BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF DELMARVA POWER & LIGHT COMPANY FOR APPROVAL OF A CHANGE IN ELECTRIC DISTRIBUTION BASE RATES AND MISCELLANEOUS TARIFF CHANGES (FILED SEPTEMBER 1, 2005)	))))))	PSC DOCKET NO. 05-304

FINDINGS, OPINION, AND ORDER NO. 6930

BEFORE:

ARNETTA MCRAE, Chair
JAYMES B. LESTER, Commissioner
JOANN T. CONAWAY, Commissioner
J. DALLAS WINSLOW, Commissioner
JEFFREY J. CLARK, Commissioner

A**PPEARANCES:**

On behalf of the Applicant, Delmarva Power & Light Company ("Delmarva" or "the Company""):

RANDALL V. GRIFFIN, ESQUIRE
PAUL H. HARRINGTON, ESQUIRE
Pepco Holdings, Inc.

On behalf of the Public Service Commission Staff ("Staff"):

JAMES McC. GEDDES, ESQUIRE
REGINA A. IORII, ESQUIRE
Ashby & Geddes

On behalf of the Division of the Public Advocate ("DPA"):

G. ARTHUR PADMORE, ESQUIRE
Public Advocate

On behalf of the Delaware Energy Users Group ("DEUG"):

LOUIS R. MONACELL, ESQUIRE
MICHAEL J. QUINAN, ESQUIRE
Christian/Barton LLP

On behalf of the Delaware Electric Cooperative, Inc. ("DEC"):

CYNTHIA J. LONGOBARDI, ESQUIRE
Hudson, Jones, Jaywork & Fisher

MARK A. NIELSON, Vice President – Staff Services

On behalf of Christiana Care Health Services ("CCHS"):

GLENN C. KENTON, ESQUIRE
KELLY A. GREEN, ESQUIRE
Richards, Layton & Finger

On behalf of Comcast of Delmarva, Inc. ("Comcast"):

JERRY C. HARRIS, ESQUIRE
Morris, Nichols, Arsht & Tunnell

I. BACKGROUND

1. On September 1, 2005, Delmarva Power & Light Company ("Delmarva" or the "Company") applied to the Delaware Public Service Commission (the "Commission" or "PSC") for approval to: (a) increase base rates for electric distribution service by $1,232,000; (b) remove supply-related costs from the delivery components of rates; (c) modify its tariff; (d) institute new services; (e) eliminate a current service that serves no customers; and (f) waive certain filing requirements. With its application, the Company submitted direct testimony from J. Mack Wathen, Vice President - Regulatory Affairs for Pepco Holdings, Inc. ("PHI"); W. Michael VonSteuben, Manager of Revenue Requirements - Regulatory Affairs; Paul M. Normand, President of Management Applications Consulting, Inc.; J. Reed Bumgarner, Manager of Pricing - Regulatory Affairs; Timothy J. White, Manager Policy Coordinator - Regulatory Affairs; Kathleen A. White, PHI's Assistant Controller; Roger A. Morin, a professor of Finance at Georgia State University and a principal in Utility Research

International; M. Howard Yourinson, Manager of Claims, Workers Compensation for PHI; and Earl M. Robinson, President and Chief Executive Officer of the Weber Fick & Wilson Division of AUS Consultants - Utility Services.

2. On September 20, 2005, by Order No. 6727, we suspended the Company's application, with proration, subject to refund and evidentiary hearings. We also suspended the proposed non-rate-related tariff modifications to the date that a final Order was issued. We designated William F. O'Brien, Senior Hearing Examiner, to schedule and conduct evidentiary hearings and to report his proposed findings and recommendations to the Commission; appointed Rate Counsel; directed the Company to publish notice of the filing of its application and the Commission's action thereon; and granted the Company's requested waiver of certain minimum filing requirements.

3. The Hearing Examiner issued a procedural schedule establishing deadlines for intervention, discovery, pre-filing of direct testimony by Staff and intervenors, pre-filing of rebuttal testimony by the Company, and evidentiary hearings.

4. The Division of the Public Advocate ("DPA") intervened pursuant to 29 *Del. C.* § 8829(c). The Hearing Examiner also granted intervention petitions from Christiana Care Health Services, Inc. ("CCHS"), Retail Energy Supply Association ("RESA"), Comcast of Delmarva, Inc. ("Comcast"), MBNA America Bank, N.A. ("MBNA"), the Delaware Energy Users Group ("DEUG"), and the Delaware Electric Cooperative, Inc. ("DEC"). Of the latter intervenors, only DEUG,

Christiana Care, and Comcast actively participated in the docket; although DEC did file testimony regarding the depreciation issues.

5. On December 2, 2005, Delmarva filed a motion for leave to file supplemental testimony and the supplemental testimony of Frank J. Salotto, III, PHI's Manager of Tax, and Mr. VonSteuben. Mr. Salotto's supplemental testimony addressed a tax issue that had the effect of increasing the Company's net Delaware revenue requirement by $1,511,470.

6. On December 9, 2005, Staff and intervenors pre-filed direct testimony. Staff submitted testimony from Janis L. Dillard, the PSC's Regulatory Policy Administrator; Robert J. Howatt, a PSC Public Utility Analyst III; David E. Peterson, Senior Consultant at Chesapeake Regulatory Consultants; David C. Parcell, Executive Vice President and Senior Economist with Technical Associates, Inc.; Brian Kalcic, principal of Excel Consulting, Inc.; and Michael J. Majoros, Vice President of Snavely King Majoros O'Connor & Lee, Inc. The DPA submitted testimony from Andrea C. Crane, a principal of The Columbia Group, Inc., and Ralph C. Smith, a Certified Public Accountant and senior utility regulatory consultant with Larkin & Associates, PLLC. DEUG submitted testimony from Michael Gorman and Alan Chalfant, consultants with Brubaker & Associates, Inc. Comcast submitted testimony from Richard E. Stinneford, a member of Cablesave LLP. CCHS submitted testimony from Lewis Cohen, an independent energy management and professional consultant.

7. On January 17, 2006, the Company submitted pre-filed rebuttal testimony from Messrs. Wathen, VonSteuben, Normand, Bumgarner, White,

Morin, Yourinson, and Robinson. As a result of the tax issue addressed in the Company’s supplemental testimony, the Company increased its rate request to $2,047,000. DEC submitted pre-filed rebuttal testimony from John S. Ferguson, a self-employed management consultant in the area of depreciation. DEUG submitted pre-filed rebuttal testimony from Mr. Chalfant.

8. On January 31, 2006, Staff requested leave to present its request to modify the procedural schedule to allow Staff witness Majoros to file supplemental testimony on whether the Commission should consider amortizing the accumulated removal cost reserve back to ratepayers. The DPA supported Staff’s request; the Company and DEC objected. On February 1, 2006, the Hearing Examiner held a teleconference, after which he denied Staff’s request on the ground that the substantive issue on which Staff sought to submit supplemental pre-filed testimony was a public policy issue that the Commission should decide.

9. On February 2, 2006, Staff filed an Emergency Motion to Modify Schedule to Address Limited Public Policy Issue Regarding Depreciation (the “Motion”). In its Motion, Staff sought to modify the procedural schedule to provide for the filing of supplemental testimony on the depreciation issue, and to hold a separate evidentiary hearing on this issue with a separate briefing schedule that would run on a relatively parallel track to the main rate case. The Company submitted an objection to Staff’s Motion on February 2, 2006.

10. The scheduled evidentiary hearings began on February 6, 2006 and continued through February 8, 2006. On February 1, 2 and 6, 2006, public comment sessions were held in each of the three Delaware

counties. Several members of the public appeared to comment on the application and on the recently-announced rate increases resulting from the deregulated electric standard offer service ("SOS") rates to become effective on May 1, 2006. These comments will be summarized in a separate section of this Findings, Opinion, and Order.

11. On February 7, 2006, during a break in the evidentiary hearings, we heard oral argument on Staff's Motion from the parties via telephone at our regularly-scheduled meeting, and deliberated in open session on Staff's Motion. We granted Staff's Motion and directed the Hearing Examiner to consider the amortization issue in the context of this case.

12. On February 8, 2006, the hearings on all issues except the limited depreciation issue were concluded.

13. On February 9, 2006, the parties participated in a teleconference to attempt to address the scheduling issue resulting from the Commission's February 7, 2006 decision granting Staff's Motion. Pursuant to the Hearing Examiner's instruction, Staff and Delmarva submitted proposed schedules. Staff's proposal contemplated that we would conduct our deliberations and implement rates by May 1, 2006; the Company's proposal contemplated going beyond May 1, 2006. Other parties commented on the proposed schedules. On February 10, 2006, the Hearing Examiner issued a letter opinion approving Staff's proposed amended procedural schedule.

14. On February 14, 2006, the Hearing Examiner wrote to Staff (on which all parties were copied) indicating a potential issue regarding certain witnesses' availability on the date of the evidentiary hearing

and advising Staff, as drafter of the Order memorializing the actions the Commission took at the February 7, 2006 deliberations, to consider that issue in drafting the Order.

15. On February 15, 2006, the Company filed an interlocutory appeal of the Hearing Examiner's approved schedule (the "Appeal"). Staff filed a response to the Appeal. At our regularly-scheduled meeting on February 28, 2006, we heard oral argument on the Appeal, deliberated in open session, and rejected the Appeal. Also on February 28, 2006, we entered Order No. 6855, memorializing our decision on Staff's Motion.

16. Pursuant to the amended procedural schedule, on February 17, 2006, Staff submitted the supplemental testimony of Mr. Majoros and the DPA submitted the supplemental testimony of Mr. Smith. On March 3, 2006, the Company submitted supplemental depreciation testimony from Messrs. VonSteuben and Robinson, Dr. Morin and Anthony J. Kamerick, PHI's Vice President and Treasurer, and DEC submitted supplemental depreciation testimony from Mr. Ferguson. On March 13, 2006, Staff and the DPA submitted supplemental rebuttal testimony from Messrs. Majoros, Peterson, Parcell, Smith, and Ms. Crane. At the evidentiary hearing on March 20, 2006, the parties' prefiled supplemental and supplemental rebuttal testimonies were entered into evidence, and the witnesses were subject to cross-examination. In addition, Mr. John Kowalko, associated with the group ACORN, spoke regarding Staff's amortization proposal. At the conclusion of the hearing, the record, consisting of 113 exhibits and the transcript, was closed.

17. Pursuant to the amended procedural schedule, the parties submitted post-hearing briefs and proposed findings and conclusions for the Hearing Examiner's consideration. On April 14, 2006, the Hearing Examiner issued his proposed Findings and Recommendations.

18. Exceptions to the Hearing Examiner's proposed Findings and Recommendations, which were due on April 21, 2006, were filed by the Company, Staff, DEUG, DEC, Christiana Care, and Comcast.

19. On April 25, 2006, we met at a regularly-scheduled meeting to deliberate in open session on the Hearing Examiner's proposed Findings and Recommendations and the parties' exceptions thereto. Commission Order No. 6903, which reflected a decrease of $11,128,000 based on the data available at the time, was approved on April 25, 2006. This is our Findings, Opinion, and Order regarding the substantive issues raised in this docket.

II. PUBLIC COMMENT

20. As previously mentioned, on February 1, 2 and 6, 2006, the Hearing Examiner conducted evening public comment sessions in Millsboro, Dover, and Wilmington, Delaware, respectively. No members of the public appeared at the Millsboro hearing. Two representatives of AARP attended the Dover hearing; Jim Wilson, the sole AARP representative to speak, stated that Delmarva should not be permitted to recover its costs for construction work in progress and that any rate increase granted in this case should be phased-in over time. He noted that older Americans devote a higher percentage of their income to energy costs and that one-quarter of the low-income, older households spend 19% or more of their entire income on energy bills. (Tr. at 20-23.)

21. On February 6, 2006, at the public comment session held in Wilmington, approximately 100 persons attended, 27 of whom offered comments over nearly three hours. Chair McRae and Commissioner Lester attended this session. The vast majority of the speakers did not discuss the rate increase proposed in this docket, but rather addressed the estimated 59% increase in the supply rate for residential customers scheduled to become effective on May 1, 2006. Only Brian Gallagher, representing the Delaware Energy Office, and Alan Muller, representing Green Delaware, offered comments relating to this distribution rate case.

22. Mr. Gallagher recommended that the Commission exempt standby charges for renewable generators for up to one MW. (Tr. at 346.) He explained that Delmarva proposes to impose standby charges to cover delivery costs for customers that generate their own electricity of up to 2 cents per kWh generated by the customer. Mr. Gallagher recommended an exemption for renewable generators so as not to discourage the development of renewable energy in Delaware. Additionally, Mr. Gallagher argued that Delmarva had not shown that the surcharge was necessary to cover its delivery costs, especially when delivery charges are developed based on peak generation times while many renewable generators operate during peak times (such as hot, sunny days) and therefore do not contribute to those costs. Mr. Gallagher observed that other states have exempted renewable generators from a delivery standby charge. In addition, after the Hearing Examiner issued his proposed findings and recommendations, Mr. Gallagher wrote a letter to the Commission regarding the proposed findings and recommendations. As the

Delaware Energy Office was not a party to the proceeding, we have treated the letter as additional public comment.

23. Mr. Muller stated that the numbers in the distribution rate case may not support any rate increase. (Tr. at 349.) He also objected to the standby charge for customer generation because it penalizes small generators and would harm a transition to a system of distributed generation. (*Id*. at 350.) He further objected to the 59% increase in supply rates. (*Id*. at 351-55.)

24. Speakers opposing the 59% supply rate increase included two elected officials (State Senator Cathy Cloutier and Wilmington City Councilman Charles Potter, Jr.). (Tr. at 356-57; 382-86.) The following persons representing various organizations also spoke: John Kowalko and Sandra Carpenter of ACORN (Tr. at 340-45, 434-35) (several other members of ACORN also spoke); Lonnie Edwards of People's Settlement (*Id*. at 362-65); Kristina Wallig of Ministry of Caring, the Samaritan Outreach and Lutheran Volunteer Corps (*Id*. at 371-73); Susan Regis Collins of Let My People Know Coalition (*Id*. at 386-88); Herman Holloway of the Martin Luther King Center (*Id*. at 388-94); Alexandra Perella of the Latin America Community Center (*Id*. at 405-09); and Pastor Calvin Brown of New Life Christian Center (*Id*. at 420-35).

25. Approximately 15 others not representing organizations offered statements. In general, the comments described the "human devastation" that the 59% increase will cause for low- and moderate-income customers. (Tr. at 348). Speakers also emphasized various avenues of redress, including contacting legislators, electing new legislators, and boycotting the Company. Additionally, speakers

criticized the 1999 deregulation legislation and complained of the absence of competition.

26. At the March 20, 2006 evidentiary hearing, Mr. Kowalko of ACORN addressed Staff's mitigation proposal. He opposed it because the effect on rates would be too small to justify jeopardizing the Company's bond rating and because the change would not be sustainable, since the reserve account that would be returned to customers is earmarked for future use. (Tr. at 1189-92.)

III. INTRODUCTION

27. For the test period ending March 31, 2005, the Company calculated a revenue deficiency of $2,047,000, derived from a test period rate base of $429,473,000 an overall rate of return of 7.64% on a capital structure consisting of 50.55% long-term debt, 1.73% preferred stock, and 47.72% common equity (Exh. 17 (Morin) at 56 and Ex. RAM-10); and test period pro forma operating income of $31,615,000. (Exh. 70 (VonSteuben-R) at Sch. WMV R-1 p. 3)).[1]

28. Staff calculated a revenue requirement of negative $24,477,234, based on a test period rate base of $400,195,050, an overall rate of return of 7.17% on the Company's capital structure; and test period pro forma operating income of $43,093,790. (Exh. 22 (Parcell) at 3); Exh. 100 (Peterson-R) at Ex. __ (DEP-2), Sch. 1, p.1). The primary differences between the Company's and Staff's positions are

[1]References to the exhibits introduced at the evidentiary hearings will be cited as "Exh. __ (Witness' Name) at ___" for direct testimony; "Exh. __ (Witness' Name-S") at ___" for supplemental testimony; "Exh. __ (Witness' name-R") at ___" for rebuttal testimony; "Exh. __ (Witness' Name-SD" at __" for Delmarva's supplemental depreciation testimony; "Exh. __ (Witness' Name-SR.) at __" for Staff's and the DPA's supplemental rebuttal testimony; and

the return on equity, the calculation of depreciation rates and whether the accumulated removal cost reserve should be amortized separately to ratepayers.

29. The DPA calculated a revenue requirement of negative $15,662,298, based on a test period rate base of $395,538,287 an overall rate of return of 6.79% on the Company’s capital structure; and test period pro forma operating income of $36,078,674. (Exh. 78 at ACC-1R). The primary differences between the Company’s and the DPA’s positions are the return on equity, the calculation of depreciation rates, and whether the accumulated removal cost reserve should be amortized separately to ratepayers.

30. DEUG did not proffer an accounting witness, but it did sponsor witnesses on cost of capital, rate design and revenue distribution, and Delmarva’s proposed new Riders S (Standby) and RDCS (Reserved Delivery Capacity Service). DEUG recommended an overall rate of return of 7.07% on the Company’s proposed capital structure. (Exh. 16 (Gorman) at 2).

31. The remaining parties that submitted pre-filed testimony and proffered witnesses at the evidentiary hearings (Comcast and CCHS) limited their testimony to rate design issues.

IV. UNCONTESTED ISSUES

32. The following adjustments to the Company’s per books test period results were uncontested:

- Weather Normalization (Exh. 70 (VonSteuben-R) at Sch. WMV R-1, p. 1, line 4);

---

simply “Exh. __” for non-testimonial exhibits. References to the transcript of the hearings will be cited as “Tr. at ___.”

- Bill Frequency (*Id*. at Sch. WMV R-1, p. 1, line 5);
- Remove Employee Association Expense (*Id*. at Sch. WMV R-1, p. 1, line 6);
- Rate Case Expense Normalization (*Id*. at Sch. WMV R-1, p. 1, line 7);
- Decreased Liability O&M Expenses (*Id*. at Sch. WMV R-1, p. 1, line 8);
- Proform OPEB Costs (*Id*. at Sch. WMV R-1, p. 1, line 9);
- Remove Severance Costs (*Id*. at Sch. WMV R-1, p.1, line 10);
- Plant Closing Adjustment through 7/31/05 (*Id*. at Sch. WMV R-1, p. 1, line 11);
- Actual Refinancings (*Id*. at Sch. WMV R-1, p. 1, line 12);
- Remove Prior Period Property Taxes (*Id*. at Sch. WMV R-1, p. 1, line 13);
- Remove Supply and Transmission Other Taxes (*Id*. at Sch. WMV R-1, p. 1, line 14);
- Remove Supply and Transmission Regulatory Assessment (*Id*. at Sch. WMV R-1, p. 1, line 15);
- Increase DPSC Regulatory Assessment (*Id*. at Sch. WMV R-1, p. 1, line 16);
- Remove Post-80 ITC Amortization (*Id*. at Sch. WMV- R-1, p. 1, line 17);
- IOCD Adjustment (*Id*. at Sch. WMV R-1, p. 1, line 18);
- Remove Billing Expert (*Id*. at Sch. WMV R-1, p.1, line 19);
- Remove Selected Plant Held for Future Use Investment (*Id*. at Sch. WMV R-1, p. 1, line 20);
- Restate Revenue Lag in Cash Working Capital (*Id*. at Sch. WMV R-1, p. 1, line 21);
- Remove Working Funds from Cash Working Capital (*Id*. at Sch. WMV R-1, p.1, line 22);

- Restate Association Dues (*Id*. at Sch. WMV R-1, p. 2, line 4);

- Reflect Uncollectible Expense Normalization (*Id*. at Sch. WMV R-1, p. 2, line 5);

- Proform Pension Expense (*Id*. at Sch. WMV R-1, p. 2, line 8 and Exh. 78);

- Reclassify Transmission Uncollectible Expense to Supply Function (Exh. 70 (VonSteuben-R) at Sch. WMV R-1, p.2, line 15); and

- Remove Peach Bottom Litigation Costs (*Id*. at Sch. WMV R-1, p. 2, line 21).

33. In addition, there is no dispute as to the appropriate capital structure to be used for ratemaking purposes in this case, nor does any party contest the Company's proposed long-term debt and preferred stock cost rates. As a result, whatever the Commission decides is the appropriate cost of equity for the Company will also determine the Company's fair overall rate of return.

34. **The Hearing Examiner's Findings and Recommendations.** Some of these issues were contested initially, but the parties have either resolved their differences or accepted another party's position during the course of this proceeding. Others were originally contested, but the challenging party later accepted the position of another; generally because the party being challenged presented additional evidence sufficient to satisfy the opposing party that the adjustment was justified. The Hearing Examiner reviewed the evidence submitted on all of these issues, and found that that evidence was satisfactory to support the proposed adjustment. He therefore recommended that the Commission adopt these adjustments to the Company's test period per books results.

35. **Discussion and Decision.** The Hearing Examiner reviewed these issues and the record evidence supporting the proposed adjustments, and found that they should be accepted. For the reasons cited by the Hearing Examiner, we adopt his proposed findings and recommendations on these issues. (Unanimous.)

V. ACCOUNTING ADJUSTMENTS ARISING SOLELY BECAUSE OF POSITIONS ON OTHER ADJUSTMENTS "FALL-OUT ISSUES."

36. Contested accounting issues between the parties and Delmarva due only to their positions on other issues are: (a) group insurance benefits (pension, group insurance, workers' compensation insurance); (b) payroll taxes; (c) income taxes; (d) taxes other than income; and (e) interest synchronization.[2] The resolution of the disputes on the underlying adjustments will resolve these issues as well; thus, we need not specifically address them.

VI. RATE BASE ISSUES.

A. CWIP and Rate Base.

37. Delmarva's proposed test period rate base includes approximately $13.5 million of construction-work-in-progress ("CWIP") that had not been closed to plant-in-service by the end of July 2005 (4 months past the end of the test period). (Exh. 87 (Peterson) at 6-7.) The Company claimed that these projects were "technically complete" and were providing service to customers, but simply had not

[2]The Company and Staff also disagreed with respect to Miscellaneous Service Revenues (MSRs), but this was more a difference of approach than a bona fide issue. The Company calculated its revenue requirement assuming that its proposed fee increases would be accepted. Staff removed the revenue associated with the increased fees in calculating Delmarva's total distribution revenue requirement and deficiency. Since Staff witness Kalcic recommended that the MSR adjustments be approved, the Hearing Examiner did not consider this to be a contested issue requiring resolution.

been transferred to plant. (Exh. 70 (VonSteuben-R) at 17-18.) It further claimed that the amount of AFUDC associated with the CWIP was substantially lower in this case than in past cases because routine distribution-related projects typically have shorter construction periods and thus lower dollar values. (Id. at 17.)

38. Both Staff witness Peterson and DPA witness Crane rejected the Company's adjustment to include CWIP in rate base on the ground that the CWIP was not used and useful in providing service to customers during the test period. (Exh. 87 (Peterson) at 7; Exh. 77 (Crane) at 23-24.) Ms. Crane argued that the inclusion of CWIP violated the regulatory principle of intergenerational equity by requiring current ratepayers to pay a return on plant that was not providing them with service. (Id. at 24.) Mr. Peterson further observed that although the Company had made an adjustment to include CWIP in rate base, it had not made corresponding adjustments to reflect the revenue-enhancing and/or expense-reducing impact of the projects, and thus there was a mismatch among the various components of the ratemaking formula. Exh. 87 (Peterson) at 7.)

39. In its post-hearing brief, Staff further argued that because Mr. VonSteuben had made his statement regarding the projects' "technical completeness" in rebuttal, neither Staff nor the DPA were able to challenge it. (Staff PHB at 70.) According to Staff, the whole purpose of the "plant closing" adjustment was to include in rate base plant that was "technically complete" and providing service as of the end of the test period, and this additional $13.5 million of CWIP was never identified as such. Indeed, both Staff and the DPA accepted

other adjustments to rate base to include plant closings up to four months beyond the end of the test period. (*Id*.).

40. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner began his analysis by noting that the Commission had long held that it has discretion in determining whether to allow CWIP in rate base based on the circumstances of each case. *In the Matter of the Application of Delmarva Power & Light Co. For an Increase in Its Electric Base Rates and for Certain Revisions to Its Electric Service Rules and Regulations*, 1992 WL 465021 (Del. PSC 1992) at *5; *In the Matter of the Application of Artesian Water Company For an Increase in Water Rates*, 1991 WL 496943 (Del. PSC 1991) at *3; *In re Artesian Water Company, Inc.*, 101 PUR 4th 451, 461 (Del. PSC 1989). In this case, the Hearing Examiner recommended that the Commission deny the Company's request to include the $13.5 million of CWIP in rate base. First, he found that the Company had not demonstrated that the $13.5 million of CWIP that had not been closed to service as of July 31, 2005 was actually *in* service as of March 31, 2005. (HER at 80, citing Staff PHB at 71.) Second, in contrast to the prior *Delmarva Power* case, in this case there was only a minimal AFUDC offset of $39,796 compared to the $13.5 million of CWIP. (HER at 80, citing Exh. 87 (Peterson) at 8.) This resulted in an effective AFUDC rate of 0.2%, which was "far less" than the 7.64% rate of return that Delmarva sought and "far less" than the rate of return recommended by any witness sponsoring testimony on the issue. (HER at 80, citing Staff PHB at 71.) Because of the small AFUDC allowance, the inclusion of CWIP in rate base would have a "considerable adverse impact on

Delmarva's revenue requirement," unlike in Delmarva's previous case. (HER at 80.)

41. Additionally, the Hearing Examiner noted that including CWIP in rate base created a mismatch among the test period components, because it represents plant that was not actually serving customers during the test period. (HER at 80, citing DPA Proposed Findings at 10.) As a result, the Hearing Examiner concluded that including CWIP in rate base overstates the amount of plant necessary to provide service to the customers that were present during the test period and which form the basis for the Company's revenue claim. (This adjustment reduces the Company's rate base by $13,469,995).[3]

42. **Exceptions.** The Company excepted to the Hearing Examiner's findings and recommendations. It first contended that the Hearing Examiner had "recommended the reversal of more than 20 years of Commission practice with respect to the inclusion of CWIP in Delmarva's rate base," based almost entirely on a factual finding that the Company claimed was "contrary to the record evidence:" that it had not demonstrated that the $13.5 million of CWIP that had not been closed to service by July 31, 2005 was actually providing service by March 31, 2005. (Delmarva Brief on Exceptions at 44-45.) It also challenged the Hearing Examiner's finding with respect to the low

[3]In connection with removing CWIP from rate base, it is appropriate for the Company to capitalize AFUDC and add accumulated AFUDC to plant-in-service once construction is completed and plant is used and useful. Because the Company's AFUDC adjustment increased its current earnings, Staff witness Peterson made a corresponding adjustment to reverse the Company's AFUDC credit (and reduce current earnings). Since the Hearing Examiner recommended excluding CWIP from rate base, this adjustment reduces the Company's income under present rates by $39,376. (HER at 80, n. 25, citing Exh. 87 (Peterson) at 21 and Ex. __ (DEP-1) Sch. 3, p. 1.)

percentage of AFUDC relative to Delmarva's past cases. (*Id*. at 45.) The Company claimed that these findings were "erroneous" because its witness, Mr. VonSteuben, had testified that most of the CWIP was associated with facilities that were "technically complete" in the test period and were providing service to customers. (*Id*.). The Company described the processes used to validate the installed cost and materials and to reflect follow-on charges, transfers, and other post-construction costs associated with the work before it is placed in service" on the Company's books. (*Id*. at 46.) Furthermore, the Company argued, it made sense that more AFUDC was accrued on projects in the past, when the Company was an integrated utility with long-term generation and transmission projects and bundled rates. (*Id*. at 46, citing Tr. at 961 and Exh. 70 (VonSteuben-R) at 17.)

