IN THE MATTER OF THE APPLICATION OF POTOMAC ELECTRIC POWER COMPANY FOR ADJUSTMENTS TO ITS RETAIL RATES FOR THE DISTRIBUTION OF ELECTRIC ENERGY	* * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9602

PROPOSED ORDER OF PUBLIC UTILITY LAW JUDGE

Before: Ryan C. McLean
Chief Public Utility Law Judge

Issued: July 9, 2019

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I. Executive Summary

Potomac Electric Power Company ("Pepco" or "the Company") provides electric delivery service to approximately 578,000 customers in Montgomery and Prince George's Counties. The Company's last base rate case, Case No. 9472 in 2018, resulted in a settlement agreement that decreased revenues by $15 million.[1]

On January 15, 2019, Pepco filed an application seeking authority to increase its rates and charges ("Application") with the Public Service Commission of Maryland ("the Commission") seeking to increase revenues by approximately $30 million based upon a test year that reflects the 12-month period ended January 31, 2019. As part of the Application, the Company proposed an overall rate of return ("ROR") of 8.18%, including a return on equity ("ROE") of 10.30%. The Company's request is based upon the continuing, substantial investments in replacing and enhancing its infrastructure, and that revenue growth has not kept pace with the growth in operating costs and rate base. Pepco ultimately reduced its revenue requirement to $26.71 million.

AOBA recommended an increase of approximately $398,000 and included a ROE of 9.45%, and the Maryland Office of People's Counsel ("OPC") recommended a decrease of $318,000, including a 9.00% ROE. Finally, Staff recommended a revenue increase of approximately $4.5 million, including a 9.30% ROE. After conducting two public hearings and four days of evidentiary hearings, reviewing all parties' testimonies and briefs, I authorize Pepco to increase its electric rates by $10,289,000, which will result in an increase to the average monthly Standard Offer Service ("SOS") residential total bill of $1.76, or 1.40%. Additionally,

[1] *In the Matter of the Application of Potomac Elec. Power Co. for Adjustments to Its Retail Rates for the Distribution of Electric Energy,* Case No. 9472, Order No. 88719, *slip op*. (dated May 31, 2018).

based upon the record, I find that a slight increase to the Company's return on equity to 9.60% is warranted.

II. Procedural History

On January 15, 2019, Pepco filed an Application for authority to increase its retail rates for the distribution of electric energy by $29,990,000, supported by pre-filed testimony, exhibits, and proposed revised tariff pages with an effective date of February 14, 2019. The Application included the testimony of the following individuals: Kevin M. McGowan, Vice President, Regulatory Policy & Strategy of Pepco Holdings, LLC ("PHI"); Bryan L. Clark, Director, Utility of the Future for PHI; Jay C. Ziminsky, Director, Regulatory Strategy and Revenue Policy for PHI; Tyler W. Wolverton, Manager, Revenue Performance for Pepco; Michael T. Normand, Senior Rate Analyst, Regulatory Strategy and Revenue Policy for PHI; Peter R. Blazunas, Manager, Rate Administration for Pepco; Tammy D. Sanford, Manager, Environmental Services for PHI; and Robert B. Hevert, Partner, Scott Madden, Inc.[2]

On January 16, 2019, the Commission issued Order No. 89000, which initiated a docketed proceeding to consider the Application, suspended the proposed tariff revisions for a period of 150 days from February 14, 2019, and delegated this matter to the Public Utility Law Judge Division to conduct proceedings to determine the justness and reasonableness of the proposed rates.

On January 24, 2019, the Apartment and Office Building Association of Metropolitan Washington ("AOBA") filed a Petition to Intervene.

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[2] The Direct Testimony of Messrs. McGowan (Pepco. Ex. 3), Hevert (Pepco Ex. 10), Clark (Pepco Ex. 12), Ziminsky (Pepco Ex. 16), Blazunas (Pepco Ex. 22), Wolverton (Pepco Ex. 25) and Normand (Pepco Ex. 31), and Ms. Sanford (Pepco Ex. 21) were admitted into the administrative record.

On February 6 and 11, 2019, Montgomery County, Maryland ("Montgomery County") and Prince George's County, Maryland ("Prince George's County") filed Petitions to Intervene, respectively.

On February 12, 2019, the United States General Services Administration ("GSA") filed a Petition to Intervene.

On February 13, 2019, a pre-hearing conference was held to address the petitions to intervene and any other preliminary matters, and set a procedural schedule. Representatives from Pepco, OPC, Staff, AOBA, Montgomery County, Prince George's County, and the GSA appeared at the conference, the petitions to intervene were granted, and a procedural schedule was adopted.

On February 26, 2019, the Commission issued Order No. 89040, suspending the proposed tariff revisions for a period of not more than 180 days from February 14, 2019.

On March 14, 2019, the Company filed supplemental direct testimony and exhibits of Messrs. Ziminsky, Wolverton, Normand, and Blazunas as updates to its initial filing with 12 months of actual data that reduced the Company's revenue requirement by approximately $763,000 to $29.227 million.

On April 12, 2019, OPC filed the Direct Testimonies of David J. Effron, a consultant specializing in utility regulation, Kevin W. O'Donnell, President of Nova Energy Consultants, Inc., and Karl Richard Pavlovic, a Senior Consultant and Managing Director of PCMG and Associates, LLC,[3] and AOBA filed the Direct Testimonies of Bruce R. Oliver, President of Revilo Hill Associates, Inc., and Timothy B. Oliver, Revilo Hill Associates, Inc.[4]

[3] Messrs. Effron's, O'Donnell's, and Pavlovic's Direct Testimonies were entered into the administrative record as OPC Exs. 1, 2, 2C, and 3.

[4] Messrs. T. Oliver's and B. Oliver's Direct Testimonies were entered into the administrative record as AOBA Exs. 13 and 15, respectively.

On that same date, Staff filed the Direct Testimonies of Felix L. Patterson, a Public Utility Auditor in the Accounting Investigations Division, Roger A. Austin, an Electrical Engineer in the Engineering Division, David Hoppock, Assistant Director of the Electricity Division, Benjamin Baker, a Regulatory Economist in the Electricity Division, and Drew M. McAuliffe, a Regulatory Economist in the Electricity Division.[5]

On April 18, 2019, OPC filed the Revised Direct Testimonies of Dr. Pavlovic and Mr. Effron.[6] On that same date, AOBA filed an errata to Mr. B. Oliver's Direct Testimony.[7]

On April 19, 2019, OPC filed an errata to Mr. O'Donnell's Direct Testimony.[8]

On April 30, 2019, the Company filed rebuttal testimony of Messrs. McGowan, Clark, Ziminsky, Wolverton, Normand, Blazunas, and Hevert, and Ms. Sanford.[9] Additionally, OPC filed rebuttal testimonies of Mr. O'Donnell and Dr. Pavlovic, and Staff filed rebuttal testimonies of Messrs. Hoppock and McAuliffe.[10]

On May 6 and May 9, 2019, evening hearings for public comments were held in Prince George's County and Montgomery County, respectively. Approximately 30-40 individuals attended the two evening hearings, with 21 individuals making comments. A majority of the individuals, which included residential and business customers, and municipalities, supported Pepco's request noting the improved reliability over the past several

[5] The Direct Testimonies and Exhibits of Messrs. Austin (Staff Ex. 3), McAuliffe (Staff Ex. 5), Patterson (Staff Ex. 9), Baker (Staff Ex. 11), and Hoppock (Staff Ex. 13) were admitted into the administrative record.

[6] The Revised Direct Testimonies (clean and red-lined versions) of Mr. Effron ("Effron Revised Direct") and Dr. Pavlovic ("Pavlovic Revised Direct") were entered into the administrative record as OPC Exs. 4, 5 (Effron), 6 and 7 (Pavlovic).

[7] The errata to Mr. B. Oliver's Direct Testimony ("B. Oliver - Errata") was admitted into the administrative record as AOBA Ex. 16.

[8] The Revised Direct Testimony (public and confidential) of Mr. O'Donnell ("O'Donnell Revised Direct") was entered into the administrative record as OPC Ex. 8 and 9C.

[9] The Rebuttal Testimony of Messrs. McGowan (Pepco Ex. 4), Hevert (Pepco Ex. 11), Clark (Pepco Ex. 13), Ziminsky (Pepco Ex. 18), Ms. Sanford (Pepco Ex. 21), Messrs. Blazunas (Pepco Ex. 24), Wolverton (Pepco Ex. 27), and Normand (Pepco Ex. 33) were admitted into the administrative record.

[10] The Rebuttal Testimony of Mr. O'Donnell and Dr. Pavlovic were admitted into the administrative record as OPC Exs. 10 and 11, respectively. Additionally, the Rebuttal Testimonies of Messrs. McAuliffe and Hoppock were entered into the administrative record as Staff Exs. 6 and 14, respectively.

years. Those that opposed the Company revenue increase raised issues related to AMI meters, Pepco's increased profits, and the Company's inability to cost-effectively manage its operations. Additionally, written comments were received from municipalities (the Town of Glen Echo and the City of New Carrollton) in support of Pepco's application, and citizens opposed to the rate increase.

On May 16, 2019, Pepco filed the surrebuttal testimonies of Messrs. Ziminsky and Wolverton,[11] AOBA filed surrebuttal testimony for Messrs. B. Oliver and T. Oliver,[12] OPC filed the surrebuttal testimonies of Mr. Effron and Dr. Pavlovic,[13] and Staff filed the surrebuttal testimonies of Messrs. Austin, Baker, Hoppock, McAuliffe, and Patterson.[14]

On May 21 through May 24, 2019, evidentiary hearings were held at the Commission's offices in Baltimore, Maryland. Pepco's request for a waiver of the page limit for briefs to go up to 90 pages was granted over the objections of Staff and AOBA.

On June 17, 2019, Pepco, AOBA, GSA, OPC, and Staff submitted briefs, and Montgomery County filed comments in lieu of a brief.[15]

III. The Application and Test Year

A. Pepco

Mr. Ziminsky stated the Company's test year was the 12-month period ended January 31, 2019, and included eight months of actual data and four months of forecasted data.

[11] The Surrebuttal Testimonies of Messrs. Ziminsky and Wolverton were admitted into the administrative record as Pepco Exs. 19 and 28, respectively.
[12] The Surrebuttal Testimonies of Messrs. T. Oliver and B. Oliver were admitted into the administrative record as AOBA Exs. 14 and 17, respectively.
[13] Rebuttal Testimonies of Mr. Effron and Dr. Pavlovic were admitted into the administrative record as OPC Exs. 12 and 13, respectively
[14] The Surrebuttal Testimonies of Messrs. Austin (Staff Ex. 4), McAuliffe (Staff Ex. 7), Patterson (Staff Ex. 10), Baker (Staff Ex. 12), and Hoppock (Staff Ex. 15) were admitted into the administrative record.
[15] On June 19, 2019, OPC filed a revised brief as its initially filed brief inadvertently contained an adjustment Mr. Effron had agreed to in his surrebuttal testimony. ML 225806.

Based on the test year, Pepco's fully adjusted ROR was 6.74%, which translated into a ROE of 8.18%, well below its authorized 9.5% ROE in Case No. 9472.[16] Based on his calculations, an increase of $29.990 million was necessary to achieve a 7.81% ROR on rate base. However, in his supplemental direct testimony, Mr. Ziminsky indicated Pepco's revenue requirement, based upon 12 months of actual data, was $29.227 million.[17]

B. AOBA

Mr. B. Oliver was critical of the differences between Pepco's initial application and its supplemental filing which provided actual data for the entire test year. While the revenue requirement changed by a small amount, he noted significant differences between the Company's forecasted data for the last four months of the test year and the actual data without explanation or justification. Mr. B. Oliver noted that of the 31 accounts that have direct assignment amounts to Maryland, only three had forecasted values over the last four months within 20% of the actual data in Pepco's supplemental filings, whereas 23 accounts had forecasted errors in excess of 50%.[18] He made a similar observation related to Operations and Maintenance ("O&M") expenses allocated to Maryland. Based on forecasted data, Mr. B. Oliver asserted the Company is unable to forecast actual expenditures over a one- to four-month time period with reasonable accuracy.

Mr. B. Oliver also claimed Pepco's partially projected test year does nothing to improve either the reasonableness or accuracy of rates. The significant variances between the initial application and the supplemental filing make it difficult given the time constraints for the intervenors to identify or discuss the basis for the changes. While he noted testimony was filed

[16] Ziminsky Direct at 4-5.
[17] Ziminsky Supplemental Direct at 1.
[18] B. Oliver Direct at 25.

with the actual data, the testimony lacked justification or explanation for significant changes in the Company's costs. Therefore, Mr. B. Oliver recommended the option for Pepco to file rate cases based upon a partially projected test year be eliminated in future rate cases.[19]

C. Parties' Responses

Mr. Ziminsky acknowledged variances between the Company's actual O&M expense by FERC account will always vary from the budgeted amounts. He pointed out that Pepco develops its O&M expense budget not by FERC account, but by department, project, and Generally Accepted Accounting Principles ("GAAP") expense category.[20] Mr. Ziminsky dismissed AOBA's concern that more information was not provided regarding the budget versus actual variances in the Company's Supplement Direct Testimony. Mr. Ziminsky noted such information has not historically been provided and that Pepco's adjusted distribution O&M expense between the initial filing and supplemental filing changed by $1.2 million (0.5%).[21] He claimed similar arguments made by AOBA had not been adopted by the Commission. Mr. Ziminsky acknowledged there can be movement within FERC accounts between the filing of direct testimony and when the Company updates for actuals due to reprioritization of work.[22] Mr. Ziminsky testified the variations occur due to work being reprioritized and redeploying resources.[23]

Mr. T. Oliver asserted the prudency of the Company's expenditures must be determined by examining costs detailed by account and identifying the reasons the costs were

[19] B. Oliver Direct at 6.
[20] Ziminsky Rebuttal at 3-4.
[21] Ziminsky Rebuttal at 4-5.
[22] Tr. at 225-226.
[23] Tr. at 255-256.

incurred, not by reviewing aggregate measures of O&M costs.[24] He added there was insufficient time to investigate Pepco's actual test year costs.

D. Decision

The Commission has routinely accepted partially projected test years in rate cases and Pepco's reliance upon eight months of actual data and four months historical data is not unusual.[25] In this case, Pepco's update to its test year resulted in a reduction to its requested revenue requirement. Mr. Ziminsky pointed out that the difference between the Company's adjusted O&M between the initial filing and the supplemental filing was a difference of only $44,000.[26] In the Company's most recent litigated base rate case, the Commission rejected a similar AOBA argument and stated, "We find that the use of 8 months actual data, four months projected when filing a rate case strikes the correct balance between Company and intervenor interests."[27] Based upon the record, I am not convinced that requiring the Company to file a rate case with 12 months of actual data is necessary as variances between forecasted and actual data will always occur for the reasons noted by Mr. Ziminsky, and that the 8 + 4 methodology has already been determined to strike an appropriate balance.

However, it is evident there were significant variations in the amounts set forth in the Company's individual FERC accounts. As Mr. Oliver pointed out, a comparison of Pepco's O&M expense directly assigned to Maryland distribution based on its initial filing and its update for actuals varied between -1,173.6% an +14,073%, while the O&M expense allocable to jurisdictions – distribution only, varied between -1,632.5% to 459.8%.[28] I also agree that the

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[24] T. Oliver Surrebuttal at 26-27.
[25] *See, for example, Re Potomac Elec. Power Co*., 108 Md. P.S.C. 651, 653 (2017).
[26] Tr. at 252-253.
[27] 108 Md. P.S.C. at 705.
[28] B. Oliver's Direct Testimony at 25 and BRO-1.

Company's supplemental testimony does not proffer appropriate explanations to address the large variances.

I agree with AOBA that it is not unreasonable for a utility to provide explanations of large variances in FERC accounts between the filing of an application with forecasted data and its supplemental filing that contains 12 months of actual data. While the Company provides the underlying data, the supplemental testimony in support is extremely brief. Providing such explanations in supplemental testimony will provide more transparency, and potentially reduce discovery and narrow contested issues.

After reviewing the O&M expense accounts and the percentage differences between the Company's forecasts and actual data,[29] I agree with AOBA and find a +/- 20% threshold to be reasonable to trigger a requirement for Pepco to provide an explanation for the variance. Therefore, in its next application for a change in rates, if a supplemental filing is used to update actual data for the test period, Pepco shall provide appropriate explanations in its supplemental testimony to address variances for any FERC account where the actual data reflects a change of +/- 20% from the level presented in its direct filing.

IV. Contested Rate Base and Operating Expense Adjustments

The Commission has the authority to set a just and reasonable rate for a utility, and a "just and reasonable rate" is defined by Public Utilities Article, *Annotated Code of Maryland* ("PUA"), § 4-101 as a rate that:

(1) does not violate any provision of this article;
(2) fully considers and is consistent with the public good; and

[29] *See* B. Oliver Direct, Schedule BRO-1 at 1-2.

> (3) except for rates of a common carrier, will result in an operating income to the public service company that yields, after reasonable deduction for depreciation and other necessary and proper expenses and reserves, a reasonable return on the fair value of the public service company's property used and useful in providing service to the public.

Furthermore, pursuant to PUA§ 3-112(b), in a proceeding involving a permanent rate or change in rate, the burden of proof is on the proponent of the new rate or change in rate. In other words, "in any rate case, the utility bears the burden of proof with respect to any costs that it claims."[30]

There are several adjustments proposed by the parties which reflect an average level of expenses based on activity over a period of years. Additionally, parties have proposed to not average certain expenses that have been averaged in previous cases. The use of an average level has been a common practice the Commission followed for years and the Commission has indicated, "it is appropriate to normalize costs in a rate case when their extraordinary nature would make it inappropriate to reflect the full amount in a single test year. Such normalization would better ensure that these costs would be representative of costs to be incurred during the rate-effective period."[31]

Pepco argued that some of the parties' adjustments in this proceeding were intended to deprive the Company of prudently incurred costs and reduce the revenue requirement by either averaging expenses that have not been traditionally or not averaging certain expenses that have historically been averaged.[32] First, the past treatment of a particular expense, averaged or not, does not guarantee the same practice in future cases. While previous Commission Orders provide guidance, each adjustment is reviewed on a case-by-case basis and is authorized/rejected/modified based on the record. Additionally, the averaging of expenses

[30] *Re Washington Gas Light Co*., 95 Md. P.S.C. 58 (2004).
[31] *Re Baltimore Gas & Elec*. *Co*., 102 Md. P.S.C. 74 (2011).
[32] Pepco's Brief at 14.

should work both ways. Just because a utility's test year expenses for a particular item are lower and the use of a three-year average increase the utility's recovery does not mean the use of an average is unreasonable. Conversely, when averaging reduces a utility's recovery for a particular test year expense, it does not render an adjustment unreasonable.

The Company's filing, as supplemented and amended, contained 42 separate adjustments and the parties proposed eight additional adjustments after analyzing Pepco's application and supporting documentation. After reviewing the record, the uncontested adjustments proposed by the Company and accepted by the parties, will be reflected in the development of the revenue requirement. The uncontested adjustments reduce rate base by $2,806,000 and increase operating income by $5,518,000. The discussion that follows will resolve matters that are at issue between the parties.

Appendix I hereto details the calculation of the adjusted rate base and adjusted operating income.

A. RMA 1 & RMA 2 – Test Year & Post-Test Year Reliability Plant Closings – Adjustments to Overtime Labor Charged to Capital Projects, Accumulated Deferred Income Taxes, the 69 kV Feeder Rebuild Program, and Merger Condition 8

1. Pepco

These adjustments to Plant in Service are intended to annualize the effect of reliability projects added to Electric Plant in Service ("EPIS") during the test year (RMA 1) and the inclusion of post-test year reliability projects that will be closed to EPIS between February 2019 and April 2019 (RMA 2).[33] RMA 1 increases rate base by $39,042,000 and

[33] Wolverton Direct at 4.

decreases operating income by $2,036,000, and RMA 2 increases rates base by $19,255,000 and decreases operating income by $1,103,000.

Mr. Clark provided an overview of Pepco's Maryland Distribution Program which he described as "a combination of activities designed to provide service to new customers, meet future load growth, modernize the distribution system, and continue to maintain a safe and reliable system to meet the needs and expectations of customers."[34] The activities are classified by function into three work areas: Customer Driven; Reliability; and Load.

Mr. Clark explained the system performance category seeks to prevent and reduce the number of customers impacted by an outage through modifying the system design and applying new technology and equipment, and specifically includes the Feeder Reliability Improvement program (including the Comprehensive Feeder Improvement and Priority Feeder Program).[35] Mr. Clark stated the Company's reliability capital spending over the period 2016-2018 was expected to be below the spending limits set forth in Merger Condition 8 and noted the $4.3 million exclusion of costs associated with Winter Storm Riley.[36]

Mr. Clark indicated Pepco's aging infrastructure was a driver for the Company's distribution investment. He stated projects are primarily focused on replacing infrastructure at or near substations and converting feeders to higher operating voltages, which enables the implementation of distribution automation schemes.[37]

2. AOBA (Overtime)

Mr. B. Oliver expressed concern over the Company's shift of overtime labor charged to capital projects contained in RMAs 1 and 2, as well as 3a and 3b. Pepco incurred

[34] Clark Direct at 4.
[35] Clark Direct at 6-7.
[36] Clark Direct at 10, *see Re Merger of Exelon Corp. and Pepco Holdings, Inc*., 106 Md. P.S.C. 95, 149-151 (2015).
[37] Clark Direct at 18.

almost $30.5 million of overtime expense during the test year, of which approximately $18.6 million was charged to capital.[38] He claimed it was neither reasonable nor appropriate to charge a substantial amount of overtime expense to capital projects given Pepco's performance related to the Commission's reliability standards and its merger commitments related to system reliability. Mr. B. Oliver concluded the Company's overtime expense was not driven by reliability, and therefore should be excluded.

He testified, "Excessive use of Overtime to complete plant additions unnecessarily inflates the costs of those additions while provide no additional benefits to ratepayers."[39] Mr. B. Oliver questioned whether the amount of capital-related overtime expense was incurred in order to include as much plant in rate base prior to the end of this case. Typically, utilities use overtime for capital projects for emergency situations and/or completing upgrades or replacement to existing facilities to maintain safety and reliability. Mr. Oliver claimed there was no evidence of these situations driving the Company's overtime expense.

AOBA recommended removing the test year level of Overtime expense charged to capital from the test year reliability closings, which would reduce the costs of reliability plant closings from $49.4 million to $30.6 million.[40] Mr. Oliver also recommended denying post-test year reliability closings for RMA 2 due to the lack of information related to overtime costs related to these adjustments. He claimed acceptance of these adjustments is not driven by a need to improve reliability (System Average Interruption Duration Index ("SAIDI") or System Average Interruption Frequency Index ("SAIFI")) or merger commitments as Pepco's current SAIDI and SAIFI levels are based on the Company's performance.[41] Despite Pepco's exceeding

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[38] B. Oliver Direct at 61.
[39] B. Oliver Direct at 62.
[40] B. Oliver Direct at 63.
[41] B. Oliver Direct at 64.

both the RM 43 standards and merger-related reliability conditions, the Company's overtime has increased at the same time as the need for overtime to complete reliability projects has decreased.

3. OPC - Accumulated Deferred Income Taxes ("ADIT")

Mr. Effron claimed the Company failed to recognize capital repairs deductions when calculating ADIT for its reliability plant additions. He stated, "The capital repairs deductions represent expenditures that are capitalized to plant accounts on the Company's books of account but are deducted as repairs expense in the determination of currently taxable income."[42]

Mr. Effron disagreed with Pepco's assertion that its calculations where consistent with Commission precedent as a basis not to account for capital repair deductions. He indicated the combination of the capital repairs deduction and bonus depreciation put Pepco in a net operation loss ("NOL") position for tax purposes in recent years, which essentially meant the Company was not able to fully utilize the capital repairs deduction and/or bonus depreciation.[43]

However, by the end of 2018, the Company's NOL had been eliminated, thus, Mr. Effron testified, "increases to ADIT from capital repairs deductions would no longer be matched by an equal and offsetting increase to the NOL balance," and impact the net balance of ADIT related to reliability plant additions.[44] Mr. Effron relied upon the average of the capital repairs deduction as a percentage of distribution plant for 2015-2017, which was 22.61%, and applied that percentage for RMAs 1 and 2 resulting in a net increase to ADIT of $4,418,000.[45]

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[42] Effron Direct at 8.
[43] *Id*. at 8.
[44] Effron Direct at 9.
[45] Effron Direct at 10.

4. Staff (ADIT and 69 kV Feeder Reliability Program)

Mr. Patterson made adjustments for capital repairs deductions to plant and for projects that Staff determined were not reliability-related projects. First, for both RMA 1 and 2, Mr. Patterson claimed Pepco failed to account for the deduction of capital repairs. He explained, "The capital repairs deduction is the conversion of capitalized plant expenditures on the Company's books to repair expense and its deduction for tax purposes to help determine taxable income as allowed by the Internal Revenue Service resulting in additional ADIT."[46] He stated that ADIT is the difference between the book income tax expense and the actual income tax amount based on deductions per the utility's tax return and is deducted from rate base.[47]

In terms of Pepco's overall reliability, Mr. Austin reviewed the Company's five-year projections that compared the SAIFI Target to the Projected SAIFI, which suggested a regression in reliability performance from 2018 levels, but the projections indicate that Pepco would still meet the SAIFI targets.[48] Mr. Austin briefly discussed the Company's allowed reliability-driven capital expenditures for the 2016 through 2020 time period and the limits imposed by Merger Condition 8. He noted Pepco spent $134,557,431 during 2018; however, that amount was reduced by approximately $4.5 million that was associated with Winter Storm Riley.[49] Mr. Austin also testified, "$4.7 million of assets which were placed in service during Q4 2017 and that should have been accrued in December 2017 were not recorded until January 2018."[50] Mr. Austin concluded that the $9.2 million in costs did not count towards the Company's reliability capital expenditures in 2018, therefore, the Company was compliant with the spending limits set forth in Merger Condition 8.

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[46] Patterson Direct at 7.
[47] *Id*. at 7.
[48] Austin Direct at 5.
[49] Austin Direct at 6.
[50] *Id*. at 6.

Next, Mr. Austin recommended that all capital expenses related to Pepco's 69 kV Feeder Rebuild Program ("69 kV FRP" or "the Program") be removed because Staff viewed the Program as a resiliency program that had not been approved by the Commission in accordance with Merger Condition 12 in Case No. 9361.[51] Mr. Austin stated Staff became aware of the Program in 2018 as part of Case No. 9353, during which Staff found, "the negative impacts that the 69 kV Feeder Rebuild Program was having on Pepco's cost effectiveness, cost efficiency, and societal benefits/cost when characterized as a reliability program."[52] In Case No. 9353, Mr. Austin claimed the Company indicated the 69 kV FRP was "a resiliency program that resulted from a resilience study performed in 2013-14 on its overhead 69 kV system."[53] In that proceeding, Staff's analysis found the Program appeared to have reached a point of diminishing returns.

Mr. Austin testified the Company did not dispute Staff's calculations in Case No. 9353, but asserted the Program was driven by aging infrastructure and resiliency goals that provide little direct reliability improvement benefit. Staff verified Pepco's claim that absent the 69 kV FRP, its cost/benefit improved from 104% to 278% pursuant to the Department of Energy's ("DOE") Interruption Cost Estimate ("ICE") calculator, and the cost/effectiveness as measured by Staff's $/SAIFI calculation also improved, thereby making Pepco competitive with other Maryland electric companies.[54]

In relation to Case No. 9361 and Merger Condition 12, Mr. Austin discussed the 2012 Report of the Grid Resiliency Task Force ("Task Force") and the differences between reliability and resiliency, and Staff's conclusion that given the utilities' increased reliability, "it is

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[51] Austin Direct at 7-8.
[52] Austin Direct at 9; *see In the Matter of the Review of Annual Performance Reports on Electric Service Reliability Filed Pursuant to COMAR 20.50.12.11*, Case No. 9353, Order No. 89056, *slip op*. (March 6, 2019).
[53] Austin Direct at 9.
[54] Austin Direct at 11.

likely that large investments primarily benefiting resiliency will be a future trend for some utilities with reliability spend normalizing. Therefore, it is important to establish consistent resiliency objectives and resiliency investment evaluation criteria in the future before utilities file resiliency programs."[55] He referenced Staff's use of the DOE ICE calculator in Case Nos. 9353 and 9361, and indicated utilities are capable of using the ICE calculator to evaluate resiliency investments by considering the costs of outages to customer classes.[56]

Mr. Austin stated Pepco has not conducted an analysis comparing the costs of the improvements to the benefits provided by the Program. Instead, he claimed the Company relied upon "an internal resiliency target 'to have at least one hardened 69 kV feeder supply to every distribution substation in case of a large scale storm event.'"[57] Mr. Austin disagreed with Pepco's "comprehensive target for 69 kV feeders," and believed the 69 kV FRP was a traditional utility wires-type solution that "fails to recognize the benefits that grid modernization will have on resilience."[58] He questioned whether spending $428.8 million through 2029 on wires-type solutions was a cost-effective approach to improving Pepco's resiliency given evolving grid modernization, if the Program was needed, or if it should include "non-wires" alternatives.[59] Mr. Austin explained that metrics are necessary to properly evaluate resiliency levels and the cost/benefit of alternatives.

