis points above the applicable interest rate. OPC Br. 54.

¹⁶⁰ OPC (B) at 17 (Woolridge).

¹⁶¹ AOBA (A) at 37-41 (Oliver).

¹⁶² Pepco (3A) at 12 (Kamerick).

AOBA's contention, Pepco submits that funding for the MAPP project was \$56 million, or only 8 percent of Pepco's construction budget for 2009 of \$727.0 million.¹⁶³

DECISION

82. The Commission traditionally has adopted a cost of debt that is reasonable and accurately reflects the Company's costs. Pepco has presented evidence that its current cost of long-term debt of 6.63 percent is both. OPC adopts this rate. While, AOBA argues that Pepco's cost rate should be lower, we disagree. The Commission finds that Pepco has correctly calculated its long-term debt cost. We are convinced that Unamortized Loss on Debt Reacquisition was treated correctly in Pepco's calculation of the cost of debt. AOBA's second argument is equally without merit. There is nothing in the record that suggests that the issuance of the December 2008 bonds was primarily related to the MAPP project.¹⁶⁴ We also agree that the Company had no basis in December 2008 to assume that credit market conditions would improve in the near term. There is nothing in the record showing that the Company's action was imprudent and AOBA has not provided any evidence to the contrary. Therefore, based on the foregoing, the Commission accepts Pepco's cost of long-term debt of 6.63 percent. As discussed below, the capital structure allowed for Pepco does not include short-term debt.

d. Capital Structure (Issue No. 4c)¹⁶⁵

83. **Pepco.** PEPCO uses an actual test year capital structure as of December 31, 2008. Pepco asserts that a balanced debt-equity ratio is essential to securing good credit ratings and accessing the capital markets on reasonable terms.¹⁶⁶ Pepco argues that in these difficult times it is essential that it have investment grade ratings. According to Pepco, an investment-grade status decreases borrowing costs, improves access to capital of longer terms, and enables Pepco to absorb any negative volatility in its financial performance.¹⁶⁷ The Commission, Pepco asserts, should strive to maintain and improve the Company's financial ratings so that it will continue to have access to the capital markets on reasonable terms, which is in the best interest of ratepayers and Pepco's ability to provide cost-effective, safe and reliable service.¹⁶⁸

84. Dr. Morin states that, if the Commission deviates substantially from this proposed capital structure, the cost of common equity and the cost of debt should be adjusted as well. If

¹⁶³ *Id.* at 13-15.

¹⁶⁴ PHI's financial reports show that the bulk of the Holding Company's 2009 financing needs are associated with distribution and the MAPP project is only 8% of 2009 construction costs. *Id.* at 15.

¹⁶⁵ Issue No. 4c asks, "Is the capital structure that PEPCO uses to develop its overall cost of capital reasonable and appropriate?"

¹⁶⁶ Pepco (A) at 22 (Kamerick).

¹⁶⁷ Pepco (B) at 75 (Morin).

¹⁶⁸ Pepco (A) at 23-25 (Kamerick); Pepco (B) at 77 (Morin).

the debt ratio is increased, the risk and required returns of the Company also are increased. Dr. Morin compares Pepco's capital structure with the capital structure of electric utilities, and that of combination electric and gas companies. He contends that the Company's requested common equity ratio of 46.18 percent, while lower than the common equity ratios adopted by regulators for electric utilities in 2008 (48.4 percent) and the common equity ratios of combined electric and gas utilities (48.3 percent), is reasonable for ratemaking purposes.¹⁶⁹

85. **OPC.** OPC includes short-term debt in its proposed capital structure, arguing that Pepco, normally, and electric utilities, typically, employ short-term debt in their capital structures.¹⁷⁰ OPC witness Woolridge adds that his proposed capitalization is in line with the average capital structure of OPC's Electric Group.¹⁷¹ Dr. Woolridge states that Pepco's average capital structure ratio for the most recent four quarters includes 6.80 percent short-term debt, 47.37 percent long-term debt, and 45.83 percent common equity. Dr. Woolridge contends that the average capital structure of OPC's Electric Group for the most recent four quarters includes 5.60 percent short-term debt, 49.9 percent long-term debt, 0.50 percent preferred stock and 44.00 percent common equity.¹⁷² Based on this information, OPC proposes capitalization ratios it believes are consistent with the average capital structure of its Electric Group – 51.51 percent long-term debt, 4.30 percent short-term debt, and 44.20 percent common equity.¹⁷³

86. **AOBA.** Mr. Oliver does not accept Pepco's argument that its proposed capital structure is based on Company-specific data. He offers two reasons. First, as a subsidiary of PHI, Pepco's utility capital structure is insulated from market forces and subject to potential manipulation by the holding company. Second, Pepco's capital structure is not static over time. The Company's proposed capital structure represents a "snap-shot" view of the Company's capital structure.¹⁷⁴ Mr. Oliver also takes issue with Dr. Morin's assertion that the method Pepco used to compute the proposed capital structure is consistent with Commission precedent, claiming that nothing in F.C. No. 1053 established precedent. Nor, he states, does Dr. Morin offer any evidence of precedent for the pro forma adjustments reflected in the Company's capital structure calculations.¹⁷⁵

87. AOBA also challenges Dr. Morin's representation that his common equity percentages compare favorably with those of other electric utilities. Witness Oliver submits that

¹⁶⁹ Pepco (B) at 72-73 (Morin).

¹⁷⁰ OPC (B) at 16 (Woolridge).

¹⁷¹ OPC (B) at 16-17 (Woolridge).

¹⁷² OPC (B) at 16 (Woolridge); OPC (B)-5.

¹⁷³ *Id.* at 16-17.

¹⁷⁴ AOBA (A) at 43. (Oliver).

¹⁷⁵ *Id.* at 44.

this is because the common equity ratios in Dr. Morin's analyses show a wide range of common equity ratios, and simply averaging those percentages without examining the reasons for the differences is not instructive. Further, the combination electric and gas companies relied on by Dr. Morin are actually holding companies, many of which have substantial generation ownership and diversified operations which may influence their common equity ratios. Mr. Oliver contends that updated data for Dr. Morin's combination companies show that the common equity ratio has fallen from the 48.3 percent figure reported by Pepco to 46.6 percent. Finally, he "observes" that, if a common equity percentage is computed for companies in Dr. Morin's group of comparable size to Pepco Holdings (he does not identify these companies), the average common equity ratio is 43.9 percent. On this basis, AOBA recommends a capital structure for use in this proceeding consisting of 44 percent common equity and 56 percent long-term debt.¹⁷⁶

88. **Pepco Rebuttal.** According to Pepco, AOBA disregards Pepco's capital structure and, instead, uses a hypothetical one. Pepco contends that Witness Oliver ignores the fact that Pepco issues its own debt and that the rating agencies rely on Pepco's financial information in rating that debt. Pepco notes that witness Oliver also ignores the fact that the Commission, in Formal Case No. 1053, adopted Pepco's capital structure. Witness Kamerick testifies that Pepco's capital structure is in line with the average common equity ratio for electric companies as reported in the July 2, 2009, Regulatory Research Associates' Regulatory Focus Report and with the revised average common equity ratio for Dr. Morin's entire group of combination electric and gas comparables provided by Oliver.¹⁷⁷

89. Regarding OPC's recommended capital structure, Pepco states that short-term debt as it is used by Pepco provides temporary funding for the Company's construction requirements, which are permanently financed with either long-term debt or common equity. OPC's comparables include companies with debt that is financing the securitization of stranded costs and should be excluded from OPC's calculations because it is not used to finance utility operations. Pepco contends that, if securitization debt is excluded, OPC's data are updated for the four quarters ended June 30, 2009, and other classification adjustments made, OPC's comparables would support a higher common equity ratio. Further, Pepco indicates that it has repaid all of its short-term debt as 2009 progressed.¹⁷⁸

DECISION

99. The issue before the Commission is the reasonableness of Pepco's capital structure. However, no party has presented any persuasive testimony that shows that Pepco's capital structure is unreasonable. They merely have presented alternative capital structures. As long as we find Pepco's proposed capital structure to be reasonable, it does not matter that there are alternatives that may be reasonable also.

¹⁷⁶ *Id.* at 44-46.

¹⁷⁷ Pepco (3A) at 16 -17 (Kamerick Rebuttal).

¹⁷⁸ *Id.* at 17- 20.

100. OPC recommends a capital structure that includes short-term debt because it states that Pepco normally employs short-term debt in its capital structure. OPC further states that its proposed capitalization is in line with the average capital structure of its Electric Group. We are satisfied that Pepco uses short-term debt as a temporary funding source for the Company's construction requirements, which are permanently financed with long-term debt and common equity. The outstanding short-term debt Pepco had on its books in 2008 was completely repaid in 2009.

101. AOBA suggests an alternative capital structure based on its interpretation of the data Pepco uses as support for its proposed capital structure. Nevertheless, Pepco's capital structure compares reasonably to those of other electric utilities. Finally, AOBA alleges that Pepco's capital structure is subject to manipulation by PHI. However, AOBA has not presented any evidence to support that contention.

102. The Commission finds Pepco's proposed capital structure to be reasonable and adopts it to calculate the Company's overall rate of return. In this proceeding, Dr. Morin presented Pepco's capital structure. In future rate cases, the testimony on Pepco's capital structure should be offered by the individual who prepared, or is responsible for the preparation of, the capital structure calculations.

e. Surcharge and Deferral Mechanism (Issue 4d)¹⁷⁹

DECISION

103. Because the Commission rejects Pepco's proposed surcharge and deferral mechanism,¹⁸⁰ this issue is moot.

f. BSA Adjustment (Issue No. 4e)¹⁸¹

104. **Pepco.** Dr. Morin testifies that, with a Bill Stabilization Adjustment, the Company's risk is reduced and the cost of common equity "declines by some 25 basis points." Dr. Morin explains that his 25 basis point adjustment is based on: (1) utility bond yield differentials between A-rated and Baa-rated bonds, (2) observed beta differentials, (3) differential common equity ratio requirements for S&P Business Risk Score, and (4) the

¹⁷⁹ Issue No. 4d asks, "If PEPCO is permitted to implement the surcharge and deferral mechanism that it has proposed, should there be a reduction in PEPCO's authorized return on equity (ROE) to account for the Company's reduced business risk? If so, by how much should the authorized ROE be reduced?"

¹⁸⁰ See Issue No. 8.

¹⁸¹ Issue No. 4e asks, "Should PEPCO's authorized ROE be adjusted downward to reflect reduced risk resulting from the Company's proposed implementation of a Bill Stabilization Adjustment and, if so, by how many basis points?"

application of informed judgment.¹⁸² These are the same bases he relied on in Formal Case No. 1053. When Dr. Morin revised his proposed ROE, rather than include a 25 basis point adjustment, he simply adopted the lower end of his range of reasonable estimates, 10.75 percent to 11.00 percent to reflect the reduced risk associated with the Company's proposed BSA.¹⁸³

105. **OPC.** Dr. Woolridge recommends a 25 basis point ROE adjustment to reflect the reduction in risk associated with a BSA. He testifies that he has not conducted any studies and is not aware of any studies that ascertain the reduction of risk associated with decoupling rate design mechanisms.¹⁸⁴ However, Woolridge indicates that he is aware of a number of commissions that have adopted such mechanisms, recognized the related risk reduction, and adjusted the authorized return on equity. These decisions, he states, indicate that an adjustment of up to 50 basis points may be appropriate.¹⁸⁵ Dr. Woolridge's BSA recommendation is revised by witness Ramas to reflect the Commission's 50 basis point BSA ROE adjustment in Formal Case 1053.¹⁸⁶

106. **AOBA.** AOBA witness Oliver contends that there should be a downward adjustment to Pepco's ROE of 55 - 75 basis points if the BSA is adopted. The first basis of Mr. Oliver's adjustment is the same as in F.C. No. 1053 -- Pepco's willingness to give up its repression adjustment in F.C. No. 1053 if the BSA were adopted and his estimate of the dollar value of the Company's proposed repression adjustment, along with the dollar value of Pepco's proposed ROE adjustment if the BSA were approved (25 basis points). On this basis alone Witness Oliver believes the ROE adjustment should be at least 55 basis points. In this proceeding, Mr. Oliver adds that parties rarely offer trade-offs that are not structured to be favorable to the offering party. Therefore, "it would follow that, if Pepco were willing to forgo a revenue adjustment assessed to have at least 55 basis points of value, the value to the Company of the BSA must be noticeably in excess of 55 basis points." On this basis witness Oliver recommends a total adjustment of 55-75 basis points.¹⁸⁷

107. **WMATA.** Dr. Foster testifies that the ROE adjustment to reflect the BSA (although he does not recommend a BSA) should be 50 basis points.¹⁸⁸

¹⁸² PEPCO (B) at 69 -71 (Morin)

¹⁸³ Tr. 241-242.

¹⁸⁴ OPC (B) at 53 (Woolridge).

¹⁸⁵ *Id.*

¹⁸⁶ Tr. 865-866.

¹⁸⁷ AOBA (A) at 30-32 (Oliver).

¹⁸⁸ WMATA (A) at 12-13 (Foster).

108. **Pepco Rebuttal.** Dr. Morin avers that there is no foundation or support for Mr. Oliver's 50 basis point adjustment to the ROE to reflect the reduced risk associated with the BSA. Morin claims that most, if not all, electric utilities are under some form of adjustment clause/cost recovery/rider mechanisms. Dr. Morin indicates this is largely embedded in financial data, such as bond ratings and business risk scores. Further, Dr. Morin states that a 50 basis points adjustment makes no sense because, if the same adjustment is made to the Company's long-term bond yield of about 5.75 percent, the resulting bond yield would be 5.25 percent, which is less than the bond yield on utility bonds rated AA (double A). Morin submits that this is an "absurd situation" given that utility bonds are rated Baa on average.¹⁸⁹

109. Dr. Morin claims that the 50 basis point adjustment is not consistent with other recent regulatory decisions. He contends that his Exhibit (3B)-2 shows that the difference in allowed returns for utilities with, versus those without, revenue decoupling mechanisms is 10 basis points. He states that the average authorized ROE in 2009 through the time of his rebuttal testimony was 10.5 percent for utilities with BSA-like mechanisms.¹⁹⁰

DECISION

110. Dr. Morin testifies that with a Bill Stabilization Adjustment the Company's risk is reduced and the cost of common equity "declines by some 25 basis points." He claims that a 50 basis point adjustment is not consistent with other recent regulatory decisions. We do not believe the comparison to other jurisdictions is compelling. Although the other jurisdictions may have had similar issues, it has not been shown that mechanisms in those jurisdictions are comparable to Pepco's BSA or that the overall focus and concerns in those proceedings were similar to those of this Commission. Each jurisdiction applies its own informed judgment based on the information before it to determine the respective ROE adjustments. Based on our review of the record and our informed judgment, we find that the 50 basis point BSA ROE adjustment determination made in Formal Case No. 1053, Phase II, should be adopted in this proceeding as well.¹⁹¹

¹⁸⁹ Pepco (3B) at 79-81 (Morin).

¹⁹⁰ Pepco (3B) at 82 (Morin).

¹⁹¹ See *Formal Case No. 1053, Phase II*, Order No. 15556. Beginning November 1, 2009, and thereafter, the BSA is calculated based on Pepco's monthly billed revenues, modified to account for major outages. A 50 basis point reduction in Pepco's return on equity (ROE) was ordered, as part of the approval of the BSA, to provide a balance of benefits to consumers in exchange for the benefit to the Company and shareholders of reaping lowered business risk. The Commission ordered the BSA to apply to all customer classes except streetlights ("SL"), telecommunications network service ("TN"), and Temporary Service ("T").

G. Overall Cost of Capital

111. Based on our findings, above, we determine that the following reflects a fair and reasonable overall cost of capital for Pepco.

<u>Capitalization</u>	<u>Ratio</u>	<u>Cost Rates</u>	<u>Return</u>
Long-Term Debt	53.82%	6.63%	3.57%
Common Equity	<u>46.18</u>	9.625	<u>4.44</u>
	100.00 %		8.01 %

This return falls within the zone of reasonableness. It will allow the company to maintain its financial integrity, attract capital on reasonable terms, and earn a return commensurate with those other investments of similar risk.

VI. OPERATING EXPENSES (Issue No. 5)¹⁹²

A. Unopposed Adjustments (Ratemaking Adjustments Nos. 2, 3, 5, 6, 7, 8, 10, 12, 18, 19, 21, 22, 23, and 24)

112. Operating income is derived by subtracting the costs Pepco incurs in providing service to customers (including taxes) from the revenue it receives for electric distribution service.¹⁹³ Various adjustments to the test year revenues and expense are proposed by the parties and are either accepted, rejected, or otherwise modified by the Commission in order to determine operating income. In this case, the Company's uncontested operating income was \$762,000 for the test year period which include RMA No. 2, Inclusion of Projects Completed and In Service; RMA No. 3, Annualization of NE Substation Cut In; RMA No. 5, Exclusion of Supplemental Executive Retirement Plans; RMA No. 6, Exclusion of Industry Contributions and Membership Fees; RMA No. 7, Exclusion of Advertising and Selling Expense; RMA No. 8, Inclusion of Interest Expense on Customer Deposits, RMA No. 10; Reflection of Non-Deferred Regulatory Costs at 3-Year Average Amount, RMA No. 12; Formal Case No. 1076 Outside Counsel/Consulting Deferred Costs, RMA No 18; Reflection of Change in PSC and OPC Budget Assessment; RMA No. 19, Annualization of Software Amortization; RMA No. 21, Reflection of F.C. No. 939 Disallowance; RMA No. 22, Reflection of Disallowance of Incentive Plan Costs;

¹⁹² Designated Issue No. 5 asks, "Is each of Pepco's proposed adjustments to test-year operating expenses just and reasonable?"

¹⁹³ See *OPC v. Pub. Serv. Comm'n*, 399 A2d. 43 (D.C. 1979).

RMA No. 23, Removal of Adjustments to Deferred Compensation Balances; and RMA No. 24, Inclusion of Deferred Customer Education Costs.

DECISION

113. The parties agree that there is no dispute and either support the above adjustments or do not oppose them. Inasmuch as no party challenges the above adjustments and the Commission has reviewed them and independently found them reasonable, we approve the adjustments. The parties dispute other operating income and expenses adjustments that we discuss and decide below.

B. Pepco's Proposed Adjustments

1. Credit Facility Costs

114. **Pepco.** Pepco proposes to adjust rate base and operating income to reflect the inclusion of Pepco's share of the cost associated with PHI's \$1.5 billion credit facility (RMA No. 9). Pepco explains that the credit facility, which terminates in 2012, facilitates the issuance of commercial paper (short-term debt) on an as-needed basis, assuring investors and rating agencies that Pepco has a committed line of credit with banks in the event of a liquidity problem.¹⁹⁴ The credit facility provides Pepco with a backstop borrowing mechanism to handle day-to-day cash requirements.¹⁹⁵

115. Pepco's credit facility includes two costs: start-up costs, which are amortized over the facility's useful life; and an annual maintenance fee. Pepco proposes to include the D.C.-allocated portion of the average unamortized start-up costs balance (\$143,000) in rate base and the amortization of the start-up costs (\$37,000) in O&M expense, similar, it contends, to the treatment of interest paid on customer deposits. Pepco indicates that the annual maintenance fee is \$211,000; \$88,000 on a D.C. allocated basis and that it is responsible to pay this fee whether Pepco uses the facility or not. The Company proposes to add the D.C. allocated portion of this fee to O&M expense as well.¹⁹⁶ Together, the D.C. allocated credit facility costs total \$125,000.

116. **OPC.** OPC does not challenge recovery of annual maintenance fees. It does, however, challenge the recovery of start-up costs. OPC proposes to reduce rate base by \$143,000 to remove the unamortized balance of start-up costs and expenses by \$37,000 to remove the associated amortization amount.¹⁹⁷ OPC argues that the amortization of start-up

¹⁹⁴ Pepco (C) at 10-12 (Hook).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* 11-12.

¹⁹⁷ OPC (A) at 50 (Ramas).

costs is not a cost that is typically included in above-the-line costs and should be recorded in FERC Account 428 – Amortization of Debt Discount and Expense, in which the Company confirms that it records such amortization. OPC contends that the cost of financing is a debt cost, and Pepco has excluded short-term debt from its capital structure¹⁹⁸

117. OPC asserts that the majority of the start-up fees was incurred prior to the test year and should have been included in Pepco's last rate case.¹⁹⁹ The costs include charges from the entity providing the credit facilities and administrative costs such as outside counsel fees.²⁰⁰ OPC contends that while these costs may be deferred and subsequently amortized as debt costs for book purposes, these costs typically are not included in above-the-line costs, and deferral is not treated as a regulatory asset.²⁰¹ Pepco, OPC further contends, should not be allowed to now to go back and request a return on these costs through their inclusion in rate base. OPC avers moreover that Pepco should not be allowed to record the associated amortization of these costs as operating expense because these costs are not analogous to either interest earned on customer deposits or bank commitment fees.²⁰²

118. **AOBA.** AOBA also believes that the costs associated with the credit facility should be eliminated. AOBA argues that Pepco's proposal denies District ratepayers any recognition of short-term debt costs that are significantly below long-term debt costs while requiring ratepayers to pay for setting up and maintaining the credit facility.²⁰³ AOBA states that Pepco's proposal would allow the Company to substitute lower short-term borrowing costs for long-term debt assumed in its capital structure and capture the difference as earnings for its shareholder, PHI.²⁰⁴ AOBA argues that the Company's request should be denied in the absence of explicit recognition of short-term debt in the Company's capital structure. AOBA recommends that O&M expense be reduced by \$125,000.²⁰⁵

119. **Pepco Rebuttal.** In rebuttal, Pepco argues that the credit facility plays a critical role in Pepco's liquidity and its ability to access the credit market in difficult economic times.²⁰⁶

¹⁹⁸ *Id.* at 47; OPC Br. 84.

¹⁹⁹ OPC (A) at 48.

²⁰⁰ *Id.*

²⁰¹ *Id.* at 49.

²⁰² OPC Br. 85-86.

²⁰³ AOBA Br. 23.

²⁰⁴ *Id.*

²⁰⁵ AOBA (A)-6 (Oliver).

²⁰⁶ Pepco (4C) at 21-22 (Hook Rebuttal).

Pepco contends that amortization of the start-up costs over the life of the facility is similar to how one would amortize the underwriting costs of bonds, over the remaining life of the facility. Pepco maintains that what is relevant is not when the costs were incurred but whether the credit facility is providing a benefit to customers.²⁰⁷ Pepco acknowledges the oversight in not requesting cost recovery in Formal Case No. 1053, but argues that that should not bar recovery at this time. Pepco further contends that the Commission has allowed retroactive commencement of amortization periods.²⁰⁸ Pepco also asserts that the inclusion of the costs in FERC Account 428 is not a bar to cost recovery through rate base amortization.²⁰⁹

DECISION

120. We are not persuaded by OPC's and AOBA's arguments that ratepayers are being deprived of recognition of short-term debt costs in their capital structure, as a basis for rejecting Pepco's credit facility adjustment. The Commission determines that Pepco's actual capital structure, which does not include short-term debt, is reasonable and compares reasonably to that of other electric utilities.²¹⁰ Short-term debt as it is used by Pepco provides temporary funding for the Company's construction requirements, which are permanently financed with either long-term debt or common equity.²¹¹ The credit facility supports liquidity, or the Company's short-term financing needs.

121. The Commission is mindful of the doctrine of retroactive ratemaking.²¹² While we recognize the general principle precluding Pepco from charging higher rates in the future to recoup past costs, that concept does not bar the Commission from properly recognizing the amortization of costs associated with the credit facility.²¹³ Costs that are amortized by definition are not retroactive. Moreover, the Commission is not authorizing recovery of prior period costs; these are ongoing costs associated with the credit facility.

122. As Pepco enters into new, and amends existing credit facility agreements, start-up costs are incurred and the prior agreement costs are then rolled into the new or modified agreement, just like a revolving credit agreement. We recognize that these costs normally would

²⁰⁷ Pepco Br. 42.

²⁰⁸ *Id.*, citing *Formal Case No. 929*, Order No. 10448 (June 7, 1994) (allowing retroactive commencement of amortization of costs back to 1992).

²⁰⁹ Pepco Br. 43.

²¹⁰ *See infra* ¶¶ 101-102.

²¹¹ Pepco (3A) (Kamerick) at 17-20.

²¹² *See People's Counsel of District of Columbia v. Pub. Serv. Comm'n*, 472 A.2d 860, 866 (D.C.1984).

²¹³ *Id.*

be reflected in the calculation of the cost of short-term debt. We also recognize that Pepco did not request permission to defer credit facility costs in any prior proceeding. However, Pepco's oversight notwithstanding, the credit facility is beneficial to ratepayers. It has allowed the Company to access the capital and credit markets to meet its daily working requirements on less expensive terms. Balancing the interest of ratepayers and the Company, and recognizing the importance of Pepco's ability to raise capital on reasonable terms, the Commission approves the Company's adjustment and will permit the Company to recover start-up costs and annual maintenance fees.

2. Deferral of Formal Case No. 1053 Costs

123. **Pepco.** Pepco increases O&M expense by \$31,000 and the unamortized balance to be included in rate base by \$643,107, and reduces accumulated deferred income taxes ("ADIT") by \$267,000 to reflect the amortization of outside counsel and consulting costs incurred in Formal Case No. 1053 over a three-year period.²¹⁴

124. **OPC.** OPC does not challenge Pepco's proposed O&M expense adjustment, but takes issue with Pepco's calculation of the unamortized balance included in rate base. OPC states that Pepco calculated the 12-month average by using \$747,839 (actual costs incurred) as the starting point and then taking the monthly unamortized balances through December 2008 to arrive at the Company's proposed \$643,107 adjustment. OPC contends that the appropriate amount is \$155,800 (which represents the total unamortized balance of deferred costs as of the mid-point of the rate effective period), which is consistent with the methodology Pepco uses to calculate the unamortized balance of Formal Case No. 1076 rate case costs (RMA No. 12). OPC originally recommended reducing Pepco's rate base by \$487,307.²¹⁵ ADIT would be reduced by \$116,337, instead of the \$267,000 proposed by Pepco (increasing rate base by \$150,448).²¹⁶ In its revised revenue requirement filing, OPC's \$116,337 ADIT figure was changed to \$64,153, and its \$150,448 increase in rate base was changed to \$202,632.²¹⁷

DECISION

125. OPC argues that the methodology Pepco uses to calculate the average unamortized balance of Formal Case No. 1053 costs is inconsistent with the methodology used to calculate the average unamortized balance of Formal Case No. 1076 costs.²¹⁸ According to

²¹⁴ Pepco (C) at 12 (Hook); Pepco (C)-1 at 11; *Formal Case No. 1053*, Order No. 14712, ¶¶ 198-199.

²¹⁵ OPC (A) at 16-17 (Ramas); OPC (A)-3, Sch. 2 (Ramas).

²¹⁶ *Id.* at 18.

²¹⁷ OPC Revised Revenue Requirement Schedules, (Exhibit (A) -3, Schedule 2 (revised) (November 20, 2009).

²¹⁸ OPC Br. 34-36.

OPC, Pepco proposes to set the unamortized balance of Formal Case No. 1076 costs at the average balance as of the mid-point of the rate-effective period (June 30, 2010), while it calculates the unamortized balance of Formal Case No. 1053 costs using the average balance for the twelve months ending December 2008. This results in an inflated balance of Formal Case No. 1053 costs being included in rate base.²¹⁹ OPC contends the method used to calculate the unamortized balances of both cases should be the same.²²⁰ This would reduce unamortized balance of Formal Case No. 1053 costs. Pepco challenges OPC's recommendation to decrease the amount of unamortized Formal Case No. 1053 costs reflected in rate base. Pepco argues that in Formal Case No. 1053, the Commission approved a three-year amortization of the 13-month average of total costs incurred.²²¹ Pepco contends that OPC is proposing to roll forward a full two years after the end of the test period to pick up the average unamortized cost balance at December 31, 2010.²²²

126. No party opposes Pepco's proposed O&M expense. We find the Company's adjustment reasonable and, therefore, the Commission accepts the adjustment. However, as it relates to the unamortized deferred Formal Case No. 1053 costs, the Commission agrees with OPC that the reflection of these costs in rate base should be concurrent with the first year of the rate-effective period of this proceeding. The costs are known and measurable. The Company's argument that using the 2010 average would effectively be "rolling forward a full two years after the end of the test period"²²³ incorrectly characterizes the related costs. The average unamortized cost balance for the 13-months ending December 31, 2010, includes costs beginning within a year after the end of the test year. Therefore, the Company's reliance on Formal Case No. 869 is misplaced. In Formal Case No. 869, the Commission refused to consider the final increment of the Ohio Edison capacity because it would not begin until 18 months from the close of the test period. The expense was too remote from the test year.²²⁴ In the instant case, the cost calculation begins within a year from the close of the test period. Remoteness from the test year is not at issue as it relates to this adjustment. Formal Case No. 1076 costs (RMA No. 12) are calculated based on the expected first year of the rate-effective period. The Commission finds that because Formal Case No. 1076 costs are based on the first year of the rate-effective period, and because the average Formal Case No. 1053 unamortized cost balance is known and measurable for that first year of the rate-effective period, those costs should be used in the Formal Case No. 1053 calculations as well.

²¹⁹ OPC R. Br. 11.

²²⁰ *Id.*

²²¹ Pepco Br. 6.

²²² Pepco(4C) at 5 (Hook Rebuttal).

²²³ Pepco (4C) at 5:3-4 (Hook Rebuttal).

²²⁴ *In re Potomac Electric Power Co., Formal Case No. 869*, Order No. 9216, 10 DCPSC 23, 110 (1989).

3. Uncollectible Expense

127. **Pepco.** Pepco proposes to increase O&M expense by \$300,000 (RMA No. 16) from \$3.142 to \$3.442 million to reflect the budgeted 2009 level of uncollectible expense.²²⁵

128. **OPC.** According to OPC, Pepco has not supported its projected 2009 uncollectible expense for the District of Columbia or for its distribution-related costs, nor has the Company shown that its methodology is reasonable. OPC states Pepco derived its 2009 Maryland, District of Columbia and total uncollectible expense by utilizing the total net write-offs and the total reserve adjustments for 2007 and 2008 for the District of Columbia and Maryland, and compared them to total District of Columbia and Maryland billed revenues.²²⁶ OPC challenges this adjustment in that it includes revenues beyond distribution revenues and the District is disproportionately impacted by the higher bad debt ratio estimate for Maryland. OPC also contends that the level of uncollectible expense appears to be significantly impacted by adjustments to bad debt reserve made by Pepco in 2007 and 2008, instead of being based on net write-offs of uncollectibles.²²⁷ Further, the Company's projection methodology factors in total budgeted revenues for the District of Columbia and Maryland and is not specific to distribution service.²²⁸

129. OPC recommends that the percentage of the historic average of net write-offs to revenues, which the Company has not calculated, be applied to the adjusted test year revenues to determine a normalized uncollectible cost to include in rates.²²⁹ OPC contends that the amount included in the test year includes not only the net write-offs of account balances but also adjustments to the bad debt or uncollectible reserve. Additionally, the test year amount includes the impact of amounts expensed to increase the bad debt reserve that are not specific to distribution-related accounts receivable balances being written off.²³⁰ OPC estimates the three-year average (2006-2008) of D.C. distribution-specific uncollectible expense to be \$1.28 million, \$2.16 million less than requested by the Company.²³¹

130. **AOBA.** AOBA contends that Pepco's proposal is not reflective of the expense it should anticipate for the rate-effective period.²³² AOBA argues that a three-year (2007-2009)

²²⁵ Pepco (C) at 14 (Hook); Pepco (C)-1 at 19; Pepco (4C) at 13 (Hook Rebuttal).

²²⁶ OPC (A) at 36 (Ramas).

²²⁷ *Id.* at 37.

²²⁸ *Id.*

²²⁹ *Id.* at 39.

²³⁰ *Id.* at 38.

²³¹ OPC Br. 75; Tr. 866-867. Initially, OPC recommended that test-year uncollectibles be set at \$1.01 million. OPC (A) at 41 and 42 (Ramas).

²³² *Id.*

historical average of actual write-offs would be more appropriate.²³³ The three-year average is \$2.98 million, \$458,000 less than the Company's proposed \$3.44 million.²³⁴

131. **Pepco Rebuttal.** Pepco counters that the Commission's policy has consistently been to set rates based on the conditions that are likely to exist during the rate-effective period, and, for that reason, it allows post-test-year adjustments and projections.²³⁵ Pepco argues that its forecasts are accurate. Pepco indicates that its budgeted uncollected expense was \$3.44 million; its actual expense for the twelve months ended September 30, 2009, was \$3.50 million, and its year-to-date (September 30, 2009) recorded amount on an annualized basis was \$3.53 million.²³⁶ Pepco claims that OPC's suggested \$1.28 million uncollectible expense is slightly more than one-half the write-offs likely to occur in 2009, without taking in account the need for allowance for reserve balances.²³⁷ Pepco argues that the use of the average of 2006-2008 data introduces significant regulatory lag, since uncollectible amounts are not written off until six months after the fact.²³⁸

DECISION

132. Pepco proposes an adjustment to test-year operating expenses to reflect the 2009 budgeted amount of uncollectible expense.²³⁹ Both OPC and AOBA object to using the budgeted amount of uncollectibles. OPC proposes a three-year historical average of actual write-offs net of collection, with no recognition of a reserve balance,²⁴⁰ while AOBA proposes a three-year average because it believes that the budgeted amount is not reflective of the expense Pepco will incur during the rate-effective period.²⁴¹ All the parties acknowledge, either implicitly or tacitly, that the economic crisis has had an impact on uncollectibles.²⁴² The data presented by Pepco in this proceeding, however, does not show a discernable trend in the actual uncollectible

²³³ AOBA (A) at 53-54 (Oliver).

²³⁴ *Id.* at 54,

²³⁵ Pepco Br. 39, citing *Formal Case No. 1053*, Order No. 14712, ¶¶ 7, 208-209 (citations omitted).

²³⁶ Pepco (4C) at 14 (Hook Rebuttal).

²³⁷ *Id.* at 16.

²³⁸ *Id.* at 15.

²³⁹ Pepco (C) at 19 (Hook); Pepco (4C) at 13 (Hook Rebuttal).

²⁴⁰ OPC (C) at 38-39 (Ramas).

²⁴¹ AOBA (A) at 53-54 (Oliver).

²⁴² OPC Br. 2; AOBA (A) at 53-54 (Oliver); Pepco Br. 38.

rate. In determining the allowance for uncollectibles, the Commission is concerned with Pepco's actual bad debt experience, not the potential for bad debts, which may or may not be realized. Despite Pepco's contention that its post year budgeted uncollected expense is accurate, Pepco has not unequivocally shown that the budgeted amount is reflective of the rate-effective period. Pepco maintains that reliance on a three-year average is indefensible in light of current economic conditions.²⁴³ However, the economy has shown signs of improvement. In fact, Pepco's testimony was revised to reflect the improvement in financial conditions and the subsiding of the economic crisis.²⁴⁴ Pepco's 2009 uncollectible expense appears to be an anomaly and not reflective of rates to be expected in the rate-effective period. Therefore, we reject Pepco's adjustment to use the 2009 budgeted uncollectible expense.

133. We have often used a three-year average to provide normalization for expenses that fluctuate from year to year. Expense fluctuations may be the result of such things as revenue fluctuations or the general state of the economy. Nevertheless, we believe the use of a three-year average may dampen the unusual volatility experienced in 2009 and result in under-recovery. Therefore, we determine that the average of 2008 and 2009 uncollectible expense best reflects the rate-effective period, for this proceeding only.

4. Storm Restoration Costs

134. **Pepco.** Pepco proposes to normalize O&M expense associated with storm restoration efforts (RMA No. 17) to its three-year average level consistent with Formal Case No. 1053. This would result in an increase of the three-year average storm damage costs of \$517,000 and O&M expense of \$190,922.²⁴⁵

135. **OPC.** OPC contends that costs (such as base salary, wage costs and employee benefits) which comprise more than half of this adjustment would have been incurred regardless of the storm and should not be included in the normalized adjustment. OPC asserts that storm damage costs should be limited to incremental, non-labor costs that were specifically caused by the storm and that an employee labor cost adjustment is reflected in other adjustments, specifically, wages and employee benefit costs.²⁴⁶ OPC submits that Pepco's wages and salaries adjustment presumably includes overtime-related costs which include overtime for storm-related costs.²⁴⁷ OPC argues that Pepco has not demonstrated that the level of overtime costs incorporated in its wage annualization adjustment is not reflective of normal, recurring overtime levels. According to OPC, Pepco's test year storm damage restoration costs of \$190,922 should

²⁴³ Pepco Br. 40, n. 178.

²⁴⁴ Tr. 239.

²⁴⁵ Pepco (C) at 14 (Hook); Pepco (C)-1 at 20; *See Formal Case No. 1053*, Order No. 14712, ¶¶ 195, 199.

²⁴⁶ OPC (A) at 43-44 (Ramas).

²⁴⁷ *Id.* at 45.

be reduced by \$74,775 (the labor component to the adjustment), reducing storm damage restoration costs by \$265,697.²⁴⁸

136. **Pepco Rebuttal.** The Company responds that storm restoration efforts result in higher than normal labor costs, which are by definition incremental and that there is no duplication of the adjustment to labor costs.²⁴⁹ To exclude labor costs from the three-year normalized amount would defeat the purpose of normalization.²⁵⁰ Pepco contends that OPC's argument ignores the fact that the storm damage normalization adjustment in this case is not driven by 2008 labor costs, which are the subject of other adjustments, but by 2006 costs which are not.²⁵¹ Further, Pepco claims that storm costs are not typical of on-going O&M activities, which it argues is the premise of OPC's conclusion that labor is addressed in other adjustments. Pepco asserts that during storms all Company employees become available to work storm-related activities which increase the storm workforce by 50-60 percent. Pepco argues that these costs are "all subject to unusual increases during significant storm events due to extended overtime at time and a half and double pay, shift differentials, holiday pay, changes of shift payments, etc."²⁵²

DECISION

137. We agree with Pepco that storm restoration efforts do result in higher than normal labor costs, which are by definition incremental. The Company has satisfactorily explained its storm damage restoration adjustment. Labor costs increase during storm events due to overtime, pay and shift differentials, and the use of all available personnel (labor and management) to respond to storms.²⁵³ Based on our review of the record, there is no evidence of duplicative overtime labor costs. Therefore, the Commission approves Pepco's adjustment to normalize O&M expense associated with storm restoration efforts to its three-year average level consistent with Formal Case No. 1053. However, in the next rate case, the Company should more clearly demonstrate that storm expense is "incremental" and that its internal labor costs (and in particular base/non-overtime wages) have not been incurred elsewhere such that they are additive or incremental costs. Moreover, the Company is directed to clearly separate out storm-related labor costs from its wage and salary adjustment in its next rate case.

²⁴⁸ *Id.* at 45; OPC (A)-3, Sch. 14.

²⁴⁹ Pepco (4C) at 19-22 (Hook Rebuttal).

²⁵⁰ *Id.*

²⁵¹ Pepco Br. 37.

²⁵² Pepco (3D) at 21 (Gausman Rebuttal).

²⁵³ Pepco (3D) at 21 (Guasman Rebuttal).

5. Interest Synchronization

138. **Pepco.** Pepco proposes to increase D.C. Income Tax ("DCIT") and Federal Income Tax ("FIT") expense (RMA No. 27) by \$312,000 and \$985,000, respectively, to reflect the synchronization of interest expense for income tax purposes with that inherent in the Company's return on rate base.²⁵⁴ Pepco represents that this treatment is in accordance with the Commission's decision in Formal Case No. 1053 and prior cases. Pepco explains the Company's interest synchronization adjustment is based on the weighted cost of debt of 3.57 percent comprised solely of long-term debt.²⁵⁵

139. **OPC.** OPC recommends an adjustment to synchronize interest expense used to calculate income based on the embedded cost of debt and capital structure recommended by OPC. OPC recommends a weighted cost of debt that includes both short-term and long-term debt of 3.47 percent. OPC also uses its adjusted rate base of \$841,923 in its calculation. OPC indicates that the resulting adjustment to net operating income is \$3.49 million.²⁵⁶

DECISION

140. Pepco and OPC used the same method of calculating interest synchronization and its approach is in accordance with Commission precedent. The difference in its recommended adjustment reflects the differences in its proposed rate base and weighted cost of debt. Accordingly, we approve the Company and OPC's method of adjustment and its approach, but the interest synchronization adjustment must reflect the Commission's decision in this proceeding related to the weighted cost of debt and the adjusted rate base.

C. OPC's Proposed Adjustments

1. Directors' & Officers' Liability Insurance

141. **OPC.** OPC recommends that Directors' and Officers' Liability insurance ("D&O insurance") expense be shared 50/50 between shareholders and ratepayers, reducing insurance costs by \$163,379.²⁵⁷ OPC argues that the purpose of D&O insurance is to protect shareholders from decisions of the Board of Directors. Ratepayers have no role in choosing the Board of Directors or the Company officers. OPC asserts in the event that Pepco's officers and directors are successfully sued by its shareholders, it is shareholders and not ratepayers who will be compensated for the losses incurred due to mismanagement or impropriety.²⁵⁸

²⁵⁴ Pepco (C) at 17 (Hook); Pepco (C)-1 at 30 (original filing). This adjustment was amended and reflected in Pepco's November 20, 2009, filing (Responses to Transcript Data Requests) (November 20, 2009).

²⁵⁵ *Id.*

²⁵⁶ OPC Revised Revenue Requirement Schedules, OPC (A)-3, Sch. 18 (Ramas).

²⁵⁷ OPC (A)-3, Sch. 17 (Ramas).

²⁵⁸ OPC (A) at 50-51 (Ramas).

142. **Pepco Rebuttal.** D&O insurance, Pepco submits, enables the Company to: (1) attract and retain competent directors and officers; and (2) protects the Company's balance sheet from losses due to lawsuits that could divert needed capital from investments made to provide reliable service to customers.²⁵⁹ Increasing scrutiny and the risk exposures related to corporate governance decreases the ability to maintain a high-quality board and senior management team. Pepco notes that the vast majority of all publicly-held companies purchase D&O insurance. Pepco indicates that OPC neglects to consider the necessity for publicly-held companies to have D&O insurance and contends that it ultimately benefits customers. Pepco notes that the Commission has approved full recovery of D&O insurance premiums in all its prior rate cases. Pepco asserts D&O insurance is a reasonable and necessary cost of doing business for any publicly-traded corporation²⁶⁰ and that OPC's adjustment should be rejected.

DECISION

143. The Commission finds that Pepco has met its burden of persuasion for the inclusion of D&O insurance costs in rates. D&O insurance is a necessary and reasonable expense to attracting and retaining qualified officers and directors and a reasonable cost of business. Therefore, we reject OPC's proposed adjustment.

D. Pension and OPEB Expenses (Issue No. 5a)²⁶¹

1. Pension Expense

144. **Pepco.** The Company, in RMA No. 15, seeks to increase rate base by \$20.09 million and O&M expense by \$6.3 million, consistent with the treatment approved in Formal Case No. 1053, for 2009 pension and OPEB costs as estimated by the Company's independent actuary, Watson Wyatt Worldwide.²⁶² To keep costs under control, Pepco indicates that PHI entities made a \$300 million cash infusion to the Company-wide plan, of which Pepco made a \$170 million contribution.²⁶³

²⁵⁹ Pepco (4C) at 23-25 (Hook Rebuttal).

²⁶⁰ Pepco Br. 43.

²⁶¹ Designated Issue No. 5a asks, "Is the level of Pension and OPEB expenses in the revenue requirement just and reasonable?"

²⁶² Pepco (C) at 14 (Hook); Pepco (C)-1 at 18 of 33; Pepco (2C) at 3-4. (Hook Supp.). See Order No. 14712, ¶¶ 112, 113. In the November 20, 2009, filing, the overall increase to rate base was revised to \$20.09 million and the O&M expense was revised to \$6.3 million.

²⁶³ Pepco (2A) at 5 (Kamerick Supp.).

145. **OPC.** OPC agrees that the Company's proposed level of OPEB expense is reasonable.²⁶⁴ However, OPC contends that Pepco's proposed pension expense is not reflective of the costs that will be incurred in the rate-effective period. OPC noted that Pepco proposes an increase from the test year level of \$8.558 million to \$25.196 million, a 194 percent increase,²⁶⁵ which includes Pepco's pension costs and PHI Service Company costs allocated to Pepco.