43. The Company argued that Mr. VonSteuben's testimony showed that AFUDC cannot be accrued on projects that: are technically complete and providing service but which have not yet been completed on the Company's books; are routine work completed during a short duration; or are purchases of property immediately ready for service such as meters and office furniture. (*Id.*, citing Exh. 70 (VonSteuben-R) at 16.) Thus, according to the Company, Mr. VonSteuben's testimony "destroy[ed] the foundation" for both of the Hearing Examiner's findings. Moreover, because the facilities were in service at the end of the test period, there was no mismatch of the test period components. (*Id*. at 45.)

44. The Company contended that Staff's complaint that Mr. VonSteuben's testimony was unable to be challenged because it had

been raised in rebuttal was “a make-weight argument” because: (a) the Company cannot predict and preemptively argue issues in its original application, and it had no reason to believe that its inclusion of CWIP in rate base would be challenged; (b) Staff and the DPA both had the opportunity to conduct discovery on Delmarva’s rebuttal testimony; (c) Staff and the DPA were permitted to give oral surrebuttal at the evidentiary hearing; and (d) if Staff or the DPA had believed they were prejudiced in their ability to respond to the rebuttal testimony, they could have made motions or sought to supplement their testimony, which they did not do. (*Id*. at 46.)

45. The Company next contended that all of the arguments that Staff and the DPA had made against including CWIP in rate base had been rejected in prior cases. (*Id*. at 47). It cited the Hearing Examiner’s Report in Docket No. 84-23, in which the Hearing Examiner rejected a mismatch argument and treated the issue as “essentially settled by precedent.” (*Id*.) The Company claimed that the Commission had not deviated from such treatment with respect to Delmarva in more than 20 years, and that in every Delmarva rate case since Docket No. 84-23, the Commission had included CWIP in rate base with the appropriate corresponding AFUDC offset. (*Id*. at 48-49.) The Company contended that there was no basis for departing from the Commission’s past practices with respect to including CWIP in Delmarva’s rate base, and that if the Commission were going to do so, it must have a rational basis for doing so. (*Id*. at 51-55.) It further argued that the Commission had also permitted Chesapeake Utilities Corp. to include CWIP in its rate base for at least 20 years. (*Id*. at 49-50,

citing Docket No. 85-17.) The Company acknowledged that the Commission had rejected an attempt by Artesian Water Company to include CWIP in its rate base, but contended that the Commission had not explained why its treatment of Artesian should differ from the Delmarva precedent regarding CWIP and rate base. The Company also noted that even though it denied Artesian’s request to include CWIP in rate base, it permitted that utility to accrue AFUDC for inclusion in future base rate cases, which provided Artesian a benefit equal to including CWIP in its rate base for the longer-term projects. (*Id*. at 50.)

46. The Company finally argued that there was no “rational” basis for including in rate base $10.9 million of CWIP that had been closed to service on the Company’s books as of July 31, 2005 but not the $13.5 million that had not been closed to service on the Company’s books as of July 31, 2005 (but most of which had been closed to service by December 31, 2005). (*Id*. at 50.) Apparently, the Company stated, both Staff and the DPA accepted the Company’s explanation with respect to the $10.9 million of facilities that were closed to plant-in-service by July 31, 2005, because neither opposed the adjustment to include these projects in rate base. The Company contended that there was no “rational” reason for using July 31, 2005 as a cut-off date for the inclusion of CWIP in rate base. (*Id*. at 51.) In this regard, the Company pointed out that as of December 31, 2005, all but $788,000 of the $13.5 million had been closed to service on the Company’s books. (*Id*., citing Tr. at 967.)

47. **Discussion and Decision**. We adopt the Hearing Examiner's findings and recommendations with respect to the exclusion of CWIP (and the corresponding adjustment to earnings). We are sensitive to the Company's contention that we have permitted Delmarva to include CWIP in rate base since at least 1984; however, we note that in its discussion of Hearing Examiner Brill's proposed findings and recommendations, Delmarva did not cite to a Commission decision adopting the Hearing Examiner's assertion that the inclusion of CWIP in rate base is "essentially settled." Moreover, as the Company itself recognized, in its most recent fully-litigated base rate case (Docket No. 91-20) we addressed this same issue and therein we stated that it is within our discretion as to whether CWIP should be included in a utility's rate base. Thus, we do not see this as changing our position: our position is, and has been for some time, that we retain the discretion to include or exclude CWIP from rate base based on the facts presented in each individual case.

48. In this docket, because the AFUDC allowance is so low, including CWIP in rate base has a considerable adverse impact on Delmarva's revenue requirement. This was not the situation in Docket No. 91-20, where the revenue requirement effect of the CWIP allowance in rate base was essentially equal to the overall rate of return approved in that case. Each case stands on its own facts, and the facts presented in Docket No. 91-20 are different than those presented in this case. Therefore, for these reasons and the reasons set forth by the Hearing Examiner, we adopt the findings and recommendations of the Hearing Examiner to exclude CWIP from rate base. (This requires a

corresponding adjustment to remove the AFUDC adjustment associated with the CWIP adjustment from the Company's earnings). (3-2: Chair McRae and Commissioners Conaway and Clark voting yea; Commissioners Lester and Winslow voting nay.)

B. Pre-Paid Pension Asset.

49. The Company's books and records contain a pre-paid pension asset of $16,614,593. The pre-paid pension asset arises when:

> annual increases in pension plan assets exceed annual costs associated with pension obligations. The prepaid pension asset included in rate base represents the accumulated amount of negative pension expense that the Company has booked pursuant to Financial Accounting Statement 87 ("SFAS 87").

(Exh. 77 (Crane) at 31.)

50. Delmarva proposed to include this asset in rate base. The DPA recommended excluding the pre-paid pension asset from rate base. DPA witness Crane testified that the Commission has the ability to establish pension expense using the methodology set forth in SFAS 87, but that a cash method was also available. She further testified that since the Company adopted SFAS 87 in 1987, it has been booking a negative pension expense. (*Id*. at 31-33.) In Ms. Crane's view, "the booking of a prepaid pension asset results from accounting requirements that have no relationship to the rate making treatment afforded these costs, "and that it is more likely than not that the Company has over-collected pension expense from customers in the past. (*Id*. at 34-35.)

51. The Company testified that the SFAS 87 methodology for determining pension expense was superior to a cash method.

Mr. VonSteuben explained how pension expense is developed under SFAS 87, including the influence that stronger-than-expected investment returns can have in creating negative pension expense. (Exh. 70 (VonSteuben-R) at 20-22.) In his view, investment returns, not the alleged "overpayments by customers," created the negative pension expense, and that the negative pension expense is a benefit to customers because it offsets other expenses. (*Id*. at 23-24.) He testified that the pre-paid pension asset represents the accumulated amount of negative pension expense, which has reduced the Company's per books cost of service since the adoption of SFAS in 1987. Due to this and the fact that the Company is prohibited by federal law from removing the money in the pension trust fund, the Company's revenues and cash flows are reduced. Therefore, Mr.VonSteuben testified that this results in a working capital requirement that should be included in rate base for the same reason that rate base is reduced by accumulated deferred income taxes. (*Id*. at 22.) Finally, Delmarva contended that the Virginia Commission includes the pre-paid pension asset as part of its calculations to review the Company's rate of return. (*Id*. at 23.)

52. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner observed that this appeared to be the first time that the Commission had been asked to consider this issue, and that the issue had apparently only rarely been litigated. (He identified Kansas as a case where the issue had been decided contrary to the DPA's position and less favorably than the Company was proposing in this case), and Virginia as a jurisdiction where the asset was included in rate

base for purposes of determining Delmarva's rate of return). He concluded that the Commission should allow the Company to include the negative pension expense in rate base "in order to compensate the Company for funding the revenue gap caused by recording a negative pension expense." (HER at 82-83.)

53. First, the Hearing Examiner explained that a negative pension expense is created when the pension fund asset exceeds pension fund liabilities, both of which are actuarially determined on the basis of past and present investment returns and future obligations and expected investment returns. (HER at 83, citing Exh. 77 (Crane) at 31.) If the Company had had no pension expense since 1987, rates in past proceedings (and in this one) would have been set at a level sufficient to allow a reasonable return on investment to shareholders and to recover all other allowed expenses. If the Company's obligations to current and future retirees were such that the Company needed to recover an additional amount in rates to cover those future costs (positive pension expense), rates would be adjusted so that there would also be a matching of revenues set in this proceeding and the Company's expenses. (HER at 83, citing Delmarva PHB at 65.) But a negative pension expense, such as in this case, disrupts the matching of revenues and expenses. When Delmarva's rates are reset, they are reduced by the negative pension expense; rates are reset at levels lower than would otherwise be necessary to provide the reasonable return to shareholders and to cover allowed expenses. The Hearing Examiner found that this would not be a problem if Delmarva could withdraw from the prepaid pension asset or could use the negative pension expense amounts from the pension fund. Such a withdrawal would cover the other expenses and is, by definition, not needed by the pension fund – the negative pension expense represents the amount not needed to cover pension fund liabilities. However, such a withdrawal would violate federal law. (HER at 83-84, citing Delmarva PHB at 66.)

54. The result of including the pre-paid pension asset in rate base is to reduce rates below the level that they would otherwise be in order to cover expenses and enable the Company to earn a fair return, and the Company has no means of covering this gap save through investors. Customers pay reduced rates due to the negative pension expense, but there is no reduced cost to Delmarva except in a booked account that the Company is legally prohibited from accessing. Thus, the decrease in the Company's cash flow increases its need to access capital markets to cover its expenses. The Hearing Examiner concluded that the Company's proposed rate base adjustment "properly permits the return necessary to reflect these funds supplied by investors." (HER at 84, citing Delmarva PHB at 66-67.)

55. **Exceptions.** The DPA excepted to the Hearing Examiner's findings and recommendations. First, the DPA pointed out that the Commission had never included a pension asset in any other Delaware utility's rate base; therefore, adopting the Company's proposed adjustment would be a "significant departure from past practice" that would not only affect ratemaking for Delmarva, but would affect ratemaking for other utilities subject to the Commission's jurisdiction. (DPA Brief on Exceptions at 9.)

56. The DPA contended that a negative pension expense means that the Company has actually collected more from ratepayers than it has needed to fund its current obligations. The DPA acknowledged that pension expense is calculated based on estimates of factors such as future market returns on investments, salary levels, average retirement ages, average life expectancies, and the like. Since these

estimates are not always accurate, they result in either understated or overstated pension expense. SFAS 87 provides a built-in true-up mechanism over time, which is why pension expense is positive in some years and negative in others. When it is negative, there is a credit to cost of service, whereby the Company essentially "gives back" the over-collection to ratepayers through a pension credit. The DPA contended that if there is any cash working capital implication, these amounts should be deducted from rate base, not added to rate base, since they represent a prepayment of pension expense. (*Id*. at 10.)

57. The DPA pointed out that the Kansas Commission has permitted the inclusion of pension expense in rate base only to the extent that the utility could show that there was a shortfall between amounts actually collected from ratepayers and amounts booked to the Company's pension expense. The Kansas Commission will track all amounts actually collected from ratepayers each year and adjust the pension asset accordingly. (Tr. at 1046-47.) Since Delmarva proposes no tracking, the Kansas decision is "materially different" from the Company's proposal here. (DPA Brief on Exceptions at 11.) As for Virginia, the DPA pointed out that the pension asset is only used in the Company's earnings filing, and there was no evidence that that Commission had actually included the pre-paid pension asset in rate base when establishing prospective rates. (*Id*.). Finally, the DPA contended, the Company's proposal adds $1.9 million of "unnecessary" costs to the Company's revenue requirement. (*Id*.).

58. **Discussion and Decision.** We are sympathetic to the DPA's concern that the Company has long been collecting more than it needs

for pension payments. However, we believe that the pre-paid pension asset is appropriately included in rate base because it is caused by a negative pension expense, which both reduces base rates, resulting in rates that are lower than they otherwise might be, and at the same time creates a cash working capital requirement. We also recognize that the Company has no access to this asset to use for other operating expenses; it is precluded by federal law from using any of the money it has collected for pensions for any other purpose. Thus, for these reasons and the reasons set forth in the Hearing Examiner's findings and recommendations, we adopt the Hearing Examiner's findings and recommendations. (Unanimous.)

C. Deferred Income Tax Reserve.

59. In supplemental testimony filed after the DPA, Staff, and others had filed their direct testimony, the Company submitted the testimony of Frank Salotto. Mr. Salotto testified that the Company had adopted a tax accounting method for capitalized overheads for the 2001 tax year that allowed it to generate additional tax benefits on its returns from 2001 through 2004. Mr. Salotto testified that the Treasury Department subsequently promulgated regulations that would eliminate the Company's ability to use this accounting method, resulting in a restatement of the Company's deferred income tax reserve. At the time Mr. Salotto filed his supplemental testimony, he observed that the new method that the IRS was requiring was "unspecified;" however, he assumed that a best-case scenario estimate of the benefits of the new method that would be adopted would be in the range of 50% of the benefits of the incremental benefits that the

Company received from the 2001 method. Company witness VonSteuben quantified the impact of this change as a $26 million rate base adjustment and a $1.5 increase in the Company's revenue requirement. During cross-examination at the evidentiary hearings, however, Mr. Salotto updated the projections to show a $30.9 million rate base adjustment.

60. The DPA accepted the Company's initial estimate of a $26 million rate base adjustment and a $1.5 million increase in revenue requirement. It argued, however, that there was no support for the increase to $30.9 million that Mr. Salotto claimed during cross-examination. In light of the "considerable uncertainty" surrounding the IRS's eventual ruling on this issue, the DPA argued that the Commission should limit the adjustment to 50% of the net tax benefit, as Mr. Salotto had originally proposed and as Mr. VonSteuben had quantified. The DPA's adjustment resulted in a rate base reduction of $4.9 million and a revenue requirement reduction of approximately $550,000. (DPA Brief on Exceptions at 15-16.)

61. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner, believing that this issue was not contested, did not address it as a contested issue; rather, he identified it as an uncontested issue. (See HER at 78.)

62. **Exceptions.** The DPA excepted to the Hearing Examiner's statement that this issue was not contested. (DPA Brief on Exceptions at 14.) It noted that although it had accepted the Company's initial claim with respect to this issue, there was no support for the revision that Mr. Salotto made during cross-examination, and therefore

the Commission should limit the adjustment to 50% of the originally-proposed net tax benefit. (*Id*. at 15-16.)

63. **Discussion and Decision.** The Company has represented that the $30.9 million figure proffered during the evidentiary hearing is the figure that the Company will be using for its 2006 income tax return (for the 2005 tax year) and is the figure that the Company has put on its books. There is nothing that this Commission can do with respect to the IRS's change in position with respect to the capitalizing and expensing of costs. It is unfortunate that the IRS changed its position, but it has. We believe that it is appropriate to use the figures that the Company will be using on its own books and tax return for the tax year 2005 for ratemaking purposes in this case. We recognize that by the time of the Company's next base rate case, the figure is likely to be more accurate, and the parties may address this issue again at that time. (Unanimous.)

D. <u>Cash Working Capital</u>

64. Cash working capital ("CWC") reflects the need for investor-supplied funds to meet day-to-day operating expenses that arise from timing differences between when Delmarva spends money to pay those expenses and when it receives revenues for utility services. The purpose of a lead-lag study for calculating a CWC requirement is to match cash inflows with cash outflows, and thus to determine the level of investor-supplied funds needed for daily operations. Only items for which the Company makes actual out-of-pocket cash expenditures should be included in a lead-lag study. (Exh. 77 (Crane) at 29-30.)

65. Delmarva included depreciation and amortization expenses in its lead-lag study. Both Staff and the DPA contest the inclusion of depreciation expense in the lead-lag study; the DPA also contests the inclusion of amortization. (Exh. 77 (Crane) at 29-30; Exh. 87 (Peterson) at 10-11.)

66. **Discussion and Decision.** The Hearing Examiner recommended that the Commission continue to exclude depreciation expense from a utility's lead-lag study. (This adjustment reduced the Company's proposed CWC allowance by $2,980,687.) (HER at 87.) He did not address the DPA's additional contention that amortization expense should also be excluded. The Company, which was the only party to contest Staff's and the DPA's position, did not except to the Hearing Examiner's findings and recommendations. Thus, we adopt the Hearing Examiner's findings and recommendations. (Unanimous.)

E. Costs For The Company's Proposed Conservation Information Program.

67. In its direct testimony, the Company proposed to implement a new "Conservation Information" program for residential customers. Company witness Wathen testified that this program would "allow customers to access on-line information that would facilitate making better decisions and choices related to their energy needs." (Exh. 2 (Wathen) at 14.) The Company sought to amortize $130,000 of start-up costs over three years and include $108,000 of annual expenses ($9,000 per month) in its revenue requirement. (Exh. 68 (VonSteuben) at 12.)

68. Staff and the DPA objected to the Company's proposal. Staff witness Peterson testified that the Company was still evaluating

offers from potential vendors, and so there was no evidence as to what program would be implemented or what it would actually cost to implement and administer it. (Exh. 87 (Peterson) at 11; *see also* Tr. at 98-99.)

69. **Discussion and Decision.** The Hearing Examiner recommended that the Commission disallow these costs. (This adjustment resulted in a $64,290 decrease in rate base and a $108,000 decrease in expenses. (HER at 88.) The Company, which was the only party to contest Staff's and the DPA's position, did not except to the Hearing Examiner's findings and recommendations. Thus, we adopt the Hearing Examiner's findings and recommendations. (Unanimous.)

F. Adjustment to Rate Base to Reflect New Depreciation Rates.

70. This issue was not raised and litigated in the normal manner; rather, it came up in the context of Staff's amortization proposal regarding the cost of removal reserve (which will be discussed *infra*). Delmarva witness VonSteuben testified that if Staff's amortization proposal was approved, then the Commission should adjust the Company's rate base to account for the effect of the amortization. (Exh. 111 (VonSteuben-R) at 111.) Since that recommendation will be rejected (*see infra*), the issue is moot as to any adjustment for the effect of the amortization on rate base. Staff and the DPA argued against such an adjustment, noting that the Company had not proposed any adjustment to rate base to account for new depreciation rates even though increased depreciation accruals would result in a larger accumulated depreciation reserve on a prospective basis. (Exh. 100 (Peterson-R) at 4.) During the evidentiary hearing

on the amortization proposal on March 20, 2006, Mr. VonSteuben stated that rate base should have been adjusted to reflect the new depreciation rates that the Commission will approve in this case, and apologized for neglecting to make such an adjustment. (Tr. at 59.)

71. Staff and the DPA objected to such an adjustment, arguing that the Commission considers depreciation and amortization expense changes to be prospective, and therefore changes to an historic test period are not required. (Exh. 100 (Peterson-R) at 4; Exh. 94 (Crane-R) at 5-6.)

72. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner accepted Staff's and the DPA's position that no adjustment should be made to rate base to account for the new depreciation rates. (HER at 61.) The Hearing Examiner agreed with Staff and the DPA that the Commission considers depreciation and amortization expense changes to be prospective and does not make corresponding changes to an historic test period. He found that the effects of the accumulated reserves for removal cost and deferred taxes would be recorded on the Company's books as they are incurred and will be made part of the Company's rate base in future rate cases, which is the same way that all of its jurisdictional investments, revenues, and expenses are treated. (HER at 61.)

73. **Exceptions.** In its exceptions, the Company contended that such an adjustment should be made, and that the Hearing Examiner relied on "unsupported statements made by out-of-state consultants" in recommending to the contrary. (Delmarva Brief on Exceptions at 96.) The Company argued that just such an adjustment had been made in

Docket No. 91-20, where the Commission found that the depreciation rates it had approved in Docket No. 90-25 should be used to restate test period rate base, even though those new rates were approved after the end of the test period used in Docket No. 91-20. (*Id.* at 96-99.)

74. **Discussion and Decision.** We have reviewed our decision in Docket No. 91-20. It appears that our decision there was based in large part on the fact that the parties agreed that the new rates from Docket No. 90-25 should be applied in that rate case if an Order was entered prior to the conclusion of the rate case. (*See Delmarva Power*, Docket No. 91-20, at 47.) In that case we did note that the new depreciation rates were known and measurable. However, that does not appear to have been our usual practice; rather, that case seems to represent a departure from our usual practice of not adjusting rate base for the effect of new depreciation rates. We also note that in this case the Company used an historic test period ended March 31, 2005, whereas in Docket No. 91-20, the Company used a "3 + 9" partially forecasted test period ending September 30, 1991. Thus, the rate base to which those new depreciation rates applied was a future rate base, not an historic one as we have here. Therefore, for the foregoing reasons as well as the reasons set forth by the Hearing Examiner, we adopt the Hearing Examiner's findings and recommendations. (Unanimous.)

VII. OPERATING EXPENSES

A. Injuries & Damages Expense and Storm Restoration Expenses.

75. Normally, the test period level of expense is used as the proxy for the reasonably anticipated level of expense during the rate

effective period. In this case, however, the Company normalized the I&D and storm restoration expenses using a three-year average of such expenses (2003-2005). Staff agreed that the test period expenses seemed low and that normalization was appropriate, but proposed a two-year normalization period (2004-2005). Thus, the sole difference between Staff's and the Company's positions on these two items were the number of years of historical information considered in the normalization adjustment. Staff recommends two years (2004-05 actual expense); the Company recommends three (2003-05 actual expense).

76. The Company's actual I&D expense for the test year was $546,111. For the 12-months ended March 31, 2004, I&D expenses were $875,214 and for the 12-months ended March 31, 2003 those expenses were $979,321. (Exh. 87 (Peterson) at 16.) Mr. Peterson testified that the test year expenses seemed "uncharacteristically low," but that the 2003 expense level was "abnormally high" compared with the following two years. Similarly, Delmarva's test year storm restoration expense level of $8,032,882 appeared low compared to the two prior years, and these expenses for the 12-months ended March 31, 2003 ($13,222,147) appeared abnormally high. He therefore recommended averaging the 2004 and 2005 expenses for I&D and storm restoration to derive prospective expense levels. (Id. at 16-19.)

77. The Company asserted that a three-year normalization period for I&D and storm restoration expenses is appropriate because Staff and the DPA accepted that period in the Company's last gas base rate case, Docket 03-127. (Exh. 70 (VonSteuben-R) at 8-9.) The Company further contends that if any year in the proposed normalization period

is unrepresentative, it is the test year, and if a two-year normalization period were to be accepted, then the test year should be excluded in determining the appropriate prospective expense level for these items. (Id. at 8, 10.) According to Mr. VonSteuben, a three-year normalization period is proper because normalization takes into account both high and low expense years in order to establish a reasonable expense level for the rate effective period. (Id. at 8, 10.)

78. **Discussion and Decision.** The Hearing Examiner recommended that the Company's proposed three-year normalization period for I&D and storm restoration expenses be accepted. (HER at 95.) Staff, which was the only party to contest the Company's proposed normalization periods for these expenses, did not except to the Hearing Examiner's findings and recommendations. Therefore, we adopt the Hearing Examiner's findings and recommendations. (Unanimous.)

B. Incentive Compensation.

79. Delmarva included approximately $1.3 million of incentive compensation payments, made under incentive plans that are no longer operative, in test period expenses. (Exh. 87 (Peterson) at 17.)[4] In its 2004 annual report to stockholders regarding those plans (p. 23), PHI stated:

> The Company's compensation programs are designed to provide a strong and direct link between compensation

[4]In its exceptions, the Company voluntarily withdrew its claim for $231,240 of that amount because it determined that amounts paid in the test period to service company employees and partially allocated in the rate case process to Delmarva had included payment under a plan that should have been allocated 100% to a non-utility affiliate. (Delmarva Brief on Exceptions at 55 n. 9.)

> and executive performance and short- and long-term Company performance. The objective of the Company's executive compensation policy is to attract and retain key executives with a program that compensates executive officers competitively with other companies in the industry *and rewards executives for* achieving levels of operational excellence and *financial results which increase shareholder value.*

(Id. at 17) (emphasis added.) The Annual Incentive Plan ("AIP") now in effect is even more clearly tied to corporate earnings and shareholder interests: its target threshold is PHI actual earnings relative to budgets. (Id.).

80. Staff witness Peterson excluded $1,201,351 of these payments, arguing that they were inconsistent with the ratepayers' goal of receiving service at the lowest possible price and were primarily designed to increase shareholder wealth. (Id. at 18.) Mr. Peterson included $106,359 of incentive payments for achieving safety-related performance goals, as safety is an important goal for ratepayers as well as shareholders. (Id.). The DPA also objected to the level of incentive compensation payments. Ms. Crane observed that the 2005 payments were significantly more than the payments in the prior three years; were almost double the level of payments in 2002 and 2003; and were almost triple the level of payments in 2004. Furthermore, almost $2 million was paid in the first three months of 2005 alone. (Exh. 77 (Crane) at 45.) DPA witness Crane did not recommend excluding all non-safety-related incentive compensation payments, but rather recommended that a three-year normalized level of the incentive compensation for service company employees (as well as the entire amount of the incentive compensation payments made directly

to Delmarva employees) be included in rates. (Exh. 77 (Crane) at 44-46.)

81. The Company objected to Staff's and the DPA's adjustments. First, Mr. Wathen disagreed that the incentive plan was tied to corporate earnings. He claimed that having a financially strong utility directly benefits ratepayers, and that the financial targets are set to allow for reasonable levels of investment to meet customer reliability, safety, and service level obligations and commitments at reasonable cost. Furthermore, he asserted that a premise of the incentive plan is to ensure that employees conserve the Company's assets. According to Mr. Wathen, performing these tasks successfully "can lengthen the period of time between rate cases and we can mitigate the size of increases when rate cases are filed." (Exh. 3 (Wathen-R) at 9.)

82. Next, Mr. Wathen claimed that it is "difficult" to quantify specific dollar benefits of some of the safety and customer programs, but "[c]ertainly, reliability targets are beneficial to customers and help to ensure that the Company focuses on providing reliable service to customers." (Id. at 10.) Mr. Wathen then argued that he is not aware of any regulatory principle that provides for service at the lowest possible price, but in any event the stated objective of the AIP is "entirely consistent" with that goal. (Id.).

83. Mr. Wathen noted that in Docket No. 03-127, Staff did not adjust incentive compensation payments to exclude all but safety-related payments. (Id. at 11.) He testified that whether the compensation is in the form of base salary or incentive compensation,

it is a legitimate expense and should be recovered. Furthermore, the Company's total compensation plan (including incentives) was designed to be at the mid-point of the competitive market. (Id. at 7, 11.)