Mr. Austin recommended removing a total of five 69 kV FRP projects - four projects from RMA 1 and one project from RMA 2. Based upon Mr. Patterson's and Mr. Austin's recommendations, Staff's adjustment to RMA 1 removed plant in the amount of $1,648,000 and the ADIT related to the capital repairs deduction resulted in a rate base

[55] Austin Direct at 14.
[56] Austin Direct at 15.
[57] Austin Direct at 15, citing Pepco's response to Staff DR 29-03.
[58] Austin Direct at 16.
[59] Austin Direct at 16-17.

adjustment of $1,966,000, for a net rate base adjustment of $3,576,000, and a corresponding $27,000 adjustment to depreciation expense and operating income.[60] Staff's adjustment to RMA 2 removed plant in the amount of $1,492,000 and the ADIT related to the capital repairs deduction resulted in an $877,000 adjustment to rate base, for a net rate base adjustment of $2,335,000, and a corresponding adjustment to depreciation expense and operating income of $25,000.[61]

5. Parties' Responses

First, Mr. Wolverton claimed it was common practice for a utility to incur overtime costs related to capital work, the amount claimed by Pepco was not excessive, and Mr. B. Oliver's calculations were flawed. Mr. Wolverton explained the Company was under merger spending limits for reliability-related capital expenditures for 2018 calendar year, which included 11 of the 12 months of the test year, and Pepco surpassed the RM 43 and Merger Commitment SAIDI and SAIFI goals.[62]

In regard to AOBA's recommendations, Mr. Wolverton noted it was common for utilities to incur overtime costs on capital projects, the amount was not excessive, and Mr. B. Oliver's calculations were flawed. He claimed only a portion of the $18.593 million of overtime charged to capital projects were related to Maryland-distribution operations, and that figure represented the total for Pepco and included transmission capital projects and distribution projects in the District of Columbia.[63] Mr. Wolverton asserted the disallowance of overtime labor charged to capital projects could result in unintended consequences, such as delaying the

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[60] Patterson Direct at 8.
[61] Patterson Direct at 8-9.
[62] Wolverton Rebuttal at 15.
[63] *Id*. at 15.

restoration of customers. Finally, in relation to RMA 2, he stated reliability projects included in the adjustment allow the Company to maintain and improve reliability.

Mr. Clark provided several scenarios that cause the Company to incur overtime being charged to capital projects, and he stated such projects address reliability, customer satisfaction, and cost-effectiveness concerns.[64] He also explained that it was common utility practice to incur overtime for both O&M and capital projects.[65]

Next, Mr. Wolverton noted both Staff and OPC's capital repairs adjustments were made by estimating the capital repairs deductions by multiplying the EPIS additions by a percentage based on historical capital repairs divided by plant additions.[66] He cited an Internal Revenue Service publication, Revenue Procedure ("RP") 2011-43, which "provides guidance for determining whether expenses to maintain, replace, or improve electric transmission and distribution property are immediately deductible for income tax purposes."[67] He stated RP 2011-43 provides a "safe harbor method" to determine whether expenditures to maintain, replace or improve electric transmission and distribution property are immediately deductible for income tax purposes.

While Mr. Wolverton agreed certain reliability plant additions qualify for immediate deduction, Pepco has not filed its 2018 or 2019 federal income tax return. Mr. Wolverton stated since it is not known and measurable whether the additions will qualify under the safe harbor rules, the Company did not include an estimated tax repairs deduction for

[64] Clark Rebuttal at 9.
[65] Tr. at 151.
[66] Wolverton Rebuttal at 5.
[67] *Id*. at 5.

RMAs 1 and 2.[68] He concluded that an adjustment was not necessary, but found OPC's three-year average percentage approach was not unreasonable.

In response to Staff Witness Austin, Mr. McGowan claimed the Company complied with Merger Condition 12, therefore, the costs associated with the 69 kV FRP should be permitted. He testified the Commission has not established resiliency targets that would trigger the requirements of Merger Condition 12, namely, to cooperate with Staff and other stakeholders to determine the funding and resources to meet Commission-established resiliency targets, and Commission approval of funding for any such projects.[69]

Mr. Clark explained the 69 kV rebuild projects have been part of the Company's Reliability Enhancement Plan ("REP") as part of Case No. 9240, which required, among other things, that Pepco file work plans for its REP and Emergency Response Improvement Project with quarterly and annual reports filed on both.[70] Mr. Clark noted the Company's 2012-2016 Reliability Work Plan ("RWP") was filed in February 2012 and included an Enhanced Line Hardening plan to harden supply lines and repair/replace all marginal assets on 34 kV and 69 kV subtransmission lines.

Mr. Clark testified that in 2013, ENERCON was hired to conduct a 69 kV reliability analysis of Pepco's overhead 69 kV system, which resulted in the Company undertaking a 12-year rebuild project of the 69 kV system.[71] He claimed the 69 kV FRP was simply a continuation of the referenced Line Hardening project, not a new resiliency program. Mr. Clark stated ENERCON's analysis was completed in October 2014, approximately seven months prior to the issuance of the Merger Order. Mr. Clark asserted the 69 kV FRP was

[68] Wolverton Rebuttal at 6.
[69] McGowan Rebuttal at 3.
[70] Clark Rebuttal at 2.
[71] Clark Rebuttal at 3.

important for the Company's Distribution Backbone and plan to mitigate substation outages during storms by having at least one hardened supply to every distribution substation.[72]

Mr. Clark specified that one of the projects recommended by Staff to be excluded, UDLPRM62M, has had costs that have been included in and approved by the Commission in previous rate cases.[73] He pointed out there have been numerous filings that included sections on Substation Supply Line Hardening Program and substation reliability projects. Furthermore, Mr. Clark stated these projects have been included in rate making adjustments in four of Pepco's rate cases (Case Nos. 9311, 9336, 9443, and 9472) and without any project being excluded.[74]

Mr. Clark disagreed with Staff's interpretation of Merger Condition 12 and Mr. Austin's statement regarding the program reaching diminishing returns in Case No. 9353. He testified, "In the Company's filing for its recommended reliability standards, the statement was made 'it should be noted that the rate of historical reliability improvement may not continue in future years as diminishing returns adversely impacts reliability investments."[75] Mr. Clark clarified that Pepco has not reached that point, and the Company has made significant improvement in terms of reliability and the work cannot stop.

On cross-examination, Mr. Clark continued to disagree that the Program was a resiliency rather than a reliability program. He claimed that while the projects within the Company's reliability portfolio definitely contribute to resiliency, the programs have always been represented as reliability programs, and noted the 69 kV FRP would "probably be better

[72] Clark Rebuttal at 4.
[73] Clark Rebuttal at 5-6.
[74] Clark Rebuttal at 7.
[75] Clark Rebuttal at 8.

characterized as an aging infrastructure replacement program then even a reliability program in some cases."[76]

Mr. Clark also disagreed with the Staff's assertion that the 69 kV rebuild was found to be not cost effective and therefore not prudent in terms of reliability. He stressed that Pepco's reliability program, including the 69 kV FRP, was found to be cost-effective at 104%, which means "the benefits inclusive of that program of our overall reliability portfolio outweighed the costs by 4 percent."[77] Witness Clark further testified that Staff has not alleged that the 69 kV rebuild was imprudent in any of Pepco's previous rate cases.

He explained that there are a number of reasons, even in blue sky circumstances, that could cause a substation to be taken out of service, and that each 69 kV substation feeds over 14,000 customers.[78] Pepco argues that during one of those events, its SAIFI could be affected by approximately .02 to .03, a huge impact from a reliability perspective.[79]

Mr. Clark highlighted Staff's testimony in Case No. 9353 which stated, "Our analysis techniques are not valuing those aging infrastructure type projects or resiliency type projects, not giving you a lot of safety improvement, but maybe nonetheless needed because of other drivers."[80] Mr. Clark stated the DOE ICE calculator was "not the best tool to determine prudency of projects that are meant to provide either redundancy, security or even resiliency."[81] Mr. Clark stated resiliency is difficult to measure as there is no industry standard to measure resiliency. In terms of this case, he noted Pepco completed reliability work, and the overall system reliability also improved resiliency.[82]

[76] Tr. at 136.
[77] Tr. at 138.
[78] Tr. at 148-49.
[79] Tr. at 149.
[80] Tr. at 144-145, *quoting* Pepco Ex. 15 at 77.
[81] Tr. at 145.
[82] Tr. at 195.

He stated that Staff did not conduct a granular review of the 69 kV FRP that was referenced by Staff in Case No. 9353.[83] Mr. Clark acknowledged the name of the Program has changed over the past years, but the intent of the program and project numbers have remained the same.[84] He testified, "But at the end of the day, … to me it's aging infrastructure replacement," and pointed out that some lines are 40 to 60 years old and would be replaced given the age of the infrastructure.[85]

Mr. B. Oliver clarified that some level of overtime to complete capital projects for reliability purposes should be anticipated; however, as the Company's reliability results have improved, the level of overtime should be reduced.[86] He disagreed with Pepco's explanations for the overtime costs and claimed the Company failed to provide supporting evidence.

Mr. Effron explained that Pepco's position assumed that the capital repairs deductions will be zero since the Company has not filed its 2018 or 2019 federal income tax returns. He claimed such an assumption was not reasonable given the magnitude of the capital repairs deduction in recent years.[87]

Mr. Patterson did not oppose OPC's proposed three-year average percentage from 2015 through 2017, but continued to maintain the 2017 percentage to be more appropriate. Based upon Pepco's rebuttal, he noted Mr. Austin's adjustment to RMA 2 removes plant in the amount of $54,000 and the ADIT related to the capital repairs deduction results in an adjustment to rate base in the amount of $450,000 for a net rate base adjustment of $503,000, a

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[83] Tr. at 204; *see* Pepco Ex. 15 at 76.
[84] Tr. at 203, 213-214.
[85] Tr. at 217-218.
[86] B. Oliver Surrebuttal at 4.
[87] Effron Surrebuttal at 3.

corresponding adjustment to depreciation expense and operating expense in the amount of $1,000.[88]

Mr. Austin did not dispute that Staff was aware of the 69 kV FRP prior to 2018, but continued to argue that the Program should not be classified as a reliability project. He indicated the work associated with the 69 kV feeders had always been presented as a reliability project, but Case No. 9353 was the first time Pepco referred to the Programs "69 kV Feeder Rebuild Projects."[89] Mr. Austin continued to assert the 69 kV FRP was not cost effective, and therefore not prudent, from a reliability perspective. He cited Pepco's own statements from Case No. 9353 wherein Pepco asserted that there is "minimal associated reliability improvement under normal weather conditions" for the 69 kV projects."[90] He reiterated that if Pepco wants to recover costs associated with the 69 kV FRP, the Company should consider the rebuild a resiliency project and consult with Staff as required by Merger Condition 12 to determine the best way forward.

On cross-examination, Mr. Austin acknowledged he did not review information contained in Case Nos. 9240, 9298, 9396, or 9418 in preparation of his direct testimony.[91] He clarified that Staff believes Merger Condition 12 requires Exelon to work with Staff and stakeholders "to determine what resiliency programs the Commission should consider in order for the Commission to establish those targets."[92] Mr. Austin also agreed the Commission was investigating resiliency plans in Case No. 9298,[93] and that Merger Condition 12 did not specifically contain a precursor to establishing resiliency.[94]

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[88] Patterson Surrebuttal at 4-5.
[89] Austin Surrebuttal at 3-4.
[90] Austin Surrebuttal at 7.
[91] Tr. at 546-547.
[92] Tr. at 553.
[93] Tr. at 566.
[94] Tr. at 570.

Mr. Austin confirmed previous Pepco filings included plans to harden its 69 kV feeders for reliability purposes[95] and that since 2014 the Company was rebuilding the feeders and presented the work as a reliability project. In Case No. 9353, Mr. Austin noted Pepco presented the Program as an aging infrastructure and resiliency program.[96] He testified, "All I have done as far as your 69 kV feeder rebuild is an analysis we did back in 9353, we did an analysis on its appropriateness from reliability," which he agreed was 104% cost beneficial.[97] Mr. Austin acknowledged Staff did not conduct a prudency review of the Program in this proceeding, but claimed the Program was imprudent, in terms of reliability, based on its analysis in Case No. 9353.[98] In response to my questions, Mr. Austin agreed with Mr. Clark that resiliency is difficult to capture using the ICE calculator, and he was unaware of another methodology to properly measure resiliency.

On brief, Staff reiterated the arguments asserted by Mr. Austin and highlighted the 69 kV FRP's 12-year, $428 million price tag and that the Program will not be completed until 2029.[99] Staff also asserted simply calling a resiliency project a reliability project does not transform the project. The GSA supported Staff's removal of costs related to the Company's 69 kV FRP due to Pepco's failure to comply with Merger Condition 12.[100] Montgomery County recommended the Commission either require Pepco to file a request in Case No. 9298 that the Commission can rule with respect to the Company's resiliency plan or file a new resiliency plan.[101]

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[95] Tr. at 582-583.
[96] Tr. at 590-591.
[97] Tr. at 613-615.
[98] Tr. at 627-633.
[99] Staff's Brief at 15.
[100] GSA's Brief at 4.
[101] Montgomery County's Comments at 7.

Montgomery County cited Merger Condition 8 that requires, among other things, that Pepco achieve certain enhanced reliability performance standards without exceeding specified annual capital and O&M spending levels, absent a major outage event.[102] The 2018 spending limit was $126,050,722 and the Company acknowledged in a data request that its total 2018 Reliability Spend Total, less $4.4 million for Winter Storm Riley, was $130,650,131; however, Pepco claimed $4,687,955 was spent in the fourth quarter of 2017 and should have accrued in December 2017, but was not recorded until January 2018, and resulted in a total amount of $125,962,176.[103] Montgomery County did not disagree with Staff's conclusion that Pepco was compliant with Merger Condition 8, but would defer to the Commission's decision.

6. Decision

The Commission has permitted utilities to recover "known and measureable expenses for actual, prudently incurred costs, for non-revenue producing safety and reliability investments through the hearing date."[104] Parties have raised three issues in relation to Pepco's RMAs 1 and 2.

a. Overtime

In approving the Company's reliability enhancement plan in 2010, the Commission declined to micromanage Pepco in terms of how much funding should be spent on each element of its plan and directed the Company to take the necessary steps to improve its

[102] Montgomery County's Comments at 3, *citing* 106 Md. P.S.C. at 149-151.
[103] Montgomery County's Comments at 3-4, *citing* Montgomery County Ex. 2 – Pepco's Response to Montgomery County DR 1-6.
[104] *In the Matter of the Application of Baltimore Gas & Elec. Co. for Adjustments to Its Gas Base Rates*, Case No. 9484, Order No. 88975, *slip op*. at 12 (dated January 4, 2019).

reliability.[105] The Commission noted Pepco's duty to provide reliable service to its customers and stated, "If it spends ratepayer money imprudently, it will face the risk that reimbursement for those costs will be denied, and if it cannot improve reliability to an acceptable level, it will incur the risk of additional fines."[106] The Commission has recognized that Pepco's improved performance and reliability metrics comes at a cost to customers.[107] It is not contested that Pepco's reliability has significantly improved over the past several years. The Company's performance is apparent based not only on the Commission's reliability standards, but also upon customers' positive comments at the evening hearings.

AOBA's argument, in part, seems to imply that because Pepco is currently meeting the reliability standards, the Company's test year level of overtime is not geared towards improving reliability or meeting reliability standards. I find no evidence to support that assertion. The mere fact that a utility is currently meeting the applicable reliability standards does not provide an excuse to discontinue efforts to improve reliability.

Staff Witness Austin's testimony included the Company's SAIFI targets for 2019 through 2023. For 2019 and 2020, Pepco's SAIFI targets are 0.92 and 0.90, while the projected SAIFI for those two years are 0.90 and 0.87, respectively.[108] He noted that while the Company should be able to meet its reliability targets, the projections over the 2019 to 2023 time period "suggest there will be a regression in reliability performance from 2018 levels."[109] A difference of 0.20 between SAIFI targets and projections amounted to a "very small reliability margin," which he considered to be very good from a customer's perspective in terms of

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[105] *Re Potomac Elec. Power Co*., 102 Md. P.S.C. 408, 437 (2011).
[106] *Id*.
[107] 108 Md. P.S.C. at 653.
[108] Austin Direct at 5.
[109] *Id*. at 5.

spending.[110] With such a small buffer and the predicted regression, Pepco must continue to expend funds, including overtime as necessary, to meet the Commission's desire for increased reliability standards or face potential civil penalties.[111]

I also find no evidence that Pepco's increased overtime for capital projects "can only be attributable to the Company's efforts to accelerate completion of reliability plant closings."[112] In response to my questions on this issue, Mr. Clark dismissed the notion and testified:

> I don't think we have the time with the heavy workload that we're managing on a day-to-day basis to be that strategic about what gets in and out of rate base. We schedule work on a daily basis to meet the needs of the electric system as well as the customers.[113]

He added that individuals responsible for scheduling a project or completing a project are not considering the impact of the work on the Company's next rate case.[114] AOBA offered no testimony or evidence that supported its position or that contradicted Mr. Clark's testimony.

Based on the record, I find Pepco's capital-related overtime spending levels to be reasonable, especially in light of the Company's reliability targets. I found Mr. Clark's testimony to be particularly persuasive and no party challenged the improvement in Pepco's reliability. There is nothing in the record to demonstrate that Pepco's level of spending was imprudent, and accepting AOBA's adjustment amounts to micromanaging the Company's spending, which is not appropriate on this record. Therefore, AOBA's adjustment is denied.

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[110] Tr. at 648.
[111] 106 Md. P.S.C. at 150. I note that in 2016, Pepco failed to meet its SAIFI goals due to several intense storms and a substation fire and the Commission elected not to impose a civil penalty at that time. *Re Annual Performance Reports on Electric Service Reliability*, Case No. 9353, Order No. 88406 at 8 (dated September 28, 2017).
[112] AOBA Brief at 34.
[113] Tr. at 221.
[114] Tr. at 221.

b. ADIT

The Commission addressed the ADIT issue (capitalized repair deduction) in the recent Potomac Edison ("PE") rate case, wherein the Commission found "the Company's use of zero as the amount of a capital repairs unreasonable,"[115] and adopted OPC's proposed estimate in that proceeding. In this case, Mr. Effron succinctly addressed this matter and I find an adjustment to the Company's ADIT is both necessary and reasonable as developed by OPC. Staff relied upon the Company's 2017 percentage, but did not oppose OPC's proposed three-year average. While I do not find Staff's position to be unreasonable, I find OPC's normalization of the ADIT to be more appropriate. Therefore, I accept OPC's capital repairs deduction based upon a three-year average (2015-2017) for both the terminal test year reliability spend and post-test year reliability spend.

c. 69 kV Feeder Rebuild Program

Staff effectively presented two arguments in support of Mr. Austin's adjustments: Pepco's failure to comply with Merger Condition 12; and the projects in the Program were not prudent from a reliability perspective. In brief, Staff stated the 69 kV FRP is not entitled to special accounting treatment since it is not a reliability project and that the Commission has placed "special restrictions on resiliency projects"[116] as part of the PHI/Exelon Merger, specifically, Merger Condition 12.

First, Merger Condition 12 of Case No. 9361 states:

> Exelon shall cooperate with Staff and other stakeholders to determine the funding and other resources necessary to meet future resiliency targets that may be established by the Commission. The

[115] *In the Matter of the Application of the Potomac Edison Co. for Adjustments to Its Retail Rates for the Distribution of Electric Energy*, Case No. 9490, Order No. 89072, *slip op*. at 29 (dated March 22, 2019).
[116] Staff's Brief at 12.

> Commission does not endorse any recommended funding or resource requirements until such time as the recommendations are fully considered and approved by the Commission.[117]

The Commission has previously interpreted language in settlements and found that the parties to an approved settlement are bound by the terms of the Order accepting the settlement, "including the plain meaning of words contained therein."[118] This case is no different as all parties that participated in Case No. 9361 are bound by the Commission's Order and conditions therein.

As noted by Pepco in brief, the language of Merger Condition 12 is clear and unambiguous and I find it unnecessary to consider the intent or background of Merger Condition 12 as asserted by Staff. The Commission has not established resiliency targets, therefore, the requirement for Exelon, Staff, and stakeholders to determine the level of funding and resources to meet those targets, which do not exist, has not been triggered. In relation to the second sentence, Staff Witness Austin agreed that the second sentence would be dependent on establishing resiliency targets as noted in the first sentence.[119] Since the Commission has not established resiliency targets, the issue of the Commission's endorsement contained in the second sentence of Merger Condition 12 is not relevant.[120] Therefore, I find Staff's reliance on Merger Condition 12 to be misplaced and that Pepco's 69 kV FRP is not a violation of Merger Condition 12.

Next, in relation to Staff's prudency argument, I find no support in the record that the Program is not prudent. Mr. Austin acknowledged a prudency review had not been conducted as part of this proceeding, that individual projects and aging infrastructure had not

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[117] 106 Md. P.S.C. at 152.
[118] *Re Potomac Edison Co*., 92 Md. P.S.C. 458, 462 (2001).
[119] Tr. at 571-572 and Pepco's Brief at 23.
[120] I also question Staff's reliance on the second sentence as a basis for its adjustment. I do not read the Condition to mean the lack of a Commission-endorsed funding or resource requirements automatically results in Pepco not being able to recover for resiliency-type projects.

been reviewed, and that the "granular review" referenced by Staff in Case No. 9353 had not been conducted.[121]

Pepco demonstrated the 69 kV FRP has existed, albeit under various names, for several years and has been granted recovery for projects within the Program over the past several rate cases.[122] Mr. Austin acknowledged Staff has been aware the Company was rebuilding its 69 kV lines as part of a reliability program for years.[123] While the repeated changing of the name could have caused some confusion as to the Program's intent, I found Pepco Witness Clark's testimony that described the Program an aging infrastructure to be the most accurate description. In Case No. 9353, Chief Engineer John Borkowski considered the Program to be primarily aging infrastructure replacement and resiliency," and while the Program may not provide "a lot of SAIFI improvement but maybe nonetheless needed because of other drivers."[124] It certainly appears the "other drivers" referenced by Staff agrees with Mr. Clark's contention that the lines were between 40 and 60 years old and that the Company would be addressing the feeders due to their age.[125]

Staff's prudency argument does not rest on an accounting-prudency basis, but upon the prudency of the Program's reliability based solely upon the DOE ICE calculator results from Case No. 9353. Pepco and Staff both agreed the DOE ICE calculator does not capture the benefits of a project's impact on resiliency and reliability.[126] In light of Staff's sole reliance on the DOE ICE calculator results, which it agreed found Pepco's reliability plan and included the 69 kV FRP to be cost effective, I find no basis to determine the Program is imprudent from a reliability perspective.

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[121] Tr. at 627-628 and 633-634.
[122] Pepco's Brief at 31.
[123] Tr. at 586-608; *see also* Pepco Exs. 40C-43.
[124] Pepco Ex. 15 at 77.
[125] Tr. at 217-218.
[126] Tr. at 190 and 649.

Additionally, the record does not support a finding that a program that was found to be cost effective in one proceeding (Case No. 9353) to be imprudent in a subsequent proceeding given the tool relied upon does not capture the true impact of the Program. In the absence of any type of actual review of the Program or the projects therein, I find no support for Staff's reliance on the results of the DOE ICE calculator as a basis for its adjustment to RMAs 1 and 2.

d. Merger Condition 8

Merger Condition 8 of the Exelon/PHI merger addressed reliability and quality of service requirements, and included SAIDI and SAIFI commitments for 2016 through 2020, Compliance Payments for 2018 through 2020 to be paid in the event those commitments are not met, and capped the annual capital and O&M spending levels that may be spent to meet the SAIDI and SAIFI commitments for the 2016 through 2020 time period.[127] In the event Pepco exceeded the budget requirements for any reason other than a major outage event, the Company is required to automatically place in escrow a compliance payment in the amount of $65,000 for every $1 million spent in excess of the reliability-related capital budget levels in any of the years (2016-2020).[128] In 2018, Pepco's reliability-driven capital expenditures were capped at 126,050,722.[129] After removing approximately $4.4 million from Winter Storm Riley, the Company also noted that $4,687,955 was spent in the fourth quarter of 2017, but was not recorded until January 2018, resulting in a total of $125,962,176.[130]

In Case No. 9443, OPC raised an issue related to Pepco's compliance with Merger Condition 8. In denying OPC's recommendation to reclassify certain load-related projects as

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[127] 106 Md. P.S.C. at 149-151.
[128] *Id*. at 150.
[129] *Id*. at 151.
[130] Montgomery County Ex. 2.

reliability-related projects, the Commission stated, "The Commission will vigorously uphold the requirement that Pepco meet its merger reliability Condition 8 according to the budget caps set in that commitment. We welcome the scrutiny given the Company's capital spending."[131]

Given the Commission's invitation to scrutinize Pepco's capital spending in rate cases, all parties had an opportunity to address and challenge, if warranted, the Company's compliance with Merger Condition 8. Only Staff commented on Merger Condition 8 in pre-filed testimony and it did not contest Pepco's explanation of its 2018 reliability spending. There was no cross-examination of Pepco witnesses regarding compliance with Merger Condition 8, aside from Montgomery County introducing data requests related to the Company's 2018 spending level. Based upon Pepco's explanation of its 2018 reliability spending and the two adjustments thereto, and that no party challenged the Company's explanation, I find no evidence that a violation of Merger Condition 8 occurred in this proceeding.

B. RMA 3a (May 2019 Reliability Closings) and 3b (June-July 2019 Reliability Closings)

1. Pepco

The Company proposed to include reliability closings for May 2019 (RMA 3a) and for June 2019 through July 2019.[132] RMA 3a increases rate base by $5,452,000 and decreases operating income by $351,000, and RMA 3b increases rate base by $7,979,000 and decreases operating income by $651,000.

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[131] 108 Md. P.S.C. at 707.
[132] Wolverton Direct at 5.

2. AOBA

AOBA recommended denying post-test year reliability closings for RMA 3a and 3b due to the lack of information related to overtime costs related to these adjustments.

3. OPC

Mr. Effron asserted that both adjustments are a departure from traditional ratemaking and inconsistent with recent Commission decisions.[133] He stated the adjustments are not known and measurable, and the Company did not assert either adjustment was consistent with previously accepted adjustments.

4. Staff

Mr. Patterson testified both RMA 3a and 3b include post-test year plant additions that were expected to be closed to plant in service from May through July 2019, after the hearing dates. He noted the Commission's previous rejection of similar adjustments in recent Pepco rate cases. Since the amounts are not known and measurable, as well as not being used and useful, Mr. Patterson removed post-test year reliability plant additions for the period of May through July.[134]

5. Parties' Responses

Pepco Witness Wolverton does not believe that timing should act as a bar to either adjustment. Pepco is willing to continue to provide information regarding the adjustments from plant closing between May and July 2019, and would agree to a true-up provision of any

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[133] Effron Direct at 5-6.
[134] Patterson Direct at 8.

variations between projected versus actual amounts.[135] Alternatively, he opined the Company could record a regulatory liability for amounts in excess of what actually goes into service and refund that amount back, with carrying costs, in the next rate case.

OPC Witness Effron noted Pepco agreed that the Commission has previously rejected similar adjustments and Mr. Wolverton offered no basis as to why this case should be treated differently.[136] Staff Witness Patterson claimed the Commission has consistently disallowed post-hearing reliability investment closings.[137] Both Montgomery County and the GSA supported OPC's and Staff's position on disallowing both RMA 3a and 3b.

6. Decision

The Commission has allowed post-test year adjustments for reliability plant additions as noted above. However, the Commission has consistently rejected adjustments that include post-hearing reliability additions. In Case No. 9443, the Commission once again rejected post-hearing reliability plant additions, and noted the rejection of similar adjustments in Pepco's three previous cases, Case Nos. 9418, 9336, and 9311.[138]

The record in this case is no different from Pepco's four prior rate cases and the Company has not made a compelling case to depart from the Commission's stance on post-hearing reliability adjustments. The plant additions in Adjustment 3a did not close until after the hearings, and Adjustment 3b will not close until after the issuance of the Proposed Order. As such, there is no information in the record as to the actual costs posed in either adjustment, hence the adjustments are neither known nor measurable and, due to the timing of the projects, no party can challenge the adjustments. Therefore, RMA 3a and 3b are denied.