146. OPC argues that the primary driver behind the increase in pension costs is the actuarial loss (26.6 percent) experienced by the pension plan during 2008.²⁶⁶ The actuarial assumptions for 2008 had assumed a long-term rate of return on plan assets of 8.25 percent. According to OPC, two components of the pension expense calculation were impacted by the loss: the component for the expected return on plan assets; and the net loss (gain) amortization.²⁶⁷

147. OPC argues that pension costs for the rate-effective period will be lower than the 2009 costs Pepco projects.²⁶⁸ OPC indicates that from 2006 through 2008, Pepco made zero cash contributions to its pension plan assets. In 2009, Pepco made a significant contribution (\$170 million) to the pension plan assets. OPC submits that larger expected return on plan assets as a result of this contribution serves to reduce pension costs. Further, the funding of the pension plan assets served to reduce future pension costs for many years while earnings on plan assets offset the expense.²⁶⁹ Also, pension expense is projected by Pepco to significantly decline from 2009 to 2011 on a total PHI basis.²⁷⁰ OPC concedes that pension costs for the rate-effective period will likely be higher than the historic test year amounts, but maintains the costs are likely to be lower than the current year level as a result of the cash infusion into the plan.²⁷¹ While the 2009 cost is known and measurable, it is neither known nor likely to be reflective of the costs in the rate-effective period. OPC recommends that costs be based on an average of actual 2008 and 2009 pension and OPEB expenses. Therefore, OPC recommends that pension expense be reduced by \$1.94 million.²⁷²

²⁶⁴ OPC (A) at 51 (Ramas).

²⁶⁵ OPC (A) at 51-54 (Ramas). Initially, on direct, Pepco proposed a pension expense of \$22.138 million.

²⁶⁶ *Id.* at 53-54.

²⁶⁷ *Id.*

²⁶⁸ OPC (A) at 52-54 (Ramas).

²⁶⁹ In 2009, Pepco contributed \$170 million to the pension plan, with the expected contribution on a total PHI basis of \$300 million. OPC states the impact of these cash contributions on pension expense actuarial calculations will be more fully realized in 2010. *Id.* at 55.

²⁷⁰ OPC (A) at 55-56 (Ramas).

²⁷¹ OPC Br. 92.

²⁷² OPC (A) at 57 (Ramas).

148. **AOBA.** AOBA challenges both the pension and OPEB expenses alleging that 2009 expense levels are higher than the costs the Company anticipates in the rate-effective period.²⁷³ AOBA contends that even if the estimates for 2009 are reasonably accurate, there is no basis to assume that they will remain at the 2009 level for 2010 and beyond. AOBA states that, just as the stock market decline in 2008 led to the surge in the Company's estimated 2009 pension expense, the rebound of the market over the past several months can be expected to yield a decline in estimated 2010 pension costs. AOBA contends that it would be more appropriate to use a three-year historical average of pension and OPEB costs.²⁷⁴ Based on its recommendation, AOBA's adjustment reduces pension and OPEB expense by \$3.49 million.²⁷⁵

149. **Pepco Rebuttal.** Pepco modified its request and proposes an increase in its pension expense to \$25.196 million to reflect a subsequent valuation by Watson Wyatt Worldwide.²⁷⁶ Pepco contends OPC "has not demonstrated that using the simple average of 2008 and 2009 pension expense as a predictor is any more reasonable than would be any other random assumption about the 2010 level of expense."²⁷⁷ Pepco argues that OPC's proposed treatment would violate the ratemaking principles which OPC elsewhere defends that adjustments should not reflect predicted changes more than 12 months beyond the test year.²⁷⁸ Pepco contends that AOBA's recommendation (use of a three-year average) should likewise be rejected because AOBA has not offered any evidence that a three-year average will be representative of pension and OPEB costs in the rate-effective period.²⁷⁹

2. Prepaid Pension Asset

150. **OPC.** OPC also asserts that it would not be appropriate to reflect the impact of the 2009 actuarial valuation on the prepaid pension asset in rate base. OPC submits that net-of-tax, the prepaid pension asset should be reduced by \$814,000 on a Pepco distribution-related basis and \$299,796 on a District of Columbia basis.²⁸⁰ OPC also contends the calculation of net-of-tax prepaid OPEB liability was in error and should be corrected. OPC submits that the adjustment necessary to reflect the corrected net-of-tax OPEB liability is an additional \$633,000

²⁷³ AOBA (A) at 51 (Oliver).

²⁷⁴ *Id.* at 41.

²⁷⁵ AOBA (A)-4 (Oliver).

²⁷⁶ Pepco (4C) at 30 (Hook Rebuttal).

²⁷⁷ Pepco (4C) at 27 (Hook Rebuttal).

²⁷⁸ Pepco Br. at 32; Pepco (4C) at 26-27 (Hook Rebuttal).

²⁷⁹ Pepco (4C) at 27-28.

²⁸⁰ OPC (A) at 58 (Ramas).

offset to rate base on a Pepco distribution-related basis and \$233,134 on a District of Columbia basis.²⁸¹

151. OPC argues that Pepco has not established that irreparable injury to its financial metrics is inevitable unless it receives an immediate order for regulatory asset treatment of its increased pension costs.²⁸² OPC states that, to date, it has not seen where Pepco's 2009 pension expense has negatively affected Pepco's credit rating or financial metrics.²⁸³

152. **Pepco Rebuttal.** The Company asserts that OPC has provided no basis to use an average of actual 2008 and 2009 pension asset data. Additionally, it avers that OPC uses the average expense for 2010 while using the average rate base for 2009, which results in a mismatch of the asset with expense. In fact, Pepco contends that the average net-of-tax balance of the prepaid asset will be significantly higher in 2010 than 2009. Finally, Pepco argues that, if the expense level is updated to reflect 2010, then so too should the corresponding rate base component.²⁸⁴

DECISION

153. While Pepco argues that its pension costs should be based on the final 2009 Watson Wyatt Worldwide actuarial report, AOBA correctly points out that, even if the estimates for 2009 are reasonably accurate, there is no basis to assume that they will remain at the 2009 level for 2010 and beyond. Pepco states that there has been significant improvement and stability in the capital markets, and, as noted previously, the Company acknowledges that the stock market has shown recent signs of improvement.²⁸⁵ As stock prices improve, pension costs will decline as shown in the actuarial report. The record shows that pension expense is projected by Pepco to significantly decline from 2009 to 2011.²⁸⁶ The actuarial report estimates that pension costs will decline from a high of \$95.25 million in 2009 to \$69.1 million in 2011.²⁸⁷ Moreover, the 2009 projections do not reflect the PHI entities' \$3 million contribution to the pension plan assets. We agree with OPC that pension costs for the rate-effective period will likely be higher than the historic test year amounts, and that costs are likely to be lower than the current year level as a result of the cash infusion into the plan.

²⁸¹ *Id.* at 59.

²⁸² OPC (C) at 45 (Bright).

²⁸³ *Id.* at 46-47.

²⁸⁴ *Id.* at 29.

²⁸⁵ Tr. 239.

²⁸⁶ OPC (A) at 55-56 (Ramas).

²⁸⁷ OPC (A)-22 (Ramas) (Watson Wyatt Worldwide project pension costs).

154. Based on the record, it is clear that the extreme volatility experienced by Pepco will not likely continue in the future and that an averaging that recognizes 2009 as an anomaly is appropriate. A two-year average (2008-2009) will appropriately recognize the higher expense incurred by Pepco, also will recognize that 2009 was an unusually bad year and provide the Company's pension assets with an opportunity to rebound. Therefore, for this case and this case only, Pepco's pension costs will be estimated for the rate-effective period based on a two-year (2008-2009) average of actual pension costs. The prepaid pension asset will, for this proceeding only, likewise be calculated based on a two year average (2008-2009). The Commission's decision on these two adjustments shall not be viewed as precedent going forward. Finally, the Commission also accepts the Company's proposed level of OPEB expense as reasonable.

E. Pepco Employees and Employee Related Costs (Issues No. 5b)²⁸⁸

1. Wage and Salaries

155. **Pepco.** Pepco proposes to increase O&M expense by \$422,000 (RMA No. 13) to reflect annualized employee salary and wage increases which occurred during the test year (March 1, 2008, for exempt employees, and June 1, 2008, for union/bargaining unit employees).²⁸⁹ This adjustment also includes a 2.0 percent wage increase effective June 1, 2009. There was no non-union wage merit increases in 2009, so there is no adjustment to non-union wages beyond the annualization of the March 1, 2008, increase. Pepco represents that the level of employees and employee-related costs reflected in the test year represents the Company's best estimate of what it thinks it will experience in the rate-effective period. The amount of the adjustment to wages takes into account changes in employee levels, consistent with the Commission-approved treatment in Formal Case No. 1053.²⁹⁰

156. **OPC.** OPC contends that the Commission should: (1) disallow the Company's projected 1.5 percent union wage increase effective June 1, 2009; (2) correct the average number of test year employees used in determining the test year wage increase annualization; and (3) use the July 31, 2009, employee counts for determining the test period wage annualization adjustment.²⁹¹

²⁸⁸ Designated Issue No. 5b asks, "Do Pepco's representations regarding number of employees and employee-related expenses accurately portray the number of employees and employee-related expenses that the Company will experience during the rate-effective period?"

²⁸⁹ Pepco (C) at 12-13 (Hook); Pepco's initial request was \$384,000, which was subsequently revised in its November 20, 2009, update. See Pepco's November 20, 2009, response to Transcript Data Requests, page 18.

²⁹⁰ *Id.*

²⁹¹ OPC Br. 92.

157. In support of its first contention, OPC states that the union contract expired on May 31, 2009 and Pepco, nine months after the end of the test year, still has not provided a new union contract or disclosed the percentage wage increase for 2009 allowed for in the new contract.²⁹² Therefore, OPC submits that the 2009 wage increase is not known and certain, and too remote from the test year.

158. As for OPC's second contention above, OPC asserts that Pepco should use a 13-month average number of employees (exempt and union) to calculate the impact of annualization of the 2008 wage increases and the projected 2009 bargaining unit increase.²⁹³ OPC claims that the number of employees used by Pepco differs from both the 12-month and 13-month average. Pepco applies a reduction factor to apply to the annualized wage increases in the prior rate case (F.C. No. 1053). The Company derived its reduction based on the number of employees at the end of the test year as compared to the average number of employees during the test year. The 13-month average test year numbers for exempt and bargaining unit employees are 306 and 1,056, respectively.²⁹⁴

159. Finally, because the number of employees continues to decline, OPC applies a reduction factor it says is consistent with Formal Case No. 1053, utilizing a post-test year employee count based on most recent known and measurable data. OPC therefore uses the actual number of exempt and bargaining unit employees, which, as of July 31, 2009, was 299 and 1,031 respectively.²⁹⁵

160. Based on the above, OPC proposes an adjustment that reduces Pepco's wage annualization adjustment by \$131,000.²⁹⁶

161. **Pepco Rebuttal.** Pepco responds that the union contract was ratified on September 3, 2009, with a 2.0 percent wage increase (0.5 percent more than estimated) just over eight months after the end of the test year.²⁹⁷ This makes the increase known and measurable. Pepco submits that OPC acknowledges that the remoteness argument does not apply to known and measurable changes occurring within one year of the end of the test year.²⁹⁸ Pepco contends in addition that OPC's remoteness argument is contradictory to its recommendation that the

²⁹² OPC (A) at 60-62 (Ramas).

²⁹³ *Id.* at 63.

²⁹⁴ *Id.* at 64.

²⁹⁵ *Id.* at 64-65.

²⁹⁶ *Id.* at 65.

²⁹⁷ Tr. 351-352; Pepco (4C) at 30-31 (Hook Rebuttal).

²⁹⁸ Tr. 894-896.

Commission calculate the wage and salary adjustment using a July 2009 headcount as opposed to an end of the year headcount.²⁹⁹

2. Employee Health and Welfare Costs

162. **Pepco.** As for employee health and welfare costs, the Company proposes to increase O&M expense (RMA No. 14) by \$315,000 to reflect changes in employee health and welfare costs in the rate-effective period.³⁰⁰ The Company urges the Commission to accept its forecasts of trends in costs in that they are supported by expert judgment.³⁰¹ The proposed increase consists of: (1) an eight percent escalation of test year medical costs (\$877,000); (2) a five percent escalation of test year dental costs (\$54,000); and (3) a five percent escalation of test year vision costs (\$13,000).³⁰² Pepco also includes employee club costs of \$132,000, of which \$95,000 is associated with an annual dinner for Pepco employees.³⁰³

163. **OPC.** OPC argues that RMA No. 14 should be rejected in its entirety. It claims that the escalation factors are unsupported, ignore changes in the employee benefits plans that would offset costs increases and are inconsistent with the actual trends in benefit costs experienced by the Company over the past several years.³⁰⁴ More significantly, OPC contends that Pepco does not identify how the changes and/or revisions to its medical, dental, and vision plans going into effect in 2009 will impact overall costs. OPC states that Pepco's benefit trends generally are based on a regional survey of six companies in Virginia, Maryland, and the District of Columbia. However, the escalation factors used by Pepco did not appear in the survey. In addition, the survey does not appear to factor in changes in Pepco's medical, dental and vision plans structures or changes in cost sharing between employers and employees.³⁰⁵

164. OPC further asserts that, on average per-employee, medical and prescription costs have declined between 2007 and 2008. Overall medical costs decreased by 0.4 percent in 2007 and increased by 1.0 percent in 2008. Clearly, OPC asserts, Pepco has not justified the 8 percent

²⁹⁹ Pepco (4C) at 32-33 (Hook Rebuttal).

³⁰⁰ Pepco (C) at 13-14 (Hook). Changes associated with medical, dental and vision plans reflect anticipated percentage increases developed by the Human Resources Department based on surveys conducted by Lake Consulting, a consulting actuary.

³⁰¹ Pepco Br. 35, citing *Potomac Electric Power Co., Formal Case No. 785*, Order No. 7716 at 38-39 (1982) ("we are inclined to accept the indications of 1982 trends and the judgmental predictions of the experts as to the continuation of those trends with respect to the cost of money").

³⁰² Pepco (C)-1 at 17.

³⁰³ See Pepco's Response to OPC follow-up data request OPC 19-26(c) (Exhibit OPC (A)-30), and OPC's revised revenue requirement schedules, Schedule 12, filed November 20, 2009.

³⁰⁴ OPC (A) at 66-67.

³⁰⁵ *Id.* at 67-68.

medical escalation rate that it proposes for 2009. Therefore, OPC recommends that Pepco's proposed \$315,000 increase in employee benefit costs should be denied.³⁰⁶

165. As to Pepco's \$132,000 employee club costs, OPC recommends that the Commission deny the entire amount including funding for the annual dinner function and other employee club events in light of the current economic environment. This cost should be funded entirely by shareholders. Therefore, OPC concludes that test year expense should be reduced by \$44,036.³⁰⁷

166. **Pepco Rebuttal.** Pepco argues that the benefit survey is reliable to use as a basis for future projections and states that, based on annualized data reflecting eight months of actual 2009 experience, the projections are 99 percent accurate.³⁰⁸ Pepco also notes that OPC witness Ramas agreed on cross examination, that the forecast was accurate and acknowledged that she had no information to refute the accuracy of the numbers.³⁰⁹ Regarding employee club costs, Pepco argues that, in addition to the small dollar amount, the expenditure reflects the Company's aim of attracting and retaining workers.³¹⁰

DECISION

167. It has been the Commission's policy to include collectively bargained union wage increases that are known and measurable in rates in order to more accurately reflect cost in the rate-effective period.³¹¹ In keeping with its practice, the Commission will authorize Pepco's 1.5 percent union wage adjustment that the Company originally expected would be effective June 1, 2009, five months after the end of the test period. However, the Commission finds that it cannot approve the entire 2.0 percent increase that is represented to be included in the ratified contract. Although Pepco claims that the contract has been ratified, much is not known regarding the contract. Pepco has yet to present the contract to the parties and to this Commission to review and evaluate the scope and effect of the negotiated concessions made by the Company and its rate impact, if any. Additionally, the Commission accepts Pepco's headcount as modified by OPC, to reflect the reduction in the number of employees.³¹²

³⁰⁶ *Id.* at 69.

³⁰⁷ *Id.* at 70. This represents the D.C. portion of the expenses.

³⁰⁸ Pepco (4C) at 32-33 (Hook Rebuttal).

³⁰⁹ Tr. 901-902.

³¹⁰ Pepco (4C) at 35 (Hook Rebuttal).

³¹¹ *See Formal Case No. 929, Order No. 10387.*

³¹² OPC (A) at 60-64. Tr. 1242.

168. As for employee health and welfare costs, the Commission accepts Pepco's proposed adjustment which reflects changes in employee health and welfare costs in the rate-effective period.³¹³ The Company had urged the Commission to accept forecasts of trends in costs which are supported by expert judgment.³¹⁴ The actual 2009 employee health and welfare benefit costs support the accuracy of the Company's forecast. The costs are known and measureable. However, the Commission rejects that portion of Pepco's adjustment that relate to employee club costs. Although the dollar amount is small and Pepco's effort to increase employee morale is commendable, this is a cost that shareholders, and not ratepayers, should bear.

**F. Pepco's Proposed Three-Year Rolling Average of Pension Costs,
OPEB, and Uncollectible Expenses (Issues Nos. 8 and 8a)³¹⁵**

169. **Pepco.** To smooth out the impact of unusually high 2009 pension costs, Pepco proposes a surcharge to collect a three-year rolling average, rather than each year's actual costs, of its volatile pension costs, uncollectible expenses, and other post-employment benefit ("OPEB") expenses.³¹⁶ The surcharge would be reset annually, and any difference between the surcharge amount and the actual expense for each year would be deferred as a regulatory asset/liability and treated as a recoverable cost of service in the Company's next rate case.³¹⁷ According to Pepco, the impact of its "Volatility Mitigation Surcharge" ("VM tariff") would be a \$3.4 million reduction in Pepco's revenue requirement in the present case.³¹⁸

170. Alternatively, Pepco proposes to use ordinary base rates (rather than an annually updated surcharge) to collect its pension/OPEB/uncollectible expenses, set at a three-year average level.³¹⁹ Under this alternate proposal, "any differential between the three-year average level reflected in base rates and the current-year expense is deferred as a regulatory asset upon which capital costs accrue at the authorized rate of return."³²⁰ Pepco contends that this

³¹³ Pepco (C) at 13-14 (Hook).

³¹⁴ Pepco Br. 35, citing *Potomac Electric Power Co., Formal Case No. 785*, Order No. 7716 at 38-39 (1982) ("...we are inclined to accept the indications of 1982 trends and the judgmental predictions of the experts as to the continuation of those trends with respect to the cost of money").

³¹⁵ Designated Issue No. 8 asks, "Is Pepco's proposal to recover a rolling three-year average of pension costs, other post-employment benefits, and uncollectible expenses through a surcharge, and to defer for future recovery or refund the difference between the average and actual incurred amounts, reasonable?" Designated Issue No. 8a asks, "Is Pepco's alternative deferral proposal reasonable?"

³¹⁶ See Pepco (A) at 30 (Kamerick); Pepco (G) at 14 (Bumgarner).

³¹⁷ Pepco (C) at 22-24 (Hook); Pepco (A) at 30 (Kamerick). See also OPC (C) at 29-30 (Bright).

³¹⁸ Pepco (C) at 23-24 (Hook); Pepco (A) at 30-31 (Kamerick); Pepco (G)-6 (Bumgarner).

³¹⁹ Pepco (2A) at 5 (Kamerick Supp. Direct).

³²⁰ See Pepco (C) at 24- 25 (Hook); Pepco (G) at 15 (Bumgarner); OPC (C) at 39-40 (Bright).

alternative is workable because, “although it hurts the Company’s cash flow, it provides for cost recovery.”³²¹

171. **OPC.** In opposing Pepco’s initial proposal, OPC points out that the Commission rejected a similar Pepco proposal in Formal Case No. 1053, on the grounds that pension/OPEB costs do not require any different treatment than Pepco’s other operating expenses.³²² OPC argues that the alleged volatility of the pension and OPEB expenses in this case is not materially different from the variability that the Commission found insufficient to justify a departure from test year ratemaking in Formal Case No. 1053.³²³ Nor do Pepco’s “uncollectibles” show sufficient “volatility” to justify a surcharge.³²⁴ OPC argues that the spike in Pepco’s 2009 pension costs reflects the recent economic downturn, that it is not representative of the future, and that it does not show that pension expenses are typically so volatile that they should be recovered through an extraordinary surcharge mechanism.³²⁵ OPC asserts that a surcharge would undercut Pepco’s incentive to control its pension, OPEB, and uncollectible expenses. The Company’s proposed VM tariff contains only perfunctory procedures that OPC contends do not present a meaningful opportunity for review by OPC and other intervenors.³²⁶ OPC notes that the Maryland Public Service Commission recently rejected a similar surcharge request from Delmarva Power and Light. In sum, OPC argues that Pepco has not justified a surcharge for recovering its pension costs, OPEB, and uncollectible expenses. OPC concludes that these are ordinary operating expenses that should be considered in traditional ratemaking procedures. OPC submits that there is no support for Pepco’s claim that a surcharge is necessary to avoid a downgrade in the Company’s credit rating.³²⁷

³²¹ Pepco (2A) at 6 (Kamerick).

³²² OPC (C) at 29-32 (Bright), citing *Formal Case No. 1053*, Order No. 14712, ¶365.

³²³ See OPC Br. 138-140; OPC R. Br. 57-58; OPC (C) at 34. “Although the amount of D.C. pension expenses shown on OPC’s Exhibit varied from a negative \$600,000 in 2001 to \$3.8 million in 1994, and the D.C. OPEB expense varied from \$2.2 million in 1994 to \$4.6 million in 2007, this Commission concluded [in *Formal Case No. 1053*] that such fluctuations in expense did not justify a departure from test-year ratemaking.” *Id.*

³²⁴ *Id.* at 35.

³²⁵ *Id.* at 34, 36. OPC also states the \$3.4 million revenue reduction associated with Pepco’s proposal occurs only because a three-year average is less than the immediate 2009 “spike” in Pepco’s pension costs. “By using the average expenses to lower the amounts included in the initial surcharge, Pepco is giving up only a very short term reduction in cash flow in exchange for a guaranteed recovery of these expenses on a dollar for dollar basis.” OPC (C) at 37 (Bright).

³²⁶ *Id.* at 38-39 (OPC also states the surcharge VM tariff rider “does not provide for the recovery of the [possible \$10 million] regulatory asset/liability between general rate proceedings,” though “Pepco witness Bumgarner indicated that a provision would be added if the Commission approves the mechanism”).

³²⁷ OPC Br. 137; OPC R. Br. 56-58; OPC (C) at 39.

172. OPC opposes Pepco's alternative proposal on similar grounds. It claims that Pepco's alternative proposal entails a higher revenue requirement than the VM tariff surcharge, because "it includes an accrued return on the regulatory asset and the surcharge does not." OPC contends that the Commission should simply set Pepco's pension, OPEB and uncollectible expenses at reasonable, representative levels.³²⁸

173. OPC argues that Pepco's recent multi-million-dollar contributions to its pension fund (approved by the Commission over OPC's objections)³²⁹ do not support the Company's request for extraordinary relief on its 2009 unrecovered pension expense. Those contributions were made to satisfy mandatory pension funding requirements, and OPC claims that Pepco's proposal to include them in rate base will more than recover these amounts from ratepayers.³³⁰

174. **AOBA.** Echoing many of the same contentions as OPC, AOBA objects to Pepco's new proposed surcharge. AOBA argues that a surcharge would recover increasingly large pension and OPEB costs outside of normal ratemaking procedures; it would make these costs more difficult to verify; it would undercut Pepco's incentives to manage its pension, OPEB, and uncollectible expenses; and it would shift risk on these costs to ratepayers who are not in a position to manage them.³³¹ Further, AOBA contends that the surcharge allows only a shortened period (60 days) for parties to review the prudence of costs flowed through the surcharge, and no opportunity for review or comment by parties other than Commission staff.³³²

³²⁸ OPC (C) at 40 (Bright). OPC urges that, if the Commission imposes a surcharge, it should apply only to pension costs which have "shown somewhat greater variability year-to-year" than OPEB and uncollectible expenses. "Second, the Commission should specify that any surcharge mechanism is not intended to be permanent and that Pepco will have the burden of showing * * * why any deferral mechanism should remain in place. Third, the Commission should make clear that Pepco is not entitled to earn a return on any regulatory asset that should accrue for under-recovered amounts." Finally, OPC suggests that an annual open hearing should be held on any surcharge, with the burden of proof on Pepco to justify the reasonableness of any expenses included in the surcharge. *Id.* at 40-41.

³²⁹ See *Formal Case No. 1053*, Order No. 14712, ¶¶ 102-113.; Order No. 14832, ¶¶ 6-16.

³³⁰ OPC Br. 143; OPC (C) at 47-48 (Bright).

³³¹ AOBA (A) at 72, 71-82 (Oliver). AOBA contends that the surcharge rider VM proposed by Pepco is also technically flawed. *First*, Pepco's rolling 3 year average would always be based in part on estimated costs (not actual costs as Pepco suggests). *Second*, Pepco proposes to treat pension/OPEB/uncollectible expenses as a "regulatory asset/liability," improperly suggesting that, even before these expenses are examined, they are presumptively recoverable in future rates. Finally, the surcharge contains no effective date or schedule for annual filings. See *id.* at 73-75.

³³² To reasonably assess the prudence of Pepco's pension and OPEB costs, AOBA argues, one would have to examine whether Pepco has limited its use of "defined benefit" pension plans or replaced those programs with "defined contribution" pension plans whose costs can be more easily controlled. Pepco's pension and OPEB costs would have to be compared with those for other electric distribution utilities, and reasonable limitations and controls would have to regulate how pension and OPEB costs are charged by PHI to Pepco. AOBA (A) at 80-82.

175. AOBA also disagrees with Pepco's alternative suggestion to create a regulatory asset for future recovery of the amount by which Pepco's actual pension, OPEB, and uncollectible expenses exceed the level allowed in base rates. AOBA contends that this proposal would diminish Pepco's incentives to control costs, and shift risks to ratepayers that traditionally have been borne by the Company. Pepco's regulatory asset approach provides no assurance that only "prudently incurred" pension costs would be allowed.³³³

176. With the significant upturn in the stock market during the second half of 2009 and the improvement in the economy, AOBA argues that Pepco's early forecasts overstate its actual requirements for future pension, OPEB, and uncollectible funding.³³⁴

177. **WMATA.** WMATA points out that, over the period 2007 through 2009, pension costs are responsible for most of the volatility and increase in Pepco's pension, OPEB and uncollectible expenses. WMATA graphically presented the evidence on Pepco's year-by-year pension, OPEB and uncollectible expenses (in thousands of dollars) as follows:³³⁵

	Pension	OPEB	Uncollectibles	Total
2007	\$7,280	\$11,075	\$2,367	\$20,722
2008	\$8,558	\$10,800	\$3,142	\$22,500
2009 est.	\$22,138	\$10,915	\$3,442	\$36,495

If Pepco were granted a surcharge, WMATA argues, this would reduce its risks, thereby reducing its cost of capital and warranting an adjustment of Pepco's ROE.³³⁶

178. The surcharge mechanism in Rider VM is preferable, WMATA argues, to Pepco's "regulatory asset" proposal because the VM surcharge adjusts up and down with the swings associated with the expenses. WMATA argues that the surcharge in Rider VM should include only pension expenses, which account for a significant portion (10 percent) of Pepco's operating expenses, and which are outside Pepco's control and volatile because they are related to the financial markets. WMATA argues that, by contrast, Pepco's OPEB and uncollectible expenses are not volatile or unpredictable, and they should remain as part of Pepco's base rates.³³⁷

179. **Pepco Rebuttal.** The Company defends its three-year amortization proposal for pension/OPEB/uncollectible expenses as a "typical regulatory approach," often used to prevent

³³³ *Id.* at 76-82.

³³⁴ AOBA R. Br. 20-23.

³³⁵ *See* WMATA (A) at 14 (Foster).

³³⁶ WMATA Br. 6, 8, 9; WMATA (A) at 14-15.

³³⁷ WMATA Br. 8-9; WMATA (A) at 15-16.

rates being set based on an unusual expense event.³³⁸ To support its proposition, Pepco cites Formal Case No. 922 where the Commission accorded Washington Gas Light Company “an opportunity to file for an annual increase for OPEB related costs” on the ground that “without this mechanism, Washington Gas may not be able to record a regulatory asset, which will significantly damage the Company’s earnings.” For similar reasons, Pepco seeks to recover volatile pension, OPEB, and uncollectible expenses in this case.³³⁹ Pepco avers that there is “volatility from year to year” in these costs because of changes (beyond Pepco’s control) in the discount rate and the financial markets that impact the amount of PHI’s pension liability.³⁴⁰

180. Pepco argues that OPC is simply speculating in using a simple average of the Company’s 2008 and 2009 pension expenses to estimate the level of pension expense that should be reflected in the rate effective period beginning in January 2010.³⁴¹

181. The Company also objects to setting pension and OPEB expenses at the three-year average level, as AOBA recommends, without creating an associated regulatory asset covering the difference between that average level and the actual expense incurred.³⁴² While some of the expenses recovered under Rider VM would be estimated costs, Pepco contends that they would be continually subject to true-up so the Company would not over-recover actual expenses. Equally without merit is AOBA’s claim that Rider VM implies Commission pre-approval of the prudence of the costs. Pepco asserts, to the contrary, that the Rider does not foreclose prudence review; in fact, it requires Pepco to furnish the Commission staff with sufficient workpapers for the review and audit of the surcharge. Pepco contends also that there is no merit in AOBA’s objection that many pension/OPEB costs covered by the proposed surcharge are billed to Pepco by PHI. Pepco argues that these pension/OPEB costs are no less real or necessary for Pepco because they relate to PHI Service Company employees.³⁴³

182. Moreover, Pepco argues, the originally estimated pension costs could now be replaced by actual cost figures.³⁴⁴ Pepco submits, assuming the expense levels are updated to reflect the final 2009 actuarial report, OPC has correctly stated the necessary revisions to OPEB liability, namely a \$7.6 million reduction to D.C. distribution-related rate base, or a reduction of

³³⁸ Pepco (3A) at 22 (Kamerick).

³³⁹ Pepco R. Br. 41-42, citing *Washington Gas Light Co., Formal Case No. 922*, Order No. 10307 (1993).

³⁴⁰ Pepco (3A) at 23- 25.

³⁴¹ Pepco (4C) at 25-27 (Hook).

³⁴² *Id.* at 27-28.

³⁴³ Pepco R. Br. 42-43.

³⁴⁴ See Pepco (4C) at 28-29. Pepco objects to OPC’s proposed adjustment to prepaid pension costs unless the Commission should decide that actual 2009 expenses should be used. Moreover, Pepco cautions that the timing of the expense and rate base components should be the same, so that “if the expense level is updated to reflect calendar year 2010,” as OPC proposes, “then so too should be the corresponding rate base component.” *Id.*

\$233,000 from the Company's original filing. The Company also submits Pepco Exhibit (4C)-8 to show the adjustments that would be made if both 2009 actual pension costs and 2009 actual OPEB expenses were used in calculating Pepco's rates. The exhibit also reflects the correction to the computation of the OPEB liability.³⁴⁵

DECISION

183. The Commission rejects the Company's surcharge proposal and directs Pepco to continue recovering these expenses through rates. We are persuaded by the evidence presented by OPC and WMATA that no striking "volatility" is shown in Pepco's OPEB and uncollectible costs, and it is less than that found insufficient to justify a surcharge in Formal Case No. 1053. There was a spike in Pepco's 2009 pension costs, but this appears to be an anomaly.

184. Traditional ratemaking treatment, instead of a surcharge, is supported by the fact that Pepco failed to show that the recent volatility in its pension costs is likely or expected to be a recurring issue. As pointed out by the parties, the stock market has improved. A surcharge would guarantee a dollar-for-dollar recovery of these specific costs and would diminish the Company's incentive to control those costs. The Company failed to show that a pension/OPEB/uncollectibles surcharge is necessary to avoid serious harm to Pepco's financial well-being. Accordingly, we find no justification on this record for ordering specialized rate treatment by excluding these classic, ongoing utility expenses from the standard, contextual ratemaking analysis.

G. Pepco's Proposed Regulatory Asset Treatment of Its 2009 Pension Costs

185. **Pepco.** The Company alternatively seeks regulatory asset treatment of the excess of its 2009 pension expenses over what is currently being recovered in Pepco's rates. (OPEB and uncollectibles were not included in this request.) Pepco states that the rates set in this case will not become effective until 2010. However, the spike in its 2009 pension expenses will have to be recorded on the Company's books in 2009. Unless its requested accounting treatment is approved in 2009, Pepco argues, it will not have any opportunity to earn its authorized rate of return and its stock prices and bond ratings will be adversely affected.³⁴⁶

186. Pepco avers that its pension expenses have increased dramatically from \$2.791 million a year (the amount reflected in Pepco's current rates) to \$8.153 million a year (Pepco's calendar year 2009 O&M pension expenses as estimated on March 1, 2009) to \$9.280 million a year (the Company's calendar year 2009 O&M pension expenses as estimated more recently).³⁴⁷ Though expense items often show some variation, Pepco argues that its 2009 pension costs should be given special accounting treatment because of the sheer size of this unexpected

³⁴⁵ *Id.* at 29-30.

³⁴⁶ Pepco Br. 74-79; Pepco R. Br. 43; *Affidavit of Pepco Witness Anthony J. Kamerick* at 2-4.

³⁴⁷ *Id.* at 2, ¶ 4.

expense, which was caused by the impact of the current economic crisis on the value of its pension fund assets.³⁴⁸ To support its position, Pepco cites *South Carolina Electric and Gas Company*, S.Car. Docket No. 2009-36-E, Order No. 2009-81, where the South Carolina Commission authorized the establishment of a regulatory asset to track the \$26.7 million decline in value of a utility's pension fund assets due to current economic conditions.

187. In supplemental direct testimony, Pepco witness Hook testified that the regulatory asset covering 2009 pension costs would be approximately \$6.5 million. Pepco would amortize this sum over a three-year period which would increase Pepco's revenue requirement by approximately \$2.5 million.³⁴⁹

188. **OPC.** OPC argues that stock market fluctuations in the value of Pepco's pension assets do not justify special regulatory treatment for Pepco's pension costs. OPC contends that, ordinarily, the risks of stock market fluctuations are borne by the utility. OPC notes that, to date, the 2009 pension expense issue has not negatively affected Pepco's credit rating or financial metrics or caused "irreparable harm."³⁵⁰

189. OPC points out that the Commission recently rejected a similar Pepco request in Formal Case No. 1053.³⁵¹ There Pepco requested a surcharge to permit recovery of its pension and OPEB expenses, arguing that financial conditions including stock market fluctuations cause its pension-related expenses to deviate significantly from its test period expenses. OPC argues that the Commission properly rejected this claim.³⁵²

190. OPC's supplemental direct testimony notes that, in Order No. 15540, the Commission rejected Pepco's request for an immediate order for regulatory asset treatment of its 2009 pension costs.³⁵³ Further, OPC notes that none of the jurisdictions to which Pepco has applied (Maryland, New Jersey and Delaware) has authorized Pepco to treat its 2009 pension expenses as a regulatory asset.

191. OPC argues that Pepco has not shown that its 2009 pension costs have dramatically affected its financial status, threatened its credit rating, or justified regulatory asset treatment for its pension costs.³⁵⁴ OPC concludes that Pepco's request for a pension related

³⁴⁸ *Id.* at 2-4.

³⁴⁹ Pepco (3C) at 1-2 (Hook).

³⁵⁰ OPC (C) at 45, 46 (Bright).

³⁵¹ *Id.* at 44. *Formal Case No. 1053*, Order No. 14712, ¶ 365.

³⁵² OPC (C) at 46-47.

³⁵³ OPC (2C) at 4 (Bright).

³⁵⁴ *Id.* at 6-10 (Bright).

regulatory asset of \$6.5 million amounts to impermissible “single issue ratemaking and retroactive ratemaking.”³⁵⁵

192. **Pepco Rebuttal.** The Company retorts that, contrary to OPC’s submissions, Pepco’s proposed tracking mechanism for pension costs is used by many utility companies and is consistent with the widespread use of ROE incentives, riders, trackers, and other cost recovery mechanisms.³⁵⁶ Pepco contends that other jurisdictions are now actively considering Pepco’s request for regulatory asset treatment of its 2009 pension costs.³⁵⁷

193. The Company states that its pension costs spiked dramatically in 2009, yielding a \$6.5 million shortfall. Pepco claims that were it denied authorization to collect that \$6.5 million shortfall, it would equate to a loss of “approximately 60 basis points in rate of return, which translates to over 130 basis points return on equity.” While OPC discounts the impact of this on Pepco’s financial ratings, Pepco asserts that Fitch’s rating service recently noted (September 2, 2009) that Pepco’s “stable” credit rating assumes that regulatory Commissions “will provide reasonable and timely recovery of costs incurred by PHI’s utility subsidiaries, including pension costs.”³⁵⁸ Moody’s Investor Service also stated in August 2009 that a utility’s ability to timely recover costs is critical. The Company argues that “the inability to recover as a regulatory asset the 2009 pension expense not recovered through rates effective in 2009 is detrimental to the Company in areas that encompass 90 percent of what Moody’s takes into account when deriving our credit rating.”³⁵⁹

DECISION

194. The Commission rejects Pepco’s alternative proposal seeking the creation of a “regulatory asset” for recovery of its pension costs. Our decision here is in accord with our recent ruling in Formal Case No. 1053, where we rejected a comparable tracking proposal.³⁶⁰ It also accords with the recent decision of the Maryland Public Service Commission, which rejected a similar request by Delmarva Power & Light for a surcharge, or amortization, of large pension and OPEB costs incurred because of the recent economic downturn.³⁶¹ None of the

³⁵⁵ OPC (2C) at 11; OPC (C) at 47-48.

³⁵⁶ Pepco (3B) at 85-87 (Morin). The pension costs at issue are from a current period, Pepco notes, so OPC is mistaken in claiming that establishment of a regulatory asset would constitute retroactive ratemaking. Pepco R. Br. 44.

³⁵⁷ Pepco (4A) at 2 (Kamerick).

³⁵⁸ Pepco (4A) at 2-5.

³⁵⁹ *Id.* at 3-8.

³⁶⁰ Order No. 14712, ¶ 365.

³⁶¹ See *In re Delmarva Power & Light Company*, Maryland PSC Case No. 9192, Order No. 83085 at 12-16 (December 30, 2009).

other jurisdictions to which Pepco has applied (Maryland, New Jersey and Delaware) has authorized Pepco to treat its 2009 pension expenses as a regulatory asset.

195. Ordinarily, the risks of stock market fluctuations are borne by the utility.³⁶² Traditional ratemaking analysis is well-suited to address fluctuations in pension costs. Pepco did not demonstrate that its financial situation is as precarious, or that its pension fund losses were as extreme, as was the case for the South Carolina utility that received “regulatory asset” relief in the *South Carolina Electric and Gas Company* case.³⁶³ Regulatory asset treatment might diminish Pepco’s incentives to control its pension costs. We also have considered the community comments objecting to high pension cost recovery by Pepco.³⁶⁴ The Commission finds that, on this record, Pepco failed to carry its burden of proof to justify a departure from traditional ratemaking procedures for recurring pension costs.

H. Transactions between Pepco and Other PHI Affiliates (Issues Nos. 7 and 7a)³⁶⁵

196. **Pepco.** The Company submitted a benchmarking study by the Hackett Group to support the reasonableness of its affiliate transactions. The study compares Pepco to 27 other electric utility companies on: (1) the ratio of “Administrative and General” (“A&G”) expenses to total sales; and (2) the ratio of total A&G expenses to net utility plant.³⁶⁶ Hackett concluded that PHI Service Company’s costs are in line with its peers and are therefore reasonable.³⁶⁷

197. **OPC.** OPC seeks a \$189,000 reduction in Pepco’s District operating expenses to eliminate an error in which the PHI Service Company over-allocated deferred compensation costs to Pepco. OPC indicates that Pepco has agreed to make this correction.³⁶⁸ OPC also seeks to eliminate from Pepco’s operating expenses \$170,691 in one-time, non-recurring District-

³⁶² See, e.g., Order No. 15540, ¶ 11.

³⁶³ Our decision today safeguards Pepco against any “significant damage” to the Company’s earnings. Accordingly, this case is very different from *In re Washington Gas Light Co.*, Formal Case No. 922, Order No. 10307 (1993) (cited by Pepco R. Br. 41-42), where special regulatory treatment was found necessary to avoid damage to the utility.

³⁶⁴ See ¶ 456 *infra*.

³⁶⁵ Designated Issue No. 7 asks, “Are the PHI Service Company costs charged by Pepco reasonable?” Designated Issue No. 7a asks, “Are the benchmarks filed by Pepco reasonable and do they support the costs charged to Pepco?”

³⁶⁶ Pepco (A)-1 at 1, 2 (Kamerick).

³⁶⁷ Pepco Br. 62-63; Pepco (I) at 4, 5, 9, 10 (Snowball).

³⁶⁸ OPC Br. 128; OPC (C) at 16 (Bright).

allocated costs that PHI Service Company paid to outside consultants for work on its “Utility of the Future” initiatives.³⁶⁹

198. Over the longer term, OPC recommends several Commission actions to facilitate further inquiry into the costs (over \$160 million in direct and allocated charges) that have been allocated to Pepco by PHI Service Company. *First*, OPC asks the Commission to issue a final Affiliate Transactions Code of Conduct for energy utilities in D.C. in Formal Case 1009. *Second*, OPC requests an audit of the transactions between Pepco and its affiliates as well as an audit of Pepco’s adherence to the new Code of Conduct.³⁷⁰ *Third*, OPC contends that Pepco should be required to submit more information about its “affiliate transactions,” both in Compliance Filings and in annual filings of FERC Form No. 60 with this Commission. Otherwise, OPC states that it is waiting for the results of the independent audit that the Commission ordered in Formal Case No. 1053 to assess many of the costs that PHI’s Service Company has allocated to Pepco in the District.³⁷¹

199. OPC submits a list of reasons why it considers Pepco’s benchmark study defective and why the study should not be used to determine the reasonableness of the PHI costs that were allocated to Pepco.³⁷² More fundamentally, OPC questions whether any benchmark study which does not exclude unreasonable costs from all the “benchmarked” companies (such as executive incentive plan and supplemental retirement plan costs of the kind that this Commission has excluded from Pepco’s recoverable costs) should be used to decide the reasonableness of the “affiliate charges” borne by Pepco.³⁷³

200. OPC argues that comparing the ratio of A&G expenses to sales is not meaningful. Moreover, OPC states that Pepco reports a ratio of A&G to sales that is higher than that of PHI’s other utility affiliates. Similarly, OPC points out that another PHI-affiliated electric utility has a lower ratio of total A&G expenses to net utility plant than Pepco. OPC contends the implication is that Pepco may be allocated disproportionate A&G costs within the PHI group.³⁷⁴

³⁶⁹ OPC (C) at 16-17; *see also* OPC Br.128.

³⁷⁰ OPC Br. 126-127; OPC (C) at 12, 11-14.

³⁷¹ *See* OPC Br. 127-128; OPC (C) at 4-5, 12-13, citing *Formal Case No. 1053*, Order No. 14712, ¶ 170.

³⁷² OPC (C) at 17-27 (Bright). The study is based on a small sample of peer group companies; the data for the peer group companies was based primarily on years prior to 2007; the A&G costs included in the study represent only about 60% of the costs charged to Pepco by the PHI; revenue is used as the primary driver for the Finance and Executive & Corporate Services functions which represent 62% of the A&G costs studies; the median companies included in the Finance and Executive & Corporate Services function peer group had substantially less revenue than PHI, which causes a distortion of these benchmark ratios in favor of PHI; study lacks the qualitative analysis (executive interviews, stakeholder surveys, and recommendations) that would have yielded a deeper analysis.

³⁷³ OPC Br. 135; OPC (C) at 26.

³⁷⁴ *Id.* at 27-29. OPC argues that, in any event, Pepco witness Kamerick failed to show how his sample of 27 electric companies is comparable to Pepco, or how Pepco’s A&G expenses are reasonable.