84. Mr. Wathen stated that the purpose of the incentive plans is to permit the Company to "hire and retain talented and motivated personnel," which is a "clear" benefit to ratepayers, the State, and the communities Delmarva serves. Moreover, the Commission has a duty to "look out for the financial well being" of the utilities it regulates, and a financial objective is an appropriate incentive from a customer perspective in that regard. (Id. at 11-12.)

85. Staff contended that the Company bears the burden of establishing that it is entitled to recover expenses in rates, and none of its arguments justifies ratepayers paying incentive compensation that is based primarily on attaining goals that increase shareholder wealth. At a time when the costs of all commodities (including electricity) are skyrocketing, Staff argued that incentive compensation payments are a discretionary cost that is completely unnecessary for the provision of adequate and reliable service. (Staff PHB at 82.)

86. Staff contended that there appeared to be a trend among regulatory authorities, in this time of increasing costs for consumers, to reduce allowable expenses to those that are truly necessary for the provision of safe, adequate, and reliable utility service. It argued that commissions that had considered this issue in the last few years had concluded that payments made pursuant to incentive plans that are based primarily on achieving financial goals

should be excluded from rates. *See Re Union Light, Heat & Power Co.*, 245 PUR 4th 1 (Ky. PSC 2005); *Re Consumers Energy Co.*, 2005 WL 3617546 (Mich. PSC Dec. 22, 2005); *Re Northern Illinois Gas Company dba Nicor Gas Company*, 245 PUR 4th 194 (Ill. Commerce Comm. 2005); *Re Missouri Gas Energy, a Division of Southern Union Co.*, 235 PUR 4th 507 (Mo. PSC 2004), *order clarified* in 2004 WL 2411284 (Mo. PSC Sept. 28, 2004), and *decision clarified on denial of rehearing*, 2004 WL 2434227 (Mo. PSC Oct. 19, 2004). (Staff PHB at 83.) Additionally, Staff argued that "[m]ost of Delmarva's purported explanations as to how an incentive plan that is triggered by financial goals benefits ratepayers are unsupported assertions" and that the others were unpersuasive. (Staff PHB at 84-85.)

87. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner agreed with Staff that it was improper to ask ratepayers to shoulder the burden of paying for incentive compensation programs that are based primarily on the achievement of financial goals and which primarily benefit shareholders. The Hearing Examiner was persuaded by the reasons given by the commissions in the cases cited by Staff for excluding the costs of such programs from the revenue requirement, specifically citing the Illinois Commerce Commission's addressing and rejecting of several of the same arguments that Delmarva made:

> A vague allegation that ratepayers benefit from an incentive compensation program is insufficient to demonstrate savings or benefits and thereby justify recovery of costs from ratepayers. . . . In this case, Nicor relies primarily on very general testimony to support its request for recovery. While the Company maintains that the reasonableness of the amount is unchallenged, the AG expressed concern that the test year amount requested by Nicor is almost triple the amount compared to that incurred two years earlier.
>
> * * *
>
> Nicor also emphasizes that it attempts to pay employees at the industry median, and that incentive compensation helps the Company to accomplish this goal. Again, given the heavy dependence on financial targets in the incentive compensation program, the Commission is not swayed by Nicor's argument. Nicor further contends that no party has argued that the concept of incentive compensation is imprudent. Whether or not these arguments are correct, they do not help Nicor to meet the standard of recovery of these types of costs from ratepayers.
>
> * * *
>
> The hope of less frequent rate cases in the future in exchange for a larger rate increase today is precisely why the Commission views with skepticism incentive compensation plans based largely on financial goals or targets.
>
> * * *

(HER at 99-100, quoting *Re Northern Illinois Gas Company dba Nicor Gas Company*, 245 PUR 4th 194 (Ill. Commerce Comm. 2005.)

88. The Hearing Examiner ultimately concluded that if the Company wants to offer its employees an incentive program triggered by financial goals, it is free to do so, but the stockholders who benefit from the achievement of those financial goals should pay for it. *See Consumers Energy, supra; Missouri Gas, supra; Nicor, supra.* Therefore, he recommended that the Company's request to include the $1.3 million of financial-goal-related incentive payments in rates

should be rejected. (This adjustment results in a decrease of approximately $1.3 million to operating expenses.)

89. **Exceptions.** The Company excepted to the Hearing Examiner's findings and recommendations. First, it contended that no party had contended that overall compensation was excessive. The Company stated that of the approximately $1.08 million at issue, approximately $909,000 related to incentive compensation paid to non-executive employees. The Company theorized that because much of the testimony and argument regarding disallowance was directed toward the executive compensation plans, the non-executive incentive plans may have been unfairly criticized. (Delmarva Brief on Exceptions at 55.) Thus, Delmarva argued, the Hearing Examiner's recommended disallowance was overly broad because it rejected virtually all incentive program costs, even those with "significant safety and customer satisfaction components." (*Id*.). Delmarva noted that 40% of its CVP plan (applicable to non-managerial, non-union employees) was based on customer service and satisfaction targets; 50% of its MVP plan (applicable to non-union, non-executive managerial employees) was based on customer service and satisfaction and safety goals; and 30% of the executive incentive plan was tied to meeting customer service and satisfaction goals. (*Id*. at 55-57.)

90. Second, the Company contended that the Commission had recognized the value of incentive programs to customers in prior cases. It cited the Commission's decision in Docket No. 91-20, in which the Commission rejected the Hearing Examiner's recommendation to split the incentive compensation program costs 50-50 between

shareholders and ratepayers, and in which the Commission rejected the same arguments that Staff and the DPA made in the instant case. (*Id*. at 58-59.) The Company observed that the incentive programs at issue in Docket No. 91-20 also had financial triggers similar to the plans at issue here. In Docket No. 91-20, the Commission reasoned that requiring shareholders to absorb the costs of incentive programs would act as a disincentive for Delmarva to engage in such plans, and expressed a belief that ratepayers benefit from incentive plans because the increased productivity extends the time between rate case filings. (*Id*. at 59, quoting Commission Order No. 3389.)

91. Next, the Company cited to recent cases in other jurisdictions in which incentive compensation was included in rates. (*Id*. at 59-61.)

92. Fourth, the Company argued that the record evidence demonstrated the value of the incentive programs in managing costs, which was a benefit to customers. (*Id*. at 62.) It contended that the Hearing Examiner was "simply wrong" in saying that the programs were tied primarily to the achievement of financial goals and were unrelated to meeting safety goals. The Company pointed out that 50% of its MVP plan was tied to customer-related goals (and 30% and 40% of the other plans were too), and that customers *did* have an interest in the remaining (financial goal) portion because that portion motivated employees not to be wasteful with their budgets and to meet financial targets. (*Id*.). The Company claimed that Staff witness Peterson misunderstood how an incentive program can and should operate to benefit all stakeholders, because Mr. Peterson "agreed" that his

approach was essentially recommending that the Company "redesign its plans to make incentive compensation payouts if it achieves safety and reliability goals, even if the Company were 'flat broke and in bankruptcy' and employees were 'spending prodigiously, vastly exceeding their budgets.'" (*Id*. at 62, quoting Tr. at 1119.) The Company further objected to the Hearing Examiner's apparent rejection of Mr. Wathen's testimony regarding the value of the programs as "vague allegations," claiming that it had "prove[d]" that its total compensation was reasonable and at or below the median of other companies. (*Id*. at 62-63). It pointed to Mr. Wathen's testimony that including incentive compensation as a portion of an employee's total compensation helped to focus the employee's attention and efforts on achieving the Company's goals. (*Id*. at 63, citing Exh. 3 (Wathen) at 5.) The Company contended that the goals in its incentive programs were all valid objectives that benefited customers by keeping test period expenses (and therefore rates) lower than they otherwise might be. (*Id*. at 63-64.)

93. Finally, the Company posited that if the Commission were inclined to adopt some new position for incentive compensation, it should consider a normalization approach similar (but not identical) to that proposed by the DPA. (*Id*. at 64.) It noted that its books include $340,124 as the Delaware distribution share of incentive compensation for Delmarva employees and $738,336 as the Delaware distribution share of incentive compensation for employees of the service company that provide services to support Delmarva. (*Id*.). The Company stated that the DPA's proposed approach would have used

the test period amount for payments made to direct Delmarva employees, but would have normalized the payments to service company employees. Delmarva argued that any normalization approach should treat both sets of costs in the same manner. Additionally, DPA's normalization of service company payments excluded the test year expense level; the Company contended that any normalization should include the test period data. (*Id*. at 65-66.)

94. The DPA also excepted to the Hearing Examiner's findings and recommendations. Noting that the Hearing Examiner had not addressed the DPA's argument that the service company incentive payments included in the Company's claim were excessive, the DPA assumed that there had been no such discussion because the Hearing Examiner had accepted Staff's proposal to disallow the vast majority of the incentive compensation payments. The DPA did not except to that portion of the Hearing Examiner's findings and recommendations. (DPA Brief on Exceptions at 16.)

95. However, the DPA contended that if the Commission should reject the Hearing Examiner's recommendation, then it urged the Commission, at a minimum, to disallow $344,075 of Delaware electric distribution incentive compensation costs. (*Id*.). The DPA argued that Delmarva's incentive compensation payments to service company employees during the test period had been "abnormally large relative to amounts paid in prior years," and that there were "significant and unusual payments made during the first three months of 2005 that accounted for the extraordinary incentive costs incurred during the test period." (DPA Brief on Exceptions at 16-17.) The DPA noted that

actual test year costs were double the amount incurred in 2003 and 2004 and almost triple the level of 2002, and these increases could not have been the result of a shift in employees from the utility to the service company because employee levels did not significantly increase at the service company. (*Id*. at 17.) The DPA contended that the Company had not provided an adequate explanation for the significant increase in incentive compensation payments during the test period. Thus, in the event that the Commission rejected the Hearing Examiner's recommended treatment of incentive program costs, the DPA urged it to use a three-year (2002-2004) average of service company costs to determine the Company's revenue requirement. The DPA did not include the test period in this normalization because it was abnormally high compared to prior levels; the Company had not shown that the test year level was likely to continue in the future; and the Company had not shown that the test period incentive costs were reasonable or appropriate. (*Id*.).

96. **Discussion and Decision.** This is a difficult issue for the Commission. We recognize that we have allowed payments made under incentive compensation payments to be included in rates in the past, both for this utility and for others subject to our jurisdiction. We recognize that we have expressed a belief that such programs benefit ratepayers by extending the period between rate cases. We also believe that certain incentive compensation plans have value. But we also believe that we cannot consider the effect of including the incentive program payments in rates in a vacuum; rather, we must consider that effect in light of the currently existing economic

circumstances. Those circumstances change from time to time and we must acknowledge the economic climate in which the utility operates. Regulation is a substitute for competition, and if in the competitive sector incentive compensation plans are being reconsidered, we should also do so – especially where, as here, the ratepayers who have been paying for such programs are being buffeted from all sides with vast increases in other costs of living.

97. We agree that incentive plans that are triggered by the achievement of safety, reliability, and goals of that nature benefit ratepayers. Fewer accidents mean less time missed by employees and hopefully fewer outages.

98. The majority of the plans at issue here, however, apparently have primarily financial triggers. According to the Company’s brief on exceptions, 50-70% of the payout for the three plans it specifically discussed therein (representing $627,000 of the $1 million at issue) was related to the achievement of financial goals. The Hearing Examiner clearly studied the issue and concluded that the incentive programs that were not primarily triggered by the achievement of safety-related goals should not be included in rates, but, rather, the shareholders should bear that expense. Thus, for these reasons as well as the reasons expressed by the Hearing Examiner, we adopt the Hearing Examiner’s findings and recommendations with respect to incentive compensation. (3-1: Chair McRae and Commissioners Conaway and Clark voting yea; Commissioner Lester voting nay; Commissioner Winslow abstaining.)

C. Advertising Expenses.

99. Staff removed $310,627 of the Company's test period general education advertising expenses. According to Delmarva, the "general education" advertising was designed "to inform customers about the Company's investments in reliable service." (Exh. 87 (Peterson) at 20.) Staff perceived the intent of that advertising to be to promote corporate branding, loyalty, and image, rather than customer safety and service reliability. (Id.). In rebuttal, the Company attached four examples of such advertising, which it claimed were a representative sample of the advertising at issue. After reviewing the ads, the DPA, which had originally objected to including this advertising expense in rates, withdrew its objection.

100. Staff admitted that there may be some educational value to these ads, but argued that they were primarily image enhancing. Staff noted that three of the four ads contained Delmarva's tag line "Because at Conectiv, every job is about reliability," and that two of the print ads stated that "[a]t Conectiv Power Delivery, we're working hard to bring our region safe, reliable electric service." Staff contended that any ad containing that tag line or that sentence could be said to "discuss" reliability, but in reality it did not tell customers anything about reliability. Staff observed that the Company only attached 4 out of how many advertisements that it ran during the test period to Mr. VonSteuben's rebuttal testimony, and wondered what the advertisements that Mr. VonSteuben did *not* include said. Finally, Staff noted that its witness did not change his position after reviewing the advertisements that the Company provided after he had filed his

testimony, so he was not persuaded that the ads were wholly educational. (Staff PHB at 86.)

101. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that the educational advertising expenses be included in operating expenses. He acknowledged that the ads may not be "wholly educational," but he found that they *did* contain educational information despite the existence of logos or tag lines. He observed that the ads contained information about walk-in offices, energy saving tips, improving response times for outage calls, and preparing for a storm, all of which was useful to customers. Although sharing Staff's concern about the ads that were not produced, he observed that any party could have requested copies of the other ads through the discovery process or through motion practice. He also found it "instructive" that the DPA withdrew its objection to the expenses after reviewing the ads. (HER at 102.)

102. **Discussion and Decision.** Staff, which was the only party to challenge these expenses, did not except to the Hearing Examiner's findings and recommendations. We therefore adopt the findings and recommendations of the Hearing Examiner. (Unanimous.)

D. <u>Merger Amortization.</u>

103. The Company included an expense adjustment to reflect the Delaware distribution share of $99.34 million of costs related to the 1998 merger between Delmarva and Atlantic City Electric, amortized over 10 years. It also included the Delaware distribution share of the unamortized balance in rate base. The methodology Delmarva used is consistent with the agreement reached by the parties in the

settlement of the merger docket, but the amount of total merger costs being included in rate base and operating expenses is significantly higher than the estimate in the merger docket ($71.6 million).

104. The DPA recommended reducing Delmarva’s claim for unamortized costs associated with the 1998 merger of Delmarva and Atlantic City Electric to the amount of the estimate, or $71.6 million. (Exh. 77 (Crane) at 40.) The DPA contended that if the parties had known that actual merger costs were going to be significantly above $71.6 million, they may have reached a different settlement, or may not have settled at all. (*Id*.).

105. The Company argued that the $71.6 million figure was only an estimate; that the settlement of the merger docket contained no reservations or conditions limiting the recovery of out-of-pocket costs to the estimated amount; the Commission Order likewise contained no such limitation; and the annual benefit of an $8.5 million rate reduction exceeded the Delaware retail portion of the amortizable amount. (Exh. 70 (VonSteuben-R) at 14-15.)

106. **The Hearing Examiner’s Findings and Recommendation.** The Hearing Examiner recommended that the Company’s actual merger costs should be recovered in accordance with the terms of the settlement of the merger docket. (HER at 103.) He found there was no legal basis for rewriting a portion of the settlement now, and that the $71.6 estimate of merger costs could not be seen as a “guarantee” eight years after the settlement. He further found that it was “unlikely” that a higher estimate of merger costs would have affected the settlement, since the estimated net merger savings in that case would

have only been approximately 5% less than the estimate used for the settlement. (HER at 103-104.)

107. **Discussion and Decision.** The DPA, which was the only party to challenge these costs, did not take exception to the Hearing Examiner's findings and recommendations. Therefore, we adopt the Hearing Examiner's findings and recommendations. (Unanimous.)

E. <u>Wage and FICA Adjustment.</u>

108. The Company included in its revenue requirement the effects of eight scheduled wage and FICA increases, two of which occurred before the end of the test period (i.e., prior to March 31, 2005) and three which will occur prior to May 1, 2006. The remaining three increases will occur in June 2006 and February and March 2007. (Exh. 68 (VonSteuben) at 10.) These latter three include two scheduled increases under union-negotiated contracts and one non-union wage increase. (*Id.*). The Company contended that the increases were reasonably known and measurable and reflected the situation as it would exist during the rate effective period. (Exh. 70 (VonSteuben-R) at 5.)

109. The DPA objected to the inclusion of the 2006 and 2007 wage increases, recommending instead that the increases to be included in rates be limited to those in effect by December 31, 2005. The DPA contended that the 2006 and 2007 wage and FICA adjustments reached too far beyond the end of the test period, which, it noted, was selected by Delmarva, and "significantly distort the regulatory triad of synchronizing rate base, revenues, and expenses at a point in time." (DPA Proposed Findings at 28-29.) The DPA noted that in Docket No.

92-47, the Commission rejected a utility's attempt to include wage and salary increases that were to become effective in April and August 1993, when the test period ended March 31, 1992.

110. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that the Commission include all of the proposed wage and salary increases in the Company's revenue requirement. He agreed with the Company that the increases were reasonably known and measurable, noting that 5 of the increases were encompassed in existing union contracts, and that one of the non-union increases had already taken effect. (HER at 105.)

111. **Exceptions.** The DPA excepted to the Hearing Examiner's findings and recommendations. First, it argued that the 2006 and 2007 wage and salary increases went too far beyond the end of the test period, noting that it was Delmarva that selected the test period, which ended March 31, 2005 and that Delmarva could have selected some other test period, including a partially-forecasted one, which could have encompassed the proposed wage and salary increases. (DPA Brief on Exceptions at 12.) Second, it contended it did not follow from the fact that a union increase was known and measurable that it should necessarily be included in a utility's revenue requirement. In this regard, the DPA noted that the 2007 increases would take place almost two full years after the end of the test period. It argued that the existence of long-term union contracts did not mean that all scheduled contractual increases should be included in the utility's rates, because to do so would violate the matching principle. (*Id*. at 12-13.) Third, the DPA again cited the Commission's decision in Docket No. 92-

47, in which the Commission declined to include in a telephone utility's revenue requirement wage increases that would not become effective until a year after the end of the test period, arguing that in that case the Commission had recognized the importance of the matching principle with respect to rate base, revenues, and expenses. (*Id*. at 13.) Fourth, the DPA contended that there was no record evidence regarding the magnitude of the March 2006 and 2007 non-union wage increases, observing that Company witness VonSteuben testified in February 2006 that he had not yet been informed about his March 2006 increase and that the March 2007 non-union increase was a "budgeted" increase. (*Id*. at 13-14.) The DPA argued that budgeted expenses can vary significantly from actual expenses, and that budgeted increases do not represent known and measurable changes to actual test period results. (*Id*. at 14.) Thus, the DPA urged the Commission to limit the wage and FICA increases to be included in the Company's revenue requirement to those in effect by the end of December 2005, which the DPA claimed represented a "reasonable compromise between preserving the integrity of the test period and the attempt to reflect known and measurable changes to test period results." (*Id*).

112. **Discussion and Decision.** We are sympathetic to the DPA's argument regarding how far outside the test period these adjustments go. However, we recognize that several of the adjustments relate to contractually-required wage and salary increases that the Company is not free to ignore and which are known and measurable. We also recognize that the Company has reflected the effects of the wage and salary increases through the rate effective period rather than putting

the full annualized effect of all of the increases into its expenses. Therefore, for these reasons and the reasons set forth by the Hearing Examiner, we adopt the Hearing Examiner’s findings and recommendations. (Unanimous.)

VIII. DEPRECIATION ISSUES

113. As the Hearing Examiner observed, “[t]aken as a whole, depreciation is the single largest issue in terms of dollars at stake and, as such, was the most hotly contested matter.” (HER at 44.) The depreciation issues include Staff’s proposal to mitigate the impact of the supply side rate increase (supported by the DPA; opposed by Delmarva and DEC); Staff’s and DPA’s proposal that the Company be required to report its cost of removal reserve as a “regulatory liability” (opposed by Delmarva and DEC); the overall amount of removal costs to be included in the Company’s revenue requirement; and overall depreciation rates.

A. Staff’s Mitigation Proposal.

114. Delmarva’s announcement that the implementation of deregulated standard offer supply rates effective May 1, 2006 would result in huge increases in electric rates caused Staff to investigate whether the effect of those increased rates on Delaware consumers might somehow be mitigated. Staff’s idea – which the Hearing Examiner noted was brought forward four business days prior to the start of the evidentiary hearings – was to return to ratepayers the Company’s cost of removal reserve, amortized over five years via a bill credit that would become effective at the same time that new distribution rates went into effect. Staff’s proposal would have the short-term effect

of reducing the typical residential customer’s bill (at current levels) by approximately 2.01%.

115. On February 17, 2006, Staff witness Majoros filed testimony outlining Staff’s proposal, in which he quantified the financial effects using 5-, 7- and 10-year amortization periods. He testified that Delmarva’s system-wide cost of removal reserve was $105 million, of which $58.4 was allocated to the Delaware jurisdiction. (Exh. 101 (Majoros-S) at 3-4.) In support of his proposal, Mr. Majoros cited a New Jersey case involving Atlantic City Electric (Delmarva’s affiliate), in which Atlantic City Electric agreed to amortize a depreciation reserve excess back to ratepayers. (*Id*. at 2.) On the same date, DPA witness Smith filed testimony supporting Staff’s amortization proposal. (Exh. 97 (Smith) at 2.) Mr. Smith noted that when the current rate freeze expired on May 1, 2006, Delmarva’s ratepayers would face substantial increases in energy costs, and that Staff’s mitigation proposal was “conceptually consistent with” the recommendations in his direct testimony. (HER at 45, citing Exh. 97 (Smith) at 3.)

116. On March 3, 2006, Delmarva witness Kamerick submitted supplemental depreciation testimony explaining that the proposed amortization would create intergenerational inequities among past, current, and future customers. (Exh. 107 (Kamerick-SD) at 3-5.) He further testified that the Company’s annual interest expense is approximately $32 million and that amortization of either $58 million (Delaware distribution) or $105 million (system-wide) “would significantly lower the Company’s cash interest coverage ratio, which

is one of the very significant factors measured by the credit rating agencies when assessing the credit quality of the Company's debt securities." (*Id*. at 7.) Mr. Kamerick testified that this deterioration in cash flow, standing alone, would not likely cause a credit downgrade, but that it would be coming at a time when Delmarva's credit ratings have been placed on Negative Outlook by two of the three major rating agencies. (*Id*.). He explained the importance of cash flow on the Company's credit rating and the consequences of higher interest costs and higher borrowing levels overall that result from a deterioration in cash flow. (*Id*. at 8.)

117. Company witness Morin testified that approval of Staff's proposal would cause the rating agencies to treat Delmarva as a generation utility, with the concomitant risks that go with generation, as opposed to the lower risks of a transmission and distribution utility. (Exh. 95 (Morin-SD) at 2; Tr. at 1199.) He quoted a recent Fitch Ratings report that identified Delaware as one of four states in which political/regulatory developments were of particular concern where policy changes "could result in significantly reduced cash flow" or "more gradual deterioration of creditworthiness as regulators attempt to minimize rising consumer rates." At the March 20, 2006 evidentiary hearing, Dr. Morin discussed a Standard & Poor's Credit Watch report dated March 17, 2006 that placed Delmarva and its affiliates on a Negative Credit Watch due to increased risks associated with regulatory proceedings, particularly the recently announced proposal to phase-in supply rates. (Tr. at 1166-67; Exh. 96.) He did not re-compute his recommended return on equity, but

testified that Staff's proposal confirmed the conservative nature of his previous recommendation of 11%. (Exh. 95 (Morin-SD) at 8.)

118. Company witness Robinson testified that amortizing and returning cost of removal reserve amounts to customers was inconsistent with depreciation principles in that it would not allocate costs over the estimates remaining useful life of the assets in a systematic and rational manner. (Exh. 109 (Robinson-SD) at 4.) Past and current customers have been using the facilities and the removal cost amounts collected from them (which are reflected in the cost of removal reserve component of the Company's book depreciation reserve) are "simply the accumulated (but yet unspent) portion of the plant-in-service's future cost of removal (retirement) that the customers have consumed in receipt of service." (*Id*. at 5). Mr. Robinson also contended that these removal cost amounts are not properly viewed for ratemaking purposes as a liability available for repayment to customers. (*Id*. at 6-7.) He explained that the amounts recorded as a regulatory liability for financial reporting purposes will generally be spent on payments to salvage and waste hauling companies or internally expended costs, not payment in the form of refunds to customers. (*Id*. at 8.) He contended that the Atlantic City Electric settlement was fundamentally different from the instant case in that it involved moving a depreciation reserve toward a theoretical reserve level based on a new set of depreciation rates, not moving a reserve to zero and then refilling the reserve through higher rates. (*Id*. at 8-9.) Mr. Robinson prepared calculations showing that the removal cost reserve was not over-funded and, in

fact, required additional amounts to bring the reserve to the theoretically correct level. (*Id*. at 11-16 and Schs. EMR-1 SD, EMR-5 SD.)

119. In response to the DPA, Mr. Robinson attempted to clarify an issue that had been the subject of some semantic dispute. Mr. Smith used the word "incurred" as equivalent to cash payments made. Mr. Robinson claimed that under the accrual method of accounting, costs are "incurred" as the assets are used. (*Id*. at 23.) He further testified that as a depreciation professional he could not support "arbitrary" flow-backs or amortizations for the purpose of trying to offset supply-related costs. (HER at 48.)

120. Delmarva witness VonSteuben described Staff's proposal as "short-term gain means long-term pain." (Tr. at 1372.) He corrected some small errors in Mr. Majoros' allocation methods and quantified the Delaware distribution amount at issue as $58.2 million. (Staff accepted those corrections.) Mr. VonSteuben testified that the removal cost reserve was a deduction from rate base and if any of that reserve was removed, the effect would be an increase in rate base. (Exh. 111 (VonSteuben-SD) at 3.)

121. Mr. VonSteuben also quantified the rate base effects for each of the proposed amortization periods. For the 5-year period recommended by Staff and supported by the DPA, the annual amortization amount would be $9,187,042, comprised of $11,647,059, offset in part by Mr. Majoros' increased future removal cost of $1,494,103, and further offset by an additional $965,914 increase in rate base. (Exh. 111 (VonSteuben-SD) at Sch. WMV SD-2.) He also quantified the rate

relief from this approach as approximately 2.01% of current rates. (*Id*. at 4.) He also showed that the rate relief in years 1-5 were followed by more than 20 years of higher rates caused by the increased rate base and the increased removal cost expense related to "refilling" the reserve. (HER at 49.)

122. DEC witness Ferguson also opposed Staff's proposal. He notes that the $105 million removal cost reserve was the net collections from customers and the recording of costs from work orders for removal projects that have been completed. (Exh. 113 (Ferguson-SD) at 2.) He testified that: (a) in any removal of the reserve, deferred taxes must be taken into consideration; (b) Mr. Majoros' estimated future cost of removal amount was far too low; (c) there would be a permanent inflation of the rate base, to the detriment of Delmarva's customers; (d) regulatory risk would increase, which should be taken into account in setting rate of return; (e) the refund proposal conflicted with the Uniform System of Accounts and the regulatory objective of intergenerational equity; and (f) the financial community was likely to react negatively to a refund proposal driven by political considerations. (*Id*. at 2-6.) He further testified that Mr. VonSteuben's projections of the long-term "pain" could be understated because the amounts proposed by Mr. Majoros for future removal costs were too low to replenish the reserve. Therefore, there would be a permanent increase in rate base, not the slowly diminishing effect that Mr. VonSteuben projected. (Tr. at 1394.)