[135] Wolverton Rebuttal at 7.
[136] Effron Surrebuttal at 2.
[137] Patterson Surrebuttal at 5.
[138] 108 Md. P.S.C. at 660.

C. RMA 5 (pension) and RMA 6 (Other Post-Employment Benefits ("OPEB"))

1. Pepco

Mr. Ziminsky stated these adjustments reflect the distribution-related pension (RMA 5) and OPEB (RMA 6) expenses in accordance with the 2019-level costs that will be accrued by the Company pursuant to a preliminary actuarial report issued by Willis Towers Watson ("Towers Watson") in June 2018.[139] RMA 5 increases operating income by $207,000 and RMA 6 increases operating income by $4,000

2. Staff

Mr. Patterson proposed using a three-year average developed from the Towers Watson report and information from two prior rate cases in an effort to accommodate a large increase in pension expense.[140] Pepco's pension expenses increased by $6 million between the filing of direct testimony to supplemental direct testimony, which Pepco indicated was due to the actual return on the pension being 4.86%, when the expected return had been 7%.[141] Mr. Patterson claimed using a three-year average was more reflective of the Company's actual pension expense given the variance over the last three cases.[142] Staff similarly recommended using a three-year average for consistency purposes with RMA 5.[143]

3. Pepco's Response

Mr. Ziminsky claimed the Company's proposal to rely upon known and measurable changes in the most recent actuarial report was consistent with Case No. 9443 and

[139] Ziminsky Direct at 12.
[140] Patterson Direct at 12.
[141] Patterson Direct at 12-13.
[142] Patterson Direct at 13.
[143] *Id*. at 13.

previous decisions. He asserted that Mr. Patterson provided no support for his use of a three-year average pension and OPEB expenses over what Pepco will actually record during the rate-effective period based on the actuarial report. Mr. Ziminsky testified that using a three-year average expense has been used for certain O&M expenses that have year-to-year volatility; however, Pepco's pension and OPEB expenses are both known and measurable based on the actuarial report.[144]

On brief, Pepco argued Staff's adjustment was arbitrary and results-oriented, and there was no evidence to support the use of a historical three-year average as being more appropriate than the figures set forth in the Towers Watson actuarial report.

4. Staff's Response

Mr. Patterson maintained his initial position and claimed the Company failed to demonstrate these expenses are in jeopardy of being underfunded and thus recommends the use of the average level of cost for both expense components.[145]

5. Decision

In a 2010 Pepco rate case, the Commission denied a similar proposal by AOBA to use a three-year historical average for pension and OPEB expenses and found "AOBA's historical analysis is backward-looking and is not likely to reflect expected future costs. For these reasons, we find that Pepco's adjustment is appropriate, and we reject AOBA's counterarguments."[146] However, the mere fact that these expenses have not been previously normalized does not mandate acceptance of Pepco's proposed adjustment.

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[144] Ziminsky Rebuttal at 8.
[145] Patterson Surrebuttal at 10.
[146] *Re Potomac Elec. Power Co.*, 101 Md. P.S.C. 290, 306 (2010).

In this case, the record indicates that these costs have fluctuated over the past three years, but no party challenged the basis of Pepco's adjustment, the Towers Watson actuarial report. There were also no claims that the expenses were imprudent. Staff Witness Patterson indicated that he did not challenge the results from Towers Watson actuarial report and agreed the report presented the more recent and best estimate of the Company's actual pension and OPEB costs to be incurred during the rate effective period.[147]

Based on the record, I find Pepco's adjustment to be reasonable given the undisputed findings of the Towers Watson actuarial report as the best estimate of the pension and OPEB costs that will be incurred during the rate effective period. Therefore, Staff's adjustments are denied. Additionally, I disagree that the Company was somehow required to demonstrate that these accounts would be in jeopardy of being underfunded as I do not believe that is the correct or proper standard. Accordingly, I accept Pepco's adjustment which results in a decrease to operating income of $2,151 million (RMA 5) and $0.197 million (RMA 6), respectively.

D. RMA 10 (Non-Executive Incentive Plan expense)

1. Pepco

The Company's adjustment provides a three-year average for the non-executive incentive plan expense for management employees and increases operating income by $562,000.[148]

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[147] Tr. at 717.
[148] Ziminsky Direct at 14.

2. AOBA

Mr. B. Oliver compared Pepco's proposed three-year average of AIP costs to the Company's last four rate cases. He found the Company's AIP costs three-year average increased by $7.2 million (168%) since Case No. 9336, and no support for the increase was provided.[149] Mr. B. Oliver also claimed Pepco did not provide a correlation between the AIP costs increase to additional benefits to Maryland customers. Instead, he claimed the AIP increases offset synergy savings benefits that ratepayers were expecting from the Exelon merger.

Mr. B. Oliver stated the increase was not driven by the number of non-executive management employees, which has slightly declined, or the number of management employees, which has drastically declined. He explained that despite the employee decreases, the incentive costs for the Company's Distribution and Administrative and General ("DA&G") functions increased by 56.2%.[150] Mr. Oliver also noted a 25% decrease in Pepco's Service Company employees only resulted in an 11% decline in the DA&G functions. Finally, the AIP costs charged by Exelon Business Service Company ("EBSC") increased by more than $2.6 million (140%).

Based on Pepco's failure to demonstrate the reasonableness of these costs, Mr. B. Oliver recommended limiting the AIP costs increase to the $8,468,000 million level reflected in Case No. 9472, resulting in a $5,001,000 reduction to the Company's test year AIP expenditures.[151]

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[149] B. Oliver Direct at 76-77.
[150] B. Oliver Direct at 79.
[151] *Id*.

3. Pepco's Response

Mr. Ziminsky testified the Commission has found that using a three-year average for non-executive expense to be appropriate over the past seven rate cases. He noted the higher payout resulted from Pepco achievement of higher performance during the year and indicated both record performances in call center satisfaction and results on SAIFI, as well as CAIDI improvements.[152]

Mr. Ziminsky indicated the proposed use of a three-year average for non-executive AIP results in a $1.186 million reduction in Pepco's revenue requirement. He argued AOBA's adjustment to the amount included in Case No. 9472, a settled case, was arbitrary and without justification.

In brief, Pepco pointed out that Mr. B. Oliver agreed Case No. 9472 contained no specific dollar figure was contained in the settlement for AIP; therefore, AOBA's adjustment could not be accepted.[153] In terms of customer benefits, the Company noted its higher performance during the year for its customer-related metrics and cited its record performances for call center satisfaction and SAIFI.[154]

4. AOBA's Response

Mr. B. Oliver stressed the Company's AIP costs have increased more than 300% over the past four rate cases, but Pepco has not provided any evidence of a corresponding increase to customer benefits.[155] During cross-examination, Mr. B. Oliver clarified that his

[152] Ziminsky Rebuttal at 10-11.
[153] Pepco's Brief at 38-39.
[154] Pepco's Brief at 39.
[155] B. Oliver Surrebuttal at 31-32.

recommendation is that the Company's adjustment in this case be limited to the figure it presented in Case No. 9472.[156]

On brief, AOBA cited the significant increases in AIP costs over the past several years and claimed there is no evidence of increased ratepayer benefits that supports the increases that have occurred since Case No. 9311.[157] AOBA also discounted Pepco Witness Wolverton's testimony which referenced part of the increase was due to Exelon Business Service Company exceeding its key performance indicators as there was nothing in the record regarding EBSC's performance or how EBSC's performance related to the key performance indicators.[158]

5. Decision

In previous Pepco's rate cases, the Commission has stated "non-executive AIP is an appropriate method to encourage employees to achieve operational efficiency and promote quality customer service, which benefits ratepayers,"[159] but subsequently clarified that "the Company should only be allowed to recover non-financial-related goal expenses to the extent that the Company can demonstrate that they provide benefits to Maryland ratepayers."[160] In Case No. 9443, the Commission disallowed a portion of Pepco's AIP expense due to its failure to meet the SAIFI reliability commitments that it made in exchange for merger approval.[161]

In AOBA's request for rehearing, AOBA argued the Commission "inappropriately places a burden on intervenors to assess cost increases and explain appropriate adjustments when

[156] Tr. at 528.
[157] AOBA's Brief at 19-20.
[158] AOBA's Brief at 20, *citing* Wolverton's Rebuttal at 30 and Tr. 361-362.
[159] *Re Potomac Elec. Power Co.*, 104 Md. P.S.C. 292, 323 (2013).
[160] *Re Potomac Elec. Power Co.*, 107 Md. P.S.C. 701, 736 (2016).
[161] 108 Md. P.S.C. at 677.

the Company itself did not do so in its direct case."[162] In denying AOBA's request, the Commission found AOBA did not rebut the Company's *prima facie* case, and that "Mr. Oliver's mere observation that the expenses had increased significantly was not sufficient to conclude that the expenses were necessarily unjust or unreasonable, imprudently incurred, or not supported by evidence."[163]

In this case, despite AOBA's claim of that there have been no ratepayer benefits, the record demonstrates that Pepco's performance has significantly improved over the past several years, notwithstanding missing the referenced reliability commitment, and included setting a Company best in call center satisfaction and matching the Company's best SAIFI performance. I find both of these items to represent ratepayer benefits. Pepco's increased reliability is evident based not only on its performance in terms of the Commission's reliability standards, but the public was, for the most part, very complimentary of the Company's performance over the past several years.

I find AOBA's claim that the AIP increases have somehow offset synergy savings benefits to be speculative and unsupported. Additionally, given the Case No. 9472 black box settlement, I find that it is not appropriate or reasonable to rely on that proceeding's AIP figure. Given the timing of the settlement in Case No. 9472, no party filed testimony replying to Pepco's initial position on AIP costs or any other adjustment. It is not appropriate to simply insert information from a settled case where no party examined the data and determined how it correlates to this specific proceeding, and the resulting settlement does not reference what AIP-related amounts were agreed to by the parties.

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[162] *In the Matter of the Application of Potomac Elec. Power Co. for Adjustments to Its Retail Rates for the Distribution of Elec. Energy*, Case No. 9443, Order No. 89124, *slip op*. at 7 (May 10, 2019).
[163] *Id*. at 8.

Therefore, I accept the Company's adjustment to reflect a three-year average of AIP costs which increases operating income by $0.841 million.

E. RMA 12 (rate case expenses)

1. Pepco

The Company proposed to defer and amortize incremental rate case expenses from this proceeding over a three-year period, resulting in an adjustment that would decrease operating income by $39,000.[164]

2. Staff

Mr. Patterson recommended recovery of only actual, prudently incurred expenses. Additionally, he recommended the total costs be expensed in one year, rather than amortizing the costs over a period of several years, due to the Company's frequent filing of rate cases.

3. Pepco's Response

Mr. Wolverton did not oppose Staff's proposal that rate case costs be expensed, but disagreed that only actual rate case expenses be included. He explained Pepco does not have all the invoices until after the evidentiary hearings conclude.[165] On brief, the Company reiterated its position that all expenses associated with this case should be recovered, including those costs incurred after the conclusion of the evidentiary hearings.

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[164] Ziminsky Direct at 14-15.
[165] Wolverton Rebuttal at 32-33.

4. Staff's Response

Staff continued to oppose Pepco's proposed recovery of rate case expenses beyond the evidentiary hearings. On brief, Staff indicated the Company provided additional invoices which increased the total amount of rate case expenses from $24,000 to $44,000.[166]

5. Decision

In Case No. 9443, the Commission agreed with Staff's proposal to limit recovery of expenses that were known and measurable as of the end date of the evidentiary hearing. The Commission stated:

> We agree with Staff and find, in accordance with our past decisions on this matter, that the submission of actual costs by the end date of the evidentiary hearing is consistent with the regulatory principle of allowing recovery of costs that are known and measurable. Although Pepco argues that some expert witness bills may be submitted to it outside the end date of the evidentiary hearings, we find that adhering to the principle of allowing recovery only of known and measurable and prudently incurred costs outweighs the risk that some bills may not be submitted in time.[167]

Pepco has not provided a compelling argument to depart from limiting the recovery of actual rate case expenses. The inclusion of post-hearing rate case expenses would effectively require both the parties and Commission to simply accept costs that are neither known nor measurable without review.

Therefore, I will accept Staff's adjustment to the Company's rate case expenses based upon Staff's position in surrebuttal testimony. I cannot accept the proposed $20,000 increase in rate case expenses noted for the first time in Staff's Brief as there is nothing

[166] Staff's Brief at 23.
[167] 108 Md. P.S.C. at 667. (footnotes omitted)

in the record to support the proposed increase in costs. If Staff needed to update its recommendation on this adjustment after receiving additional invoices during the hearing, it should have been highlighted at some point during the four-day evidentiary hearings. The Company also had an opportunity during Staff Witness Patterson's cross-examination to inquire if his rate case adjustment had changed, but failed to do so. Acceptance of Staff's position reduces operating income by $0.24 million.

F. RMA 16 (Average Overtime levels)

1. Pepco

The Company proposed to adjust O&M expense to reflect the three-year average for overtime which decreases operating income by $1,544,000.

2. AOBA

Mr. B. Oliver was critical of this adjustment because in the initial application, Pepco estimated its Overtime Labor expense would be less than $10.2 million. Mr. B. Oliver stated Pepco's use of a three-year average to adjust its estimated test year Overtime expense added more than 35% to the Company's distribution overtime expense.[168] Based on Pepco's actual data for the test year, the O&M expense was only $8.177 million, approximately $2 million less than its initial estimate. Mr. B. Oliver explained the three-year average added approximately $5 million to the O&M expenses for Distribution Overtime, an increase of more than 60% to its actual test year expense.[169]

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[168] B. Oliver Direct at 53.
[169] B. Oliver Direct at 54.

He claimed Pepco failed to provide an explanation why the test year was $7 million below the previous two years or justification for an upward adjustment to the test year expense other than simply noting the Commission previously accepted a three-year average in Case No. 9443. Mr. B. Oliver recommended Pepco's adjustment be rejected due to the lack of any evidence that the three-year average is reflective of costs expected during the rate-effective period than the Company's actual test year expenses.[170] He also asserted Pepco failed to explain why these expenses declined or that they will rebound during the rate-effective period.

Mr. B. Oliver opined the reduction in Distribution Overtime expense resulted from the Company's reliability plant investment and that reduction was an anticipated ratepayer benefit of the investment that Pepco Witness Wolverton referred to in Case No. 9443.[171] He concluded the reduction was not an aberration and that the Company's test year expense was a reasonable representation of Distribution Overtime expense likely to be incurred in the future.

3. Pepco's Rebuttal

Mr. Wolverton described AOBA's proposal as inconsistent with Commission precedent, and based on inference and incorrect assumptions. In Case Nos. 9286, 9311, and 9418, a six-year average overtime expense was used, and in Case No. 9443, the Company proposed a three-year average overtime expense that was unopposed.[172]

Next, Mr. Wolverton claimed Mr. B. Oliver's assertion that Pepco's reduced distribution overtime O&M expense resulted from the realization of anticipated ratepayer benefits related to reliability investments recovered in Case No. 9443 was unsupported. Mr. Wolverton similarly dismissed Mr. B. Oliver's reliance on decreased employment levels

[170] B. Oliver Direct at 56.
[171] B. Oliver Direct at 59.
[172] Wolverton Rebuttal at 9.

accounting for the reduced overtime expense. He testified AOBA's position was illogical, that the number of PHISCO employees has a small impact on overtime charged to Pepco, and Pepco's employee level actually increased approximately 1.2% from Case No. 9472 and this proceeding.[173] Over the past five years, Mr. Wolverton asserted the Company's overtime expense has fluctuated between $28.8 and $34.5 million, and the test year expense in this case is within that range.

On brief, Pepco argued that averaging overtime cost was a long-standing practice and noted that three-year and six-year periods have been used in four previous rate cases, all of which resulted in a reduction to the Company's review requirement and were unopposed by AOBA.[174] In this case, Pepco's averaging adjustment would increase the revenue requirement, and the Company claimed AOBA changing positions based solely on observed cost increases or decreases was not appropriate and creates an unstable regulatory environment.[175]

4. AOBA's Response

Mr. B. Oliver cited Pepco's reliance on its Total Overtime expenses rather than Distribution Overtime. Based upon the Company's figures presented in Case Nos. 9443 and 9472, AOBA asserted the test year expenses were a substantial outlier. Mr. B. Oliver concluded that there must have been fundamental changes in the Company's activities and that deployment of its resources caused the reduction compared to previous years.[176]

[173] Wolverton Rebuttal at 10-11.
[174] Pepco's Brief at 40.
[175] Pepco's Brief at 41.
[176] B. Oliver Surrebuttal at 15.

5. Decision

It is clear the Company's test year expense significantly decreased, but I do not believe that a one-year decrease, without additional information, is evidence of a future trend. The Commission's treatment of this particular expense demonstrates that this is exactly the type of cost that should be averaged. As previously noted, just because the normalization of a cost results in an increase to a utility's revenue requirement does not mean normalization is not appropriate.

Based on the record, I find Pepco's three-year average to be appropriate and therefore will accept the Company's proposed adjustment. In the event the Company's overtime expenses stay at the current test year level or decrease, then it may be appropriate to revisit how the costs are treated in future cases.[177] Additionally, I also find Mr. B. Oliver's claim of "fundamental changes" as a basis for the decrease to be unsupported by the record.

Acceptance of Pepco's adjustment reduces operating income by $1.695 million.

G. RMA 17 (Benning Road environmental remediation cost)

1. Pepco

This adjustment reflected an amortization of actual costs associated with the Remedial Investigation/Feasibility Study ("RI/FS"), less recovery that began on June 1, 2018 through August 13, 2019, pursuant to the interim, 10-year amortization authorized by the Commission in Case No. 9472.[178] Pepco's adjustment increases rate base by $2,612,000 and decreases operating income by $275,000.

[177] Pepco Witness Wolverton testified the Company estimated distribution-related overtime expenses during 2019 were anticipated to increase to $12.7 million, a $3.4 million increase over the test-year. Tr. at 345.
[178] Ziminsky Direct at 15.

Ms. Sanford provided the history of the Benning Road facility, the Company's environmental remediation efforts, and a discussion of the costs incurred associated with the remediation. She stated the Benning Road facility is approximately 77 acres and is located at 3400 Benning Road, N.E., Washington, D.C. In 1906, Pepco purchased an 11-acre parcel abutting the Anacostia River and began constructing the original Benning power plant.[179] Over the next 50 years, the Company expanded the site to its current size by acquiring seven additional parcels.

Currently, the activities at the Benning Road facility include system engineering and telecommunications, vehicle fleet maintenance and refueling, central warehousing, and operating three electric substations.[180] Ms. Sanford noted the facility is also used for storage, repair, and processing for disposal of transformers and electrical equipment used in the Company's transmission and distribution system.

The original power plant burned coal, and two oil-fired steam turbine units were added in 1968 and 1972, as well as two cooling towers to prevent thermal pollution to the Anacostia River. In 1976, coal was no longer used and the power plant operated on fuel oil to provide electric power to meet peak demand in Maryland and Washington, D.C. In 2000, the power plant facilities were transferred to Potomac Power Resources, LLC. Ms. Sanford testified prior to the transfer of the Benning Road facility, there had been several releases of polychlorinated biphenyls ("PCBs") and Pepco conducted cleanups in accordance with U.S. Environmental Protection Agency ("EPA") regulatory standards.[181]

Ms. Sanford explained the events that resulted in Pepco's RI/FS that commenced in 2012. On October 8, 2010, the District of Columbia Department of Energy and Environment

[179] Sanford Direct at 2. (citation omitted)
[180] Sanford Direct at 3
[181] Sanford Direct at 5.

("DOEE") notified Pepco of its intent to file an action pursuant to the Resource Conservation and Recovery Act to compel an environmental investigation and clean up of the Benning Road facility.[182] The DOEE's notice cited several PCB spills between 1985 and 2003, and the PCBs had allegedly migrated into the sediments of the Anacostia River despite the Company's cleanup efforts. The DOEE asserted the condition posed human health and environmental risks and Pepco could be compelled to take corrective action.[183]

Pepco entered into a Consent Decree with the DOEE and agreed to conduct a RI to assess the environmental conditions on the entire site and a FS to evaluate possible cleanup actions.[184] The Company signed the Consent Decree on February 1, 2011, and the DOEE subsequently filed suit in the U.S. District Court for the District of Columbia to obtain the court's approval of the Consent Decree. On December 1, 2011, the U.S. District Court approved the consent decree finding it was "adequate, reasonable, and appropriate."[185]

Ms. Sanford noted the DOEE did not make any findings of negligence or lack of prudent operation by Pepco or that the PCB contamination was the result of any violation of an environmental law or regulation. She stated the DOEE found the Company's remedial efforts in response to the PCB releases were conducted in accordance with the applicable legal requirements.[186] The Consent Decree required a RI/FS to assess the entire Benning Road facility and a 10-15-acre portion of the adjacent Anacostia River and evaluate possible cleanup actions. Ms. Sanford explained the RI's first phase of field sampling and data analysis was completed and a Phase I RI report for public view and comment was released on March 1, 2016. The RI's

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[182] *Id*.
[183] Sanford Direct at 6, *citing* DOEE's Notice of Intent to Sue, dated October 8, 2010 ((TDS)-2).
[184] Sanford Direct at 6.
[185] Sanford Direct at 6, *citing* Memorandum Opinion, *District of Columbia v. Potomac Elec. Power Co.*, No. 1:11-cv-00282 (D. DC. December 1, 2011)(Dkt. No. 31) at 12; *see* Sanford Direct Sch. (TDS)-3 for a copy of the Memorandum Opinion.
[186] Sanford Direct at 7, *quoting* Consent Decree at 2.

second phase of field sampling and data analysis has also been completed, and a draft Final RI Report was sent to DOEE for its review on November 5, 2018.[187]

The RI found a number of constituents of potential concern ("COPCs"), including PCBs, which was generally consistent with historical operations at the Benning Road facility, other sites along the river, and the urban character of the surrounding area.[188] Ms. Sanford explained the Benning Road facility's contaminants did not pose an ecological risk and only a limited potential risk to human health, and the risks to human health posed by the contaminants in the water and sediment of the river were within the EPA's acceptable risk ranges.[189] The RI set forth recommendations for conducting the FS, with a focus on reducing the potential for exposure to COPCs within the RI study area.

In relation to the FS, Ms. Sanford stated the Company is planning to conduct a treatability study to evaluate the effectiveness of potential remedial options, and a proposed Treatability Study Workplan was submitted to the DOEE on November 30, 2018.[190] Pepco hopes to complete the Treatability Study by September 2019, and submit a draft FS report during the first quarter of 2020 for review and comment by the DOEE and the public.

Ms. Sanford testified that from January 1, 2011 through September 30, 2018, Pepco incurred $10.08 million related to the RI/FS, primarily from the RI and the removal of the cooling tower basins.[191] She explained how the cooling towers contributed to the contamination and, during demolition of the cooling towers, the surrounding contaminated soil was also removed. Ms. Sanford concluded that Pepco's costs to investigate the Benning Road facility

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[187] Sanford Direct at 9.
[188] *Id*.
[189] *Id*.
[190] Sanford Direct at 11.
[191] Sanford Direct at 12.

were prudently incurred and necessary to comply with legal obligations from the Consent Decree.

Mr. Ziminsky testified the Company has separately tracked costs related to RI/FS. Previously, those costs had been removed from Pepco's costs of service O&M expenses and the Company did not seek recovery of the Benning Road environmental remediation costs in Case Nos. 9336, 9418, and 9443, as the ultimate amount of the environmental liability was uncertain.[192] In Case No. 9443, he noted the Commission accepted an uncontested adjustment to remove costs related to the Benning Road facility environmental remediation activities from the Company's cost of service.

Mr. Ziminsky pointed out that the Commission has previously authorized recovery of environmental remediation costs for other utilities, such as Columbia Gas of Maryland and Baltimore Gas & Electric Company ("BGE"). Such costs were recoverable provided the utility demonstrated that the remediation costs were prudently incurred and the remediated asset was "used and useful" in providing service to current customers.[193] Mr. Ziminsky asserted the Benning Road remediation costs were prudently incurred, cited the mandate by the DOEE, and claimed the remediation was necessary to protect the general public.[194] Additionally, the RI/FS costs were not incurred as a result of violations of environmental regulations or Pepco's negligence.

He claimed that the Benning Road facility is still used and useful with three substations and the Benning Service Center, which supports the Company's transmission and distribution system.[195] From January 1, 2011 to September 30, 2018, Pepco has incurred

[192] Ziminsky Direct at 15-16.
[193] Ziminsky Direct at 18.
[194] *Id*.
[195] Ziminsky Direct at 19.

approximately $10.08 million in RI/FS expenses. Mr. Ziminsky stated after deducting the allowance for remediation permitted in Case No. 9472, the amount allocated to Pepco Maryland distribution is approximately $3.8 million. Customers will benefit from the remediation and the Company is also seeking insurance recovery related to the remediation costs.

Mr. Ziminsky explained the Company's allocation of the RI/FS costs between Maryland and the District of Columbia. Pepco used a two-factor allocation, each factor being equally weighted, with the first part based upon the allocation of distribution plant at the Benning Road facility, and the second based upon the allocation of Benning distribution labor operations and maintenance expense.[196] He explained the Company is seeking recovery only of actual costs incurred, and will continue to remove from test period O&M expense any accrual adjustments to the environmental liability balance.[197] The future anticipated costs for the environmental liability are expected approximately $18.4 million. Moving forward, Mr. Ziminsky stated Pepco is requesting that a regulatory asset be authorized to track the costs to complete RI/FS and perform the necessary environmental remediation activities.[198]

2. Staff

Mr. Hoppock explained Pepco allocated the Benning Road remediation and investigation costs by assigning 95% to Pepco and 5% to Pepco Energy Services ("PES"), based upon Pepco's ownership of the entire facility, when the generation portion was acquired by PES, and when the hazardous material spills occurred.[199] He noted Pepco's preferred allocation was not contained in the Company's testimony or exhibits. Mr. Hoppock stated the Company used a two-factor allocation based upon electric plant in service at the facility and a site specific labor

[196] Ziminsky Direct at 20.
[197] *Id*.
[198] Ziminsky Direct at 20-21.
[199] Hoppock Direct at 24-25.

allocator, resulting in 42.3% of the costs being allocated to Maryland distribution customers.[200] He testified a total of $10.8 million of Benning Road costs are allocated to both D.C. and Maryland distribution ratepayers, including $3.28 million for the removal and cleanup for the former power plant.

Mr. Hoppock recommended that the allocation of the Benning Road remediation and investigation costs be delayed. He opined that the final RI report, which will be approved by the DOEE, may contain information as to what the type of function, *i.e.*, distribution, subtransmission or generation, contributed to and to what degree of the contamination.[201]

Mr. Patterson indicated the Case No. 9472 settlement permitted a 10-year amortization period for $3.9 million for RI/FS costs, but the issue of recovery of further costs was deferred until this case. Staff argued it was more appropriate to wait until the final RI and FS Reports were completed prior to considering Pepco's recovery of the associated costs. The RI Report should be completed by February 2020 and the FS Report should be completed by September 2021, and after those reports have been issued, Staff believes it will be better able to evaluate the recovery of costs and future remediation costs.[202] Staff's proposed adjustment reduces rate base by $2,761,000 and increases operating income b $291,000.

3. Pepco's Response

Ms. Sanford reiterated the purpose and information that will be contained in both the final RI and FS reports, but opined the reports would not be pertinent to whether the Company should recover the remediation costs or how those costs should be allocated between Pepco and PES, and between Maryland and D.C. Ms. Sanford testified, "The only remediation

[200] Hoppock Direct at 25.
[201] Hoppock Direct at 27.
[202] Patterson Direct at 10.

costs proposed to be included in RMA 17 relate to the removal of the concrete basins for the former cooling towers and the surrounding soil."[203] The remaining costs include those incurred for site investigation activities as required by the court-approved consent decree.

During cross-examination, Ms. Sanford stated the purpose of the RI was to look at the entire site and determine if the contamination exists on the site that may or may not have contributed to the contamination of the Anacostia River, while the FS's purpose is to review the RI and determine what remediation, if any, is required and review the remediation options.[204] She agreed that four other locations in the Benning Road's vicinity have environmental actions ongoing that are separate from the Company's investigation. Ms. Sanford also specified that the costs Pepco was seeking recovery for relate to the investigation required by the Consent Decree and the remediation of the cooling tower basins.[205]

Mr. Ziminsky claimed Staff's position was based upon the erroneous premise that the reports may contain information about the business operations that may have contributed to the contamination. He explained the Commission has permitted the recovery of environmental remediation costs provided the costs were prudently incurred and the remediated asset was used and useful in providing service to current customers.[206] Mr. Ziminsky stated no party argued the remediation costs incurred were either improper or imprudent, or that the Benning Road Facility is not used and useful.

