Appendix D

COST RECOVERY PROPOSAL

A. Availability

The Company proposes that availability of SOS continue as provided under the current tariff provisions.

B. Procurement

Residential and small commercial customers have not chosen alternative suppliers to provide generation services in significant numbers. Less than 4% of residential and small commercial customers have chosen an alternative supplier. In contrast, over 65% of the large commercial load is served by alternative suppliers. This is due in large part to the fact that there are fewer suppliers offering competitive offers to residential and small commercial customers (5) versus those marketing to large commercial customers (17).

Due to the robust large commercial market, the Company proposes to continue procurement of generation services for large commercial customers using an RFP to acquire one year contracts from wholesale providers.

Because residential and small commercial customers are both less likely to receive a competitive offer from alternative suppliers and also less likely to choose an alternative supplier, the Company proposes to procure generation services for these customers through a portfolio of sources which as described in prior sections of this document. As part of this portfolio procurement process, longer term contracts shall be

obtained through a Commission approved process and subject to Commission approval similar to the approvals process for the current SOS procurement process as established by the Commission orders in Docket No. 04-391. Shorter term contracts and purchases will be made within the guidelines for the portfolio approved by the Commission.

C. <u>Pricing</u>

Pricing of SOS needs to reflect the costs associated with the energy used as closely as practical. Under the current SOS structure, the seasonal (winter and summer) bids received from the RFP procurement are allocated to the appropriate rate class blocks which were established prior to the implementation of market based SOS rates. A procurement portfolio strategy, which could evolve as required, will include spot market purchases as well as a portfolio of contracts and other instruments, including those needed to meet the RPS requirements. This strategy requires more responsive pricing. As part of the implementation of a procurement portfolio, the Company proposes to set rates to more accurately match the costs of generation to the usage. To accomplish this, the Company proposes the following:

First, the company proposes to reset rates quarterly. Historically, prices are higher in the summer and the winter with somewhat lower prices in the shoulder months. Quarterly pricing would allow better matching of rates to seasonal price changes. The Company proposes to move to a process, to be approved by the Commission, in which the tariff rate is automatically updated by the Company and billed to customers without Commission pre-approvals and formal notice. Under this proposal, the Company would submit proposed pricing along with supporting documentation at least sixty (60) days prior to the effective date. Rates would become effective subject to refund (through the Procurement Cost Adjustment which is described below) on the first of each quarter and

would be noticed to customers through a bill insert and posting to the Company's website. The quarters would begin June 1, September 1, December 1, and March 1 of each year. Prices would reflect current contracts in place as well as a forecast of costs for hourly and other short term market purchases.

Second, the Company proposes the elimination of usage blocks (i.e., 1st 100 kWh). These blocks reflect cost structures that were relevant prior to the implementation of market based SOS but are not useful today.

Third, the Company proposes to price capacity costs through a generation customer charge that would be based on customers' PJM peak load contribution (PLC). This is because capacity costs have become a more significant part of total supply costs.

Pricing options need to remain flexible in order to adapt to changing price patterns and technological capabilities. As the Company is able to implement advanced metering infrastructure (AMI), then pricing block options which could include time of use, hourly, and/or critical peak pricing may be adopted.

From a pricing perspective, the change from the current RFP procurement method to the portfolio will require a transition period. The Company currently has rolling three year contracts with wholesale suppliers with the longest outstanding contracts expiring May 31, 2011. As each set of contracts expire, it would be replaced using the portfolio procurement method. Also, the portfolio procurement method will create additional costs above and beyond the costs of the energy contracts. These include, but are not limited to, costs associated with credit support, as well as "mark to market" issues (i.e. assigning current market value to positions held), and additional infrastructure such as IT systems and additional personnel to manage the portfolio.

These costs should be included in the Reasonable Allowance for Retail Margin ("RARM") which is employed currently with SOS. The RARM mechanism is currently comprised of the following components: a) incremental expenses incurred: i) to provide fixed priced SOS ("FP-SOS") and hourly priced service ("HPS"); ii) to administer the Volumetric Risk Mitigation ("VRM") mechanism applicable to FP-SOS customer load; and iii) carrying costs on Cash Working Capital ("CWC") for FP-SOS and HPS; b) $2.75 million per 12 month period; and c) for GS-T customers and those in the GS-P class that elect HPS, the allocable share of the above categories. The incremental costs include uncollectibles related to the provision of SOS. The Company proposes that these additional costs associated with the portfolio procurement method would be incremental expenses incurred to provide SOS and should therefore be included in the calculation of the RARM.

Discussion of several of these issues could begin prior to the acknowledgment of this IRP. Each year the Commission Staff conducts a procurement improvement process ("PIP") working group. We recommend that these issues be discussed further as part of this process.

D. <u>True-ups (Procurement Cost Adjustment)</u>

Currently differences in stated versus actual line losses as well as unaccounted for energy ("UFE") create differences in what is paid for the supply of electricity and what is collected from SOS customers. Also under the current SOS pricing system, there are differences created from converting wholesale bids into the block prices as discussed earlier. Currently, these differences are reviewed annually and a procurement costs adjustment ("PCA") charge or credit is instituted for the following year. The PCA is readjusted annually in subsequent years.