123. On March 13, 2006, Staff and the DPA filed rebuttal testimony. Staff witness Peterson testified that DEC witness Ferguson's adjustment for deferred taxes had no net impact because once the net of deferred taxes amortization amount is determined, it is grossed up by the revenue conversion factor. (Exh. 100 (Peterson-R) at 2-3.) He also objected to Mr. VonSteuben's rate base adjustment on the ground that depreciation and amortization changes are prospective and do not require adjustments to an historic test period, noting that no such adjustments had been proposed to reflect the new depreciation rates that will result from this case. (*Id*. at 4-5.) He further argued that such adjustments violate test period matching principles and that there was "nothing unique about the removal cost amortization that sets it apart from any of Delmarva's other cost of service items that ultimately affects its revenue requirement." (*Id*. at 5-6.) He testified that in future rate cases, Delmarva's rate base would reflect the amortizations. (*Id*. at 6.) Mr. Peterson also quantified Staff's new revenue requirement position as negative $24,477,234. (*Id*.).

124. Staff witness Parcell testified that the amortization proposal did not affect Delmarva's earnings and that its cash flow indices would still be above Standard & Poor's benchmark range for an A-rated utility. (Exh. 92 (Parcell-R) at 2.) He observed that Standard & Poor's reports indicated that other of PHI's business lines were riskier than Delmarva and that any downward pressure on Delmarva's ratings were more likely to result from its ownership by PHI than from Staff's amortization proposal. He further testified

that as he understood the amortization proposal, it only changed the timing of the amortization to ratepayers, not the total amount to be amortized. (*Id*. at 4.)

125. Mr. Majoros accepted Mr. VonSteuben's corrections regarding the Delaware distribution amount to be amortized back to ratepayers. (Exh. 102 (Majoros-R) at 1.) He stated that he endorsed any of the three amortization periods, but was recommending the 5-year period to match the supply rate increase as closely as possible. (*Id*. at 14.) He testified that the only revenue requirement difference between his amortization proposal and the Company's position was a matter of timing – the prospective amortization period for the removal cost reserve. (*Id*.). He claimed that because Delmarva has been reporting the removal cost reserve as a regulatory liability since 2003, there should be no negative effect on its ratings from requiring the removal cost reserve to be amortized. (*Id*. at 15.) He testified that while he was using a net present value approach to determine removal cost, he could support any of the approaches that he included in his direct testimony. (*Id*. at 17.) He asserted that the Company does not "need" the $105 million currently in the removal cost reserve and that it was unlikely that Delmarva would spend the $200 million he included in his proposed depreciation rates; that he is not recommending a "refund" but rather a reduction in depreciation expense; and that no political pressure was exerted on him in making the amortization proposal. (*Id*. at 19-20.) He further testified that "GAAP does not allow future cost of removal to be included in depreciation rates." (*Id*. at 19.)

126. DPA witness Smith testified that Mr. Majoros's amortization proposal was a "systematic and rational" approach. (Exh. 98 (Smith-R) at 2.) He stated that declaring the removal cost reserve to be a regulatory liability would protect those funds and assure that they are not transferred to shareholders as income. (*Id*. at 3.) He disputed Company witness Robinson's position with respect to the definition of "incurred" costs and took the position that future removal costs were not "incurred" for non-legal asset retirement obligations. (*Id*. at 6.)

127. DPA witness Crane testified that the amortization of the removal cost reserve was an issue independent from supply-related costs and any "excess" should be refunded to customers regardless of what occurs with supply costs. (Exh. 94 (Crane-R) at 3.) She testified that PHI's non-utility businesses were riskier than Delmarva, so that Staff's and DPA's proposals would not change the way ratings agencies look at Delmarva on a consolidated basis. (*Id*. at 4.) She also opposed a rate base adjustment on the grounds that this case is predicated on an historic test period, that numerous factors affect post-test period rate base, and that the rate base effects of the amortization would be recognized in Delmarva's next base rate case. (*Id*. at 5-6.)

128. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that the Commission reject Staff's amortization proposal. (HER at 53.) First, he observed that the amounts in the removal cost reserve had been collected pursuant to previously-approved depreciation rates, and therefore Staff's proposal

raised an issue of potential retroactive ratemaking. He acknowledged Staff's argument that the remaining life depreciation technique used by Delmarva amortizes excess removal cost back to ratepayers, but found that that technique only returns *actual* excess (unneeded) amounts – not the type of "excess" that Staff claimed (which the Hearing Examiner called "anything over zero). (*Id*. at 53-54.) He further noted that there was no precedent in Delaware or anywhere else for returning to customers amounts previously collected for removal costs over any time period. (*Id*. at 53-54.)

129. Next, the Hearing Examiner observed that Staff's proposal would only reduce a typical residential customer's bill by approximately 2.01%. He found that such a reduction was not "meaningful" in light of the projected 59% increase in supply rates that would become effective May 1, 2006. (*Id*. at 53). He further noted that to achieve this "modest" reduction in overall rates, amortization of the removal cost reserve would reduce depreciation expense by more than 60%. (*Id*. at 54.) This, in turn, would cause rates to increase faster than they otherwise would. The Hearing Examiner credited Mr. VonSteuben's testimony that over 20 years Delmarva customers would pay anywhere from $3-4.9 million more in rates under Staff's amortization proposal than they would under the Company's proposal due to the increase in the Company's rate base, and cited DEC witness Ferguson's testimony that Mr. VonSteuben's calculations were understated because he assumed that Staff's proposal would replenish the removal cost reserve; in reality, however, Staff proposed to include an amount that would only "barely cover current

expenses," which would make the rate base effect permanent. (*Id*. at 54-55.)

130. The Hearing Examiner was also persuaded that Staff's amortization proposal would create intergenerational inequity. He found that past customers had already paid into the reserve as part of their usage of the assets to be retired in the future; however, customers in years 1-5 of the amortization would receive the equivalent of refunds of those payments, and would then pay even more in order to repay the amounts refunded plus the amount needed to retire the assets. (*Id*. at 55.) He further found that it was "possible" that a more than $10 million reduction in cash flow each year for a company with only $32 million in interest costs on debt may contribute to a further downgrading of Delmarva's creditworthiness by rating agencies, which would increase the Company's borrowing costs and would ultimately be reflected in rates. (*Id*.).

131. The Hearing Examiner found that it was "misleading" to claim that there were "excess" removal costs. (*Id*.). He noted that before advancing the mitigation proposal, Staff had quantified $207 million of estimated future removal costs. In the same calculation, the removal cost book reserve was $102.3 million, which left $104.9 million to be collected in future rates over the remaining life of the assets. Thus, Staff proposed a separate removal cost reserve depreciation rate averaging 0.31% to collect approximately $3.7 million more annually toward future removal cost. Thus, there was actually a deficiency in the removal cost reserve. (*Id*. at 55-56.)

132. The Hearing Examiner further agreed with Delmarva that the removal cost reserve reflects collections above what has actually been spent. (*Id*. at 56.) He noted that the account was for *future* removal costs; past expenses that had already been paid to vendors and for internal costs have been charged against the account (reducing the reserve), so that what remains is a net amount that would help fund future removal costs. (*Id*.).

133. Finally, the Hearing Examiner observed that the Vermont Commission had recently rejected the position that a positive removal cost reserve means that the utility has over-collected removal costs. (*Id*.).[5]

134. **Exceptions.** Staff and the DPA excepted to the Hearing Examiner's findings and recommendations. The DPA did not address all of the Hearing Examiner's findings and recommendations, but focused on his observation that the amortization proposal would not effect a meaningful reduction in the average customer's overall bill. The DPA contended that the Commission should adopt the amortization proposal with a shorter amortization period in order to make the reduction in overall energy bills more meaningful. (DPA Brief on Exceptions at 6.)

135. Staff first contended that its proposal did not constitute retroactive ratemaking because the remaining life technique that Delmarva's witness used to calculate proposed depreciation rates itself amortizes the removal cost reserve by "truing up" over time. (Staff Brief on Exceptions at 9.) The Hearing Examiner believed that

[5]The Hearing Examiner also addressed the necessity for a rate base adjustment if Staff's amortization proposal were adopted by the Commission.

this true-up feature did not "return" excess funds to ratepayers, but rather reduced depreciation rates when they are reset at some later date. Staff argued that this is essentially a timing issue: under the remaining life technique, if there is an over-collection, the excess removal cost reserve will be returned to ratepayers in the form of lower depreciation rates the next time rates are reset; under Staff's proposal the excess is returned now. Staff contended that if its proposal constituted retroactive ratemaking, then so did the use of the remaining life technique to establish depreciation rates, but no one had suggested that the remaining life technique resulted in retroactive ratemaking. (*Id*. at 10.)

136. Staff next argued that the size of the overall bill reduction should not affect whether an amortization of the removal cost reserve is appropriate. (*Id*.). Staff observed that the average residential customer was not the only type of customer that would receive a bill credit under its proposal, and that the credit going to those other customers could have a significant impact on those customers' overall bills. Staff acknowledged that 2% did not look large compared to 59%, but contended that "every little bit helps" at a time when the cost of other commodities is also rising. (*Id*.).

137. Third, Staff argued that any amount more than what the Company actually needs in a given year *is* "excess" removal cost. Staff sought to reassure the Hearing Examiner and Commission that it did not intend to mislead anyone with its position on this issue; Staff argued that it truly believes that any amount of removal cost

---

(HER at 57-61.) In light of our rejection of the amortization proposal, we above and beyond that amount necessary to pay for the current costs of removal constitutes "excess" removal cost. Staff further contended that the Hearing Examiner misunderstood Mr. Majoros's testimony: if, as the Hearing Examiner found, the removal cost reserve reflects collections above what has already been spent, then there can be no "deficiency" in the removal cost reserve, and anything that the Company collects above and beyond what it needs annually (which has averaged $4 million over the last 5 years and was $6.2 million in the test period) is excess. (*Id*. at 11.)

138. Next, Staff took issue with the Hearing Examiner's finding that amortization of the removal cost reserve would result in higher rates in the future. Staff acknowledged that the removal cost reserve would have to be replenished, but noted that its proposed rates would collect approximately $6.3 million annually for removal costs, whereas the Company's proposed rates would collect $15.8 million – over twice as much. (*Id*. at 11-12.)

139. Staff contended that its proposal did not result in intergenerational inequity. Rather, Staff argued that the current situation resulted in intergenerational inequity, because current ratepayers have paid far more in removal costs than the Company has spent, and unless the Commission adopted FAS 143 for ratemaking purposes, the Company had no obligation to spend any of the removal cost reserve on removal costs. (*Id*. at 12-13.)

140. Staff next argued that its amortization proposal would not have the negative financial effect that the Hearing Examiner feared.

---

need not address this issue.

It noted that Delmarva’s bond rating is “A,” which is higher than the average distribution utility. It noted that at a 10% return on equity, Delmarva’s pretax interest coverage was 4.54x, which was well above the benchmark range for an A-rated utility with a business position of 3 (Delmarva’s situation). It noted that Delmarva’s debt ratio was below that acceptable for an A-rated utility. It noted that the amortization proposal would not affect Delmarva’s capital structure or earnings. Finally, it noted that the Company had conceded that any reduced cash flow from the amortization would not likely cause a downgrade. (*Id*. at 13.). Rather, Staff contended that if anything was going to cause Delmarva to be downgraded, it was Delmarva’s status as a subsidiary of PHI. (*Id*. at 14-15.)

141. Staff next argued that the Hearing Examiner had himself recognized that the removal cost reserve represents amounts over and above what the Company has spent on removal costs to date. (*Id*. at 14-15). Finally, Staff argued that the *Central Vermont* case that the Hearing Examiner cited did not support his decision because the Commission in that case was not asked to (and did not) consider whether an amortization back to ratepayers was appropriate. (*Id*. at 16).

142. **Discussion and Decision.** We believe that it was beneficial for Staff to bring this issue to our attention, but we also realize that Delmarva must remove and replace equipment that has served its useful purpose, even if it does not have a legal obligation to do so, and we expect that the monies currently in this account will be used for that purpose in the future. Therefore, for these reasons and the

reasons set forth in the Hearing Examiner's findings and recommendations, we adopt those findings and recommendations. (Unanimous.)

B. <u>FAS 143: Reporting the Removal Cost Reserve as a Regulatory Liability</u>.

143. Under FAS 143, if a rate-regulated company has no legal obligation to incur removal costs that it has collected through depreciation rates, the company must record the removal costs that have been collected but remain unspent as a regulatory liability on its financial statements. (Exh. 43 (Majoros) at 11; Exh. 41 (Smith) at 16-17.) PHI's 2004 SEC Form 10-K states that in order to comply with FAS 143, at December 31, 2004 and 2003 respectively, the Company reclassified $176.9 million and $181.6 million as a regulatory liability. (*See* PHI 2004 Form 10-K; *see also* Exh. 41 (Smith) at 21.) Both Staff and the DPA urged the Commission to adopt FAS 143 for ratemaking purposes, arguing that "since Delmarva has no legal obligation to spend the finds collected for removal costs on actual removal costs, Staff and the DPA ask the Commission to require Delmarva to record such costs as a regulatory liability [Account 254] and segregate them in order to ensure that they are *used* for that purpose." (Staff PHB at 42) (emphasis in original.) Otherwise, the Company could take the reserve into income for the benefit of shareholders in the event that Delmarva's distribution business is

deregulated or some other non-traditional regulation such as price caps is imposed. (Exh. 43 (Majoros) at 16-17; Tr. at 588.)[6]

144. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that the Commission reject Staff's and the DPA's proposals to adopt FAS 143 for ratemaking purposes. First, the Hearing Examiner found that it was "undisputed that no authority or standard … requires or directs utilities to record [cost of removal] reserve as a regulatory liability for ratemaking purposes, and Staff cites no state commission that has so required." (HER at 62.) Second, he concluded that the removal cost reserve "falls more naturally into the Accumulated Reserve account, rather than as a liability, because the collections reflect payment for the customers' share of the total cost of the asset, which includes original capital costs of installation and future retirement costs." (*Id*. at 62-63.) Thus, from a ratemaking perspective, the Company did not owe these funds to customers. Moreover, the Hearing Examiner found that even if the Company did over-collect funds for future removal costs (which he found was not the case here), the remaining life technique would true up the depreciation rates so that the excess would be returned to customers when rates were reset. (*Id*. at 62.) Furthermore, the Hearing Examiner found that the Commission could handle the issue at the time that Delmarva's distribution function was deregulated or subject to an alternative form of regulation. He further observed

[6]The Hearing Examiner stated that Staff and the DPA raised this FAS 143 issue after Staff made its mitigation proposal. (HER at 62.) The record reflects that Staff and the DPA witnesses both made their proposals in their direct testimony filed on December 9, 2005, and thus the proposals were timely.

that the removal costs were already tracked separately, obviating the need to transfer the removal cost reserve to Account 254. Finally, he found it "misleading" to say that the Commission had to adopt FAS 143 in order to follow GAAP for ratemaking purposes, since GAAP also supported the current policy of including removal costs as part of a utility's depreciation rates. (*Id*. at 63.)

145. **Exceptions.** Both the DPA and Staff excepted to the Hearing Examiner's findings and recommendations. The DPA first argued that the Hearing Examiner's conclusion was apparently based on his mistaken belief that Staff and the DPA had not raised the issue until the end of the case. (DPA Brief on Exceptions at 7-8.) Second, the DPA noted that the Hearing Examiner had stated that "[I]t is reasonable … for the Commission to protect these funds in the depreciation reserve account that are earmarked for future removals." (*Id*. at 8, quoting HER at 72.) The DPA argued that the best way to achieve that protection would be to require Delmarva to record the removal cost reserve as a regulatory liability. Third, the DPA contended that the Commission should require Delmarva to record the removal cost reserve as a regulatory liability to protect ratepayers and assure that the funds previously collected from them for removal costs are either spent for that purpose or returned to ratepayers. (*Id*.). The DPA observed that implementing FAS 143 would not change the revenue requirement or cost Delmarva anything; rather, it would simply protect ratepayers. (*Id*.).

146. Staff first contended that FAS 143 is a generally accepted accounting principle, and noted that the Commission generally applies

GAAP for ratemaking purposes. (Staff Brief on Exceptions at 17, 20.) Staff argued that it was *not* "misleading" to claim that adoption of FAS 143 was necessary to comply with GAAP; while the currently-used accrual accounting (the subject of a separate FAS) was appropriate at the time the Company last had depreciation rates established, FAS 143 had been promulgated in the interim and so GAAP had changed. (*Id*. at 19-20.) Staff further observed that a California administrative law judge had recommended applying FAS 143 in the ratemaking context in a case involving Southern California Edison, but that Commission had not yet entered a final order. (*Id*. at 20 n. 5.) Third, Staff found that whether the removal cost reserve more naturally fell into the accumulated reserve account rather than the regulatory liability account was irrelevant in light of FAS 143's requirement that it be recorded and reported as a regulatory liability. (*Id*. at 20-22.) Fourth, Staff argued that the Hearing Examiner's observation that the remaining life trued-up the depreciation reserve over time was likewise irrelevant to whether FAS 143 should be adopted for ratemaking purposes; rather, the issue was whether a company should be precluded from using funds collected for spending on removal costs for some other unrelated purpose. (*Id*. at 22-23.) Fifth, Staff contended that the reason that removal costs are currently tracked is *because* of FAS 143, and the Hearing Examiner's conclusion was akin to saying that the Commission need not formally order the Company to comply with FAS 143 for ratemaking purposes because it already does so informally. (*Id*. at 23.) Finally, Staff argued that ratepayers deserve protection now, rather than waiting until a potential issue arises. (*Id*. at 23-24.)

147. **Discussion and Decision.** We adopt the Hearing Examiner's findings and recommendations. We acknowledge that we generally follow GAAP in the ratemaking context, but we do not perceive that we are not following GAAP by not requiring the Company to record the removal cost reserve in Account 254 (Regulatory Liability) rather than Account 108 (Accumulated Depreciation). As we mentioned earlier, the Company will continue to incur costs to remove and replace equipment, even if it has no legal obligation to do so. We also note the Company's representation in connection with its discussion of Staff's mitigation proposal that "that $58 million dollars will stay there on the books unless we have removal costs charged against it." (Tr. at 1276.) Therefore, for these reasons and the reasons cited by the Hearing Examiner, we adopt his findings and recommendations. (Unanimous.)

C. <u>Recovery of Cost of Removal.</u>

148. Delmarva witness Robinson estimated future removal costs at $626 million using an inflated future cost approach,[7] while Staff witness Majoros estimated future removal costs at $207 million using a new present value accrual approach. DPA witness Smith proposes to use a five-year normalized historical average of removal costs. DEC witness Ferguson supported Delmarva's approach.

149. In developing Cost of Removal depreciation rates, Company witness Robinson proposed a target level of $626,177,054 for future

[7]"Inflated" as used here is not a pejorative term; rather, it simply reflects that the estimated costs include an adjustment for the effect of inflation on those costs.

removal costs for the distribution and general plant accounts. (Exh. 30 (Robinson) at Depreciation Study, Tables E-2 and C-2, cols. (e).) Because Delmarva had $105 million of removal costs in its reserve, Mr. Robinson developed removal cost rates designed to recover an additional $535,858,771 over the remaining lives of the assets. (*Id.*, cols. (g) and (h).) He prepared a comprehensive depreciation analysis that includes a detailed analysis of the Company's fixed capital books and records through December 31, 2004.[8] He attempted to summarize this comprehensive study in his testimony. For the removal cost estimate, he developed a net salvage database that was used as a basis to identify historical experience and trends and to determine each property group's recommended net salvage factors. (Exh. 30 (Robinson) at 6.) He testified that most of the Company's asset groups generate negative net salvage – that is, their removal costs exceed any revenue received from the sale of retired and removed plant. The salvage database provides account-by-account data on actual removal costs incurred each year between 1978-2004 (except for private area lighting, where the data were for 1993-2004). (Exh. 30 (Depreciation Study, Section 7.)

[8]The study was attached to Mr. Robinson's pre-filed direct testimony and consists of an Executive Summary, tables showing the summary results of the plant, net salvage and cost of removal studies, a section discussing the procedures used to develop the data base and perform the study, the account-by-account plant results, a service life analysis, the remaining life calculations and account-by-account salvage results. The portions of the study relevant to this discussion are set forth in the tables within Section 2 labeled E-2 Cost of Removal (for Electric and General plant accounts) and C-2 Cost of Removal (for Common plant accounts); Sections 3 (starting at page 3-11 discussing salvage; the portions within each account description in Section 4 that summarizes the removal cost estimate for that account; and Section 7, which contains an account-by-account trend line analysis of salvage values and removal costs and forecasted removal cost amounts. (HER at 65.)

150. Mr. Robinson testified that the first step in estimating retirement cost was a standard analysis approach that was used to identify a company's historical experience with respect to the end of life costs relative to the original cost of the assets. (Exh. 30 (Robinson) at 18-19.) Staff witness Majoros agreed that this method is the traditional one for calculating net salvage. (Exh. 43 (Majoros) at 24.) Mr. Robinson used that historical approach and then made further refinements to adjust for the fact that the retirements that had actually occurred were of plant that was "younger" than the average life of the plant that would be returned over time. (Exh. 30 (Robinson) at 19-21.)

151. In his rebuttal testimony, Mr. Robinson addressed Messrs. Majoros's and Smith's criticisms of his study. He noted that the differences between his depreciation recommendations and those of Mr. Majoros (before the amortization issue came up) was approximately $14,068,557 on a system-wide basis, of which $12,515,540 related to the differences in removal cost amounts. (Exh. 31 (Robinson-R) at 3.) He acknowledged that his proposed rates collected an additional $15.8 million annually for removal costs, but testified that using a backwards-looking 5-year average of removal costs does not match the costs associated with salvaging the assets providing service with the service that is being provided; rather, the average historical removal costs relate to facilities that are no longer providing service to customers. (*Id*. at 4.) Mr. Robinson specifically noted that the 2004 level of removal costs was $6.2 million, which was more than 50% higher than the 5-year average. (*Id*. at 4-5.)

152. Mr. Robinson stated that the remaining life technique was a well-defined one that required use of future net salvage, and both the technical literature and common sense supported using estimates of future net salvage, so that current ratepayers would pay their pro rata share over time (i.e., ratably) of the full costs of the facilities, including the future net salvage costs. (*Id*. at 5.) He acknowledged that his $15.8 million for future removal costs was an estimate, but contended that it was reasonable based on historical retirement costs and his adjustments based on his professional judgment. (*Id*.). In addressing DPA witness Smith's cash basis methodology, Mr. Robinson discussed the concept of ratability and the inclusion of net salvage factors in depreciation rates as set forth in NARUC manuals and Bulletin #1 of the American Institute of Certified Public Accountants. (Exh. 31 (Robinson-R) at 43.) He noted that neither SFAS 143 nor FERC Order No. 631 controlled how annual depreciation rates are developed by regulatory commissions for ratemaking purposes. (*Id*. at 44-48.) Finally, he testified that the cash basis method of accounting is inconsistent with the accrual accounting principle of "ratable" recovery over time of the cost of the assets, including end of life costs. (*Id*. at 51.)

153. Mr. Robinson testified that his methodology was recognized as the most widely used in the industry and was the standard method discussed in NARUC's 1996 Public Utilities Depreciation Practices Manual. (*Id*. at 6-8.) He noted that it was irrelevant that the removal cost reserve contains more than has been spent over the past few years, because "spent" is a cash basis concept applied to already-

retired plant and which by definition will not be as large as the amounts needed to fund future removal costs. (*Id*. at 20.)

154. Mr. Robinson testified that notwithstanding Mr. Majoros's views of the traditional methods of determining estimates for future removal costs, those methods actually understated the removal costs likely to be incurred because it does not take trends into account. (*Id*. at 23.) Mr. Robinson noted that although Mr. Majoros criticized Mr. Robinson's forecasts of future removal costs as double-counting inflation, Mr. Robinson did not actually use his forecast level to develop the proposed rates, but rather used a more gradual approach that resulted in more conservative rates. (*Id*. at 24.)

155. Mr. Robinson rejected Mr. Majoros's four alternatives to the traditional methods for determining future removal costs, finding that each was simply a different version of an approach designed to "back-end-load costs" (*Id*. at 29.) He testified that Mr. Majoros's net present value approach was theoretically flawed in the context of a stream of negative values. (*Id*. at 30-32.) He rejected Mr. Majoros' adjustment for "gains and losses" because the Company's records were accurate and did not require any adjustment. (*Id*. at 35.) He recognized an error in his spreadsheets where some retirement amounts were not picked up in the summary spreadsheets, but claimed that the magnitude of the error was insignificant and did not affect the correctness of the removal cost amounts in his study. (*Id*. at 34-35.)

156. DEC witness Ferguson provided a thorough critique of the proposals offered by Staff and DPA. He set forth a historical survey dating back to 1913 showing that depreciation rates included an

allowance for net salvage. (Exh. 45 (Ferguson) at 8-20.) He testified that to his knowledge, no state commissions had adopted FAS 143 for ratemaking purposes. He further discussed this Commission's historical treatment of net salvage and noted that it had previously rejected cash basis methods similar to those proposed by Staff and the DPA. (*Id*. at 12, 21-22.)

157. Mr. Ferguson asserted that Mr. Majoros had been proposing cash methods and other methods of computing net salvage for years prior to FAS 143 and FERC Order No. 631 and was now using them as a "crutch" to continue to propose the same recommendations that had been rejected by several other commissions. (*Id*. at 32-39.) He testified that neither FAS 143 nor FERC Order No. 631 addressed how rates should be set to account for future net salvage costs of non-legal asset retirement obligations and that FERC had rejected suggestions that removal costs be removed from depreciation rates. (*Id*. at 32-33.) He testified that Mr. Robinson's approach to estimating negative net salvage resulted in a conservative estimate and was consistent with the general principles of depreciation practice. (*Id*. at 40.) In contrast, Mr. Majoros's net present value approach erroneously assumed that all actual retirements experienced in 2004 were of assets that were all 26 years old, and claimed that Mr. Majoros's proposal was "a rather strange present value calculation to reflect the price level 26 years prior to the price level that existed at the time the cost of removal was recorded." (*Id*. at 44; Exh. 113 (Ferguson-SD) at 9.)

158. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that the Commission adopt the DPA's

proposed five-year normalized net salvage allowance for the amount of removal costs to be included in depreciation rates. (HER at 71.) Noting that Mr. Majoros had testified that the DPA's approach was "probably the best approach" (Tr. at 569), the Hearing Examiner concluded that "[f]or purposes of this case at this time, the five-year rolling average for recovery of cost of removal provides a reasonable and preferred method for addressing this controversial aspect of depreciation, and better conforms with the generally accepted accounting principles articulated in Statement of Financial Accounting Standards 143 (SFAS 143) by not treating non-legal asset retirement obligations (AROs) as if they were legal AROs." (HER at 71.) The Hearing Examiner found that Delmarva's method of including estimated future removal costs in the depreciation rates essentially treated a non-legal ARO as if it were a legal ARO. (*Id*.).