Mr. Ziminsky disagreed with Staff Witness Hoppock's testimony that Pepco was including costs from generation assets. Mr. Ziminsky testified the costs are for remediation, and

[203] Sanford Rebuttal at 4-5.
[204] Tr. at 292-293.
[205] Tr. at 314.
[206] Ziminsky Rebuttal at 14.

since there is no mechanism to include the costs in SOS rates, it was appropriate to include them in distribution rates.[207]

4. Staff's Response

Mr. Hoppock stated, "the opinion of the DOEE about whether and to what extent historical operations contributed to contamination of the river may provide information whether Pepco's proposed allocation between PES and Pepco is reasonable and has a cost causation basis."[208] On cross-examination, he specified Staff's position that "the final version of these reports, which will incorporate the comments of the District of Columbia Department of Energy and Environment, may contain information that may help guide the allocation."[209]

On cross-examination, Mr. Patterson indicated Staff did not oppose the establishment of a regulatory asset for future Benning Road remediation costs. He cited environmental concerns from properties nearby Benning Road as a basis to wait for the RI/FS report prior to determining the responsibility for and proper allocation of costs to Maryland customers.[210] Mr. Patterson also cited a D.C. program for the revitalization and redevelopment of the area around Benning Road, and that Maryland ratepayers only pay for a portion of the revitalization, not the redevelopment.[211] He confirmed Staff did not raise the issue of revitalization in its pre-filed testimony.

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[207] Ziminsky Rebuttal at 15.
[208] Hoppock Surrebuttal at 11.
[209] Tr. at 766.
[210] Tr. at 712-713.
[211] Tr. at 713.

5. Decision

The Commission has previously permitted utilities to recover environmental remediation costs when there is no evidence the clean-up costs resulted from the utility's imprudence or mismanagement, and that the remediation site is used and useful.[212] The Commission has previously used a ten-year amortization period as an appropriate period to recover actual expenditures.[213]

In this case, Pepco is performing environmental remediation of a site pursuant to a consent decree with DOEE, subsequently approved by the U.S. District Court for the District of Columbia on December 1, 2011, which obligates the Company to conduct a RI/FS, and which provided and continues to provide service to ratepayers.[214] No party contested that the Benning Road facility has been and continues to be used and useful in providing service to Pepco's customers. Although the Benning Road power plant is no longer owned by Pepco, the Company still owns the land and the substations that support Pepco's electric transmission and distribution system for its entire service, including Maryland.[215] Additionally, no party alleged that the Benning Road facility's environmental contamination was a result of the Company's negligence or that the costs to date were not prudently incurred.[216]

Pepco Witness Sanford was the only witness with actual experience with environmental remediation and RI/FS reports, and I found her testimony to be compelling. The RI/FS studies will certainly provide information related to the extent of Pepco's responsibility for remediating the Benning Road facility and possibly the Anacostia River; those studies will not change the investigation and remediation costs that have been incurred thus far. Therefore, I find

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[212] *Re Columbia Gas of Maryland, Inc*., 104 Md. P.S.C. 487, 499 (2013), *citing Re Chesapeake Utils. Corp*., 80 Md. P.S.C. 187 (1989).
[213] 104 Md. P.S.C. at 500.
[214] Sanford Direct at 6.
[215] Ziminsky Direct at 19.
[216] Tr. at 711.

no basis to delay Pepco's recovery of the costs it has incurred thus far, and Staff's proposal is denied. As no party challenged the reasonableness of the Company's investigative and remediation costs, I approve Pepco's adjustment and find the proposed 10-year amortization period to be reasonable.

I also find it appropriate that Pepco establish a regulatory asset for the purpose of tracking future investigation and remediation costs related to remediation efforts pertinent to the Benning Road Facility. However, this decision does not guarantee Pepco recovery of remediation costs that will be incurred in the future, especially since the extent of the remediation that will occur on the site is not known at this point. As such, this finding should not be viewed as upfront approval of any level of costs for Pepco. The Company will continue to have the burden to demonstrate the prudency of future remediation costs that it seeks to recover and when Pepco seeks recovery of those costs in future rate cases, parties will be free to challenge those costs, as well as the reasonableness of Company's allocation methodology which was not directly challenged in this proceeding.

Acceptance of Pepco's adjustment increases rate base by $2.761 million and decreases operating income by $0.291 million.

H. RMA 20 (expiring amortization expense)

1. Pepco

The Company proposed to remove expiring amortization expense for amortization periods that end during the test year or prior to the rate effective period. Mr. Wolverton specified the adjustment includes a Local 1900 Contract Ratification Bonus approved in Case No. 9336, the Derecho Storm, Hurricane Sandy, and the 2013 Nor'easter storm preparation

expenses.[217] RMA 20 decreases rate base by $803,000 and increases operating income by $1,580,000.

2. OPC

In addition to the expenses referenced by Pepco, Mr. Effron indicated there will be other amortizations that will expire in November 2019, specifically, the February 2010 storm, the January 2011 storm, Hurricane Irene, Case No. 9418 rate case costs, and the Electric Vehicle pilot costs.[218] While a full-year amortization was recorded in the test year for the referenced costs, less than a full year of amortization will remain when rates become effective. Absent an adjustment, the Company will over-recover the remaining balances for these expenses. Therefore, Mr. Effron recommended recovery be limited to the remaining balances as of mid-August, $914,000 less than the amortization expenses recorded in the test year.[219]

3. Pepco's Response

Mr. Wolverton disagreed with OPC's position that the amortization periods be extended. He asserted extending amortization periods creates a never-ending cycle and is not consistent with the Commission's intent.[220] During cross-examination, Mr. Wolverton agreed that absent an adjustment to the test year amortization, the Company would recover $913,000 more than the remaining balances of the accounts over the course of a year.[221]

[217] Wolverton Direct at 11-12.
[218] Effron Direct at 14.
[219] Effron Direct at 15.
[220] Wolverton Rebuttal at 32.
[221] Tr. 440-441.

4. OPC's Response

Mr. Effron explained the amortization for the February 2010 and January 2011 storms, Hurricane Irene, Case No. 9418 rate case costs, and the Electric Vehicle pilot costs would be complete and end during the rate-effective period.[222] He stated his adjustment was necessary to avoid Pepco's over-recovery, which the Company did not dispute.

5. Decision

In Case No. 9443, OPC proposed a similar adjustment to defer the amortization of storm costs. The Commission held "that the amortization of deferred storm costs recorded in the test year should be adjusted to avoid over-recovery of the remaining balance of deferred storm costs."[223]

The record in this case presents a similar situation. Depending on the timing of the filing of Pepco's next rate case, the Company could over-recover these costs, but Pepco did not provide any indication of when it intends to file its next rate case. I find the potential over-recovery of more than $900,000 from ratepayers provides sufficient justification for OPC's adjustment. Therefore, I adopt OPC's adjustment which reduces rate base by $0.803 million and increases operating income by $2.242 million.

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[222] Effron Surrebuttal at 5.
[223] 108 Md. P.S.C. at 672-673.

I. RMA 21 (Winter Storm Riley)

1. Pepco

This adjustment amortizes over five years the incremental O&M costs incurred for the March 2018 Winter Storm Riley costs which increases rate base by $3,383,000 and decreases operating income by 751,000.[224]

2. AOBA

Mr. B. Oliver claimed Pepco failed to demonstrate its costs were reasonable. He explained Pepco Witness Wolverton referenced mutual assistance, but all work associated with the storm was performed by contractors. Mr. B. Oliver noted the Company paid contractors at substantially different rates with no justification or explanation.[225] He also questioned Pepco being billed for 16 hours per day per worker, including 16 hours per day for travel days, which he found to be excessive.

In relation to the total costs sought by the Company, Pepco's updated information indicated $3,615,000 in contractor costs, but discovery responses had a total of $2,952,757, an unexplained difference of $662,243.[226] Mr. Oliver recommended a $662,243 adjustment, as well as eliminating half of the travel time (8 hours) for each contractor employee after being released by Pepco, which lowers the total invoiced amount by $361,000.[227] He also recommended reducing hourly charges in excess of twice the average hourly charge for the three lowest cost contractors, resulting in a $411,224 adjustment, for a total of $2,180,541 in contractor charges, and the balance of costs to be deferred and amortized to be $3,027,000.[228]

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[224] Wolverton Direct at 12.
[225] B. Oliver Direct at 67.
[226] B. Oliver Direct at 68-69.
[227] B. Oliver Direct at 69.
[228] B. Oliver Direct at 70.

3. Pepco's Response

Mr. Wolverton claimed that differences in wages for mutual assistance contractors was common and varies depending on the duties performed. He also asserted the travel expenses were not excessive and that 16-hour travel time was the industry standard.[229] Mr. Wolverton explained the difference between the contractor costs in the Company's regulatory asset ($2,952,757) and the figure provided during discovery ($3.62 million), which was subsequently updated in rebuttal ($3.69 million) to account for another contractor invoice. He testified the $3.62 million was "the total contractor O&M expense related to Pepco Maryland for Winter Storm Riley," and includes mutual assistance contractors, contractors of choice, and other contractors.[230] The $2.95 million Mr. B. Oliver referenced represents the total amounts for mutual assistance, which includes O&M and capital, for all of Pepco (D.C. and Maryland).

Mr. Wolverton stated AOBA's adjustment was based on an inappropriate comparison between the $3.69 million incremental contractor O&M expenses, costs related to the Company's response in Maryland, to the $2.95 million that represents mutual assistance for O&M and capital for D.C. and Maryland.[231] During cross-examination, Mr. Wolverton claimed documentation of the Company's contractor costs was provided to AOBA.

Mr. Clark disagreed with AOBA that its contractor costs were unreasonable and he explained the Company's storm preparedness activities.[232] He discussed the Governing Principles Covering Emergency Assistance Arrangements ("GPCEAA"), which addresses when an assistance period begins and ends, and the incursion of expenses.[233]

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[229] Wolverton Rebuttal at 18.
[230] Wolverton Rebuttal at 19.
[231] Wolverton Rebuttal at 20.
[232] Clark Rebuttal at 12-13.
[233] Clark Rebuttal at 13-14.

Mr. Clark explained how the Company secures mutual assistance from other utilities and contractors, and that rates are determined after the contractors have been secured. He clarified that Pepco's expectations in relation to contractors obtained through mutual assistance is that even though contractors are not signatories to the GPCEAA, the Company expects the contractor would meet and abide by the general rules and principles in the GPCEAA and industry-standard mutual assistance practices.[234]

Mr. Clark testified the 16-hour workday commitment is considered industry standard and Pepco applies that standard to mutual assistance received from other utilities and contractors.[235] On cross-examination, he stated Pepco's expectations that all mutual assistance contractors conform to the GPCEAA requirements.[236]

On brief, Pepco argued its Winter Storm Riley costs were just and reasonable, and supported by the record, including Staff and OPC's acceptance of the adjustment. The Company claimed non-utility contractors were classified as mutual assistance and were used due to the availability of utility resources. Pepco explained the wage differentials paid to contractors and the 16-hour day industry standard for mutual assistance. The Company discounted AOBA Witness B. Oliver's opinion on mutual assistance and emergency management given the lack of applicable experience, and highlighted Mr. Clark's extensive operations and storm restoration experience.[237]

The Company claimed its adjustment was supported by ample evidence and that AOBA was making an "apples to oranges" comparison as the foundation of its position.[238] Pepco countered AOBA's claim of inaccuracies and inconsistencies related to the information

[234] Tr. at 176-177.
[235] Tr. at 161-162, 171.
[236] Tr. at 182-183.
[237] Pepco's Brief at 45.
[238] Pepco's Brief at 46.

provided by citing over 1,200 pages of contractor invoices provided during discovery and exhibits that demonstrated the total invoiced amounts and the amounts sought in this proceeding.[239] The Company also noted AOBA only challenged the cost related to outside contractors; therefore, exclusion of all storm restoration costs would be inappropriate.

4. AOBA's Response

Mr. B. Oliver asserted the amounts for mutual assistance contractors in Pepco Witness Wolverton's rebuttal testimony deviates from the invoiced amounts for the same contractors provided during discovery for which no explanation for the difference was provided, and included incurred costs from "other contractors" that had not previously been disclosed.[240]

In response to my questions, Mr. B. Oliver stated the appropriate portion of Maryland O&M costs charged by contractors were not known and measurable. He was not opposed to recovery of these costs in a later proceeding, but there were considerable inconsistences in the information provided by Pepco.[241]

In brief, AOBA noted the Company's "substantive corrections" to information related to Winter Storm Riley and Pepco's failure to explain how O&M components of invoiced amounts for each mutual assistance contractor were determined.[242] AOBA argued that discovery provided by Pepco the evening before surrebuttal testimony was due established that not all costs included in the Storm Riley costs billed by contractors was for storm-related work; there was no support for how the Company determined what storm costs were charged to capital and O&M; and large variances in the amounts paid to contractors raised questions of reasonableness.[243]

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[239] Pepco's Brief at 47.
[240] B. Oliver Surrebuttal at 24 and 26.
[241] Tr. at 529-530.
[242] AOBA's Brief at 29.
[243] AOBA's Brief at 30-31.

5. GSA's Brief

The GSA agreed with AOBA's adjustment. GSA noted AOBA demonstrated that travel time charges for third-party contractors could be considered excessive, and Pepco failed to provide adequate documentation or explanation for its third-party contractor costs.[244]

6. Decision

Just as the Commission has previously declined to micromanage Pepco's spending in regards to a reliability enhancement plan, I find it is not appropriate to micromanage how a utility plans for and secures contractors in preparation for storms. In relation to the rates paid to contractors, Mr. Clark explained the Company secures the contractor first and once they are on the way to the service territory, the rates to be paid are determined. Mr. Clark was the only witness with extensive experience in utility operations and storm preparedness and I found his testimony persuasive. I find the Company's approach to secure contractors and the hourly rates, including travel time, to be appropriate. There is no evidence to support AOBA's proposed adjustment to reduce contractor wages based simply on the amounts charged by the contractors. Additionally, I accept Mr. Clark's explanation regarding the standard 16-hour work day as the industry standard based largely on his experience and the lack of any evidence to the contrary.

In response to AOBA's proposed disallowance of outside contractor costs, I agree the Company adequately supported its expenses and the inaccuracies corrected and explained by Mr. Wolverton on the stand were not significant as claimed by AOBA. Therefore, AOBA's adjustment and recommendation to establish a regulatory asset is denied. Acceptance of Pepco's adjustment increases rate base by $2.964 million and decreases operating income by $0.659 million.

[244] GSA's Brief at 5-6.

J. RMA 29 (Reflection of Rate Effective Period Property Tax Increase)

1. Pepco

The Company adjusted its test period property tax expense based on expected changes for the fiscal year (beginning July 1, 2019). Mr. Wolverton indicated Pepco's property assessments have increase by an average of 6.8% per year over the past five years; therefore, Pepco increased its 2019 fiscal year assessment by 6.8%, which results in a decrease to operating income by $1,919,000.[245]

2. OPC

Mr. Effron testified this adjustment does not reflect a known and measurable change and is a projection of the actual Fiscal Year 2019 Property Tax Assessment to the 2020 Property Tax Fiscal Year based on increases in recent years.[246]

3. Staff

Mr. Patterson disagreed with Pepco's adjustment because it falls outside the test year as the rate effective period Property Tax adjustment will not be effective until July 1, 2019.[247] Therefore, he claimed the adjustment is not known and measurable and the adjustment was not necessary given Pepco's frequent rate case filings.

4. Parties' Response

Mr. Wolverton explained the adjustment was based on the Company's projected increase in Pepco Maryland's property taxes, which have increased by an average of 6.8% over

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[245] Wolverton Direct at 16-17.
[246] Effron Direct at 16.
[247] Patterson Direct at 16.

the past five years.[248] He noted the next property assessment will be effective July 1, 2019 and that accepting OPC's and Staff's adjustment will likely result in rates that do not include the higher property taxes. However, Mr. Wolverton stated if RMA 29 is disallowed, the Company should be permitted to establish a regulatory asset to track future property tax increases and seek recovery of the regulatory asset in a future rate case.

Mr. Effron noted his recommendation was based upon the property tax expense for the actual Fiscal Year 2019 Property Tax Assessment, which is both known and measurable.[249] He also claimed his position was consistent with the Commission's practice on this issue. Staff's position remained unchanged.

5. Decision

I agree that accepting OPC's or Staff's position could result in rates not including higher property taxes, but the converse it also true. If Pepco's position is adopted, it is entirely possible that the Company's rates will include a much higher property tax rate when the July 1, 2020 assessment is issued. The Company has not provided sufficient justification to dismiss relying upon known and measurable figures in favor of its significantly higher estimated tax rate, or that a regulatory asset should be established. Accordingly, I find OPC and Staff's adjustments to be reasonable and they are accepted.

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[248] Wolverton Rebuttal at 20.
[249] Effron Rebuttal at 6.

K. RMA 31 (Reduction of Maryland apportionment factor rate change)

1. Pepco

On April 26, 2018, legislation was signed into law that altered the formula used to apportion income to Maryland for certain corporations that conduct business both inside and outside of Maryland. The legislation provided a phase-in of a single sales factor apportionment formula from the current three factor formula (sales, payroll, and property) that will be fully implemented by 2022.[250] As a result of the change, Mr. Wolverton stated Pepco has an apportioned State income tax increase from 4.5% to 5.1%, which results in an increased per books Maryland income tax expense that will be captured in the Company's State Income Taxes (per books), and creates a deficient deferred income tax scenario.[251] Similar to Case No. 9472, Pepco proposed a 20-year amortization period for non-protected property and a 7-year amortization period for non-protected non-property.[252] Pepco's proposed adjustment decreases rate base by $674,000 and decreases operating income by $674,000.

2. Staff

Mr. Patterson recommended an adjustment for the deficient ADIT because Staff believes the flow-back periods should match the average remaining lives for the non-protected property and the non-property.[253] He stated Staff's proposal was consistent with the Company's Reflection of Additional Subtraction Modification Adjustment, which was unopposed (RMA 30).

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[250] Wolverton Direct at 21-22.
[251] Wolverton Direct at 22.
[252] *Id*. Mr. Wolverton included the definitions of both terms. Non-protected property: these EDIT balances that include items such as repair allowance. Non-protected non-property: these EDIT balances include, but are not limited to, labor-related items (pension), and regulatory assets. Neither category is protected by the TCJA's normalization provisions. *Id*. at fn. 21 and 22.
[253] Patterson Direct at 11.

3. Pepco's Response

On rebuttal, Mr. Wolverton stated the Company did not oppose Staff's adjustment.[254]

4. Decision

In light of Pepco's acceptance of Staff's adjustment and the adjustment's consistency with RMA 30, I find Staff's position to be reasonable and it is hereby accepted. Acceptance of Staff's adjustment decreases rate base by $0.383 million and decreases operating income by $0.383 million.

L. RMA 36 (5-yr Historical Average Inflation on non-labor O&M)

1. Pepco

Mr. Ziminsky noted this adjustment was consistent with a BGE proposal recently accepted in Order No. 88975. Since the use of an historical test year will not sufficiently cover the actual cost incurred during the rate effective period, he stated an adjustment to address inflation of non-labor O&M expenses to partly address the mismatch between rates and costs during the rate effective period.[255] Pepco's proposed adjustment decreases operating increases by $1,225,000.

2. AOBA

Mr. Oliver claimed Pepco failed to present evidence that inflation impacted this expense. He stated the Consumer Price Index ("CPI") relied upon by the Company to estimate the impact of inflation was based upon a "market basket" of goods and services that does not

[254] Wolverton Rebuttal at 33-34.
[255] Ziminsky Direct at 25.

relate to the non-labor goods and services Pepco annually purchases to support its distribution operations.[256] Mr. Oliver explained that even though Company's non-labor O&M expenses constituted more than 55% of the total O&M expense, Pepco did not examine the composition of the non-labor O&M expenses or address factors that impact the year-to-year changes of those costs.[257] Therefore, he recommended rejecting Pepco's proposed adjustment.

3. Pepco's Response

Mr. Ziminsky cited the Commission's approval of an inflation factor based on the CPI in BGE's recent gas rate case. He asserted Pepco has experienced cost increases in non-labor O&M expense that warrant an inflationary adjustment. Mr. Ziminsky stated, "the five-year average CPI is a common inflation measure that the Commission has recently deemed a reasoned and accurate approach, addressing trends in inflation in a verifiable and measurable manner."[258]

On brief, the Company noted the consistency of its proposed adjustment with the recently approved non-labor O&M inflation adjustment in BGE's gas rate case.[259] Pepco highlighted Mr. B. Oliver's agreement that Pepco's non-labor O&M expenses have increased over the past five years at a rate greater than the rate of inflation.[260]

4. AOBA's Response

Mr. B. Oliver dismissed Pepco's reliance on the BGE rate case and claimed he "demonstrated that there is no relationship between the changes Pepco has experienced in its

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[256] B. Oliver Direct at 72.
[257] B. Oliver Direct at 73.
[258] Ziminsky Rebuttal at 17.
[259] Pepco's Brief at 63.
[260] Pepco's Brief at 64, *citing* B. Oliver Direct at 74.

Non-Labor costs in recent years and changes in the Consumer Price Index."[261] He asserted the Company's Non-Labor costs declined in 2017 despite a 1.8% change in the CPI. Mr. B. Oliver also testified the CPI was not designed to measure Non-Labor components of utility costs.[262]

On brief, AOBA cited the Company has not previously sought an adjustment for inflation and failed to offer any compelling evidence supporting the adjustment, and Pepco's increases in non-labor costs were not driven by inflation.[263] AOBA also noted Mr. B. Oliver's disagreement that the CPI was an appropriate measure for the inflationary impacts on Pepco non-labor O&M costs.

5. Decision

In Case No. 9484, the Commission granted BGE's proposal for an inflation adjustment for non-labor O&M expense as the use of historic test year does not reflect inflation.[264] In that case, Staff and OPC raised several concerns related to BGE's proposed inflation adjustment, including the estimated amounts not being known and measurable, the lack of adjustments for decreased costs or increased revenues, and that the CPI is updated on a monthly basis and is an historic index.[265] The Commission approved a non-labor O&M inflation adjustment and found "inflation can be deemed known and measurable."[266] The Commission found the use of a five-year average of the CPI (1.40%) to be a more reasoned and accurate approach to assess the impact of inflation.[267] The Commission noted that Staff included

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[261] B. Oliver Surrebuttal at 27.
[262] B. Oliver Surrebuttal at 28.
[263] AOBA's Brief at 26.
[264] Case No. Case No. 9484, Order No. 88975, *slip op*. at 19.
[265] *Id*. at 21-23.
[266] *Id*. at 24.
[267] *Id*. at 25.

evidence that tracked changes in prices of goods and services for all urban populations within the BGE service territory.[268]

I agree with AOBA that the mere fact that one utility has been granted a particular adjustment does not mean another utility is entitled to the adjustment. Each case is evaluated on the record and findings are based upon the facts of the particular case. However, in this case, Pepco's proposal is consistent with BGE's recently approved adjustment, with the only difference being that Pepco calculated a lower computed average annual CPI of 1.23%. The record contains no evidence the Company's proposal is irrationally inconsistent with or contains material facts different than those set forth in the Commission's Order approving BGE's inflation adjustment. Based on the record, I find Pepco's adjustment is consistent with the Commission's approval of a similar BGE adjustment, and the proposed inflation rate of 1.23% is an appropriate proxy for the impact of inflation during the rate effective period. As with any adjustment, the utility has the burden of proof and the acceptance of an adjustment in this case does not guarantee the adjustment will be accepted in future cases.

Therefore, I accept Pepco's inflation adjustment which reduces operating income by $1.145 million.

M. Distribution Plant Sales Gain

1. Staff

Mr. Patterson indicated Pepco inadvertently omitted in its initial filing information related to the sale of .034 acres to Prince George's County, and that it was granted a perpetual easement of .116 acres and a temporary easement of .018 acres for the Emory Grove substation on June 1, 2017. Staff noted the gain from the sale was $71,108.42.

[268] *Id*.

2. Pepco's Response

Mr. Wolverton claimed providing the distribution gain from the June 2017 sale to customers would amount to retroactive ratemaking.[269] He noted that gains and losses recorded prior to the test period are generally not appropriate adjustments to the test period. During the evidentiary hearings, Mr. Wolverton testified the gain from the sale was not included in Case No. 9472 as it was recorded to a below the line FERC account that is not picked up in the Company's cost of service.[270]

3. Staff's Response

Mr. Patterson disagreed that Staff's adjustment constituted retroactive ratemaking and testified that Pepco did not give customers the benefit of the gain at the time of the sale.[271] On cross-examination, Mr. Patterson stated Staff was aware of the sale during Case No. 9472, but the adjustment was not included in testimony because of a settlement entered into prior to the filing of testimony.[272] He asserted the proposed adjustment was not retroactive ratemaking, but was "just basically righting a wrong."[273] Mr. Patterson testified since Case No. 9472 was a black box settlement, this particular adjustment may or may not have been incorporated. He asserted the adjustment was correcting an error, specifically, that the Company booked the gain below the line and gave the profit to shareholders rather than ratepayers.[274]

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[269] Wolverton Rebuttal at 33.
[270] Tr. at 448 and 453.
[271] Patterson Surrebuttal at 11.
[272] Tr. at 723.
[273] Tr. at 724.
[274] Tr. at 727.

4. Decision

Typically, the Commission has found that "ratepayers should share the gains realized on the sale of property which had been included in rate base with ratepayers paying a return thereon."[275] However, Staff's adjustment includes the sale of a property that occurred prior to this case's test year. In a 1991 PE rate case, the Commission rejected a proposed adjustment that sought to include the proceeds of sales for five years prior to the test year.[276] The Commission stated, "Unless extraordinary circumstances or occurrences justify departure from the rule, adjustments to the test year results for gains on the sale of property should be limited to sales which took place during the test year."[277] Staff has failed to present adequate justification or extraordinary circumstances to include the proceeds of the 2017 sale in this case.

Additionally, unlike the PE case, the sale at issue occurred within the test year in Pepco's previous rate case. While the Company acknowledged the sale was not specifically included in Case No. 9472 and was recorded below-the-line, Staff became aware of the sale during discovery.[278] Case No. 9472 resulted in a black box settlement, which typically results in an agreement among the parties without disclosing or agreeing on the various components that make up the revenue requirement contained in the settlement. The fact that the Case No. 9472 settlement does not specifically include an adjustment for the sale of Pepco's property is not justification for including an adjustment, which occurred prior to the test year, in this case. Accordingly, I reject Staff's proposed adjustment.

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[275] *Re Delmarva Power & Light Co*., 103 Md. P.S.C. 377, 395 (2012), *citing Re Baltimore Gas and Elec. Co*., 78 Md. P.S.C. 129, 146-147 (1987).
[276] *Re Potomac Edison Co*., 82 Md. P.S.C. 470, 477 (1991).
[277] *Id*. at 478.
[278] Tr. at 724-728.

N. Relocation Costs

1. Staff

Mr. Patterson used a four-year average which he claimed better reflected the Company's relocation costs for the rate-effective period given the large increases from calendar year 2015 ($52,000) to the current test year ($217,000).[279] The adjustment normalizes the expense as the test year expense may not reoccur.

2. Pepco's Response

Mr. Wolverton stated Staff's proposal was an inconsistent application of averaging and was arbitrary because it included another year of lower expense to the calculation.[280] He noted Mr. Patterson did not claim the Company's costs were imprudently incurred and offered no evidence to support the use of a four-year average. Finally, Mr. Wolverton stressed the comparison to 2015, prior to the Exelon-PHI merger, was not appropriate. He explained as a result of the merger, Pepco's relocation costs have increased due to the "significantly more geographically diverse talent pool to hire from" and has led to an increase in relocation expenses.[281]

3. Staff's Response

Mr. Patterson used a four-year average due to the large differences between relocation costs in 2015 ($52,000) and 2016 ($36,000) versus 2017 ($197,000) and 2018 (217,000).[282] He stated relocation costs should be going down because the merger was effective

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[279] Patterson Direct at 17.
[280] Wolverton Rebuttal at 26.
[281] Wolverton Rebuttal at 26-27.
[282] Patterson Surrebuttal at 8.

in March 2016. During cross-examination, Mr. Patterson stated there is sufficient talent located in the D.C.-Maryland-Virginia area and that it is not necessary to go outside service territory.[283]

4. Decision

The record indicates that in the two years following the Exelon/PHI merger, 2017 and 2018, relocation costs have significantly increased. No party challenged the prudency of these costs and Staff has not provided a reasonable basis to justify that relocation costs should be decreasing post-merger or that the costs are not representative of the Company's costs during the rate-effective period. I find that Pepco's expenses for 2017 and 2018 to be more representative of the costs the Company will incur during the rate-effective period. Therefore, Staff's proposed adjustment is denied.