201. **AOBA.** AOBA argues that the Commission should deny Pepco any increase in Service Company charges over the levels currently included in Pepco's D.C. distribution rates. AOBA argues that Pepco has not shown the reasonableness of any of the "affiliate costs" allocated to it. Instead, AOBA contends that Pepco witness Snowball's benchmark study addresses only vaguely-defined holding company costs (not the costs allocated by holding companies to utilities). Unlike a normal third-party service contract, the Service Agreement between Pepco and PHI places no limitations on the dollar amounts or number of hours that the Service Company can bill to Pepco. AOBA contends that there are no criteria for assessing the adequacy, timeliness or quality of the Service Company's performance. The Company's benchmarking study does not compare the cost of services provided by PHI against what the cost would be if the services were provided by Pepco or an independent third party. Nor does the study address whether the PHI Service Company costs charged to Pepco are in line with similar charges made to other utilities.³⁷⁵

202. **Pepco Rebuttal.** The Company defends its benchmarking study as one that contains "appropriate peers" for comparison with PHI, because of its correlation with PHI on the "core demographics of revenue, countries and employees." Pepco argues that OPC's criticism about the lack of a service company within the organizational structure of the peer group companies is of no moment, because "Hackett eliminates these organization difference by evaluating the full cost of the process to the company – regardless of where the activity occurs."³⁷⁶

203. Pepco claims the study appropriately focuses on A&G costs because it provides the Commission with an opportunity "to get deep down into productivity-type measures to figure out if the services that [the] Service Company was providing were comparable to other similar services being provided and paid for by other companies."³⁷⁷ In focusing on A&G costs, the study excludes costs that are not subject to allocation to Pepco,³⁷⁸ and it shows the reasonableness of the total Service Company A&G costs assigned to Pepco. Pepco indicates that older labor costs in the study were appropriately adjusted for inflation.³⁷⁹ Pepco also claims that "the methods by which these Service Company costs are directly charged or allocated to Pepco

³⁷⁵ AOBA Br. 32-34; AOBA (A) at 66-70 (Oliver).

³⁷⁶ Pepco Br. 63; Pepco (3I) at 3-7 (Snowball).

³⁷⁷ *Id.* at 66-67.

³⁷⁸ The study covers A&G costs that are charged or allocated to both regulated and non-regulated entities within PHI, including Pepco. Pepco Br. 65; Pepco (3I) at 8. "Groups within the Service Company, which provide services directly to:(1) one or a discreet number of regulated utilities; or (2) non-regulated affiliates, were not included within the scope of the benchmark study." *Id.* at 8-9. "In other words, if the costs were not subject to allocation to Pepco, they were excluded. The excluded groups were associated with engineering, call center and non-regulated activities of energy business affiliates." Pepco Br. 65-66; Pepco (3I) at 8-9.

³⁷⁹ Pepco Br. 64-65.

are covered by the PHI Cost Allocation Manual, which has been approved by the Commission.”³⁸⁰

204. The Company states that its study is one in which the “Finance and Executive & Corporate Services (ECS) comparisons are normalized using revenue.” OPC criticizes the smaller size of the comparison peer companies, but Pepco argues that its “normalization” procedure accounts for this difference in size and that ECS activity is driven more by revenue than by other factors such as number of employees, cost of goods sold and number of legal entities.³⁸¹

205. In response to AOBA’s contentions, Pepco claims that its study properly assesses the costs of a particular service based on “Hackett’s definition of a particular A&G process, not how each individual company may internally define such a process.” Pepco acknowledges that its benchmarking study did not compare services provided in-house with those that PHI outsourced. The study did, however, factor in outsourced costs as part of a total aggregated cost against which to compare peer group data.³⁸²

206. With respect to “Utility of the Future Costs” which OPC challenges as one-time consultant expenses, Pepco explains that these costs relate to a variety of ongoing projects and activities. While they were categorized under a general “Utility of the Future” umbrella, these costs are for initiatives that would have been undertaken anyway as part of Pepco’s ongoing utility operations.³⁸³

DECISION

207. The Commission finds that the Company’s presentation is generally similar to the one that Pepco made in Formal Case No. 1053, where the Commission approved Pepco’s recovery of the PHI/affiliate costs allocated to it.³⁸⁴ Pepco has justified its recovery of PHI/affiliate costs under the standards in our earlier case. The Commission is persuaded by Pepco’s testimony to also allow recovery of the disputed \$170,691 in “Utility of the Future” operating expenses, since these appear to be on-going recurring expenses for a variety of

³⁸⁰ Pepco (3I) at 6, 14 (Snowball).

³⁸¹ See *id.* at 9-12.

³⁸² *Id.* at 12-14.

³⁸³ Pepco R. Br. 39-40; Pepco (4C) at 36 (Hook); Pepco (3D) at 15-16 (Gausman).

³⁸⁴ In *Formal Case No. 1053*, the Commission had only an estimate that Pepco’s D.C. customers were being allocated roughly \$37 million of PHI Service Company costs. *Formal Case No. 1053*, Order No. 14712, ¶ 154-160. In this case, Pepco is seeking to recover approximately \$41.3 million of PHI Service Company costs from District ratepayers, an increase of approximately \$4.3 million, or 11.6%. See OPC Exhibit (C)-1, Pepco response to OPC Data Request 3-38.

traditional utility activities and projects, not one-time non-recurring expenses. While the parties object to certain costs, no party has shown that the PHI Service Company has been inefficient or ineffective in the services that it provides to Pepco, or that the PHI/affiliate costs allocated to Pepco are unreasonable. The only exception, which OPC and Pepco have agreed to, is that \$189,000 should be deleted from Pepco's D.C. operating expenses to eliminate an over-allocation of deferred compensation costs from the PHI Service Company to Pepco.

208. The Commission still has some outstanding concerns regarding the level of costs that the PHI Service Company is incurring and then allocating to its subsidiaries including Pepco. We agree with OPC about the desirability of: (a) issuing a final Code of Conduct for energy utilities in the District in Formal Case No. 1009; (b) requiring Pepco to submit more information about its affiliate transactions in its Compliance Filings and in annual filings of FERC Form No. 60 with this Commission; and (c) ordering a more investigative audit of the transactions between Pepco and its affiliates. To address our concerns, the Commission has decided to order an independent audit and operational review of the PHI Service Company and Pepco to determine the reasonableness of the costs that are being incurred by the Service Company, and allocated to Pepco, as well as the effectiveness of Pepco's operations. This will be a prospective review. It will look at management, operating practices and procedures, and the services provided to Pepco, to determine its effectiveness and efficiency and whether the costs being incurred and allocated to Pepco are reasonable and appropriate. To save costs and improve our own efficiency, we will consider a regional approach working in coordination with Commissions from other jurisdictions.³⁸⁵ This will require Commission action in other dockets as well as in this case. Separate orders, to be issued later, will address all these matters in more detail.

I. Past AMI Expenses (Issue No. 9)³⁸⁶

209. **Pepco.** The "smart grid" program embraced by Pepco's Blueprint for the Future includes a commitment to implement Advanced Metering Infrastructure ("AMI"). The Company now seeks to amortize, over a three-year period, the December 31, 2008, balance of its AMI start-up costs in the District, while including the unamortized portion in its rate base. Pepco indicates that the start-up AMI costs at issue (some \$911,000) were incurred in 2007 and 2008 primarily for outside consultants and reassigned Pepco employees, who were investigating customer needs and planning to make AMI work. Pepco claims that the only AMI costs at issue are "incremental costs," not previously accounted for.³⁸⁷

³⁸⁵ We note that two other jurisdiction, New Jersey and Delaware, have already undertaken PHI/affiliate management audits.

³⁸⁶ Designated Issue No. 9 asks, "Is Pepco's proposal to include in proposed rates amounts previously expended for AMI reasonable?"

³⁸⁷ See Pepco Br. 80, 82-83; Pepco (A) at 5-8 (Kamerick); Pepco (C) at 16-17 (Hook) (discussing Adjustment 26). The start-up AMI costs "support the future installation and integration of a meter data management system, the AMI requirements development, AMI software applications, and the overall management of the project." Pepco (D) at 13 (Gausman). "We also developed Requests for Proposals and sent them to vendors to obtain pricing

210. In June 2009, the Council passed an emergency statute authorizing recovery of Pepco's AMI costs.³⁸⁸ The Council subsequently passed the Fiscal Year 2010 Budget Support Second Emergency Act of 2009 ("Budget Act") which effectively approves the implementation of AMI in the District of Columbia.³⁸⁹ Thereafter, Pepco received a \$44.6 million federal grant for its smart grid/AMI activities under the American Recovery and Reinvestment Act of 2009 ("ARRA").³⁹⁰ However, neither the D.C. statute nor the federal grant covers Pepco's start-up AMI costs incurred in 2007 and 2008.³⁹¹

211. Pepco argues that these start-up AMI costs should be treated as a regulatory asset subject to Commission review for prudence.³⁹² The Company also argues that "regulatory asset" treatment is appropriate because it had ample evidence from which to conclude that its recovery of AMI start-up costs was "probable." According to Pepco, this evidence included support by the Commission and OPC for the Company's AMI pilot program; the record of prior Commission hearings relating to AMI; communications from the Commission; the Council's enactment of two pieces of legislation supporting AMI; and the Commission's leadership role at N

information for a meter data management system, IT systems (software and hardware) and AMI systems consisting of meters, communication equipment and software. * * * we [also] formulated detailed business cases for each of P

³⁸⁸ See *Emergency Act of 2009, (Bill 18-207, Act 18-107) (June 18, 2009) (calling on Pepco "to net any utility cost savings resulting from AMI deployment from the regulatory asset" and specifically reserving the Commission's authority to review Pepco's AMI expenses for prudence).*

³⁸⁹ See *Fiscal Year 2010 Budget Support Second Emergency Act of 2009 (Bill 18-443, Act 18-207) (October 15, 2009).*

³⁹⁰ See Tr. 51-52, 120, 128, 130 (Pepco witness Kamerick). The ARRA statute appears at 123 Stat. 115, 26 U.S.C. §1 (February 17, 2009). There are still open questions about exactly how this ARRA money will be used in Pepco's AMI activities. See Tr. 130 (Kamerick). These matters will be addressed by the Commission in *Formal Case No. 1056, In the Matter of the Application of the Potomac Electric Power Company for Authorization to Establish a Demand Side Management Surcharge and an Advance Metering Infrastructure Surcharge and to Establish a DSM Collaborative and an AMI Advisory Group ("Formal Case No. 1056")* filed, April 4, 2007. See ¶ 453, *infra*.

³⁹¹ The statute on AMI costs that was enacted by the Council appears to apply prospectively only, from and after the date of its enactment (June 18, 2009). Technically, then, this D.C. statute does not apply to the 2007 and 2008 AMI start-up costs at issue here in Formal Case No. 1076. Similarly, testimony at the hearings indicated that Pepco's recently-received federal grant money is not available to cover Pepco's \$911,000 in AMI start-up costs. See Tr.1456-1457 (colloquy between Chairman Kane and Pepco witness Gausman) (U.S. DOE grant money does not cover Pepco's 2007 and 2008 AMI expenses; instead, it covers earlier AMI expenses only during the 90 day period (August, September, and October 2009) before the federal grant was made).

³⁹² Pepco (A) at 6 (Kamerick).

³⁹³ Pepco Br. 81; Tr.54,135,137-138,164-165 (Pepco witness Kamerick); OPC Exhibits 2,3.

212. **OPC.** OPC objects to Pepco's three-year AMI amortization proposal, arguing that the Company is improperly using "regulatory asset" treatment as a means to retroactively recover AMI expenses incurred in 2007 and 2008.³⁹⁴ OPC claims that SFAS No. 71 and the FERC Uniform System of Accounts prohibit creation of a regulatory asset in the absence of a prior regulatory approval.³⁹⁵ Moreover, OPC argues that "the Company should not be encouraged to take a self-help approach of deciding that such unapproved retroactive costs can be reclassified as regulatory assets on the assumption that it is 'probable' that the Commission will allow retrospective recovery."³⁹⁶

213. OPC also argues that Pepco cannot show that, at the time it decided to create a regulatory asset in 2007, it had "available evidence" that its recovery of AMI start-up costs was "probable" under SFAS 71. OPC contends that the unspecific statements of alleged support by the Commission for Pepco's recovery of the AMI expenses, aired for the first time on redirect examination, are far from sufficient to demonstrate that at the time the Company decided in 2007 to defer its AMI expenses as a regulatory asset, it had available evidence to support a determination that the Commission would probably allow future recovery of the expenses.³⁹⁷ Citing a Maryland PSC order, OPC argues that Pepco did not need to create a regulatory asset for AMI costs in order to obtain federal funding.

214. OPC acknowledges that the Council passed legislation (D.C. Act 18-107) authorizing Pepco to implement AMI "if the Company obtains a sufficient amount of federal funds" under the new ARRA statute. OPC argues that the statute should not have any impact on this case, because the Act does not address Pepco's 2007 and 2008 expenses. Nor does that Act approve of Pepco's unilateral use of a "regulatory asset" as a means to retroactively recover AMI expenses incurred in earlier years.³⁹⁸

215. OPC objects to Pepco's 2007 AMI start-up costs as improper retroactive recovery.³⁹⁹ OPC also argues that because Pepco's 2008 AMI expenses were a one-time, non-recurring "abnormal" contractor costs, they should not be included in Pepco's test year expenses. OPC thus argues that Pepco should write-off the entire \$911,000 D.C. portion of its AMI expenses for 2007 and 2008.⁴⁰⁰

³⁹⁴ OPC Br. 154-168; PC R. Br.59-60; OPC (C) at 50 (Bright).

³⁹⁵ OPC Br. 156-160; OPC (C) at 50-56.

³⁹⁶ OPC (C) at 56 (Bright).

³⁹⁷ OPC Br. 163; and *see* OPC R. Br. 60.

³⁹⁸ OPC Br. 164-166; OPC (C) at 58. *Accord* Tr. 927-928 (OPC witness Bright).

³⁹⁹ OPC Br. 166-168.

⁴⁰⁰ *Id.* at 168; OPC (C) at 57, 59.

216. **AOBA.** Objecting to Pepco's recovery of AMI start-up costs, AOBA argues that Pepco failed to show that these costs were "incremental." Nowhere in its presentation does Pepco detail the base from which it measures "incremental" costs. AOBA submits that this Commission's policies leave Pepco with considerable discretion as to how to treat expenditures that occur between rate cases. However, Pepco's sweeping theory that it can recover "incremental" costs from a prior period (which allegedly caused Pepco to exceed its authorized revenue) threatens to place all such costs beyond effective Commission scrutiny. Accordingly, AOBA opposes Pepco's "incremental cost" theory.⁴⁰¹

217. Further, AOBA contends that Pepco has not shown that its AMI start-up costs were necessary or essential to its provision of distribution service. AOBA argues that Pepco has not yet demonstrated the cost-effectiveness of its proposed AMI plan for the District of Columbia.⁴⁰²

218. AOBA points out that the Company failed to obtain prior Commission approval for the creation of a "regulatory asset" to cover the AMI start-up costs that it elected to defer for future recovery. AOBA concedes that a "regulatory asset" can be created in some circumstances for Pepco costs whose recovery is "probable." However, AOBA argues that Pepco did not identify any specific "signals from the Commission or other documents" that supported its decision that AMI recovery was "probable" so as to justify the creation of a regulatory asset for 2007 and 2008 AMI-related costs.⁴⁰³

219. In any event, AOBA contends that the three-year amortization is arbitrary, and fails to match the recovery of AMI start-up costs with the timing of expected benefits from the AMI system. AOBA concludes that if these AMI start-up costs are permitted in rates, they should be recovered over the full expected 15-year life of the associated AMI equipment.⁴⁰⁴

220. **Pepco Rebuttal.** Contrary to OPC's submission, Pepco counters that its AMI start-up costs were prudently incurred, for the benefit of customers. The start-up AMI work was necessary to enable the Commission to review the cost-effectiveness of the technology. It helped obtain federal funding. Pepco argues that denying cost recovery would create a disincentive for Pepco initiatives that benefit ratepayers. Pepco argues that the overall prudence and cost effectiveness of the AMI project was shown in Formal Case No. 1056, and is supported by the

⁴⁰¹ AOBA Br. 27-28; AOBA R. Br. 23-24. *See generally* AOBA (A) at 56- 61, 82 (Oliver).

⁴⁰² AOBA Br. 27, 28.

⁴⁰³ *Id.* at 27; AOBA R. Br. 23-24.

⁴⁰⁴ AOBA Br. 28-29; AOBA R. Br. 25.

District Government's recent enactment of legislation supporting the AMI project.⁴⁰⁵ Accordingly, Pepco argues that its 2007 and 2008 AMI start-up costs should be recoverable.⁴⁰⁶

221. Pepco witness White proffers that the Company's decision to record certain AMI costs as a regulatory asset is consistent with SFAS No. 71 and FERC and GAAP accounting principles. Both of these standards provide that a regulatory asset may be established if recovery in future rates is "probable."⁴⁰⁷ Moreover, Pepco argues that it did not need a prior regulatory order before these costs were recorded as a regulatory asset based on its interpretation of the standards.⁴⁰⁸ Pepco proposes to treat its AMI start-up costs as a regulatory asset and to amortize them over a three-year period rather than expensing them in the year they were incurred.⁴⁰⁹ These are "incremental, one-time expenses in support of the AMI project," and Pepco argues they are properly treated as deferred expenses.⁴¹⁰

DECISION

222. We find that the totality of events surrounding Pepco's AMI program implementation in the District of Columbia warrants Pepco's recovery of its AMI start-up costs. Beginning in April 2007, the Company originally proposed the implementation of AMI in the District of Columbia as part of its "Blueprint for the Future" initiative.⁴¹¹ While this matter was under Commission review, the federal government enacted the American Recovery and Reinvestment Act of 2009 ("ARRA").⁴¹² The ARRA authorizes the U.S. Department of Energy ("DOE") to award grants up to 50 percent of the cost to facilitate the deployment of smart grid technologies, including AMI.⁴¹³ In order to ensure that the District of Columbia was positioned

⁴⁰⁵ Pepco (3D) at 23-26 (Gausman).

⁴⁰⁶ Pepco R.Br. 45-46; Pepco Br. 79-80, 83.

⁴⁰⁷ Pepco Br. 80-81; Pepco R.Br. 45; Pepco (3E) at 7-9 (White). Pepco argues that OPC quoted only part of the FERC standard for reporting costs as a regulatory asset, and that the Company's AMI costs fit under one of the FERC criteria that OPC neglected to mention. *Id.* Pepco Br. 81-82.

⁴⁰⁸ Pepco Br. 80-82; Pepco R. Br. 45; Pepco (3E) at 6-10 (White).

⁴⁰⁹ Pepco (4C) at 37-38 (Hook), referring to Pepco (3E) at 6-10 (White) and Pepco (3D) (Gausman). According to Pepco, "A three-year amortization period has historically been used in the District of Columbia to spread out the recovery of certain costs; a recent example would be the costs associated with Formal Case No. 1053, which are currently being amortized over a three-year period. Costs associated with severance programs have also been amortized over three years." *Id.* at 39.

⁴¹⁰ Pepco (3D) at 23-26 (Gausman).

⁴¹¹ *See Formal Case No. 1056* (April 4, 2007).

⁴¹² *See Pub. Law 111-5* (February 2009).

⁴¹³ *Id.*

to receive ARRA funding, the Council passed the Budget Act,⁴¹⁴ which effectively approves the implementation of AMI in the District of Columbia, provided the Commission determines that the Company has received a sufficient amount of federal funds (presumably) to make AMI cost effective.⁴¹⁵ In October 2009, DOE granted Pepco \$44.6 million under the ARRA statute for AMI implementation, covering both future AMI expenses and some earlier AMI expenses incurred during the 90 day period before the federal grant was made.⁴¹⁶ Subsequently, in December 2009, we determined that Pepco had received sufficient federal funds for AMI implementation in the District of Columbia.⁴¹⁷

223. These events support Pepco's proposal for recovery. We further conclude that these start-up AMI costs were prudently incurred. However, the Commission finds that Pepco's 2007 and 2008 AMI start-up costs should be capitalized, and amortized over 15 years – the average service life of AMI meters – rather than the three years requested by Pepco.⁴¹⁸ The start-up AMI costs that Pepco incurred in 2007 and 2008 should be recorded in a tracking capital account and amortized over 15 years. Only the \$911,000 in 2007 and 2008 start-up AMI costs are at issue in this Pepco rate case, and only the capitalization and amortization of those start-up AMI costs will be reflected in the rates that we set today.

224. We are not approving “regulatory asset” treatment for these AMI start-up costs. The Commission agrees with OPC and AOBA that “regulatory asset” treatment is not appropriate for costs incurred before the issuance of a regulatory order approving AMI implementation. Previously-incurred AMI start-up costs that are not recoverable under the ARRA grant are to be capitalized and amortized over 15 years, not expensed in Pepco's rates, so there is no retroactive ratemaking. We appreciate AOBA's concern about the sweeping nature of

⁴¹⁴ See D.C. Act 18-207 (October 15, 2009).

⁴¹⁵ *Id.*

⁴¹⁶ We note that at the hearing Pepco correctly indicated that ARRA funding is available for AMI expenses incurred within the 90 day period before the October 2009 award. However, the Company's 2007 and 2008 AMI expenses do not qualify to be paid by the new funding. See DOE FOA- DE-FOA-0000058, p. 37.

⁴¹⁷ See *Formal Case No. 1056, In the Matter of the Application of the Potomac Electric Power Company for Authorization to Establish a Demand Side Management Surcharge and an Advance Metering Infrastructure Surcharge and to Establish a DSM Collaborative and an AMI Advisory Group and Formal Case No. 1070, In the Matter of the Investigation into the Potomac Electric Company's Non-AMI Demand Response Program*, Order No. 15629, ¶¶ 14-15 (December 17, 2009).

⁴¹⁸ There was some variance in the evidence submitted about the average service life of AMI meters. The Commission is persuaded, however, that 15 years is a fair figure. Testimony from Pepco witness Spanos was that the average service life of the new AMI meters is 15 years. Pepco (3H) at 24 (Spanos) (“manufacturers of the technology and utility meter specialists anticipate an average service life of 15 years. . . . Finally, the estimated parameters used by other electric utilities for the implementation of AMI meters is an average service life between 12-18 years and a net salvage percent between 0 and negative 5 percent.”). *Accord* Tr. 442-445, 450-459, 478-479 (Pepco witness Spanos) (though expected service life of a new non-AMI meter is about 39 years, the average service life of a new AMI meter is 15 years, in part because of its computer-based components). See also Commission Ex. No. 18.

Pepco's "incremental cost" theory. The start-up AMI costs being placed into a tracking/capital account will be subject to Commission scrutiny. Our decision properly spreads the recovery of these AMI start-up costs over the time when benefits are expected to be received from the AMI system.⁴¹⁹ As a result of the 15-year amortization, Pepco's annual amortization expense is \$60,708, as compared to \$303,543 under a 3-year amortization. Based on a 15-year amortization, the average unamortized balance to be included in rate base is \$880,274, as compared to \$758,857 under a 3-year amortization. The average accumulated deferred tax (a reduction to rate base) is \$365,171 under the 15-year amortization, as compared to \$314,802 under the 3-year amortization.

VII. DEPRECIATION RATES (Issue No. 6)⁴²⁰

225. **Pepco.** Pepco proposes new depreciation rates to be applied to the District of Columbia assets for electric distribution and general plant. Pepco uses the straight-line remaining life technique method with the average life procedure.⁴²¹ As it relates to the treatment of net salvage, the Company contends that its estimate of future costs results in the most reasonable interpretation of the full service value of Company assets.⁴²² Based on the difference between the depreciation rates proposed in Pepco's new Depreciation Study (filed December 31, 2008) and the currently approved rates (approved in Formal Case No. 869), Pepco proposes an increase in depreciation expense (RMA No. 25) of \$4.7 million. Rate base would be reduced by \$2.35 million.⁴²³

226. Pepco contends that its depreciation study is reasonable; its proposed depreciation rates were computed with the appropriate District of Columbia book reserve; and its accumulated depreciation reserve is computed correctly based on the District of Columbia's jurisdictional amounts.⁴²⁴ The plant studied matched, as closely as possible, the plant allocated/assigned to the District of Columbia cost of service calculations. The accumulated depreciation reserve amounts were consistent with the plant balances that were studied and historical depreciation rates

⁴¹⁹ Pepco argued that its AMI start-up costs were largely employee costs (for hiring outside consultants, and moving around PHH/Pepco employees), not associated with AMI meters. There is no doubt, however, that these employee costs were associated (though not exclusively with AMI meters) with the start-up of the AMI program as a whole.

⁴²⁰ Designated Issue No. 6 asks, "Is Pepco's depreciation study reasonable?"

⁴²¹ Pepco (H) at 8, 12 (Spanos).

⁴²² *Id* at 22.

⁴²³ Pepco (C) at 17-18 (Hook); Pepco (C)-1 at 28. Accumulated depreciation would be increased by \$2.35 million which would result in a decrease of \$2.35 million in rate base.

⁴²⁴ Pepco (2F) at 4 (Browning).

approved by the Commission and that served as the basis of the depreciation expense incorporated in rates.⁴²⁵

227. **OPC.** OPC counters that Pepco's depreciation study is not reasonable. OPC recommends a net depreciation and amortization expense for plant of \$45.4 million, which is \$6.4 million less than the Company's current depreciation expense of \$51.8 million. Combining the \$6.4 million with OPC's recommended \$975,000 amortization of regulatory liability for cost of removal results in a net \$7.4 million reduction in depreciation and amortization expense.⁴²⁶

1. Reserves Used in the Computation of Depreciation Rates (Issue No. 6a)⁴²⁷

228. Pepco's Depreciation Study shows the book reserve amounts and how they were used in the calculations.⁴²⁸ According to Pepco, its Depreciation Study used the simulated accumulated depreciation reserves for the system general plant accounts. For the plant located in Virginia, simulated depreciation reserves were developed for these plant balances that were consistent with the historical approved District of Columbia depreciation rates.⁴²⁹ Pepco contends that the book reserve used in its study is the most reasonable given that many assets for Pepco are not maintained on a jurisdictional level.⁴³⁰ The Company further states that [t]he "simulation" of the reserve was simply dividing of the District of Columbia book reserve by the District of Columbia general plant allocation ratio.⁴³¹ Subsequently, during the evidentiary hearing, Pepco provided information showing that it had removed \$60 million from D.C. depreciation reserve amounts in its newly implemented PowerPlant accounting record system.⁴³² OPC expressed concern about Pepco's removal of \$60 million on the Company's books from the District of Columbia Depreciation Reserve.⁴³³

⁴²⁵ *Id.* at 4-5.

⁴²⁶ OPC (E) at 41 (Majoros); OPC (E)-12 and (E)-13.

⁴²⁷ Designated Issue No. 6a asks, "Are Pepco's proposed depreciation rates computed with the appropriate District of Columbia book reserve?"

⁴²⁸ *See*, Pepco (H)-1 at III-3-III-6, III-116-III-160 (Spanos).

⁴²⁹ Pepco (F) at 22-25 (Browning).

⁴³⁰ Pepco (2H) at 9 (Spanos Supp.).

⁴³¹ Pepco (2F) at 5-8 (Browning Supp.).

⁴³² Tr. 1385-1387, 1398.

⁴³³ *See* Issue No. 6b, asks, "Is Pepco's accumulated depreciation reserve computed accurately based on District of Columbia's jurisdictional amounts?"

DECISION

229. The Commission has reviewed Pepco's Depreciation Study for General Plant Accounts and finds that Pepco utilizes "system-wide" depreciation reserve amounts, instead of the D.C. depreciation reserve amounts.⁴³⁴ This results in an overstatement of D.C. depreciation rates. In calculating the proposed 4.89 percent amortization rate for Account 397, Communication Equipment, Pepco uses "system-wide" numbers in which the book accumulated depreciation reserve is 65.95 percent of the original cost of Plant-in-Service.⁴³⁵ However, Pepco's Study shows for the District of Columbia that the book accumulated depreciation reserve is 74.70 percent of the original cost of Plant-in-Service.⁴³⁶ This indicates that past District of Columbia ratepayers provided recovery for a higher percentage of the investment than is true system-wide. Using District of Columbia-specific depreciation reserve, the D.C. depreciation/amortization rate for this account is 3.63 percent.⁴³⁷ A similar problem exists for the other "General Plant" depreciation/amortization rates that Pepco proposes. Pepco acknowledges that it did not use D.C. reserve values in the calculation of its proposed D.C. depreciation rate.⁴³⁸ The Commission finds it troubling that Pepco used system-wide depreciation reserve figures when D.C.-specific figures are available. Pepco is directed to recalculate "General Plant" depreciation/amortization rates using D.C. book reserve and D.C. original cost amounts. Using D.C.-specific General Plant depreciation/amortization rates result in a General Plant accrual that is \$687,743 less than the amount calculated using system-wide depreciation reserves numbers.⁴³⁹

2. Computation of Accumulated Depreciation Reserve (Issue No. 6b)⁴⁴⁰

230. **Pepco.** Pepco's plant accounting system captures, among other things, the depreciation reserve by jurisdiction. The system then calculates the jurisdictional reserve, with the exception of general plant which is functionalized between transmission and distribution

⁴³⁴ In *Formal Case No. 1053*, the Commission directed Pepco to place in service a system that would maintain depreciation expense, accumulated depreciation reserve, cost of removal, and salvage information separated by jurisdiction and by FERC account each month. See Order No. 14712, ¶¶ 129-131.

⁴³⁵ $\$73,558,650$ (System-wide Book Reserve) / $\$111,532,249$ (System-wide Original Cost) = 65.9 5%. See Pepco (H)-1 at III-5 and III-159 (Pepco Depreciation Study) (Spanos).

⁴³⁶ $\$35,689,386$ (D.C. Book Reserve) / $\$47,774,524$ (D.C. Original Cost) = 74.70 %. See Pepco (H)-1 at III-6 (Pepco Depreciation Study) (Spanos).

⁴³⁷ Commission Ex. No. 32.

⁴³⁸ Commission Ex. No.1 6.

⁴³⁹ Commission Ex. No. 32.

⁴⁴⁰ Designated Issue No. 6b asks, "Is Pepco's accumulated depreciation reserve computed accurately based on District of Columbia's jurisdictional amounts?"

because it supports all facets of Pepco's operations.⁴⁴¹ Pepco contends that its accumulated depreciation reserve is computed accurately and based on D.C. jurisdictional amounts.⁴⁴²

231. **OPC.** OPC asserts that Pepco has failed to show that its accumulated depreciation reserve has been computed accurately based on District of Columbia jurisdictional amounts. OPC's concern relates to the transfer in 2008 of \$60 million from D.C. jurisdictional accumulated depreciation reserve into the corresponding Maryland account and a similar, nearly \$1 million transfer in 2009.⁴⁴³ OPC argues that the accuracy of Pepco's allocation of accumulated depreciation reserves between jurisdictions can be eliminated by the use of the whole life technique because the whole-life technique does not rely on depreciation reserves in calculating rates.⁴⁴⁴

232. According to OPC, the whole life technique is theoretically superior because it does not skew the depreciation rates to be applied to new plant based on the condition of the reserve accumulated through depreciation of existing plant.⁴⁴⁵ OPC maintains that the whole-life technique (along with separate handling of the reserve imbalances) ensures that depreciation rates consistently match the projected service life of plant assets, while still allowing for the recovery of the appropriate depreciation expense.⁴⁴⁶ OPC recommends that a depreciation study be conducted every three to five years and asserts that frequent depreciation study updates are important regardless of the technique employed.⁴⁴⁷

233. **Pepco Rebuttal.** Pepco counters that the whole-life technique is flawed in that it does not take into account past recovery patterns or the relationship of the theoretical reserve to the actual accumulated depreciation amount. Unlike the remaining-life technique, the whole-life technique has no checks and balances to make sure full recovery is achieved.⁴⁴⁸ Pepco states that the jurisdictional amounts used to calculate the Company's accumulated depreciation reserves matched what the Company had developed in the past for cost of service and what was used in cost of service based on the rates approved by the Commission and that Pepco tracked the

⁴⁴¹ Pepco (F) at 15 (Browning).

⁴⁴² Pepco (2F) at 4 (Browning Supp.).

⁴⁴³ OPC Br. 100.

⁴⁴⁴ OPC (E) at 37 (Majoros). The whole-life technique calculates depreciation rates based on expected average service life of the utility's assets. The remaining-life technique subtracts any existing depreciation reserve from the original cost of the plant assets, plus current estimate of net salvage, and divides the results by the estimated remaining service life of those assets.

⁴⁴⁵ OPC Br. 103.

⁴⁴⁶ OPC (E) at 6 (Majoros).

⁴⁴⁷ OPC Br. 106; Tr. 434.

⁴⁴⁸ Pepco Br. 50-51.

amounts at the function level.⁴⁴⁹ Pepco argues that without the benefit of the reserve, the Company would not be able to access the reserve to address under-recovery.⁴⁵⁰

DECISION

234. One of the goals of depreciation is to have the investment fully recovered at the time of its expected retirement. The accumulated depreciation reserve is the amount that has been recovered already from customers in past depreciation rates. In order to calculate how much remains to be recovered in the future, one needs to deduct the amount already recovered from customers in past depreciation rates. Adjusting for the amount in the accumulated depreciation reserve occurs in the remaining-life technique, but does not occur in the whole-life technique.

235. OPC has not shown that it would be advantageous to change from the use of remaining-life to whole-life in determining depreciation reserve. OPC contends that with whole-life, the reserve imbalance would be addressed “with separate amortization of the reserve imbalances.”⁴⁵¹ However, it still would be necessary to determine the D.C. reserve amount for use in the amortization of the reserve imbalances. In addition, depreciation reserve amounts are used in other important calculations, such as the calculating of the net rate base. Moreover, OPC acknowledges that if the Commission were to adopt whole-life rates, in some instances an asset may not be fully depreciated at the time of its expected retirement.⁴⁵² OPC argues the whole-life rate is better for new investment; however, at the time of the installation of a new investment, the whole-life rate for that new investment is the same as the remaining-life rate.⁴⁵³ The Commission will continue to use remaining-life depreciation rates which are designed to have an investment fully depreciated by the time of its expected retirement.

236. Prior to the implementation of PowerPlant, Pepco did not track jurisdictional depreciation reserve in an accurate manner. Pepco acknowledges that it did not keep jurisdictional records by FERC account and that it employed a blended depreciation rate.⁴⁵⁴ Further, the Company acknowledges that the \$60 million PowerPlant adjustment was necessary to align or match up the amounts shown using the prior depreciation method with the amounts used in PowerPlant.⁴⁵⁵ The Commission is satisfied with Pepco’s explanation for this adjustment.

⁴⁴⁹ Pepco R. Br. 28.

⁴⁵⁰ *Id.* at 30.

⁴⁵¹ OPC R. Br. 40.

⁴⁵² OPC (E) at 38 (Majoros).

⁴⁵³ Commission Ex. No. 30.

⁴⁵⁴ Tr. 1390 -1392.

⁴⁵⁵ Pepco indicates that it plans to implement another \$940,000 adjustment to PowerPlant near the end of 2009. Commission Ex. No. 54.

The \$60 million adjustment will be accepted to establish the District of Columbia accumulated depreciation reserve amount to be used as the starting point for the new PowerPlant accounting system. After this \$60 million adjustment, no further adjustment to the D.C. reserve is allowed for the purpose of changing the PowerPlant reserve amounts to match the reserve amounts as calculated under the prior cost-of-service method. All entries into PowerPlant must be in conformance with the Uniform System of Accounts ("USOA"). Additionally, for the sake of uniformity, consistency, and clarity, in all future reports, studies, and other filings before the Commission, Pepco is directed to use the D.C. accumulated depreciation reserve amounts and D.C. depreciation expenses as shown in PowerPlant.

3. Regulatory Liability Account

237. **OPC.** OPC recommends that the \$33 million⁴⁵⁶ in the depreciation reserve that is for net removal cost be transferred to a regulatory liability to prevent the possibility that these excess collections might be diverted to general income by Pepco.⁴⁵⁷ OPC states that the \$33 million represents excess money collected from ratepayers in anticipation of a future expense. Currently the \$33 million liability is recorded in the accumulated depreciation reserve. OPC urges the Commission to recognize Pepco's non-legal asset retirement obligations ("AROs") reserve as a regulatory liability for regulatory and ratemaking purposes. OPC states that Pepco has done so in its annual GAAP reports; however, it has not done so for regulatory and ratemaking purposes.⁴⁵⁸ If future costs prove lower than forecasted, the unused money should be returned to ratepayers.⁴⁵⁹ OPC states that two recent events underscore the need to protect this money: (1) the impending move from GAAP to International Financial Reporting Standards ("IFRS"); and (2) a filing by Georgia Power asking to amortize its cost of removal regulatory liability back to the company.⁴⁶⁰ Based on the above, OPC proposes amortizing the \$33 million back to ratepayers over the remaining life of Pepco's plant, which would produce a negative \$975,000 annual expense.⁴⁶¹

238. **Pepco.** Pepco counters that OPC's proposal is "bad ratemaking" and that OPC has failed to substantiate that the amount in reserve for net salvage represents excess

⁴⁵⁶ OPC states that the regulatory liabilities from non-legal asset retirement obligations ("AROs") associated the cost of removal of long-lived plant for 2006, 2007, and 2008 equals \$298 million. The D.C. jurisdictional portion as of December 31, 2008, was \$32.9 million.

⁴⁵⁷ OPC Br. 121.

⁴⁵⁸ *Id.* at 26.

⁴⁵⁹ OPC (E) at 22 (Majoros).

⁴⁶⁰ *Id.* at 30.

⁴⁶¹ *Id.* at 36.

collection.⁴⁶² Pepco states that OPC has made no showing that the theoretical reserve amounts for net salvage are zero. Returning these amounts back to customers will cause further under-recovered situations for all accounts.⁴⁶³ Moreover, Pepco replies that it cannot transfer depreciation reserve money to income without the Commission's approval. Georgia Power neither did, nor could, take such action unilaterally.⁴⁶⁴

DECISION

239. Any method that recovers the future cost of removal over the life of the investment will collect money from ratepayers in advance of paying for the actual removal (this includes both the SFAS-143 method and Pepco's proposed method). That money should be held for future removal costs, and not all of it should be returned to ratepayers. Thus, transferring the reserve to a regulatory liability or returning all of the non-legal removal cost reserve to ratepayers would not be appropriate. Therefore, OPC's proposal is denied. To address OPC's concerns about the possible transfer of any excess collections to income by Pepco, the Commission hereby orders that Pepco not transfer any money from Account 108, Accumulated Provision for Depreciation, to income without prior Commission approval.

4. Pepco's Net Salvage/Net Removal Cost (Issue No. 6c)⁴⁶⁵

240. **Pepco.** Pepco maintains that its net salvage/net removal cost is properly calculated and fair to both Pepco and its customers.⁴⁶⁶ Pepco opposes the use of the SFAS-143 present value method⁴⁶⁷ to determine net salvage/net removal costs stating that the use of the methodology would result in Pepco under-recovering its costs.⁴⁶⁸ Pepco alleges that it would under-recover because the future net salvage percents it employed were conservative and that the traditional present value approach is dependent on annual increases.⁴⁶⁹ Pepco admits that its method results in the collection of future inflated removal costs from current customers and uses

⁴⁶² Pepco (3F) at 24-26 (Browning Rebuttal).

⁴⁶³ Pepco (3H) at 23 (Spanos Rebuttal).

⁴⁶⁴ Pepco R. Br. 39.

⁴⁶⁵ Designated Issue No. 6c asks, "Is Pepco's Net Salvage/Net Removal Cost properly computed?"

⁴⁶⁶ Pepco (H) at 21-24 (Spanos), Pepco (2H) at 9-10 (Spanos Supp.).

⁴⁶⁷ The Commission in Order No. 15322 ordered Pepco to file a revised Depreciation Study using the SFAS-143 present value formula used in the Maryland Public Service Commission Case No. 9096. *See Formal Case No. 1076*, Order No. 15322 (July 10, 2009). Pepco, though, calculated its rates following the approach in Maryland Case No. 9092 stating that the Case No. 9096 SFAS-143 formulas initially used in Maryland were flawed.

⁴⁶⁸ Pepco (2H) at 5 (Spanos Supp.).

⁴⁶⁹ *Id.* at 2, 5.

net salvage cost at a future price level.⁴⁷⁰ Pepco contends, however, that recovery under the SFAS-143 present value method using a 7.96 percent discount factor is “significantly back loaded.”⁴⁷¹ In its direct testimony, Pepco utilizes a zero percent discount factor in an alternate SFAS-143 calculation.⁴⁷²

241. **OPC.** OPC argues that Pepco charges current ratepayers the full costs of future inflation, costs that Pepco has not incurred. This approach front-loads costs and fails to match costs to the period in which they are incurred. OPC contends that Pepco’s approach is inconsistent with “intergenerational equity” concepts and accrual accounting.⁴⁷³

242. OPC states that only the present value approach matches inflation to the periods in which it is incurred. According to OPC, Pepco front-loads future inflation costs into current periods resulting in the collection of excess payments from current customers.⁴⁷⁴ OPC points out that Commissions in the three nearby jurisdictions do not allow Pepco nor the Pepco affiliates (Pepco in Maryland, Atlantic City Electric in New Jersey, and Delmarva in Delaware) to charge current customers for future inflation.⁴⁷⁵

243. OPC asserts that, consistent with the Commission’s directive in Order No. 15322, Pepco should have used the present value of the projected future costs in order to develop the current dollars needed to cover the future cost of removal, i.e., discounted the inflated amounts back to its present value. OPC states that the same result can be reached by removing inflation from the calculation of projected future removal costs.⁴⁷⁶ OPC claims that the present value approach reduces Pepco’s inflated future cost of removal ratio and, therefore, the resulting net salvage ratio, to a much smaller component of the depreciation rate calculation.⁴⁷⁷ OPC states that Pepco should be required to recalculate its depreciation rates consistent with SFAS-143 as ordered in Order No. 15322. OPC maintains that Pepco has failed to recalculate depreciation rates using the jurisdictional District of Columbia book reserve and SFAS-143 present value method for future net salvage as directed by the Commission.⁴⁷⁸

⁴⁷⁰ Pepco (3H) at 11 (Spanos Rebuttal).

⁴⁷¹ Pepco (2F) at 11 (Browning Supp.).

⁴⁷² Pepco (2H) at 7-8 (Spanos Supp.).

⁴⁷³ OPC Br. 113.

⁴⁷⁴ OPC (E) at 19 (Majoros).

⁴⁷⁵ Tr. 1064 -1066.

⁴⁷⁶ OPC (E) at 14-15 (Majoros).

⁴⁷⁷ *Id.* at 16. New Jersey, Pennsylvania, and Delaware have adopted a variant of the present value approach - an average net salvage allowance approach which sets the cost of removal to the dollar level the utility actually experienced on average over a recent period to remove plant from service.

⁴⁷⁸ OPC (E) at 8 (Majoros); *See* Order No. 15322 at 8-9.

244. OPC offers adjustments to the “present value” rates as filed by Pepco. OPC replaced the 7.96 percent discount rate with discount factors solely reflecting inflation; adopted whole-life depreciation, which will eliminate the debate on the propriety of jurisdictional book depreciation reserves in the context of depreciation rate calculations; and made other changes to present value calculations. OPC argues that use of a rate of return as the discount rate implies that the rate has some relationship to earnings. However, OPC asserts, the purpose of the discount rate is to remove the effect of future inflation from Pepco’s charges to current customers. OPC contends that using its present value methodology would decrease annual depreciation expense by \$6.4 million.⁴⁷⁹

245. **Pepco Rebuttal.** Pepco states that if the SFAS-143 method is used, which it opposes, the maximum discount rate it supports are the same inflation rate Majoros had proposed as the discount rate, as opposed to using the 7.96 percent cost of capital.⁴⁸⁰ Use of the inflation rate as the discount rate produces a higher accrual than using the cost of capital. Using the inflation rate as the discount rate produces a SFAS-143 net salvage cost of approximately \$7 million, whereas, the 7.96 percent rate produces an annual accrual of \$4.2 million.⁴⁸¹ Pepco contends that if a 7.96 percent discount rate were used, future customers will pay up to 7 times more toward the cost of removal than current customers. In inflated adjusted dollars, the present value method results in future customers paying up to 3 times more than current customers using the 7.96 percent discount rate.⁴⁸²

246. Pepco challenges OPC’s calculation using the present value method, stating that the formula used by OPC bears no resemblance to the SFAS-143 calculations the Commission requested and that Pepco performed.⁴⁸³ Pepco states that OPC’s recommended distribution-net salvage annual accrual of \$1.9 million would not even meet the historical \$4.5 million distribution D.C. removal cost that occurred in 2008.⁴⁸⁴

⁴⁷⁹ *Id.* at 8-9; OPC (E)-3 (Majoros).

⁴⁸⁰ *Id.* at 22-23.

⁴⁸¹ Pepco (3H)-1.

⁴⁸² Pepco Br. 54.

⁴⁸³ Pepco (3F) at 19 (Browning Rebuttal).