159. The Hearing Examiner found that the 5-year rolling average method offered the advantages of being simple, straightforward, easy to implement, and avoided charging current customers for estimated future costs and estimated future inflation. (*Id*.). The Hearing Examiner recognized that this approach represented a departure from the Commission's past procedure for determining depreciation rates, but observed that the cash basis method had been "strongly endorsed by two credible expert witnesses," and established a "sensible and verifiable method to recover such costs." (*Id*. at 71-72.) The Hearing Examiner found that even if the 5-year average proved to be too low, it was unlikely that the Company would experience any shortfall in the long term given the $105 million in the removal cost

reserve, and in the long term, and necessary increases or decreases would occur in future cases, just as with any other normalized expense. (*Id*. at 72.)

160. The Hearing Examiner recognized that recommending DPA's cash basis method appeared to conflict with the reasons the Hearing Examiner proffered for rejecting Staff's and DPA's position that the Commission should adopt FAS 143 for ratemaking purposes (such as its proper classification as a depreciation reserve and the potential for intergenerational inequity). The removal cost reserve, however, was amassed under an approach that estimated future removal costs and recovered those costs in depreciation rates. Thus, it was reasonable to protect those funds already in the depreciation reserve that were earmarked for future removals. He observed that the cash basis method was "radically different" from the method Delmarva had used and that this Commission had used in other cases because it is based on a prediction that future removal costs will approximate the 5-year historical average of such costs. (*Id*.). Nevertheless, the Hearing Examiner found that removal costs would be removed from depreciation rates and recorded as a recurring operational expense rather than as a capital cost subject to depreciation. Due to this fundamental difference in how such costs will be viewed and recorded, the Hearing Examiner concluded that his recommendation was not inconsistent with his earlier recommendations regarding FAS 143, which only related to protection of and accounting treatment for the existing removal cost reserve. (*Id*. at 73.)

161. **Exceptions.** Both Delmarva and DEC excepted to the Hearing Examiner's recommendation. The Company first argued that the Hearing Examiner's recommendation represented a "'radical' and 'fundamental' departure from Delaware's past practice," as the Hearing Examiner himself recognized. (Delmarva Brief on Exceptions at 26, citing HER at 72-73.) Delmarva contended that the traditional method, which has been used in Delaware and the vast majority of other states, is based on the principle that cost responsibility should lie with the customers who cause the costs to be incurred, and ensures that *all* users pay their pro rata share of the retirement costs associated with their use of a depreciating asset. (*Id*. at 26, 31-32.)

162. Second, the Company questioned the Hearing Examiner's assessment of Mr. Majoros's credibility, claiming that Mr. Majoros originally sponsored an accrual approach (although he testified that he would support a cash basis approach), and then, when his variations on the traditional approach were challenged, "fled from his own study's approach and results in order to support the five-year average approach." (*Id*. at 26-27.) Delmarva likened the Hearing Examiner's reliance on Mr. Majoros's experience to "hiring an experienced football coach who has led many, many teams to losing seasons." (*Id*. at 27.) Delmarva also pointed out that Mr. Majoros had advocated the cash basis approach for removal costs many times, but had lost many times, citing to Mr. Ferguson's discussion of the cases in which Mr. Majoros had lost the issue. (*Id*. at 27-29, citing Exh. 45 (Ferguson) at 8-19, 34-39.) The Company observed that Messrs. Ferguson and Robinson had 70 years' experience between them as

depreciation professionals, and their proposals were supported by the 1996 NARUC Manual on Public utility Depreciation Practices. (*Id*. at 29-30.)

163. Third, the Company argued that the traditional accrual accounting method and inclusion of removal cost estimates in depreciation rates for Delmarva went back to Docket No. 898 in 1978. (*Id*. at 32.)[9]

164. Fourth, the Company argued that the historical five-year average was arbitrary and did not even cover the Company's test period removal cost expenses. (*Id*. at 38.) The Company took issue with the Hearing Examiner's reliance on the existence of the removal cost reserve. Delmarva contended that this was "technically true," but that the Hearing Examiner had not "adequately considered" the repercussions of his recommendation: that creating a gap between cash expenses and recoveries is an indirect means of draining the removal cost reserve, which the Hearing Examiner had earlier rejected. The Company observed that the drain may not take place as quickly as it would have under Staff's amortization proposal, but it had the same effect. (*Id*.). The Company further argued that the 5-year time period selected by the Hearing Examiner was arbitrary and seemed to be based almost solely on the fact that Pennsylvania uses a five-year period. The Company contended that there had been no testimony that would explain why the test period expense level of $6.2 million should

[9]Delmarva's exceptions include arguments against Staff witness Majoros's proffered removal cost estimate to be included in the depreciation rates. (Delmarva brief on Exceptions at 32-38.) Since we did not adopt Staff's recommendation with respect to the removal cost estimate, we do not see any need to include those exceptions in this description.

be disregarded in favor of a normalized average. (*Id*. at 38-39.) Because costs are typically normalized only when there is reason to believe that test period expenses are abnormally high or low, the Company claimed that at a minimum the test period expense level should be used. (*Id*. at 39.)

165. Fifth, the Company argued that the Hearing Examiner incorrectly relied on and misapplied FAS 143. (*Id*.). Delmarva contended that the Hearing Examiner's statement that the five-year normalized average approach better conforms with FAS 143 by not treating non-legal asset retirement obligations as if they were legal asset retirement obligations was "factually incorrect: Delmarva stated that companies with legal asset retirement obligations capitalize into basis their estimated future net salvage costs, but no party has advocated that approach for Delmarva's non-legal obligations to retire and remove assets. (*Id*.). Moreover, the Company claimed that the traditional accrual approach is in accord with FAS 143, which recognizes that ratemaking approaches for regulated industries typically include an allowance for future net salvage, as even DPA witness Smith acknowledged. (*Id*.). Furthermore, neither FAS 143 nor FERC Order No. 631 suggests that it is improper to continue traditional ratemaking practices, and FERC specifically did not adopt FAS 143 for ratemaking purposes. (*Id*. at 40.)

166. Sixth, the Company contended that just because an approach is easier does not mean that it represents an improvement over the traditional approach. (*Id*.). Delmarva submitted that the traditional approach was also simple and easy to implement, and that the Hearing

Examiner may have seen it as more complex than it truly is because of the various adjustments that Messrs. Robinson and Majoros made to it. (*Id*.).

167. Finally, the Company argued that the avoidance of costs by current customers is a flaw rather than a benefit of the cash basis approach. (*Id*. at 41.) Delmarva contended that this allows current customers to evade their pro rata share of cost responsibility for the assets they are consuming, which results in intergenerational inequity. Delmarva observed that utilities do not charge current customers with the full costs in Year 1 of capital investments made to place new assets into service; rather, they recognize that those assets will be in service for some number of years and therefore charge those customers with only a fraction of those capital costs via a depreciation rate on the asset. It is well-recognized that at the end of the asset's useful life, the utility will incur costs to retire and replace it. These costs, even though estimated, should be collected over the same time period from the same customers and for the same reason: those who benefit from the use of the asset should pay the costs of that usage. (*Id*.).

168. DEC argued that the Hearing Examiner's recommendation was not supported by the record evidence. (DEC Brief on Exceptions at 6.) First, DEC contended that the cash basis methodology conflicts with the purpose of depreciation accounting and with the accounting and regulatory framework for depreciation. (*Id*.). Like Delmarva, DEC contended that the purpose of depreciation accounting is to record asset costs in a pattern that matches the pattern of asset usage or

revenue-generating capability, and those costs are to be recorded on an accrual basis over the asset's useful life. (*Id*. at 7.) The principle of intergenerational equity means that each generation of ratepayers pays only those costs incurred to serve that generation. (*Id*.).

169. DEC next argued that the cash basis method conflicts with GAAP. (*Id*.). According to DEC, three aspects of the GAAP definition of depreciation accounting are significant to the treatment of removal costs. The first is that it be systematic and rational. By rational, it is meant that the pattern of recording depreciation is to match the pattern of usage or revenue-generating capability of the related property – that is, accelerated relative to the life span for a decreasing pattern, constant (ratable) for a constant pattern, and deferred for an increasing pattern. (*Id*. at 7-8.) The second aspect is the consideration of salvage. This means net salvage, and thus removal costs are incorporated into depreciation for financial accounting purposes because: if the definition had been intended to mean only salvage proceeds, it would have stated "gross salvage;" it is inconsistent to specify that investment and salvage cost elements be recorded in a pattern matching the usage or revenue-generating capability of the asset when the removal cost element is not allowed to; and treating removal costs differently from investment and salvage conflicts with the premise that accounting be reliable and relevant. (*Id*. at 8.) The third aspect is that depreciation accounting is a process of cost allocation rather than valuation; this is consistent

with the requirement that depreciation accounting be rational and with the regulatory principle of intergenerational equity. (*Id).*

170. DEC next contended that the cash basis methodology was inconsistent with the Uniform System of Accounts ("USOAs"). (*Id*. at 9-11.) According to DEC, the Delaware electric USOAs dictate that jurisdictional entities practice accrual accounting, and define depreciation as the "loss in service value; define service value as "the difference between original cost and net salvage;" and define net salvage as "the salvage value of the property retired less the cost of removal." Thus, DEC concludes, Delaware requires all three asset cost elements to be recorded on an accrual basis through depreciation. (*Id*. at 10.)

171. DEC next argued that the cash basis method recommended by the Hearing Examiner conflicts with past Delaware practices and Commission precedent. (*Id*. at 11-12.) DEC specifically noted that the Commission had rejected a cash basis proposal similar to the one proffered by DPA witness Smith in Docket No. 898. (*Id*. at 12.) DEC also contended that the cash basis method had been "overwhelmingly rejected by other regulators." (*Id*. at 12-14.)

172. DEC argued that the cash basis method was detrimental to ratepayers and the State of Delaware in the long run, because under rate base regulation, an increase in depreciation rates causes cost of service to increase in the near-term but decrease in the long-term, while a decrease in depreciation rates causes a reduction in the near-term cost of service but an increase in the long-term cost of service.

(*Id*. at 14.) It included a chart purporting to show this effect. (*Id*. at 15.)

173. DEC further contended that the cash basis methodology "lacks authenticity and therefore, credibility" because Mr. Smith supposedly took the same positions as Mr. Majoros did in Docket No. 04-288. (*Id*. at 16-17.)[10] DEC also contended that the cash basis method has nothing to do with FAS 143; that Delmarva's accrual treatment of removal cost is "much different from the treatment required by SFAS 143 for legal obligations;" that Messrs. Smith and Majoros were not credible witnesses; that Delmarva will experience a shortfall in the near term; and there is "more than an 'appearance' of conflict between the Hearing Examiner's rejection of Staff's cost of service refund proposal and the adoption of a deferral mechanism for cost of removal." (*Id*. at 19-20.) Finally, DEC argued that the fact that the cash basis method was simple, straightforward and easy to implement were not appropriate reasons to adopt it. (*Id*. at 19).

174. **Discussion and Decision.** We adopt the Hearing Examiner's findings and recommendations that a rolling five-year average of actual depreciation expense be used for the removal cost component of depreciation - but, pursuant to the Company's request, we note that we will not be adverse to re-examining this issue in a future base rate case. That having been said, we recognize that using a rolling five-year average of depreciation expense is an approach that is used in only two other states, and represents a departure from our prior

[10]Pages 19-20 of DEC's exceptions contain some arguments that go to Staff witness Majoros's proposals with respect to removal cost. Since we do not accept Staff's proposals, we do not address these exceptions.

method of determining the amount of depreciation expense to be included in rates.

175. We are troubled, however, by the amount of depreciation expense that has been collected over the years and remains in the Company’s depreciation reserve ($105 million on a system-wide basis) and that the Company’s proposed rates would collect on an annual basis $15.9 million). The record evidence shows, and the Company did not dispute, that its test period depreciation expense was $6.2 million and that its depreciation expense has averaged $4 million over the last 5 years. With respect to other expenses that a utility incurs, we use a test period expense level to set the expense level going forward, or we normalize expenses over some period of years if we believe that the test period level is unrepresentative of what can be expected in the future. Here, however, it seems to us that the attempt to estimate what future removal costs will be in the future is nothing more than conjecture.

176. In this regard, we note that the expenses being discussed here are removal costs only. They are not the costs to replace the asset being removed. The replacement costs are placed into rate base when the replacement asset becomes used and useful in providing utility services, and the utility earns a return of, as well as on, that investment. The expenses being discussed here relate solely to the cost of removing an asset that has served out its useful life.

177. For the foregoing reasons, as well as those set forth by the Hearing Examiner, we adopt the Hearing Examiner’s findings and recommendations, with the caveat that we will reconsider this issue in

the Company's next base rate case should the Company choose to raise it. (3-2: Chair McRae and Commissioners Conaway and Clark voting yea; Commissioners Lester and Winslow voting nay.)

D. Overall Depreciation Rates.

178. Messrs. Robinson and Majoros were the only witnesses to take a position on depreciable lives, Iowa curves, and the resulting plant depreciation rates. Overall, their proposals were generally similar, with an aggregate difference of only approximately $1.55 million. (Delmarva PHB at 156; Exh. 31 (Robinson-R) at 3.)

179. As noted previously, Mr. Robinson prepared a comprehensive study. He described the basic parameters of his study as using the Retirement Rate Method (which is used when vintaged plant data are available), straight line depreciation, Broad Group Procedure and the Remaining Life Technique. (Exh. 30 (Robinson) at 9-15.) He then compared his results to standardized Iowa survivor curves to develop depreciation rates for each plant account. (*Id*. at 25-26.) Mr. Majoros also followed these basic parameters, although he testified that he believed the Whole Life Method was superior to the Remaining Life Technique. (Tr. at 1262-63.)

180. In rebuttal, Mr. Robinson claimed that the differences between his and Mr. Majoros's proposed rates appeared to be the result of Mr. Majoros's "simply 'picking the best fit curve from the computer generated data analysis.'" (HER at 74, quoting Exh. 31 (Robinson-R) at 39.) Mr. Robinson explained how he had analyzed that data and excluded "anomalous, extraneous, and meaningless data points for various older age intervals" prior to running the computer program to

obtain adjusted Iowa curve fits. (HER at 74, citing Exh. 31 (Robinson-R) at 39.)

181. Messrs. Robinson and Majoros agreed that the purpose of using Iowa curves was to extend utility experience to zero and smooth actual utility data. (Exh. 30 (Robinson) at 26; Exh. 43 (Majoros) at 33.) They selected the same Iowa curves for 6 of the 17 plant accounts. For 10 of the remaining 11 plant accounts, Mr. Majoros's selected Iowa curves are within 3 years of the ones Mr. Robinson chose. The most substantial difference between their selected curves is Account 366 (Underground Conduit). (HER at 74, citing Staff PHB at 67.) The Company criticized Mr. Majoros for choosing the Iowa curve that resulted in the longest remaining lives for the plant assets (for one account, describing it as "the single worst number that anyone else in the industry has," *see* Tr. at 580-81). However, the Iowa curves selected by the Company generally result in shorter service lives, which result in higher depreciation rates and higher cash flow requirements. (Staff PHB at 66.)

182. Mr. Majoros testified that based upon his observations of the data and the Company's discovery responses, he selected the best fitting Iowa curves for the particular accounts. (Tr. at 578.) He testified that Delmarva's study did not show its analysis of Account 366 (where the largest difference is),[11] and that his own study supported a much longer life than 50 years. (Exh. 43 (Majoros) at

[11]The Hearing Examiner appears to have misspoken here. Staff did not say that the Company's study omitted Account 366; rather, Staff observed that it contained no observed life analysis for this account – which the Hearing Examiner does later acknowledge. (Staff PHB at 67, citing Exh. 30 (Robinson)

Exh. __ (MJM-4), p. 3: tr. at 579-80.) Because Mr. Robinson's study did not contain an observed life table for Account 366, Staff noted that it was unclear how Mr. Robinson derived his estimated 50-year service life for the assets in this account. (Staff PHB at 67.)

183. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that Staff's proposed service lives and resulting plant depreciation rates be accepted. He noted that both witnesses' proposed rates reduced the current level of plant depreciation rates, but that Staff's proposed rates resulted in a greater decrease than the Company's. (HER at 73.) He agreed that in general, the Iowa curve that best fits the data (which presumably includes historical additions, retirements, etc.) should be selected for the property group being analyzed. Otherwise, the Hearing Examiner concluded, if the selection of the "best" remaining life is left solely to the professional's judgment, Iowa curves would be unnecessary. (HER at 75.) The Hearing Examiner observed that Mr. Robinson had used his judgment to select some other curve that was not the best fit statistically, and that Mr. Majoros had selected the best-fit curve for the accounts where he disagreed with Mr. Robinson. The Hearing Examiner concluded that "[w]ithout stronger evidence as to why the best fitting curve is inappropriate, the best fit should be used." (HER at 75.)

184. **Exceptions.** Both the Company and DEC excepted to the Hearing Examiner's findings and recommendations. DEC asserted that the Hearing Examiner's reasons for adopting Staff's recommended lives

---

at Depreciation Study Section 5; Exh. 31 (Robinson-R) (not addressed in were not valid and were not supported by the record. It argued that the Hearing Examiner "effectively fault[ed] Delmarva's depreciation witness for exercising judgment in not selecting the computer's best fitting life …" and claims that doing so conflicts with "the purpose of depreciation accounting, with the purpose of a depreciation study and with how authoritative sources indicate how a depreciation study should be conducted." (DEC Brief on Exceptions at 20.) DEC claimed that Staff's witness assumed that the future would be identical to the past, which was "the equivalent of trying to drive by looking only in the rearview mirror." (*Id*. at 20-21.) DEC cited to authorities on depreciation accounting that observed that the evaluation phase of a depreciation study is the most difficult element and that an analyst's judgment will determine the most reasonable estimate. (*Id*. at 21.) DEC next contended that whether Iowa curves would be necessary is irrelevant as to whether judgment is necessary to determine if past experience is a reasonable indication of the future. (*Id*. at 22.)

185. Delmarva argued that the Hearing Examiner recommended Staff's proposed depreciation rates even though Mr. Majoros was performing a type of depreciation study that he has rarely proposed in prior proceedings. (Delmarva Brief on Exceptions at 42, citing Tr. at 1262-63.) Delmarva contended that Mr. Majoros simply took the Company's data, "plugged it into a model, and read the output." (Delmarva Brief on Exceptions at 42.) Mr. Robinson, however, "described a more careful and analytic approach" in which he analyzed the input data and excluded "anomalous, extraneous, and meaningless

---

rebuttal)).

data points for various older age intervals" before he ran his computer program to obtain an adjusted Iowa curve fit. (*Id.*, citing Exh. 31 (Robinson-R) at 39.)

186. The Company next contended that "[t]he Hearing Examiner appeared to be troubled by a misleading and incorrect observation" that Staff made in its brief: that the Company's study contained no observed life table for Account 366 and therefore it was unclear how Mr. Robinson derived his recommended 50-year remaining life. (Delmarva Brief on Exceptions at 42-43.) The Company claimed that Mr. Robinson provided "a very clear and full explanation in his rebuttal testimony of what he did with respect to Account 366 and why he did it." (*Id.* at 43, citing Exh. 31 (Robinson-R) at 38.) Mr. Majoros, however, "merely plugged in the data with one control…" - that being that in no instance would his model generate a longer useful life than the longest life currently being used somewhere in the country by some other utility. (Delmarva Brief on Exceptions at 43.) This resulted in Mr. Majoros selecting a 100-year remaining life for the assets in this account, which, the Company asserted, ""'tie[s]'" Delmarva "with the one utility in the country that has the single longest life for that particular account." (*Id.*).

187. Delmarva noted that Mr. Robinson agreed with the Hearing Examiner's conclusion that the best fit Iowa curve should generally be used; however, the Hearing Examiner incorrectly assumed that Staff had some record support for its claim that the differences between the parties' recommended curves was that Mr. Robinson used some curve other than the best fit. (*Id.* at 44). The Company claims that no

such record support exists. According to the Company, Mr. Robinson "carefully reviewed the input data and excluded anomalous, extraneous, and meaningless data points for various older age intervals" before he ran his computer model and selected the appropriate Iowa curve. Therefore, for some of the accounts a different data set was used, which explains the different "best fit" curves for those accounts. (*Id*.).

188. **Discussion and Decision.** We adopt the findings and recommendations of the Hearing Examiner. We believe that this issue presented a "battle of the experts," and thus was an area in which the credibility of the experts was important to the Hearing Examiner's assessment. The Hearing Examiner, who was present during the hearings, was able to assess the witnesses' demeanor on the stand as they testified and therefore made a decision as to which witness he believed was more credible. We did not see the witnesses testify and therefore should be loath to disturb the Hearing Examiner's assessment. (Unanimous.) The approved depreciation rates are attached hereto as Exhibit "A".

IX. RATE OF RETURN ISSUES.

189. As Staff witness Parcell observed, exact procedures for precisely determining the cost of equity (which must be estimated because it is an opportunity cost and is therefore prospective) have not been developed. (Exh. 22 (Parcell) at 7.) Several models exist for estimating the cost of equity, such as the Discounted Cash Flow method, the Comparable Earnings ("CE") method, the Capital Asset Pricing Method ("CAPM"), and the Risk Premium ("RP") method.

190. Because Delmarva's stock is not publicly traded, it is necessary to analyze groups of proxy companies as a substitute for Delmarva to determine its cost of equity. (*Id*. at 20.)

A. Summary Of Positions.

1. The Company.

191. The Company proposed an 11% equity cost rate. (Exh. 17 (Morin) at 54.) To derive his recommended equity cost, Dr. Morin compiled a proxy group of 20 electric companies located throughout the United States.[12] (*Id*. at Ex. RAM-2 p. 1.) He used several different CAPM and RP approaches and a DCF approach to calculate Delmarva's equity cost, and adjusted each result upward by 30 basis points to capture flotation costs. (*Id*. at 14.)

192. **DCF**. Although he criticized the DCF model as unreliable for estimating Delmarva's equity cost (*Id*. at 15-21), Dr. Morin performed a DCF analysis on two proxy groups: investment-grade dividend-paying electric utilities and investment-grade widely-traded dividend-paying natural gas distribution utilities. (*Id*. at 39.) For the dividend yield, he used the current yields reported in the latest edition of Value Line Investment Analyzer ("VLIA") software and obtained a dividend yield of 4.1% for both groups. (*Id*. at Ex. RAM-6.) For his growth rate, Dr. Morin used only forecasts from Value Line, Zacks, and analysts. He did not use historical growth indicators because he

[12] Amaren Corp.; American Electric Power; CenterPoint Energy; CH Energy Group; Consolidated Edison; Constellation Energy; Duquesne Light Holdings; Energy East Corp.; Exelon Corp.; FirstEnergy Corp.; Northeast Utilities; NSTAR; Pepco Holdings (Delmarva's parent); PPL Corp.; Public Service Enterprises; SCACA Corp.; Sempra Energy; TXU Corp.; Vectren Corp.; and Wisconsin Energy.

believes that historical growth patterns are already incorporated into analysts' forecasts. (*Id*. at 41.) After removing some proxy companies because of their negative long-term growth projections, he derived growth rate forecasts of 5.1% (Value Line) and 5.9% (analysts' consensus). Combining these growth rates with his 4.1% dividend yield resulted in a cost of equity for his electric proxy group ranging from 9.2%-9.8%. (*Id*. at 45.) For his natural gas distribution proxy group, Dr. Morin derived earnings growth rates of 4.9% from Zacks and 5.8% from Value Line, which, when added to his 4.1% dividend yield, resulted in a cost of equity ranging from 9%-9.9%. (*Id*. at 46). Adding his flotation cost adjustment, Dr. Morin's DCF-derived cost of equity for his proxy groups ranged from 9.2%-10.1%. (*Id*. at 45-46.)

193. **CAPM.** Dr. Morin testified that the fundamental idea underlying the CAPM is that risk-averse investors demand higher returns for assuming additional risk; therefore, higher-risk securities are priced to yield higher returns than lower-risk securities. (*Id*. at 22.) Three inputs are needed to calculate a CAPM cost of equity: a risk-free rate, beta, and a market risk premium. (*Id.*).

194. *Risk-Free Rate.* Dr. Morin used the actual and forecasted yields on 30-year Treasury bonds because the expected return on equity is based on long-term cash flows, regardless of the holding time period. He testified that this is appropriate because stock is a long-term investment and cash flows to investors in the form of dividends last indefinitely. Furthermore, utility assets generally have long-term useful lives and should be matched with long-term maturity financing instruments. (*Id*. at 23-24.) The yield on 30-year Treasury bonds as of

August 2005 was 4.5%, but Dr. Morin claimed that this yield may not fully reflect the level of long-term bond yields in the near term because long-term yields are projected to increase sharply in response to economic recovery, high federal deficits and Federal Reserve Board policies. (*Id*. at 25.) He observed that the consensus forecasted yield on 10-year Treasury bonds in August 2006 was 4.9%, and since long-term interest rates generally move together, increases or decreases in the 10-year yields would likely be accompanied by corresponding increases or decreases in the 30-year yield. (*Id*.). In light of the current 30-year 4.5% yield, the implied forecast for such bonds was a 60-basis-point increase to 5.1%. (*Id*.).

195. *Beta.* Dr. Morin testified that a "major element" of modern financial theory as reflected in the CAPM is that perfect diversification can eliminate company-specific risk, leaving only market risk. Beta measures the dispersion of a stock's return that diversification cannot reduce. (*Id*. at 26.)

196. Delmarva is not publicly traded and does not have a beta. Thus, Dr. Morin examined the betas of Delmarva's parent PHI, a sample of publicly-traded electric distribution utilities, and a sample of publicly-traded natural gas distribution utilities obtained from the VLIA software. He considered only companies whose market capitalization exceeded $500 million to minimize the "well known thin trading bias in measuring beta." (*Id*. at 26-27.) PHI's beta was 0.90 and the average betas for his electric and natural gas utility samples were 0.82 and 0.78, respectively. Based on those results, but placing less weight on PHI's beta, he selected 0.82 for Delmarva. (*Id*. at 27.)

197. *Market Risk Premium.* Dr. Morin's 7.8% market risk premium was derived from historical and forward-looking studies of long-term risk premiums. The Ibbotson 2004 Yearbook results from 1996-2003 showed that a broad sample of common stocks outperformed long-term Treasury bonds by 6.6%. The historical market risk premium over the income component of long-term Treasury bonds (rather than over total return) was 7.2%.[13] He calculated his 8.3% market risk premium by applying a DCF analysis to the aggregate equity market as of August 2005 (using the Value Line aggregate stock market index and growth forecasts).[14] He obtained his 7.8% market risk premium by averaging his 7.2% and 8.3% results. (*Id*. at 28.) Inserting his risk-free rates (4.5% and 5.1%), the 0.82 beta and his market risk premium of 7.8% yielded a CAPM-derived cost of equity for Delmarva ranging between 10.9%-11.5% (11.2-11.8% with a flotation cost adjustment). (*Id*. at 31.)