With the adoption of the portfolio procurement method, periodic changes in the portfolio as well as the use of spot market to ensure proper load following will also create differences that will require true-ups. Even though the portfolio procurement method may create more long-term price stability, the use of spot market as part of that portfolio can create more month to month fluctuations.

If not addressed for longer periods of time, the differences can build up and create significant price changes from year to year. An example of this is the SOS service for the Delmarva Delaware LGS class. After the first year of SOS the PCA had developed into a large credit for the LGS SOS customers. This over-collected amount was returned to the LGS SOS customers during the second year of SOS. However, the large credit also led to some LGS customers, which had chosen an alternative retail supplier, returning to SOS. Because the PCA was a credit and more customer returned than had been forecast, the next year the PCA was a charge to LGS SOS customers. This year to year swing in the PCA helped create a 17% annual bill increase to those customers in one year.

These swings in SOS prices can keep retail suppliers from making offers. One year they may be competitive and the next year they may be priced out of the market. Given that customer acquisition costs can be significant, they may choose to devote resources to other regions.

To avoid this in the future, the Company proposes to move to a system in which the PCA tariff rate is automatically updated monthly by the Company and billed to customers without Commission pre-approvals and formal notice. Rate changes related to the PCA would be posted to the Company website prior to the beginning of each month. The difference between what is paid for supply and transmission and what is billed to

customers for those services is put into a deferral account. Each month the total amount in the deferral account will be divided by a forecast of kWh sales for the next twelve (12) months. These calculations will be subject to review by Staff at any time.

This proposed process is similar to the process that is currently employed in both Maryland and the District of Columbia. It has been successful in keeping the PCA from becoming a significant issue. In both jurisdictions, the PCA calculation is subject to Staff audit.

As with several of the pricing issues, we recommend that this issue also be added to the agenda for this year's PIP.

E. <u>Migration Risks</u>

When generation assets, which may include contracts and other instruments as well as physical assets, are procured for a period of time for a particular load requirement, and that load migrates to another supplier, and the generation assets are worth less that what was paid for them, stranded costs are created. If these stranded costs are passed on to the remaining SOS customers the cost of SOS service is driven up, encouraging more migration and more stranded costs.

Title 26, Chapter 10, §1010 (c) provides the Commission with the authority to restrict retail competition and/or add a non-bypassable charge in order to protect customers receiving SOS. In order to protect customers in the event of significant migration that creates stranded costs, the Company proposes to put into place a non-bypassable charge that would be triggered in the event that customer migration out of SOS creates a situation in which the generation procurement portfolio contractually and/or physically has more energy and capacity to serve SOS load than is needed and that

as a result SOS prices, in the absence of the non-bypassable charge, would increase by more than five percent (5%).

In order to trigger the mechanism, the Company would submit a filing to the Commission showing both the migration away from SOS, the stranded costs created by this migration, and the effect these costs would have on SOS prices.

The Company believes that this mechanism is the appropriate means to ensure that migration does not adversely affect the provision of SOS. First, it allows customers who have chosen alternative suppliers to remain with those suppliers. Second, it allows customers the opportunity to continue to seek alternatives if they choose. Finally, it does not immediately create any additional burden as the mechanism would not be used unless circumstances require its implementation.

F. Regulated Physical Generation Assets to Supply SOS

Although the Company does not recommend the building of physical generation assets to meet the needs of SOS load in Delaware for this IRP, it does recognize that the Commission may require or that at some time in the future it may be appropriate to build, own, and operate such assets for reliability purposes. An important part of that process is developing a clear understanding of the process for how such assets will be operated for the benefit of SOS and how cost recovery will be treated for these assets.

Any generation assets operated within PJM are bid into the pool and dispatched by PJM. The assets cannot be operated just to serve SOS load. Therefore the economically efficient way to operate such an asset is to sell the energy and capacity from the asset into the market. The proceeds from operation of the plant would be netted against the costs of running the plant including a reasonable return as set by the Commission in hearings.

The net amount would be placed in a deferral account that would be used to calculate an on-going non-bypassable surcharge applicable to all customers eligible for SOS. Please note that the net amount could be either a benefit or a cost at any point in time. The surcharge would be calculated by taking the cumulative amount in the deferral account plus interest (calculated at the utility's most recent authorized rate of return) divided by a twelve (12) month forecast of kWh sales for all customers eligible for SOS service.

G. Regulated Physical Generation Assets for Reliability

Although the Company does not recommend the building of physical generation assets to meet reliability needs, if the Commission determines that this is in the public interest, then a surcharge will be required to cover all of the costs incurred in owning and operating the generation. Since the generation is required for reliability reasons, the generation will benefit all of Delmarva's customers and the net costs should be recovered in a non-bypassable surcharge charged to all Delmarva customers. The generation would be operated and the net costs determined in the same manner described above for Regulated Physical Generation to Supply SOS. However, the net costs will be recovered over all the customers, regardless of whether they receive SOS service, since all customers receive the reliability benefit.

H. Renewable Portfolio Standards (RPS) Costs

The Company proposes purchasing renewable energy to meet Delaware's RPS requirements for all Delaware customers. This would better encourage the development of new renewable resources and allow more Commission oversight. The Company will provide a more detailed proposal shortly. As part of that proposal, the Company proposes to recover the costs for the RPS costs through a non-bypassable surcharge. The

Company recognizes that there will be the need for a transitional period. Some customers may have already procured their RPS requirements and would be dealt with on a case by case basis.