⁴⁸⁴ *Id.* at 22. Pepco notes that OPC used the whole-life technique which Pepco opposes.

247. The parties presented several different net salvage recovery proposals. The annual expense that would be charged to customers are shown below:

Summary of Net Salvage Proposals

	Total Annual Accrual for Future Net Cost of Removal In D.C. Distribution Accounts (millions)
1. <u>Pepco Primary Recommendation</u> ⁴⁸⁵	\$14.4
2. <u>SFAS-143 (MD Case No. 9092 Formulas)</u> at 7.96% Discount Rate ⁴⁸⁶	\$4.2
3. <u>SFAS-143 (MD Case No. 9092 Formulas)</u> at "Inflation only" Discount Rate (2.66% to 5.24% depending on the account) ⁴⁸⁷	\$7.0
4. <u>OPC (OPC (E)-12,13)</u> OPC calculation of Present Value at "Inflation only" Discount Rate and uses Whole life & Regulatory Liability. ⁴⁸⁸	\$1.9 ⁴⁸⁹
5. OPC Calculation of Present Value at 7.96% Discount Rate (OPC (E)-3) ⁴⁹⁰	\$0.5 ⁴⁹¹
6. For Comparison: Actual Cost of Removal expense for D.C. Distribution in 2008 ⁴⁹²	\$4.5

⁴⁸⁵ Pepco (C)-2 (Hook); Exhibit (H)-1 at III-4 and III-6 (Spanos).

⁴⁸⁶ Pepco (3H)-1 (Spanos Rebuttal).

⁴⁸⁷ Pepco (3F)-7 at 1 (Browning Rebuttal); OPC (E)-5.

⁴⁸⁸ OPC (E)-12 and (E)-13 (Majoros).

⁴⁸⁹ Pepco calculated. See Pepco (3F)-6 (Browning Rebuttal).

⁴⁹⁰ OPC (E)-3 (Majoros).

⁴⁹¹ Pepco calculated. See Pepco (3F)-4 at 2 (Browning Rebuttal).

DECISION

248. Pepco's existing depreciation rates were established approximately 20 years ago at a time when net salvage was often positive.⁴⁹³ In the past when net salvage was positive, that meant that the gross salvage received at the time of retirement would adequately pay for the cost of removal. In that instance, the Commission did not need to determine how to collect the future cost of removal in customer rates because the future gross salvage usually covered the future cost of removal. Since its last depreciation study, Pepco's net salvage factors have become negative for almost all of the distribution accounts.⁴⁹⁴ One reason for this is that Pepco changed its accounting methodology, which reduces the reported amount of gross salvage. This is the first case in which the Commission is faced with a proposal that would impose significant charges on current customers to pay for the future distribution costs of removal.

249. Now is the time to review the methodology used by Pepco to ensure that the treatment adopted is designed to properly charge current customers for future costs. The Commissions in at least three nearby jurisdictions do not allow Pepco or Pepco affiliates to use the net salvage method that Pepco proposes in this case. In addition, as a result of SFAS-143 and FERC Order No. 631, companies nationwide, including Pepco, are already using the SFAS-143 present value calculations for future cost of removals that are legally required to occur ("legal AROs").

250. OPC's argument that Pepco's method creates intergenerational inequity by charging current customers more in "real" dollars than future customers has merit. Pepco acknowledges as much.⁴⁹⁵ Additionally, the record shows Pepco's method charges current customers for future inflation.⁴⁹⁶ Because of this, the Commission will adopt a net salvage method that minimizes the collection of future inflation from current customers and corrects these other problems.

251. OPC proposes several adjustments to the SFAS-143 formulas, as shown in Maryland Case No. 9092, including the use of whole-life, the creation and amortization of a regulatory liability, and the use of a discount rate based on inflation. OPC has not identified any jurisdiction that is using OPC's modified "present value" formulas, and the modified formulas produce very small dollar accruals, as shown in the "Summary of Net Salvage Proposals" table above. Pepco points out that OPC's recommended annual accrual of \$1.9 million would not

⁴⁹² Pepco (3F) at 22 (Browning Rebuttal).

⁴⁹³ OPC Br. 42-43.

⁴⁹⁴ OPC (E) at 5; OPC (E)-1 (Majoros).

⁴⁹⁵ See, OPC Br. at 113, OPC Cross Examination Exhs. 16 and 34.

⁴⁹⁶ Pepco (3H) at 11 (Spanos Rebuttal); Tr. 414-415.

equal the historical \$4.5 million distribution D.C. removal cost that occurred in 2008.⁴⁹⁷ We therefore reject OPC's modified "present value" formulas. The Commission believes that the formulas from Maryland Case No. 9092, using inflation based discount rates, produce an annual accrual for D.C. distribution net salvage of \$7.0 million that is both fair and reasonable.⁴⁹⁸

252. The record shows that the SFAS-143 method does collect the necessary amount of net salvage costs over the life of the asset. Pepco's example (Pepco Ex. (2F)-2), where the average remaining life increases midway in the life of an account, never occurs in any actual account.⁴⁹⁹ In all actual accounts, the average remaining life decreases over time, i.e., it has a declining pattern. Pepco admits that its method results in the collection of future inflated removal costs from current customers and in the collection of net salvage cost at a future price level. Fairness and equity require that the Commission adopt a methodology that, to the extent possible, balances the interest of current and future ratepayers. The SFAS-143 method accomplishes this. Pepco should not be allowed to charge current customers for future inflation, nor should Pepco be allowed to charge current customers in higher-value current dollars for a future cost of removal amount that is calculated in lower-value future dollars. Therefore, the Commission adopts the SFAS-143 method, using the formulas from Maryland Case No. 9092, with the rate of inflation rate used as the discount factor. These SFAS-143 present value calculations as reflected in Pepco (3F)-7 will result in an annual D.C. distribution accrual for net cost of removal of approximately \$7 million.

5. Recording of Gross Salvage Value (Issue No. 6d)⁵⁰⁰

253. During the hearings, the Commission became aware that Pepco made two different internal accounting changes in 2004 and 2005 that have reduced the amount of gross salvage that Pepco records.⁵⁰¹ In 2004, Pepco changed the accounting treatment of "third party" accident reimbursements, which reduced the amount of third party reimbursements that Pepco recorded as gross salvage.⁵⁰² In 2005, Pepco changed its accounting of scrap materials.⁵⁰³ Some

⁴⁹⁷ Pepco (3F) at 22 (Browning Rebuttal).

⁴⁹⁸ Pepco criticized the Maryland Case No. 9092 formulas. Many of Pepco criticisms of Maryland Case No. 9092 were based on a discount rate of 7.96%, which produced an annual accrual for D.C. distribution net salvage value of \$4.2 million. Pepco (3H)-1.

⁴⁹⁹ Pepco's Ex. (2F)-2 (Browning Supp).

⁵⁰⁰ Designated Issue No. 6d asks, "Is Pepco correctly recording its gross salvage in accordance with FERC's Uniform Systems of Accounts?" In response to Issue No. 6d, OPC answers, "Yes". OPC did not provide any other testimony on this issue. See OPC (E) at 5 (Majoros); OPC Br. 122.

⁵⁰¹ Tr. 316-317; Commission Ex. 10.

⁵⁰² Commission Ex. 10.

⁵⁰³ *Id.*

costs previously assigned as salvage are now considered scrap not related to retirement of assets.⁵⁰⁴ The Commission is concerned about the impact that these two internal accounting changes made by Pepco may have on future depreciation studies and resulting customer rates.

DECISION

254. Reducing the recorded gross salvage amount makes the net salvage more negative and increases the calculated depreciation rates, everything being equal. Reducing reimbursements recorded as gross salvage decreases gross salvage that Pepco records and could increase the calculation of future depreciation rates. The two accounting changes made by Pepco would have a tendency to increase depreciation rates, which, in turn, may increase customer rates. We find no acceptable rationale for Pepco's changes in the accounting methods. Therefore, we direct Pepco to resume recording capitalized third-party reimbursements as salvage and resume crediting them into Account 108, Accumulated Provision for Depreciation. In addition, Pepco is directed to record scrap salvage as salvage and credit it to Account 108. However, nothing in this Order prohibits Pepco from using a representative sampling to decrease the effort required to comply with this directive.

VIII. IMPACT OF D.C. AND FEDERAL TAXES⁵⁰⁵

A. Consolidated Tax Returns

255. The Commission stated in Pepco's last rate case that it might revisit the "consolidated tax issue", *i.e.*, the issue of what ratemaking treatment is appropriate to reflect the fact that Pepco participates in the PHI group's consolidated income tax returns.⁵⁰⁶ As part of a consolidated group of PHI companies, with losses to offset Pepco's taxable income, Pepco's effective tax liability in a consolidated return is generally less than it would be if it files as a stand-alone company. In Formal Case No. 1053, the Commission approved its "long-standing position that a stand-alone approach is the most reasonable method of setting rates." However, the Commission went on to state:

While a stand-alone method may have the disadvantage of saddling ratepayers with tax costs that are not actually paid to the Government, it has the benefit of insulating ratepayers from the losses attributable to PHI's unregulated affiliates in a volatile market. Courts have held that adopting the stand-alone method is a matter within the discretion of the regulatory body.

⁵⁰⁴ Pepco (2E) at 2 (White Supp.).

⁵⁰⁵ Designated Issue No.10 asks, "Does PEPCO's presentation of its revenue requirements properly reflect the impacts of any changes in District of Columbia and Federal tax regulations?"

⁵⁰⁶ Pepco's federal consolidated group includes over 60 corporations, while the D.C. consolidated group includes just over a dozen. Pepco (J) at 5 (Warren).

We recognize that other jurisdictions have adopted alternatives to the pure stand-alone approach that we uphold here. The other alternatives range from sharing mechanisms to a prorated consolidated return approach.⁵⁰⁷ However, the advantages and disadvantages of those alternative methods have not been sufficiently explored in this proceeding to warrant the adoption of a new policy. If the parties wish to make more detailed arguments supporting an alternative method in the next rate base proceeding, the Commission will revisit its policy of pure stand-alone treatment.⁵⁰⁸

256. **Pepco.** The Company requests an annual allowance of \$9,758,000 for District of Columbia income taxes and \$33,260,000 for federal income taxes. Pepco updated its annual allowance to \$8,835,000 for District of Columbia income taxes and \$30,366,000 for federal income taxes.⁵⁰⁹ The Company states that these figures were calculated on a stand-alone basis for determining its taxes, as approved by the Commission in Formal Case No. 1053.⁵¹⁰

257. **OPC.** OPC seeks a rate base reduction of \$172.9 million, and recognition of “Intercompany Deferred Income Taxes,” to give ratepayers some of the tax savings that Pepco’s parent company PHI realizes from filing consolidated federal and D.C. income tax returns covering Pepco.⁵¹¹ OPC argues that Pepco did not – and will not in the future – actually pay the higher taxes that Pepco collects from its ratepayers.⁵¹² Instead, OPC asserts that Pepco pays taxes only through PHI, whose consolidated tax returns show much lower federal and D.C. tax liabilities because they add together Pepco’s taxable income with tax losses from other PHI

⁵⁰⁷ In particular, the Commission noted New Jersey’s rationale that where a utility’s operations produce income that provides the opportunity for tax savings through offsetting annual losses of the other subsidiaries, the “ratepayers who produce the income that provides the tax benefits should share in those benefits.” *Formal Case No. 1053*, Order No. 14712 at 88 n. 616.

⁵⁰⁸ *Formal Case No. 1053*, Order No. 14712, ¶ 240.

⁵⁰⁹ See Tr. 1242.

⁵¹⁰ See Pepco (C) at 17, 14-15 (Hook); Pepco (2C) at 6 (Hook) on Adjustments 27 and 18.

⁵¹¹ See OPC (C) at 60-73 (Bright) (urging a \$140.2 million rate base reduction for federal taxes); OPC (C) at 73-85 (urging an additional \$32.7 million rate base reduction for D.C. taxes); and OPC (C)-7. OPC first calculates how much money PHI currently transfers from Pepco to other PHI unregulated subsidiaries (as money collected from Pepco ratepayers for Federal and D.C. taxes but never paid to the Federal or D.C. governments). OPC states that balance should be included in Pepco’s rate base as a rate base deduction “similar to the rate base deduction for Accumulated Deferred Income Taxes.” *Id.* at 73, 77-78.

⁵¹² OPC states that Pepco has been paying Federal income taxes on a consolidated basis since 1984 and D.C. income taxes on a consolidated basis since 2001. OPC (C) at 78. “In the 24 years the Company has been paying taxes using a consolidated tax return, there were always Group Members with tax losses.” *Id.* at 81.

subsidiaries. OPC claims its “Consolidated Tax Adjustment” (“CTA”) properly recognizes this fact and adjusts the utility’s cost of service to prevent an over-recovery from ratepayers.⁵¹³

258. OPC points out that PHI has saved millions of dollars in federal and D.C. income taxes over the years by filing consolidated income tax returns covering Pepco, two other regulated subsidiaries, and 60 other non-regulated subsidiaries.⁵¹⁴ OPC argues there is no reason to saddle Pepco ratepayers with the costs of “phantom income taxes” that Pepco never actually pays to the government. First, OPC argues that there is nothing about PHI’s self-serving intra-company tax sharing agreement with its subsidiaries that justifies forcing Pepco ratepayers to subsidize PHI’s unregulated loss affiliates. Second, OPC argues that its CTA system is fairer because it would allow PHI’s unregulated loss affiliates to continue to realize benefits from associating with PHI (such as improved access to capital), without being unfairly subsidized by Pepco ratepayers.⁵¹⁵ OPC argues that its even-handed CTA proposal allows unregulated loss affiliates to get the benefit of cash payments for tax losses, while Pepco ratepayers get a rate base reduction for Pepco funds transferred to the affiliates (originally collected by Pepco as “taxes” but never actually paid to the government by PHI/Pepco).⁵¹⁶ Without this rate base reduction, OPC argues, Pepco’s ratepayers are subsidizing PHI’s non-regulated affiliates since these non-regulated affiliates are not entitled to cash payments for tax losses on a stand-alone basis.⁵¹⁷

259. OPC claims that its CTA proposal represents a sharing of benefits in much the same way as the tax benefits of accelerated depreciation are shared between shareholders and ratepayers. OPC indicates that in both cases the deferred income taxes are deducted from rate base as ratepayer supplied capital and in both cases the Company retains use of the money but ratepayers are not charged for the time value (return) of the funds.⁵¹⁸

260. OPC points out that its CTA rate-base-reduction proposal is different from its earlier proposal (rejected in Formal Case No. 1053) to decrease Pepco’s tax expense.⁵¹⁹ OPC’s new CTA proposal treats consolidated tax savings in the same manner as other accumulated deferred income taxes, as a reduction of rate base. OPC contends that this sort of sharing of CTA tax benefits between shareholders and ratepayers was approved in *Washington Gas Light Co. v. Pub. Serv. Comm’n*, 450 A.2d 1187, 1233-1235 (D.C. 1982). OPC argues that its new rate

⁵¹³ *Id.* at 62-63.

⁵¹⁴ OPC Br. 169-171; OPC (C) at 69, 76-77.

⁵¹⁵ OPC Br. 172-173.

⁵¹⁶ OPC Br. 179.

⁵¹⁷ OPC Br. 178.

⁵¹⁸ OPC Br. 174.

⁵¹⁹ OPC Br. 174-176; OPC (C) at 79; Tr. 938- 939, 962-963 (OPC witness Bright).

base reduction proposal also responds to the Commission's concern about insulating ratepayers from the losses attributable to PHI's unregulated affiliates in a volatile market.⁵²⁰ Essentially, OPC suggests that its proposal would yield only downward adjustments to Pepco's rate base,⁵²¹ because OPC's adjustment comes into play, and yields a rate base adjustment, only when Pepco's collection of stand-alone taxes from Pepco ratepayers creates "consolidated income tax savings" that PHI transfers internally from Pepco to other PHI unregulated subsidiaries (as money collected from Pepco ratepayers for "current" taxes, but never paid to the Federal or D.C. governments).⁵²² Consequently, OPC contends that "Pepco's utility customers would never be required to pay for income taxes greater than the income taxes computed using the stand-alone method."⁵²³

261. OPC indicates that three major alternatives exist for making a consolidated tax adjustment.⁵²⁴ (1) *New Jersey Approach*. OPC states that its approach is modeled after the one in New Jersey, where the Commission makes a consolidated tax deduction from rate base. The rationale is similar to the rationale for deducting accumulated deferred income taxes from Pepco's rate base because this is ratepayer-provided money that Pepco has not yet had to pay to the government. OPC argues that this approach appropriately recognizes the time value of money.⁵²⁵ (2) *Texas Approach*. OPC proffers that Texas follows a slightly different "time value of money" approach that ultimately makes a deduction from utility income taxes (not utility rate base). OPC indicates that Texas earlier followed a "consolidated capital structure" approach (described below), but then switched to its current method. Texas first calculates what the deduction for rate base would be (i.e., the taxes that the utility pays out to its unregulated affiliates) and then calculates a time value of money associated with that, because the unregulated affiliates get to use that money before they actually have any taxable income. Texas

⁵²⁰ OPC agrees that "Pepco's customers are not and should not be exposed to the costs and risks associated with PHI's non-regulated operations since these businesses are engaged in non-regulated activities." OPC (C) at 81 (Bright).

⁵²¹ Two caveats were added by OPC witness Bright during the Commission hearings. First, OPC states that if PHI's unregulated loss companies eventually have taxable income, as Pepco said they would, then "it turns around" so that Pepco's rate base would be increased. Tr. 994 (OPC witness Bright). OPC also testified that, if Pepco experiences a tax loss, as it did in 2008 that would cause an upward adjustment to Pepco's rate base. Given the experience of PHI and Pepco during the last several years, however, when Pepco generally had positive taxable income and PHI's affiliates generally had large tax losses, OPC indicates that it would take "a whole bunch of years in a row of tax losses" by Pepco before this effect would register as an increase in Pepco's rate base. See Tr. 989-999 (colloquy between OPC witness Bright and Commissioner Morgan).

⁵²² OPC (C) at 84-85.

⁵²³ *Id.* at 80. OPC avers that its proposal would not confiscate PHI shareholder property. Its proposed rate base reduction for deferred income taxes "is not a permanent reduction of the Company's tax expense for ratemaking purposes. Instead, these consolidated tax savings are treated in the same manner as other accumulated deferred income taxes – as a reduction of rate base." *Id.* at 84.

⁵²⁴ Tr. 961 (OPC witness Bright).

⁵²⁵ Tr. 972, 962, 963, 968 (OPC witness Bright).

then takes the number that OPC proposes to deduct from rate base, multiplies it by an interest factor, and then reduces the income taxes of the utility by the amount of that interest.⁵²⁶ (3) *Florida/ Pennsylvania/ Virginia/ West Virginia Approach*. OPC notes that other states set utility rates by using a consolidated capital structure. That is, they use the capital structure of the consolidated group of which the utility is a member, relying on using the debt of the consolidated entity for calculating the interest that is used in calculating income taxes, and then reducing the tax expense listed for the regulated utility.⁵²⁷

262. OPC witness Bright states that PHI's consolidated group (including Pepco) paid taxes in 2008, but not before.⁵²⁸ OPC's witness confirms that OPC is seeking a CTA based on at least five years of accumulated deductions from rate base.⁵²⁹ Theoretically, OPC acknowledges, if PHI's unregulated loss affiliates never have any taxable income, then there could be losses that could get larger than Pepco's rate base. However, OPC points out that Pepco witness Salatto testified that the unregulated loss affiliates would eventually have taxable income, in which case "it turns around" and Pepco's rate base would grow again.⁵³⁰ OPC points out that Pepco had an income tax loss in 2008 and might have one in 2009 because of bonus depreciation.⁵³¹ Citing decades of PHI history, OPC argues that "[t]he income taxes paid to the federal and D.C. governments are never equal to the stand alone amounts of the Group Members with positive taxable income because there are always some entities with taxable losses."⁵³²

263. OPC witness Bright suggested during the hearings that a 50/50 split of benefits might be appropriate, between the unregulated loss companies (on the one hand) and Pepco and its ratepayers (on the other hand). OPC contends this would give the unregulated loss companies some of the benefit of the tax deductions they generate, which lower taxes for the consolidated group, while also giving some compensation to Pepco and its customers who are providing immediate cash to the PHI consolidated group and its loss companies.⁵³³ OPC agrees that when it talks about the current value of money, it conceptually is looking at the benefit that is going to the unregulated loss companies as if it were a loan from Pepco to those companies that eventually will be repaid. That is why OPC deducts just the interest from Pepco's rate base.⁵³⁴

⁵²⁶ Tr. 958- 959, 961 (OPC witness Bright).

⁵²⁷ Tr. 959-960 (OPC witness Bright).

⁵²⁸ Tr. 967 (OPC witness Bright).

⁵²⁹ Tr. 975-976, 978-982, 993-994 (OPC witness Bright).

⁵³⁰ See Tr. 994 (OPC witness Bright).

⁵³¹ Tr. 952 (OPC witness Bright).

⁵³² OPC Br. 179.

⁵³³ Tr. 986-988, 992 (OPC witness Bright).

⁵³⁴ Tr. 994-995 (OPC witness Bright in colloquy with Chairman Kane).

OPC insists that, under its proposal, the unregulated loss companies would still get the cash payments to them from the consolidated group in payment for its tax deductions,⁵³⁵ but that “ratepayers get the rate-based deduction,” and therefore get a return on the money.⁵³⁶

264. **Pepco Rebuttal.** Overall, Pepco’s rebuttal characterizes OPC’s view as “a punitive consolidated tax adjustment that retroactively strips tax benefits away from other PHI companies, *i.e.*, the companies that bore the risks and incurred the costs associated with attaining the tax benefits, and unilaterally assigns the benefits, but not the costs, to Pepco’s District of Columbia utility operations, as a cost of service adjustment, to artificially lower customer rates.” The Company argues that OPC has not justified overthrowing this Commission’s longstanding “stand-alone” policy of keeping a consolidated Company’s utility operations separate from its unregulated businesses.⁵³⁷ Pepco asserts that OPC’s CTA proposal reflects a small minority viewpoint that “conflicts with settled D.C. practice, economic logic and, most significantly, regulatory equity.”⁵³⁸ The Company marshals a broad array of legal and policy arguments in opposition to OPC’s proposed CTA.

265. *First*, Pepco argues that CTAs are contrary to settled ratemaking practices of the FERC and the vast majority of state commissions. According to Pepco, there are only five States that recognize CTAs of the kind that OPC seeks here. Pepco contends that two states (Pennsylvania and Oregon) require CTAs through legislation, while three other states (New Jersey, West Virginia, and Texas) allow their Commissions discretion to impose CTAs.⁵³⁹

266. At least 37 other states have rejected CTAs, according to Pepco, noting that this Commission rejected CTAs as “highly speculative” in Formal Case No. 912 (decided in 1992). In Formal Case No. 929 (decided in 1994) this Commission again rejected CTAs on the ground that they “distort[] the true costs of electric service.”⁵⁴⁰ While the Maryland Commission is currently considering a CTA proposal, it earlier rejected CTAs in a 1972 *Columbia Gas* rate case, stating “[i]t is not proper rate-making to base revenue requirements upon costs not related to the utility operation under review.” Similarly, the Maryland Commission again rejected CTAs in a 1991 Pepco case, stating that “[i]t is a rule of general application that the rates charged for a

⁵³⁵ Tr. 989-999 (OPC witness Bright).

⁵³⁶ Tr. 990-991 (OPC witness Bright).

⁵³⁷ See Pepco Br. 83-98; Pepco R.Br. 46-52; Pepco (3A) at 8-9 (Kamerick).

⁵³⁸ Pepco (J) at 4 (Warren).

⁵³⁹ Pepco Br. 86, 95-98; Pepco (J) at 30-34 (Warren). *Accord* Tr. 1258-1259 (Pepco witness Warren).

⁵⁴⁰ Pepco Br. 95-97. To be sure, Pepco acknowledges, the Commission approved of CTAs in an old 1982 Washington Gas Light case. However, Pepco argues that old WGL case was “factually unique” because WGL owned the unregulated affiliate company that incurred the tax losses. “Here, Pepco has not invested in, nor has it taken any of the risks associated with the activities of other PHI unregulated affiliates.” Pepco R. Br. 50. As the D.C. Court of Appeals noted, the Federal Power Commission decided to return to a stand-alone method, after briefly approving of CTAs. Pepco R. Br. 51.

regulated utility service should reflect only the cost associated with providing utility service; they should not reflect costs associated with other businesses run by the utility.”⁵⁴¹ The Commissions in Minnesota and New Mexico similarly rejected CTAs in recent opinions.⁵⁴²

267. The Company states that FERC also has consistently used the “stand-alone” method (excluding affiliates) to calculate regulatory tax liability.⁵⁴³ In sum, Pepco argues that there is “a message in the fact that only a handful of regulatory jurisdictions employ CTAs – and that in only three states have regulators affirmatively chosen to do so. CTAs, while they may be superficially attractive mechanisms to lower rates, simply cannot stand up to anything like a rigorous reasoned analysis. The broad application of principled analysis and regulatory equity is the reason why CTAs remain rare.”⁵⁴⁴

268. *Second*, Pepco argues that CTAs unreasonably reduce a utility’s revenues. In its post-hearing brief, Pepco claims that Statement of Financial Accounting Standards No. 109 (SFAS 109) compels it to follow a “stand-alone” approach to taxes regardless of whether this Commission decides to impose CTAs for ratemaking purposes. The “imposition of CTAs will reduce revenues but will have no impact on the Company’s financial reporting obligations. Pepco contends that if the Commission were to impose a CTA, the Company’s revenues would decrease, but its tax expense would remain the same.” Over time, Pepco argues, this will simply erode a utility’s ability to achieve its authorized equity return.⁵⁴⁵

269. *Third*, Pepco argues that CTAs violate the “cost responsibility” principle, which dictates that the party that incurs a cost is entitled to the associated tax benefit.⁵⁴⁶ Pepco avers that tax benefits have value and belong to the entity that incurred the tax loss. OPC’s proposed CTA adjustment violates these principles, Pepco submits, because OPC “asks this Commission to assign to customers, tax benefits that are embedded in costs incurred by shareholders.” That is, CTAs extract the benefits of non-regulated tax losses from shareholders and assign them to utility customers who did not share in the costs and risks of the underlying investments that

⁵⁴¹ Pepco Br. 95-97.

⁵⁴² Pepco Br. 97-98; Pepco (J) at 31, 33, and Pepco (J)-2, citing *Xcel Energy*, Minn. Docket No. E-022/GR-05-1428 (September 1, 2006) and *Pub. Ser. Comm’n of New Mexico*, N. Mex. Case No. 07-00077- UT (final order April 25, 2008).

⁵⁴³ Pepco Br. 91, 98.

⁵⁴⁴ Pepco (J) at 34 (Warren).

⁵⁴⁵ See Pepco Br. 86, 93-94; Pepco (J) at 28-29 (Warren). See also Pepco Br. 87-89.

⁵⁴⁶ Pepco Br. 90; Pepco (J) at 19 (Warren). Two common examples that OPC acknowledges, Pepco states, concern the ratemaking treatment accorded to imprudent or unnecessary utility costs that are disallowed for ratemaking purposes (*i.e.*, costs that a Commission decided cannot be recovered from ratepayers). The Company and OPC agree, says Pepco, that utility shareholders (not ratepayers) get the tax benefit of such disallowed costs. *Id.* at 20-24.

generated these tax benefits.⁵⁴⁷ They thereby diminish the profitability of the non-regulated activities that produce tax losses. Pepco argues that this may impede socially beneficial activities by non-regulated affiliates (such as alternative energy investments) that Congress wishes to incentivize with tax benefits.⁵⁴⁸

270. *Fourth*, Pepco claims that CTAs lack any coherent rationale. To begin, Pepco states that CTAs are inconsistent with tax principles allowing consolidated tax returns. Tax sharing agreements (like the one between Pepco and its PHI affiliates) that “compensate loss affiliates for the use of their losses” represent a common, commercially reasonable practice and they are “the norm.”⁵⁴⁹ Moreover, Pepco witness Warren states that PHI’s allocation of internal losses to its affiliates, including Pepco, is consistent with traditional accounting and SEC principles.⁵⁵⁰ The SEC approved PHI’s internal tax sharing agreement.⁵⁵¹ Another basic objection, Pepco argues, is that allowing CTAs would breach the traditional regulatory wall between regulated and non-regulated entities. “Where a CTA is imposed, the results of non-jurisdictional operations will have a direct effect on the setting of jurisdictional rates.” Finally, “while the consolidated return process was intended to prevent the imposition of a tax cost on the use of multiple corporations under common ownership, the imposition of a CTA creates a regulatory cost in its stead, thereby frustrating the very purpose for which consolidated returns exist.”⁵⁵²

271. *Fifth*, Pepco contends that OPC’s proposal is deeply flawed because OPC crams five years’ worth of CTAs into its proposed \$172.9 million reduction to rate base. OPC gives no explanation for using five years worth of CTAs, including prior years’ CTAs, and Pepco argues that OPC’s proposal amounts to retroactive rulemaking.⁵⁵³

⁵⁴⁷ See Pepco Br. 86.

⁵⁴⁸ See Pepco Br. 86, 91-93; Pepco R.Br. 49-50; Pepco (J) at 25-26. Pepco noted that, under tax law at the time of the Commission hearings, tax losses may be carried back two years, and carried forward for 20 years into the future. *Id.* at 8.

⁵⁴⁹ Pepco (J) at 14, 6; Pepco Br. 87; Pepco R. Br. 48-49. *Accord* Tr. 1269- 1272 (Pepco witness Warren).

⁵⁵⁰ Pepco (J) at 15-16, 26-28 (Warren). Pepco witness Salatto confirms that “all companies with positive taxable income pay their separate company, stand-alone tax liabilities, and all companies that incur tax losses are paid for the use of those losses when they are absorbed, thereby reducing PHI’s consolidated taxable income. No distinction is made between regulated and non-regulated companies. * * * In fact, on its 2001 and 2008 tax returns, Pepco reported stand alone, separate company tax losses and received, or will receive, substantial cash transfers as a result of the absorption of its tax losses by PHI.” Pepco (K) at 4-5.

⁵⁵¹ Tr. 1310 (Pepco witness Salatto).

⁵⁵² *Id.* at 9.

⁵⁵³ *Id.* at 11-13.

272. Pepco argues further that OPC's CTA proposal is very different from that of New Jersey's. To begin with, New Jersey's CTA started in 1990 and was effective only prospectively, and not a retroactive basis.⁵⁵⁴ OPC and New Jersey both use cumulative CTAs, but under the New Jersey approach, rate-based offsets can be reversed whenever the non-regulated company that produced the loss can use its own loss. Earlier losses would not give rise any longer to a rate-based offset. Pepco contends that this is very different from OPC's proposal, under which the regulated utility would have to suffer a loss before OPC's cumulative CTAs would reverse.⁵⁵⁵ Pepco argues that, under OPC's approach, rate base is permanently reduced and goes only one way and will not "reverse" at some point, unless the regulated utility suffers a tax loss.⁵⁵⁶

273. The Company argues that OPC's presentation on the CTA issue is largely the same as the inadequate CTA claims it presented in Pepco's last rate case.⁵⁵⁷ According to Pepco, OPC's assumptions seeking to justify a CTA are wrong. OPC's fundamental claim is that ratepayers should not have to pay for "phantom" taxes that are never in fact paid by Pepco. But tax expenses set during a rate case need not be (and seldom is) the same as the actual taxes paid by Pepco.⁵⁵⁸ OPC's assumptions about how its CTA would work also are flawed, according to Pepco. Though PHI affiliates' losses frequently offset Pepco's taxable income, Pepco had income tax loss in 2001 and 2008, because of bonus depreciation, pension contributions, and a change in its tax accounting method for treating capitalized overhead costs. The Company contends that it might have another tax loss year in 2009 because of bonus depreciation.⁵⁵⁹

274. *Sixth*, Pepco argues that PHI investors, in making investments relied on the continuing availability of tax deductions that are safeguarded by longstanding Commission precedent upholding the stand-alone method of computing income tax expense.⁵⁶⁰ At least for

⁵⁵⁴ Tr. 1260-1261, 1281-1282 (Pepco witness Warren).

⁵⁵⁵ Tr. 1261, 1264-1265 (Pepco witness Warren).

⁵⁵⁶ Tr. 1266-1267 (Pepco witness Warren). *Accord* Tr. 988-989, 975-976, 978-983 (OPC witness Bright) (acknowledging that, under OPC's proposal, if Pepco experiences a tax loss, it would cause an upward adjustment to rate base, but that it would take "a whole bunch" of tax loss years in a row by Pepco to significantly reduce the large CTAs produced under OPC's proposal).

⁵⁵⁷ See Pepco Br. 84-85; Pepco R. Br. 46-47; Tr. 930-946 (OPC witness Bright).

⁵⁵⁸ Tax-book timing differences, Pepco states, are in all cases temporary and are caused by normalization, interest synchronization and other similar adjustments. See Pepco R.Br. 47; Pepco Br. 87-89.

⁵⁵⁹ See Tr. 1253-1254, 1256 (Pepco witness Warren); Tr. 1295-1297, 1303-1305, 1312-1314 (Pepco witness Salatto). See also Tr. 952 (OPC witness Bright).

⁵⁶⁰ Pepco Br. 83-84, 92. "Departure from the Commission's stand-alone method without grandfathering investments made on the basis of existing Commission policy at the time such investments were made is highly punitive and is the equivalent of changing the ground rules in the middle of a contest. Accordingly, any Commission change in policy regarding CTAs should apply only to investments made after the imposition of the policy." Pepco Br. 84; see *id.* 92-93.

those PHI affiliated member companies that engage in leveraged leasing of equipment,⁵⁶¹ those member companies relied on a “stand-alone” assignment of tax benefits to them (for accounting purposes in pricing and structuring their equipment leasing deals years ago). “If the tax benefits are commandeered by inclusion in a CTA calculation, the investment itself is impaired.” Consequently, Pepco argues, “any CTA calculation should exclude tax losses attributable to leveraged lease investments.”⁵⁶²

DECISION

275. Given the record before us, the Commission has decided to adhere to our traditional stand-alone approach regarding federal and district tax expense, which is widely followed by the majority of Commissions throughout the country.⁵⁶³ OPC’s CTA proposal has several flaws which, in our opinion, reinforce our adherence to this long-standing policy.

276. OPC’s CTA proposal undercuts common tax practice for affiliate companies, violates the “cost responsibility principle,” and threatens to create inequities for other PHI affiliate companies (such as those engaged in equipment leasing) that “earned” the tax benefits and relied on their availability to them, as Pepco notes. Moreover, OPC’s proposal is significantly different from the New Jersey approach.⁵⁶⁴ OPC’s CTA proposal threatens to create an immediate massive \$172.9 million reduction to Pepco’s rate base in this case. A rate base adjustment of that magnitude might well destabilize Pepco’s financial condition. Over time, recognizing “Intercompany Deferred Income Taxes” on Pepco’s books as OPC urges might reduce Pepco’s rate base to zero.⁵⁶⁵ By contrast, under New Jersey’s CTA approach, PHI’s unregulated loss affiliates will eventually have taxable income so that “it turns around” and Pepco’s rate base rises again.⁵⁶⁶ OPC’s proposal would not “turn around” unless Pepco suffers significant tax losses year after year, a much less likely prospect in our view.⁵⁶⁷

⁵⁶¹ Pepco (J) at 45-48. “[S]everal of the PHI affiliates that produced substantial tax losses did so directly as a result of being engaged in the business of leveraged leasing. * * * The consideration of the tax losses produced by such transactions in the calculation of a CTA essentially appropriates for customers part of what the lessor has paid for. In other words, these highly engineered transactions are priced to reflect the cash flows generated by the tax losses that are embedded in their structures.” *Id.* at 46-47.

⁵⁶² *Id.* at 47, 48.

⁵⁶³ The Maryland PSC recently reaffirmed the majority view and rejected CTAs. *See In re Delmarva Power & Light*, Md. Case No. 9192, Order No. 83085 at 20-23 (December 30, 2009).

⁵⁶⁴ *See* Tr. 1261, 1264-1267 (Pepco witness Warren) (explaining differences between OPC’s CTA proposal and New Jersey’s CTA system). *Accord* Tr. 988-989, 975-976, 978-983 (OPC witness Bright).

⁵⁶⁵ *See* Tr. 994 (OPC witness Bright).

⁵⁶⁶ *See* Tr. 1317-1318 (Pepco witness Salatto).

⁵⁶⁷ *See* Tr. 1261, 1264-1265 (Pepco witness Warren).

277. The Commission did not receive evidence on, and was unable to fully evaluate, the possible impact of the 2008 tax loss position of Pepco and PHI,⁵⁶⁸ recent changes in tax law,⁵⁶⁹ and whether PHI's unregulated affiliates would be immune from D.C. taxes with or without an intercompany agreement on taxes.⁵⁷⁰ As was the case in Formal Case No. 1053, the Company proffers a more sound policy argument in favor of maintaining the stand-alone approach. We were particularly persuaded by the sound tax and accounting arguments made by Pepco witness Warren which were reflected in the Minnesota and New Mexico Commission decisions cited by Pepco.⁵⁷¹ Therefore, the Commission rejects the adoption of OPC's particular CTA proposal.

B. Bonus Depreciation

278. **OPC.** OPC argues that the Company should make an adjustment to show the actual amount of bonus depreciation it received for 2008, instead of the preliminary audit amount it included in rate base.⁵⁷²

279. **Pepco.** The Company agrees. Pepco changed its tax accounting method for its 2008 tax return, but it did not receive IRS approval to do so until May 2009, too late to reflect the new method in its original ratemaking filing here. "Due to the difference related to this deduction between Pepco's tax provision and its return, there is an increase of \$85.6 million, on

⁵⁶⁸ In most years PHI as a whole reports taxable income. Tr.1304 (Pepco witness Salatto). In 2008, however, PHI had a tax loss. See Tr. 1302, 1305-1306 (Pepco witness Salatto).

⁵⁶⁹ Ordinarily, the net operating loss (NOL) carry-back period for businesses is two years, and the NOL carry-forward period is 20 years. In the 111th Congress, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) provided business taxpayers with \$15 million or less in gross receipts an opportunity to extend the carry-back period for up to five years for NOLs incurred in 2008. The Worker, Homeownership, and Business Assistance Act of 2009 (Pub. L. No. 111-92), enacted on November 6, 2009, extended the carry-back period to five years for all business taxpayers except those who have received certain federal assistance relating to the financial crisis. Under this law, a taxpayer can use the extended carry-back period for an NOL incurred in 2008 or 2009, but not both. Further, P.L. 111-92 stipulates that the amount of loss that can be carried back to the fifth year is limited to 50% of the taxpayer's taxable income in the fifth carry-back year. This limitation, however, does not apply to businesses with \$5 million or less in gross receipts that make a five-year carry-back election after enactment of the legislation.

⁵⁷⁰ The query is whether an unregulated PHI affiliate that is immune from D.C. taxes, and which would never contribute D.C. tax deductions to the PHI group, should be entitled to any allocated "state tax" payments from Pepco under PHI's intercompany tax agreement.

⁵⁷¹ See Pepco (J) at 31-33 (Warren), Pepco (J)-2, citing *Xcel Energy*, Minn. Docket No. E-022/GR-05-1428 (September 1, 2006); *Pub. Ser. Comm'n of New Mexico*, N. Mex. Case No. 07-00077-UT (final order April 25, 2008). Accord: *City of Charlottesville, Virginia v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985), cert. denied, 475 U.S. 1108 (1986) (court upholds FERC's stand-alone policy); *Hahne & Aliff, Accounting for Public Utilities* §§17.05-17.06, §19.03 (2009) (strongly arguing against CTAs).

⁵⁷² OPC (A) at 22 (Ramas).

a system basis, to the 2008 deferred tax balance. This amount was recorded in the Company's books and records in September 2009."⁵⁷³ The Company states that the DC allocated portion of its increased bonus depreciation deduction, taking interest synchronization into account, reduces Pepco's revenue requirement by \$4.5 million.⁵⁷⁴

DECISION

280. The Commission accepts the adjustment for bonus depreciation (and interest synchronization) that Pepco and OPC agreed upon.

IX. JURISDICTIONAL COST ALLOCATION (Issue No. 11)⁵⁷⁵

281. The Commission approved Pepco's jurisdictional cost allocations in its last rate case. Rejecting OPC's proposed coincident peak method, the Commission reaffirmed the validity of the average and excess noncoincident peak ("AED-NCP") method for allocating Pepco's system-wide costs to the District of Columbia.⁵⁷⁶

282. **Pepco.** The overwhelming majority of Pepco's distribution costs (e.g., for lines, substations, transformers, and meters) were directly assigned to the jurisdiction that uses those plant facilities.⁵⁷⁷ The study in Pepco (F)-1 shows how other costs and operating expenses such as Cash Working Capital were calculated by jurisdiction.

283. Though most of its cost figures for transmission and distribution facilities are taken from FERC accounts, Pepco states that several items (e.g., uncollectible accounts, and General Plant) had to be "functionalized" to determine the distribution-related portion of those costs.⁵⁷⁸ For example, the major exception to Pepco's direct cost assignment approach concerns the cost of subtransmission facilities – which carry electricity through both the District of Columbia and other jurisdictions. Pepco states that it allocated these costs between jurisdictions, based on the Commission-approved AED-NCP method.⁵⁷⁹ Pepco submits that its other jurisdictional cost allocations are not disputed.

⁵⁷³ Pepco (K) at 7-9 (Salatto).

⁵⁷⁴ See Pepco (4C)-12 (Hook) and Pepco (4C) at 40 (Hook).

⁵⁷⁵ Designated Issue No.11 asks, "Are Pepco's proposed jurisdictional cost allocations for distribution service reasonable?"

⁵⁷⁶ *Formal Case No. 1053*, Order No. 14712, ¶¶ 253-256.

⁵⁷⁷ Pepco (F) at 7, 24 (Browning).

⁵⁷⁸ Pepco (F) at 5-6.

⁵⁷⁹ Pepco submits that the Commission has consistently approved the AED-NCP allocation method for many years, citing *Formal Case No. 905*, Order No. 9868, *Formal Case No. 929*, Order No.10387, *Formal Case No. 939*, Order No. 10646, and most recently in *Formal Case No. 1053*, Order No. 14712. Pepco (F) at 10-11, 24.

284. **OPC.** OPC argues that the AED 4-CP coincident peak demand allocation method is superior to the AED-NCP method for allocating Pepco's subtransmission costs between Maryland and the District of Columbia.⁵⁸⁰ OPC agrees with Pepco's approach of directly assigning most of its costs to each jurisdiction.⁵⁸¹ OPC argues, however, that using the AED-NCP method to allocate other costs (particularly subtransmission costs) is not optimal;⁵⁸² that it is inconsistent with the AED 4-CP jurisdictional cost allocation method that Pepco uses in Maryland, and that it risks over-collecting distribution costs from D.C.⁵⁸³

285. OPC asks the Commission to "direct Pepco to provide a test year jurisdictional and class cost of service study based on application of the AED 4-CP method to subtransmission plant and related costs." As Pepco's AMI system is deployed, and more demand interval data becomes available for each of Pepco's customer classes, OPC predicts that the accuracy of test year jurisdictional and class coincident and non-coincident demands should improve, resulting in more accurate jurisdictional and CCOS studies in the future.⁵⁸⁴ OPC asserts, however, that there is no reason for delay in switching to the AED 4-CP method for jurisdictionally allocating Pepco's subtransmission costs.⁵⁸⁵

286. **GSA.** GSA states that Pepco's jurisdictional cost allocations "follow generally accepted techniques approved in prior Commission rate cases."⁵⁸⁶

287. **Pepco Rebuttal.** OPC has identified no new circumstances, Pepco argues, that would warrant a change from the traditional AED-NCP method. According to Pepco, when accurate data are used, OPC's AED 4-CP method would actually increase the assignment of costs to the District of Columbia. The Company agrees that cost allocation methods might be

⁵⁸⁰ OPC (F) at 5 (Smith).

⁵⁸¹ *Id.* at 8.

⁵⁸² OPC states that Pepco's subtransmission system is designed to serve the single CP peak on the subtransmission system. OPC argues that there is "a disconnect" between the CP-related way in which costs are incurred on Pepco's subtransmission system (on the one hand) and how costs are allocated under the AED-NCP method (on the other hand), because the AED-NCP method considers energy use and non-coincident peak demand, but not the CP demand of the facilities. OPC (F) at 9-10; OPC Pre-Hearing Br. 20-21. By contrast, the AED 4-CP method of allocating subtransmission costs, used in Maryland, considers a combination of energy use and coincident peak demand. OPC (F) at 11.