198. **Empirical CAPM ("ECAPM").** Dr. Morin also performed an "ECAPM" analysis to account for what he called the "well-established" fact that the traditional CAPM produces reduced equity costs for companies whose beta is less than 1. (*Id*. at 32.) According to Dr. Morin, "expanded" CAPMs "relax some of the more restrictive

[13]According to Dr. Morin, Ibbotson recommends using the income return component rather than the total return component because the income component (coupon rate) is a better estimate of expected return than the total return (coupon rate plus capital gain); this is because, he claims, investors do not anticipate capital gains or losses on long-term bonds. (*Id*. at 27-28.)

[14] Dr. Morin calculated this market risk premium by applying a DCF analysis to the S&P 500 using VLIA software. The dividend yield on the aggregate market was 2%, and projected long-term dividend growth was 10.8%, for a 12.8% expected return. Converting the dividend yield to the expected dividend yield increased the estimate to 13%, and recognizing quarterly dividends increased the return to 13.2%. (*Id*. at 29.)

assumptions responsible for this bias" and produce a risk-return relationship that is "flatter" than the traditional CAPM prediction, consistent with literature finding that investors require higher returns for low-beta stocks and lower returns for high beta assets than the traditional CAPM would predict. (*Id.*). Using 4.5% and 5.1% as his risk-free rates, Dr. Morin derived an ECAPM cost of equity ranging from 11.5%-12.1%. (*Id.* at 33.)

199. **RP Study - Historical Risk Premium Estimate***.* As a proxy for Delmarva's risk premium, Dr. Morin estimated historical risk premiums for the electric utility industry with annual time series applied to the industry as a whole, using *Moody's Electric Utility Index* as the industry proxy. (*Id.* at 33.) He estimated the risk premium by computing the actual return on equity for the Moody's *Index* for each year using the *Index's* actual stock prices and dividends, and subtracting the long-term government bond return for that year. The average risk premium was 5.6%. The implied returns on equity for the average electric utility using this method were 10.1% if 4.5% is used as the long-term bond yield (10.4% with flotation costs) and 10.7% if 5.1% is used as the long-term bond yield (11% with flotation costs). (*Id.* at 34.). For the natural gas proxy group, the average risk premium was 5.7%; thus, the resulting returns on equity using the 4.5% and 5.1% bond yields were 10.2% and 10.8% respectively (10.5% and 11.1% with flotation costs). (*Id.* at 34-35.)

200. **RP Study - Allowed Risk Premium.** Dr. Morin next examined the historical risk premiums implied in the authorized equity returns for electric distribution utilities over the last decade relative to the

contemporaneous level of the long-term Treasury bond yield for the 1996-2005 time period. The average equity return spread over long-term bond yields was 5.5%. (*Id*. at 35.) Dr. Morin testified the risk premium narrowed as interest rates rose and widened as interest rates fell, and that this relationship was statistically significant. (*Id*. at 36.) His resulting equity cost estimates ranged between 10.7% and 10.9% (11% and 11.2% with flotation costs). (*Id*. at 37.)

201. **Flotation Costs.** Dr. Morin added 30 basis points to all of his market-based equity cost estimates even though Delmarva, as a wholly-owned subsidiary of PHI, does not issue its own stock. He testified that issuance costs are incurred but are not expensed at the time of issuance, and so must be recovered through an equity return adjustment. He noted that such costs are routinely recovered for bonds and preferred stock through an annual amortization charge embedded in the cost of service. In his view, a flotation cost adjustment was permanently required to avoid confiscation even if no further issuances were planned. (*Id*. at 49-52.)

202. **Delmarva Summary.** Dr. Morin's equity cost models resulted in estimated equity costs ranging from 9.2%-12.1%, with overall results in the 10.7%-10.8% range. Placing less weight on his DCF results increased the cost of equity to closer to 11%. Thus, he recommended that the Commission authorize a return on equity of 11% for Delmarva. (*Id*. at 53-54.)

203. Dr. Morin emphasized that it was important for the Commission to approve an appropriate equity return because low authorized returns can increase future capital costs. If an allowed equity return is less

than investors require, it will be hard for the utility to access the equity market through issuances at the stock's current market price; the stock price will decline, thus decreasing the net proceeds from stock issuances, and the potential dilution risks will reduce investors' inclination to purchase new stock. Ultimately, the utility will rely on more debt financing, which results in more leverage, which could result in decreased earnings for dividends and a greater default risk. (*Id*. at 54-55.)

B. Staff.

204. Staff witness Parcell recommended a return on equity between 9.5%-10.5%. (Exh. 22 (Parcell) at 3 and Sch. 13.) He examined two proxy groups: Dr. Morin's electric group and a group of electric companies with operating and risk characteristics similar to PHI. (*Id*. at 3-4.)[15]

205. **DCF.** Mr. Parcell testified that the DCF model is based on the "dividend discount model" of financial theory, which provides that the value (price) of any security is the discounted present value of all future cash flows. (*Id*. at 21.) He used the constant growth variation of the DCF model and combined the current dividend yield for each of his proxy groups with several indicators of expected growth. (*Id*. at 22.) He recognized the timing of dividend payments and increases by making a quarterly compounding adjustment to the dividend yield component. For

[15]This group (Alliant Energy, Idacorp, NSTAR, SCANA, Wisconsin Energy and Xcel Energy) met the following criteria: $1-8 billion market capitalization; electric revenues of 40% or greater; common equity ratio of 35% or greater; Value Line safety ranking of 1, 2 or 3; S&P/Moody's A bond ratings; and S&P stock ranking of B or B+. (Exh. 22 (Parcell) at 20 and Sch. 6.)

his price component he used the average of the high and low stock price for each company for the period August-October 2005. (*Id.*). This resulted in an average adjusted yield of 3.9% for his electric proxy group and 3.7% for the Morin electric proxy group. (*Id.* at Sch. 7 p. 4.)

206. Mr. Parcell then turned to the growth rate, which he called "the [DCF's] most crucial and controversial element." (*Id.* at 23.) He testified that the objective of estimating this component is to reflect the growth expected by investors that is embodied in the price (and yield) of a company's stock. Since not all investors have the same expectations, it is important to consider alternative indicators in deriving their expectations. He examined five different indicators in his analysis:

- 2000-04 (5-year average) earnings retention (fundamental growth);
- 2000-04 (5-year average) of historic growth in earnings per share ("EPS"), dividends per share ("DPS") and book value per share ("BVPS");
- 2005-09 projections of earnings retention growth;
- 2003-09 projections of EPS, DPS and BVPS; and
- 5-year projections of EPS growth as reported in First Call.

(*Id.*). The average growth rates derived from this analysis were 3.3% for his electric proxy group and 4.7% for the Morin proxy group. (*Id.* at Sch. 7, p. 4.) The resulting equity cost for the electric proxy companies ranged from 2.5-8.5%, with an average of 7.2% and median of 7.3%. For the Morin proxy companies, the resulting equity cost ranged from 5.2-9.6%, with an average and median of 8.4%. (*Id.* at 24 and

Sch. 7, p. 4.) Based upon his analyses, Mr. Parcell concluded that 8.5%-9.5% represented the DCF-calculated cost of equity for Delmarva.

207. **CAPM.** Mr. Parcell performed a CAPM[16] analysis for the same groups of companies in his DCF analysis. For the risk-free rate,[17] he used the three-month average yield from August-October 2005 for 20-year U.S. Treasury bonds, or 4.59%. (*Id*. at 26.) He used the most current Value Line betas for each of his proxy group companies, which ranged from 0.60-1.20. (*Id*. and Sch. 9.)

208. Finally, Mr. Parcell estimated the market return component of the CAPM, which represents the expected return from holding the entire market portfolio. Technically, this reflects the return from holding the weighted combination of all assets (stocks, bonds, real estate, etc.); however, in utility rate proceedings, the traditional CAPM analysis focuses on the market return as the return on common stocks. Like the DCF's growth component, Mr. Parcell testified that investors do not universally share the same expectations of the overall market return; thus, there are alternative methods for estimating this component. (*Id*. at 26.)

[16]Mr. Parcell testified that the CAPM, a variant of the RP method, describes and measures the relationship between a security's investment risk and its market rate of return. In his view, the CAPM is generally superior to the RP method because, unlike RP, the CAPM specifically recognizes the risk of a particular company or industry. (Exh.22 (Parcell) at 25.)

[17]Mr. Parcell testified that in reality, there is no such thing as a riskless asset; however, in CAPM analyses, the risk-free rate is generally recognized by the use of U.S. Treasury securities, which are default-free owing to the government's ability to print money and/or raise taxes to pay its debts. (Exh. 22 (Parcell) at 26.)

209. Mr. Parcell performed two measures of return for the S&P 500 Composite. First, he evaluated various averages of the equity return for this group from 1978-2004 (all available years reported by S&P). The average return over this period was 14.02%; thus, Mr. Parcell concluded that the expected equity return for this group was approximately 14%. (*Id*. at 26- 27.) Second, he considered the total return for this group, as tabulated by Ibbotson Associates, using both arithmetic and geometric means. Combining the total returns for the entire 1926-2004 period, he derived a 12.4% arithmetic mean return and a 10.4% geometric mean return. Based on this, he concluded that the expected total return for the S&P 500 was 11.4%. He then averaged the results of the equity return (14%) and total return (11.4%) to derive a 12.7% market return component. (*Id*. at 27.)

210. Mr. Parcell's mean and median CAPM-derived equity costs were 11.1% for his electric proxy group and 11.3% and 11.1% respectively for the Morin proxy group. (*Id*. and Sch. 9.) Thus, his CAPM results collectively indicated an 11% equity cost for the proxy groups. (*Id*. at 27.)

211. **CE**. Finally, Mr. Parcell also applied a CE method to estimate the Company's cost of equity. He testified that the CE method was derived from the "corresponding risk" standard of the *Bluefield Water Works* and *Hope Natural Gas* Supreme Court cases, and was based upon the opportunity cost concept. (*Id*. at 28.) According to Mr. Parcell, the CE method is intended to measure the expected returns on the original cost book value of similar risk enterprises. He testified that it provides a direct measure of the fair return because it translates

the competitive principle upon which regulation rests into practice. It normally examines the experienced and/or projected returns on book common equity; this follows from the use of original cost rate base regulation for public utilities, which uses a utility's book common equity to determine the cost of capital. This cost of capital is then used as the fair rate of return applied to the book value of rate base to establish the dollar level of capital costs to be recovered. Thus, this method is consistent with the rate base methodology used to set utility rates. He noted that the CE analysis he employed is based upon market data (through use of market-to-book ratios), and is essentially a forward-looking market test. Consequently, he testified, his CE analysis is not subject to the criticisms made about the CE analysis that past earned returns do not represent the current cost of capital. (*Id*. at 28-29.)

212. Mr. Parcell considered the experienced equity returns of two comparison groups from 1992-2004 and for the future periods 2005-09. (*Id*.). He testified that a relatively long period of time is required for the analysis to determine trends in earnings over at least a full business cycle and to avoid any undue influence of unusual or abnormal conditions that may occur in a single year or shorter period. (*Id*. at 29.) His analysis demonstrated that historic returns on equity between 10.3%-12.5% have produced market-to-book ratios of 138%-165%. (*Id*. at 30 and Sch. 10.) Additionally, projected returns on equity for 2005, 2006 and 2008-10 range from 9.7%-12.7% for the proxy groups, which relate to market to book ratios of 143% and higher. (*Id*. at 30.) Next, Mr. Parcell also examined the S&P 500 Composite group, which is

comprised of “largely unregulated” firms. He observed that over the periods studied the S&P 500's earned returns ranged from 12.3%-14.7% and its market-to-book ratios ranged from 334%-341%. (*Id*. and Sch. 11.)

213. Mr. Parcell testified that the recent earnings of utilities and the S&P 500 can be used to indicate the level of return expected and achieved in the regulated and competitive sectors of the economy. To apply these returns to the cost of equity for electric companies, however, it is necessary to compare the risk levels of the electric utility industry with those of the competitive sector. Mr. Parcell's comparison demonstrated that the S&P 500 group is riskier than the utility comparison groups. (*Id*. at 30 and Sch. 12.)

214. From this analysis, Mr. Parcell concluded that the Company’s cost of equity is no greater than 10.5%. Given the recent returns and resulting market-to-book ratios, he testified that a return on equity of 10.5% should result in a market to book ratio of at least 100%. (*Id*. at 31.)

215. **Flotation Costs.** Mr. Parcell rejected the Company’s adjustment. He testified that a utility should only be allowed to recover its actual and quantifiable flotation costs, and Delmarva had not demonstrated that it had incurred any. Furthermore, this adjustment, based on companies whose market-to-book ratios already well exceed 100%, was unnecessary, since any common stock issuance would actually increase the book value of existing stockholders’ shares. (*Id.* at 40.)

216. **Staff Summary.** Mr. Parcell's three analyses indicated a cost of equity ranging from 8.5%-11% for the electric utility industry. (*Id*.

at 32.) In determining his recommended cost of equity for Delmarva, Mr. Parcell testified that he focused on the higher end of his equity cost results, which already reflect the upper range of fair returns, and that Delmarva was viewed as average risk relative to the proxy companies. Based on his equity cost results and those factors, Mr. Parcell testified that Delmarva's fair cost of common equity was in the 9%-11% range, and so recommended a range of 9.5%-10.5% for Delmarva. He observed that this recommendation resulted in pre-tax interest coverage of 4.54x, well above the benchmark range for an A-rated utility. Furthermore, he observed, the Company's debt ratio was substantially less than that acceptable for an A-rated utility. (*Id*. at 33 and Sch. 14.)[18]

C. <u>DEUG.</u>

217. DEUG witness Gorman performed a constant growth DCF analysis, a CAPM analysis and a bond yield plus equity RP analysis to derive his recommended return on equity of 9.8%. (Exh. 16 (Gorman) at 2, 6.) For his DCF and RP analyses, Mr. Gorman used a proxy group of electric companies meeting the following criteria: (1) investment bond rating of "A" and "BBB" from Standard & Poor's and "A" and "Baa" from Moody's; (2) business risk profile no higher than 6; (3) common equity ratio of 40% from C.A. Turner and Value Line; (4) no suspension of dividends for the

[18]S&P's utility credit ratings are based on its assessment of the utilities' financial and business risks. The overall total credit risk exposure depends on a combination of those risks. S&P publishes a matrix of financial ratios that defines the level of financial risk as a function of the level of business risk. Business risk is based on a business profile score from 1 (lowest) to 10 (highest), and S&P uses three primary financial ratios in reviewing creditworthiness: (1) funds from operations to debt interest expense; (2) funds from operations to total debt; and (3) total debt to total capital. (Exh. 16 (Gorman) at 19-20.)

last two years; (5) growth rate estimates available from Zacks, Reuters and Thomson Financial (First Call); and (6) no recent merger and acquisition activities. (*Id*. at 6.)[19]

218. **DCF.** For his stock price, Mr. Gorman relied on the average of the weekly high and low stock prices over a 13-week period ending November 28, 2005. According to Mr. Gorman, a 13-week average contained data that reasonably reflected current market expectations but was not so short as to be susceptible to market price variations that may not represent the stock's true long-term value. (*Id*. at 8 and Ex. MPG-4.) He also used the most recently paid quarterly dividend as reported in Value Line Investment Survey, annualized and adjusted for next year's growth. (*Id*. at 8.)

219. Mr. Gorman testified that to determine the market required equity cost, one must attempt to estimate what the consensus of investors believe the dividend or earnings growth rate will be, not what an individual investor or analyst may use for individual investment decisions. He testified that analysts' growth estimates more accurately predicted future returns than historical growth rate information. Thus, he relied on a consensus of professional analysts' earnings growth estimates from Zacks, Reuters, and Thomson Financial (First Call) available on-line as of November 30, 2005. Each consensus growth rate was based on a survey of analysts, and was an arithmetic average of

[19] The companies in Mr. Gorman's proxy group are Alliant Energy; Ameren Corp.; Cleco Corp.; Consolidated Edison; Empire District; Energy East Corp.; Entergy Corp.; FirstEnergy Corp.; IDACORP, Inc.; NiSource Inc.; OGE Energy; Pinnacle West Capital; Progress Energy; SCANA Corp.; Southern Co.; Vectren Corp.; Wisconsin Energy; and Xcel Energy, Inc. (Exh. 16 (Gorman) at Ex. MPG-2.)

those analysts’ earnings growth forecasts (that is, the analysts’ forecasts are weighted equally). He then averaged the three sources of his growth estimates to derive an average growth rate of 4.57%. (*Id*. at 8-9 and Ex. MPG-3.)

220. Mr. Gorman testified that several factors rendered his growth rate result “conservatively high.” First, the consensus growth rates were “reasonably consistent” with 5-year projected GDP growth of 5.5% and “considerably higher” than the 5-year projected 2.5% GDP inflation growth rate. (*Id*. at 10.) He observed that utilities’ dividend growth rates could not sustain a growth rate exceeding that of the overall economy. He explained that the utility’s service territory growth rate was the proxy for the sustainable long-term earnings growth rate: utilities invest in plant to meet sales growth, and sales growth was tied to economic activity. Thus, nominal GDP growth is a proxy for the highest sustainable long-term utility growth rate. Utilities’ growth, however, has historically been tied to the inflation growth rate. Utilities typically pay out a high percentage of earnings as dividends, which limits earnings reinvestment and thus the growth to their business platforms. The growth rate Mr. Gorman used in his DCF analysis was much higher than expected inflation rates, and approached the maximum sustainable growth estimate as indicated by the proxy GDP growth factor. (*Id*.) This, he claimed, indicated a “very strong and relatively high growth rate” used in his DCF analysis compared to actual historical growth. (*Id*. at 10-11.)

221. Mr. Gorman further testified that his projected 4.57% growth rate was considerably higher than the proxy group’s actual historical

growth rate over the last 5-10 years and the group's projected growth rate over the next 3-5 years. (*Id*. at 11.) He testified that a growth rate that exceeds projected inflation growth and approaches the expected nominal GDP growth illustrated the conservative nature of his projection and therefore results in higher DCF results. (*Id.*).

222. Mr. Gorman's DCF analysis resulted in an average equity cost of 8.9% for his proxy group. (*Id*. and Ex. MPG-4.) He testified that these results reflected today's "very low cost capital market," as well as rational investment financial metrics, and therefore are reasonable. (*Id*. at 10.) He noted that the proxy group's 4.38% yield exceeded the current 5-year Treasury bond rate of 4% and was lower than the projected 5-year Treasury note yield of 4.9%; thus, it reflected both current and projected interest rates. As for financial metrics and dividend expectations, he observed that the dividend fundamentals of his proxy companies showed "strong and consistent earnings strength to support dividend payments," which indicated that current and projected earnings support dividends and permit continued predictable growth in dividends. (*Id*.).[20]

223. **RP.** Mr. Gorman's RP model rested on the principle that equity is riskier than bonds because bonds have more security of payment in bankruptcy and the coupon payments represent contractual obligations.

[20]Mr. Gorman pointed to his proxy group's 72% dividend payout ratio and 6.9% dividend to book ratio as an example. Traditionally, utilities pay out approximately 70% of their earnings as dividends; Value Line's projected dividend to book and payout ratios are 6.5% and 66%. A 6.5% dividend to book ratio means that companies must earn 6.5% on their book value to produce earnings to pay dividends and indicates that such dividend payouts are affordable in today's capital cost environment. With authorized returns declining due to large reductions in capital costs, he testified that such

In contrast, companies are not required to pay dividends on common equity, nor are they required to guarantee returns on equity investments. Thus, investors require a higher equity return to assume greater risk. (*Id*.).

224. Mr. Gorman's RP model was based on two equity RP estimates. First, he estimated the difference between Commission-authorized equity returns and Treasury bonds on an annual basis for each year from 1986-June 2005. (*Id*. at 12-13.) The average indicated equity RP of allowed electric utility equity returns over Treasury bond yields from this analysis was 4.99%. Fourteen of the 20 observations fell within the 4.4%-5.7% range. (*Id*. at 13 and Ex. MPG-7.) Since market conditions and changing investor risk perceptions can cause the RP to vary, Mr. Gorman testified that using an estimated range of RPs is the best way to measure the current equity return using this method. (*Id*.).

225. Mr. Gorman's second RP model was based on the difference between Commission-authorized equity returns and contemporary A-rated utility bond yields between 1986-June 2005. He testified that he selected this time period because utility stocks have consistently traded at a premium to book value; thus, authorized returns were sufficient to support market prices that at least exceed book value. This analysis indicated that authorized equity returns support a utility's ability to issue additional common stock without diluting the value of existing shares, and thus utilities were able to access capital markets without adversely affecting current shareholders. (*Id*). The average indicated equity RP of authorized electric utility returns over contemporary Moody's utility bond yields is 3.6%. After removing the three

---

dividends will be supported by today's lower authorized returns. (Exh. 16 (Gorman) at 12.)

highest and lowest RP estimates, the spread ranges from 3%-4.6%. (*Id*. at 13-14 and Ex. MPG-8.)

226. To estimate Delmarva's equity cost using his RP models, Mr. Gorman first added a projected long-term Treasury bond yield to his estimated equity RP. Using the 5.3% long-term bond yield and an equity RP of 4.4%-5.7%, he derived an estimated equity cost of 9.7%-11%, with a midpoint of 10.4%. Next, he added his equity RP over utility bond yields to the 13-week average of the current yield on "A"-rated utility bonds for the period ending November 25, 2005 (5.71%). Using the 5.71% current yield and an equity RP of 3%-4.6%, he derived an equity cost rate of 8.7%-10.3%, with a midpoint of 9.5%. (*Id*. at 14 and Ex. MPG-9.) Mr. Gorman's RP studies produced equity cost estimates ranging from 9.5%-10.4%, with a midpoint of 10%. (*Id*. at 14.)

227. **CAPM.** For his risk-free rate, Mr. Gorman used Blue Chip Financial Forecasts' projected 20-year Treasury bond yield of 5.3%. (He noted that the current yield on 20-year Treasury bonds was 4.51%.) (*Id*. at 16.) For his beta, he relied on the proxy group average beta of 0.79, derived from Value Line's published betas. (*Id*. at 16-17 and Ex. MPG-10.) Finally, he derived two market premium estimates. He obtained the first, a forward-looking estimate, by adding an expected inflation rate (2.4% from Blue Chip Financial Forecasts) to the long-term arithmetic historical average real return on the market (9.2% for the 1926-2004 period from Ibbotson's 2005 Yearbook). The resulting market premium was 6.5% (the difference between the 11.8% expected market return and his risk-free rate of 5.3%). (*Id*. at 17).

228. For his second estimate (a historical market RP), Mr. Gorman

again used Ibbotson's 2005 Yearbook. Over the 1926-2002 period, Ibbotson's study estimated the arithmetic average of the achieved total return on the S&P 500 at 12.4%. The total return on long-term Treasury bonds was 5.8%, resulting in an equity risk premium of 6.6%. (*Id*. at 18.) Mr. Gorman's CAPM studies resulted in an estimated equity cost of 10.5%. (*Id*. at 18 and Ex. MPG-11.)

229. **Flotation Costs.** Mr. Gorman rejected Delmarva's flotation cost adjustment. He testified that they are a legitimate issuance cost, but actual costs should be used for the adjustment so the Commission, Staff, and other parties can audit those expenses for reasonableness and amount. Any adjustment, therefore, should only be based on known and measurable expenses. In this case, Delmarva's adjustment was not based on known and measurable expenses, but on a general study of market flotation costs that may not have any relationship to its actual issuance costs. Furthermore, while Delmarva receives its incremental equity capital from PHI, it is unclear whether that equity is being funded by public common stock issuances, debt issuances, or internally generated funds; hence, it is not known and measurable what, if any, flotation costs should be allocated to Delmarva and reflected in cost of service. (Id. at 35.)

230. **DEUG Summary.** Mr. Gorman testified that his recommended equity cost supported Delmarva's current investment grade bond rating and, as such, fairly compensated Delmarva for its investment risk and was sufficient to support the Company's financial integrity. (Id. at 19.) He testified that his recommended overall rate of return of 7.07% was sufficient to support Delmarva's current "A" bond rating. He

compared the key credit rating financial ratios for Delmarva at his proposed capital structure (same as Delmarva's) and return on equity to S&P's financial benchmark ratios for "A" and "BBB" rated utilities with a business profile score of 3, and calculated each of S&P's financial ratios based on Delmarva's cost of service for retail Delaware operations. Normally, Mr. Gorman testified, S&P would look at the total of Delmarva's and PHI's consolidated financial ratios, but the goal here is to assess the reasonableness of his proposed cost of capital for Delmarva's Delaware utility operations; therefore, he sought to ascertain whether the opportunity for cash flow generation inherent in his proposed rate of return and capital structure would support the Company's current grade bond rating and financial integrity. (Id. at 20.) His calculations show that based on a 9.8% return on equity:

- Delmarva will have an opportunity to produce a Funds from Operations to Debt Interest Expense of 6.6x (above the S&P benchmark for an A-rated utility with a business profile score of 3);

- Delmarva's total debt ratio to total capital is 51% (within S&P's "A"-rated utility range of 50-55%); and

- Delmarva's retail operations Funds from Operations to total debt coverage will be 28% (above S&P's range of 25-15% for an "A"-rated utility).

(*Id*. at 21.) Thus, if the Commission adopted DEUG's proposed 9.8% return on equity and capital structure, S&P's financial metrics would support Delmarva's current investment grade bond rating.

D. The DPA.

231. The DPA recommended a return on equity of 9.2%, based on a 75% weighting of DCF results and a 25% weighting of CAPM results. (Exh. 77 (Crane) at 18.)

232. **DCF.** DPA witness Crane used the same proxy group as Dr. Morin, although she generally did not eliminate any of the companies from any of her analyses as Dr. Morin did. (*Id.* at 11.) She calculated two dividend yields: one using the average of the stock prices over the last 12 months (3.77%) and one using the spot price as of November 23, 2005 (3.75%). (*Id.* at 11 and Sch. ACC-5.) She also examined the average dividend yields reported in the November 2005 C.A. Turner Utility Reports (4.3% for electric companies; 3.8% for combination electric and gas companies). (*Id.* at 11.) Noting that Dr. Morin's recommended dividend yields were 3.9% and 3.7% depending upon the companies that he included, Ms. Crane recommended a 3.9% dividend yield, which she increased by ½ of her recommended growth rate to reflect that the DCF is prospective. (*Id.* at 12.)

233. To derive her recommended growth rate, Ms. Crane examined several factors: 5- and 10-year historic earnings growth; 5- and 10-year historic growth in dividends; 5- and 10-year historic growth in book value; Value Line earnings projections (with and without TXU Corp.); and analysts' earnings projections (with and without TXU Corp.). (*Id.* at 12-13.) She noted that projected earnings growth rates were significantly higher than historic growth rates, which she attributed to the inclusion of extraordinary growth rates projected for TXU Corp. (31% by Value Line; 13.6% by the analysts' forecasts). (Id. at 13.)[21]

[21]Ms. Crane observed that even Dr. Morin called the TXU projected growth rate "unsustainable." (Exh. 77 (Crane) at 13.)