O. Operating Supervision & Engineering (Training)

1. Staff

Mr. Patterson proposed a three-year average of these costs given Pepco acknowledged an increase in training activities resulting from several system conversions, and that refresher training would only be required in the future.[284] Staff believes its proposed adjustment is more reflective of Pepco's cost during the rate-effective period and normalizes the large increase.

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[283] Tr. at 737.
[284] Patterson Direct at 17.

2. Pepco's Response

Mr. Wolverton stated the Company's training expenses are not incremental above and beyond normal costs.[285] He indicated Pepco would still have incurred costs if there was no training as employees would have coded their time to normal work activities. Mr. Wolverton testified there will always be some level of training costs and, prior to surrebuttal, no party raised an issue about the contractor-related training costs.[286]

In brief, Pepco reiterated that the training costs were not incremental.[287] The Company also cited the absence of basis, *i.e.*, not known and measureable or imprudently incurred, as a means to reduce and allow a lower portion of the costs.

3. Staff's Response

Staff maintained its position and noted Pepco failed to address whether the Company's training costs included contractor-related costs.[288]

4. Decision

The test year training costs are significantly higher than the 2017 and 2018 calendar years, and the Company represented the increase resulted from several system conversions and that refresher training would be needed in the future.[289] However, Staff's adjustment is not truly a three-year average as it included calendar years 2017 and 2018, and the test year, which includes 11 months of 2018. While I agree this is exactly the type of expense that should be normalized, the record does not support Staff's three-year average adjustment. I

[285] Wolverton Rebuttal at 25.
[286] Tr. 455-456.
[287] Pepco's Brief at 68.
[288] Patterson Surrebuttal at 7-8.
[289] Patterson Direct at 17.

find it more reasonable to use a two-year average, 2017 and the test year, as being more reflective of the Company's costs in the rate-effective period. This adjustment increases operating expenses by $19,000.

I also dismiss Staff's concerns related to contractor-related training costs, which appear to have been initially raised in surrebuttal testimony which explains the Company's failure to address that point in rebuttal. In order to provide a party an opportunity to respond to a specific concern, the issue must first be raised in testimony.

P. Maintenance of Line Transformers

1. OPC

Mr. Effron found Pepco's test year expense of $6,583,000 was significantly higher and stated, "In each of the two preceding twelve month periods, the Company incurred approximately $3.7 million of expenses for maintenance of line transformers."[290] According to the Company, the test year level of expense was not anticipated to continue. Mr. Effron recommended adjusting the expense charged to Account 595 and that the expense for maintenance of line transformers be normalized based on the average expense for the three years ended January 31, 2019.[291]

2. Staff

Staff proposed a three-year average due to Pepco's response that this expense should decrease in 2019.[292]

[290] Effron Direct at 10.
[291] Effron Direct at 11.
[292] Patterson Direct at 17-18.

3. Pepco

Mr. Wolverton noted neither OPC nor Staff found the expenses to be imprudent, and just because the expenses were higher does not mean they should be adjusted. However, if an adjustment is made, he proposed the adjustment include a regulatory asset for the increase in corrective maintenance expense over Staff's three-year average level and amortized over three years, resulting in an $183,000 adjustment to amortization expense for three years.[293]

4. Parties' Responses

Mr. Effron noted Staff's adjustment was narrow and focused on the corrective maintenance expense to Account 595. He found Staff's adjustment to be more appropriate and reflected an adjustment to corrective maintenance of $550,000.[294] Both Staff and OPC opposed Pepco's request for a regulatory asset.

5. Decision

The Company agreed that these costs, which were significantly higher than the previous two years, were expected to decrease during the rate-effective period. The purpose of normalizing costs is intended for this situation. As noted by OPC, the increase of the expense was significant compared to previous years and normalizing the costs will be more representative of the Company's costs during the rate-effective period. Therefore, I accept OPC and Staff's adjustment which increases operating income by $399,000.

I also reject Pepco's request that a regulatory asset be established. The Company did not provide sufficient justification to support its request and it is simply an attempt to recover

[293] Wolverton Rebuttal at 28.
[294] Effron Surrebuttal at 4.

costs that are lost through a normalization adjustment, and would defeat the entire purpose of normalizing costs.[295]

Q. Maintenance of Street Lighting & Signal System

1. AOBA

Mr. B. Oliver was critical of increases in operating expenses by FERC account compared to the expenses in those same accounts in Case No. 9472 and the Company's failure to identify and justify the changes. Based on his review, he found 22 accounts had changes of reported actual costs of more than +/- 20% after 13 months.[296] As an example, Mr. B. Oliver indicated Account 596, Maintenance of Street Lighting and Signal Systems, which costs were reported as $4,614,323, reflects an increase of 1,896,889 (69.8%) from Case No. 9472's costs.[297] Additionally, the five-year average for this account was $3.4 million, and was forecasted to decrease to $4.0 million in 2019 and $3.4 million in 2020.[298] Thus, AOBA averred the test year expense for Account 596 should be adjusted because it was not reflective of a normal level of expenditures, and without a demonstration to justify the test year costs, Mr. B. Oliver recommended reducing the test year level for Account 596 to $3.4 million, which represents a reduction of $1.2 million to expenses in the test year.[299]

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[295] If Pepco demonstrated a legitimate basis to establish a regulatory asset in this type of situation and the request was granted, there would be a very compelling argument to establish regulatory liabilities when the Company benefits from a normalization adjustment.
[296] B. Oliver Direct at 80.
[297] B. Oliver Direct at 82-83.
[298] B. Oliver Direct at 83.
[299] B. Oliver Direct at 84.

2. Staff

Mr. Patterson proposed a three-year average of Maintenance of Street Lighting & Signal System based upon the Company's Jurisdictional Cost of Service Study due to the large increase in cost compared to the prior two rate cases.[300] Staff believed its proposed adjustment to be more reflective of the maintenance-related costs during the rate effective period and, therefore, Staff recommended an increase to operating income of $1,256,000.[301]

3. Pepco's Response

Mr. Wolverton claimed Staff's adjustment was not a three-year average, but a three-rate case average with overlapping time periods. He similarly disagreed with AOBA's proposed five-year averaging of the expense level. First, Mr. Wolverton explained no adjustment to Account 585 should be made. He stated the Company incurred $0.6 million of costs from a preventative maintenance re-lamping program that were not incurred in 2017, and these costs were expected to continue during the rate-effective period.[302]

In relation to Account 596, Mr. Wolverton noted the cost increase since Case No. 9472 and proposed certain adjustments. First, he indicated the $2.7 million included in Case No. 9472 should have been $3.0 million as approximately $0.25 million should have been recorded in 2017, not 2018, and that amount was removed. Mr. Wolverton also stated approximately $0.72 million of overhead lines maintenance expense should have been recorded in Account 596, not Account 593. Finally, he noted a $0.53 million increase in street lighting maintenance in the test year compared to 2017 due to underground fault repairs. Mr. Wolverton

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[300] Patterson Direct at 18.
[301] *Id.*
[302] Wolverton Rebuttal at 23-24.

concluded after these adjustments are made, the Company's street lighting maintenance expense is comparable to prior years.[303]

On brief, Pepco continued to assert no adjustments were necessary. The Company pointed out that costs in Account 585 are expected to continue into the rate-effective period and, with the adjustments to Account 596, the test year expenses were comparable with prior periods.[304] Pepco also found Staff's position, in light of the Company's two adjustments to Account 596 to be arbitrary.

4. Parties' Response

Mr. B. Oliver noted Pepco's rebuttal testimony provided a "very clear reconciliation of costs," compared to data responses that he claimed were fragmented and incomplete.[305] He indicated that if Mr. Wolverton had provided the information set forth in his rebuttal testimony in his direct or supplemental testimony, or data requests, issues with respect to the Company's Street Lighting O&M costs could have been narrowed.

Staff witness Patterson revised his adjustment based upon Pepco's rebuttal testimony and now recommends in an adjustment of $605,000; however, he maintained his initial position that the expenses should be normalized.[306]

5. Decision

No party appears to contest the ongoing nature of Pepco's preventative maintenance re-lamping program in Account 585 or that the costs ($0.6 million) were either imprudently incurred or that the costs were anticipated to continue. Pepco Witness Wolverton's

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[303] Wolverton Rebuttal at 24-25.
[304] Pepco's Brief at 70.
[305] B. Oliver Surrebuttal at 23.
[306] Patterson Surrebuttal at 7.

adjustments to Account 596 resulted in a reduction of the test year expense from $4.6 million to $3.6 million. In comparison, the expenses for this account for the 2014 through 2017 calendar years ranged from $3.0 million to $3.4 million.[307]

Given Pepco's adjustments, it's unchallenged representation that the costs associated with the re-lamping program are expected to continue, and the Company's costs are relatively consistent expense amount over the past several years, I find there is no significant variation of costs between the test year and previous years that requires the costs to be normalized. Therefore, AOBA's and Staff's adjustments are denied.

R. Cash Working Capital ("CWC") Allowance

This adjustment is generally based upon a lead lag study, a methodology used to determine the amount of cash working capital need by a utility. It estimates the timing difference between when Pepco renders service and receives payments from customers for services (revenue lag) versus when Pepco incurs and pays operating expenses (expense lag). In this case, the appropriate amount of CWC resulting from adjustments to operating income result in a reduction of CWC of $5.192 million.

S. AFUDC Synchronization

The Allowance for Funds Used During Construction ("AFUDC") synchronizes with the Company's authorized ROR with the average balance of the test period Construction Work in Progress ("CWIP") accruing AFUDC. In this case, the adjustment to AFUDC increases operating income by $29,000.

[307] Wolverton Rebuttal at 25, Table 4.

T. Interest Synchronization

Interest Synchronization adjusts the Company's interest deduction for state and federal income taxes stemming from the various ratemaking adjustments reflected in the development of operating income. The calculation multiplies the authorized ROR by the authorized weighted cost of debt, which is then compared to the Company's interest on debt. The difference is then adjusted for state and federal income taxes which results in the required operating income adjustment. The adjustment to interest synchronization increases operating income by $257,000.

V. Cost of Capital

A utility's cost of capital, or overall ROR, consists of its ROE and return on the cost of long-term debt. The returns are weighted based on their percentages in the utility's capital structure and determine what overall return the utility may earn on its rate base. Unlike the cost of debt, a utility's ROE is not directly observable and parties often rely upon various calculations and a group of comparable utilities, the proxy group, that have a similar risk profile to the respective utility.

Many parties cite to two United States Supreme Court decisions, namely *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.* ("*Bluefield*") and *Fed. Power Comm'n v. Hope Natural Gas Co.* ("*Hope*").[308] The Commission has frequently cited and relied upon both cases in which the Supreme Court determined "that a utility's rate of return on equity must be comparable to returns earned on investments of similar risk, sufficient to ensure

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

confidence in the company's financial integrity, maintain and support the company's credit, and attract investment in its securities."[309]

A. Return on Equity

1. Pepco

Mr. McGowan claimed Pepco has, on average, earned approximately 200 basis points less than its authorized ROE. He claimed the current ratemaking process has not changed with the industry and has created a disconnect between the timing of the Company's investments and the resulting rates, noting the Commission's reliance on a past test year to set rates for a future period.[310] As a result, Pepco must file annual rate cases because it under-earns on prudently-incurred costs. Mr. McGowan testified the Company cannot continue to make investments to its system while earning well below its authorized ROR. He discussed the importance of Pepco being able to earn its authorized ROE and demonstrate to investors there is a realistic opportunity to earn a ROR commensurate with other rates of return earned by companies of similar risks.[311]

Mr. Hevert relied upon three different methodologies to develop his ROE recommendation, specifically, the Constant Growth Discounted Cash Flow ("DCF") model, the Capital Asset Pricing Model ("CAPM"), including both the traditional and empirical ("ECAPM") forms, and the Bond Yield Plus Risk Premium ("RP") method. Those methods indicated a ROE in the range of 10.00% to 11.00%. Based on his analysis, which relied on both quantitative and qualitative data and analyses, Mr. Hevert concluded a 10.30% ROE was reasonable and

[309] 108 Md. P.S.C. at 679.
[310] McGowan Direct at 16.
[311] McGowan Direct at 17.

appropriate.[312] In reaching that recommendation, he considered numerous factors, including the Commission's ruling in the Company's last litigated rate case and the Commission's preference for gradualism.

Since Case No. 9472, in which Pepco sought a 10.10% ROE, Mr. Hevert noted there have been changes in the capital market. He noted the Federal Reserve raised the Federal Funds rate three times since May 31, 2018, and has continued to gradually reduce its security holdings by reducing its reinvestment activities.[313] Additionally, both long-term interest rates and volatility have increased. Mr. Hevert pointed to the recently authorized ROEs for BGE and Washington Gas Light Company ("WGL") of 9.80% and 9.70%, respectively, which reflect the increased cost of capital environment. BGE's ROE was 15 basis points higher than its last rate case in June 2016, while WGL's ROE was 20 basis points higher than what it was authorized in November 2013. He explained his recommendation balanced both the interests of investors and ratepayers, which have a common interest in a financially strong utility that can access low-cost capital when and as needed.[314]

Mr. Hevert stated investors will provide funds to a firm only if the return the investors expect is equal to or greater than the return they require to accept the risk of providing funds.[315] He discussed the principle of opportunity costs, and the differences between debt and equity. Mr. Hevert explained the cost of debt is contractually defined and is directly observed as the interest rate or yield on debt securities, whereas the equity investors have a claim on cash flows after debt holders are paid, and the uncertainty (risk) associated with the residual cash

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[312] Hevert Direct at 3.
[313] Hevert Direct at 5. (footnote omitted)
[314] Hevert Direct at 9.
[315] Hevert Direct at 11.

flows determines the cost of equity.[316] As a result of that uncertainty, equity investors take greater risks and require higher returns than debt holders. Citing both *Bluefield* and *Hope*, Mr. Hevert stated the U.S. Supreme Court "recognized that the fair rate of return on equity should be (1) comparable to returns investors expect to earn on other investments of similar risk; (2) sufficient to assure confidence in the company's financial integrity; and (3) adequate to maintain and support the company's credit and attract capital."[317]

Mr. Hevert indicated Pepco's parent company, Exelon, has a current long-term issuer credit rating from Standard and Poor's ("S&P") of BBB (outlook: Positive), Baa2 (outlook: Stable) from Moody's Investors Service ("Moody's"), and BBB (outlook: Stable) from Fitch Ratings ("Fitch"), while Pepco is currently rated BBB+ (outlook: Positive) by S&P, Baa1 (outlook: Stable) by Moody's, and BBB (outlook: Stable) by Fitch.[318] Mr. Hevert created a proxy group of companies that are publicly traded and have comparable risk profiles to Pepco. He began with companies Value Line classifies as Electric Utilities and then applied the following screening criteria: companies that do not consistently pay quarterly cash dividends were excluded; all companies in the proxy group have been covered by at least two utility industry equity analysts; all companies have investment grade senior bond and/or corporate credit ratings from S&P; excluded companies that had regulated operating income over the three most recently reported fiscal years comprised of less than 60.00% of the respective totals for that company; excluded companies whose regulated electric operating income over the three most recently reported fiscal years comprised of less than 60.00% of the total regulated operating income; and companies known to be a party to a merger or other significant transaction were also

[316] Hevert Direct at 11-12.
[317] Hevert Direct at 13.
[318] Hevert Direct at 17.

excluded.[319] Mr. Hevert claimed that since there are no "pure play" state-jurisdictional electric transmission and distribution companies to use as a proxy for Pepco's Maryland distribution operations, he determined it was reasonable to include vertically integrated companies in his proxy group, which consisted of 23 different companies.[320]

Mr. Hevert explained the Constant Growth DCF model is based upon a theory that a stock's current price represents the present value of all expected future cash flows, and expresses the cost of equity as the sum of the expected dividend yield and long-term growth rate.[321] He relied upon stock prices over multiple periods, the annualized dividend per share, and consensus long-term earnings growth estimates from both Zacks and First Call, and Value Line long-term earnings growth estimates.[322] He explained how he calculated the high and low DCF estimates over three time periods (30-, 90- and 180-day average), which resulted in a mean range of 9.11% to 9.25%, and a mean high range of 10.02% to 10.16%.[323]

Mr. Hevert discounted these results because the time period covered by his analysis included market data that was inconsistent with the DCF's fundamental assumptions and the results were at odds with current observable capital market conditions.[324] He pointed to the model's assumption that the estimated return will be the same return required in the future, even though the Federal Reserve's policy toward monetary policy normalization only recently began.[325] Mr. Hevert indicated his other methodologies better reflect the risk premium required by investors in response to market and industry risks; therefore, he opined the Constant Growth DCF should be given less weight than other methods.

[319] Hevert Direct at 17-18.
[320] Hevert Direct at 19 – Table 1: Proxy Group.
[321] Hevert Direct at 21.
[322] Hevert Direct at 25.
[323] Hevert Direct at 26 – Table 2: Constant Growth DCF Results.
[324] Hevert Direct at 26-27.
[325] Hevert Direct at 27.

Next, Mr. Hevert used the CAPM, which estimates the cost of equity as a function of a risk-free return plus a risk premium, and consists of four components (market ROE for a security, a beta coefficient of that security, the risk-free rate of return, and the required return on the market as a whole), each with forward-looking estimates.[326] The beta coefficient represents the relative volatility of returns and the correlation in returns between the subject company and the overall market.[327] He also relied upon the ECAPM, which "addresses the tendency of the CAPM to underestimate the cost of equity for low-beta coefficient companies such as regulated utilities." In both the CAPM and ECAPM, Mr. Hevert used three different risk-free rate estimates: the current 30-day average yield on 30-year Treasury bonds (3.37%), and both the near-term and long-term projected 30-year Treasury yields (3.57% and 4.30%), respectively.[328] He explained how he estimated the market risk premium with information from Bloomberg and Value Line. Mr. Hevert's CAPM resulted in ROE means ranging from 9.79% to 11.85%, and the ECAPM analysis resulted in ROE means ranging from 11.14% to 13.18%.[329]

Finally, Mr. Hevert testified the RP approach "is based on the basic financial tenet that equity investors bear the residual risk associated with ownership and therefore require a premium over the return they would have earned as a bondholder."[330] This method estimates the cost of equity as the sum of the equity risk premium and the yield on a particular class of bonds. Mr. Hevert used the difference between authorized ROEs for electric utilities and the long-term Treasury yield.[331] He relied upon data from over 1,500 electric utility rate proceedings between January 1, 1980 and November 16, 2018, and calculated the average 30-year Treasury yield over an approximate 200-day lag period, the period between the filing of a rate case and the final

[326] Hevert Direct at 28-29.
[327] Hevert Direct at 29-30.
[328] Hevert Direct at 30.
[329] Hevert Direct at 34 – Tables 4a and 4b.
[330] Hevert Direct at 35.
[331] *Id*.

order, to reflect the prevailing level of interest rates during the pendency of proceedings.[332] His analysis produced an implied ROE between 9.99% and 10.27%.

Mr. Hevert also considered other factors in his analysis. Specifically, he addressed the importance for a utility's access to capital, and highlighted Pepco's $1.32 billion plan for additional capital investments during the 2019-2023 period and the requirement to access external capital. He explained Pepco has consistently under-earned its authorized ROE over the past five years, and the Company's recent earnings are well below returns available to other regulated electric utilities. Mr. Hevert opined that if Pepco continues to under-earn, it will become difficult to compete for capital with utilities that have earned returns consistent with their authorized returns.[333] He conducted an analysis of the relationship between capital expenditures and the earned return on common equity using the DuPont Formula, which contains three components: profit margin (net income/revenue); asset turnover (revenues/net plant); and the equity multiplier (net plant/equity).[334] Mr. Hevert determined that as capital expenditures increase, the asset turnover ratio decreases, resulting in a decrease in the return on common equity. As Pepco continues to significantly invest in its infrastructure, there will be additional pressure on cash flows and making regulatory support, in terms of earning a reasonable return on its investments, more important.

Mr. Hevert also considered flotation costs in his ROE recommendation. He used a modified DCF to provide a dividend yield to reimburse investors for issuance costs associated with the issuance of common stock. He explained a great majority of flotation costs are incurred prior to the test year, but remain part of the cost structure.[335] Mr. Hevert considered flotation

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[332] *Id*.
[333] Hevert Direct at 40-41.
[334] Hevert Direct at 41. (citation omitted)
[335] Hevert Direct at 43.

costs to be an appropriate consideration even though Pepco is a subsidiary of Exelon. His floatation cost estimate included the costs of issuing equity incurred by Exelon and the proxy companies for their most recent two issuances, and recommended an adjustment of nine basis points.[336] Despite Mr. Hevert's estimated nine basis points for flotation costs, he did not adjust his ROE recommendation, but considered it along with Pepco's other business risks.

Mr. Hevert also explained the current capital market environment. He noted the Federal Reserve's completion of its Quantitative Easing initiative in October 2014, but it was not until December 2015 that the Federal Reserve raised the Federal Funds rate and began the process of normalization. Mr. Hevert acknowledged all analyses require an element of judgment, which must be made in the context of both quantitative and qualitative information available and the capital market environment in which the analyses were undertaken. He indicated that as the Federal Reserve increased the Federal Funds target rate, both short-term and long-term rates have also increased since 2016. Mr. Hevert cited the December 2018 Federal Open Market Committee meeting during which the Federal Reserve Chairman expected further gradual increases and a strengthening economy, a strong labor market, and rising wages.[337] Mr. Hevert also pointed to the Federal Reserve's balance sheet normalization program initiated in October 2017 and an increasing supply of U.S. Treasury securities. He testified the consensus near-term forecasts of the 30-year Treasury yield, as reported by Blue Chip Financial, indicates that long-term rates will reach 3.70% by first quarter of 2020.[338]

Mr. Hevert also discussed the impact of the Tax Cuts and Jobs Act ("TCJA") on utilities. He explained the rating agencies "observed that a reduction in the utilities' revenue associated with the lower income taxes and the potential return of excess accumulated deferred

[336] Hevert Direct at 44.
[337] Hevert Direct at 49, *citing* transcript of Chairman Powell's Press Conference, December 19, 2018.
[338] Hevert Direct at 50, *citing* Blue Chip Financial Forecast, Vol. 37, No. 11, November 1, 2018 at 2.

income taxes also may reduce utilities' cash flow."[339] Mr. Hevert noted the major rating agencies made similar statements and highlighted that on June 18, 2018, Moody's changed its outlook on the U.S. regulated utility sector to "negative" from "stable."[340] He concluded investors have begun to view utilities as less attractive relative to other industry sectors that may benefit from the TCJA. Mr. Hevert did not include a specific adjustment, but again considered the market implications of the TCJA.

2. AOBA

Mr. B. Oliver disagreed with Mr. McGowan's representation of the Company's earned ROEs and described them as providing "a distorted and misleading assessment of the relationship between the Company's revenues and costs of service."[341] Mr. B. Oliver pointed out most of the earned ROEs reflect Pepco's unadjusted per books results, which can inappropriately include costs previously disallowed by the Commission.

Additionally, the 8.18% ROE for the period ending January 31, 2019 noted by the Company is an adjusted ROE, which includes post-test year additions and should not be included in assessing Pepco's actual earned ROE for the test year. Mr. B. Oliver noted Company Witness Ziminsky's testimony indicated an unadjusted ROE (not including post-test year rate base additions), was 8.83%.[342] Mr. Oliver asserted the 8.83% ROE includes other costs ($5 million) that have been previously disallowed in rate cases. When those costs are removed, the Company's earned ROE increases to 9.40%.[343] He also pointed out that Mr. McGowan's earned ROE for the 12 months ending December 2017 of 6.82% was the unadjusted per books

[339] Hevert Direct at 53.
[340] Hevert Direct at 55.
[341] B. Oliver Direct at 20.
[342] *Id*.
[343] B. Oliver Direct at 20-21.

ROE from the Company's initial filing in Case No. 9472. When Pepco updated its information to account for the TCJA, the ROE rose to 9.27%.[344]

In response to Mr. Hevert, Mr. B. Oliver stated the 10.30% ROE recommendation was unreasonable and significantly overstated compared to ROEs ultimately authorized by regulatory commissions. In comparing Pepco's recommendation in this case to Case No. 9418, Mr. B. Oliver indicated Mr. Hevert's ROE estimates have only slightly changed. Mr. B. Oliver was also critical of Mr. Hevert's proxy group which has 23 utility holding companies, a majority of which have substantial investments in more risky generation assets and/or non-regulated business ventures.[345]

Mr. B. Oliver also disagreed with Pepco's claim that nine basis points was a reasonable assessment of floatation costs, noting Mr. Hevert's argument has been previously presented and rejected by the Commission.[346] Despite the lack of a specific adjustment for floatation costs, Mr. B. Oliver found the Company's argument meritless. He indicated that Pepco no longer issues common stock, therefore, the Company would not directly incur flotation costs for equity issuances. Mr. B. Oliver asserted that Mr. Hevert provided no direct or verifiable connection between the Company's need for additional capital or a recent issuance of additional equity by Exelon.[347] AOBA claimed Pepco's need for additional capital has been historically met through retained earnings, and accepting Mr. Hevert's proposal of perpetual recognition of flotation costs would result in a substantial over-collection of the actual costs of an equity issuance.

[344] B. Oliver Direct at 21. (citations omitted)
[345] B. Oliver Direct at 38.
[346] B. Oliver Direct at 40. (citations omitted)
[347] B. Oliver Direct at 41-42.

Mr. B. Oliver found Mr. Hevert's use of the DuPont Formula to have "serious shortcomings, and it provides no useful or reliable input for the Commission in its evaluation of Pepco's required ROE."[348] He testified, "The DuPont Formula was developed to assess the manner in which a competitive firm (*e.g*., DuPont Chemicals) can improve the ROE it derives from individual products it manufactures by altering the elements of the formula."[349] Mr. B. Oliver claimed the formula was not useful for a capital intensive, non-manufacturing provider of utility distribution services.

He explained Mr. Hevert's regression analysis provided no assurances of the accuracy of the estimates and there were issues with the database Mr. Hevert relied upon. Specifically, Mr. B. Oliver pointed to measures of "Net Profit," "Revenue," and "Net Plant" for holding companies, which could include non-utility investments and revenues, and those components are not consistent across the proxy companies.[350]

Mr. B. Oliver recommended a 9.45% ROE be approved which is consistent with the Commission's preference for gradualism, as it represents a five-point reduction from Pepco's most recently authorized ROE of 9.5%. He relied upon the DCF and CAPM to determine his recommendation, and used the Company's proxy group and earnings estimates from three different sources for his Constant Growth DCF. Without any adjustments, Mr. B. Oliver's DCF produced results in the range of 8.75% and 8.95%, with an overall average of 8.82%.[351] Mr. B. Oliver's CAPM analysis resulted in a range from 7.89% to 9.29%, and an overall average of 8.59%.[352] The average of his DCF and CAPM results indicated a ROE of 8.71%.

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[348] B. Oliver Direct at 44.
[349] *Id*.
[350] B. Oliver Direct at 45.
[351] B. Oliver Direct at 47.
[352] *Id*.

Mr. B. Oliver disagreed with Pepco's assertion that long-term interest rates will reach 3.7% by the first quarter of 2020. He claimed there have been no sustained increases in 30-year U.S. Treasury Bonds, and despite Mr. Hevert's calculation of a 3.37% yield on those bonds, as of the end of March 2019 the average yield was only 2.988%.[353] AOBA also claimed the Blue Chip forecasts for the 30-year Treasury Bond yields were both unreliable and biased upward. Mr. B. Oliver stated that given the difficulties in accurately predicting near-term bond yields, the value of long-term estimates, especially as predicted by Mr. Hevert's forecast through the 2025-2029 time period, is questionable.[354] Additionally, Mr. Oliver pointed to the frequency of Pepco rate cases as another basis to disregard reliance on long-term bond yield estimates.

3. OPC

Mr. O'Donnell stated that since Commission's Order was issued in Pepco's last rate case, long-term interest rates have fallen slightly. He specified that on May 1, 2018, the yield on a 30-year U.S. Treasury Bond was 3.13%, but by March 29, 2018, the yield had decreased to 2.83%.[355] Mr. O'Donnell noted the Federal Reserve increased the Federal Funds rate from 2.25% to 2.50% on December 19, 2018, but that does not always result in the increase to long-term interest rates. Additionally, in March 2019, the Federal Reserve indicated it would not increase rates during 2019. OPC pointed out that since May 1, 2018, the Dow Jones Utility Average increased from 703.59 to 774.06, a 10% return in less than a year.[356]

Mr. O'Donnell stated the Commission granted PE a 9.65% ROE on March 22, 2019. He noted PE is owned by FirstEnergy, which has a common equity ratio of 24%

[353] B. Oliver Direct at 48.
[354] B. Oliver Direct at 49.
[355] O'Donnell Direct at 7.
[356] O'Donnell Direct at 8.

compared to Exelon's 47% common equity ratio.[357] Based upon these equity ratios, OPC claimed PE has more financial risk than Pepco and highlighted Mr. Hevert's exclusion of FirstEnergy from his proxy group.