⁵⁸³ OPC acknowledges that subtransmission facilities account for only about \$155 million (approximately 8%) of Pepco's \$1.9 billion total distribution plant. OPC (F) at 11.

⁵⁸⁴ OPC (F) at 13.

⁵⁸⁵ OPC Br. 183-187; OPC R. Br. 65-66.

⁵⁸⁶ GSA (A) at 5 (Goins).

reexamined when the AMI system is in place and better data on customer usage becomes available.⁵⁸⁷

DECISION

288. OPC has not presented any new circumstances or “good reason” to overthrow the well-established AED-NCP method of jurisdictional cost allocation. The Commission recently approved that method as valid and imbued it with a heavy presumption of reasonableness. As stated in our opinion in Formal Case No. 1053:

The Commission believes the AED-NCP approach appropriately combines an energy allocator with a non-coincident peak allocator because the design of the subtransmission and distribution system is properly based on both energy and demand characteristics. An energy allocation component is appropriate because as energy costs have risen, an electric utility should utilize cost effective methods to reduce energy losses in its substations, lines, and transformers. A non-coincident peak allocator is also appropriate because the maximum energy and peak demands of the subtransmission and distribution system are non-coincident peak demands. The use of a non-coincident peak based methodology such as AED-NCP is reasonable to reflect demand-related system design and

Even if Pepco were to focus on the distribution business, in its post-divestiture period, “it would remain appropriate to apply the AED-NCP method.”⁵⁸⁹ The Commission’s rationale specifically covers Pepco’s subtransmission costs.

289. The Commission may re-examine the AED-NCP method, and whether it should be replaced with the AED 4-CP method, once AMI is in place and better data on customer usage is available. OPC and Pepco both agree that this should be done.

X. THE COMPANY’S REVENUE REQUIREMENT

290. The Commission finds that Pepco’s District of Columbia adjusted rate base for the test period is \$1,010,267,000, and that a fair rate of return (including capital costs and capital structure) on that D.C. rate base is 8.01 percent. The Commission further finds that the level of return required when the 8.01 percent rate of return is applied to the adjusted test year rate base of \$1,010,267,000 is \$80,922,000.

⁵⁸⁷ Pepco Br. 99; Pepco (3F) at 11-12 (Browning).

⁵⁸⁸ Formal Case No. 1053, Order No. 14712, ¶ 255.

⁵⁸⁹ *Id.* at 94.

291. The Commission finds that the adjustment that would increase Pepco's test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order is \$19,833,000, which includes a proper allowance for taxes.

**XI. CUSTOMER CLASS DISTRIBUTION OF
PEPCO'S RATE INCREASE (Issue No. 12)⁵⁹⁰**

292. The Company proposes to move gradually ("one-quarter of the way") toward equalizing class rates of return by raising distribution rates (which are only part of each customer's bill) more for residential than for commercial customers. Overall, an average residential customer's bill would increase by 6.1 percent (\$6.43 on the total bill) under Pepco's proposal. Pepco justifies its proposed class revenue requirements by pointing to its Class Cost Allocation Study ("CCOSS"), which shows significant disparities in class rates of return ("ROR").⁵⁹¹

293. OPC urges a nearly across-the-board approach, modeled on the Commission's decision in Pepco's last rate case (Formal Case No. 1053), with the residential class receiving an increase of 1 percent more than non-residential classes. GSA recommends cutting interclass revenue subsidies under Pepco's proposed revenue spread by 10 percent (around \$6.2 million) to \$56 million to make a stronger movement toward cost-based rates and equal class RORs. WMATA proposes a stronger movement ("one third of the way") toward equalized class RORs. Traditional principles of gradualism, Pepco argues, support its more gradual approach to lessening the disparities in customer class RORs.⁵⁹²

A. Class Cost Allocation Study (CCOSS) (Issue No. 12a)⁵⁹³

294. **Pepco.** The Company's class allocation study shows that current earned returns vary widely by customer class. At the low end of the range are the standard residential classes, Schedules R and AE, and Rider RAD, with returns in the negative range (-2.6 percent to -4.6 percent) and the streetlighting class (Schedule "SL") with a -4.3 percent. The high end of the

⁵⁹⁰ Designated Issue No. 12 asks, "Is Pepco's proposed distribution of its revenue requirements reasonable?"

⁵⁹¹ The Company's CCOSS, in Pepco (F)-3 (Browning), shows the demand and customer components of embedded cost for each of Pepco's customer classes. The study compares class RORs to the overall jurisdictional ROR. Pepco (F) at 17 (Browning). To comply with past Commission directives, Pepco also submitted a marginal cost study in Pepco (G)-5, that covers only distribution costs. The Company states that "[b]ecause this is a Distribution-only rate request, the Company has not produced Generation or Transmission Marginal Cost Studies." Pepco (G) at 13-14 (Bumgarner). PEPCO argues that marginal cost studies have been used in the past to design rates that primarily recovered generation-related costs; that there is no longer any good reason to produce a marginal cost study, now that PEPCO has sold its generation plants; and that the Commission should dispense with the obligation to produce such studies in future Pepco rate cases. *Id.* at 14.

⁵⁹² See Pepco (G) at 3-8 (Bumgarner).

⁵⁹³ Designated Issue No. 12a asks, "Is Pepco's proposed Class Cost Allocation Study reasonable?"

range contains the large commercial high voltage class (Schedule GT-3A) at 15.6 percent and the Rapid Transit Schedule RT class at 13.4 percent. Generally, the residential classes provide significantly negative earnings on distribution service while commercial classes provide above average rates of return.”⁵⁹⁴ To develop the Company’s CCOSS, Pepco witness Browning assigned and allocated rate base items and operating expenses to functions and classes based on the principle of cost causation.⁵⁹⁵ He utilized different types of “demand allocators” to allocate demand costs in a way that appropriately recognizes that various facilities are sized to meet various loads.⁵⁹⁶

295. **OPC.** OPC claims that the cost of subtransmission facilities should be allocated by the AED 4-CP method. OPC argues that Pepco’s CCOSS fails to distinguish between the differing cost of the cheaper “radial and overhead systems” that serve residential customers on the one hand and more costly network and downtown D.C. underground systems that serve commercial customers on the other hand. Nearly 90 percent of Pepco’s investment in distribution lines is related to the more costly underground system that commonly serves commercial customers. OPC stops short of saying that Pepco’s CCOSS is “fatally flawed.” However, OPC argues that the defects in Pepco’s CCOSS would support an across-the-board approach to setting customer class revenue targets in this case.⁵⁹⁷ OPC also requests that, in the future, the Commission should direct Pepco to use the AMI system to obtain detailed information regarding the load characteristics and types of customers served by radial and underground network facilities respectively, which may allow a more accurate CCOSS.⁵⁹⁸

296. **AOBA.** AOBA accepts Pepco’s CCOSS, saying that it reflects Commission-accepted methodology and provides a reasonable assessment of costs and revenues by class of service. AOBA warns, however, that Pepco’s CCOSS does not reflect the substantial subsidies that are being provided to Residential Aid Discount (“RAD”) customers through the Energy Assistance Trust Fund (“EATF”) and the Residential Aid Rider Surcharge (“RAD surcharge”). According to AOBA, the customers in all other classes are required to pay over \$5.1 million in EATF and RAD surcharges each year to subsidize the RAD class.⁵⁹⁹

297. AOBA also states that the Company’s CCOSS shows wide differences in customer class rates of return. The overall average ROR for the District is 7.04 percent, with commercial customers paying more than twice the system average ROR, while the residential, RAD and SL classes pay a negative ROR. AOBA asserts that test year 2008 D.C. jurisdictional

⁵⁹⁴ Pepco (G) at 6 (Bumgarner); *see* PEPCO (F)-3.

⁵⁹⁵ Pepco (2F) at 13 (Browning); Pepco (F) at 16-19 (Browning).

⁵⁹⁶ *Id.* at 18-19 (Browning).

⁵⁹⁷ OPC (F) at 5-6, 16-19 (Smith); OPC Pre-Hearing Br. 21-22.

⁵⁹⁸ OPC (F) at 5-6, 20.

⁵⁹⁹ AOBA (A) at 84-85, 88 (Oliver).

revenues for Pepco were \$68.8 million, with Pepco's large and small commercial customers (*i.e.*, the GT and GS customer classes) contributing \$79.1 million, while all other classes combined contributed a negative net income of -\$10.3 million. AOBA also claims that Pepco's commercial customers have long paid more than their fair share, and that residential and streetlighting customers clearly contribute disproportionately to Pepco's need for additional revenue. Moreover, AOBA submits, class RORs have grown further apart since Pepco's last distribution base rate case. AOBA concludes that fairness and equity dictate that this trend toward growing the subsidization of residential and streetlighting services must be reversed.⁶⁰⁰

298. **District Government.** The District Government argues that Pepco's CCOSS is inaccurate for the streetlighting ("SL") and traffic signal ("TS") classes. DCG contends that earlier deferred AMI/smart meter costs are improperly attributed to the SL class, which has no use or need for smart meters.⁶⁰¹ DCG also argues that the CCOSS improperly includes a small amount of revenue from 24-hour Burning Streetlights, which DDOT has totally eliminated. DCG submits that streetlighting is an off-peak service and that the streetlighting and traffic signal classes have shown a negative 10.13 percent growth in kWh usage because of DDOT's conservation efforts. Accordingly, DCG argues, the SL and TS classes do not create any added costs or a need for an expanded Pepco system; yet Pepco's CCOSS does not consider peaking or system cost additions.⁶⁰²

299. DCG maintains that the Company's CCOSS is also internally inconsistent on SL/TS rates. Though it allocates demand and customer costs to the SL and TS rate schedules, DCG contends that the CCOSS does not include these demand elements in its rate designs for SL and TS. Instead, DCG argues, Pepco uses energy-only rates in pricing the cost of service for these schedules. Overall, the District Government criticizes Pepco's CCOSS as a "mechanistic model" that gives some information about relative class RORs, but is limited because it involves no judgment or consideration of non-cost factors that have long been considered in setting class revenue targets for the SL and TS rates.⁶⁰³

300. Turning to the RAD rate, DCG argues that, contrary to AOBA, Pepco's CCOSS accurately tracks RAD costs, using methods that have long been approved.⁶⁰⁴ DCG states that RAD class costs do not reflect the RAD and EATF surcharges because the RAD class gets the benefit. The District Government submits that other customer classes, however, received credit

⁶⁰⁰ AOBA Br. 41-43; AOBA (A) at 85-89.

⁶⁰¹ "The SL and TS rate schedule services do not need smart meters, since their usage is estimated based on type and size of lamp. Further, there can be no direct load control capability or dynamic pricing to produce incentives to change the SL and TS loads during peak periods." DCG (2A) at 6-7.

⁶⁰² DCG Br. 8-9; DG Govt. (A) at 12-15 (Petniunas).

⁶⁰³ DCG (A) at 12-15, 19-20 (Petniunas).

⁶⁰⁴ DCG (2A) at 13-15.

in the CCOSS for providing those benefits to the RAD.⁶⁰⁵ It concludes that the CCOSS is accurate for the RAD class.

301. **GSA.** GSA accepts Pepco's CCOSS as reasonable.⁶⁰⁶ The only criticism that GSA has is that Pepco's CCOSS is based on identifiable loads without regard to a customer's on-site generation or when maintenance might be scheduled or other factors recognizing that distributed generation may add value to the system.⁶⁰⁷

302. GSA asserts that OPC's criticisms of the CCOSS are wide of the mark. GSA claims that whether or not OPC has correctly identified flaws in the CCOSS,⁶⁰⁸ it is essentially irrelevant given the massive residential subsidies identified by Pepco's CCOSS. GSA recognizes that target class revenue requirements proposed by Pepco seek to address "an interclass subsidy problem that keeps getting bigger." GSA argues that no one can reasonably claim "rate shock" if a 50 percent increase in distribution charges produces an increase of less than 10 percent in a customer's total electricity bill. Neither GSA's nor Pepco's proposed revenue spread would create rate shock in trying to move residential rates towards cost of service.⁶⁰⁹

303. **WASA.** WASA submits that Pepco's CCOSS utilizes a general cost allocation formula that overstates the costs of serving WASA's Blue Plains facility under the GT-3B rate. Two old subtransmission feeder lines running under the Potomac River and dating from the 1950s and 1970s provide service solely to Blue Plains.⁶¹⁰ When the depreciated costs of these old subtransmission facilities are directly assigned to Blue Plains, as WASA urges, the cost of service for Blue Plains is significantly lowered.⁶¹¹ WASA's "corrected" CCOSS shows an above-system-average 16.02 percent class rate of return for the GT-3B class, as opposed to

⁶⁰⁵ DCG R.Br. 5; DC Govt. (2A) at 14-15.

⁶⁰⁶ GSA (A) at 5 (Goins).

⁶⁰⁷ See Tr. 1182-1183, 1192 (GSA witness Goins). This CCOSS dispute between GSA and Pepco affects the rates for standby service (S) and the dispute about Pepco's proposed new GT-3A-S rate for GSA's steam plant with its on-site generation capability. See *infra* pp. 137-141.

⁶⁰⁸ GSA (B) at 7 (Goins). GSA submits that OPC's criticisms of the CCOSS are minor, in that using OPC's recommended AED 4-CP allocation method (instead of Pepco's AED-NCP method) would reduce the District's revenue requirement by less than 1%. The Commission rejected OPC's criticism of the way the CCOSS allocated overhead and underground distribution system costs in *Formal Case No. 1053*. *Id.* at 6-8.

⁶⁰⁹ GSA Br. 5; GSA R.Br. 2; GSA (B) at 6-10.

⁶¹⁰ WASA Br. 7-8; WASA (A) at 10, 6 (Phillips).

⁶¹¹ *Id.* at 8-9 (Phillips). While Pepco's CCOSS uses an allocation formula to allocate approximately \$1.5 million in rate base to Blue Plains, WASA's direct cost allocation method assigns only \$921,000 in rate base to Blue Plains. *Id.* WASA states that "the total original cost of the Blue Plains Feeders was \$1,574,000. This stands in stark contrast to the allocated subtransmission costs of \$3.2 million reflected in Pepco's allocation." WASA Br. 8.

Pepco's 6.77 percent class ROR figure. WASA submits that the impact on other classes is slight (less than 1 percent) when the over-assignment of costs to the GT-3B class is corrected.⁶¹²

304. WASA urges that direct cost assignments can and should be made for Blue Plains instead of using Pepco's general cost allocation formula. First, WASA argues that NARUC principles encourage direct cost assignments in preference to allocation formulas whenever possible. Blue Plains is served exclusively by two under-river 69 kV lines, and does not benefit from Pepco's subtransmission system generally.⁶¹³ Second, WASA argues that direct cost assignments lead to the best price signals.⁶¹⁴ Testimony at the hearings established that the old feeder lines running under the Potomac River meet all reliability criteria and give Blue Plains a "firm supply," such that Blue Plains could still maintain its supply even if it loses one of these under-river supply lines.⁶¹⁵

305. WASA and Pepco disagree about whether two temporary overhead 69 kV lines ("Emergency Overhead Feeders"), which are now partially dismantled and not in use, provide "backup" facilities for Blue Plains whose costs could or should be allocated to WASA.⁶¹⁶ WASA witness Edwards testified that, because the Blue Plains facility is already served by two reliable 69 kV subtransmission lines that run under the Potomac River, WASA did not pursue the idea of using the Emergency Overhead Feeder lines as long-term additional backup.⁶¹⁷ WASA argues that the two overhead 69 kV lines in dispute (Emergency Overhead Feeder lines 69021 and 69022) were installed temporarily, as an aid to Pepco's construction in 2006-2007 of two major new underground 230 kV transmission lines running into the Potomac River Substation. After that, the Emergency Overhead subtransmission lines would no longer be in use.⁶¹⁸ WASA

⁶¹² WASA Br. 3, 7, 9, 22; WASA (A) at 10-14. "This difference is strictly a result of directly assigning the full cost of the two 69 kV feeders to WASA rather than allocating WASA a share of the total subtransmission plant, which WASA's Blue Plains facility does not and cannot use." *Id.* at 13.

⁶¹³ WASA R.Br. 1-3.

⁶¹⁴ WASA R.Br. 3-4.

⁶¹⁵ See WASA Br. 2, 5; Tr. 1484 (Pepco witness Lizza), Tr. 1475-1476 (WASA witness Edwards), Tr. 1435-1436, 1467-1468 (Pepco witness Gausman).

⁶¹⁶ See WASA R.Br. 4-11.

⁶¹⁷ See WASA Br. 18; Tr. 1475-1476 (WASA witness Edwards); Tr. 1435-1436 (Pepco witness Gausman). WASA's full load at Blue Plains could be served by just one of the two 69 kV lines running under the Potomac River. Moreover, these two old 69 kV subtransmission lines meet all of the applicable reliability criteria that Pepco has for service to Blue Plains. WASA Br. 2, 15, 14; Tr. 1435-1436, 1467-1468 (Pepco witness Gausman). Blue Plains has a firm supply, Pepco witness Lizza acknowledged, and can still maintain supply if it lost one supply line. See Tr. 1484.

⁶¹⁸ See WASA Br. 4; Tr. 1471-1472 (WASA witness Edwards). WASA states that "the Emergency Overhead Feeders were installed as only a temporary measure to facilitate construction of the long term solution to the Mirant situation, i.e., two new 230 kV transmission lines that would connect additional supply sources to the Potomac River Substation. During that time, the Emergency Overhead Feeders allowed Pepco to shift the Blue Plains load off of the Potomac River Substation, freeing up capacity on the two existing 230 kV lines into that station to serve other

argues that these Emergency Overhead Feeder lines are not currently in use; not providing any “backup” service to its Blue Plains facility; and WASA is not pursuing any such overhead “backup” lines for Blue Plains.⁶¹⁹ WASA’s emergency plans at Blue Plains do not include restoring power on the Emergency Overhead Feeder 69 kV subtransmission lines, which WASA understood were only temporary.⁶²⁰

306. WASA is sympathetic to Pepco recovering the costs of the Emergency Overhead Feeders. However, WASA insists that those feeders supplied many Pepco customers (not just Blue Plains). WASA concludes that, to the extent the Commission permits recovery of the costs of the Emergency Overhead Feeders in this case, those costs must be allocated among all Pepco customers.⁶²¹

307. **WMATA.** WMATA argues that Pepco’s CCOSS shows that the residential class is being unfairly subsidized by other customer classes. This sends the wrong price signals, and undercuts the residential class’s incentives to conserve.⁶²²

308. **Pepco Rebuttal.** Pepco states that OPC’s complaint about residential class cost assignments makes no difference because even if the cost of underground-related expenses is eliminated from the calculation, the residential class is still earning a negative rate of return.⁶²³ Equally without merit, Pepco contends, are the District Government’s objections to the costs assigned to the streetlight class. Though DCG touts the off-peak nature of SL usage, Pepco states that SL costs were calculated in accord with methods that the Commission has approved in earlier cases. The Company states that it took into account the energy conservation reductions in kWh usage by the SL and TS classes. Pepco claims that, even if no subtransmission or primary related costs were assigned to the SL class, the SL class would have a negative ROR (–0.6 percent) showing that the SL class is due a substantial rate increase in order to begin to align revenues with costs.⁶²⁴

309. Addressing WASA’s claims about the cost of serving Blue Plains, Pepco states that WASA overlooked the costs of the two 69 kV Emergency Overhead circuits that were connected to Blue Plains to maintain reliable service during the construction of the additional

customers. Construction of the new 230 kV transmission lines was completed in 2006 and 2007, respectively, and, as Pepco freely acknowledges, the Emergency Overhead Feeders were taken out of service in July 2009, as required by a critical National Park Service permit that has now expired.” WASA Br. 4. *Accord.* WASA Br. 12, 24.

⁶¹⁹ WASA Br. 4; Tr. 1472, 1475-1476, 1482 (WASA witness Edwards).

⁶²⁰ WASA Br. 4-5, 14-18, 24-25; Tr. 1470 (WASA witness Edwards).

⁶²¹ WASA R.Br. 11.

⁶²² WMATA (A) at 16-18 (Foster).

⁶²³ Pepco (3F) at 13-14 (Browning).

⁶²⁴ *Id.* at 2-3.

230 kV circuits that was authorized in Formal Case No. 1044. The original \$6,182,033 cost of these Emergency Overhead circuits—which provide reliability and backup benefits to Blue Plains -- significantly exceeds the costs that Pepco now allocates to Blue Plains. Pepco argues that it would likely increase the assigned costs to Blue Plains, rather than decrease them, if a major share of the costs of these feeders were added to the cost of service of Blue Plains that WASA calculates.⁶²⁵ The Company insists that it should be allowed to recover the costs of the two overhead 69 kV lines, which were installed as an emergency measure with Commission approval in Formal Case No. 1044.⁶²⁶ Moreover, Pepco argues, once the new 230 KV underground lines were installed in May/June 2007, the continued operation of the 69 kV lines would be solely for the reliability of the Blue Plains facility.⁶²⁷ Pepco states that the overhead 69 kV lines have not operated since the removal of a section on National Park Service land in Oxon Cove Park. Instead, Pepco submits, the overhead lines served as a backup, ensuring reliability to Blue Plains, the Naval Research Lab substation, the Metro Traction Power Station at Congress Heights, the District of Columbia Fire and Police training centers, D.C. Village, and the Hadley Memorial Hospital, as well as other facilities.⁶²⁸ According to Pepco, the overhead 69 kV lines could be reconnected within 5 to 7 days in the event of an emergency.⁶²⁹

DECISION

310. We find that the Company has established the basic reasonableness of its CCOSS. Pepco properly assigned and allocated rate base items and operating expenses to functions and classes based on the principle of cost causation.⁶³⁰ The Company also utilized different types of

⁶²⁵ *Id.* at 9-11 (Browning). Pepco witness Hook stated that “these 69 kV lines were used to provide back-up support for the District of Columbia load supplied from the Potomac River Substation, as well as for the operation of Blue Plains facility in the event of loss of Mirant’s Potomac River generating system. In July of 2009, pursuant to an agreement with the National Park Service, a segment of the lines over Park Service land was removed; the remaining portion is available to serve in a back-up capacity if needed.” Pepco (4C) at 2 (Hook).

⁶²⁶ Pepco (3D) at 13-16 (Gausman). Pepco states that the two new 69 kV lines were built in 2005- 2006 on an emergency basis to ensure continuous service to Blue Plains. With little or no warning, Mirant shut down its Potomac River Plant, threatening reliable electric service to a major portion of the District of Columbia, including the Blue Plains treatment facility. *Id.* at 14. Originally, Pepco planned to ensure service to Blue Plains with new underground 230 kV lines. However, licensing difficulties with the National Park Service, the time required for underground construction of the new 230 kV lines, and the need to avoid a “Blue Plains failure,” led Pepco to construct two new 69 kV lines overhead with a permitting condition to remove part of the overhead line at Oxon Cove Park within two years. For a period of eleven months, from July 2006 through June 2007, the two 69 kV lines ensured adequate service to Blue Plains until the new underground 230 kV systems were built. *Id.* at 13-20 (Gausman).

⁶²⁷ *Id.* at 16.

⁶²⁸ Pepco (3D) at 19 (Gausman). *Accord* Tr. 1439-1440 (Gausman).

⁶²⁹ *See* Tr. 1435 (Pepco witness Gausman).

⁶³⁰ Pepco (2F) at 13 (Browning); Pepco (F) at 16-19 (Browning).

“demand allocators” to allocate demand costs in a way that appropriately recognizes that various facilities are sized to meet various loads.⁶³¹

311. OPC’s objections concerning differences between overhead and underground facilities were considered and rejected in Pepco’s last rate case where we found that OPC’s concern with the assignment of overhead and underground facilities does not undermine Pepco’s allocation of rate base and operating expenses to the residential class.⁶³² We also rejected in that case OPC’s suggested use of the AED 4-CP method (instead of the AED-NCP method) for allocating subtransmission costs.⁶³³ The Commission finds that Pepco now has the ability to identify outages by customer class,⁶³⁴ so that it should be able to study and resolve the issue raised by OPC about the relative cost of overhead versus underground systems. The Company is directed to examine this issue and to include the study and its results in its CCOSS presentation in the next Pepco rate case.

312. We also noted in Pepco’s last rate case that, “while it is true that the Commission previously gave weight to PEPCO’s embedded and marginal class cost-of-service studies, the Commission’s more recent guidance shows a preference for embedded costs.”⁶³⁵ Obtaining valid Pepco marginal cost studies has been fraught with difficulty. Nevertheless, we deny Pepco’s request to dispense with marginal cost studies altogether. There may be some value in our looking at marginal cost studies in the future, as a judgmental factor, even if they cover only marginal distribution costs. The Commission will continue its past practice in which marginal costs may be one non-mathematical, judgmental factor among many that the Commission may consider in its discretion in the future in setting class rates.

313. WASA’s suggested direct-cost-allocation “correction” to Pepco’s CCOSS on the GT-3B (Blue Plains) rate is denied for several reasons. WASA and Pepco vigorously disputed whether it is proper to set the Blue Plains rate by direct cost allocations instead of an allocation formula.⁶³⁶ Our general policy, however, is to disfavor single-customer rates that are set solely on the basis of narrowly-based directly-assigned costs, as opposed to costs that are determined by allocation from a wider pool of costs for similarly-situated customers. Such single customer rates, based on a very narrow base of cost information, may be subject to volatile changes if their directly-assigned CCOS changes suddenly because of future events.

⁶³¹ *Id.* at 18-19 (Browning).

⁶³² *Formal Case No. 1053*, Order No. 14712, ¶ 282.

⁶³³ *Formal Case No. 1053*, Order No. 14832 at 10.

⁶³⁴ *See Formal Case No. 1053, Phase II*, Pepco Deborah Royster’s July 7, 2009, letter to Commission (Company has developed necessary programming to calculate outage hours by customer class); *see also* Direct Testimony of Pepco witness Browning, pp. 11-12 (May 12, 2009).

⁶³⁵ *Formal Case No. 1053*, Order No. 14712, ¶ 274.

⁶³⁶ *Compare* WASA Br. 19-23 and WASA R.Br. with Pepco Br. 102 and Pepco R. Br. 52-56.

314. We have also determined that the cost of the physically intact part of the 69 kV Emergency Overhead Feeders⁶³⁷ should be placed in rate base as “emergency capitalized spare.”⁶³⁸ Our decision today is that Pepco is entitled to full recovery (*i.e.*, recovery of costs plus a rate of return) on that rate base item from Pepco’s customer base as a whole. We agree with WASA, and the record overwhelmingly demonstrates, that Pepco’s recovery on this item should come from its system as a whole, and not just from WASA. The currently unused, partially dismantled overhead 69 kV lines provide potential “back-up support” not only for WASA’s Blue Plains facility, but also for many other customers on the system.⁶³⁹ OPC’s claim that the Emergency Overhead Feeder lines were or are primarily for Blue Plains is inconsistent with the evidence in this record and the Commission’s decision in Formal Case 1044.⁶⁴⁰ Accordingly, the cost of the 69 kV Emergency Overhead Feeder lines, which are in Pepco’s rate base as “emergency capitalized spare,” should be recovered equitably from all of Pepco’s customers, and not just from WASA.

315. To safeguard the safety and reliability of the electric distribution system in this area, the Commission also directs that Pepco not dismantle what remains of the 69 kV Emergency Overhead Feeders without first obtaining prior explicit Commission permission. We thus agree with the point made by Pepco witness Hook that it might be “better to leave [the 69 kV Emergency Overhead Feeder lines] up and ready to use again if it were needed, than to tear it down.”⁶⁴¹

⁶³⁷ OPC stated that no service has been provided through these two overhead 69 kV lines since July 2007. *See* Tr. 881-883 (OPC witness Ramas); WASA Br. 11-12. Pepco admits that these lines were removed or “cut” in July 2009. Tr. 1434 (Pepco witness Gausman); Tr. 1489 (Pepco witness Lizza). One portion of these lines -- approximately 4,000 feet (out of 13,000 to 16,000 feet) over National Park Service land in Oxon Cove Park -- has been physically removed and retired on Pepco’s financial records. *See* Tr. 1328-1331, 1342 (Pepco witness Hook); Tr. 1421-1422 (Pepco witness Gausman). Pepco conceded that OPC is right to delete \$61,000 from plant in service to account for the fact that these facilities are not in service. Tr. 1328-1330 (Pepco witness Hook). Given that 25% of the \$2.5 million Emergency Overhead lines have been retired, the Commission directs that an additional \$574,000 be deleted from Pepco’s plant in service.

⁶³⁸ *See infra* ¶¶ 22-26.

⁶³⁹ *See* WASA Br. 3-4, 12-13, 23-24; WASA R. Br. 5; Pepco (3D) at 19 (Gausman); Pepco (4C) at 2 (Hook); Tr. 905-906 (Pepco witness Morin) (14,000 other customers, besides Blue Plains, are served by the Potomac River substation).

⁶⁴⁰ Testimony was presented that Blue Plains is a “firm supply” facility, with reliable supply lines (two 69 kV lines running under the Potomac River), so that Blue Plains can still maintain its supply even if it loses one supply line. *See* Tr. 1484 (Pepco witness Lizza), Tr. 1475-1476 (WASA witness Edwards), Tr. 1435-1436 (Pepco witness Gausman). The two old 69 kV feeder lines running under the Potomac River to serve Blue Plains currently meet all the applicable reliability criteria that Pepco has for service to Blue Plains. Tr. 1435-1436 (Pepco witness Gausman); Tr. 1484 (Pepco witness Lizza). *See Formal Case No. 1044*, Order No. 13895 at 10-11, and Order No. 13958 at 5-6 quoted in WASA’s R. Br. 8-9, 10.

⁶⁴¹ Tr. 1337 (Hook).

B. Impact on Customer Class Rates

316. **Pepco.** The Company seeks to reduce the amount by which any class rate of return is greater or less than its overall D.C. jurisdictional ROR.⁶⁴² According to Pepco, the rate designs approved in Formal Case No. 1053 provide improved price signals,⁶⁴³ but the rates resulting from that case made little progress in eliminating interclass subsidies between the residential and non-residential classes. Gradualism was an overriding concern of the Commission in that case, given the then recent large increases in Standard Offer Service ("SOS") rates. The small 1 percent differential between the residential and non-residential class increases authorized in that proceeding did not reduce the significant disparities that currently exist in class RORs.⁶⁴⁴

317. Two steps were utilized by Pepco to allocate its overall revenue requirement in a way that reduces disparities in class RORs. Because the residential classes were shown to have very low negative returns, the first step increased their rates of return by one-quarter of the way toward the overall rate of return of 8.88 percent that the Company is seeking in this case. This resulted in the residential class receiving \$18.8 million, or about 36 percent of the total \$51.7 million increase originally requested by Pepco. The other major under-earner, the SL energy class, was then adjusted one-half of the way from the present negative 4.33 percent return toward a zero return, producing an additional \$324,000. The SL service class's return was judgmentally set at 1 percent producing a \$33,000 increase from that class. Next, each remaining commercial class was adjusted half of the way toward the overall rate of return. Since this step still resulted in a revenue deficiency, each commercial class's return was adjusted by a constant factor until the overall revenue increase target was reached.⁶⁴⁵ According to Pepco, the outcome brings class RORs closer together.

⁶⁴² Pepco (G) at 5 (Bumgarner); PEPCO (2G) at 2 (Bumgarner). The Company states that it measures its success at achieving this goal by utilizing a Unitized Rate of Return ("UROR"). "A UROR greater than 1.0 means that the customer class is providing a greater than average return. A UROR less than 1.0 means that the customer class is providing less than the average return." Pepco (G) at 5.

⁶⁴³ In particular, Pepco applauds the Commission's decisions to modify the Residential Standard Schedule "R" Minimum Charge to a Customer Charge, to increase that charge to \$2 per month. This moves the non-residential Customer and Demand charges closer to cost and reduces the relative energy component of the "R" rate. Pepco (G) at 4.

⁶⁴⁴ *Id.* at 3-4.

⁶⁴⁵ Pepco (G) at 6-7 (Bumgarner); see Pepco (2G) at 2.

Customer Class RORs under PEPCO's Proposals⁶⁴⁶

		Current		PEPCO's Proposed	
	Class Revenues	class ROR	UROR	new class ROR	UROR
1. Residential					
Residential R	\$48.21m	-3.05%	-0.43	0.27%	0.03
Residential AE	\$11.94m	-3.90%	-0.55	-0.28%	-0.03
RAD	\$3.94m	-5.35%	-0.76	-4.56%	-0.51
Residential TOU	\$1.05m	10.84%	1.54	12.97%	1.46
2. Small Commercial					
GS					
GS-LV	\$51.80m	14.25%	2.02	15.05%	1.69
GS-HV	\$0.061m	21.51%	3.06	19.48%	2.19
SL Energy	\$1.11m	-5.07%	-0.72	-2.17%	-0.24
SL Service	\$0.477m	0.37%	0.05	1.00%	0.11
TN	\$0.37m	6.59%	0.94	10.38%	1.17
3. Large Commercial					
GT-LV	\$168.64m	12.39%	1.76	13.91%	1.57
GT-HV-3A	\$0.49m	10.62%	1.51	12.83%	1.44
GT-HV-69KV	\$3.15m	6.77%	0.96	10.48%	1.18
GT-HV-other	\$73.16m	18.24%	2.59	17.48%	1.97
Metro-RT	\$9.06m	15.70%	2.23	15.93%	1.79
Total D.C. jurd.	\$373.45m	7.04%	1.00	8.88%	1.00

318. **OPC.** Relying on the approach taken by the Commission in Pepco's last rate case, OPC recommends that each customer class receive the same percentage increase in base distribution charge with the exception that the residential class receive an additional 1 percent increase over the non-residential increase.⁶⁴⁷ OPC argues that Pepco's proposed class revenue targets would result in rate shock for the residential class. According to OPC, Pepco's proposed 47 percent increase in residential distribution rates cannot be masked as only a 6.1 percent increase when rolled into the total bill for supply, transmission, distribution and surcharges.

⁶⁴⁶ See Pepco (G) at 6-7 (Bumgarner); Pepco (G)-1 and (G)-1a (charts) (Bumgarner); Pepco (F)-3 (chart) (Browning). See also AOBA (A) at 85-92 (Oliver); WMATA (A) at 17 (Foster); GSA (A)-1 (Goins).

⁶⁴⁷ OPC (F) at 5-6, 23-24 (Smith); OPC Pre-Hearing Br. 22.

319. OPC argues that the Commission's policies of gradualism and rate-continuity are undermined by Pepco's proposed sharp increase in residential rates. As in Pepco's last rate case, OPC urges the Commission to be mindful of continuing increases in the SOS rates, which have increased approximately 25 percent in the last two years, and the continuing economic challenges facing consumers, as well as the District of Columbia's unemployment rate of over 10 percent (placing D.C. at the ninth highest unemployment rate of all U.S. states).⁶⁴⁸

320. **AOBA.** In general, AOBA agrees with Pepco's proposed method to distribute its overall jurisdictional revenue increase among customer classes.⁶⁴⁹ The only exception, according to AOBA, is the RAD class, in which the RAD class rates should not be frozen (as Pepco recommends) but instead should be raised by the lesser of: (1) the percent increase in the Consumer Price Index for urban wage and clerical workers (CPI-W) since the time that the most recent RAD rate caps were initiated (*i.e.*, 22.4 percent); or (2) 50 percent of whatever increase the Commission approves for the Residential ("R") class. If the Commission does not grant Pepco's full requested revenue increase, then AOBA recommends that one-third of any reduction in the Company's overall revenue request be spread among all classes across-the-board. The remaining two-thirds should be distributed among the rate classes that have greater than system average RORs to reduce subsidies between Pepco's customer classes.⁶⁵⁰

321. **District Government.** The District Government argues that there should be no increase in the streetlight and traffic signal rates, or at most, an increase of the average increase for all classes of customers.⁶⁵¹ Objecting to Pepco's proposed class revenue targets for the SL and TS classes, DCG argues that Pepco's proposed increase of 211 percent (or \$324,000) for these classes⁶⁵² overemphasizes class RORs, creates rate shock, and ignores rate gradualism and non-cost factors.⁶⁵³

322. DCG contends that the Company's proposals reflect a mechanistic reliance on embedded costs, overlooking the fact that, since the 1980s, the Commission has always priced the SL and TS rates at only marginal energy costs because of public safety and welfare

⁶⁴⁸ *Id.* at 22-24.

⁶⁴⁹ AOBA (A) at 91 (Oliver).

⁶⁵⁰ *Id.* at 91-93.

⁶⁵¹ DCG Br. 1-2, 6, 11.

⁶⁵² Even worse, DCG states, is GSA's proposed 319.82% increase for the SL and TS rates. Because SL/TS service has long been considered a public good, it is reasonable to expect other classes of service to subsidize SL/TS service to some extent. DCG Br. 7-8.

⁶⁵³ DCG (A) at 7 (Petniunas). DCG argues that the Commission in allocating costs among customer classes and in designing rates, has long considered a wide variety of non-cost factors, including peak causation/diversity; risk and reliability; growth of load; historical rate patterns; equity; fairness; conservation; revenue stability; social goals; value of service; and public safety and welfare. DCG (2A) at 8-9 (Petniunas).

considerations, and the extreme off-peak nature of SL/TS service. According to DCG, the Company's, AOBA's and GSA's proposals for raising SL and TS rates do not follow principles of gradualism, equity, and rate stability; they disregard important historical considerations like the value of service to the community provided by streetlights and traffic signals; and they overlook the fact that SL/TS rates provide risk-free returns.⁶⁵⁴

323. DCG submits that the SL and TS classes are risk free, providing stable usage patterns, loads and revenues for Pepco.⁶⁵⁵ DCG submits that this stability reduces the need for future rate increases. Accordingly, the District Government maintains that the SL/TS classes should receive a lower rate increase and a lower required ROR than other classes.⁶⁵⁶

324. The District Government also contends that the Company's proposed 211 percent increase in SL rates will result in rate shock, arguing that there is no merit in Pepco's "total bill argument," which seeks to mask a sharp increase in SL distribution rates by bundling it together with unregulated SL generation costs. DCG submits that the same principles that moderated the requested SL/TS increase in Pepco's last rate case, gradualism and non-cost factors, should apply again in the present case.⁶⁵⁷

325. DCG states that the only significant development in SL/TS load or usage patterns since Pepco's last rate case is an increasing trend in reduced usage due to conservation. More SL/TS conservation measures are planned for the future.⁶⁵⁸ DCG argues that it should be rewarded for its successful conservation efforts.⁶⁵⁹ DCG also relies on the provisions of the Clean and Affordable Energy Act of 2008 ("CAEA") to support its proposition that those with the greatest ability and follow-through on conservation should get the lowest rates.⁶⁶⁰

⁶⁵⁴ DCG Br. 4-6, 10-11; DCG (2A) at 5, 7, 13.

⁶⁵⁵ DCG Br. 10; DCG (2A) at 10 (Petniunas).

⁶⁵⁶ DCG Br. 11-13; DCG (A) at 16-17; DCG (2A) at 6.

⁶⁵⁷ DCG Br. 3-5; DCG R.Br. 4-5.

⁶⁵⁸ DCG Br. 7; DCG (A) at 17-18. Trends in SL energy usage are pointed downward with a 10% reduction since 1995 and a 3% reduction in the last two years alone. "Thus, 30% of DDOT's 19 year energy reduction was achieved since the Commission's last rate order." DCG Br. 7. Old inefficient traffic signal lights have been replaced with high efficiency LED lights, the District reports. "This measure has reduced the TS kWh use from 18.1 million kWh in 2001, to 10.5 million kWh in 2008, a 42% decrease in usage." DCG (A) at 18. According to the District Government, DDOT is planning to replace over 800 more streetlights with LEDs this October. It is also planning to replace all streetlights with LEDs in the future. *Id.* DDOT recently eliminated all unmetered 24-hour burning streetlights in the District, and all streetlights now receive the lower Standard Night Burning rate. DCG Br. 7, 13.

⁶⁵⁹ DCG Br. 7.

⁶⁶⁰ DCG cites Section 401 of the CAEA. DCG (A) at 18-19.

326. The District Government argues further that SL/TS service is a public good that benefits the community, without excluding any potential user. It promotes social interaction, deters crime, promotes business, and facilitates pedestrian and vehicular traffic. These unique public safety and welfare benefits, combined with the extreme off-peak nature of the service, DCG argues, justify low rates for the SL/TS class.⁶⁶¹

327. DCG claims that there is improper loading of Pepco's system costs on the SL and TS classes because these classes are billed on a straight kWh basis that triggers the imposition of a set of surcharges, even though Pepco's CCOSS calculates the cost of the SL and TS classes based on demand and customer costs (not energy costs).⁶⁶² SL and TS base revenues are only \$166,189, but when six surcharges based on kWh energy usage are added, the total of the base rate and distribution surcharges on a kWh basis produces a total bill of \$1,085,423, reflecting 85 percent in surcharge revenues.⁶⁶³

328. Finally, DCG asserts that outages in streetlighting and traffic signal service also trigger additional operational costs, and risks of liability, which should be reflected in lower rates for the SL and TS rate schedules.⁶⁶⁴ Because signal outages create a public safety hazard, the District Government has incurred significant capital expenses (over \$3.5 million since 2007) to obtain emergency back-up generators, uninterruptible power supply systems, and retrofitted cabinets. In addition, DCG submits that it has incurred significant personnel costs (about \$400,000 in 2008) for responding to traffic signal outages.⁶⁶⁵

329. GSA. GSA contends that, while Pepco's proposed revenue spread reduces disparities in customer class rates of return, this allocation still would increase the interclass revenue subsidy for the residential class from \$61 million to \$62 million. GSA claims that OPC's proposal would balloon the residential subsidy to around \$72 million, leaving a negative residential class ROR and only an "extremely modest" movement towards cost of service. GSA recommends cutting interclass revenue subsidies under Pepco's proposed revenue spread by 10

⁶⁶¹ DCG Br. 11; DCG (A) at 6-8. SL/TS's non-cost benefits include: crime prevention, promotion of social interaction, promoting business, and facilitating pedestrian and vehicular traffic. Moreover, any traffic signal outages can provide significant risks for citizens and liability risks to the District Government. DCG states that the Commission's decision in *Formal Case No. 1053* recognized the validity and importance of non-cost factors (such as rate continuity, gradualism, their off peak nature, and the value of services as a public good) in setting class revenue targets for the SL and TS classes. In that case, the Commission limited the percentage increases for the SL and TS classes to the increase for the residential class. DCG (A) at 9-10.

⁶⁶² DCG (A) at 20.

⁶⁶³ *Id.* at 20-21.

⁶⁶⁴ DCG Br. 14; DCG (A) at 23. For example, the number of power outages to District traffic signals has increased in recent years from 216 (2006) to 239 (2007) to 284 (2008) to 203 in the first eight months of 2009. DCG (B) at 2 (Dey).

⁶⁶⁵ *Id.* at 5.

percent (around \$6.2 million) to \$56 million to make a stronger movement toward cost-based rates and equal class RORs.⁶⁶⁶

330. GSA notes that OPC's proposed revenue spread is identical to the one adopted in Formal Case No. 1053, but the revenue spread did nothing to mitigate the huge interclass revenue subsidies that continue to this day. GSA contends that OPC's approach fails to move toward cost-based rates. GSA states that though OPC relies on Pepco's CCOSS to propose higher Customer Charges in the residential rate design, OPC ignores the massive subsidies shown in the CCOSS that keep residential rates far below cost.⁶⁶⁷

331. GSA contends that residential customers (excluding RTM customers) should receive a 61 percent distribution base rate increase (compared to Pepco's proposed 47 percent increase). GSA's proposal would increase an average residential customer's total bill by 8.2 percent. If Pepco receives less revenue than it is requesting, then GSA recommends reducing the increase for each class while maintaining the relative increases it recommends. For example, if the allowed increase is half of Pepco's requested increase, then the increase for residential customers should be 30.51 percent (half of GSA's recommended 61.02 percent).⁶⁶⁸

332. Opposing Pepco's proposed new GT-3A-S tariff for GSA's steam plant, GSA objects to the high cost that Pepco is proposing for this new rate which may discourage the development of distributed on-site generation.⁶⁶⁹ GSA argues that the rate for its steam plant should be no higher than the actual cost of providing service to it.⁶⁷⁰ According to GSA, this would involve a 20.93 percent increase for its steam plant as opposed to Pepco's proposed 23.38 percent increase.⁶⁷¹ Eventually, GSA suggests, a 10 to 20 percent discount might be appropriate for customers that (like GSA's steam plant) have distributed generation.⁶⁷² These issues are discussed further in the rate design section of this Order.