Reviewing all the growth rates, Ms. Crane recommended using 5% for the proxy group. She noted that her recommended growth rate exceeded actual growth rates in earnings, dividends, and book value per share over the last 5 and 10 years, and was higher than the proxy group's projected growth rates (excluding TXU Corp.).[22] Ms. Crane's DCF analysis resulted in an estimated 9% cost of equity for the proxy companies. (*Id*. at 14-15.)

234. **CAPM.** Ms. Crane used a risk-free rate of 4.78% (the yield on long-tern government bonds as of November 29, 2005). (*Id*. at 16 and Sch. ACC-7.) She used her proxy group's average beta (0.82). (*Id*. and Sch. ACC-8.) Because she used a long-term government bond as the risk-free rate, she testified that the appropriate risk premium was the historic risk premium of stocks over long-term government bonds. The geometric mean RP, as calculated in the Ibbotson 2005 Yearbook, was 6.15%. (*Id*. at 17.)[23] Using a 4.78% risk-free rate, a 0.82 beta, and a market RP of 6.15%, Ms. Crane derived a CAPM cost of equity of 9.82%. (*Id*. at 18.)

235. **Flotation Costs.** Ms. Crane did not discuss Dr. Morin's flotation cost adjustment other than to say it was "inappropriate." (*Id*. at 19.)

[22]Ms. Crane further testified that it was reasonable to examine historic as well as projected growth rates because "security analysts have been notoriously optimistic in forecasting" future earnings growth. (Exh. 77 (Crane) at 14-15.)

[23]Ms. Crane described the difference between the arithmetic and geometric mean, and testified that the geometric mean is more appropriate for use here because she is using it simply to develop an historic relationship, not to predict future results. (Exh. 77 (Crane) at 17-18.)

236. **DPA Summary.** Recognizing that the Commission has relied primarily on the DCF model for determining the cost of equity, Ms. Crane assigned her DCF results a 75% weight and her CAPM a 25% weight. This weighting results in a 9.2% equity cost for Delmarva. (*Id.* at 18-19.) She testified that her recommendation is substantially lower than Dr. Morin's because he largely ignores his own DCF results (which ranged from 9.2%-9.8% before adding flotation costs) and because he uses an excessive risk premium in his CAPM. (*Id*. at 19.)

E. Overall Rate of Return.

237. The Company's overall rate of return was 7.64% as follows:

	Capital Structure	Cost Rate	Weighted Return
Long-Term Debt	50.55%	4.57%	2.31%
Preferred Stock	1.73%	4.81%	0.08%
Common Equity	47.72%	11%	5.25%
Total	100%		7.64%

(Exh. 17 (Morin) at Ex. RAM-10.)

238. Staff's overall rate of return was 7.17% as follows:

	Capital Structure	Cost Rate	Weighted Return
Long-Term Debt	50.55%	4.57%	2.31%
Preferred Stock	1.73%	4.81%	0.08%
Common Equity	47.72%	9.5-10.5%	4.53-5.01%
Total	100%		6.93-7.40%(7.17%)

(Exh. 22 (Parcell) at 3.)

239. The DPA's overall rate of return was 6.79% as follows:

	Capital Structure	Cost Rate	Weighted Return
Long-Term Debt	50.55%	4.57%	2.31%
Preferred Stock	1.73%	4.81%	0.08%
Common Equity	47.72%	9.20%	4.39%
Total	100%		6.79%

(Exh. 77 (Crane) at 6, 20.)

240. DEUG’s overall rate of return was 7.07% as follows:

	Capital Structure	Cost Rate	Weighted Return
Long-Term Debt	50.55%	4.57%	2.31%
Preferred Stock	1.73%	4.81%	0.08%
Common Equity	47.72%	9.80%	4.68%
Total	100%		7.07%

(Exh. 16 (Gorman) at 2-3 and Ex. MPG-1.)

241. **The Hearing Examiner’s Findings and Recommendations. DCF.** The Company contended that the DCF understates the cost of equity when the market value of a utility’s stock greatly exceeds its book value, and overstates the cost of equity when the market value of a utility stock is substantially less than its book value. (Exh. 17 (Morin) at 47.) Dr. Morin stated that “[u]ncritical acceptance of the standard DCF equation vests the model with a degree of infallibility that is not necessarily present.” (*Id*. at 18.) He claimed that the financial literature warned against relying solely on the DCF to estimate a utility’s cost of equity (*Id*. at 18-19.) He asserted that the assumptions underlying the DCF are not always reasonable in “today’s changing utility industry.” (*Id*. at 19-20.)

242. Staff asserted that there were two main issues separating Delmarva’s proposed equity cost from that of the other parties that filed cost of capital testimony: that Dr. Morin essentially ignored his DCF results and that he adds 30 basis points to the results of his equity cost models for flotation costs. (Staff PHB at 28.) Staff asserted that Dr. Morin spent a great deal of his time urging the Commission to place little or no reliance on DCF-generated costs of

equity, although the Commission has heard and rejected these same arguments many times before. (*Id*. at 29.) Staff argued that the Commission has consistently adhered to its primary reliance on the DCF model to determine the appropriate cost of equity. (*Id*.). The DPA also argued that this Commission has primarily relied upon the DCF to establish a utility's cost of equity. (Exh. 77 (Crane) at 19.)

243. The Hearing Examiner agreed with Staff and the DPA, finding no reason to depart from the Commission's traditional primary adherence to the DCF model in this case, while recognizing that the Commission does consider the results from other equity cost models. (HER at 38.) As Staff noted, other commissions before whom Dr. Morin has made the same argument about the DCF have dismissed it and reaffirmed their primary reliance on the DCF for estimating a utility's cost of capital.[24] The Hearing Examiner observed that this Commission has heard the same arguments that the Company made here, but has consistently stated its preference for the DCF model as its primary equity cost model.[25] The Hearing Examiner understood the

---

[24]*See, e.g., Re Public Service Company of New Hampshire,* 242 PUR 4th 118 (N.H. PUC June 8, 2005), *motion for rehearing granted in part and denied in part,* 2005 WL 3691934, Order No. 24,552 (N.H. PUC Dec. 2, 2005); *In re Application of Nevada Power Company for Authority to Increase Its Annual Revenue Requirement for General Rates Charged to All Classes of Electric Customers and for Relief Properly Related Thereto*, 2004 WL 3409380 (Nev. PSC May 20, 2004), ¶¶208, 212; *cf. Re Sierra Pacific Power Company*, 218 PUR 4th 1 (Nev. PSC May 28, 2002), ¶148, *petitions for reconsideration and clarification granted in part and denied in part*, 2002 WL 1943602 (Nev. PSC July 29, 2002).

[25]*Re Artesian Water Company, Inc.,* 225 PUR 4th 81 (Del. PSC 2003) at ¶22; *In the Matter of the Application of Delmarva Power & Light Company for an Increase in Its Electric Base Rates and for Certain Revisions to Its Electric Service Rules and Regulations*, 1992 WL 465021, PSC Docket No. 91-20, Findings, Opinion and Order No. 3389 (Del. PSC March 31, 1992), at *50, ¶228; *In the Matter of the Application of Artesian Water Company, Inc. for an Increase in Water Rates*, 1991 WL 496943, PSC Docket No. 90-10, Findings, Order and Opinion

contention that the DCF tends to understate the cost of equity when capital costs are low; it is also true that the DCF tends to overstate the cost of equity when capital costs are high. Yet this Commission primarily relied upon the DCF to estimate equity costs for utilities when capital costs were high. (*Id*.).

244. Every rate of return expert witness in this case performed a DCF analysis, and their results were similar. Dr. Morin came in at 9.2% (without flotation costs); Mr. Parcell obtained results between 8.5%-9.5%; Mr. Gorman recommended 8.9%; and Ms. Crane derived a result of 9.0%. (HER at 38-39.) The Hearing Examiner agreed with Staff that the differences among the witnesses' DCF analyses did not affect the final results greatly (with the exception of the adjustment for flotation costs). The Hearing Examiner also noted that Company witness Morin expressed agreement with almost everything that Mr. Gorman did in his DCF analysis save the rejection of the flotation cost adjustment (Exh. 18 (Morin-R) at 43.) Indeed, removing Dr. Morin's flotation cost adjustment results in a DCF-derived cost of equity identical to Mr. Gorman's and 10 basis points lower than the DPA's recommended DCF-generated cost of equity. This suggested to the Hearing Examiner that the variances in the models that the witnesses used were not so great as to render any of their analyses unreliable. (*Id*. at 39.)

245. **CAPM***.* The Hearing Examiner agreed with Staff and DEUG that Dr. Morin's CAPM analysis overstated the Company's CAPM-generated cost of equity. First, as Staff pointed out, the Tennessee Regulatory

---

No. 3274 (Del. PSC May 28, 1991) at *27; *Re Wilmington Suburban Water Corp.*, 88 PUR4th 234, 238 (Del. PSC 1988).

Authority recognized the inconsistency in Dr. Morin's CAPM calculation in using a 30-year Treasury bond as the risk free rate for a market premium developed using 20-year bonds, and concluded that a 20-year bond rate should be used.[26] Delmarva asserted that the U.S. Treasury "has recently announced its intention to issue 30-year bonds" and that 30-year bond prices can be used as the risk free rate "[i]n the same way that we use stock prices in the application of the DCF model to a given company even though that company has not issued stock in the recent past." (Exh. 18 (Morin-R) at 74.) Nevertheless, the Hearing Examiner agreed with Staff (and the Tennessee Commission) that it was inconsistent to use a 30-year bond rate as a risk free rate (in conjunction with a risk premium based on 20-year bond rates) to determine the cost of equity for a company as expected by an investor, and found that the proper risk-free rate for use in the CAPM was 4.59% (the 20-year bond rate), not 5.1% (the 30-year bond rate as estimated by Dr. Morin based on the yield for 10-year bonds). (*Id*. at 39-40.)

246. The Hearing Examiner also agreed with Staff and DEUG that the total Treasury bond return, rather than the income Treasury bond return, should be used to estimate the market risk premium. (Exh. 22 (Parcell) at 36; Exh. 16 (Gorman) at 25.) He found that if the idea of estimating the cost of equity is to capture what investors expect, and the risks of changes in inflation and interest rates are included in Treasury bond investment valuations, then those risks (which result in capital gains or losses) *are* expected by investors, and it would be

[26] *Re Chattanooga Gas Company*, 236 PUR 4th 1 (Tenn. Reg. Auth. Oct. 20, 2004), *motion for reconsideration denied*, 2005 WL 3091723 (Tenn. Reg. Auth. Nov. 1, 2005).

inappropriate to ignore the real risk/return opportunities of investing in such bonds. (HER at 40.) With this change, the market risk premium is 6.6% rather than 7.2% or 8.3%. (*Id*.).

247. **ECAPM and RP.** The Hearing Examiner further agreed with Staff and DEUG that Dr. Morin's ECAPM and RP analyses overstated Delmarva's cost of equity. (HER at 40.) He noted that Dr. Morin's ECAPM essentially double-counted an upward adjustment for companies with a beta less than 1 because the Value Line betas already account for the tendency of betas lower than 1 to increase toward 1 over time (and vice versa). Staff further observed that the Tennessee Commission, in *Chattanooga Gas*, had rejected Dr. Morin's ECAPM because it inflated an already-inflated beta adjustment. (*Id*. at 40-41.)

248. For his historic RP, Dr. Morin examined the total returns (capital gains/losses plus interest) of 20-year Treasury bonds and total returns of either Moody's Electric Utility Stock Index or Natural Gas Distribution Index (capital gains/losses plus interest) over the period from 1931-2001. The Hearing Examiner credited the testimony of Staff witness Parcell, who contended that it was doubtful that investors would place equal weight on events in the 1950s and 1990s in making investment decisions, but by weighting each year equally, Dr. Morin assumes that investors do exactly that. (Exh. 22 (Parcell) at 38-39; Staff PHB at 34.) In addition, the Hearing Examiner was persuaded by DEUG witness Gorman, who testified that Dr. Morin's omission of 2002-04 data likely had a "meaningful impact" on his historic RP study and could have significantly skewed the results. (Exh. 16 (Gorman) at 29-30.) The Hearing Examiner also noted Mr. Gorman's argument that that the achieved

return on electric utility stocks has been dramatically affected by (among other things) expectations of large profits from competitive operations unrelated to wholesale market trading and merchant plant development, which means that the equity RP is likely biased upward.

249. With respect to Dr. Morin's allowed RP analysis, the Hearing Examiner cited Staff's observation that in a 2004 case, the Tennessee Commission identified Dr. Morin as the first witness in a rate case before the Authority to propose this methodology. (HER at 42, citing Staff PHB at 35, quoting *Chattanooga Gas*, 236 PUR 4th at Section V(c)4e.) The Hearing Examiner noted that the Tennessee Commission rejected the allowed RP methodology because: (1) the data used could not be verified; (2) the purported relationships between the allowed returns and yields had not been shown to hold over a long time period; and (3) "the methodology was not within the mainstream of equity valuation techniques." (HER at 42.) Since Dr. Morin's analysis in this case was done in the exact same manner as the one in *Chattanooga Gas*, the Hearing Examiner found that it was fair to say that it suffered from the same flaws that the Tennessee Commission identified. (*Id.*). Furthermore, the Hearing Examiner agreed with Staff and DEUG that Dr. Morin's allowed RP methodology inflated the risk premium in several ways, including using a regression analysis to track the risk premium against rising and falling interest rates, which is inconsistent with the method he used in his historic RP analysis and which incorrectly assumed that as nominal interest rates decline, equity risk premiums increase. (*Id.*, citing Exh. 22 (Parcell) at 39; Exh. 16 (Gorman) at 31-33.)

250. The Hearing Examiner ultimately agreed with Staff, DEUG, and the DPA that the Company’s proposed 11% cost of equity was overstated at this point in time. Rather, considering all of the witnesses’ testimony and the evidence presented, the Hearing Examiner found that 10% was a fair cost of equity for the Company. He noted that 10% was above the results of all of the witnesses’ DCF equity cost models, but below the results of most of the witnesses’ CAPM calculations that 10% was the resulting cost of equity from the CAPM using the 4.59% risk free rate, a beta of 0.82, and a market risk premium of 6.6%; and that 10% was the middle of the range of equity cost results that Staff witness Parcell derived from his equity cost models.

251. The Hearing Examiner found that the evidence indicated that a 10.0% return on equity would be sufficient to maintain the Company’s financial integrity and allow it to attract capital. He noted that both Staff’s and DEUG’s witnesses testified (and Dr. Morin did not dispute) that their recommended total returns would produce coverage levels above the benchmarks for an A-rated utility (which Delmarva already is) and would not cause its debt levels to dip below those necessary to maintain its A rating. (HER at 43, citing Exh. 22 (Parcell) at 33 and Sch. 13; Exh. 16 (Gorman) at 19-21 and Ex. MPG-12.) The Hearing Examiner observed that Delmarva had a business profile of 3 and the proxy companies had an average business profile of 5, which meant that Delmarva was less risky than the companies that the witnesses used as a proxy, and therefore it would not be inappropriate for Delmarva to have a lower return on equity than those companies.

252. **Flotation Costs.** Finally, turning to the Company's request to include an allowance for flotation costs, the Hearing Examiner noted that the Commission has consistently rejected utilities' attempts to include an allowance for flotation costs in their authorized returns on equity. *See Delmarva Power*, *supra* at ¶231; *Wilmington Suburban*, 88 PUR 4^{th} at 240. Furthermore, he noted that one of the leading treatises on public utility regulation stated that the need for a flotation cost adjustment is "less urgent when utility stocks are selling above book value." Bonbright, Danielsen & Kamerschen, *Principles of Public Utility Rates* at 333 (2d ed. 1988). He found that the evidence presented in this case demonstrated that utility stocks were selling above book value and that that they had been doing so for some time. (HER at 44, citing Exh. 22 (Parcell) at Sch. 12.) The Hearing Examiner found that Dr. Morin's discussion of flotation costs provided no reasons or facts to support such an adjustment that were any different than the reasons or facts put forth by expert witnesses supporting such an adjustment in prior rate cases in which this Commission has rejected such an adjustment. Thus, the Hearing Examiner recommended that the Commission reject the flotation cost adjustment.

253. **Exceptions.** The Company, the DPA, and DEUG all excepted to the Hearing Examiner's findings and recommendations. The DPA argued that the 10% return on equity that the Hearing Examiner recommended was too high and was not supported by the record. (DPA Brief on Exceptions at 3.) The DPA pointed out that the average of the witnesses' DCF results was 9.025%, but that the 10% recommended by the Hearing Examiner was nearly 100 basis points higher than that average. By contrast, the

average of the parties’ CAPM results was 10.864%. (*Id*. at 5.) Consequently, the DPA contended that the Hearing Examiner “gave at least equal, and perhaps greater, weight to other methodologies.” (*Id*. at 4.) This, the DPA claimed, was inconsistent with a primary reliance on the DCF model. (*Id*. at 5.) The DPA observed that it was the only party to recommend a return on equity that was objectively determined by a formula that weighted the DCF result more heavily than the results of other cost of equity models, and that resulting cost of equity was 9.2%. (*Id*.). Even if the Commission took the average DCF and CAPM results of 9.02% and 10.864% and weighted them 75/25, the resulting return on equity would be no more than 9.48%. (*Id*. at 6.) Thus, the DPA contended that the allowed return on equity should be no greater than 9.48%. (*Id*.).

254. DEUG argued that the Hearing Examiner correctly rejected Delmarva’s proposed 11% return on equity, but that the 10% return on equity that the Hearing Examiner recommended was still too high, and that the allowed return on equity should be the 9.8% recommended by its witness Gorman. (DEUG Brief on Exceptions at 23.) DEUG noted that the Hearing Examiner did not disagree with any of Mr. Gorman’s arguments or criticize his analyses. While DEUG recognized that the difference between its recommended 9.8% equity cost and the Hearing Examiner’s recommended 10% equity cost was “relatively small,” DEUG asked the Commission to keep in mind that the Hearing Examiner essentially agreed with both DEUG and Staff, and selected Staff’s higher return on equity without explanation. (*Id*. at 23-24.)

255. DEUG argued that Delmarva's DCF results ranged from 9-9.9% (without flotation costs), with a midpoint of less than 9.5%. This showed that its recommended 11% return was overstated. DEUG stated that "DCF return estimates today are quite robust, and do reflect today's very low-cost capital market environment." (*Id.* at 24.) DEUG contended that Dr. Morin's growth rates were "very high" relative to historical dividend growth, and that his dividend yields reflected today's low interest rate environment. Consequently, DEUG contended, "the DCF results clearly reflect optimistic growth expectations for these companies and today's low cost capital market environment. They need to be given much greater weight." (*Id.*).

256. DEUG pointed out that the Hearing Examiner agreed with Mr. Gorman on the following issues:

- Dr. Morin included high-risk companies in his proxy groups that biased his analysis and increased his return on equity estimates. (*Id.* at 25.)

- Delmarva is less risky than the companies in the proxy groups, and so it would not be inappropriate for Delmarva to have a lower return on equity than those companies. (*Id.*).

- Dr. Morin's CAPM analysis was based upon an unreasonably high market risk premium resulting from his use of the income Treasury bond return rather than the total Treasury bond return. (*Id.*).

- Dr. Morin's ECAPM analysis double-counts the impact of Value Line's adjusted betas and therefore overstated the Company's cost of equity. (*Id.* at 25-26.)

- Dr. Morin's historical risk premium analysis excluded 3-½ years of the most recent available data and gave equal weight to returns over the 70-year period between 1931-2001. (*Id.* at 26.)

- Dr. Morin's risk premium analysis was inflated by high expectations of results from riskier competitive operations, while excluding market corrections that occurred after 2002. (*Id*.)

- Dr. Morin's allowed risk premium analysis did not comport with observable market data or Commission-authorized returns because it was based on the flawed premise that as nominal interest rates decrease, equity risk premiums increase. (*Id*.).

- Dr. Morin's allowed risk premium methodology inflated the risk premium by, among other things, using a regression analysis to track the risk premium against rising and falling interest rates. (*Id*.).

257. DEUG also argued that Mr. Gorman had testified that a 9.8% equity return would provide adequate credit rating financial ratio metrics that would support Delmarva's current A bond rating and fairly compensate Delmarva for its investment risk and allow it to maintain its financial integrity. (*Id*. at 26-27.) Thus, there was no record evidence that 9.8% would be any less sufficient to satisfy these financial criteria than a 10% return. DEUG therefore urged the Commission to approve its recommended 9.8% equity return. (*Id*. at 27.)

258. The Company argued that the Commission should reject the Hearing Examiner's recommended 10% return on equity because it was "out of line with very recently authorized returns on equity for electric utilities and, therefore, does not meet the requirement that a utility should be given the opportunity to earn a return on equity that is commensurate with the returns that would be expected on other investments of similar risk." (Delmarva Brief on Exceptions at 7.) The Company urged the Commission to look at the broader picture, noting that the issue was even more significant in light of the recent rating agencies' reports regarding Delmarva's creditworthiness. (*Id*.). Delmarva argued that the investment community would be closely watching

this Commission's regulatory decisions, and so it was "critical" that the Commission carefully consider the return on equity to be allowed in this case. (*Id.*).

259. The Company contended that the concept of a fair return on equity was connected to the economic concept of opportunity cost associated with foregoing returns on alternative investments of comparable risk. (*Id*. at 9). Under existing United States Supreme Court precedent, the Company's return on equity should be sufficient to give it "the opportunity to earn a return on equity that is: (1) commensurate with returns on investments in other firms having corresponding risks; (2) sufficient to assure confidence in the company's financial integrity; and (3) sufficient to maintain the company's creditworthiness and ability to attract capital on reasonable terms." (*Id*. at 9, citing Exh. 17 (Morin) at 10-11; *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).) Delmarva noted that the Commission has recognized that "'the return which a utility investor can expect should be commensurate with the returns that would be expected on other investments of comparable risk.'" (*Id*., quoting *Delmarva Power & Light Co.*, Docket No. 91-20, Order No. 3389 at 129-30 (Mar. 31, 1992).)

260. Delmarva argued that the Hearing Examiner did not address Dr. Morin's testimony that allowed returns for electric utilities in the years 2002, 2003, and 2004 of 11.2%, 11%, and 10.7 respectively. (*Id*. at 9.) Moreover, the average return on equity in the third quarter of 2005 for the 4 electric companies with decisions in that quarter was

10.8%. In the last quarter of 2005, there were 11 return on equity decisions; according to Dr. Morin, the average allowed return on equity for those cases was also 10.8%. (*Id*. at 9-10.) The average return on equity for the companies in the DPA's electric proxy group was 10.8%. (*Id*. at 10.) As of January 2006, the average current allowed return on equity for electric utilities was 11.14%, 11.01% for combination gas and electric utilities, and 11.12% for natural gas utilities (although Company witness Morin did admit that some of those returns may be stale). (*Id*.). The Company contended that investors are aware of these authorized returns and they are important determinants of investor growth perceptions and investor expected returns. (*Id*., quoting Exh. 18 (Morin-R) at 8.)

261. Next, the Company argued that the DCF methodology understates the cost of equity when the market-to-book ratio is substantially above unity. (*Id*. at 11-14.) The Company urged the Commission to use the DCF as a guide but also take other methods and factors into consideration, as it has in past cases. (*Id*. at 11, 14.) The Company pointed out that in Docket No. 91-20, the Commission added 50 basis points to the DCF-derived cost of equity proffered by Staff's witness, recognizing, among other things, "any alleged tendency of the DCF to understate the cost of equity." (*Id*. at 14, quoting *Delmarva Power* at 131.)

262. The Company next argued that the Hearing Examiner erred in concluding that Dr. Morin's CAPM analysis overstated the cost of equity. (*Id*. at 15.) First, the Company observed that the Hearing Examiner did not dispute Dr. Morin's estimated 30-year Treasury bond rate of 5.1%, and that subsequent events have proven this estimate to be accurate.

(*Id*. at 15-16.) The Company disagreed with the Hearing Examiner's conclusion that it was inconsistent to use a 30-year bond rate as the risk-free rate in conjunction with a risk premium based on a 20-year bond rate, claiming that this conclusion "might be justified if there were a significant difference in the projected yields of 20-year and 30-year bonds." (*Id*. at 16.) The Company observed that the Hearing Examiner had used Staff's proposed 20-year bond rate, which was derived from the three-month average yield for such bonds from August-October 2005. Mr. Gorman, however, used Blue Chip Financial Forecasts' projected 20-year bond yield of 5.3%. (*Id*. at 16.) Since the most up-to-date information should be used, the Company argued that either its 5.1% rate or Mr. Gorman's 5.3% rate should be used because Mr. Parcell's 4.59% rate was too stale. (*Id*. at 17.) Substituting 5.1% for 4.59% in the CAPM model results in a return of equity of 10.5%. (*Id*.). Finally, the Company pointed out that Dr. Morin used the 5.1% rate in all of his CAPM studies and his historical risk premium study. (*Id.*).

263. The Company took issue with the Hearing Examiner's acceptance of Staff's and DEUG's arguments that the total Treasury bond return (6.6%) rather than income Treasury bond return (7.2%) should be used to estimate the market risk premium for the CAPM model. (*Id*.). The Company asserted that the Hearing Examiner "apparently overlooked Dr. Morin's complete explanation of why it is appropriate to use the income component of those long-term bonds rather than the total return on those bonds." (*Id*. at 17-18.) If the 7.2% is used in the CAPM, then the CAPM-derived cost of equity (with the 5.1% risk-free rate) is 11.0%. (*Id*. at 18.)

264. The Company next argued that the Hearing Examiner erred in concluding that the ECAPM overstates the cost of equity because he failed to consider Dr. Morin's "extensive discussion" of that method. (*Id*. at 19.) Delmarva claimed that on rebuttal, Dr. Morin demonstrated that Staff's and DEUG's criticisms were meritless and that the ECAPM was a return adjustment rather than a beta adjustment. (*Id*.). The Company contended that both Staff and DEUG had had the opportunity to respond to Dr. Morin's rebuttal on oral surrebuttal, but failed to do so. (*Id*.).

265. The Company contended that the Hearing Examiner's criticisms of Dr. Morin's historic risk premium studies were also wrong, noting that the Hearing Examiner had "once again" failed to address Dr. Morin's rebuttal testimony in which he challenged those criticisms. (*Id*. at 20.) Specifically, Dr. Morin testified that the review of long time periods minimizes subjective judgment, that unexpected capital gains are often offset by unexpected capital losses, and that the best estimate of the future risk premium is the historical mean. (*Id*., citing Exh. 18 (Morin-R) at 78.) Dr. Morin testified that realized returns can be substantially different from prospective returns anticipated by investors, especially over short time periods. According to Dr. Morin, a risk premium study should consider the longest possible period for which data are available, because only over long time periods will investor return expectations and realizations converge. (*Id*. at 20, citing Exh. 18 (Morin-R) at 77-78.) He further claimed that he excluded the years 2002-04 because his source no longer published the data he used in his study. (*Id*. at 21, citing Exh. 18 (Morin-R) at 57-58.) The Company challenged the Hearing Examiner's reliance on what it called Mr.