Next, Mr. O'Donnell testified that ROE witnesses should be consistent in their testimony before commissions, but he claimed that Mr. Hevert changes his cost of capital models to produce higher results. Mr. O'Donnell pointed to Mr. Hevert's CAPM model in this case wherein he changed the actual market risk premiums. Mr. O'Donnell cited several cases in different jurisdictions between 2008 and 2019 (including this case) where Mr. Hevert's market risk premiums have increased from 7.10% in 2008 to 11.47%-13.41% in 2019. OPC asserted that despite the 140+ basis point reduction in the risk-free rate since 2008, Mr. Hevert's risk premiums have increased 631 basis points. Mr. O'Donnell claimed Mr. Hevert's market premiums tend to increase when interest rates decrease. Mr. O'Donnell stated Mr. Hevert's Chart 1 actually reflects a risk premium of approximately 7%, not the 11.47%-13.28% he relied upon.[358]

Additionally, OPC pointed to Mr. Hevert's reliance on historical data in 2008, but in this proceeding, he relied upon forecasted data resulting in an expected market return of 14.83% to 16.78%. Mr. O'Donnell testified that return is not realistic and forecasters are expecting returns to average approximately half of Mr. Hevert's forecast.[359] OPC believed a more reasonable approach was to estimate Pepco's earnings associated with the Company's pension expense request. Mr. O'Donnell testified, "The pension plan revenue requirement moves

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[357] O'Donnell Direct at 10. (citations omitted)
[358] O'Donnell Direct at 16, *citing* Hevert's Direct at 37.
[359] O'Donnell Direct at 17.

inversely relative to the assumed equity return on the market meaning that the higher the assumed equity return, the lower the pension plan funding requirements and vice versa."[360]

Mr. O'Donnell also noted changes in Mr. Hevert's RP method over the past several years. OPC pointed to Mr. Hevert's claim that the risk premium between ROEs granted by state regulators and the 30-year U.S. Treasury bond yield was 465 basis points, and then he increased the risk premiums by 197 basis points to 662, because a 465 point increase was not reasonable.[361] However, in a 2010 case before the South Carolina Public Service Commission ("SC PSC"), Mr. Hevert preformed the same analysis, determined a risk premium of 588 basis points was reasonable, but he did not make an additional adjustment as he did in this case. Additionally, Mr. O'Donnell asserted the weighting of Mr. Hevert's methods has varied. Mr. O'Donnell referenced the same SC PSC case wherein Mr. Hevert used both the CAPM and RP approaches to check the reasonableness of his DCF, but Mr. Hevert dismissed his DCF in this proceeding.[362]

Mr. O'Donnell provided an overview of the current U.S. economy and equity markets. He explained, "The U.S. Gross Domestic Product ('GDP') is hovering right around a three percent (3%) growth rate, which implies slow and steady growth."[363] Mr. O'Donnell stated that state regulators have noted the significant increase in the stock market and lower debt costs over the past six years, and have lowered RORs for utilities. He anticipated that if the economy continues at its slow expansion pace in the future and market returns in the single digits, utility ROEs should either decrease or remain at current levels for the foreseeable future.[364]

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[360] O'Donnell Direct at 18.
[361] O'Donnell Direct at 20.
[362] O'Donnell Direct at 23.
[363] O'Donnell Direct at 25.
[364] O'Donnell Direct at 26.

In determining his ROE recommendation, Mr. O'Donnell relied upon the DCF, which he believes is the most useful model, and presented a CAPM and Comparable Earnings Analysis as a check to his DCF results. Mr. O'Donnell adopted Mr. Hevert's proxy group for his analysis, and he also conducted an analysis of Exelon's ROR.

Mr. O'Donnell developed his dividend yield ranges by averaging each proxy group company's forecasted 12-month dividend yield over 13-week and 4-week periods, and the forecasted 12-month dividend for each company.[365] He explained using three different time periods, as well as averaging the dividend yield results, minimized the possibility of short-term price movements unnecessarily influencing the results.

Mr. O'Donnell used five methods to determine the expected growth rate. First, he used the "plowback ratio" method, which considers the percentage a company earns on its common equity and retains versus the amount of the earnings paid out in dividends.[366] He explained his calculation and noted the proxy group's plowback estimates were available through a Value Line Investment Survey.

He explained the amounts retained by a company are reinvested to generate future growth; therefore, he believed book value growth should also be considered when determining expected dividend growth. Mr. O'Donnell considered the 5-year and 10-year historical compound annual rates of change for earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BPS") according to Value Line.[367] OPC's third and fourth methods relied upon Value Line's forecasted compound annual rates of change for EPS, DPS, and BPS, and the forecasted rate of change of EPS. Finally, Mr. O'Donnell considered the forecasted earnings growth rate supplied by Charles Schwab & Co., which is a compilation of forecasts.

[365] O'Donnell Direct at 33.
[366] *Id*.
[367] O'Donnell Direct at 34.

In comparing Exelon's growth over the past ten years to the proxy group's solid growth, Mr. O'Donnell found both the earnings and dividend growth rates for Exelon were negative. However, based upon industry forecasts, Exelon and the proxy group's dividend yields were similar, 2.9%-3.1% and 3.1%-3.3%, respectively.[368] Mr. O'Donnell concluded the plowback growth rate for the proxy group was 3.5%, compared to Exelon's 4.3%.

He reviewed the historical earnings and dividends of the proxy group to determine the appropriate dividend growth rate. Mr. O'Donnell stated the proxy group's 10-year and 5-year historical growth rates indicated that dividends have been growing slightly faster than earnings, but that trend cannot continue over the long-term.[369] According to Value Line, the proxy group's forecasted dividends were 5.7% compared to 5.6% forecasted earnings. Therefore, Mr. O'Donnell concluded the appropriate growth rate was 4.0% to 6.0%. Based upon Mr. O'Donnell's analysis, his DCF produced a range of 7.1% to 9.3%, compared to Exelon's 6.9% to 9.1%. He concluded the appropriate range to be between 8.0% and 9.0%.

Mr. O'Donnell conducted a Comparable Earning Analysis wherein he considered the earned and forecasted ROE's of the proxy group and Exelon from 2017 through 2024, a timeframe with two historical returns and five years of forecasted returns.[370] This produced a ROE range of 9.6% to 10.2% for the proxy group and 6.5% to 9.5% for Exelon. Mr. O'Donnell also considered ROEs from commissions across the country and he found a downward trend over the past 16 years. He determined an appropriate return based upon his Comparable Earning Analysis to be between 9.25% to 10.25%, with the lower end recognizing the downward trend in the average ROE.[371]

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[368] O'Donnell Direct at 35.
[369] O'Donnell Direct at 36.
[370] O'Donnell Direct at 38.
[371] O'Donnell Direct at 40.

Next, Mr. O'Donnell presented his CAPM method, but did not give the results much weight. He developed risk premiums relative to the 30-year Treasury bonds which provide consumers the longest protection at the risk-free rate of return. Mr. O'Donnell asserted current interest rates are expected to remain relatively stable over the next several years. He considered a number of forecasts for market returns, as well as historical data, and found the equity risk premium fell within a range of 4.0% to 6.0%.[372] Mr. O'Donnell's CAPM analysis resulted in a range of 5.5% to 7.5%.

Mr. O'Donnell ultimately recommended a 9.0% ROE for Pepco. In reaching his recommendation, Mr. O'Donnell stated he considered the strength of the stock market and that his ROE was at the top of his DCF results.[373]

4. Staff

Mr. Baker discussed the purpose of setting a ROE, the guiding principles, including the referenced U.S. Supreme Court cases, and the Commission's applications to the standards from those proceedings. He also relied upon the gradualism principle in order to avoid sudden and dramatic shifts both for customers and the utility.[374]

Mr. Baker developed his recommendation using the DCF and CAPM methods.[375] His analysis resulted in a 9.08% ROE, which was arrived at by averaging the results from the DCF (9.31%) and CAPM (8.84%). However, Mr. Baker recommended a ROE of 9.30%, a

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[372] O'Donnell Direct at 45.
[373] O'Donnell Direct at 47.
[374] Baker Direct at 6.
[375] Mr. Baker also used the Internal Rate of Return ("IRR") method, but ultimately did not include the results because they were too close to Pepco's cost of debt to be a proxy of an investor's expectations. Baker Direct at 14. Since he did not rely on the IRR's results, it will not be discussed further.

20-point reduction from the Company's current authorized 9.50% ROE, based on the Commission's application of gradualism.[376]

Mr. Baker used a proxy group of holding companies that have both distribution and vertically integrated utilities due to the low number of pure electric distribution companies. His criteria included companies that had Value Line financial strength ratings of B++ or higher, companies for which Value Line had all relevant data, and he excluded companies involved in a merger during the sample period, which produced 29 companies. Mr. Baker then reduced the group to 24 based upon his DCF analysis and removed companies with ROEs below 7.0% and above 14.0%.

Mr. Baker's DCF used the annual dividend paid over the last year according to Yahoo Finance as of March 22, 2019, the projected 3- to 5-year dividend growth rate and the projected 3- to 5-year EPS from Value Line, and the average stock price over the 180-day period prior to the Company's filing date.[377] He took the annual dividend and applied it to the dividend growth rate to find the expected dividend in the first year, then divided that figure by the average stock price to develop the expected dividend yield, resulting in an average 9.31% ROE.[378]

Mr. Baker's CAPM relied upon betas from Value Line, a risk-free rate of return based on the average of the projected 30-year treasury bonds from IHS Markit from 2019-2024, and a market return based upon the 1926-2017 market return arithmetic mean for large-cap stocks from Duff & Phelps.[379] He then subtracted the average 30-year treasury bond from the market return for the market risk premium, which was then multiplied by the beta for each

[376] Baker Direct at 9.
[377] Baker Direct at 11.
[378] Baker Direct at 11-12.
[379] Baker Direct at 12.

company and the projected 30-year Treasury bond. This calculation produced an average 8.84% ROE.

In response to the Company's recommendation, Mr. Baker noted Mr. Hevert's DCF was the only method that resulted in an average ROE that reflects recently authorized ROEs, noting there have been no ROEs over 10.0% in a distribution case since 2012.[380] Mr. Baker claimed the Company should have used the average of the three DCF means, which would have resulted in a 9.17% ROE. Instead, Mr. Hevert's DCF result was based upon the highest growth rate estimates for EPS, whereas his low DCF result was based upon the lowest growth rate estimates.

Next, Mr. Baker averred Pepco's CAPM should be given less weight given the market return of 14.0% to 16.0% used by Mr. Hevert. Mr. Baker claimed a more realistic market return was between 9.0% and 13.0% based upon historic figures, and even forward-looking models estimate long-term returns near 9.0%.[381] If Mr. Hevert's projection was averaged with Duff & Phelps projected market return, it would result in a 12.4% market return, and ultimately an 8.86% ROE.

Mr. Baker testified the Company's ECAPM should be given no weight. He claimed this method, which is approximately 30 years old, has not been updated to account for market data and the Commission recently found little or no support for this methodology.[382] Staff also disagreed with Mr. Hevert's RP method. Mr. Baker claimed Pepco's argument was circular and relied upon other jurisdictions' decisions to determine what a Maryland utility's ROE should be going forward.[383] Mr. Hevert also relied upon awarded returns, rather than earned,

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[380] Baker Direct at 19. (citation omitted)
[381] Baker Direct at 21.
[382] Baker Direct at 22, *citing* Case No. 9490, Order No. 89072, *slip op*. at 75.
[383] Baker Direct at 23.

"which fails to align with investor expectations since the investor will only experience an earned return."[384]

Finally, Mr. Baker disagreed with Pepco's position on flotation costs. He noted the Commission has previously rejected Mr. Hevert's argument when the Company has not incurred flotation costs within the test year. Mr. Baker stated neither Pepco nor Exelon issued new stock during the test year, therefore, flotation costs should not be addressed.

5. Parties' Responses

Mr. McGowan disagreed with AOBA's claim the Company presented a distorted and misleading assessment of revenues and cost of service. He explained Pepco's calculations were consistent with its last three litigated rate cases and its quarterly ROR reports filed with the Commission.[385] Based upon the annual rate cases recently filed by Pepco, Mr. McGowan claimed it was well known and documented that the Company has earned less than it's authorized ROE.

He testified that Mr. B. Oliver's comparison of Pepco's adjusted ROE and unadjusted ROEs was not appropriate and that he selected favorable adjustments to make it appear the Company's ROE was higher than what it claimed.[386] Mr. McGowan asserted if AOBA's claim that Pepco was actually earning an approximate 9.40% ROE, Mr. B. Oliver would likely not recommend a $4.5 million revenue requirement increase to the 9.45% ROE.

Mr. Hevert criticized the ROE witnesses' reliance on the DCF model which has produced estimates consistently and meaningfully below authorized returns from regulatory

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[384] *Id*.
[385] McGowan Rebuttal at 4.
[386] McGowan Rebuttal at 5.

commissions since 2014.[387] He claimed the parties' DCF results were unduly low and would place Pepco at regulatory and financial risk if adopted.

Mr. Hevert disagreed with both Messrs. Baker and B. Oliver's use of gradualism in their ROE recommendations. He claimed the Company's authorized 9.5% ROE was already low compared to authorized ROEs since 2017 and there was no reasonable basis that would justify that the cost of capital has fallen since that time. Mr. Hevert stated, "the proposition that an unreasonably low ROE recommendation would have been even lower but for the application of gradualism would only heighten investors' uncertainty regarding the regulatory environment."[388] He cautioned applying gradualism to the cost of equity and claimed its use was not supported by models and theories to develop ROEs.

In response to Staff, Mr. Hevert recalculated Mr. Baker's DCF with an 8.0% exclusion threshold (rather than 7.0% used by Staff), which the Company claimed to be more reasonable and produces a mean of 9.8% and median of 9.71%.[389] He also disagreed with Staff's CAPM's use of historical market return data to estimate the Market Risk Premium ("MRP"), which he believed should be forward looking. Mr. Hevert analyzed the historical relationship between interest rates and the MRP, and found the MRP varies with the level of interest rates.[390] Applying this relationship to Staff's CAPM, he claimed Mr. Baker's results would have been approximately 9.01%, and 9.84%, if Staff had used the ECAPM.

In relation to Mr. Hevert's expected market returns being too high, he stated Staff failed to note that 15 of the 24 CAPM and ECAPM were above the Company's recommended range. While Staff Witness Baker suggested a historic average market return range of

[387] Hevert Rebuttal at 4-5.
[388] Hevert Rebuttal at 8.
[389] Hevert Rebuttal at 12.
[390] Hevert Rebuttal at 14-15.

9.0% to 13.0%, Mr. Hevert claimed Staff omitted the long-term historical standard deviation has been approximately 19.80%.[391] He concluded the returns he relied upon for his CAPM and ECAPM were consistent with historical experience.

Next, Mr. Hevert defended the use of the ECAPM, a model that has been supported by multiple studies.[392] He pointed out that Staff has previously relied upon the ECAPM and the Commission has found multiple methods to be reasonable. Mr. Hevert claimed the research indicates companies with low-beta coefficients, including utilities, have tended to earn returns greater than returns projected by the CAPM.[393] He found that applying the ECAPM to Staff's CAPM analysis produces an average of 9.65%.

In relation to Staff's criticism of his RP method, Mr. Hevert continued to assert that authorized returns for other regulated electric utilities were highly relevant to estimate Pepco's return.[394] He stated his analysis demonstrated that the equity risk premium changes inversely to interest rates and is support by both financial literature and Staff's data.

Mr. Hevert disagreed with many aspects of OPC Witness O'Donnell's testimony. First, he explained FirstEnergy was not included in his proxy group because it is a parent holding company and, therefore is not comparable to Pepco. Mr. Hevert also disagreed with OPC's consideration of Exelon based both on his practice to exclude parent companies from proxy groups as doing so involves circular logic.[395]

Similar to his criticism of Staff, Mr. Hevert disagreed with OPC's DCF, which used historical growth rates as a measure of expected growth rates, as the DCF is a forward-looking measure. Additionally, he argued that cost of equity is a function of the expected growth

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[391] Hevert Rebuttal at 16.
[392] Hevert Rebuttal at 20-21.
[393] Hevert Rebuttal at 25-27.
[394] Hevert Rebuttal at 29.
[395] Hevert Rebuttal at 37.

in earnings, not dividends or book value as relied upon by Mr. O'Donnell. Mr. Hevert conducted an analysis that demonstrated that EPS was the only growth rate that was both statistically and positively related to the price-to-earnings ratio.

Mr. Hevert also expressed concerns with OPC's Retention Growth model. He analyzed the data relied upon by Mr. O'Donnell and found that earnings decreased as the retention ratio increased.[396] Mr. Hevert claimed OPC's model includes "an element of circularity" and the data relied upon was obtained from a single source, Value Line, "which increases the risk of idiosyncratic error that may bias the end results."[397] He indicated Value Line expects actual earnings growth to exceed the growth rate in Mr. O'Donnell's formula.

Mr. Hevert was critical of Mr. O'Donnell's use of negative growth rates in the DCF. Mr. Hevert testified, "No rational investor would invest in a stock that is expected to decrease its earnings in perpetuity."[398] Mr. Hevert asserted Mr. O'Donnell's Comparable Earning Analysis indicated the proxy group's average returns for 2019 and 2022/2024 were 10.10% and 10.20%, respectively.[399] Those averages were much closer to Pepco's recommended 10.30% than OPC's 9.0%.

Mr. Hevert responded to OPC's criticism that he used a historical arithmetic average MRP in 2008. He testified that interest rates in 2008 were within a reasonable range of the long-term average, so it was reasonable to assume at that time that the MRP was within a reasonable range of the long-term average.[400] However, Mr. Hevert explained after 2008, central banks began to intervene in capital markets, reducing interest rates and altering other market

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[396] Hevert Rebuttal at 42-43.
[397] Hevert Rebuttal at 44.
[398] Hevert Rebuttal at 46.
[399] Hevert Rebuttal at 50, *citing* O'Donnell's Direct, Ex. KWO-3.
[400] Hevert Rebuttal at 55.

relationships, and the historical average MRP fell even though risk increased.[401] Additionally, he noted the Federal Reserve's actions to reduce interest rates after the 2008-2009 financial crisis.

Mr. Hevert argued OPC's claim he inconsistently applied the Bond Yield Plus Risk Premium as misplaced. He cited the average 4.65% equity risk premium (over 1980-2018) was not used as a basis for his ROE. Rather Mr. Hevert's 5.97% to 6.62% equity risk premium estimate was higher than the 4.65% average because interest rates remain low relative to historical levels.[402]

Mr. Hevert dismissed OPC's position that his ROE recommendation contradicts Pepco's pension plan funding assumptions and explained pension plan assumptions are based on expected returns, whereas cost of equity is a measure of investors' required returns. Mr. Hevert testified, "A pension fund asset manager will match the expected returns available from various asset classes to the expected liability that must be funded. Investors seeking to maximize their risk-adjusted return will only invest in a security if the expected return is equal to or greater than the required return."[403] He was not aware of any financial texts recommending using pension fund assumption to estimate a company's ROE.

In response to AOBA, Mr. Hevert dismissed Mr. B. Oliver's "Regulator Adjustment Method," an approach AOBA proposed in Case No. 9443 but failed to provide adequate support.[404] Mr. Hevert asserted simply subtracting a set number of basis points from a requested return would simply lead utilities to increase their ROE requests. Despite AOBA's claim that his ROE recommendations have not considerably varied over recent Pepco cases,

[401] Hevert Rebuttal at 55.
[402] Hevert Rebuttal at 59-60.
[403] Hevert Rebuttal at 63.
[404] Hevert Rebuttal at 74.

Mr. Hevert indicated in Case No. 9418, he recommended a 10.60% ROE, but in this case he has recommended a 10.30%.

In terms of relative risks, Mr. Hevert noted the Company's credit ratings are similar to the weighted average of the proxy group. He claimed Mr. B. Oliver appears to have not considered that the Company has consistently under-earned by approximately 200 basis points in concluding Pepco is less risky than the holding companies in the proxy group.

Mr. Hevert asserted Mr. B. Oliver did not state how he determined the MRP estimate of 7.00% to 8.00% for his CAPM. Based on testimony from a previous case, Mr. Hevert believed AOBA relied upon an estimate of the risk premium associated with utilities rather than the entire market as required by the CAPM. Mr. Hevert corrected AOBA's approach and calculated a Market Risk Premia of 11.29% and 12.90% for the CAPM, rather than a utility-specific Equity Risk Premia of 7.00% to 8.00%.[405] Based on that correction, Mr. B. Oliver's CAPM produces a 10.93% to 11.92% range.

Mr. Hevert defended his use of the DuPont formula which disaggregates the return on common equity into profit margin, asset turnover, and an equity multiplier. He found no support for Mr. B. Oliver's notion that capital intensity is a factor for non-regulated manufacturing companies but not utilities. Mr. Hevert indicated utilities are a capital-intense industry, which is a factor for investors. He claimed the DuPont formula was applicable to both manufacturing companies and utilities, and stated, "[a]ny company that requires a reasonable return on its equity will seek to understand the fundamental determinants of that return."[406]

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[405] Hevert Rebuttal at 79.
[406] Hevert Rebuttal at 91.

Mr. Hevert argued that without direct recovery of issuance costs, a deficiency remains and will be embedded in retained earnings going forward.[407] Since flotation costs permanently reduce the equity portion of the balance sheet, an adjustment must be made to the ROE. Although he did not make a specific adjustment, Mr. Hevert stated flotation costs should be reflected in a company's awarded ROE.

During his rejoinder testimony, Mr. Hevert explained Staff's gradualism adjustment results in the devaluation of stock.[408] On cross-examination, Mr. Hevert testified the capital market is fundamentally different now than it was in 2013 and market volatility is considerably higher than in the past.[409] He recognized the Commission's preference to avoid abrupt changes to the cost of equity in response to market changes, but believed gradualism was more appropriately applied to rate design rather than ROE.[410] Mr. Hevert explained that he relied upon the proxy group to estimate Pepco's flotation cost and that it is difficult to go back in time to determine a company's actual issuance costs.[411]

On brief, Pepco criticized the intervenors' ROE recommendations as unreasonably low and that the "'end result' doctrine in *Hope*, which finds it is the reasonableness of the result, rather than the method employed, that controls in determining whether rates are just and reasonable."[412] Based on this premise, the parties' DCF results should not be given substantial weight. The Company also compared the parties' ROE recommendations to other Maryland utilities recently awarded ROEs, which range between 9.60% and 9.80%.

OPC Witness O'Donnell criticized both AOBA's and Staff's recommendations because they were much higher than the ROEs produced by their respective methodologies due

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[407] Hevert Rebuttal at 92.
[408] Tr. at 86-87.
[409] Tr. at 104.
[410] Tr. at 108 and 114-115.
[411] Tr. at 111-112.
[412] Pepco Brief at 10-11. (citation omitted)

to their gradualism adjustments. Mr. O'Donnell rejected Mr. B. Oliver's proposed five-point reduction as too small, and claimed his proposal was inflated and would result in unjust and unreasonable expenses to Maryland ratepayers.[413] Similarly, he found Staff's 20-point reduction too small and too costly for ratepayers.

On brief, OPC argued current market conditions require a lower return and Pepco failed to meet its burden to justify an increase to its ROE.[414] Instead, OPC claimed financial markets have driven down the cost of equity and authorized returns for utilities are trending downward, and highlighted that an ROE above 10.0% was not awarded in 2018, and the average ROE in distribution cases since 2011 has been below 10.0%.[415]

AOBA Witness B. Oliver noted that even though Mr. Hevert's ROE estimates noticeably declined, he continued to recommend a 10.30% ROE. Mr. Oliver also claimed the regression analyses in Mr. Hevert's rebuttal testimony failed to explain over 98% of the observable variation in the data inputs relied upon by the Company.[416]

In his surrebuttal testimony, Staff Witness Baker defended his use of gradualism which had been used by the Commission in Pepco and Delmarva Power & Light Company's most recent litigated rate cases.[417] He claimed investors should be reassured by his use of gradualism because it ensures an investments value will not devalue suddenly.[418] On cross-examination, Mr. Baker confirmed he did not conduct an analysis of Pepco's ability to attract capital with a 9.30% ROE.[419]

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[413] O'Donnell Rebuttal at 3.
[414] OPC's Brief at 14-15.
[415] OPC's Brief at 16.
[416] B. Oliver Surrebuttal at 12.
[417] Baker Surrebuttal at 3, *citing* Case Nos. 9443 and 9424.
[418] Baker Surrebuttal at 4.
[419] Tr. at 746-747.

Staff stressed the differences between the DCF ranges in Mr. Hevert's direct (8.34% to 10.16%) and rebuttal (7.74% to 9.82%) testimonies, the latter of which is either within or close to the intervening parties' DCF results.[420] Staff questioned the weighting of Mr. Hevert's methods as he ignored the lower results and focused instead on the ECAPM and Bond Yield Plus methods, with both producing results hundreds of basis points higher than his DCF. Staff claimed Mr. Hevert's methods relied upon significant long-term interest rate increases which have not occurred.[421]

In response to market volatility, Staff pointed to the consistency of Mr. Hevert's testimony before the Commission since 2012, during which time he has recommended ROEs between 10.0% and 11.0% for Pepco and two other utilities.[422]

6. Decision

The Commission described the determination of a ROE to be "more art than science."[423] The art is a balancing act. As OPC aptly stated in its brief, "Just as the Commission must guard against adopting a return that is so low that it impairs a utility's ability to attract capital, it must also prevent a return so high as to result in unjust and unreasonable rates paid by customers of the utility."[424] In determining the appropriate ROE for Pepco, I am guided by both the referenced *Bluefield* and *Hope* Supreme Court decisions and Commission Orders. Additionally, as the party seeking change in rate, Pepco bears the burden to support its request.[425]

While the parties supported their own approaches and were critical of other witnesses' methodologies and inputs, there is not one absolute way to determine a utility's ROE.

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[420] Staff's Brief at 26-27.
[421] Staff's Brief at 29.
[422] Staff's Brief at 30.
[423] *Re Delmarva Power & Light Co.*, 100 Md. P.S.C. 435, 453 (2009).
[424] OPC's Brief at 17.
[425] PUA § 3-112.

The Commission has stated, "[W]e are not willing to rule that there can be only one correct method for calculating a ROE. Neither will we eliminate any particular methodology as unworthy of basing a decision."[426] In PE's recent rate case, the Commission found no fault in the various approaches used to estimate the cost of equity. The Commission stated:

> The determination of a fair ROE therefore requires a degree of discretion from the cost of capital expert. For example, he or she must choose which model or models to employ, how to assemble the most representative proxy group, and whether or how to exclude outliers from the analysis, to name just a few of the parameters.[427]

While the Commission has discounted certain approaches in the past, specifically the ECAPM,[428] that does not mean a witness cannot utilize that method. Regardless of the approach employed, each witness must still justify the results of each method and the reasonableness of their ultimate recommendation.

In response to OPC, I find no fault in Mr. Hevert changing his approaches and inputs in his ROE analysis. As Mr. Hevert noted in rebuttal, the facts and circumstances in 2008 are much different than today, thus it is not surprising he would change how he calculates ROEs. Additionally, I do not see the relevancy of comparing Mr. Hevert's approach in other jurisdictions to his approach in Maryland. Although Mr. O'Donnell did not specify how the SC PSC views ROE or its preferred methodologies, I am fairly certain that state regulatory commissions have their own approaches on how to determine a particular utility's ROE. Just because Mr. Hevert used a particular method before the SC PSC should not require him to use the exact same method in Maryland or before any other commission.

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[426] *Re Baltimore Gas & Elec. Co.*, 107 Md. P.S.C. 206, 281 (2016). (footnote omitted)
[427] Case No. 9490, Order No. 89072, *slip. op.* at 72.
[428] *Id.* at 75.

There are significant differences between the parties' ROE recommendations as noted below.

SUMMARY OF PARTY ROE RECOMMENDATIONS

Method and Adjustments	Pepco	Staff	OPC	AOBA
DCF	9.2%-10.0%	9.31%	8.0%-9.0%	8.82%
CAPM	10.3%-11.4%	8.84%	5.5%-7.5%	8.59%
ECAPM	11.4%-12.8%	N/A	N/A	N/A
Risk Premium Model	10.0%-10.3%	N/A	N/A	N/A
Comparable Earnings Model	N/A	N/A	6.5%-10.2%	N/A
Flotation Costs	0.09%	N/A	N/A	N/A
Gradualism Adjustment	N/A	+0.22%	N/A	+0.74%
ROE Range	10.00-11.00%	8.84%-9.31%	8.00-9.00%	N/A
ROE Recommendation	10.30%	9.30%	9.0%	9.45%

The range of ROE recommendations is even greater if Staff's 22 basis point upward adjustment for gradualism is removed to Mr. Baker's unadjusted recommendation of 9.08%. Additionally, while AOBA's position is styled as a five basis point reduction, in reality it is a significant upward adjustment based upon Mr. B. Oliver's average of his DCF and CAPM results (8.71%).