333. **WASA.** WASA argues that Pepco's CCOSS overstates the costs of serving WASA's Blue Plains facility under schedule GT-3B, and that the true class rate of return for the GT-3B class is 16.02 percent (not 6.77 percent as Pepco's CCOSS claims). Since this is more than Pepco's D.C. jurisdictional average ROR, WASA argues that a decrease is appropriate to

⁶⁶⁶ GSA Br. 2, 4-5, 15; GSA R.Br. 5; GSA (A) at 8-9, 15, 16, 13-14 (Goins); GSA (B) at 3-4 (Goins).

⁶⁶⁷ GSA Br. 2; GSA (B) at 5-6.

⁶⁶⁸ GSA (A) at 16-17.

⁶⁶⁹ See Tr. 1192-1199 (colloquy between Commissioner Morgan and GSA witness Goins).

⁶⁷⁰ See GSA (A) at 25-28.

⁶⁷¹ See Tr. 1177-1181 (GSA witness Goins); GSA (A) at 25-28.

⁶⁷² See Tr. 1194-1195 (GSA witness Goins).

recognize the true cost of serving Blue Plains.⁶⁷³ WASA objects to Pepco's proposed 37.7 percent increase in GT-3B rates. Instead, WASA argues, a 29.3 percent decrease in WASA's rates is required to eliminate the subsidy presently paid by WASA.⁶⁷⁴

334. **WMATA.** WMATA argues that Pepco's proposed class revenue targets do not go far enough toward lessening residential class subsidies. WMATA is recommending no change to the residential RAD rate class, as WMATA supports the Commission's efforts to protect that segment of the population least able to pay.⁶⁷⁵ Otherwise, however, WMATA asks the Commission to move more quickly by going "one-third of the way" (as opposed to Pepco's proposed "one-quarter of the way") toward equal customer class RORs.⁶⁷⁶

335. WMATA states that the gradual movement toward cost-based rates ordered in Formal Case No. 1053 failed to reduce the significant disparities that still exist in class RORs. WMATA now contends that, since the SOS rate increase in 2009 was only 2.7 percent, as compared to more than 12 percent for 2007 when Formal Case No. 1053 was decided, the SOS should no longer constrain the Commission from moving more quickly toward cost-based rates.⁶⁷⁷

336. **Pepco Rebuttal.** The Company argues that its "one quarter of the way" approach is reasonable, as shown by the fact that it lies in the middle of the other parties' positions. It claims that a 6.1 percent increase in residential customers' total electric bill is modest and will not cause "rate shock." Rebutting OPC, Pepco argues that it is the total bundled price of electricity, not just the distribution portion, that affects the decision whether or not to consume an additional kWh. In answer to OPC's claims about increases in SOS rates and the general state of the economy, Pepco notes that a meaningful movement toward cost for the residential class may be more appropriate now than it was in Formal Case No. 1053. Pepco states further that the recent SOS increases have dramatically moderated downward to the 3 percent range from the double digit increases that the Commission was looking at when it decided Formal Case No. 1053 two years ago.⁶⁷⁸

⁶⁷³ WASA (A) at 15 (Phillips); *see id.* at 14-16.

⁶⁷⁴ WASA Br. 3, 9; WASA (A) at 15.

⁶⁷⁵ WMATA Br. 11.

⁶⁷⁶ WMATA Br. 10-11; WMATA (A) at 17-21 (Foster). WMATA states that Pepco should follow its two-stage approach to determining class RORs. The first step should be to increase the residential class rates one-third of the way toward the overall rate of return allowed by the Commission. This approach will eliminate the negative earnings in the residential classes (except for RAD), thereby requiring that the residential classes cover Pepco's allocated operating costs. In the next rate case, Pepco could take other steps toward cost based rates. *Id.*

⁶⁷⁷ WMATA Br. 9-10; WMATA (A) at 16-19 (Foster).

⁶⁷⁸ Pepco (3G) at 3-5 (Bumgarner).

337. Turning to SL and TS rates, Pepco argues that the District Government failed to show that it incurred increased costs because of power outages to traffic signals.⁶⁷⁹ Overall, Pepco argues that its proposed SL/TS distribution rate increases involve only small increases to total SL/TS bills, and are consistent with rate gradualism. Pepco states that even with this increase, the SL class will still produce a negative 2.17 percent return on equity. This degree of subsidy, Pepco argues, should more than satisfy the desire to recognize the “non-cost factors” cited by the District Government.⁶⁸⁰ Pepco acknowledges that streetlighting and traffic signals are a public good that contribute to public welfare, safety and the quality of life in the District. However, the Company asserts, there are many other businesses and organizations in the District that are served by Pepco that also contribute to the quality of life, and it points out that those considerations have rarely entered into rate design or revenue distribution decisions of the Commission.⁶⁸¹

338. Pepco argues that the “unique load characteristics” of GSA’s steam plant justify creating a new GT-3A-S rate class; that this customer’s load factor is only 16 percent, or about 75 percent lower than the 64 percent load factor for other customers on the GT-3A schedule on which the GSA plant is currently served.⁶⁸² Pepco states that GSA’s proposed 20.93 percent increase for this facility is not far from Pepco’s proposed 23.39 percent increase. Moreover, Pepco notes that the proposed GT-3A-S class provides (and will continue to provide) a lower class ROR than the remainder of the GT-3A class. The Company states that only if the GSA steam plant were relieved of its entire share of the subsidy for the residential class, would it receive a small (\$2,546) revenue decrease under a “fully equalized class ROR” regime. The Company indicates that its GT-3A and GT-3A-S rates are calculated in the same manner as all other commercial rates and that they recover the full cost of service plus a fairly determined portion of the remaining subsidy to the residential and other underperforming classes. Therefore, Pepco argues, they are not a market barrier to the development of customer-owned cogeneration plants.⁶⁸³

339. As for the two new overhead 69 kV lines that were built in 2005-2006 on an emergency basis to ensure continuous service to D.C. customers, Pepco insists that it is entitled to recover the cost of these ordinary and necessary outlays.⁶⁸⁴ The Company suggests that the

⁶⁷⁹ Pepco (3D) at 11-13 (Gausman). “The outage percentages are 0.16% and 0.13% for 2008 and 2009 (through September 11, 2009), or less than two tenths of one percent of the actual operating hours of these systems.” *Id.* at 12-13.

⁶⁸⁰ Pepco (3G) at 5-6 (Bumgarner). *Accord* Tr. 1408-1409 (Pepco witness Bumgarner).

⁶⁸¹ Tr. 1409-1410 (Pepco witness Bumgarner).

⁶⁸² Pepco (3G) at 6-8. The operation of GSA’s cogeneration plant causes the load factor for this account (*i.e.*, the ratio of the average load to peak load measured at the meter, a measure of plant utilization) to be lower than that of other customers on the GT-3A schedule. *Id.* at 6.

⁶⁸³ Pepco (3G) at 9-10 (Bumgarner).

⁶⁸⁴ *Id.* at 13-20.

costs would be properly assignable to WASA's Blue Plains facility because the continued operation of the 69 kV lines would be solely for the backup reliability of the Blue Plains facility.⁶⁸⁵

DECISION

340. The Commission enjoys wide latitude in setting customer class revenue requirements. Traditionally, in setting class revenue requirements, we have considered class cost of service as well as a broad range of other factors in addition to the cost of service for each class.⁶⁸⁶ The courts have never imposed a requirement of uniformity among the rates of return from different customer classes.⁶⁸⁷ For example, customer class rates of return may vary based on the risk to Pepco because the level of risk is a valid factor to consider in rate design.⁶⁸⁸ Differences can be based not only on quantity, but also on the nature, time, and pattern of use, so as to achieve reasonable efficiency and economic operation.⁶⁸⁹ Other valid non-cost factors that may be considered in setting both customer class revenue requirements and rate designs, include

⁶⁸⁵ *Id.* at 16. Pepco claims that WASA asked it to replace a removed overhead portion of the 69 kV lines with an underground system and that discussions on this topic, including the cost responsibility of this underground segment, are continuing. Pepco (3D) at 19-20.

⁶⁸⁶ *See, e.g., Washington Gas Light Co.*, 450 A.2d at 1199-1209. There is also a new statute that states: "In supervising and regulating utility or energy companies, the Commission shall consider the public safety, the economy of the District, the conservation of natural resources, and the preservation of environmental quality." *See Clean and Affordable Energy Act of 2008* § 401, D.C. Law 17-250, 55 DCR 9225 (October 22, 2008), amending the Commission's organic act of March 4, 1913, ch.50, § 8 ¶ 96A.

⁶⁸⁷ *Washington Gas Light Co. v. Pub. Serv. Comm'n*, 450 A.2d 1187, 1207 (D.C. 1982); *Accord Apartment House Council of Metro. Washington, Inc. v. Pub. Serv. Comm'n*, 332 A.2d 53, 57 (D.C.1975) ("equal return from customer classes is not required"). Wholesale FERC principles about equalized class RORs do not apply mechanically to set retail class RORs in Pepco rate cases. The state commissions that set electric rates at the retail level must consider a much more diverse set of customers, different issues, and a different calculus of interests, than exists at the wholesale level. For example, at the retail level the costs of electricity are commonly tax deductible business expenses for retail business customers but not for retail Residential customers. For these reasons, the case law and Commission precedent about retail electric rates in the District of Columbia are different from FERC cases about wholesale rates where fewer non-cost considerations apply and the courts insist on more equalized customer RORs. *See, e.g., Alabama Electric Coop. Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982), cited in *Formal Case No. 1053*, Order No. 14712 at 99, n. 719.

⁶⁸⁸ *Potomac Electric Power Co., Formal Case No. 1053*, Order No.14712, ¶ 337.

⁶⁸⁹ *Apartment House Council of Metro. Washington, supra*, 332 A.2d at 57. In some cases, the old discretionary factors for setting class revenue targets must be updated. To be specific, the Commission in the past sometimes allocated a greater-than-average percentage increase to the customer classes (such as WMATA) whose rapidly growing demand for electricity was contributing more than other classes to the need for Pepco to build costly new electric generating plant. *See, e.g. Formal Case No. 748*, Order No. 7457 (December 30, 1981), 2 DCPSC 401, 443-444 (1981). In today's post-divestiture environment, where Pepco is a "wires only" electric distribution company and not an electric generating company, this factor must be restated. A modern corollary might be: what customer class(es), if any, are contributing disproportionately to the need for Pepco to build costly new distribution plant?

“equitable considerations” such as value of service to the customer and ability to pay, historical rate patterns, the need to conserve energy resources, and other market-place realities, as well as principles of gradualism and rate continuity.⁶⁹⁰

341. **The Commission’s General Approach.** The options available to the Commission in setting class revenue targets in the present case cover a wide spectrum and include: (1) OPC’s nearly-across-the-board approach, with the residential class receiving an increase of 1 percent more than non-residential classes, following the approach taken by the Commission in Formal Case No. 1053; (2) Pepco’s proposed “one quarter of the way” approach toward more equal class rates of return; (3) GSA’s proposed 10 percent (approximately \$6.2 million) reduction in interclass subsidies; and (4) WMATA’s “one third of the way” approach toward more equal customer class RORs. All these options involve some departure from a strict across-the-board approach with some additional revenue burden being imposed on the residential class that has a comparatively low class ROR.

342. The Commission agrees with Pepco, AOBA, GSA, and WMATA that we should move to reduce the disparities that now exist in class RORs. This principle has limits. The Court of Appeals, and this Commission, has repeatedly held that equal class RORs are not required and that the Commission has statutory authority to consider many valid cost and non-cost factors in setting class revenue targets and rate designs.⁶⁹¹ Historic rate patterns in the District of Columbia have been that the residential classes pay lower class RORs than the commercial class RORs. The Commission is not compelled to equalize class RORs for residential and commercial retail Pepco customers. We believe, however, that the severe disparities in class RORs that now exist call for corrective action.

343. **Residential Rates.** Today’s decision reduces Pepco’s requested \$44.51 million revenue increase for the District by more than half, to \$19.833 million. Out of that D.C. jurisdiction-wide increase, only \$7.14 million (or 36.0 percent) will go to increase the residential class revenue target. This decision mirrors Pepco’s proposal, which was supported by AOBA, on the more moderate end of the proposals submitted to us, that the residential class should receive 36 percent of the total D.C. jurisdictional increase. Residential rates will increase in the present case by more than an across-the-board amount. However, the disparities in class RORs will be reduced, and all class RORs will move closer to the overall D.C. jurisdictional ROR. No further movement toward equalized class rates of return is warranted in this case. However, we must recognize that the severe economic downturn has hit District of Columbia ratepayers

⁶⁹⁰ See, e.g., *Washington Gas Light Co.*, 450 A.2d at 1199- 1209; *Formal Case No. 869*, Order No. 9216, 10 D.C.P.S.C. 22, 133-134 (1989).

⁶⁹¹ See, e.g., *Washington Gas Light Co. v. Public Serv. Comm’n*, 450 A.2d 1187, 1207 (D.C. 1982); *accord: Apartment House Council of Metro. Washington, Inc. v. Public Serv. Comm’n*, 332 A.2d 53, 57 (D.C. 1975) (“equal return from customer classes is not required”).

hard.⁶⁹² The Commission heard community comments confirming the dire economic situation of many D.C. residential ratepayers, particularly senior citizens and the disabled on fixed incomes.

344. The Commission must balance the competing interests in a way that is reasonable and fair to all stakeholders. Our ruling today is moderate. We have decided to recover the residential rate increase primarily through an increase in the Customer Charge. As discussed further below,⁶⁹³ we are increasing the Customer Charge for the residential class to \$6.65, and simultaneously reducing the volumetric (kWh) rates in residential distribution charges, so that the residential class pays no more than the class revenue target we set today. This will move the rate design of residential distribution rates away from volumetric (kWh) rates, and towards rates that are based more on customer and demand charges, as is appropriate in the new era where Pepco is a “wires only” electric distribution company.

345. In making this decision, we have very specifically considered the need for rate gradualism.⁶⁹⁴ While our ruling today will reduce the disparities that now exist in class RORs and narrow the gap between the very low residential class ROR and the higher commercial classes’ RORs, we point out that it still leaves the residential class with a negative class ROR. The Commission is acting in a measured way to narrow the gap in customer class RORs and move all Pepco customer classes closer to UROR, as all the parties agree should be done, consistent with the constraints imposed by a recovering economy, both nationally and in the District of Columbia in particular.

346. **Residential Aid Discount (RAD).** The Commission’s concern for low-income residential customers is reflected in our long-standing Residential Aid Discount (“RAD”) program, which provides rate relief to eligible, low-income residential customers. The Commission has decided to increase the class revenue target for the RAD class by only a modest amount, which will be determined by long-overdue RAD rate design changes discussed below.

347. We are simplifying and clarifying the RAD rate structure while still giving RAD customers a very sizable discount compared to non-RAD residential rates (standard R and AE). To begin, RAD rates should be structured more like standard residential rates in order to send better cost signals and reflect how Pepco’s “wires only” distribution charges should be recovered

⁶⁹² We note that in referring to the “state of the economy” in various places in this Order, such a reference will mean different things to different groups, depending upon the context in which it is used. For example, it can mean stock market prices when referring to Pepco’s cost of capital, or it can mean unemployment, the price of goods and/or median income levels when referring to District ratepayers. Whether the economy can be described as terrible, severe, recovering, etc., also depends upon the context in which it is described.

⁶⁹³ See *infra* at 118-124.

⁶⁹⁴ The Commission must fairly balance a wide variety of considerations, of which gradualism is one. See, e.g., *Watergate East Inc. v. Pub. Serv. Comm’n*, 665 A.2d 943, 949 (D.C. 1995) (court approves significant rate increase for Watergate, noting that “gradualism is but one of many factors to be considered and weighed in setting rate designs” and that it should not trump other considerations such as the need for reasonable cost recovery).

from all customers. The existing monthly Distribution Charges for RAD customers⁶⁹⁵ consist of: (1) a Minimum Charge of \$0.19 per month, which includes the first 30 kWh of electric usage; (2) a per kWh charge for electric usage between 31 and 400 kWh per month; and (3) a higher per kWh charge for electric usage in excess of 400 kWh per month.⁶⁹⁶ We are replacing the Minimum Charge with a Customer Charge of \$2.50 going forward.⁶⁹⁷ We are also eliminating the initial RAD 30 kWh rate block, a vestige of outdated tariffs, which was included in the Minimum Charge.⁶⁹⁸ That rate block will be replaced with a new initial rate block that will charge for electric usage from 1-400 kWh per month, similar to the initial 400 kWh rate block in Pepco's tariffs for standard Residential and Residential AE service. As is currently the case, a second block containing higher rates per kWh is charged for electric usage in excess of 400 kWh per month.⁶⁹⁹ The existing tailblock⁷⁰⁰ rates for RAD and RAD-AE are currently higher than the corresponding tailblock rates for the R and AE classes, a rate design anomaly that must be corrected. If the rates for the R and AE classes resulting from this case are lower than the corresponding RAD rate blocks, the RAD block rates should be adjusted downward so that the RAD and RAD-AE block kWh rates will be the same as they are in the R and AE rates.⁷⁰¹

348. Overall, the RAD class revenues to be recovered from all RAD kWh rates (in RAD's distribution rates) will remain the same as they are now. Thus, for example, to the extent that the RAD tailblock rates are reduced, then the rates from other blocks must increase to make up for the revenue loss from the tailblock.⁷⁰² This applies to RAD-AE also. The moderate increase in the RAD class revenue requirement is due solely to the increase we are ordering in the new RAD Customer Charge, which replaces the current RAD 30 kWh Minimum Charge.

349. The impact of these changes to the RAD rate structure will give RAD customers a discounted Customer Charge (as compared to standard R and AE customers) as well as retaining a discounted rate for the first 400 kWh of RAD consumption (or the first 700 kWh of RAD-AE

⁶⁹⁵ There are two RAD rate classes: RAD-Standard and RAD-AE (All Electric).

⁶⁹⁶ There is an additional block of higher rates for the RAD-AE customers for electric usage in excess of 700 kWh per month.

⁶⁹⁷ The Commission is thus increasing the RAD minimum charge by slightly less than one-half of the increase to the Residential Customer Charge.

⁶⁹⁸ A rate block is defined as a rate structure under which consumption is divided into units or tiers and a price is set for each tier or unit of service used. Block rates can be either declining or inverted. P.U.R. Glossary for Utility Management (1992).

⁶⁹⁹ Currently, the second block for RAD-AE customers covers 401-700 kWh per month, and a third block consist of even higher charges per kWh for usage in excess of 700 kWh per month.

⁷⁰⁰ The last block for each rate class is called the "tailblock".

⁷⁰¹ In no event should the RAD and RAD-AE block rates be greater than the corresponding R or AE block rates, respectively.

⁷⁰² This change in RAD structure may provide a modest conservation incentive to RAD customers.

consumption). These changes will move the RAD rate away from recovery through volumetric (kWh) rates and towards more emphasis on recovery through customer charges. These changes also will help to simplify and clarify RAD rates and reduce the size of the gap between RAD and non-RAD residential rates, which has increased unintentionally during the period when rates were capped.⁷⁰³

350. **GT-3B (WASA's Blue Plains Facility).** WASA's suggested rate reduction for Blue Plains was based on its suggested direct-cost-allocation "correction" to Pepco's CCOSS on the GT-3B (Blue Plains) rate. For the reasons we stated earlier, the Commission rejects WASA's direct-cost-allocation correction/reduction to the Blue Plains rate. The recoverable costs of Pepco's overhead 69 kV Emergency Overhead Feeder lines are to be recovered equitably from all Pepco's customers, not just from WASA. WASA's Blue Plains's class revenue target is to be calculated consistent with these principles and consistent with Pepco's proposed methodology for calculating commercial class revenue targets within the constraint of a reduced overall \$19.8 million rate increase for the District of Columbia.

351. **Streetlights and Traffic Signals.** Together the SL Energy and SL Service classes now produce some \$1.59 million in revenues, or only 4/10 of 1 percent of Pepco's total D.C. jurisdictional revenues of \$373.45 million. We stated in Pepco's last rate case that streetlight and traffic signal rates "will now, and in the future, contribute to the cost of service based on embedded cost principles tempered by the Commission's principles of gradualism and rate continuity."⁷⁰⁴ We also said that "the comparative low risk of the SL and TS classes" is a valid factor to consider in setting SL and TS rates.⁷⁰⁵

352. We determine that it is appropriate in the present case to move toward more cost-based SL and TS rates. Ordinarily, this would entail a significant increase for the streetlight class since, as Pepco emphasizes, it is presently earning a negative class ROR. We accord significant weight, however, to DCG's argument that the low risk of the SL and TS classes warrants the imposition of a lower SL/TS ROR than would otherwise be the case. Taking gradualism and rate continuity into account, as well as the low risk of the SL/TS classes and all the non-cost and other factors cited by DCG, we will raise SL and TS rates by the same percentage (approximately 17.5 percent) that is being imposed on the low-earning residential class. This increase is significantly lower than Pepco's proposed increase for the streetlight class. The Commission points out that SL/TS rates will still yield very low or negative class RORs. We find that the outcome reached in this case for SL/TS rates adequately reflects

⁷⁰³ The complexity of the RAD rate, and the need to clarify and simplify it, is illustrated by our opinion in *Formal Case No. 1053*, Order No. 14712, ¶¶ 422-442, discussing RAD summer tailblock anomalies that were created, accidentally, by the complex regulatory history of the RAD rate.

⁷⁰⁴ *Formal Case No. 1053*, Order No. 14712, ¶ 277.

⁷⁰⁵ *Id.* at 118.

gradualism, as well as all the conservation, low risk, non-cost and other factors cited by the District Government.⁷⁰⁶

353. **Commercial Classes.** The Commission adopts Pepco's proposed method to distribute among the commercial classes the remaining revenue burden, *i.e.*, the overall \$19.833 million D.C. jurisdictional rate increase, minus the \$7.14 million increase allotted to the Residential class minus the dollar increase allotted to Streetlights and Traffic Signals. The outcome brings class RORs closer together.

XII. RATE DESIGNS (Issue No. 13)⁷⁰⁷

354. **Overview.** The Company is partial to the rate designs approved in Formal Case No. 1053, which increased its fixed cost recovery relative to its recovery for energy usage. Pepco requests that these rate designs be preserved in the present case. It proposes that class revenue targets be recovered by applying an across-the-board increase to each rate component of its residential and commercial rates.⁷⁰⁸ Pepco's rate design proposals also include recognition of a new "GT-3A-S" tariff for GSA's steam plant, and a significant increase in Street Light energy distribution rates which currently earns a negative class rate of return. No increase is proposed for the Residential Aid Discount (RAD) rate.

355. We indicated in Formal Case No. 1053 that Pepco is now a "wires only" distribution company; therefore, the rate designs for Pepco's customers should shift away from volumetric recovery to recovery based on fixed customer charges and distribution charges. Consistent with this pronouncement, our Order today increases the customer charge for residential and RAD customers in order for Pepco to more gradually recover actual customer and fixed costs. Otherwise, Pepco's proposed rate designs would not adequately progress toward recovering customer and fixed costs directly (not through energy-delivery charges).⁷⁰⁹ Accordingly, the Commission directs the Company to present rate designs in its next rate case

⁷⁰⁶ See, e.g., *Watergate East Inc. v. Pub. Serv. Comm'n*, 665 A.2d 943, 949 (D.C. 1995) (court approves significant rate increase for Watergate, noting that "gradualism is but one of many factors to be considered and weighed in setting rate designs" and that it should not trump other considerations such as the need for reasonable cost recovery).

⁷⁰⁷ Designated Issue No. 13 asks, "Are Pepco's proposed rate designs just and reasonable?"

⁷⁰⁸ Pepco (G) at 4-5, 8 (Bumgarner); Pepco (2G) at 3 (Bumgarner). All of Pepco's customer class rates differentiate between summer (June through October) and winter (November through May) rates. See Pepco (G)-2 (PEPCO rate schedules); Pepco (G)-3 (Bumgarner).

⁷⁰⁹ OPC recognized that Pepco needs to redesign its rates to de-emphasize volumetric recovery and to recover more of its required revenue through demand and distribution rates. The District Government also noted that it is anomalous to calculate CCOS for the SL and TS tariffs on the basis of demand and customer costs while billing these customers on a straight kWh basis. DCG witness Petniunas stated, however, that he was not advocating a demand rate for the SL and TS rate schedules at this time. DCG (A) at 23.

that (consistent with gradualism) place greater emphasis on customer charges and demand charges and less emphasis on volumetric (kWh) charges.

A. Residential Class Rate Designs (Issue No. 13a)⁷¹⁰

1. Customer Charge for Residential, AE, and R-Time-of-Use

356. **Pepco.** Pepco supports the structure of its current residential rate designs, which encompass standard Residential (R), Residential All-Electric (AE), and Residential Time-of-Use (R-TM) rates. As approved by the Commission in Formal Case No. 1053, the R rate now collects a greater percentage of revenues from fixed customer charges as opposed to charges for energy use.⁷¹¹ To collect the class revenue target for the R class, Pepco proposes to increase each component part of the R rate by an across-the-board amount, while freezing the rates for the RAD.⁷¹² Pepco's originally proposed changes for distribution rates for standard residential customers appear below:

⁷¹⁰ Designated Issue No. 13a asks, "Are the rate designs by classes reasonable?"

⁷¹¹ Pepco (G) at 4-5 (Bumgarner). The components of Pepco's standard residential rates (R, R-AE) include a fixed customer charge, as well as rate blocks for different levels of energy usage (kWh) (covering the first 400 kWh, and in excess of 400 kWh), and surcharges. See Pepco (G)-2 (Pepco rate schedules) at R-3 to R-5, R-41 (for SOS); Pepco (G)-3 (Bumgarner). Time-metered residential rates (R-TM) include a customer charge, as well as rate components covering energy usage (kWh) (on peak, intermediate, off peak) and surcharges.

⁷¹² See Pepco (2G) at 3 (Bumgarner).

Distribution Rate Changes for Residential Classes⁷¹³

	<u>Current Rates</u>		<u>Proposed Rates</u>	
	summer	winter	summer	winter
Residential-				
Standard "R"				
Customer Charge	\$2.00	\$2.00	\$2.93	\$2.93
First 400 kWh	\$0.00945	\$0.00945	0.01385	0.01385
Excess of 400 kWh	\$0.02796	\$0.01942	0.04098	0.02846
Residential-All Electric "AE"				
Customer Charge	\$2.00	\$2.00	\$3.10	\$3.10
First 400 kWh	\$0.00945	\$0.00945	0.01467	0.01467
Excess of 400 kWh	\$0.02796	\$0.01552	0.04339	0.02408
Residential-Time-of-Use "R-TM"				
Customer Charge	\$9.09	\$9.09	\$11.17	\$11.17
kWh Charge	\$0.03717	\$0.03717	0.04566	0.04566

357. In its post-hearing brief, Pepco changed position indicating that it "does not object" to OPC's proposal to raise the residential customer charge to \$6.65 (from Pepco's originally proposed level of \$2.93), while adjusting the energy usage charges in the first 400 kWh rate block downward.⁷¹⁴ Pepco states that this might better align residential rates with the largely fixed nature of the costs of providing distribution service.

358. **OPC.** As indicated, OPC recommends increasing the customer charge in the Residential R and Residential AE rates from \$2.00 to \$6.65 per month, to move them closer to actual cost, and to match Pepco's Maryland residential customer charge. OPC recommends further that additional revenues collected through the customer charge should be used to reduce the first 400 kWh block of each rate, which will lessen the impact on average usage residential customers.⁷¹⁵

⁷¹³ See Pepco (G)-2 (Bumgarner) at Eighth and Ninth Revised Pages, pp. R-3, R-4, and Sixth and Seventh Revised Pages p. R-5 (showing before and after rate schedule tariffs for R, AE, and R-TM).

⁷¹⁴ Pepco Br. 103.

⁷¹⁵ OPC (F) at 7, 28-29 (Smith). "If the Commission orders a revenue increase for the residential class that differs from the Company's proposal, the R and AE rate design should still be set at \$6.65 and the 400 kWh block adjusted accordingly." *Id.* at 29.

359. Over the long term, OPC suggests that the Commission rely on AMI-generated meter data to quantify demand, and permit a fundamental restructuring of Pepco's rate designs. At present, OPC contends that Pepco's rate designs suffer from the fundamental problem of recovering most of its distribution-related fixed costs through an energy (kWh) charge that varies with usage. OPC argues that the objective of rate design in the future should be to move from Pepco's current outdated rates based primarily on delivered kWh to new rates that "isolate Pepco's opportunity to recover its fixed costs from the impacts of energy efficiency or DSM."⁷¹⁶ OPC states that an AMI system should allow for the design of more accurate retail electricity distribution rates (by jurisdiction and customer class) (based on kW or demand) and more controllable commodity rates (based on kWh or energy) that reward customers for lowering energy usage during peak demand periods.⁷¹⁷

360. **District Government.** DCG agrees with OPC that there is a basic disconnect between the cost allocation methodology in Pepco's CCOSS (which shows demand and customer related costs) and the Company's SL and TS rate schedules, which are designed as 100 percent kWh charges. Those kWhs are then used for surcharge collections which, in the case of SL/TS rates, account for 85 percent of the total bill. DCG contends that over the next several Pepco rate cases, Pepco's "revenue recovery should be shifted more toward demand costs and less revenue be collected from the energy charges."⁷¹⁸

DECISION

361. The Commission agrees with OPC and DCG that Pepco's rate designs should move from rates that recover costs primarily through energy-delivery (kWh) charges to rates emphasizing recovery through demand and customer charges. This is imperative in the new era of unbundled electricity service, where Pepco is a "wires only" distribution company. Pepco's costs are now demand and customer costs, not energy costs. As previously indicated, we direct Pepco and the parties to propose rate designs that reflect this reality, with due regard for concerns about transition and gradualism, in Pepco's next rate case.

362. The Commission adopts OPC's and Pepco's proposals to raise the fixed customer charge component of Residential R and Residential AE rates from \$2.00 to \$6.65 per month. This will bring customer charges closer to actual cost (about \$10.00)⁷¹⁹ and correct price signals, and is preferable to a simple across-the-board increase in all component parts of residential class rates to reach the targeted class revenue requirement. Our opinion explains that, while the

⁷¹⁶ *Id.* at 25-28. See OPC Pre-Hearing Br. 22-23.

⁷¹⁷ OPC (F) at 29-31. "Hourly pricing, critical peak pricing, and critical peak load reduction rebates are just some of the alternative rate mechanisms that can be designed and implemented with a fully functional AMI system. The availability of these new alternative pricing mechanisms will empower retail customers to better control their energy costs." *Id.*

⁷¹⁸ DCG (2A) at 22-23 (Petniunas).

⁷¹⁹ See Commission Ex. No. 22.

residential customer charge is being raised to \$6.65, the residential energy-delivery charges will be reduced to keep the residential class revenue increase limited to 36 percent (\$7.14 million) of the overall D.C. jurisdictional \$19.833 million increase that we approve today.⁷²⁰

363. We also adopt Pepco's unopposed proposal to move the Customer Charge for R-TM from \$9.09 to \$11.17.⁷²¹ The total percentage increase in the distribution rate for R-TM will be the same as that of the other residential classes (R and AE).

2. Residential Aid Discount (RAD)

364. Twenty-seven years ago, the Commission approved Pepco's residential aid rider ("RAR") program, to provide rate relief to eligible, low-income residential customers (defined as Low Income Home Energy Assistance Program ("LIHEAP")-eligible, DDOE-certified Pepco customers) by reducing their electric costs by six percent per year. The costs associated with the RAR were distributed to all customer classes equally on an across-the-board basis.⁷²² The old RAR program is now called the Residential Aid Discount (RAD) program.⁷²³

365. Two sources of funding now exist for the RAD program; the "legislative subsidy" provided by the Energy Assistance Trust Fund (EATF) and the "regulatory subsidy" provided by all other Pepco customer classes to RAD customers as approved by the Commission.⁷²⁴ The statute, as amended, establishing the EATF as a non-lapsing fund provides as follows:

(c) The Energy Assistance Trust Fund shall be used solely to fund:

- (1) The existing low-income programs in the amount of \$3.3 million annually; and
- (2) The Residential Aid Discount subsidy in the amount of \$3.0 million annually; provided, that the subsidy shall be in the amount of \$5.207 million for Fiscal Year 2009.

⁷²⁰ See *supra* ¶ 345.

⁷²¹ See Pepco (G)-2 (Bumgarner) at Sixth and Seventh Revised Pages p. R-5 (showing before and after R-TM rate).

⁷²² See *Potomac Electric Power Company, Formal Case No. 785*, Order No. 7716 (December 29, 1982), 3 D.C.P.S.C. 450, 557-565 (1982); and see *Potomac Electric Power Company, Formal Case No. 869*, Order No. 9216 (March 3, 1989), 10 D.C.P.S.C. 22, 162 (1989) (outlining the history of the RAR/RAD program).

⁷²³ See D.C. Code § 8-1773.01(13) (2009 Supp.).

⁷²⁴ See, e.g., Tr. 650, 665 (Pepco witness Bumgarner).

(d) The Mayor, pursuant to subchapter I of Chapter 5 of Title 2, may issue rules to modify the assessments under subsection (b) of this section and the programs funded by the EATF.⁷²⁵

366. Although the Commission is currently considering eligibility rules and other aspects of the RAD program in Formal Case No. 813, several RAD issues were designated for consideration in this Pepco rate case.

a. Level of RAD distribution rates (Issue No. 15a)⁷²⁶

367. **Pepco.** The Company proposes no increase in RAD distribution rates. Though the cap on RAD distribution rates expired on August 31, 2009 under the Pepco/Connectiv Merger Settlement Agreement, Pepco argues that any increase in RAD rates would not be appropriate in light of “the current adverse economic climate.”⁷²⁷

368. **AOBA.** AOBA recommends that RAD rates be raised by the “Consumer Price Index for Urban Wage-Earners and Clerical Workers” (“CPI-W”) amount or alternatively one-half of the percentage increase approved for the residential class, whichever is less. AOBA challenges Pepco’s proposed freeze on RAD distribution rates, arguing that the RAD class is already over-subsidized. AOBA recommends that, effective January 1, 2011, RAD charges should be increased by the percentage increase in the CPI-W for the 12 months ended September 2010. Additionally, AOBA recommends a similar RAD adjustment be made each year to the RAD surcharge with the revenues flowed through to all other customers.⁷²⁸

369. **District Government.** DCG urges a freeze on RAD rates.⁷²⁹ It criticizes AOBA’s request for annual increases in RAD rates, arguing that this ignores the state of the economy, historic rate patterns, and the needs of RAD customers. DCG contends that no evidence supports AOBA’s RAD proposal because AOBA failed to undertake any independent study of RAD customer needs, or the support available to RAD customers from non-utility

⁷²⁵ D.C. Code. § 8-1774.11(c), (d) (2009 Supp.) (amended 2010).

⁷²⁶ Designated Issue No. 15a states, “According to the PEPCO/Connectiv Merger Settlement Agreement, the RAD distribution price cap will be lifted on August 31, 2009. Should RAD distribution rates be maintained at the same level or should they be altered as a result of changing revenue requirements from this rate case?”

⁷²⁷ Pepco Br. 108; Pepco (2G) at 8 (Bumgarner); Tr. 574-575, 663 (Pepco witness Bumgarner).

⁷²⁸ AOBA Br. 50-52, 57; AOBA (A) at 103-108 (Oliver); Tr. 815-823 (AOBA witness Oliver). AOBA complains that Pepco’s rationale for freezing RAD rates ignores the substantial benefits the RAD class already receives from a negative class ROR, the freeze on RAD rates ordered in Formal Case No. 1053, and the additional subsidies to RAD customers provided by other customer classes through the Energy Assistance Trust Fund and the RADS surcharge. All customer classes have been hurt by “the current adverse economic climate,” AOBA argues. AOBA (A) at 103-107, 110.

⁷²⁹ DCG Br. 16, 27.

sources, or the impact of its RAD proposals. DCG argues that because unemployment in the District is over 10 percent, median income levels in D.C. fell by over 22 percent in 2009, and low-income families are having difficulties paying their bills; therefore, any proposal to reduce the RAD subsidy “should wait until after the economy turns around.”⁷³⁰

370. DCG suggests that one consideration supporting a RAD freeze is the requirement of the “Clean and Affordable Energy Act of 2008” (“CAEA”) which calls for the Commission to consider the economy and the “the situation of the low-income customers in the District of Columbia and their need for assistance” in setting rates.⁷³¹ DCG asserts that the subsidy should be recovered from other classes of customers through the RAD surcharge, or the EATF, or other mechanisms that the Council may create in the future. DCG urges the Commission to wait until Pepco’s next rate case to assess the various ways in which the RAD discount can be distributed to other classes of customers, especially in light of potential changes in the eligibility standards for Federal LIHEAP and RAD assistance.⁷³²

DECISION

371. In this instance, the options available to the Commission include (1) RAD Simplification: simplifying the RAD rate structure, including possibly increasing the fixed RAD minimum charge, as suggested at the hearings in colloquies between Pepco witness Bumgarner and Commissioners Kane and Morgan;⁷³³ or (2) RAD Rate Freeze: Pepco, the District Government, and WMATA recommend no increase or change in the RAD rate; or (3) Moderate RAD Rate Increase: for example, raising RAD rates by a CPI-W amount or one-half of the percentage increase in residential rates, whichever is less (recommended by AOBAs).

372. The Commission determines that a modest increase in the RAD class revenue requirement is in order, through the application of the new \$2.50 RAD customer charge.⁷³⁴ Our decision to moderately increase RAD distribution revenues, while simplifying and improving the RAD rate structure, considers the economy of the District of Columbia and the community

⁷³⁰ DCG Br. 16-19; DCG R.Br. 5-6; DCG (A) at 27; DCG (2A) at 16-17 (Petniunas).

⁷³¹ See DCG (A) at 18-19 (Petniunas). The statutory text of D.C. Code § 34-808.02 (new CAEA § 401) states: “In supervising and regulating utility or energy companies, the Commission shall consider the public safety, the economy of the District, the conservation of natural resources, and the preservation of environmental quality.”

⁷³² *Id.* at 25-26. “A future mechanism could be a RAD Adjustment Clause to reflect Pepco’s timely collection of the RAD discount due to changes in Federal LIHEAP standards. Whatever the case, Pepco should be allowed to recover the full costs of any revenue discounts attributable to the RAD class by allocating this discount to other classes of customers.” *Id.*

⁷³³ See Tr. 673-687; *Accord* Tr. 1135-1136 (colloquy between Commissioner Morgan and DCG witness Petniunas).

⁷³⁴ See *supra* ¶ 348.

comments we received about the economic difficulties of District residents.⁷³⁵ In this regard, we also note that SOS charges will be decreasing for the period June 1, 2010, through May 31, 2011.⁷³⁶

373. The Company's concern that it "should be allowed to recover the full costs" of any RAD discount (Pepco (G) at 12-13 (Bumgarner)) suggests the need to include an annual "true-up" mechanism for the RAD program. This is an issue that Pepco may raise with the Council for its consideration, along with other key issues regarding the RAD program.

b. RAD surcharge (Issue No. 15h)⁷³⁷

374. **Pepco.** Pepco's original filing requested an increase in the RAD surcharge to recover slightly over \$1 million in unreimbursed RAD discounts that were received by RAD customers during the billing months of December 2007 through September 2008.⁷³⁸ However, the recently-enacted "Residential Aid Discount Subsidy Stabilization Emergency Amendment Act of 2009 ("RADSSEA") authorizes a one-time \$1 million payment to Pepco to cover these RAD costs.⁷³⁹ Pepco indicates that the issue concerning Pepco's recovery of \$1 million in unreimbursed RAD discounts is now moot.⁷⁴⁰

375. **OPC, the District Government, and WMATA** filed no testimony on this issue. **AOBA** agrees with Pepco that the issue is moot because of the new statute.⁷⁴¹

376. **District Government.** However, the District Government raises other tariff design issues for the RAD surcharge. DCG argues that an automatic RAD adjustment clause

⁷³⁵ The CAEA requires the Commission to consider "the economy of the District" in setting rates (*see* D.C. Code § 34-808.02). However, it does not specifically mandate that the Commission consider "the situation of low-income customers in the District of Columbia and their need for assistance." (DCG (A) at 18-19 (Petniunas)). The Commission has considered the situation of low-income Pepco customers as a matter well within its discretionary authority.

⁷³⁶ *See Formal Case No. 1017, In the Matter of the Development and Designation of Standard Offer Service in the District of Columbia*, Order No. 15709 (March 1, 2010) (SOS rates will be reduced by 1.2% effective June 1, 2010).

⁷³⁷ Designated Issue No. 15b asks, "Should the RAD surcharge be adjusted to accommodate Pepco's request to increase the RAD surcharge by roughly \$1 million?"

⁷³⁸ Pepco (G) at 12-13 (Bumgarner).

⁷³⁹ The RADSSEA became effective on July 28, 2009 (D.C. Act 18-155, Bill 18-394).

⁷⁴⁰ Pepco Br. 108. Pepco (2G) at 8-9 (Bumgarner). *Accord* Tr. 655-657, 663 (colloquy between Chairman Kane and Pepco witness Bumgarner).

⁷⁴¹ AOBA (A) at 108 (Oliver).

should be used to compensate Pepco for the RAD subsidy.⁷⁴² DCG explains that its RAD adjustment clause would be “similar to the old utility fuel adjustment clause,” which would trigger quarterly or monthly adjustments to “alleviate the need to wait for an application for an increase in base rates before a change in the RAD income threshold could be implemented. DCG contends that this would also allow the Commission to monitor the subsidy, and ensure that Pepco recovers the subsidy through charges to other classes of customers.”⁷⁴³ DCG argues that its proposed automatic RAD adjustment clause would improve RAD program administration and speed Pepco’s recovery of RAD surcharge amounts, whether federal LIHEAP certification standards for RAD are raised or lowered.⁷⁴⁴

DECISION

377. The specific designated issue here is moot. All the parties agree that the new statute authorizes a one-time \$1 million payment to Pepco to cover its Fiscal Year 2008 unreimbursed RAD costs. We decline to act at this time on the District Government’s request for a RAD adjustment clause, despite the claim that such a clause would allow quicker and easier registration of RAD participants. Except for the new RAD customer charge and changes in energy blocks that we order today, the Commission believes that the *status quo* should be preserved on all other RAD issues until and unless the Commission decides otherwise in Formal Case No. 813 or the Council adopts legislation that further addresses the design, funding, and other issues associated with the RAD program.

c. Impact of any increased participation in RAD from DDOE’s proposed change to RAD eligibility criteria (Issue No. 15c)⁷⁴⁵

378. **District Government.** Tariff language for the RAD program currently states that RAD eligibility is based on federal guidelines for LIHEAP.⁷⁴⁶ Eligibility criteria for LIHEAP give the District Government the option to use either 150 percent of the Federal Poverty Level

⁷⁴² DCG Br. 26-27; DCG (A) at 45 (Petniunas). DCG also argues that its RAD Adjustment Clause would eliminate the flaws in the current RAD surcharge that is levied on a cents per kWh basis, which “penalizes those customers that only have energy rates and benefits those customers with demand and energy rates and that an across the board spread through a RAD Adjustment Clause might be more appropriate.” DCG (A) at 34-35 (Petniunas).

⁷⁴³ *Id.* at 28; DCG (2A) at 19; DCG Br. 26.

⁷⁴⁴ DCG Br. 26-27; DCG (A) at 28, 34-35, 45 (Petniunas); DCG (2A) at 19-21; Tr. 1121- 1122 (DC Government witness Petniunas).

⁷⁴⁵ Designated Issue No. 15c asks, “Should RAD distribution rates or the RAD surcharge be adjusted to accommodate any increase in participation resulting from changing the RAD Utility Discount Program eligibility criterion as recently proposed by DDOE?” (This refers to DDOE’s request to increase the eligibility criterion from 150% of the Federal Poverty Level to 60% of the D.C. Median Income.)

⁷⁴⁶ *See* Tr. 1139-1143 (colloquy between Chairman Kane and DCG witness Petniunas).