In terms of gradualism, Pepco, AOBA, and Staff all considered that factor in some form in reaching their ultimate recommendation. Gradualism should be a consideration in determining an increase or decrease to a utility's ROE as it could significantly impact either the utility or ratepayers depending on the ultimate decision. First, despite Mr. Hevert's assertion that he considered gradualism, I find nothing gradual about the 80 basis point increase recommended by the Company. Mr. Hevert testified recent Commission decisions reflected an increasing cost of capital environment and cited a 9.80% ROE for BGE's gas distribution operations, an increase of 15 basis points from 2016, and Washington Gas Light's 9.70% ROE, and increase of 20 basis

points from 2013.[429] Reasonable people can differ as to whether a 15 to 20 basis points increase is considered gradual. But an 80 basis point increase, approximately two years since the Company was authorized 9.50%, is not fathomable in terms of gradualism or, more importantly, supported by the record as discussed below.

In relation to Staff's recommendation, I view Mr. Baker's testimony of an appropriate Pepco ROE to actually be 9.08%, not the 9.30% he recommended. I agree with Mr. Hevert's assessment that investors could view Staff's recommended ROE, if accepted, as more risky and artificially inflated due to a gradualism adjustment. While Mr. Baker claimed his adjustment serves notice that an investment will not devalue suddenly, it overlooks the fact the investment is actually over-valued based upon Staff's calculations.

AOBA's 9.45% ROE and five basis point reduction is puzzling in light of both Mr. B. Oliver's actual calculations, both of which produced ROEs under 9.0%, and his criticism of Pepco's representation that is has been consistently under-earning. As Mr. McGowan testified in rebuttal, if AOBA actually believed Pepco was earning a 9.40%, it is unclear why AOBA would recommend only a five point reduction from the Company's currently authorized 9.50% ROE.

If Staff's and AOBA's gradualism adjustments are not included in their recommendations, the gap between the parties grows to 100+ basis points. In other words, Pepco's recommendation is inordinately high and the other parties' recommendations are exceedingly low. As indicated in the above chart, OPC's CAPM produced results 100 basis points less than all other parties, and Pepco's CAPM, ECAPM, and RP produced results between 10.0% and 12.8%. The only overlap between the parties approaches are the DCF results, which

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[429] Hevert Direct at 5; *see* Case No. 9484, Order No. 88975, *slip op*. at 65 and *In the Matter of the Application of Washington Gas Light Co. for Authority to Increase Existing Rates and Charges and to Revise Its Terms and Conditions for Gas Service,* Case No. 9481, Order No. 88944, *slip op*. at 2 (December 11, 2018).

Mr. Hevert assigned little weight as he deemed the results to be inconsistent. Not surprisingly, the intervenors argued Pepco's other approaches be given no weight.

The record indicates utilities are not being awarded ROEs over 10.0% or less than 9.0%.[430] As a measuring stick, recent Commission decisions in BGE (9.8%), WGL (9.7%), and PE (9.65%) rate cases demonstrates that Maryland is in line with, if not higher than, the average authorized ROEs over the past three years.

Given the disparity among the recommendations, I must consider what has changed since Case No. 9443 that warrants a change, either up or down, to Pepco's ROE. A review of the testimony provides contrary stances as to what, if anything, has changed since 2017. Interest rates and Treasury yields have increased, but certainly not to the level forecasted by Mr. Hevert and, at least for the remainder of the year, the Federal Reserve is not likely to increase rates further. I agree there is a level of uncertainty moving forward with the end of the Federal's Reserve's Quantitative Easing program. As this case has demonstrated, the market and entities, such as the Federal Reserve, can impact ROE witnesses' testimonies and recommendations which adds to potential market volatility, both upward and downward. Given the observed changes in this proceeding, I agree with Mr. Hevert's statement that "we should be careful about immediate and abrupt changes in market data and immediate and abrupt changes in model results," even though his recommended ROE, if adopted, would equate to an immediate and abrupt change in data and model results.[431]

Mr. Hevert also cited BGE and WGL's recent 20 and 15 basis point increases as evidence of an increased cost of equity. While these serve as reference points for other

[430] *See* Baker's Surrebuttal at 7, Figure 1. Mr. O'Donnell did reference a recent South Dakota case in which the utility was authorized an 8.75% ROE, but without more information regarding the case or how South Dakota regulates its utilities, I did not consider it relevant to my findings. Tr. at 684.
[431] Tr. at 86.

Maryland utilities, I give this observation little weight as each and every case is determined on the record and simply because two gas distribution companies were granted an increase does not mandate the same or similar increase in this proceeding. Accepting Mr. Hevert's premise related to the referenced cases works more against than for his position. He has advocated for an 80 basis point increase despite recent Commission awards that increased ROEs a fraction of that amount. There is no evidence that would warrant such an immediate increase, especially considering the Commission's stated preference to change ROEs gradually[432] and Pepco's recent history of frequently filing rate cases.

What has not changed is Pepco's credit ratings. Despite Pepco's significant infrastructure investments and the claimed volatility in the market, the Company has not had difficulty in securing capital. Even though the Company claims to have consistently under-earned for several years, Pepco's financial strength appears strong.[433]

After reviewing the entire record and considering the parties' briefs, I find that a slight upward adjustment of 10 basis points to a cost of equity award of 9.60% meets the standards of both *Bluefield* and *Hope*, is comparable to returns investors expect from investments of similar risk, will maintain the Company's financial integrity, and will permit the Company to continue to attract capital and support its credit ratings. A 10 basis point increase falls well within the range of other utilities nationwide and, more importantly, within Maryland. A 9.60% ROE also falls well short of what I consider to be the abrupt changes (+80 basis points and -50 basis points) recommended in this case.

Despite assertions of perpetual under-earning and the potential difficulty in obtaining capital in the future if the under-earning continues, the record does not support Pepco's

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[432] 108 Md. P.S.C. at 690.

[433] Mr. McGowan viewed the main reason the Company was under-earning was due to the use of a historical test year to set rates, not Pepco's ROE. Tr. at 71.

position. Pepco made a similar argument in Case No. 9443, wherein the Commission referenced the Company's reliability spending over the 2013-2016 time period, during which time Pepco made capital investments of $877.2 million and projected to spend $1.016 billion over the next five years to meet future reliability requirements.[434] The Commission stated, "We are not convinced that Pepco's projected level of reliability spending will subject the Company to an unusual level of perceived risk."[435] Both Messrs. McGowan and Hevert acknowledged the Company has experienced no difficulty in obtaining capital and has maintained a good credit rating despite the significant investments in is distribution infrastructure, and has maintained sufficient credit ratings.[436]

In the recent PE rate case, the Commission reiterated its position that flotation costs to a utility will be granted only if it has been demonstrated the utility "incurred verifiable costs of issuing new stock during the test year or will incur such flotation costs during the rate effective period."[437] Just as in the PE case, Pepco presented the same argument that flotation costs exist perpetually and should be recovered regardless of whether such costs are actually incurred. The Company made this argument even though Mr. Hevert did not specifically make an adjustment to his ROE recommendation, and Pepco has not incurred any such costs for several years. The Company has not provided a compelling reason to depart from the Commission's stance on this issue and grant a flotation cost adjustment.

Moreover, I am not convinced the Company's reliance on an average of the proxy groups' stock issuances as a basis to determine Pepco's flotation costs is appropriate. Even though Pepco may not actually incur any flotation costs, Mr. Hevert acknowledged a flotation

[434] 108 Md. P.S.C. at 690.
[435] *Id*.
[436] Tr. at 71 and 119.
[437] Case No. 9490, Order No. 89072, *slip op*. at 76, *citing* 107 Md. P.S.C. at 755. The Commission cited Case Nos. 9336 (Pepco), 9311 (Pepco), and 9285 (Delmarva Power) as cases in which flotation costs were approved. Order No. 89072, *slip op*. at 76, fn. 276.

costs adjustment could vary based solely on the issuances of the proxy group. I find the Company's proposal to be inappropriate as the costs are not verifiable.

B. Capital Structure

1. Pepco

Mr. Hevert determined the average capital structure of each proxy company over the past eight quarters and found the mean to be 52.48% common equity and 47.16% long-term debt.[438] He concluded Pepco's proposed capital structure consisting of 50.46% common equity and 49.54% long-term debt capital structure is generally consistent with the proxy companies and is appropriate in this case.

Mr. Ziminsky explained the Company's requested 7.81% ROR was based upon the Company's pro forma September 30, 2018 capital structure ratios. When Pepco updated its application with 12 months of actual data, the capital structure changed slightly to 50.46% common equity and 49.54% long-term debt, but embedded long-term debt costs of 5.27%.[439]

2. Parties' Responses

Mr. B. Oliver found the pro forma capital structure generally aligns with the capital structure proposed by the Company and the capital structures accepted by the Commission over the past three rate cases. OPC Witness O'Donnell found Pepco's proposed capital structure to be reasonable. Finally, Staff Witness Baker reviewed Pepco's proposed capital structure and found it reasonable as it represented the Company's actual capital structure.

[438] Hevert Direct at 58.
[439] Ziminsky Supplemental Direct at 3 and Schedule (JCZ-SD)-3.

3. Decision

No party raised an issue or expressed concern with regards to the Company's cost of debt or capital structure, and Staff specifically noted Pepco's proposal was based on its actual capital structure. Additionally, I note the capital structure approved in Case No. 9443 (50.15% common equity and 49.85% long-term debt)[440] is very similar to the Company's capital structure (50.46% common equity and 49.54% long-term debt) in this proceeding. Therefore, I find the Company's proposed capital structure to be reasonable. My recommended overall ROR is show below:

Authorized Return			
Type of Capital	**Ratios**	**Cost Rate**	**Weighted Cost Rate**
Long-Term Debt	49.54%	5.27%	2.61%
Common Equity	50.46%	9.60%	4.84%
Total	100%		7.45%

VI. Cost of Service

A. Pepco

Mr. Wolverton indicated the allocations of the Company's Jurisdictional Cost of Service Study ("JCOS") are driven primarily by direct jurisdictional assignments and allocations of plant, depreciation expense, and O&M expenses.[441] Most of Pepco's distribution facilities are primary- and secondary-voltage systems, including substations, overhead and underground lines, and line transformers, all of which serve customers directly and are directly assigned.[442] The

[440] 108 Md. P.S.C. at 691.
[441] Wolverton Direct at 26-27.
[442] Wolverton Direct at 27.

Company's subtransmission facilities are allocated between each jurisdiction based upon the Average and Excess Non-Coincidental Peak Demand ("AED-NCP") method.

Mr. Wolverton testified, "The Company has maintained its method of allocating distribution-general and intangible plant to jurisdiction based on the subtransmission and distribution plant less AFUDC ratios," in accordance with previous Commission decisions.[443] Mr. Wolverton stated that distribution depreciation expense is assigned to the appropriate jurisdiction based upon Pepco's records. The Company's O&M expenses are assigned based upon a detailed analysis of O&M FERC accounts or allocated using relevant plant ratios, and incremental storm and tree trimming costs were separately identified and assigned based upon the Company's records. Customer accounts and sales expenses (FERC Accounts 901 through 913) are assigned to customer classes based on recent analysis and then allocated to jurisdictions based on number of customers during test period.[444] Mr. Wolverton explained a majority of administrative and general ("A&G") expenses are allocated on an O&M expense less A&G, storm, and tree trimming allocator.

Mr. Normand presented Pepco's Class Cost of Service Study ("CCOSS") for its distribution business. The purpose of a CCOSS is to allocate the Company's test year adjusted revenue requirement to the various customer classes based on cost causation. He explained the underlying principle is that costs should be attributable to the particular classes that cause the utility to incur such costs.[445] The allocated costs provide a basis to derive class rate of return results, which serve as a guide in developing rates for each class.

Mr. Normand explained the process of cost allocation, which has three steps: cost functionalization; classification; and allocation. Cost functionalization divides the total revenue

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[443] *Id*.
[444] Wolverton Direct at 28.
[445] Normand Direct at 4.

requirement into functional categories, mainly subtransmission and distribution. He set forth the various functional categories of Pepco's plant investment, such as distribution subtransmission, distribution substations, and overhead and underground. Functional categories of O&M expenses correspond to plant categories and include additional functional categories (customer accounts expenses; sales expenses; and administrative and general expenses).

The next step is cost classification. Mr. Normand testified functionalized rate base and O&M expense items are classified as either demand- or customer-related based upon cost causation.[446] Demand-related costs are fixed costs dependent upon demand or kilowatt ("kW") requirements, whereas customer-related costs include service connections and meter investments and are primarily associated with the number of customers served.[447] Finally, cost allocation apportions the functionalized and classified costs to the appropriate customer classes. The costs are either directly assigned or allocated based upon cost-causation methodologies.

Mr. Normand indicated the Company's CCOSS model begins with rate base details, including each plant account, and continues with the remaining items of rate base, revenues, operating expenses, and taxes.[448] The model has various allocation factors, including both internally- and externally- developed allocators. Pepco's CCOSS is the same basic model used in the Company's most recent rate case, but Mr. Normand noted some changes. For billing determinant purposes, the CCOSS uses the number of lights rather than the count of contracts used in Case No. 9472 for the SL-E class, which was more appropriate for lighting classes to determine a fixed-customer charge per lamp rather than per customer account.[449] Mr. Normand also noted a component of other revenues was broken out as a line-item.

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[446] Normand Direct at 6.
[447] *Id*.
[448] Normand Direct at 7.
[449] Normand Direct at 9.

Mr. Normand explained the allocation of subtransmission-related plant facilities was done using the AED-NCAP method. Many items were allocated and assigned in the same manner as in Case Nos. 9443, 9418, and 9336. Specifically, distribution plant at the primary- and secondary-voltage levels were allocated using the NCAP and/or sum of customer maximum ("NCD") demands, line transformers were allocated on an average of NCAP and NCD demands, and FERC accounts designating customer-related distribution plant accounts, as well as numerous rate base items, were all allocated in a manner consistent with the referenced cases.[450]

Mr. Normand indicated sales revenues and Bill Stabilization Adjustment ("BSA") revenues were directly assigned to the various customer classes. In accordance with the previously referenced cases, late payment revenues and billing service revenues were allocated in the same manner. He stated depreciation and amortization, and distribution O&M expenses are allocated in-line with the corresponding EPIS functions or FERC accounts. Subtransmission depreciation was allocated using the subtransmission AED-NCAP method, and property insurance expenses have been allocated based on subtransmission and distribution plant consistent with previous cases.

Mr. Normand summarized his findings and provided the rates of return based upon the Company's current rates and each class' relative ROR. He provided a breakdown, by customer class, of the unbundled customer component, which is calculated by summing the customer-related costs and dividing by the number of customer-months (12) for that class.[451] Comparing the unbundled class customer charges from Case No. 9472 to the test year, five classes, including the Residential, have decreased as a result of decreases in the customer-

[450] Normand Direct at 10-11.
[451] Normand Direct at 14-15.

services, meters, installations, and uncollectible components.[452] Mr. Normand noted increases in the other classes' unbundled costs, largely driven by increases in street lighting, meter reading service, and customer other (storm-related regulatory assets and associated other revenue and expense items) components.[453]

Mr. Normand updated his CCOSS with 12 months of actual data and provided a comparison of various classes' RORs and the fixed-customer component unit costs based upon Pepco's initial filing and the supplemental filing.[454]

B. AOBA

Mr. T. Oliver's review found significant changes between the CCOSS in Case No. 9443 and this proceeding, despite Pepco's claim of consistency. Through discovery, he identified nine material changes in Pepco's operations, costs, and accounting that were not contained in Pepco's testimony.[455] Mr. T. Oliver also noted Pepco shifted expenses between accounts, but did not disclose the changes. He testified, "Changing the basis of the allocation of these expenses, such as moving IT and Software costs from account 903 to 923, from an allocation developed to reflect the cost causation of customer records and collection expenses to a general allocation factor for administrative and general expenses … was inappropriate," and conflicted with Company Witness Normand's statement that costs should be attributed to the class that causes the utility to incur the costs.[456] Mr. T. Oliver recommended Pepco be directed

[452] Normand Direct at 15.
[453] Normand Direct at 15-16.
[454] Normand Supplemental Direct at 2-3.
[455] T. Oliver Direct at 9-10.
[456] T. Oliver Direct at 10.

to itemize and allocate expenses charged to Account 923 based on the underlying cost-causative factors for each itemized expense.[457]

Mr. T. Oliver discussed the impact of Pepco's shift of IT and Software costs. He identified $4,832,179 being shifted from Account 903 to Account 923 (Outside Services) which resulted in more than a $1.2 million shift from the Residential, RTM, and GS-LV classes to all other classes, despite the lack of any corresponding shift in the utilization of IT and Software by any class.[458] Based upon Mr. B. Oliver's proposal, if the $1.2 million was allocated to the Street Lighting Service class, its ROR would move from -5.62% to -1.46%.[459]

Mr. T Oliver also recommended Pepco utilize the internally-developed CCOSS rather than the proprietary, confidential, and non-transparent MAC model.[460] He stated the CCOSS used in a recent D.C. rate case improved both transparency and usability.

C. OPC

Dr. Pavlovic stated the Company's JCOS classification and allocation of general and intangible plant were not consistent with costs causation, its classification and allocation to distribution jurisdictions within the JCOS, or the classification and allocation in Pepco's CCOSS.[461] He indicated Pepco used a two-step approach that first classifies and allocates general and intangible plant between transmission and distribution as largely labor-related, then classifies and allocates as plant-related the plant allocated in the first step to Maryland and other distribution jurisdictions.[462]

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[457] T. Oliver Direct at 6.
[458] T. Oliver Direct at 11.
[459] *Id*.
[460] *Id*.
[461] Pavlovic Revised Direct at 9.
[462] *Id*.

Dr. Pavlovic claimed Pepco's transmission and distribution plant causes the incurrence of the Company's general and intangible plant, and the plant-related allocation of general and intangible plant is consistent with cost causation. Therefore, he recommended the Company classify general and intangible plant as plant-related and allocate general and intangible plant using its plant ratio.[463] Dr. Pavlovic's recommendation decreases Pepco's Maryland distribution rate base by $11.7 million, and increases operating expenses by $0.6 million.[464] Dr. Pavlovic also asserted Pepco's CCOSS relied upon an erroneous allocation of general and intangible plant to its Maryland distribution system based upon his analysis of the JCOS.[465]

D. Staff

Based on his analysis of the JCOS and discovery responses, Mr. Hoppock found the Company "is directly assigning all Control Center costs in General Service Accounts 3913 and 3970 to distribution customers," and the Company indicated Control Center plant is used for both distribution and transmission customers.[466] Pepco claimed these costs have been assigned to distribution customers because the costs cannot be recovered from FERC formula transmission rates as the particular accounts are not included in the formula rate calculations.[467] Mr. Hoppock recommended "allocating these line items between distribution and non-distribution function using a labor allocator, similar to how Maryland allocates all other general

[463] Pavlovic Revised Direct at 10.
[464] Pavlovic Revised Direct at 11.
[465] Pavlovic Revised Direct at. 12.
[466] Hoppock Direct at 10. Account 3913 is Office Equipment and Furniture and Account 3970 is Communication Equipment.
[467] Hoppock Direct at 10-11.

plant between distribution and non-distribution functions."[468] Mr. Hoppock's recommendation would reduce Maryland's distribution rate base by approximately $1.125 million.[469]

In his review of the CCOSS, Mr. Hoppock found the demand data used by Pepco to develop allocators did not match the test year. Specifically, the Company used 2017 calendar year-data for its demand-related allocators in its CCOSS. Based on the time lag created by using test year and data to create demand allocators, Staff recommended the Company be required to update both its JCOS and CCOSS with demand data from the test year when it becomes available.[470]

Mr. Hoppock highlighted the Street Lighting S Service class total operations and maintenance expense increased by 99% from Case No. 9472, and FERC Accounts 580 (operation, supervision, and engineering), 585 (street lighting and signal expenses), 588 (miscellaneous distribution expense) and 596 (maintenance of street lighting and signal systems) also increased significantly.[471] Additionally, Mr. Hoppock described Pepco's 9.1% increase in total rate base from Case No. 9472 as significant and that annual growth rate implies a doubling approximately every 8 years.[472]

In terms of the CCOSS's results, Staff found several classes moved further from a Relative ROR of 1.0, and the SL-S Service class's results are much different than Pepco's previous rate case due to increased expenses. Mr. Hoppock expressed concerns with the Company's methodology to determine demand-related allocators and noted numerous rate classes have multiple monthly non-coincident peaks that were less than their coincident peaks. The Company indicated it aggregates several rate classes (GT-LV, GT-HVE-69 kV, GT-HV-

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[468] Hoppock Direct at 11. (footnote omitted)
[469] Hoppock Direct at 11.
[470] Hoppock Direct at 12.
[471] Hoppock Direct at 15.
[472] Hoppock Direct at 16.

Other, MGT-HV, and MGT-LV) into a GT-MGT class to determine a non-coincident peak.[473] He opined that if the referenced classes were determined individually, the classes would have different values and could change the demand allocators. Mr. Hoppock described Pepco's approach to be a "legacy procedure that predates AMI deployment."[474]

In Pepco's next rate case, Staff recommended the Company be required "to determine each classes' coincident peak, non-coincident peak, and sum of maximum customer demand individually and provide an explanation for how it determines each classes' coincident peak, non-coincident peak and sum of maximum customer demand," and how this approach differs from the Company's previous approach.[475] Additionally, he recommended Pepco be required to continue to provide data required by Order No. 88432.

Mr. Hoppock stated Pepco's proprietary CCOSS model was difficult to use because all of the underlying formulas are not visible and make understanding the model and the results difficult. He pointed out the Company used an updated, non-proprietary CCOSS in a recent rate case in D.C., which was provided to Staff. Mr. Hoppock found the new CCOSS to be more flexible and transparent, and recommended Pepco be directed to use the same model or one that is functionally similar, in its next rate case.[476]

Mr. Hoppock made adjustments to the JCOS and CCOSS based upon Staff witnesses Patterson's and Austin's testimony. He noted the most significant adjustment from a rate design perspective was to the Street Lighting S Service class, and he claimed his adjustments provide a better guide for Staff's rate design.

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[473] Hoppock Direct at 19.
[474] Hoppock Direct at 20.
[475] *Id.*
[476] Hoppock Direct at 22-23.

E. Parties' Responses

Mr. Ziminsky testified OPC's proposal could result in either higher transmission rates that will be paid by Maryland distribution customers if FERC changes its policy to Dr. Pavlovic's proposed allocation of common and general plant, or Pepco would not recover the costs in either distribution or transmission rates if FERC does not change its policy.[477] Mr. Ziminsky disagreed with Dr. Pavlovic's proposed allocation and explained, "General and intangible plant in rate based has always been recognized as labor-related activities for functional allocation purposes by the jurisdictions in which PHI provides service."[478] Mr. Ziminsky stated Pepco uses functional labor costs between distribution and transmission for FERC, and a plant allocator is used for jurisdictional allocations. He cited a survey of 22 PJM utilities regarding functional cost allocation ratios which found a majority of the utilities use a labor allocator for general and intangible plant costs. Additionally, in comparison to OPC's proposed plant allocator of approximately 19.04%, Pepco's 10.62% transmission labor ratio compares favorably to the survey's average transmission labor ratio of 10.94%.

Mr. Ziminsky claimed FERC has consistently ruled that the labor ratio is the appropriate methodology for functionalizing general and intangible plant costs.[479] He stated the Company's reliance of the labor ratio was consistent with the long-standing precedent of both FERC and the Commission, is consistent with other PJM utilities, and produces results similar to other PJM utilities. In response to Staff, Mr. Ziminsky reviewed Mr. Hoppock's Control Center cost adjustment and found it to be reasonable.[480]

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[477] Ziminsky Rebuttal at 19.
[478] Ziminsky Rebuttal at 20-21.
[479] Ziminsky Rebuttal at 22.
[480] Ziminsky Rebuttal at 29.

Mr. Normand dismissed Dr. Pavlovic's concerns related to the jurisdictional allocated rate base and expenses that are inputs to the CCOSS. He specified, "The CCOSS utilizes JCOS inputs that are based on the currently approved allocation methodologies with both the Maryland Public Service Commission and Federal Energy Regulatory Commission for the affected plant and expense items."[481]

Mr. Normand disagreed with AOBA's claim that there are significant changes in the CCOSS compared to Case No. 9472. He noted nine items listed by AOBA have minimal cost-causation impact and were capital-related or changes in expense.[482] In relation to the claim that accounting for IT system expenses was changed for the SL-S class, Mr. Normand explained that class receives IT and software services like all other classes, and the SL-S class should have been allocated in previous cases.[483] He explained the O&M less A&G allocation factor provides a more equitable allocation because the SL-S class benefits from IT and software costs booked to Account 923.

Mr. Normand acknowledged certain items recorded and expensed to different accounts. For example, he noted certain items (back office meter employees, intercompany transfers of facility and vehicle costs, meter department shift, and workers compensation costs were recorded to Account 925 rather than Account 926.[484] Mr. Normand indicated changes in the level of expense or booking costs to a different account does not impact cost causation.

The Company disagreed with AOBA's recommendation to itemize and allocate expenses charged to FERC Account 923 – Outside Services. Mr. Normand stated Pepco conducted an analysis of this issue in Case No. 9418, and the results were not materially different

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[481] Normand Rebuttal at 3.
[482] Normand Rebuttal at 4.
[483] Normand Rebuttal at 6.
[484] Normand Rebuttal at 6-7.

than the O&M less A&G allocation.[485] Mr. Normand explained Account 923 costs cannot be easily traced to customer classes as they are related to general support activities. In addition to using the referenced allocation in recent cases, the National Association of Regulatory Utility Commissioners ("NARUC") Electric Utility Cost Allocation Manual cites Pepco's allocation as appropriate.[486]

In response to Staff, Mr. Normand agreed to provide five years of historical data in a manner consistent with this proceeding. He also did not oppose updating the CCOSS with recent demand data when it becomes available. Additionally, Mr. Normand agreed to provide the CCOSS demand data that is disaggregated in Pepco's next rate case.

However, Mr. Normand disagreed with Staff and AOBA's criticism of the MAC model. He claimed allocation factors and calculations are clearly displayed for each line item, and parties were provided instructions on how to use the model.[487] He testified Pepco uses a non-proprietary model in D.C. as a result of a D.C. Public Service Commission's directive. The Company has used the current MAC model since Case No. 9286 and it is used by all PHI utilities, with the exception of Pepco District of Columbia.[488] Mr. Normand stated the MAC Model should continue to be used to maintain continuity between PHI and Exelon utilities.

Mr. T. Oliver continued to assert significant changes in Pepco's CCOSS in this case compared to previous rate cases which Mr. Normand failed to discuss or identify.[489] Additionally, he claimed the Company inappropriately shifted expenses between accounts and was contrary to the stated intent of allocating costs on a cost causation basis. On cross-

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[485] Normand Rebuttal at 8.
[486] *Id*.
[487] Normand Rebuttal at 12.
[488] Normand Rebuttal at 13.
[489] T. Oliver Surrebuttal at 10.

examination, Mr. T. Oliver agreed that AOBA previously raised the content of the Company's Account 923 expenses in Case No. 9418 and that he raised the same issue in this proceeding.[490]

On brief, AOBA recommended that Pepco be directed "to return the $4,832,179 of IT costs to account 903," and Pepco be required to disclose all material changes in operations, costs, accounting treatment, shifts of costs between accounts and new systems, in its initial application for a rate increase.[491] Additionally, AOBA recommended the Company be directed to perform a more detailed three-part allocation methodology in accordance with the NARUC manual.

Dr. Pavlovic disagreed with Staff Witness Hoppock's finding that Accounts 3913 and 3970 be allocated to Pepco's distribution function using the Company's labor ratio and claimed Staff provided no support for its position. Dr. Pavlovic stated Mr. Hoppock correctly found the general and intangible plant were classified by the JCOS as plant-related and allocated between Maryland and Other jurisdictional operations using plant ratios. However, OPC claimed Staff failed to address the discrepancy in cost causation between Pepco's labor-related classification and allocation of general plant to transmission and distribution functions, compared to Pepco's plant-related classification and allocation of general plant to Maryland and the other distribution jurisdictions.[492]

Dr. Pavlovic addressed the Control Center costs the Company records to Accounts 9313 and 3970, which are recoverable through Pepco's transmission rate formula. He stated, "The total general plant balance includes costs Pepco records to Accounts 3913 and 3970, including control center costs recorded to the Pepco records to those accounts."[493] Dr. Pavlovic

[490] Tr. at 503-507.
[491] AOBA's Brief at 38.
[492] Pavlovic Rebuttal at 5.
[493] Pavlovic Rebuttal at 6-7.

then noted in the calculation of the Company's transmission rate, Pepco's total general and intangible plant balance is allocated to transmission based upon Pepco's transmission labor ratio. He claimed since a portion of the control center costs are already recovered in the Company's transmission formula rate, Pepco's direct assignment of all control center costs in Accounts 3913 and 3970 to the distribution function results in double recovery for the transmission labor-allocated portion.[494]

Dr. Pavlovic noted in discovery the Company records control center costs to Account 182.3, in which regulatory assets are recorded. Based on his experience, most of PJM transmission formula rates treat regulatory assets as adjustments to rate base; however, Pepco's transmission formula rate contains no such adjustment.[495] Therefore, he concluded that "any control center costs recorded to account 182.3 should also be allocated as general plant to Pepco's distribution function using Pepco's distribution function plant ratio."[496] Dr. Pavlovic dismissed the consequences at FERC or other state commissions as having no bearing on the proper cost-allocation methodology. He claimed the Commission "is not required to make up any difference that Pepco might suffer due to unrecovered costs outside the state."[497]

On cross-examination, Dr. Pavlovic agreed with Mr. Ziminsky's discussion of FERC precedent on the use of the labor allocator for general and intangible plant, but also claimed the regulatory cost analysis policies and practices of FERC were not relevant.[498] In the event the Commission adopted his position, Dr. Pavlovic indicated Pepco would need to recover any revenue gap resulting from the use of the plant allocator for general and intangible plant at

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[494] Pavlovic Rebuttal at 7.
[495] Pavlovic Rebuttal at 8.
[496] *Id*. at 8.
[497] Pavlovic Surrebuttal at 6.
[498] Tr. at 693-694.

FERC.[499] On brief, OPC dismissed Pepco's concerns regarding the proper allocation of general and intangible plant in Maryland and the potential impact at FERC or other jurisdictions.[500]

On rebuttal, Mr. Hoppock responded to OPC's proposed method to classify and allocate general and intangible plant between transmission and distribution functions. Mr. Hoppock noted both Dr. Pavlovic's and Pepco's methods are recognized by the NARUC Electric Utility Costs Allocation Manual.[501] He concluded that neither OPC nor Pepco analyzed individual plant items or groups of plant items to determine the best method for specific general and intangible plant.[502]

Mr. Hoppock dismissed the Company's arguments regarding Account 923. He noted the 40% increase in costs ($50 million to over $70 million) since Case No. 9418, the large increase in costs included in Account 923, and the Company's shifting of costs from Account 903 to Account 923 impacts the allocation of expenses to the various customer classes. Therefore, Mr. Hoppock agreed with AOBA that the Company be directed to itemize and allocate the expenses charged to Account 923 in its next base rate case.[503]

In relation to Pepco's CCOSS model, he noted the Company's agreement to provide all parties with the non-proprietary model used in D.C. and populated with Maryland data. Despite Mr. Normand's agreement to provide the non-proprietary model, Mr. Hoppock continued to assert that Pepco's MAC model is not transparent and is difficult to use given that some cells are locked for proprietary purposes.[504] He concluded his adjusted CCOSS should be accepted as a better guide for rate design purposes.

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[499] Tr. at 694.
[500] OPC's Brief at 27.
[501] Hoppock Rebuttal at 1-2.
[502] Hoppock Rebuttal at 5.
[503] Hoppock Surrebuttal at 5.
[504] Hoppock Surrebuttal at 6.

Mr. Hoppock highlighted Case No. 9490 wherein the Commission accepted Staff's JCOS and CCOSS which were based upon a non-labor allocator.[505] In that case, he explained, "Staff evaluated each general and intangible plant FERC account (Accounts 389-398 and Intangible) by line item and determined whether an account should be allocated based on labor, plant or a combination of plant and labor and allocated based on these results in the jurisdictional costs of service study."[506] Due to the lack of a thorough analysis of those accounts, Mr. Hoppock recommended Pepco include in its next rate case an itemized analysis of FERC Accounts 389-399 and 302-303 to determine how much cost in each account is due to labor versus plant. In this proceeding, he recommended the Company allocate general and intangible plant between the transmission and distribution functions using a labor allocator.

On cross-examination, Mr. Hoppock confirmed his preliminary analysis found that Accounts 389, 390, and 391 were likely best allocated using a labor allocator, and Account 396 would likely be best allocated through a plant allocator.[507] Based on these preliminary findings, he believed an account-by-account analysis based on the items in each account be required in the next base rate case.[508]

F. Decision

The Commission views CCOSS "as guidelines for setting customer rates in a sound and reasonable way."[509] After reviewing the parties' testimonies and brief, based on the record of this proceeding, I find Pepco's JCOS and CCOSS, as amended and modified by Staff

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[505] Hoppock Surrebuttal at 13.
[506] Hoppock Surrebuttal at 13-14.
[507] Tr. at 757.
[508] Tr. at 757-758.
[509] 108 Md. P.S.C. at 691.

and discussed below, provides an appropriate measure of the Company's costs imposed on Maryland ratepayers and the costs imposed by the various customer classes.

1. Labor versus Plant Allocator

I decline to adopt OPC's recommendation to change the allocator of general and intangible plant based upon the Company's plant ratio. OPC's position is not supported by the record, and is contrary to FERC precedent, and the Commission's approval of Pepco's allocations in previous rate cases. Additionally, the Commission recently rejected a similar argument made by Dr. Pavlovic in Case No. 9490.

Dr. Pavlovic's recommendation, if accepted, would have significant impacts on Pepco's rate base (approximately $11.7 million reduction) and revenue requirement (approximately $2.7 million reduction). Given Dr. Pavlovic's acknowledgement that any gap in the revenue requirement would have to be recovered from FERC, *after* Pepco demonstrates to FERC that the use of the labor allocator is unreasonable, I am concerned the Company would be unable to recover for the plant that is both used and useful and provides service to ratepayers.[510] While Dr. Pavlovic's proposal would certainly lower rates for distribution customers, it would either result in higher transmission rates if FERC changes its policy, which seems extremely unlikely, or deny Pepco recovery of used and useful plant if FERC maintains its current position.[511] Therefore, OPC's adjustment is rejected.

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[510] Tr. at 693 and 695.
[511] Ziminsky Rebuttal at 25-26.

2. Account 923

I agree with AOBA's proposal, supported by Staff, to have the Company itemize and allocate expenses in Account 923 based on the underlying cost-causative factors for each itemized expense in its next base rate case. Although an analysis was conducted as part of Case No. 9418, there was no specific finding that the Company's analysis was sufficient. Accordingly, I agree with AOBA's proposal and direct Pepco to perform the more detailed three-part allocation methodology as outlined in the NARUC Manual.[512] In reaching this conclusion, I considered the significant increase in costs expensed to this account in just a short time period as noted by both AOBA and Staff, and the lack of any specific findings regarding Pepco's previously conducted study. However, I decline to adopt AOBA's recommendation to have Pepco return approximately $4.8 million to Account 903. I am not persuaded that a reallocation is necessary at this time.

3. Control Center

In regards to the Control Center costs, I agree with Staff's position, and Pepco's concurrence, to allocate these costs in General Service Accounts 3913 and 3970 used for both transmission and distribution functions between distribution and non-distribution functions using a labor allocator. Accordingly, Staff's adjustment is accepted.

4. FERC Accounts 389-399 and 302-303

I agree with Staff that a more precise methodology to determine the appropriate allocator for FERC Accounts 389-399 and 302-303 is warranted. Staff's proposal is consistent

[512] *See* T. Oliver Surrebuttal at 5-6.

with the Commission's recent approval of Staff's cost of service studies in Case No. 9490.[513] Given the Company has in excess of $359 million in total general and intangible plant and the wide array of FERC Accounts in which those dollars fall, it is likely that one allocator may not be the appropriate.[514] I found Mr. Hoppock's testimony on this point compelling as his limited analysis of four accounts yielded different results – three accounts were primarily labor related and one account was primarily plant related.[515] Based on Mr. Hoppock's limited analysis and the lack of a full analysis by the Company, I agree with Staff's recommendation, and direct Pepco to include an itemized analysis of FERC Accounts 389-399 and 302-303 to determine how much cost in each account is due to labor versus plant in its next base rate case.

5. Uncontested Items

Finally, based upon Pepco's agreement to Staff's proposals, I direct the Company to:

1. provide historical coincident and non-coincident peak data, kWh sales data, historical demand allocator ratios, analysis of the allocators using multi-year data, and monthly coincident and non-coincident peak demand for each customer class as required in Order No. 88432;

2. update its CCOSS and JCOS with demand data from the test year as soon as it becomes available;

3. in the next base rate case, determine each class' coincident peak, non-coincident peak, and sum of maximum customer demands individually and explain in written testimony how the Company determined those items; and

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[513] Case 9490, Order No. 89072, *slip op*. at 97.
[514] *See* Hoppock Surrebuttal at 14. (citation omitted)
[515] Hoppock Surrebuttal at 15.

4. in the next base rate case provide all parties with the non-proprietary CCOSS model populated with Maryland data that Pepco uses in the District of Columbia.[516]

VII. Rate Design

In order to properly design rates, the class rates of return reflected in the CCOSS serve as the starting point. Each return is then translated into a unitized rate of return ("UROR"), which "measures as a percentage the individual customer class rate of return compared to the utility's system average or overall rate of return."[517] A UROR of 1.0 represents the utility's overall rate of return. A class with a UROR greater than 1.0 indicates the class is over-earning, and a class with a UROR less than 1.0 indicates the class is under-earning. The goal of rate design is to move all classes towards a UROR of 1.0, but considerations such as gradualism and the avoidance of rate shock for all rate classes must be considered.[518]

The next step is to allocate any class increase among intra-class rate elements, such as the customer charge, energy charge, and demand charge. The Commission has stated intra-class rate design "is guided by principles of cost causation as well as other important policy considerations such as economic impacts, energy conservation, and gradualism."[519]

A. Pepco

Mr. Blazunas proposed to allocate Pepco's revenue requirement with a four-step methodology, which he claimed was consistent with several previously authorized methodologies. He utilized the CCOSS's UROR as a benchmark to determine how each class

[516] *See* Pepco's Brief at 76-77 and Hoppock Surrebuttal at 2-3.
[517] 103 Md. P.S.C. at 421.
[518] *Id*.
[519] *Id*.

should be moved towards the cost of service and to allocate revenue on a class-specific basis.[520] First, Mr. Blazunas indicated that any rate class with a UROR significantly above 1.0 was excluded from any allocation of the distribution rate increase. Next, rates classes that have a UROR within a band of reasonableness equal to +/- 10% of the system average ROR are allocated a portion of the revenue increase. The amount of the allocation "is calculated as each applicable class' current annualized distribution revenues multiplied by the proposed total system distribution revenue increase as expressed in percentage terms."[521]

Third, rate classes with a UROR of less than 0.9, below the lower limit of the band of reasonableness, are allocated a portion of the revenue increase calculated as 1.12, "or the ratio of the distribution revenue percentage increase for an under-earning rate class to the system-wide distribution revenue percentage increase in Case No. 9443, times the proposed total system distribution revenue increase as expressed in percentage terms multiplied by annualized current distribution revenues for that class."[522] The fourth and final step allocated the remainder of the revenue increase to all remaining rate classes in proportion to their current level of annualized distribution increase. In his supplemental direct testimony, Mr. Blazunas updated his rate class designs, bill impact analysis, and BSA calculations utilizing the same ratemaking principles and allocation methodologies relied upon his direct testimony.

Mr. Blazunas proposed no increases for the GT-3 and TN rate classes as their URORs are 4.92 and 2.76, respectively. Next, both the RTM and GS-LV rate classes are within the +/- 10% band of reasonableness; therefore, he recommended increases equal to the system average increase of 5.76%.[523] Mr. Blazunas allocated 64% of the total increase to the R, MGT-

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[520] Blazunas Direct at 6.
[521] *Id.*
[522] Blazunas Direct at 7.
[523] Blazunas Direct at 8.

3A, GT-3A, TM-RT, SL, and SSL rate classes, all of which have URORs below 0.9. Finally, the remaining revenue increase was allocated to MGT-LV and GT-LV based on their level of current annualized distribution revenue.

Mr. Blazunas' allocation resulted in only one rate class, SL, experiencing a percentage revenue requirement increase more than 1.12 times the system increase, and all rate classes currently within the band of reasonableness remained within the band based upon his allocation.[524] He noted rate schedules with URORs greater than 1.1 saw a decrease and are still within the lower limit of the band of reasonableness, and all but one rate class with a UROR below 0.9 saw either no increase or an increase while remaining below the upper limit of the band of reasonableness.[525] The SL class was the one class with an existing UROR less than 0.9, but saw a UROR decrease, and was allocated additional revenue in step 3, such that its UROR did not change.

Pepco proposed to increase the customer charge for the R and R-TM classes by 2.64% and 2.84%, respectively, the same percentage increase approved in Case No. 9443. Mr. Blazunas stated the remaining proposed revenue requirement increase would be recovered through each class' volumetric rates.

Next, the MGT-LV, MGT-3A, GT-LV, and GT-3A rate schedules all have three parts: customer; demand; and energy rate components. Mr. Blazunas proposed a 2.84% increase to the customer charge for each class, consistent with Case No. 9443, with the balance of the revenue requirement to be recovered through proportional increases in remaining distribution rate components of each class.[526] He proposed no increase to the GT-3B class as the currently authorized revenue requirement is being recovered through rates. However, since the GT-3B

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[524] Blazunas Direct at 9-10.
[525] Blazunas Direct at 10.
[526] Blazunas Direct at 12.

class' customer charge is below its customer unit costs, Mr. Blazunas proposed a 2.84% increase to the customer charge. Finally, Pepco proposed to keep the fixed charge for street lighting rate schedules SSL-OH-LED and SSL-UG-LED at a flat rate that fully reflects the underlying costs, and the fixed charge for conventional street lights was adjusted such that no conventional streetlights have a lower fixed cost than a LED street light.[527]

Mr. Blazunas provided a bill impact analysis based upon the Company's updated revenue requirement. He indicated that a residential SOS customer using an average of 855 kWh per month would see a total monthly increase of $3.56, or 2.82%.[528]

B. AOBA

Mr. T. Oliver testified the Company's distribution of its rate increase was similar to the method used in Case No. 9472 to distribute the revenue decrease. He believed more should be done to narrow the gap between ROR for the various classes, and pointed to the GT-3B class (33.77% ROR) and the TN class (18.61% ROR).[529] He questioned how these rates can be just and reasonable given that they are more than twice the 7.81% ROR sought by Pepco. Therefore, he recommended reductions be applied to both classes and all other classes remain unchanged. In relation to Pepco's rate designs for non-residential classes, Mr. T. Oliver found the designs "are arbitrarily constrained by the Company's choice to apply a single customer charge increase to all classes," and was based upon cost or the classes' ROR.[530]

Mr. T. Oliver also found the Company's bill comparison misleading for customers outside of Montgomery County and customers that do not take SOS. He claimed Pepco's comparison implies that all customers are subject to the Montgomery County Fuel and Energy

[527] Blazunas Direct at 13.
[528] Blazunas Supplemental Direct at 2-3. Pepco’s bill impact includes both generation and transmission costs.
[529] T. Oliver Direct at 16.
[530] T. Oliver Direct at 19.

Tax, which is more than twice Prince George's County's Energy Tax, and receive SOS. Therefore, Mr. T. Oliver recommended the Company be directed to provide bill comparisons for SOS customers and for customers that receive energy from third-party suppliers.[531]

C. OPC

Dr. Pavlovic claimed Pepco's rate design for classes close to the +/- 10% band was too aggressive to move those classes toward or into that band. He also asserted for those classes further away from the referenced band, Pepco's approach was not aggressive enough. Based on Dr. Pavlovic's distribution of OPC's recommended revenue decrease, the residential class would receive a (0.62%) decrease, or $1,621,391.[532] In relation to the Company's proposed customer charge increase, Dr. Pavlovic testified the increase to both the Residential and RTM classes contravene Commission precedent to minimize such increases.[533] Therefore, he recommended the revenue requirement be made to the volumetric charges.

D. Staff

Mr. McAuliffe recommended Staff's two-step approach which moves more classes towards the UROR of 1.0 and no class will receive the same revenue increase as the system average.[534] He proposed a 15% first-step allocation to any class below a UROR of 1.0, and the 85% second-step allocation to all classes, other than the TN and GT-3B classes which are both significantly over-earning.[535]

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[531] T. Oliver Direct at 22.
[532] Pavlovic Revised Direct at 17.
[533] Pavlovic Revised Direct at 19.
[534] McAuliffe Direct at 14.
[535] McAuliffe Direct at 15.

Mr. McAuliffe explained he limited his first-step allocation due to concerns expressed with Pepco's demand allocators. In his first step, he proposed to allocate 15% to any class with a UROR below 1.0, and the remaining 85% to all other classes, with exception of the TN and GT-3B classes. Mr. McAuliffe's first step allocation was based upon the respective class' proportion of the total current annualized distribution revenue of all other classes included in step one.[536] In the second step, the remaining 85% will be allocated based upon their proportion of the revenue of all the classes except for the TN and GT-3B classes. Mr. McAuliffe noted his method moves all classes closer to a UROR of 1.0, mitigates rate shock, and the increases are gradual.

Mr. McAuliffe found Pepco's proposed 2.64% increase to the residential customer charge reasonable. Additionally, he noted the proposed 2.64% summer and winter kWh increases were acceptable. However, Mr. McAuliffe stated there is no evidence to change the percentage of residential revenue collected from the summer and winter kWh charges.[537] Therefore, he changed the Company's calculation to derive the proposed rates. Staff's design results in a residential customer charge of $8.01, and summer and winter kWh rates of $0.06495 and $0.03209, respectively.[538] Mr. McAuliffe recommended accepting Pepco's 2.84% increase to all non-residential customer charges and the proportional increase in demand and kWh rates for all non-residential classes. He also recommended accepting the Company's rate design for lighting classes.

Mr. McAuliffe calculated the bill impacts based upon Staff's recommended revenue increase. He found an average residential customer that uses 855 kWh per month would

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[536] McAuliffe Direct at 16.
[537] McAuliffe Direct at 17-18.
[538] McAuliffe Direct at 18.

see a winter distribution bill (excluding generation and transmission) of $53.13, a $0.86/1.65% increase, and summer bill of $81.80, a $1.53/1.91% increase.[539]

Finally, Staff expressed concerns with Pepco's calculation of its BSA. Mr. McAuliffe specified Pepco calculates BSA revenue per customer per month assuming each customer received one bill per month based upon a count of contracts data, but the Company's monthly BSA filings use the active billed report, which is based upon bills rendered over the course of a month.[540] The Company's different approaches can lead to under- or over-collections of BSA revenue. Therefore, Mr. McAuliffe recommended Pepco use the count of contracts report for all BSA and revenue calculations as the Company does in its D.C. service territory.

E. Parties' Response

Mr. Blazunas found Staff's two-step allocation reasonable, but preferred his four-step allocation methodology as all classes' URORs remain unchanged or move closer to 1.0. He explained the two-step method constrains the movement of classes' URORs. Pepco's four-step method removes those constraints by creating the +/- 10% band of reasonableness. Additionally, he claimed the second step in his approach provides a more targeted allocation for classes outside the band of reasonableness. Mr. Blazunas also claimed his method was more flexible because it is not tied to a percentage change in total revenue.[541]

In response to OPC, Mr. Blazunas explained no rationale was provided. He added both the proposed R and RTM customer charges remain well below the amounts set forth in the

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[539] McAuliffe Direct at 19. Unlike Pepco, Staff's bill impact does not include generation or transmission costs.
[540] McAuliffe Direct at 20, *citing* Pepco response to SDR 20-7.
[541] Blazunas Rebuttal at 4.

CCOSS. Finally, Mr. Blazunas noted if approved, Pepco's $8.01 R class customer charge was $0.52 cents lower than the average residential customer charge in Maryland.[542]

Mr. Blazunas stated AOBA's rate design was initially based on a rate decrease and was not updated until surrebuttal testimony. In response to AOBA's proposed decrease for the GT-3B and TN rate classes, Mr. Blazunas indicated he was not aware of previous cases wherein the Commission authorized reallocating revenues from over-earning classes to other classes. He also disagreed with AOBA's position on non-residential customer charges and found Mr. T. Oliver's proposal to be arbitrary, not based on cost, and not sensitive to the differences in the various classes' rates of return.[543]

In response to the BSA concerns, the Company agreed to calculate the monthly levels of authorized revenue through the BSA based on data from the "Count of Contracts." Mr. Blazunas explained, "In order to be completely revenue neutral the change in methodology should correspond with the change in distribution rates and BSA targets that will result from a Commission Order in this proceeding."[544]

The Company also discounted AOBA's bill comparison criticism. Mr. Blazunas claimed Pepco's approach is the same as previous cases and the comparisons are based on SOS and includes relevant taxes, and the GT-LV, GT-3A, and GT-3B classes are based on a distribution-only basis.[545]

Mr. T. Oliver updated his rate design in surrebuttal testimony. He recommended a revenue-neutral adjustment to address the high RORs for the GT-3B and TN classes and to eliminate the negative ROR for the SSL class. Specifically, Mr. T. Oliver recommended a

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[542] Blazunas Rebuttal at 7-8.
[543] Blazunas Rebuttal at 11.
[544] Blazunas Rebuttal at 13-14.
[545] Blazunas Rebuttal at 15.

$939,098 increase for the SSL class, which would move its ROR to zero, and then apply a $939,098 decrease to the GT-3B and TN classes based on each class' operating income.[546] He then proposed to apply the system average increase to classes within +/- 10% of the system average, and 70% of the remaining increase applied to classes more than 10% below the system average.[547] The remaining 30% was then allocated to classes with a return greater than 10% of the system average proportionally based on revenue.

Dr. Pavlovic found Staff's two-step approach less precise than his four-step methodology, it failed to move all classes closer to a UROR 1.0, and the movement towards 1.0 appeared arbitrary. OPC also disagreed with Staff's support of the 2.64% increase to the customer charge for the R and RTM classes and asserted the proposed increase is contrary to Commission policy. On surrebuttal, Dr. Pavlovic continued to defend his proposed rate design and opposed an increase to the customer charge.

In his rebuttal testimony, Mr. McAuliffe claimed Dr. Pavlovic did not offer an explanation for the four-step allocation of OPC's recommended revenue decrease. Mr. McAuliffe explained the two classes with the highest URORs, GT-3B and TN, were only slightly reduced under OPC's proposal. He also claimed there was no cost causation principle that would result in allocating a small revenue reduction to classes with URORs under 1.0 when there are several over-earning classes.[548]

In its comments, Montgomery County requested the Commission keep in mind the impacts on customers when determining just and reasonable rates, and consider that shock

[546] T. Oliver Surrebuttal at 9.
[547] *Id*.
[548] McAuliffe Rebuttal at 3.

applied to both local government and customers' budgets and urged gradualism be applied to all rate classes.[549]

F. Decision

The Commission has typically utilized a two-step process to allocate revenues finding that "approach intends to balance actual rates of return reflected in the utility's COSS and the principle of gradualism."[550] However, as noted by the Company, the Commission utilized Pepco's four-step allocation in Case No. 9472. After reviewing the record in this proceeding, I find neither OPC's nor AOBA's proposed rate designs to be acceptable, as the former lacks sufficient rationale, and the latter includes decreases to certain classes which contravenes the Commission's policy that no class should receive a revenue decrease when others are receiving increases[551] and also lacks the necessary specificity for serious consideration.[552]

I find that while both Staff and Pepco's approaches are reasonable, I will utilize Staff's two-step approach as it moves more classes towards unity and avoids rate shock to any one class. However, rather than using Staff's proposed 15% first-step allocation, I find that increasing the first-step to 50% and applying it to all under-earning classes, and then distributing the remaining 50% to all classes, except the GT-3B and TN classes, allocated based upon their proportion of the distribution revenues of all the non-exempted classes to be more appropriate. Increasing the first-step allocation results in all classes moving towards a 1.0 UROR and avoids rate shock for any one class. In terms of impact, this rate design will result in an average

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549 Montgomery County's Comments at 2-3.
550 Case No. 9490, Order No. 89072, *slip op*. at 104.
551 *See Re Baltimore Gas & Elec. Co*., 104 Md. P.S.C. 64, 110 (2013).
552 Blazunas Rebuttal at 11.

residential customer using 855 kWhs per month experiencing an approximate 1.40% monthly overall bill increase ($1.76), including generation and transmission costs.[553]

In considering increases to customer charges, the Commission has been mindful of public policy goals that are intended to encourage energy conservation and lower customer charges and gives customers more control over their bills by increasing the volumetric charge.[554] Pepco's proposed increase is consistent with the 2.64% increase ($0.20) granted in Case No. 9443.[555] OPC's position effectively interprets the Commission's policy to "minimize" customer charge increases to mean "none." Such an interpretation is not reasonable and is not supported by the record. I find the Company's proposed $0.21 increase to the residential customer to be reasonable and consistent with the Commission's policy goals, and will continue to allow customers to conserve and have more control of their bill. Additionally, as noted by the Company, even with granting an increase, the $8.01 residential customer charge is very comparable to other Maryland electric utilities.

I also agree with Pepco's proposed non-residential customer charge increases, as well as the proposed increases in the demand and kWh rates for the non-residential classes. The Company's proposal, which is supported by Staff, is reasonable and consistent with the Commission's stated goals.

In relation to the BSA calculations issue raised by Staff, and given Pepco's agreement, the Company is directed to calculate the monthly levels of authorized revenue through the BSA based on data from the "Count of Contracts." Additionally, I agree with the Company that to be completely revenue neutral, the change in methodology should correspond

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[553] If generation and transmission costs are excluded, an average residential customer's bill impact would be $1.75 per month, a 2.74% increase.
[554] 108 Md. P.S.C. at 700.
[555] *Id*. at 701.

with the change in distribution rates and BSA targets resulting from this proceeding's final Order.[556]

In response to AOBA's concerns about how Pepco presents its bill comparisons, Mr. Blazunas acknowledged that the Company could present a bill comparison for both SOS customers and those customers who utilize third-party suppliers.[557] I agree with AOBA that presenting comparisons based upon customers in Montgomery County, which has a larger fuel tax than Prince George's County, could be misleading. Additionally, comparisons that remove taxes and SOS energy charges will provide customers with a more realistic impact from the Company's requested increase. Therefore, in accordance with AOBA's request, in its next base rate case Pepco shall provide bill comparisons for both SOS customers and customers that use third-party suppliers, and the comparisons shall only include the proposed distribution charges and exclude SOS energy changes and all associated taxes. This should provide all Pepco customers a more accurate estimate of how Pepco's next proposed rate increase will impact them.

VIII. Conclusion

After consideration of the entire record, including public comments and briefs, I find that based on a test year of the 12 months ending January 31, 2019, as adjusted above, Pepco is authorized to file revised rates and charges for an increase in revenues of $10,289,000. I find, based upon the approved allocation and rate design, the increase will result in just and reasonable rates for both the Company and its customers.

[556] Blazunas Rebuttal at 13-14.
[557] Tr. at 334.

Pursuant to the procedural schedule adopted in this matter, parties shall file both the Notice of Appeal and the Memorandum on Appeal by July 18, 2019 and any Reply Memorandum is due by July 24, 2019.

IT IS, THEREFORE, this 9th day of July, in the year Two Thousand Nineteen,

ORDERED: (1) That the Application of Potomac Electric Power Company filed on January 15, 2019, seeking to increase distribution rates for electric service by $29.990 million (updated to $26.71 million on May 16, 2019) in its Maryland service territory is hereby denied.

(2) That Potomac Electric Power Company is hereby authorized, pursuant to § 4-204 of the Public Utilities Article, *Annotated Code of Maryland*, to file tariffs for the distribution of electric energy in Maryland, which shall increase rates by no more than $10,289,000, in accordance with the findings in this Proposed Order, which shall be effective with service rendered on or after August 13, 2019, subject to acceptance by the Commission, and which shall otherwise be consistent with the findings of this Proposed Order.

(3) That Potomac Electric Power Company is hereby directed to provide the data, information, and studies in its next base rate case filing, consistent with the findings of this Proposed Order.

(4) That any motions or requests not granted herein are hereby denied.

(5) That this Proposed Order will become a final order of the Commission on August 9, 2019, unless before that date an appeal is noted and a memorandum of appeal filed with the Commission, in accordance with the procedural schedule, by any party to

this proceeding, or the Commission modifies or reverses the Proposed Order or initiates further proceedings in this matter as provided in Section 3-114(c)(2) of the Public Utilities Article.

/s/ Ryan C. McLean
Ryan C. McLean
Chief Public Utility Law Judge
Public Service Commission of Maryland