(FPL) or a higher income level (qualifying more people for LIHEAP) set at 60 percent (or 75 percent) of state median income (SMI).⁷⁴⁷

379. DCG submits that, in actual DDOE practice, "LIHEAP customers are certified eligible by DDOE at the 60 percent SMI income level," while "RAD customers are certified at the 150 percent FPL income level."⁷⁴⁸ DCG's post-hearing brief indicates that there is currently no legal obstacle that would prevent DDOE from applying LIHEAP standards for eligibility in the RAD program.⁷⁴⁹

380. DCG contends that DDOE wants to increase RAD participation. However, DDOE is concerned about the availability of funding to pay Pepco for any increased RAD subsidy if the number of RAD customers is increased. Accordingly, DCG argues that "the RAD Rider surcharge should be modified to produce the revenue needed by Pepco to fund expected changes in RAD participation levels to meet the LIHEAP certification threshold."⁷⁵⁰ DCG recommends that, if there is an increase in RAD participation, the resulting increase in the cost of RAD class subsidies should be allocated evenly, on an across-the-board basis, among all of Pepco's other rate classes.⁷⁵¹

381. The case for increasing participation in the RAD program was presented by DCG witness Petniunas.⁷⁵² He testified that, historically, the "penetration rate" of the RAD program (i.e., the percent of eligible persons participating in the program) has been about 20 to 30 percent, covering from 8,049 RAD customers (in 1983) to 17,656 RAD customers (in 2008).⁷⁵³

⁷⁴⁷ DCG Br. 21. DCG states that LIHEAP provides grantee jurisdictions, including the District of Columbia, the option of using "150% of the poverty level as the maximum income level allowed in determining LIHEAP income eligibility, except where 60% of state median is higher." D.C. is eligible to use the 60% of state median income criterion because this value is higher than 150% of the federal poverty level. Furthermore, DC has been using the higher 60% criterion for LIHEAP since fiscal year 2007, to enable more District residents to qualify for that program. *Affidavit of Taresa Lawrence*, ¶¶ 6, 7. See also Tr. 1404 (DCG counsel summarizing *Affidavit of Taresa Lawrence* on LIHEAP eligibility). DCG's post-hearing brief states: "Indeed, most likely in response to the recent severe economic downturn, the federal government expanded LIHEAP eligibility for FY 2009, and for the first three months of FY 2010, to 75% of the SMI." DCG Br. 20-21. DCG states that it filed a November 4, 2009 motion in Formal Case 813 to ask that the eligibility criterion for participation in all Utility Discount Programs be tied to "the highest eligibility criterion available" under current LIHEAP guidelines. DCG Br. 21.

⁷⁴⁸ DCG Br. 23. Accord Tr. 1127 (DCG witness Petniunas) and Tr. 1139-1143 (colloquy between Chairman Kane and DCG witness Petniunas) (both suggesting that RAD eligibility is currently pegged to 150% of the Federal poverty level, and that DCG wishes to change the standards for RAD eligibility to 60% of median DC income).

⁷⁴⁹ DCG Br. 2. Accord DCG Br. 21.

⁷⁵⁰ DCG Br. 2. Accord DCG Br. 21.

⁷⁵¹ DCG (A) at 5, 6, 28, 29 (Petniunas).

⁷⁵² See DCG (A) at 26-45 and accompanying exhibits.

⁷⁵³ See DCG (A) at 31-35, 39, Tr. 1123-1126 (DCG witness Petniunas), and DCG (A)-4 (chart showing RAD penetration rates varying between 20 and 30%). Accord Tr. 681-682. According to the District Government, "The

Witness Petniunas stated that the Commission has expressed its desire to increase RAD participation levels, expressing concern that the program “would reach too few low income consumers.”⁷⁵⁴ He further testified that twice before, however, the Commission denied DDOE’s requests to increase RAD participation by changing the program’s income eligibility criteria. According to Petniunas, one set of Commission concerns was that DDOE did not have a plan for expanding the RAD program and did not show a cost benefit analysis, nor did it show any progress in increasing the participation rate of currently eligible RAD customers. He also stated that the Commission was concerned about the “anomalous results of requiring non-participating lower income customers to subsidize benefits for newly eligible customers,” unless all parties do more to increase the number of lowest-income persons served.⁷⁵⁵

382. Addressing these concerns, District witness Petniunas testified that DDOE has done significant outreach work to expand RAD and, because of these activities, there has been a significant increase in the “penetration rate” of the RAD program, particularly during recent years (2006-2008) when the RAD penetration rate increased to an average of 29.6 percent.⁷⁵⁶ Turning to a cost-benefit analysis, the District Government estimates that there might be an increase of as many as 3,500 new RAD customers (each receiving about a \$350 annual benefit) if the income eligibility standard for RAD is set at the old “historical” level of 60 percent of D.C. median income. This would increase the cost of the RAD subsidies paid by all other District customer classes by \$1,227,096 (an overall increase of 0.41 percent in other customers’ bills if spread across-the-board).⁷⁵⁷ Alternatively, the District Government estimates that there would be approximately 7,000 new RAD customers if the income eligibility standard for RAD is set at the level of 75 percent of D.C. median income. The impact on rates would be twice that of moving to 60 percent of D.C. median income.⁷⁵⁸

383. To be sure, DCG acknowledges the Commission’s concerns that roughly 70 percent of eligible RAD consumers apparently are not served under the RAD rate and that non-

ratio of the RAD customers to the LIHEAP eligible customers is the penetration rate, and historically has been about 20%. The program today is tied to LIHEAP only because of its administrative simplicity.” DCG (A) at 32.

⁷⁵⁴ *Id.* at 33.

⁷⁵⁵ *Id.* at 35, citing Commission comments in *Potomac Electric Power Company, Formal Case No. 813*, Order No. 14620 at 5 (November 8, 2007). *See also* Tr. 1125-1126, 1129.

⁷⁵⁶ DCG (A) at 35-38.

⁷⁵⁷ DCG Br. 23-25; DCG (A) at 38-42 and DCG (A)-5 at 8. *But cf.* Tr. 1131-1132 (colloquy between Commissioner Morgan and DCG witness Petniunas). After the hearing, in response to concerns raised by Commissioner Morgan about these calculations, DCG witness Petniunas performed a revised calculation to determine what the revenue impact would be to the non-RAD customers after removing the 3,500 new RAD customers from the revenue base. According to the District Government, the impact on other customers’ bills from increasing RAD participation is still a 0.42% increase for the Residential class, and a 0.41% increase for all other rate classes. DCG Br. 25.

⁷⁵⁸ DCG (A) at 43.

participating lower income customers may be subsidizing RAD customers.⁷⁵⁹ Yet DCG argues that eligibility for the RAD program should be expanded.⁷⁶⁰ Pointedly, DCG argues that the RAD “penetration rate” is misleading and “greatly understates the success of DDOE in reaching RAD-eligible customers,” because the “penetration rate” refers to the ratio of RAD customers to LIHEAP-eligible customers (not RAD-eligible customers). Not all LIHEAP-eligible customers are eligible for the RAD program. In particular, tenants in master-metered apartments (who represent as many as 30 percent of the District’s low-income households) are LIHEAP-eligible, but not RAD-eligible because they are not direct Pepco customers.⁷⁶¹

384. **Pepco.** Pepco witness Bumgarner testified that, if RAD eligibility criteria were set at 60 percent of D.C.’s median income, the RAD program might add 4,385 additional RAD participants, at a cost of \$1.3 million (approximately 60 cents per month additional cost to each non-RAD customer).⁷⁶² He states that if there is an increase in RAD participation, Pepco would need to recover the resulting increased RAD subsidy either through the RAD surcharge or through the EATF surcharge. According to Bumgarner, “the RAD program is inadequately funded through the RAD and EATF surcharges at the present time. A legislative remedy will be needed to address the underfunding of the RAD program through the EATF surcharge provided in the Clean and Affordable Energy Act of 2008.”⁷⁶³

385. **AOBA.** AOBA opposes the expanded availability of subsidized low RAD rates, indicating that “further expansion of eligibility for the Company’s RAD rates will amplify the inmagnitude of existing subsidies and diminish the cost basis for, and equity of, the Company’s overall rates for electric service in the District of Columbia.” AOBA contends that expanding the RAD program as DDOE seeks would make it available to those whose needs for assistance are not as great as current RAD customers. If RAD participation is expanded, AOBA argues, “the only logical step is to allow for reduction of the average benefit provided to RAD customers as the size of the RAD class in terms of numbers is expanded.”⁷⁶⁴

DECISION

386. DCG acknowledges that tariff language for the RAD program currently indicates that RAD eligibility is based on federal guidelines for LIHEAP. Under the statutory and regulatory system today (described above in DCG’s briefs and testimony), DDOE asserts that it could set the eligibility criteria for LIHEAP and (derivatively) for the RAD program at the same

⁷⁵⁹ See DCG Br. 22.

⁷⁶⁰ DCG (A) at 44-45.

⁷⁶¹ DCG Br. 22-23.

⁷⁶² Tr. 637-639 (Pepco witness Bumgarner). *Accord* DCG Br. 21.

⁷⁶³ Pepco Br. 109; Pepco (2G) at 9 (Bumgarner).

⁷⁶⁴ AOBA (A) at 108-109 (Oliver); AOBA Br.52-53.

level. However, DDOE indicates that it seeks Commission approval before it changes DDOE practices about whom to certify as RAD eligible customer (from 150 percent FPL to 60 percent or 75 percent of SMI) to ensure that any expansion in the number of RAD customers is accompanied by adequate funding to pay Pepco for the increased RAD subsidy.

387. The subsidy for RAD customers paid by non-RAD customers is now approximately \$5.4 million per year, according to Pepco's filings. Were the *status quo* changed, to set RAD eligibility at the level of 60 percent of D.C. median income, for example, then approximately 3,500 to 4,385 additional new RAD customers might enter the program, each receiving about a \$350 annual benefit (under the old RAD rates) for a total additional cost of \$1.2 million to \$1.3 million.⁷⁶⁵

388. One interpretation of the EATF-RAD statute, which is disputed and is currently being considered by the Commission in Formal Case No. 813, is that the size and funding limits of the RAD program are set by the Council.⁷⁶⁶ We think it wise to maintain the *status quo* on the RAD program, and to avoid any change in RAD eligibility or participation levels, until we receive further guidance from the Council. Once we obtain further guidance on the RAD program from the Council, the Commission will take appropriate action in Formal Case No. 813.

B. Small Commercial Classes (Issue No. 13a)⁷⁶⁷

1. General Service (GS)⁷⁶⁸

389. **Pepco.** To collect the class revenue target from the General Service (GS) class, Pepco proposes to increase each of the rate components in the current GS rate structure in a roughly proportionate manner.⁷⁶⁹

⁷⁶⁵ See Tr. 637-639 (Pepco witness Bumgarner); DCG (A) at 38-43 (Petniunas); DCG (A)-5.

⁷⁶⁶ Pepco is seeking additional Council legislation on the RAD program, including provisions that would allow annual "true ups" of Pepco's RAD costs, subject to this Commission's review and approval. Tr. 664 (Pepco witness Bumgarner). The Company stated that its preference, in the interest of simplifying matters, would be to have the bulk of the RAD discount paid for by the legislative surcharge, not the regulatory surcharge. Tr. 666-668 (Pepco witness Bumgarner). The Company indicated that it also would consider whether it would be desirable to have the entire RAD funded through a legislative surcharge. See Tr. 668 (Pepco witness Bumgarner).

⁷⁶⁷ Designated Issue 13a asks, "Are the rate designs by classes reasonable?"

⁷⁶⁸ Pepco's General Service rates (GS) include a customer charge as well as energy-delivery charges ("all kilowatt hours") and "surcharges." "GS D LV" customers are subject to customer charges, as well as kWh charges (first 6000 kWh, additional kWh, surcharges) and demand charges (kW) (excess over 25 kW).

⁷⁶⁹ Pepco (2G) at 4-5 (Bumgarner). General Service rates (GS) include a customer charge as well as energy-delivery charges ("all kilowatt hours") and "surcharges." Schedule GS-LV is generally available to secondary voltage customers with average maximum monthly billing demands less than 100 kW. "GS D LV" customers are subject to customer charges, as well as energy-delivery charges (first 6000, additional, surcharges) and demand charges (kW) (excess over 25 kW). See Pepco (G)-2 (PEPCO rate schedules); Pepco (G)-3 (Bumgarner). See also GSA (A) at 7, n.4 (Goins).

390. **AOBA.** AOBA agrees with Pepco and supports keeping the same basic proportions among the component parts of the GS rate design to provide stability and avoid rate shock.⁷⁷⁰

DECISION

391. No party proposes any significant changes to the GS rate components. The Commission orders an across-the-board increase in the GS rate components as the parties agree, to collect the class revenue target. In Pepco's next rate case, consistent with gradualism, the Company is directed to submit proposed GS rate designs that move away from volumetric (energy-delivery) rates and toward a greater emphasis on recovery of GS class revenues through customer and demand charges.

1. Street Lighting (SL) (Issue No. 13e)⁷⁷¹

392. **Pepco.** Pepco proposes to increase the SL "energy-delivery" rate to recover the class revenue target for SL.⁷⁷²

393. **District Government.** Witness Petniunas recommends that the SL rate schedule be frozen (or that any increase be limited to at most the Commission approved average percentage increase for all customers).⁷⁷³ DCG contends that to recover Pepco's proposed 211 percent revenue increase from the SL class, the Company would increase the Standard Night Burning rate to a rate that is 74 percent greater than the current 24-hour Burning rate. DCG asserts that through this proposed increase, Pepco effectively seeks to rob the D.C. Department of Transportation ("DDOT") of the benefits of its significant efforts to achieve energy efficiency by shifting its load exclusively to night-burning only lamps.⁷⁷⁴

394. Tariff changes suggested by DCG include updating the power outage rates that are now stated in the SL and TS tariffs.⁷⁷⁵ DCG argues that other outdated information in the SL and TS tariffs also should be eliminated, in particular, the references to old 1970s manuals about "Policy and Procedure for Providing Street Lighting Service in the District of Columbia" and "Policy and Procedure for Providing Traffic Signal Service in the District of Columbia."⁷⁷⁶

⁷⁷⁰ AOBA (A) at 94-95 (Oliver).

⁷⁷¹ Designated Issue 13e asks, "Is Pepco's proposed change in rate design to the rate schedule for Street Lighting (SL) reasonable?"

⁷⁷² See Pepco (2G) at 4-5 (Bumgarner).

⁷⁷³ DCG (A) at 5 (Petniunas).

⁷⁷⁴ DCG Br. 13.

⁷⁷⁵ See *id.* at 23.

⁷⁷⁶ *Id.* at 23-24.

DECISION

395. DCG criticizes the tariff language that mathematically sets the Standard Night Burning and 24-hour Burning rates.⁷⁷⁷ However, the mathematical figures in the SL rate tariffs are based on the class revenue target and will be adjusted by Pepco to reflect whatever the Commission decides about the SL class revenue requirement.

396. Tariffs for SL should eliminate unnecessary references to outdated 1970s policy manuals. Ordinarily, we would expect Pepco to resolve these kinds of tariff issues as a matter of good customer relations. The Commission encourages Pepco and DCG to redesign SL rates in the future so that they are not “energy only” rates. We direct Pepco to conduct an up-to-date study of power outage rates in the SL and TS tariffs. This study also should examine other DCG complaints about the way Pepco includes the costs of AMI smart meters (allegedly irrelevant to SL) and 24-hour Burning streetlights (now eliminated by DCG) in the SL rate.⁷⁷⁸ The study should be part of Pepco’s next base rate case.

2. Traffic Signals (TS) (Issue No. 13f)⁷⁷⁹

397. **Pepco.** Traffic Signal (TS) like Street Lights are “energy-delivery” rates. Pepco’s proposal increases the “energy-delivery” rate to recover the class revenue target for the TS class.⁷⁸⁰

398. **District Government.** Witness Petniunas recommends no increase for the TS rate schedule or, at most, the Commission-approved average increase for all customers.⁷⁸¹ Though the District Government suggests that the SL and TS tariffs might be redesigned so that they are not “energy only” rates, witness Petniunas indicates that he is not advocating a demand rate for the SL and TS rate schedules at this time.⁷⁸²

⁷⁷⁷ See DCG Br. 12. DCG states that it has eliminated all 24-hour Burning streetlights. However, DCG does not ask that the 24-hour Burning rate be deleted from Pepco’s tariffs. There seems to be no harm in retaining this tariff language. (There might be a “straggler” 24-hour Burning streetlight, and the higher 24-hour rate encourages DCG to switch its streetlights to the lower Standard Night Burning rate.)

⁷⁷⁸ See DCG Br. 8-9.

⁷⁷⁹ Designated Issue No. 13f asks, “Is Pepco’s proposed change in rate design to the rate schedule for Traffic Signals (TS) reasonable?”

⁷⁸⁰ Pepco (2G) at 5 (Bumgarner).

⁷⁸¹ DCG (A) at 5 (Petniunas).

⁷⁸² *Id.* at 22.

399. Tariffs proposed for traffic signal service contain a 1.5 percent reduction in monthly bills to account for “normal” power outages. DCG complains that this is an outdated figure that was calculated over 25 years ago and ignores DDOT’s significant annual spending to mitigate the risks of Pepco power outages. DCG avers that in the past three years it has spent over \$3.5 million to procure backup emergency generators, as well as \$1.2 million in uninterruptible power supply investments (with an additional \$2 million budgeted for implementation in the near future), and about \$400,000 annually in personnel costs to respond to traffic signal power outages.⁷⁸³ According to DCG, traffic signal service tariffs proposed by Pepco also improperly fail to make a reduction for the time traffic signals operate off-peak.⁷⁸⁴

400. **Pepco Rebuttal.** The Company stated that its TS rate contains a 1.5 percent reduction, calculated more than 25 years ago, that is intended to adjust the energy billing for power outages. However, Pepco denies that there is any basis for comparing this 1.5 percent “outage discount” with the millions of dollars that DCG spends each year to maintain traffic signals in the District.⁷⁸⁵

DECISION

401. As with SL, tariffs for TS should eliminate unnecessary references to old 1970s policy manuals, and Pepco and DCG should seek to design TS rates in the future so they are not “energy-only delivery” rates.

402. The power outage rates for TS tariffs, and whether Pepco adequately accounts for power outages in the TS rate, is a matter of contention between the District Government and Pepco. The Commission therefore directs Pepco to conduct an up-to-date study to determine what the appropriate power “outage discount” should be for TS. The same study should examine the merits of DCG’s complaint that traffic signal service rates improperly fail to make a reduction for the time traffic signals operate off-peak. The study should be submitted as part of Pepco’s next rate case.⁷⁸⁶

403. Although DCG is prudent in ensuring an uninterruptible power supply for its traffic signals and street lights, the Commission finds that these expenditures do not warrant any reduction in Pepco’s SL/TS rates. DCG has no greater claim than any other customer or customer class to flawless power service.

⁷⁸³ DCG Br. 14-15.

⁷⁸⁴ DCG Br. 15-16.

⁷⁸⁵ Tr. 1411-1412 (Pepco witness Bumgarner).

⁷⁸⁶ See DCG Br. 15-16.

C. Large Commercial Classes (Issue No. 13a)⁷⁸⁷

1. GT

404. **Pepco.** Pepco would apply an across-the-board increase to the current GT rate structures to collect the class revenue target from the large commercial classes (GT).⁷⁸⁸

405. **AOBA.** AOBA agrees with Pepco's proposal to increase the component parts of the GT rate schedule in "a roughly proportionate manner." This will provide stability and avoid rate shock.⁷⁸⁹

DECISION

406. No party disputes Pepco's proposal to leave GT rate components unchanged, and to increase them in a roughly proportionate manner to collect the GT class revenue target. The Commission adopts the unanimous view of the parties. In Pepco's next rate case, however, the Company is directed to submit proposed GT rate designs that move away from volumetric (energy-delivery) rates and toward a greater emphasis on recovery of GT class revenues through customer and demand charges.

2. Standby Service (GT-3A-S)(Issues 13c, 13d)⁷⁹⁰

407. **Pepco.** Under Pepco's proposal, the only standby customer on its system is GSA's central heating and refrigeration plant ("CHP facility").⁷⁹¹ Pepco argues that this one customer's "unique load characteristics," notably the "much lower load factor" and the "lower

⁷⁸⁷ Designated Issue No. 13a asks, "Are the rate designs by classes reasonable?"

⁷⁸⁸ Pepco (2G) at 5 (Bumgarner). Schedule GT-LV is generally available to secondary voltage customers with maximum demands of at least 100 kW. The GT-LV rate is structured to include customer charges, demand charges (kW) ("on peak," "maximum"), energy-delivery charges (on peak, intermediate peak, off peak) and surcharges. Schedule GT-3A is available to primary voltage customers with maximum demands of 100 kW or greater. (GSA's combined heat and power ("CHP") facility, a central heating and refrigeration plant, is one of approximately 145 customers that are currently billed under Schedule GT-3A.) The GT 3A rate includes a customer charge, demand charges (kW) ("on peak" and "maximum"), energy-delivery charges (on peak, intermediate peak, off peak), and surcharges. The same rate structure holds for "GT 3B" rates (sometimes called GT-HV 69 kV), which cover WASA's Blue Plains facility. See Pepco (G)-2 (Pepco rate schedules); Pepco (G)-3 (Bumgarner); GSA (A) at 7-8 n.4, 19 (Goins).

⁷⁸⁹ AOBA (A) at 94-95 (Oliver).

⁷⁹⁰ Designated Issue No. 13c asks, "Is Pepco's proposal to eliminate the current Standby Service Schedule S tariff reasonable?" Issue No. 13d asks, "Is Pepco's proposed Standby Service Schedule GT-3A-S tariff properly designed?"

⁷⁹¹ See GSA (A) at 7, 19 (Goins). Technically, the new standby rate (GT-3A-S) will apply only to primary voltage standby customers with average loads exceeding 100 kW that would generally be billed under Schedule GT-3A. *Id.* at 7. Cf. GSA (B) at 11-12 (Goins).

contribution to cost of service from the Plant relative to all other members of the GT-3A class" caused by the operation of its cogeneration facility, merit a separate rate classification in the new GT-3A-S.⁷⁹² According to the Company, this new rate schedule provides a fair cost-reflective rate and reflects PJM and Pepco requirements for interconnected operation of this customer's generator. Pepco indicates that the cost of service for the GT-3A-S customer was calculated in the same manner as for the other two current single customer classes, Metro and WASA's Blue Plains' facility. Each component of the present GT-3A rate was given an equal percent increase to arrive at the proposed new GT-3A-S rate. According to Pepco, this single-customer tariff addresses the interest of the Company, standby customers, and all other customers of Pepco.⁷⁹³ Pepco contends that the impact of the new GT-3A-S tariff would be to increase this one customer's annual charges by \$90,555, "revenue that other customers on Schedule GT-3A will not have to bear."⁷⁹⁴

408. The Company also proposes to eliminate its old schedule S for standby customers. Within its new Schedule S, Pepco proposes to replace what it characterizes as its old difficult-to-calculate Facilities Charge (calculating the carrying costs of the plant that provides standby service) with a simplified monthly calculation based on the actual metered usage of the standby service.⁷⁹⁵ The Company's new Standby Service S tariff generally would be required for customers with behind-the-meter generation that is operated, not for emergency use, but instead in parallel with Pepco's delivery system for normal operations.⁷⁹⁶ New Standby Service S would not cover smaller customers generating less than 100 kW. Pepco indicates that either the Company or an alternate supplier would need to provide full Generation requirements. Pepco notes that under the new Schedule S, customers would be billed on net usage and would need metering and communication equipment that allows the Company to monitor and meter the output of the customer's on-site generation.⁷⁹⁷

⁷⁹² Pepco Br. 104-105; Pepco (G) at 9 (Bumgarner); see Pepco (G)-1. Pepco states that the load factor of GSA's CHP plant is less than half that of the GT-3A class customer with the next lowest factor, and about 25% of the average for the class. "Its contribution to cost of service (on a rate of return basis) on the existing rate was 42% less than the contribution of all other members, and will still be 26% below the average contribution of those customers under the new tariff." Pepco Br. 104-105.

⁷⁹³ Pepco (G) at 9-10. Pepco clarified Schedule GT-3A-S "to indicate that [it] is applicable to customers who would otherwise qualify for GT-3A, but for the requirement for Standby Service." Pepco (2G) at 4; see Pepco (2G)-1 (revised tariff GT-3A-S).

⁷⁹⁴ Pepco (G) at 11.

⁷⁹⁵ Pepco Br. 103-104; Pepco (G) at 12. "All that is required for the customer to estimate his costs under the rider is an estimate of the load that the generator will serve." *Id.*

⁷⁹⁶ The requirement that new Standby S customers have on-site generation that "operates in parallel with the Company's delivery system" excludes customers with on-site generation used primarily for emergency purposes (such as hospitals, water pumping stations, and telephone facilities). Pepco (G) at 11-12.

⁷⁹⁷ Pepco (G) at 10-11; see also Pepco (2G) at 3-4.

409. **AOBA.** AOBA does not oppose the creation of a new GT-3A-S tariff for Pepco's one and only existing standby customer. However, AOBA argues that Pepco's tariff is too limited. AOBA submits that other potential users of standby service might include those who do not take service at primary voltage or those who might seek standby service for forms of renewable generation. To account for the possibility that such customers might wish to take Standby Service in the future, AOBA recommends that Pepco "be directed to develop a parallel rate offering for customers having 'behind the meter generation' that do not take service at primary voltage."⁷⁹⁸

410. **GSA.** GSA requests the current Standby Service Schedule S be left in place and opposes the new GT-3A-S tariff.⁷⁹⁹ The only customer that would be covered by the new GT-3A-S tariff is GSA's fossil-fired CHP cogeneration facility that serves Federal buildings in the District of Columbia.⁸⁰⁰ According to GSA, Pepco is currently recovering more than its cost of serving GSA's CHP standby facility, and will recover even more under its proposed standby Schedule GT-3A-S.⁸⁰¹

411. GSA contends that the origin of Pepco's proposed new GT-3A-S rate is the Company's interpretation of a Maryland PSC ruling barring Pepco from applying a "facilities charge" to standby customers for facilities that were not specifically installed to provide standby service.⁸⁰² According to GSA, this Maryland ruling is already embodied (in effect) in Pepco's D.C. current tariffs for standby service. GSA indicates that it benefits from this because it installed its own interconnection facilities and equipment upgrades to facilitate cogeneration operations at its CHP plant; consequently, GSA's CHP plant incurs no "facilities charge."⁸⁰³

The current Schedule S appropriately provides for the instance where a standby customer invests its own resources in interconnection facilities and necessary

⁷⁹⁸ AOBA (A) at 96 (Oliver). *Accord*: Tr. 789-790 (AOBA witness Oliver) ("The Company has, from my perspective, slowed or impeded the development of onsite generation by putting customers through a very difficult process of proving that they don't need additional facilities when there are no additional facilities required.")

⁷⁹⁹ GSA Br. 6, 14, 15; GSA R.Br. 2, 5; GSA (A) at 9, 25, 27, 27-8 (Goins).

⁸⁰⁰ *See* Tr. 1190-1191, 1198 (GSA witness Goins).

⁸⁰¹ GSA (A) at 22; GSA (B) at 12; GSA Br. 12; GSA R. Br. 4. GSA claims that Pepco now recovers \$74,000 (23%) more than the Company's standby cost of serving GSA's CHP facility, and this over-recovery would increase to \$95,000 (25%) under the proposed Schedule GT-3A-S. GSA (A) at 22; GSA (B) at 12.

⁸⁰² GSA Br. 9-10; GSA R.Br. 3-4.

⁸⁰³ Ordinarily Pepco would charge a standby customer like GSA under rate schedule GT-3A with an adjustment to reflect "a credit for the monthly facilities charge paid under Schedule S." The facilities charge is "for special facilities which Pepco builds in order to service a standby customer." GSA Br. 6; GSA R. Br. 3. However, "there would be no facilities charge for GSA's CHP facility, because Pepco was not required to build special facilities to service this customer's standby load." GSA Br. 8; GSA R.Br. 3-4.

equipment upgrades to support the standby service it receives from Pepco. The revision Pepco has proposed does not recognize customer investments⁸⁰⁴

GSA challenges Pepco claims as weak *post hoc* rationales.⁸⁰⁵ In particular, GSA argues that there are no “unique load factors” that justify the creation of this unusual new stand-alone rate class: “[e]ach GT-3A customer has a load factor that likely differs from the class’s average load factor – the load factors of some customers are higher than the class average and some are lower.”⁸⁰⁶

412. GSA also claims that the proposed GT-3A-S rate is overpriced and discriminatory and will create non-cost-based barriers to customers developing independent generating capability.⁸⁰⁷ GSA submits that this would be contrary to the Commission’s stated policy that “distributed generation” should be encouraged and that “the future development of DG [distributed generation] is crucial to electric reliability in the District of Columbia.”⁸⁰⁸

413. GSA witness Goins expressed particular concern that Pepco’s rate designs should not discourage investments in new distributed generation facilities.⁸⁰⁹ He testified that eventually a 10 percent to 20 percent discount off of cost-based rates may be appropriate for distributed generation facilities like GSA’s steam plant.⁸¹⁰ GSA stated that it is contemplating a major initiative to install solar generation in buildings in the District of Columbia and

⁸⁰⁴ GSA R. Br. 4.

⁸⁰⁵ GSA argues that there is no merit in Pepco’s claim that current standby schedule S creates undue burdens in calculating a facilities charge because GSA’s CHP facility is the only customer covered by the current standby schedule S and GSA’s CHP facility has no facilities charge. GSA Br. 8-9; GSA 2.

⁸⁰⁶ GSA Br. 10-12; GSA (A) at 21. GSA states Pepco’s two other single customer rate classes - GT-RT (Metro) and GT-3B (Blue Plains) - are distinguishable from the situation of its CHP facility. *Id.* at 19-20; GSA Br. 7.

⁸⁰⁷ GSA (A) at 22 (Goins); GSA (B) at 12. GSA claims that “Pepco has an incentive as a monopoly supplier of distribution service to set the price of standby service as high as possible to discourage DG investments that might lower its distribution revenues and earnings.” GSA (A) at 23. *Accord* GSA Br. 13; Tr. 1187-1188 (GSA witness Goins).

⁸⁰⁸ GSA (A) at 24-25, citing *Formal Case No. 1053*, Order No. 14712, ¶ 421. GSA states that “DG resources may create environmental and distribution-related benefits, including capacity upgrade deferrals, reliability enhancements, and equipment life extensions.” The Commission said in *Formal Case No. 1053* that “[w]hen DG is fully planned and deployed, long-term distribution benefits should be taken into account, and a discounted “standby” rate should be calculated. *Id.* But GSA states that Pepco’s proposed new GT-3A-S rate reflects none of these values. GSA (A) at 24.

⁸⁰⁹ See GSA Br. 13 (a 2007 FERC report cited standby rates as one of the most common rate-related impediments to distributed generation); Tr. 1189, 1192, 1196-1197 (GSA witness Goins).

⁸¹⁰ Tr. 1194 (GSA witness Goins).

recommends that the Commission develop rate designs that encourage development of solar energy and other distributed generation.⁸¹¹

414. If the Commission decides to approve a new GT-3A-S rate, GSA argues that the rate should be set at a “cost-based benchmark” that is no higher than Pepco’s cost of providing standby service as determined from its CCOSS. GSA contends that this cost-based benchmark -- calculated on the basis of “backing out the interclass subsidy component of the rate” and imposing a \$95,000 reduction in test year revenues for the new GT-3A-S class -- would neither promote nor hinder the development of distributed generation.⁸¹²

415. Based on this premise, GSA proposes an alternative GT-3A-S standby rate as follows:

<u>Distribution Charge</u>	<u>Rate</u>
Customer	\$72.59 per month
Energy	\$0.00688 per kWh
Maximum kW	\$4.19 per kW

GSA states that, since its alternative standby rate “reflects no interclass revenue subsidy, customer, demand, and energy charges under the alternative rate are approximately 20 percent lower across the board” for its GT-3A-S rate.⁸¹³ GSA notes that its proposal involves only a 20.93 percent increase for the GSA steam plant, as opposed to Pepco’s proposed 23.38 percent increase.⁸¹⁴

DECISION

416. The Commission rejects Pepco’s new standby tariff GT-3A-S and maintains the current standby Service Schedule S with Pepco’s “facilities charge.” The *status quo* shall be preserved, pending further study by the Commission on how best to structure Pepco’s standby rates for cogeneration facilities.

417. The Commission is committed to ensuring that Pepco’s rates do not discourage the development of distributed on-site generation.⁸¹⁵ Consistent with our Formal Case No. 1053 decision, a Working Group will be established to discuss all standby tariff issues.⁸¹⁶ Pepco

⁸¹¹ Tr. 1198-1200, 1192 (GSA witness Goins).

⁸¹² GSA Br. 14; GSA (A) at 25-28.

⁸¹³ *Id.* at 27; GSA Br. 14.

⁸¹⁴ See Tr. 1177-1181 (GSA witness Goins).

⁸¹⁵ See Tr. 1192-1199, especially Tr. 1196-1197 (colloquy between Commissioner Morgan and GSA witness Goins).

⁸¹⁶ See Order No. 14712, ¶ 421.

should chair the Working Group meetings. The Commission encourages the parties to discuss the standby tariff issues and to propose the appropriate credit for cogeneration and other distributed generation facilities in the District of Columbia. The goal of the Working Group shall be to develop an appropriate standby tariff which can be applied to both GSA facilities and other distributed generation. An initial report from the Working Group is due 120 days from the date of this Order.⁸¹⁷

418. The Commission also directs (as the Maryland PSC has done) that Pepco's D.C. tariffs (Schedule S) shall not allow Pepco to charge cogeneration customers a "facilities charge" if those customers spend their own money to build the interconnection facilities and equipment upgrades needed to support a cogeneration facility. This directive hereby formalizes Pepco's current practice vis-à-vis GSA's CHP facility and ensures that self-funded cogeneration facilities are not discouraged by the imposition of a "facilities charge" in the District of Columbia.

3. GT-3B (WASA's Blue Plains Facility)

419. WASA's Blue Plains facility is the sole customer served under Schedule GT-3B, which is sometimes referred to as the GT-HV 69 kV rate.⁸¹⁸ WASA argues that a 29.3 percent decrease in WASA's rates (instead of Pepco's proposed 37.7 percent increase) is required to eliminate the subsidy presently paid by WASA.⁸¹⁹ WASA does not seek any change in the structure or relative importance of the rate components of the GT-3B tariff rate schedule, however.⁸²⁰

DECISION

420. The Commission's rulings on the class revenue target for the GT-3B rate appear above at p. 118 *supra*. Once the class revenue target is determined, there is no dispute about Pepco's proposed across-the-board approach to adjusting the rate components of the GT-3B rate to collect that class revenue target. The Commission approves that approach for this case. However, the Commission directs the Company to propose in its next rate case GT-3B rate designs that move away from volumetric (energy-delivery) rates toward a greater emphasis on recovery of GT-3B class revenues through customer and demand charges.

⁸¹⁷ See Order No. 14712, ¶ 420 ("When [distributed generation] is fully planned and deployed, long-term distribution benefits should be taken into account, and a discounted "standby" rate should be calculated.").

⁸¹⁸ WASA (A) at 6 (Phillips).

⁸¹⁹ WASA Br. 3, 9; WASA (A) at 14-16.

⁸²⁰ The GT-3B rate (sometimes called the GT-HV 69 kV rate) includes a customer charge, demand charges (kW) ("on peak" and "maximum"), energy-delivery charges (on peak, intermediate peak, off peak), and surcharges. See Pepco (G)-2 (Pepco rate schedules); Pepco (G)-3 (Bumgarner); GSA (A) at 7-8 n.4, 19 (Goins).

2. Metro-RT⁸²¹

DECISION

421. WMATA's issues are addressed by the Commission's rulings on the class revenue target for the Metro-RT rate where WMATA focused its advocacy. Once the class revenue target for Metro-RT has been determined, there is no dispute about Pepco's proposed across-the-board approach to adjusting the rate components of the Metro-RT rate to collect that class revenue target. As previously pronounced, Pepco, in its next rate case should propose Metro-RT rate designs that move away from volumetric (energy-delivery) rates toward a greater emphasis on recovery of Metro-RT class revenues through customer and demand charges.

XIII. TARIFF CHANGES (Issue No. 14)⁸²²

A. Tariff Schedule CG-SPP: Impact of the Clean and Affordable Energy Act (CAEA) and final rules on Small Generator Interconnection Standards (Issue No. 14a)⁸²³

422. **Pepco.** Pepco's Tariff Schedule CG-SPP allows qualifying cogeneration/small power production facilities ("QF") to sell their electricity output, either as wholesale electricity providers in the PJM market or through a bilateral contract with another purchaser. Such arrangements for the sale by a QF of its output in the wholesale energy market go beyond the net energy metering rules proposed by the Commission, which specify that the electricity output of the facility is "to be purchased by" Pepco at the retail rate.⁸²⁴ Pepco claims that "no revision is required to Schedule CG-SPP due to the issuance of the interconnection rules for small generators in Formal Case No. 1050" because the coverage of tariff CG-SPP already is broader than what is required by the Commission's net energy metering rules.⁸²⁵

423. Pepco notes that other Pepco tariffs may be affected by the new CAEA statute. The Company submits that, after the Commission issues final net metering rules in Formal Case

⁸²¹ Metro-RT rates have a customer charge as well as energy-delivery charges ("all kWh," surcharges) and demand charges ("all kW").

⁸²² Designated Issue No. 14 asks, "Are Pepco's proposed tariff changes reasonable?" OPC takes no position in this case on Issue 14. OPC (F) at 7 (Smith).

⁸²³ Designated Issue No. 14a asks, "In view of the CAEA requirements to increase the net metering size and issuance of the final rules in Small Generator Interconnection Standards in *Formal Case No. 1050*, should Schedule CG-SPP be modified? If so, what should be the modification?"

⁸²⁴ Pepco (2G) at 6 (Bumgarner).

⁸²⁵ *Id.* at 6-7; Pepco Br. 107.

No. 945 to reflect the impact of the CAEA statute, it will submit a revised Net Energy Metering Rider (NEM), consistent with the new rules, for Commission approval.⁸²⁶

DECISION

424. The Commission finds that there is no immediate need to amend Pepco's CG-SPP tariff. However, throughout the hearings, several parties suggested that Pepco needs to formulate new tariffs that encourage and support the development of solar energy and scattered onsite generation.⁸²⁷ As indicated herein, the Commission will establish a Working Group to discuss the standby tariff issues in Formal Case No. 1050.

B. CAEA's requirement to allow submetering for non-residential rental units (Issue 14b)⁸²⁸

425. **Pepco.** To allow submetering as required by the CAEA, Pepco proposes to modify its tariffs in Section 2(e) of its General Terms and Conditions.⁸²⁹

426. **AOBA.** To avoid what it characterizes as misleading non-residential customers who may not be aware of the fact that they now have the option of utilizing either sub-metering or energy allocation equipment in their buildings, AOBA recommends the following amendment to Section 2(e) of Pepco's General Terms and Conditions:

Electric service furnished to the Customer shall be for the Customer's own use and may only be re-metered or sub-metered by a Non-residential Customer as authorized under Title VII- Submetering Provisions of the Clean and Affordable Energy Act.⁸³⁰

The Company states that it has no objection to this language.⁸³¹

⁸²⁶ Pepco Br. 106; Pepco (2G) at 5-6.

⁸²⁷ See, e.g., Tr. 1189, 1192, 1196-1199 (GSA witness Goins); Tr. 789-790 (AOBA witness Oliver). See also *Formal Case No. 1053*, Order No. 14712, ¶ 420 (when [distributed generation] is fully planned and deployed, long-term distribution benefits should be taken into account, and a discounted "standby" rate should be calculated).

⁸²⁸ Designated Issue No. 14b asks, "What changes to the tariffs are needed in order to address the CAEA requirement to allow submetering for non-residential rental units?"

⁸²⁹ Pepco (2G) at 7 (Bumgarner); see Pepco (2G)-2 ("General Provisions for Electric Service and Facilities") (tariff language) at Second Revised Page No. 8 (general ban on submetering amended by adding the language "except as authorized under Title II- Submetering Provisions of the CAEA").

⁸³⁰ AOBA (A) at 97-99 (Oliver).

⁸³¹ Pepco Br. 107.

DECISION

427. We agree with AOBA's proposed tariff amendment to correct Section 2(e) of Pepco's General Terms and Conditions, containing Pepco's general ban on submetering, modified as follows:

Electric service furnished to the Customer shall be for the Customer's own use and may be re-metered or sub-metered only by a Non-residential Customer as authorized under Title VII- Submetering Provisions of the Clean and Affordable Energy Act.

C. Temporary Service rate customers (Issue No. 14c)⁸³²

428. The Commission asked Pepco to clarify some basic facts about the Schedule T customer class in this case e.g., why is the T class characterized by large variations in kWh usage, as well as wide variations (ranging from less than a year to many years) in the time period during which customers remain and take service in this class? The Commission earlier concluded that the varying nature of usage patterns and length of service do not make this customer class suitable for the BSA at this time.⁸³³

429. **Pepco.** The Company proposes a new five-year maximum time limit for serving customers under its Temporary Service (T) rate. The T rate is designed to cover the higher cost of providing service to facilities during construction or to installations that are temporary. Pepco indicates that, in some cases, the application of the tariff relies on judgmental interpretations by field personnel as to what is temporary in nature. For instance, some customer installations on non-permanent foundations, such as parking lot kiosks, were originally classified as Temporary Service, but have persisted for many years." Pepco agrees that there should be a time limit on the application of Schedule T, and it proposes five years as a reasonable time limit.⁸³⁴

430. **AOBA.** AOBA supports Pepco's proposed five-year maximum time limit for serving customers under the Temporary Service (T) rate. AOBA indicates that, as of December 2008, there were 209 T class customers, three-fourths of whom (*i.e.* 153 out of 209) had been in

⁸³² Designated Issue No. 14c asks, "Does Pepco properly classify and bill Temporary Service rate customers? Should the Temporary Service rates (Schedule T) be changed? Should there be a maximum time period established for 'Temporary Service' rates?"

⁸³³ See Formal Case No. 1053, Order No. 15556, ¶ 51.

⁸³⁴ Pepco Br. 107; Pepco (2G) at 7-8 (Bumgarner); see Pepco (2G)-3 (tariff language) ("However, customers receiving Temporary or Supplemental Service on a continuous basis for five (5) years will normally be transferred to the appropriate General Service Low Voltage Schedule "GS LV" or "GS ND" based on the customer's maximum demand, in accordance with the availability provisions therein. Rate schedule transfers will be made annually and become effective with the billing month of June.") OPC takes no position on Issue 14 concerning Temporary Service customers. OPC (F) at 7 (Smith).

that service class for less than 5 years, and over 63 percent of whom had been on Rate T for less than 3 years. On the other hand, more than 20 percent of T customers have been on that service for greater than 10 years. According to AOBA, this suggests that the vast majority of T customers employ that service for temporary requirements; yet significant numbers have used Rate T essentially for permanent service.⁸³⁵ AOBA recommends that the tariff language for Rate T be reviewed, to “eliminate all references to ‘supplementary service,’ and thereby be more clearly limited to service that is of a temporary nature (e.g., construction projects, carnivals, and festivals).”⁸³⁶

431. The Company stated that it has no objection to amending the tariff removing language about “supplemental load” from its T tariff.⁸³⁷

DECISION

432. We approve the tariff amendment for T service as proposed by incorporating a five-year maximum time limit for serving customers under the T rate and eliminating references to “supplemental load.”

⁸³⁵ AOBA (A) at 99-100 (Oliver).

⁸³⁶ *Id.* at 100-101.

⁸³⁷ Tr. 1413 (Pepco witness Burngarner).

XIV. OTHER MATTERS

A. Community Comments

433. More than 125 community witnesses submitted comments or testified at the Commission's community hearings in this Pepco rate case.⁸³⁸ Their comments went beyond protesting higher Pepco rates, an overarching concern, to highlighting other important community concerns for the Commission's consideration.

1. Objections to Higher Pepco Rates, Requests for a 50 percent Rollback in Rates, a Moratorium on All Shutoffs, and Community Hearings on Three Successive Saturdays

434. Several senior citizens living in the District reference OPC's objections to the Company's proposed \$51.7 million rate increase.⁸³⁹ OPC's one-page flyer, attached to several senior citizens' comments, argues that Pepco is seeking to shift business risks to consumers, with no guarantee that service quality will be improved. Nor has Pepco explained how consumers will be educated to use a wave of future technologies, such as smart meters. The comments recite the flyer's statement that residential rates in the District have increased by 98 percent. Other senior citizens submit related comments stating that they were living on fixed incomes, and that increasing the cost of electricity would mean even less income available for other necessities. They complain that Pepco's service is increasingly poor. While power outages affected neighborhoods around the city, and neighbors were complaining about the accuracy of their meters, they stated that it was difficult to reach Pepco service representatives.

435. Testimony on behalf of the District's seniors was presented by Shirley C. Thorne, a member of the Ward 8 Mini Commission on Aging, Jacqueline Arguelles, Chair of the Commission on Aging for D.C., and Ann Wilcox, Executive Director of the Gray Panthers of Metropolitan Washington. They requested that the Commission deny Pepco's rate increase

⁸³⁸ "Both ANCs [Advisory Neighborhood Commissions] as entities and ANC Commissioners as individuals may be heard by the PSC as part of the public at large." *Office of People's Counsel v. Pub. Serv. Comm'n*, 630 A.2d 692, 697 (D.C. 1993). The Commission is not required to give "great weight" (or any special weight) to advice it receives from ANCs in rate cases. *Id.* The Commission listens carefully to all public comments, however. We have carefully reviewed and considered all the comments from community witnesses, which are summarized in this section of the Opinion and Order, in determining Pepco's rate application.

⁸³⁹ OPC's one-page flyer (a "public notice alert" captioned "OPC opposes Pepco's \$51.7 million rate increase bid, calls for decrease in Pepco's current rates by \$10.4 million") was attached to written statements submitted by senior citizens Jay Johnson, Lawondua Jones, Tunisha Robinson, Ptasker Bennett, Carrie Sasberg, Diane Jackson, and Mary Wood. The Commission received similarly worded, or identical, letters of protest (without the OPC flyer) from senior citizens Renee Green, Josephine Givens, Anita C. Green, Joe Shelton, Thomas Perry, Elba Corley, Laura Malheur, Parnell Blas, Sean M. Leaked, Bonnie Day, Antoinette Cheek, Allan Breuer, James Crowell, Selena Brooks, Agnes L. Branch, Harriet D. Key, Hazel S. Whitby, Gwendolyn Goyhill, Evelyn C. Young, Roy Black, and Georgia Robinson.

because of its impact on nearly 100,000 fixed-income seniors living in the District.⁸⁴⁰ Two disabled District residents, Darnise Henry-Bush and Edward Durham, oppose Pepco's rate increase because of its impact on the working poor, fixed-income disabled persons, and the unemployed.⁸⁴¹ Graylin Presbury, President of the Fairlawn Citizens Association (east of the Anacostia River), echo OPC's opposition to a Pepco rate increase, noting the importance of electricity in modern life and the impact of a rate increase on fixed income ratepayers.⁸⁴²

436. The Commission also received many comments demanding a 50 percent rollback in Pepco's rates, a moratorium on all shutoffs, and community hearings on Pepco's proposed rate increase on three successive Saturdays.⁸⁴³ These comments emphasize that these are difficult economic times for ordinary citizens. While Pepco's rates have doubled in the last five years, they noted, workers' wages have not. The unemployment rate in the District of Columbia has doubled in the last two years. They state that electricity is a basic necessity, essential to good health and well-being in modern society. They oppose Pepco's proposed \$51.7 million (6.1 percent) rate increase, pointing out that Pepco's 2008 Annual Report states that Pepco/PHI has a strong financial condition with \$10.7 billion in PHI revenues, \$300 million in PHI profits, \$170 million in federal stimulus money, \$140 million in tax refunds, and a 2008 salary for the Chairman and CEO of Pepco Holdings of over \$9 million.⁸⁴⁴ Pepco also recently received a \$44.6 million award in federal funds for its AMI smart meter activities.⁸⁴⁵ They complain that

⁸⁴⁰ See Community Hearing Tr. 63-67 (Jacqueline Arguelles), Tr. 98-100 (Ann Wilcox) (November 20, 2009); Community Hearing Tr. 40 (Shirley C. Thorne) (November 19, 2009) and her written testimony to the Commission (November 19, 2009). *Accord* Community Hearing Tr. 108 (Melinda Everett, Consumer Utility Board), Tr. 110-112 (Commissioner Janet Myers, ANC 4C02) (November 20, 2009); Community Hearing Tr. 38 (Ashly Sauers, Baltimore ANSWER), Tr. 39 (Phillip Haughton) (November 19, 2009).

⁸⁴¹ See Community Hearing Tr. 22-26 (Darnise Henry-Bush), Tr. 36-39 (Edward Durham) (November 20, 2009).

⁸⁴² See Community Hearing Tr. 46-50 (Graylin Presbury) (November 19, 2009).

⁸⁴³ These sentiments were voiced by many people, including, among others, Crystal Kim who testified and submitted written comments on behalf of Justice First. See Community Hearing Tr. 11-15 (October 24, 2009); Community Hearing Tr. 11-15 (November 19, 2009); Community Hearing Tr. 5-10 (November 20, 2009). A one-page flyer from Justice First was also submitted for the record. Other residents and commenters also identified themselves as volunteers for, or supporting the views of, Justice First. See Community Hearing Tr. 16-24 (Caneisha Mills, representing the Party for Socialism & Liberation), Tr. 26-28 (Jonathan Miller, who also submitted a written statement), Tr. 29-32 (Matthew Murray, who also submitted a written statement), Tr. 36-37 (Natasha Persand, who also submitted a written statement) (November 19, 2009); Community Hearing Tr. 46-49 (Ronald Sheffer) (November 20, 2009). See, e.g., Community Hearing Tr. 17-21 (Sarah Sloan, Washington, D.C., speaking for the ANSWER Coalition), Tr. 57-58 (Elizabeth Lowengard, with the ANSWER Coalition), Tr. 104 (David Schwartzman) (November 20, 2009).

⁸⁴⁴ Objections to the high salaries and bonuses of Pepco's CEO and other top Pepco employees were strongly expressed by several people. See, e.g. Community Hearing Tr. 33 (Sarah Sloan), Tr. 45 (Esteban Olivaro) (November 19, 2009); Community Hearing Tr. 32-34 (Commissioner Gigi Ransom, ANC 5C12), Tr. 69 (Evanna Powell); Tr. 71-74 (David Borrows), Tr. 76 (Sinelle Freeman), Tr. 90 (Commissioner Jacqueline Mitchell, ANC 4C), Tr. 103-104 (David Schwartzman) (November 20, 2009).

⁸⁴⁵ See Community Hearing Tr. 17 (Chairman Kane) (November 20, 2009).

Pepco is seeking a rate increase simply to increase the Company's profits. They state they were "in vehement opposition to Pepco's proposed rate hike."

437. Yvonne Moore, Chair of ANC 7B, opposes any Pepco rate increase. Observing that Commission public hearings should be scheduled to avoid conflict with ANC meetings, she questions the quality of Pepco's service in her neighborhood on issues relating to brown outs, cut backs in electrical power, and Pepco's response time. She indicates that Pepco should tighten its belt rather than be given a rate increase.⁸⁴⁶

DECISION

438. The Commission's decision in this case sets Pepco rates at levels that fairly balance the interests of both ratepaying consumers and Company investors. In deciding the specific designated issues, we have taken into consideration a wide variety of factors, and in all our decisions, we have always considered the economy of the District and the impact of our determination on ratepayers.

439. We note also that the Commission has convened a separate case to examine issues raised by Pepco's implementation of its smart meter program.⁸⁴⁷ One of the issues in that case will be how Pepco can best insure that consumers are educated to handle the coming wave of future technologies.

440. Traditionally, the Commission has held three community hearings for each of its formal rate cases: one in the daytime on a weekday, one in the daytime on a Saturday, and one in the evening during the week.⁸⁴⁸ Given the large number of public comments submitted in this Pepco rate case, the Commission will consider holding additional public comment hearings in future Pepco rate cases.

2. Quality of Pepco's Service in the District of Columbia

441. Two commercial customers complained about the quality of Pepco's service, particularly power outages and system reliability. The American Association for the Advancement of Science (AAAS), which owns a 200,000 square foot building in the District, stated that it experienced five power outages in just over a year – each of which caused equipment failures and other damage to its property. AAAS states that Pepco has no effective communication program and relies instead on an "outage" map to explain where outages are

⁸⁴⁶ See Community Hearing Tr. 9-10 (November 19, 2009) and Yvonne Moore's written statement (November 9, 2009).

⁸⁴⁷ See Community Hearing Tr. 71 (November 20, 2009) (comments of Chairman Kane).

⁸⁴⁸ See Community Hearing Tr. 113- 114 (November 20, 2009) (comments of Chairman Kane).

occurring and when they will be corrected. AAAS asks that "Pepco be required to provide a plan of action to correct these issues as part of any approved increase to their rates."⁸⁴⁹

442. Similar comments were submitted by Akridge, which manages over 6 million square feet of office space in downtown Washington, D.C. Akridge indicates outages and service interruptions have undercut productivity, and damaged its telephone equipment, network services and other equipment. Akridge complains that Pepco lacks a plan of action to ensure greater network reliability and better communication with its commercial customers:

We need accurate and timely information from Pepco in order to implement contingency plans during service interruptions. An explanation from Pepco regarding weather related, specific equipment failures, or maintenance repairs that interrupt service and the Company's plan of action and timetable on the restoration of service is critically important information for all customers. Pepco needs to provide a strategy where the commercial sector can receive real-time information regarding any outage and the Company's plans for repairs and restoration of service. This plan must include direct personal points of contact for the downtown commercial sector.

Akridge urges the Commission to require Pepco to provide a plan that addresses these concerns.⁸⁵⁰

443. The Company's individual customers also criticize its poor service.⁸⁵¹ Testimony by Graylen Presbury, President of the Fairlawn Citizens Association, for example, indicates that Pepco's service has been declining, resulting in outages damaging appliances, and long waiting times when customers call Pepco to ask questions or report an outage.⁸⁵² Ruth Connolly, Chair of the citywide Tenant Advisory Council, also criticizes Pepco's service record on outages and long delays in restoring service.⁸⁵³ Augusto Moreno testified about the adverse impact of a Pepco service interruption at his apartment, affecting his 70-year-old-mother who needs

⁸⁴⁹ AAAS's letter to the Commission (November 19, 2009). AAAS's letter also stated: "Because we cannot depend upon Pepco, we are investigating investing in larger generation (at significant expense), and other options to ensure continuity of service. It is unacceptable for the power supply system in the District of Columbia to be as unreliable as it has become."

⁸⁵⁰ Akridge letter to the Commission (November 19, 2009).

⁸⁵¹ See, e.g., Community Hearing Tr. 18-19 (Caneisha Mills) (November 19, 2009).

⁸⁵² See Community Hearing Tr. 50 (Graylin Presbury) (November 19, 2009).

⁸⁵³ See Community Hearing Tr. 31-32 (Ruth Connolly) (November 20, 2009).

electrical power to operate a medical device.⁸⁵⁴ Other commenters also briefly state that there are too many outages.⁸⁵⁵

444. Commissioner Gale Black, ANC 4A08, speaking for the Crestwood Citizens Association and ANC 4A08, criticizes Pepco's service reliability. Opposing the Company's rate increase, she states that Pepco customers in Crestwood have experienced longer and more frequent outages and "sags." She states further that this has damaged motors, disrupted telecommunications, and threatened the health of people using medical equipment. Ms. Black contends that Crestwood is served by Pepco feeder line 15197, which is the worst performing line in the city. Taking a look at a cross-section of North American Utilities, surveyed by Best Practices Group, Ms. Black states that Pepco's System Average Interruption Frequency Index (SAIFI) was 17th out of 23 ranked utilities. Using another indicator, the large city reliability survey, Pepco ranked 12th out of 19 utilities. The survey said that for calendar year 2006 Pepco's SAIFI rating was 13, compared to a 1.1 average rating for other North American utilities. Crestwood residents question why Pepco cannot improve reliability and lower costs, as Commonwealth Edison is doing. Ms. Black urges the Commission to "adopt a reliability index with performance measures and accountability." While supporting smart meters and smart grids, Crestwood residents question whether they will see any cost benefit if they change their usage patterns to off peak times. The Company is better able to bear the cost of Pepco's infrastructure upgrades, said Ms. Black, than seniors and residents on fixed incomes.⁸⁵⁶

445. These comments by Commissioner Black are supported by ANC 4A as a whole. After hearing from representatives of Pepco and OPC, as well as neighborhood residents, ANC 4A voted to oppose Pepco's requested rate increase, for three major reasons. First, thousands of homeowners represented by ANC 4A may be adversely impacted by a Pepco rate increase. Second, there are many seniors, living on fixed income, residing in 4A who may not be able to afford an increase. Third, ANC 4A stated that Pepco did not adequately justify an increase. OPC and Pepco presented conflicting, offsetting evidence. Pepco is attempting to shift some of its operational financial burdens and risks to consumers, without guaranteeing improved service. In particular, "ANC 4A questions why consumers must bear the brunt of current and future retirement fund losses to Pepco retirees. Many ANC 4A residents have had adverse impacts to their retirement funds without a safety net or someone else to shoulder the burden or risk."

⁸⁵⁴ See Community Hearing Tr. 44-45 (Augusto Moreno) (November 20, 2009).

⁸⁵⁵ See, e.g., Community Hearing Tr. 80-81 (Sandra Mitchiner), 84-85 (Joyce Robinson-Paul, Hanover Area Civic Association, lower Shaw area of D.C.).

⁸⁵⁶ See Community Hearing Tr. 49-57 (November 20, 2009) (comments of Gale Black, President of the Crestwood Citizens Association and ANC 4A08 Commissioner). The Commission's Chairman noted that the Commission has updated its "consumer bill of rights" as well as the standards for electric quality of service and natural gas quality of service. She stated that the Commission also is receiving monthly outage reports from Pepco. *Id.* Tr. 56-57 (comments of Chairman Kane) (citing Commission *Formal Case No. 982, Electricity Quality of Service Standards*).

Pepco did not fully explain the stimulus funds it recently received. Moreover, Pepco's services have not appreciably improved since the last rate increase.⁸⁵⁷

446. "Crestwood is plagued by outages and unscheduled service interruptions," according to comments submitted by the Crestwood Neighborhood League ("League"). Apart from major outages, "everyone regularly experiences short losses of service, as evidenced by the persistent need to reset clocks and electric devices on a monthly and frequently weekly basis." Televised news reports, neighbors and elected officials report a pattern of "erratic" Pepco service in the larger Washington community, with "room for much improvement in the quality of service being offered." Taking into account the limited ability of consumers to pay more, the League supports OPC's position seeking a \$15.76 million reduction in Pepco's requested increase. They seek "steady, reliable service" at a reasonable rate.⁸⁵⁸

447. Commissioner Lenwood Johnson, ANC 1A, complains of electric power outages in southwestern Columbia Heights. Opposing the rate increase, he states that Pepco should be ordered to spend more money on solving outages and upgrading infrastructure.⁸⁵⁹ One District resident indicates that she would like to avoid "the kinds of horror stories that have showed up" and that she would like to keep her bills "about the same."⁸⁶⁰

DECISION

448. While the Commission already has several proceedings investigating Pepco's service quality and reliability, given these widespread complaints from the public about the quality of Pepco's service, service quality issues could be ripe for consideration in Pepco's next rate case.⁸⁶¹ The Commission will review Pepco's plans to address outages, reliability and improved service throughout the City. We should be aided in this task by the fact that we have already adopted electric quality of service standards, and we are now receiving monthly outage reports from Pepco.⁸⁶² According to the community comments we received in this case, two areas in particular are in need of improved service; downtown Washington D.C. and the Crestwood area in Ward 4.

⁸⁵⁷ Chair Stephen A. Whatley, ANC 4A, letter to the Commission (December 9, 2009).

⁸⁵⁸ Ronald P. Bland, President, Crestwood Neighborhood League, letter to the Commission (December 21, 2009).

⁸⁵⁹ Community Hearing Tr. 86-88 (November 20, 2009) (comments of ANC Commissioner Lenwood Johnson, ANC 1A).

⁸⁶⁰ See Community Hearing Tr. 7-8 (October 24, 2009) (Deborah Fort).

⁸⁶¹ The Commission already is considering issues about Pepco's reliability in *Formal Case Nos. 766, 982 and 1002* among others. In *Formal Case No. 766*, in particular, we are considering Pepco's efforts to improve its customer average interruption duration index (CAIDI) and its system average interruption duration index (SAIDI).

⁸⁶² See Community Hearing Tr. 56-57 (November 20, 2009) (comments of Chairman Kane).

3. Consumer Education to Use Smart Meters, Smart Grid Initiatives

449. Other District residents like Barbara D. Morgan complain (among other things) that Pepco has not explained how consumers/ratepayers will be prepared and educated for a wave of future technologies, such as smart meters and the Smart Grid.⁸⁶³

450. Carlos Bright opposes Pepco's rate increase, as a disabled individual living on a fixed income. He questions why Pepco could not improve reliability and lower its costs. He supports the Smart Grid, but questions "whether there will be any financial benefit for us, if we adjust our uses to off-peak times. How will the costs of these new technologies be allocated?"⁸⁶⁴

451. In response to Evanna Powell's concern over whether and when smart grid/smart meters would be able to turn off her air conditioning, Chairman Kane stated that Pepco's load control programs would be voluntary.⁸⁶⁵

DECISION

452. The Commission has opened a separate case (Formal Case No. 1056) to examine Pepco's smart meter program. There we will address the proper structure of associated voluntary load control programs, how Pepco plans to use the \$44.6 million in federal grant money it is receiving for its AMI smart meter programs, and the need for public information and education about these new technologies and programs.⁸⁶⁶

4. Pepco's Pension Costs and Other Expenditures

453. Mary Rowse and Jeff Hart complain that the Company's pension costs and other expenditures were too high. Opposing any rate increase, they suggest that Pepco might transfer its pension risk to its employees by offering them defined contribution, instead of defined benefits plans. They also suggest that Pepco should defer capital outlays and improvements to its network "until the capital markets have normalized and the cost of capital for Pepco is closer to historic norms."⁸⁶⁷

⁸⁶³ Written Statement of Barbara D. Morgan (November 19, 2009).

⁸⁶⁴ Carlos Bright letter to the Commission (December 2, 2009).

⁸⁶⁵ See Community Hearing Tr. 69-70 (Evanna Powell), Tr. 71 (Chairman Kane) (November 20, 2009).

⁸⁶⁶ See Community Hearing Tr. 71 (November 20, 2009) (comments of Chairman Kane).

⁸⁶⁷ Email from Mary Rowse and Jeff Hart to the Commission (November 6, 2009).

454. Advisory Neighborhood Commission 4A submits objections to ratepayers paying for pension losses suffered by Pepco employees, as noted above,⁸⁶⁸ and by Annie Winborne, a long-time member of the Consumer Utility Board.⁸⁶⁹

DECISION

455. The Commission's decision on Designated Issue No. 8 determines that traditional rate-making treatment, and not a surcharge or other special treatment, is appropriate for Pepco's pension costs, OPEB, and uncollectible expenses. We specifically considered community comments in reaching that decision.⁸⁷⁰ Testimony submitted by Pepco in this case made it clear that the Company has postponed many capital outlays and improvements during these difficult economic times.⁸⁷¹

5. Green Energy

456. David Schwartzman, representing the D.C. Statehood Green Party and D.C. Metro Science for the People, opposes Pepco's use of coal fuels. "Greater use should be made of wind turbines and renewable energy sources." To remedy high Pepco rates, he suggests the "municipalization" of Pepco's assets in the District. He also supports the views of OPC and Justice First, citing the regressive nature of utility bills, high unemployment levels in D.C., and the "depression" (not merely a recession) in the economy here in the District of Columbia.⁸⁷²

DECISION

457. Our currently-pending cases address a number of "green" initiatives. The Commission is committed to consider the conservation of natural resources in our regulation of Pepco and all other public utilities in the District. Today's decision considers the economy of the District of Columbia and awards Pepco less than half of the increase it requested.

⁸⁶⁸ Chair Stephen A. Whatley, ANC 4A, letter to the Commission (December 9, 2009).

⁸⁶⁹ See Community Hearing Tr. 42 (Annie Winborne) (November 20, 2009).

⁸⁷⁰ See *supra* ¶ 195.

⁸⁷¹ See, e.g., Pepco's Application at 4-5 ("To address the impacts of the economic and financial crisis, the Company implemented significant cost containment measures, including a freeze on salaries for non-union employees, a cap on staffing levels, and postponement of several million dollars of capital expenditures."); Pepco (a) at 4-5 (Kamerick).

⁸⁷² See Community Hearing Tr. 101-107 (David Schwartzman) (November 20, 2009).

6. Support for Pepco

458. The Company's proposed rate increase was supported by several residents as necessary to ensure safe and reliable electric service in the District of Columbia. Two District residents, James Lively, formerly an ANC Commissioner for 10 years, and Saymendy Lloyd, state that Pepco's rate increase is needed to improve service and address outage/reliability issues, as well as to improve equipment, participate in "smart grid" initiatives, and maintain Pepco's standing with rating agencies. Mr. Lively compliments Pepco on its community involvement and its development of a July 1, 2009 plan for addressing outages in Ward 3. The objective of this proceeding, he notes, is fair, just and reasonable rates.⁸⁷³

459. Marc Barnes supports Pepco's increase to facilitate the installation of smart meters and other measures to reduce costs, conserve energy and protect the environment.⁸⁷⁴ Linda Perkins similarly supports Pepco's rate increase as a means to improve energy efficiency, with programs such as the Compact Fluorescent Program and the Smart Grid Initiative. She stresses the need for outreach and education to make sure that consumers actually benefit from these programs.⁸⁷⁵

460. Commissioner Reverend Thomas Alston, ANC 7C06, supports Pepco's proposed rate increase as necessary to meet the increased costs of providing safe and reliable electric service. The Company's administrative and operational costs have spiraled upwards, and the cost of capital has increased. Pepco must be able to demonstrate its financial health in order to access needed capital, he states, and it needs money to maintain its poles, wires and other equipment. Reverend Alston notes that Pepco is educating consumers about energy efficiency and that recently-received stimulus funds of \$168.1 million will help ordinary customers monitor and save on electricity.⁸⁷⁶

461. Barbara Lang states that Pepco has undertaken significant cost containment measures, freezing salaries, capping staffing levels, and postponing several million dollars of capital expenditures. She states that Pepco has improved the reliability of its service in Ward 3. While the cost of capital and energy is rising, she notes that Pepco's responsibility to provide safe and reliable service has remained constant. This is only the second distribution rate increase the Company has proposed since 1995. To save ratepayers money, she points out that the Company recently applied for (and obtained) some \$44 million in federal funding for AMI meters to allow customers to manage their own energy use efficiently.⁸⁷⁷

⁸⁷³ See Community Hearing Tr. 51-56 (James Lively) (November 19, 2009); written comments of James C. Lively (November 19, 2009); Community Hearing Tr. 59-62 (Saymendy Lloyd) (November 20, 2009).

⁸⁷⁴ Written Statement of Marc Barnes (October 24, 2009).

⁸⁷⁵ Written Testimony of Linda Perkins (October 24, 2009).

⁸⁷⁶ Written Testimony of Reverend Thomas Alston (December 3, 2009).

⁸⁷⁷ See Community Hearing Tr. 11-17 (Barbara Lang) (November 20, 2009).

DECISION

462. The Commission's decision in this case sets Pepco rates at levels that fairly balance the interests of both ratepaying consumers and Company investors.

B. Motions to Correct Transcript

463. To correct typographical errors, garbles, misspellings, and other errors, Pepco filed a motion on November 18, 2009, to correct the transcript of the Commission hearings held from November 9 through November 13, 2009. No party opposes these proposed corrections. Accordingly, the Commission grants Pepco's motion to correct the transcript.

XV. FINDINGS OF FACT AND CONCLUSIONS OF LAW

464. Based on the evidence of record in this proceeding, the Commission makes the following findings of fact and conclusions of law:

- a. That Pepco's proposed test year ending December 31, 2008, is reasonable;
- b. That Pepco's use of a 13-month average rate base is reasonable;
- c. That Pepco's District of Columbia rate base for the test period is \$1,010,267,000;
- d. That a fair rate of return (including capital costs and capital structure) on Pepco's District of Columbia rate base is 8.01 percent;
- e. That the Commission's earlier decision, approving a 50 basis point reduction in Pepco's return on equity as part of the approval of the Company's Bill Stabilization Adjustment ("BSA"), continues to be reasonable;
- f. That Pepco shall be allowed to earn a cost of common equity, including the BSA adjustment of 50 points, of 9.625 percent;
- g. That Pepco's cost of long-term debt is 6.63 percent;
- h. That the level of return when the 8.01 percent rate of return is applied to the adjusted rate base of \$1,010,267,000 is \$80,922,000;
- i. That Pepco's adjusted District of Columbia net operating income of \$69,317,000 for the test-year was deficient by the amount of \$11,606,000;
- j. That the adjustment which would increase Pepco's test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order is \$19,833,000, which includes a proper allowance for taxes (*see* attached Schedules);
- k. That the capital structure proposed by Pepco to develop its overall cost of capital is reasonable and appropriate for this proceeding;
- l. That the Commission approves as reasonable the following uncontested ratemaking adjustments (RMA) affecting Pepco's Rate Base, which were proposed by Pepco and either stipulated or accepted by the parties:

Ratemaking Adjustment No. 2 ("RMA No."), CWIP in Rate Base;
RMA No. 3, Annualization of Northeast Substation;
RMA No. 5, Exclusion of Supplemental Executive Retirement Plans;
RMA No. 12, Reflection of FC 1076 Costs;

RMA No. 19, Annualization of Software Amortization;
RMA No. 20, Annualization of Deductible Mixed Service Cost Tax Method;
RMA No. 21, Exclusion of Capitalized Portion of Disallowed F.C. No. 939 Costs;
RMA No. 22, Reflection of Disallowance of Incentive Plan Costs;
RMA No. 24, Inclusion of Deferred Customer Education Costs; and
RMA No. 29, Reflection of New Method-Repair Categorizations.

m. That \$886,640 Retirement Work in Progress (RWIP) for Benning Road relocation has been removed from Pepco's Rate Base and the remainder of RMA No. 4 is accepted;

n. That \$635,000 should be removed from rate base, reflecting the retired portion of Pepco's 69 kV Emergency Overhead Feeders, and that Pepco is entitled to recover its costs plus a return on the remaining cost of those Emergency Overhead Feeders, which shall be reflected in Pepco's Rate Base as "emergency capitalized spare";

o. That to safeguard the safety and reliability of the electric distribution system in this area, Pepco shall not dismantle or remove what remains of the 69 kV Emergency Overhead Feeders, without first obtaining prior explicit Commission permission to do so;

p. That Pepco's Rate Base should include accruals recorded in accordance with Generally Accepted Accounting Principles;

q. That the Company's depreciation allowance (Issue No. 6) shall be calculated as specified by the Commission in this Opinion and Order. Among other things, we direct Pepco to adopt (1) the net salvage method that minimizes the collection of future inflation from current customers; and (2) SFAS 143 present-value calculations using formulas from Maryland Case No. 9092 and using inflation-based discount factors that Mr. Majoros presented and Pepco accepted (*see* Pepco (3F)-7). The Company is also directed to record scrap salvage as salvage and to resume recording capitalized third-party reimbursements as salvage and to resume crediting them into Account 108 (Accumulated Provision for Depreciation);

r. That the Commission approves as reasonable Pepco's Cash Working Capital requirements (originally a contested issue, but resolved in the hearings);

s. That weather normalization and its associated annualization of revenues should be calculated as directed by the Commission in this Opinion and Order;

t. That the Commission approves as reasonable the following uncontested Company ratemaking adjustments (RMA) affecting Pepco's test year Operating Income and Expenses:

RMA No. 2, Inclusion of Projects Completed and In Service;
RMA No. 3, Annualization of NE Substation Cut In;
RMA No. 5, Exclusion of Supplemental Executive Retirement Plans;
RMA No. 6, Exclusion of Industry Contributions and Membership Fees;
RMA No. 7, Exclusion of Advertising and Selling Expense;

RMA No. 8, Inclusion of Interest Expense on Customer Deposits;
RMA No. 10, Reflection of Non-Deferred Regulatory Costs at 3-Year Average Amount;
RMA No. 12, Formal Case No. 1076 Outside Counsel/Consulting Deferred Costs;
RMA No. 18, Reflection of Change in PSC and OPC Budget Assessment;
RMA No. 19, Annualization of Software Amortization;
RMA No. 21, Reflection of FC939 Disallowance;
RMA No. 22, Reflection of Disallowance of Incentive Plan Costs;
RMA No. 23, Removal of Adjustments to Deferred Compensation Balances; and
RMA No. 24, Inclusion of Deferred Customer Education Costs.

u. That Pepco's RMA No. 28, proposing regulatory asset treatment and amortization of its 2009 pension costs, is rejected;

v. That Pepco's proposed surcharge for pension, OPEB and uncollectible expenses (Issue No. 8) is rejected, as is Pepco's proposed regulatory asset for these costs (Issue No. 8a);

w. That the Company's pension and OPEB expenses should be treated as described in this Opinion and Order, which (among other things) accepts OPC's two-year average method for treating Pepco's pension expenses, for this case only;

x. That Pepco's allowance for uncollectible expenses, the subject of Pepco RMA No. 16, will be recognized as reasonable as directed in this Opinion and Order, in the form of a two-year average for this case only;

y. That Pepco's RMA No. 13, proposing an annualization of wage increases, is accepted with the caveat that the recognized wage increase shall be limited to 1.5 percent;

z. That Pepco's RMA No. 14, concerning 2009 employee health and welfare costs, is accepted as reasonable;

aa. That the Company's start-up costs and annual maintenance fees incurred for ensuring access to PHI's credit facility, the subject of Pepco's RMA No. 9, are allowed as reasonable recurring test year operating expenses;

bb. That Pepco's deferred costs from Formal Case No. 1053, the subject of Pepco's RMA No. 11, should be treated as directed in this Opinion and Order, using the mid-point unamortized balance (equal to a 13-month average balance) for the first year of the rate effective period;

cc. That Pepco's proposed allowance for storm restoration expenses, the subject of Pepco RMA No. 17, is approved as reasonable; and that Pepco should report and document its incremental storm damage costs quarterly, when it files its quarterly reports of its weather normalized jurisdictional earned returns;

dd. That Pepco's RMA No. 27 for interest synchronization is approved as reasonable but must reflect the rate base and the weighted cost of debt approved in this Order;

ee. That Pepco employee club costs are removed from Pepco's test year operating expenses, as OPC proposed in its RMA No. 12;

ff. That the cost of Pepco's officers and directors liability insurance is accepted as a reasonable test year operating expense;

gg. That Pepco's on-going recurring "Utility of the Future" costs are accepted as reasonable test year operating expenses;

hh. That OPC's proposed Consolidated Tax Adjustments (Issue No. 10) are rejected;

ii. That the adjustment for bonus depreciation (and interest synchronization) that Pepco and OPC agreed upon, to show the actual amount (rather than a preliminary audit amount) of bonus depreciation that Pepco received for 2008, is reasonable;

jj. That PEPCO's proposed treatment of income taxes and other tax expenses, including those related to the operating budgets of the Commission and OPC, is reasonable and consistent with Commission precedent;

kk. That Pepco's 2007 and 2008 AMI start-up costs amounting to \$911,000 should be capitalized, and amortized over 15 years;

ll. That Pepco's jurisdictional cost allocations (based on its established AED-NCP methodology) are reasonable;

mm. That Pepco's customer class revenue targets and rate designs shall be determined as directed in this Opinion and Order, making moderate progress toward reducing interclass subsidies and reducing the disparities that now exist in class rates of return;

nn. That the Residential Customer Charge shall be increased to \$6.65, while the volumetric (energy-delivery) rates in Residential distribution charges shall be reduced, so that the Residential class pays no more than 36 percent of the total revenue increase, or the class revenue target of \$7.14 million (approximately a 17.5 percent increase);

oo. That the Residential Aid Discount (RAD) rate structure shall be simplified and clarified, as set forth in this Opinion and Order, while still according RAD customers a very sizable discount compared to regular Residential customers (standard R and AE). The Commission finds that the following RAD rate structure is just and reasonable: The old RAD and RAD-AE "minimum charge" shall be replaced with a new \$2.50 RAD Customer Charge. The old RAD 30 kWh/370 kWh rate blocks will be replaced with a single new initial RAD 400 kWh rate block. Tailblock energy rates for RAD and RAD-AE shall be adjusted as directed in this Opinion and Order, so that they are the same as the corresponding tailblock rates for

standard R and AE and, overall, the RAD class revenues to be recovered from all RAD kWh rates will remain the same as they are now;

pp. That except for the changes we direct to RAD rate structure, the *status quo* should be preserved on all other RAD issues, until and unless the Commission decides otherwise in Formal Case No. 813 or the Council adopts legislation that further addresses the design, funding, and other issues associated with the RAD program. Pepco's request for an increase in the RAD surcharge is moot, in light of the statutory compensation given to PEPCO for its previously unreimbursed RAD costs by the Residential Aid Discount Subsidy Stabilization Emergency Amendment Act of 2009 (D.C. Act 18-155) (July 28, 2009);

qq. That an approximate 17.5 percent increase in the class revenue requirement for the streetlight class (SL and TS rate schedules), the same increase that is being imposed on the Residential class, is reasonable;

rr. That the Company's proposed methodology is reasonable for distributing among the commercial classes the remaining revenue burden of its revenue increase (*i.e.*, the overall \$19.833 million D.C. jurisdictional rate increase minus the \$7.14 million increase allotted to the Residential class minus the increase allotted to Streetlights and Traffic Signals);

ss. That increasing the Customer Charge for Residential Time-of-Use customers from \$9.09 to \$11.17 is reasonable;

tt. That tariffs for Street Lighting (SL) and Traffic Signals (TS) should be updated as directed in this Opinion and Order; that the District Government's expenditures to ensure uninterrupted power for its traffic signals and street lights do not warrant a reduction in Pepco's SL/TS rates; that Pepco should conduct an up-to-date study of SL/TS costs as directed in this Opinion and Order; and that Pepco and the District Government should seek to design SL and TS rates in the future so they are not "energy-only delivery" rates;

uu. That Pepco's proposal to delete its current Standby Rider, and to create a new "GT-3A-S" tariff that would apply to customers with behind-the-meter generation that runs in parallel with the Company's delivery system, is unreasonable and is rejected. The GT-3A rate is to be set as directed in this Opinion and Order. The Company's D.C. tariffs (Schedule S) shall be clarified to formalize Pepco's current practice vis-à-vis GSA's CHP facility and ensure that a "facilities charge" is not imposed on cogeneration customers that spend their own money to build the interconnection facilities and equipment upgrades needed to support a cogeneration facility. The Company is directed to convene a Working Group to discuss the standby tariff issues in *Formal Case No. 1050*. The Working Group report is due 120 days from the issuance of this Opinion and Order;

vv. That PEPCO's other proposed rate designs for other customer classes (GS, GT including GT-3B, and Metro-RT), generally increasing each rate component within each customer class rate by an "across-the-board" amount to reach the target revenue requirement for that customer class, are reasonable in this case, although in its next rate case Pepco is directed to

submit proposed rate designs that move away from volumetric (energy-delivery) rates and toward a greater emphasis on recovery of class revenues through customer and demand charges to collect its "wires only" distribution costs;

ww. That tariff language in Section 2(e) of Pepco's General Terms and Conditions, containing Pepco's general ban on submetering is amended as provided for in this Opinion and Order;

xx. That tariff language for Temporary Service shall be amended, as the parties agree, to incorporate a five-year maximum time limit for serving customers under the T rate, and to eliminate language about "supplemental load"; and

yy. That the separate Commission case (Formal Case No. 1056) examining "smart meter" issues will consider the proper structure of associated voluntary load control programs, how Pepco plans to use the \$44.6 million in federal grant money it is receiving for its AMI smart meter programs, and how Pepco can best ensure that consumers are educated to handle the new AMI programs and the coming wave of future technologies.

THEREFORE, IT IS ORDERED THAT:

465. On Pepco's District of Columbia rate base of \$1,010,267,000 for the test year, a fair and reasonable rate of return (including capital costs and capital structure) is 8.01 percent;

466. The adjustment that would increase Pepco's test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order is \$19,833,000, which includes a proper allowance for taxes;

467. Pepco is directed to file with the Commission quarterly reports of its weather normalized, jurisdictional earned returns. The reports should cover Pepco's most recent quarter and the year ending in that quarter, and provide both Pepco's earnings on average total capital and Pepco's earnings on average common equity. The reports (including workpapers) shall be filed with the Commission within 60 days following the end of each quarter. The reports shall document Pepco's incremental storm damage costs;

468. The motion of AOBA to exclude Pepco cross examination exhibits 11, 12, and 13, and to correct the transcript to show that these Pepco exhibits were never formally admitted into evidence, is **GRANTED**;

469. The motions of AOBA and the District Government to file their reply briefs one day late, on December 23, 2009, are **GRANTED**;

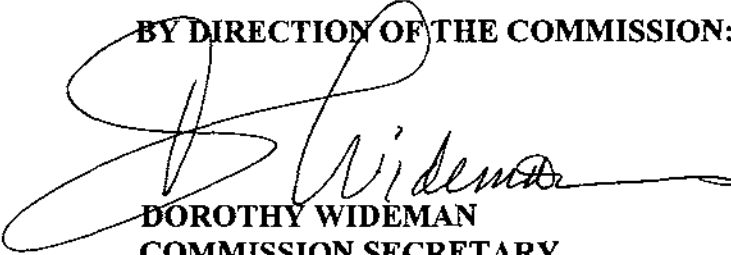
470. The motions of Pepco and OPC to correct the transcript are **GRANTED**; and

471. PEPCO is directed to file revised rate schedules and supporting exhibits, consistent with this Opinion and Order, no later than March 16, 2010. Rates authorized by this Opinion and Order shall be effective on March 23, 2010, at 12:01 a.m., unless otherwise ordered by the Commission.

A TRUE COPY:

CHIEF CLERK:

BY DIRECTION OF THE COMMISSION:



DOROTHY WIDEMAN
COMMISSION SECRETARY

DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION

Docket: FC-1076
Schedule 1Potomac Electric Power Company - District of Columbia Division

Twelve Months Ending December 31, 2008

Revenue Requirements

(in thousands)

Line	Description (A)	PEPCO-DC Adjusted (D)	Adjustments (C)	Adjusted Totals (D)
1	Rate Base			
2	Electric Plant in Service	\$ 2,133,573	\$ (635)	\$ 2,132,938
3	Accumulated Depreciation	(728,501)	4,011	(724,490)
4	Accumulated Amortization	(6,719)		(6,719)
5	Additions:			
6	Materials and Supplies	20,434		20,434
7	Cash Working Capital	12,194		12,194
8	Prepaid Pension / OPEB Liability (net of tax)	43,618	(9,825)	33,793
9	Pepco Portion of Servco Assets	4,161		4,161
10	Unamortized Credit Facility Costs	143		143
11	Unamortized Customer Education Costs	2,483		2,483
12	Unamortized Blueprint costs	759	121	880
13	Unamortized Case Costs	3,043	(487)	2,556
14	2009 Pension Asset Unamortized Balance	3,164	(3,164)	-
15	Subtractions:			
16	Accumulated Deferred Income Taxes	(448,762)	152	(448,610)
17	Customer Deposits	(19,495)		(19,495)
18	Total Rate Base	\$ 1,020,095	\$ (9,828)	\$ 1,010,267
19	Rate of Return	8.53%		8.01%
20	Return Requirement	\$ 87,014	\$ (6,092)	\$ 80,922
21	Operating Revenues			
22	Sale of Electricity	\$ 370,575		\$ 370,575
23	Other Revenues	2,877		2,877
24	Total Operating Revenues	\$ 373,452	\$ -	\$ 373,452
25	Operating Expenses			
26	O&M Expenses	\$ 96,211	\$ (3,300)	\$ 92,911
27	Depreciation	59,009	(8,035)	50,974
28	Amortization	2,332	(2,406)	(74)
29	Taxes Other Than Income	134,199		134,199
30	Total Expenses	\$ 291,751	\$ (13,741)	\$ 278,010
31	Net Operating Income Before Taxes	\$ 81,701	\$ 13,741	\$ 95,442
32	DC Income Taxes	\$ 4,395	\$ 1,308	\$ 5,703
33	Federal Income Taxes	16,340	4,082	20,422
34	Total Income Taxes	\$ 20,735	\$ 5,390	\$ 26,125
35	Adjusted Net Operating Income	\$ 60,966	\$ 8,351	\$ 69,317
36	AFUDC			-
37	Operating Income for ROR Calculation	\$ 60,966	\$ 8,351	\$ 69,317
38	Income Deficiency	\$ 26,048	\$ (14,442)	\$ 11,606
39	Revenue Multiplier	1.70893		1.70893
40	Revenue Deficiency	\$ 44,514	\$ (24,681)	\$ 19,833
41	Revenue Deficiency Percent Change		-55.44%	44.56%

DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION

Docket: FC-1076

Schedule 2

Page 1 of 2

Potomac Electric Power Company - District of Columbia Division

Twelve Months Ending December 31, 2008

Summary of Adjustments to Company's Proposed Test Year
Jurisdictional Rate Base

(in thousands)

Line	Description (A)	Impact to Rate Base (B)	Authorized Rate of Return	
			Impact on Return Requirement (C)	Revenue Requirement Impact (D)
1	<u>Electric Plant in Service</u>			
2	Retired 69kv Circuits Physically Removed	\$ (635)	\$ (51)	\$ (87)
3	<u>Accumulated Depreciation</u>			
4	Change in Depreciation Rates	\$ 4,011	\$ 321	\$ 549
5	<u>Other Rate Base Items</u>			
6	Prepaid Pension Asset	\$ (9,825)	\$ (787)	\$ (1,345)
7	Deferred FC1053 Costs	\$ (487)	\$ (39)	\$ (67)
9	Unamortized Balance of Deferred AMI	\$ 121	\$ 10	\$ 17
8	Remove 2009 Pension Regulatory Asset	\$ (3,164)	\$ (253)	\$ (433)
10	<u>Accumulated Deferred Income Taxes</u>			
11	Deferred FC1053 Costs	\$ 202	\$ 16	\$ 28
12	Amortization of Deferred AMI Costs	\$ (50)	\$ (4)	\$ (7)
13		\$ 152	\$ 12	\$ 21
14	Total Change to Rate Base	\$ (9,828)	\$ (787)	\$ (1,345)

Notes and Source

Col C: Computed using Authorized Rate of Return

8.01%

Col D: Computed using Revenue Multiplier (See Below)

1.70893

Revenue Requirement Gross-Up Factor

58.5163%

Revenue Multiplier

1.70893 = 1/0.585163

Apr 27 2018

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DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION

Docket: FC-1076

Schedule 2

Page 2 of 2

Potomac Electric Power Company - District of Columbia Division

Twelve Months Ending December 31, 2008

Summary of Adjustments to Company's Proposed Test Year

Jurisdictional Operating Revenue and Expenses

(in thousands)

Line	Description (A)	O&M Adjustment (B)	District Income Tax (C)	Federal Income Tax (D)	NOI Adjustment (E)	Estimated Revenue Requirement Impact (F)
1	Expenses					
2	Pension Expense	\$ (3,064)	\$ 319	\$ 961	\$ 1,784	\$ (3,049)
3	Wages and Salaries	\$ (42)	\$ 6	\$ 13	23	(40)
4	Reverse 2009 Uncollectible Accounts	\$ (150)	\$ 15	\$ 48	87	(149)
5	Remove PEPCO Employee Club Costs	\$ (44)	\$ 4	\$ 14	26	(44)
6	Interest Synchronization		\$ 35	\$ 110	(145)	248
7	Total Expenses	<u>\$ (3,300)</u>	<u>\$ 379</u>	<u>\$ 1,146</u>	<u>\$ 1,775</u>	<u>\$ (3,034)</u>
8	Depreciation					
9	Retired 69kv Circuits Physically Removed	\$ (13)	\$ 1	\$ 4	\$ 8	\$ (13)
10	Change in Depreciation Rates	\$ (8,022)	\$ 688	\$ 2,174	\$ 5,160	(8,818)
11	Total Depreciation	<u>\$ (8,035)</u>	<u>\$ 689</u>	<u>\$ 2,178</u>	<u>\$ 5,168</u>	<u>\$ (8,831)</u>
12	Amortization					
13	Amortization of Deferred AMI Costs	\$ (243)	\$ 24	\$ 77	\$ 142	\$ (242)
14	Remove 2009 Pension Regulatory Asset	\$ (2,163)	\$ 216	\$ 681	\$ 1,266	\$ (2,163)
15		<u>\$ (2,406)</u>	<u>\$ 240</u>	<u>\$ 758</u>	<u>\$ 1,408</u>	<u>\$ (2,405)</u>
16	Tax totals		<u>\$ 1,308</u>	<u>\$ 4,082</u>		

Notes and Source

Col F: Computed using Revenue Multiplier (See Below)

1.70893

Revenue Requirement Gross-Up Factor

58.5163%

Revenue Multiplier

1.70893 =1/0.585163

Apr 27 2018

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