Gorman's "speculative claim" that achieved returns on electric utility stocks over the last several years have been driven by high expectations of large profits from competitive operations, noting that Dr. Morin had testified that that could be true for certain segments of the industry but DEUG could not "have it both ways." (*Id.* at 21.)

266. Next, the Company argued that the Hearing Examiner erred in accepting Staff and DEUG's criticism of Dr. Morin's allowed risk premium study. (*Id*. at 21.) The Company criticized the Hearing Examiner for improperly relying on a decision by another commission rejecting Dr. Morin's same analysis "for reasons not stated by any witness in this case." (*Id*. at 22.) The Company asserted that even if it were true that the allowed risk premium methodology was out of the mainstream of equity valuation techniques, that proved nothing because DEUG witness Gorman also presented risk premium studies that used authorized returns on equity. (*Id*.). The Company further noted that the Hearing Examiner had failed to address Dr. Morin's responses to Staff's and DEUG's criticisms of that study in which he showed those criticisms to be meritless. Dr. Morin testified that the failure to recognize that Commission-authorized returns are conservative in nature in estimating changes in investor return requirements was one of the main reasons he adjusted the allowed risk premium to the level of interest rates. (*Id*.). He further stated that Mr. Gorman's claim that his analysis did not comport with observable market data or commission-authorized returns was baseless "inasmuch as Dr. Morin's analysis relied on hundreds of observed actual Commission-authorized returns and observed actual interest rates." (*Id*., citing Exh. 18 (Morin-R) at 57.) Finally, the

Company argued that Dr. Morin had addressed in rebuttal Mr. Parcell's "odd" claim that Dr. Morin's allowed risk premium analyses did not use the same method for determining the risk premium as his historic risk premium studies. (*Id*. at 23.)

267. Finally, the Company argued that despite Staff's and DEUG's testimony regarding the interest coverage that would result from their recommended equity returns, Moody's and Standard & Poor's had recently issued negative reports regarding Delmarva's creditworthiness. Moreover, neither Messrs. Parcell nor Gorman had recommended that the Commission should approve a return on equity for Delmarva that was lower than their respective comparable companies. (*Id*.).

268. The Company did not take any exception to the Hearing Examiner's findings and recommendation regarding the rejection of its claim for a 30-basis point adjustment for flotation costs.

269. **Discussion and Decision.** The appropriate cost of equity for the utilities that we regulate has always been one of the most difficult issues we consider in a rate case. Over the years we have repeatedly expressed our belief that the DCF equity cost model should be the model on which we primarily rely in establishing a utility's cost of equity. We continue to believe that the DCF equity cost model is an appropriate method for calculating a utility's cost of equity and should be the primary method for calculating the appropriate cost of equity in this jurisdiction. However, we have not said that we should rely solely on the DCF equity cost model and, in fact, over the years we have indeed examined the results of other equity cost models and taken them into account in deciding the cost of equity. In reaching our determination

as to the appropriate cost of equity for Delmarva, we give effect to the results of other equity cost models as well.

270. It is clear that Delmarva's cost of equity witness gave little weight to the results of his DCF analyses in recommending his 11% equity cost rate. We also note that at least in this case, the differences among the four cost of equity witnesses' inputs into the DCF formula resulted in very little difference in their final results: as the Hearing Examiner observed, the results ranged from 8.5%-9.5% (8.5% representing the low end of Staff's witness's calculations and 9.5% representing the high end of that same witness's calculations). This suggests that for all the argument about the unreasonableness of various witnesses' inputs, the model is such that unless the inputs are truly extreme, the witnesses are going to derive substantially similar results.

271. We also observe that in determining an appropriate cost of equity for the Company, we are treating it as a stand-alone utility. We must use proxy companies to establish Delmarva's cost of equity since it is not publicly traded. While we understand Delmarva's contention that other electric utilities have been awarded higher returns on equity, we also note that the proxy companies that Delmarva used to estimate the Company's cost of equity (and which Staff also used) are all deemed riskier by the ratings agencies than Delmarva is. The record evidence is that Delmarva has a business position of 3, whereas the average business risk of the proxy companies that Delmarva and Staff used is 5. This lower risk justifies a lower return on equity than those awarded to riskier companies.

272. We are sympathetic to Delmarva's concerns about potential downgrading of its credit rating, especially since it has been placed on negative credit watch by two rating agencies. But the record evidence indicates that the 10% return on equity that the Hearing Examiner recommended will maintain Delmarva's current A bond rating, and Delmarva's expert witness did not seem to dispute that. We also observe that the reasons for the credit downgrading relate to non-distribution issues, primarily the implementation of standard offer supply rates and the Company's agreement to phase-in those rates over time in at least Maryland and Delaware.

273. We note that each of the alternative equity cost models (CAPM, risk premium, comparable earnings, and ECAPM) all resulted in higher estimated equity costs than the DCF. Placing greater weight on the results of the DCF, but also taking into consideration the results of those other equity cost models, we agree with the Hearing Examiner that the appropriate cost of equity for the Company is 10%. This equity cost is 50 basis points higher than the high end of Staff's DCF; 80 basis points higher than the Company's DCF results without flotation costs, 100 basis points higher than the DPA's DCF result, and 110 basis points higher than DEUG's DCF result.

274. For the foregoing reasons, as well as the reasons set forth by the Hearing Examiner, we adopt the Hearing Examiner's findings and recommendations. (3-2: Chair McRae and Commissioners Conaway and Clark voting yea; Commissioners Lester and Winslow voting nay.)

275. With respect to flotation costs, as noted previously, Delmarva did not except to the Hearing Examiner's findings and

recommendation that such costs be denied. We adopt the Hearing Examiner's findings and recommendations on this issue. (Unanimous.)

X. COST OF SERVICE/RATE DESIGN/REVENUE DISTRIBUTION

A. Summary of Positions.

276. **The Company.** The Company's cost of service study ("COSS") presented class rates of return on both fully bundled and unbundled bases. For purposes of this case, however, only the unbundled basis is relevant. (Exh. 28 (Kalcic) at 5.)[27] In general, the COSS showed that the RSH, GS-P, and OL classes provided rates of return below the system average, and the R, GSS-S, GSS-L, and GS-T classes provided rates of return above the system average. The Company proposed to set class revenue requirements at full cost of service. (*Id*. at 6.) Although the system average rate increase under the Company's proposal was only 0.8%, its proposed revenue distribution would result in classes receiving rate changes ranging from a 73.5% decrease to a 36.4% increase. (*Id.* at 6-8 and Sch. BK-1.) Within individual rate schedules, the Company also proposed to set customer charges at its measure of full cost of service and to shift cost recovery from energy charges to demand charges for the MGS-S and LGS-S service schedules. Together, the Company's proposed rate design would result in higher customer charges and reduced energy

[27]The unbundled COSS includes the Residential ("R"), Residential Space Heating ("RSH"), General Service Secondary-Small ("GSS-S"), General Service Secondary-Large ("GSS-L"), General Service-Primary ("GS-P"), General Service-Transmission ("GS-T"), and Lighting ("OL"). This is not all of the Company's rate schedules, however; Delmarva maintains three smaller residential time-of-use ("TOU") rate schedules and two smaller general service heating schedules. None of these smaller rate schedules are represented on a stand-alone basis in the COSS; instead, for costing purposes, the Company combined them with the R and GSS rate classes. (Exh. 28 (Kalcic) at 5-6.)

charges, allowing the Company to recover more of its total revenue requirement on a non-volumetric basis. (*Id*. at 6-7.)

277. **Staff.** Staff witness Kalcic observed that new distribution rates will become effective at the same time as Delmarva's SOS rates (May 1, 2006), and that Delmarva's proposed revenue distribution should be examined in that context; otherwise, he testified, certain of the Company's rate classes could experience a combined rate increase "that exceeds traditional bounds." (*Id.* at 8.) Using Staff's recommended revenue requirement, Mr. Kalcic derived a proposed revenue distribution that resulted in fewer rate classes experiencing a rate increase and a reduction in the relative magnitude of such increases. (*Id*. at 9 and Sch. BK-2.) [28] He testified that his revenue distribution was derived in two stages. In Stage 1, he established specific class revenue targets for the 4 rate classes that were to receive an increase under Delmarva's proposed distribution. He assigned GS-P a 4.3% decrease (one-half the overall system average decrease of 8.6%). Next, he chose to restrain the remaining class increase to the OL classes to 4.3% (the "mirror" outcome from GS-P). Lastly, he assigned the midpoint of these two adjustments (0%) to the R class, in recognition that its proposed 15.8% increase under the Company's proposed distribution was approximately halfway between the Company's proposed increases for GS-P (5.9%) and the two OL classes (36.4%). (*Id*. at 9 and Sch. BK-2.) This first stage of the revenue distribution resulted in a shift of $2.5 million of overall

[28]Mr. Kalcic testified that he normally would have prepared his own COSS, but since he disagreed that all classes should be moved to full cost of service at this time, he chose not to expend Staff resources in "fine-tuning" the Company's methodology and results. Rather, he used the COSS results as a guide in deriving Staff's recommended revenue structure. (Id. at 6.)

revenue responsibility away from the GS-P, OL, and R rate classes and reduces the decrease that Delmarva's remaining rate classes would otherwise receive by an average of 2.4%. (*Id*. at 10.)

278. In Stage 2, Mr. Kalcic determined the remaining class revenue adjustments by scaling back Delmarva's claimed cost-based class revenue requirements for those service classifications proportionately to derive Staff's recommended base rate reduction. (*Id*. at 9-10 and Sch. BK-2.) According to Mr. Kalcic, his recommended class revenue adjustments moved classes closer to full cost of service while limiting the rate impacts on customers. (*Id*. at 10 and Sch. BK-3.) He did not adjust any of the Company's class billing determinants because Staff did not recommend any revenue adjustments that affected the class billing determinants. (*Id*.).

279. With respect to the Company's proposed customer charge increases, Mr. Kalcic testified that in general, he set his recommended customer charge at a level halfway between a customer's current customer charge and Delmarva's proposed customer charge to move the customer charges toward cost of service while simultaneously limiting the intra-class rate impacts that would otherwise result from Delmarva's proposed rate design. He observed that although Delmarva had proposed overall rate decreases for many of its service classifications, individual customers within those service classifications could receive large rate increases depending on their usage profiles: specifically, it would cause some customers with lower usage levels to incur a large rate increase despite the reduction in their energy charges. Mr. Kalcic testified that his proposed rate design, by reducing the proposed

customer charge increases, would mitigate the severity of those intraclass rate impacts. (*Id*. at 11.) For the R and RSH rate classes, however, he limited his customer charge increase to $2.60 (54.6%) to ensure that the R and RSH customer charges remained below the small customer class customer charge. (*Id*. at 10.)

280. Mr. Kalcic testified that he developed his recommended energy charges for rate schedules that lack a demand charge by applying the residual rate adjustments necessary to meet Staff's individual class revenue targets proportionately to all existing energy charges. Unlike Delmarva, he did not equalize his recommended energy charges for the R and RSH classes because it was not reasonable to eliminate the entire differences in this case given Staff's recommended class revenue distribution.

281. For the GS-P and GS-T classes, Mr. Kalcic determined the level of recommended energy and demand charges by assigning the demand charge in each class the residual rate adjustment necessary to meet Staff's recommended class revenue targets in light of the revenue level generated by his recommended customer charge. For the MGS-S rate class, he adopted Delmarva's proposed rate design (82% of the residual class revenue requirement assigned to the demand charge and 18% to the energy charge). For the LGS-S class, he assigned 69% of the residual class revenue requirement to the demand charge and 31% to the energy charge. He noted that this was slightly less demand-weighted than Delmarva's proposed 77/23 split, but that it was necessary to constrain the split to 69/31 to avoid an increase to the class's demand charge. (*Id*. at 12-13.)

282. In rebuttal, Delmarva witness Normand responded only that Staff took the gradualism principle too far and that since Delmarva was proposing only a modest rate change, its proposal “provides a rare opportunity to move rates closer to parity.” (Exh. 24 (Normand-R) at 3.)

283. **DEUG.** DEUG witness Chalfant objected to the Company’s COSS and to Staff’s proposal not to set rates on a full cost of service basis. (Exh. 27 (Chalfant-R) at passim; Tr. at 307-08.) He asserted that the COSS did not reflect the minimum distribution system concept, which he claimed was “critical to accurately allocate the costs of the distribution system.” (Exh.26 (Chalfant) at 3.) Mr. Chalfant stated that “[t]here is a customer-related component to the costs of the distribution system that is associated with the need to ‘cover the system.’” The division between customer-related and distribution-related costs is generally measured using either a zero intercept approach or a minimum size approach.[29] The distribution system must be sized to accommodate demand requirements and to physically connect each customer’s service to the system, regardless of the size of that customer’s service. Thus, while a customer’s demand requirements influence the size of the distribution facilities installed, the fact

[29]Under the zero intercept approach, a least squares regression equation is fitted relating current installed cost and capacity. The point at which the fitted line of curve crosses the vertical axis (cost) is the zero intercept cost level. All distribution is priced at the appropriate zero intercept cost to produce the minimum system total cost. The remaining distribution costs are classified as demand-related. Under the minimum size approach, the costs required to construct a distribution system only using the smallest size of each type equipment are calculated; this portion of total costs is allocated on the basis of weighted customers and remaining costs are allocated on the basis of demand. (Exh. 26 (Chalfant) at 3.)

that some facilities of at least a minimum size must be constructed relates to the existence and location of customers within the service territory, and unless this factor is considered, the COSS will depart from cost causation. (*Id*. at 3-4.)

284. Currently, Delmarva allocates all of the costs in Accounts 364-368 on the basis of demand (except for those that are directly assigned). Mr. Chalfant claimed that "[a] portion" of those costs should be allocated on the basis of customers so as to reflect the minimum distribution system concept. He testified that typically 30-50% of such costs were allocated on a customer allocation factor. (Id. at 4.) Thus, he allocated 30% of the costs that the Company allocated on demand in Accounts 364-368 on the basis of weighted customers; specifically, he used the allocation factor for meters excluding the GS-T class. According to Mr. Chalfant, a detailed analysis of the cost of minimum -sized distribution equipment on Delmarva's system would probably result in more than 30% of the costs allocated on a customer basis. (*Id*. at 5.) He conceded that the effect of recognizing a minimum distribution system in the COSS was to allocate more costs to small customer classes and fewer costs to large customer classes – in this case, the allocation would shift approximately $2 million of costs from the GS-P class to the R class. (*Id*.).[30] He further recommended

[30]Mr. Chalfant testified that recognizing a minimum distribution system would not affect the allocation to the GS-T rate class because it does not use any of these facilities and none of the associated costs are allocated to that class. (Exh. 26 (Chalfant) at 6.)

that the Commission order Delmarva to provide the results of its COSS incorporating a customer-based allocation fully reflecting a minimum distribution system component in its next base rate case. (*Id*. at 6.)

285. Mr. Chalfant next observed that the Company had followed its COSS in determining each customer class's revenue responsibility and that its class revenue targets matched the COSS results as adjusted for the test year revenue. (*Id*.). His recommended revenue allocation differed from Delmarva's, however, because the COSS was based on per books results while the Company's revenue allocation reflected test year adjustments to the per books results. (*Id*. at 7.)

286. Mr. Chalfant also disagreed with Delmarva's proposed rate design. He noted that for the GS-P class, about 6% of its revenues under present rates came from demand charges and 94% came from customer charges. Under Delmarva's proposed rates, that split would be 10% from demand charges and 90% from customer charges. Mr. Chalfant testified that although this allocation might appear reasonable based on the COSS, it actually resulted in overstating demand costs relative to his adjusted COSS because Delmarva's proposal ignores the minimum distribution system component and allocates costs to the not-yet-approved Rider RDCS service. Thus, he recommended that Delmarva's method for establishing its proposed rates be applied to his adjusted COSS at the revenue level ultimately approved by the Commission. (*Id*. at 8.) As for GS-T, Mr. Chalfant noted that under present rates, about 98% of the class revenues come from demand charges and only 2% from customer charges. Under Delmarva's proposed rates, these percentages would change "radically" to 14% from demand charges and 86% from

customer charges. (*Id*.). This allocation matched the COSS results, which were not affected by Mr. Chalfant's adjustments. Thus, his sole concern with the proposed rate design for GS-T customers related to Rider RDCS. Nevertheless, Mr. Chalfant claimed that the GS-T rate design was "very favorable to Delmarva" because fluctuations in usage or demand will have little or no impact on GS-T revenues since most of those revenues will be derived from customer charges. (Id. at 9.) In light of this, Mr. Chalfant testified that it was "hard" to understand why Delmarva needed Rider RDCS. (*Id*.).

287. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner found that the Company's only disagreement with Staff's proposed rate design and revenue distribution was that Staff "'overemphasize[s] the gradualism concept.'" (HER at 112, quoting Exh. 24 (Normand-R) at 3; Exh. 50 (Bumgarner-R) at 102.) Staff claimed that it was impossible to "overemphasize" gradualism in the circumstances present here, where a large supply-side rate increase will be taking effect. The Hearing Examiner stated that normally he would be hesitant to consider the supply rate increase as a mitigating factor in this case, but because gradualism is a concept designed to mitigate rate shock, it was sensible to look at other sources of rate shock to determine the level of gradualism that is warranted. (HER at 112-13.)

288. DEUG contended that it was important to move to full cost-based rates at the same time that SOS rates are implemented because market prices will lead to more efficient use of the economy's resources; Staff's proposal will not give customers accurate price signals. (Exh. 27 (Chalfant-R) at 3.) DEUG agrees with Delmarva that

unbundling distribution rates affords the opportunity to set rates without the historical constraints of departing from cost-based rates. (DEUG PHB at 59.) DEUG criticizes Staff’s proposed rates as “subsidizing” the RSGH and OL classes at the expense of the GS-P and GS-S classes and asserts that such subsidization is the result of Staff’s using the Company’s COSS as a “guide.” (Exh. 27 (Chalfant-R) at 5-6.)

289. The Hearing Examiner stated that generally, the Commission supports the goal of designing rates based on full cost causation. In this case, however, he agreed with Staff that that goal could not be considered in a vacuum without looking at other factors that may weigh against taking that step in one fell swoop. (HER at 113.) He stated that Delmarva customers are about to experience substantial rate shock as a result of the implementation of supply rates on May 1, 2006, regardless of whether such rates are phased-in. Although the Commission cannot do anything to protect ratepayers from that, it can do something regarding the design of distribution rates. Staff’s proposed rate design and revenue distribution of the rate decrease resulting from the Hearing Examiner’s recommendations on the rate base, operating expense and rate of return issues would move toward the goal of full cost causation, but would not do so as quickly as Delmarva’s and DEUG’s proposals. Because that rate design and revenue distribution would provide some relief to ratepayers, the Hearing Examiner recommended that Staff’s proposals be accepted. (HER at 113-14.)

290. The Hearing Examiner observed that Delmarva had agreed that in some instances, its proposed rate design could result in individual customers in a class receiving a rate increase even though the class as

a whole was receiving a decrease. (HER at 114, citing Exh. 28 (Kalcic) at 11 and Tr. at 769-70.) Residential customers using fewer than 500 kWh in winter months would receive a rate increase even though the residential class as a whole is to receive a decrease. (*Id*, citing Tr. at 770-72; Exh. 48 (Bumgarner) at Sch. JRB-3.) Staff's rates are designed to have no such effect. Moreover, Mr. Bumgarner testified that if Staff's revenue requirement were adopted and he was designing rates to recover that revenue requirement, there "could be some departure from [cost-based rates]." (*Id*, citing Tr. at 769.)

291. Turning to DEUG's argument that adoption of Staff's gradualism proposal sends the wrong price signals to customers, the Hearing Examiner observed that Delmarva had requested the Commission's approval to phase-in supply rates over time, and that if its request was granted, the price signals that customers would get would be distorted. (HER at 114-15.) The Hearing Examiner found that the effect of phasing-in the much higher supply rates will be far greater than the effect of gradualism in the implementation of distribution rates. Moreover, the Hearing Examiner surmised that Delmarva's customers have gotten the message that their energy bills are going to skyrocket. (*Id*. at 115.)

292. The Hearing Examiner next found that DEUG's proposal (which he observed was not supported by any study or supporting documentation) resulted in "unacceptable rate impacts on smaller customer classes, and therefore should be rejected." (*Id*.). First, the Hearing Examiner found that the Company's COSS did recognize customer costs; Company witness Normand testified that his COSS recognized 100% of services and meter costs as customer-related, and such an approach was the most

accurate assessment of customer-related plant costs that serve each customer individually and contains no joint costs. (*Id*., citing Exh. 24 (Normand-R) at 5.) Moreover, the Hearing Examiner was persuaded by Mr. Normand's discussion of the weaknesses of the past allocation methodologies, noting that he had testified that it was "'extremely difficult'" to quantify and properly address all elements of related cost, such as other plant and depreciation expense, where a single ratio may be inappropriate." (HER at 115-16, citing Exh. 24 (Normand-R) at 5.) Second, the Hearing Examiner accepted Mr. Normand's explanation that in order to establish a minimum distribution system size, one must estimate the system capabilities of this minimum size, and that the aggregate class loads served by this minimum system should be removed or subtracted out from each class's consumption statistics before preparing any allocations for the remaining distribution plant investments. Mr. Normand testified that overlooking or ignoring the capacity served by the minimum system over-allocates and double-counts the cost assignment to small customers when using all consumption characteristics unadjusted for the balance of capability of those investments. The Hearing Examiner noted that DEUG witness Chalfant's COSS was flawed because he had not removed the minimum size capability from his cost of service calculations, nor had he made any other effort to recognize this problem. (HER at 116.)

293. The Hearing Examiner credited Company witness Normand's testimony that developing any composite allocation factor should recognize the benefits that each element provides to classes on an allocated basis, and that ignoring or omitting these benefits can

significantly affect the COSS results, particularly for small users where the minimum system component can serve a large portion of their basic requirements. Mr. Normand explained that this occurs because, when a minimum size is identified and a corresponding load capability developed, these values are allocated to classes based on the number of customers. Next, these allocated minimum size capabilities should be removed from each customer class to obtain a residual unserved amount which would then form the basis for allocating all remaining non-customer-related distribution plant costs by account. This last step is important in developing the remaining plant allocation factor and removing the redundant allocation to small customers. (HER at 116-17, citing Exh. 24 (Normand-R) at 4.)[31]

294. Based on these reasons, the Hearing Examiner concluded that DEUG's proposal shifted "an unwarranted amount of cost responsibility onto the small customer classes," and recommended that it be rejected. (HER at 117.)

295. **Exceptions.** DEUG was the only party to except to the Hearing Examiner's findings and recommendations. Initially, DEUG contended that the Commission should modify the Hearing Examiner's recommendation and not follow Staff's recommendation on class cost of service and revenue apportionment for the GS-P service classification. (DEUG Brief on Exceptions at 1-4.) First, DEUG argued that the Hearing Examiner erred in finding that the GS-P class provides a rate of return below the

[31]The Hearing Examiner further observed that Mr. Normand testified that the double-counting aspect of Mr. Chalfant's COSS was not the same for each customer class. It constituted a far greater proportion of total requirements for small users, and this is why it appeared that R customers produce a much lower rate of return. (HER at 117 n. 32, citing Exh. 24 (Normand-R) at 4-5.)

system average. (*Id.* at 2.) According to DEUG, the only reason that Delmarva's COSS shows the GS-P class producing a rate of return of less than 100% is because its COSS departed from the accepted practice of using a minimum system customer component for Account 364-368 costs. Had Delmarva's COSS done so, $2 million of cost responsibility would be shifted away from GS-P and the service classification would contribute at an index above 100. (*Id*.). Second, although acknowledging that DEUG did not proffer a Delmarva-specific study to support a 30% customer component for Accounts 364-368, DEUG contended that the record also contained no Delmarva-specific study supporting a 0% customer component either. (*Id*. at 2-3.)

296. DEUG next contended that the Hearing Examiner erred in recommending that GS-P should receive less than the average percentage distribution rate decrease. (*Id*. at 3.) First, DEUG argued that it was undisputed that on May 1, 2006, SOS rates would increase GS-P customers' bills by 118%, larger than any increase for any other rate class. If the Hearing Examiner was concerned about rate shock, DEUG contended, the 118% increase for GS-P customers "could not logically be used to support treating GS-P customers less fairly than other rate classes." (*Id*.). At a minimum, that SOS increase should justify treating GS-P classes at least on a system average basis and not at 50% of system average. (*Id*). Second, DEUG argued that if there is no support for a 0% customer component for Accounts 364-368, at most, the Company's COSS showing GS-P at an index below 100 and DEUG's COSS showing GS-P at an index above 100 cancel each other out, and so there is no empirical evidence to favor Delmarva's COSS index over DEUG's index. (*Id.* at 4.)

297. **Discussion and Decision.** We recognize that this is a difficult issue. The last time that this Commission set rates for this utility in Dockets Nos. 91-20 (electric) and 91-24 (gas), the Commission approved a cost allocation methodology that allocated a certain amount of costs from Accounts 364-368 to a customer component. The cost allocation methodology that Delmarva supports in this case lacks such a customer component. We are sympathetic to DEUG's contentions as to why Delmarva's proposed cost allocation methodology is inappropriate and why there should be a customer component, but we believe that based on this record, Delmarva witness Normand's explanations for why such a methodology is inappropriate, which the Hearing Examiner credited, are persuasive.

298. We are also persuaded that Staff's proposed rate design should be adopted for purposes of this case. We are sensitive to the effect that the implementation of SOS rates will have on the GS-P customers that DEUG represents, and we acknowledge that those customers are a diverse group rather than a more homogenous group. Nevertheless, it must be pointed out that under the rate design that the Hearing Examiner recommended and that we will approve, all customer classes will experience a distribution rate *decrease*. Thus, it is not as if DEUG's clients will be experiencing a rate increase while the remaining customer classes will experience a decrease; rather, every rate classification will see a decrease in their distribution rates. That having been said, we believe that by the time of the Company's next rate case, gradualism may have served its purposes, and Staff should examine

that issue to ascertain whether it would be appropriate at that time to design rates based on full cost causation. (Unanimous.)

XII. DEMAND-SIDE MANAGEMENT PROGRAMS

299. Staff witness Howatt testified that a "key issue of concern" for Staff regarding traditional utility rate design was the current disincentive for distribution utilities to promote demand-side resource initiatives. (Exh. 86 (Howatt) at 2.) He described the issue as follows:

> Historically, vertically integrated utilities designed customer rates recognizing costs as well as other factors such as customer affordability and promotion of energy usage. However, more recently, and particularly where utility services have been unbundled, commissions have been more predisposed to try to more closely align the costs of service with the revenues generated by each class of customer. Depending on how far historic rates have been misaligned with costs, this rate movement can be a significant increase in cost to the customer and one which is best implemented in moderate steps as opposed to all at once.
>
> In addition, while unbundling of services provided [an] opportunity for a more clear alignment of costs and revenue, such rate structures continued to focus on energy flow as the basis for revenue for a large majority of customers. Regardless of whether it was delivery, transmission or energy, rate class revenues have been heavily based on energy flow through. More energy used, particularly during off peak periods, meant more revenue for the utility. While an expansion of demand resources, including energy efficiency, distributed generation and load reductions would be beneficial for all customers, it also means lower revenues for utilities. There is no incentive within the current rate structure for Delmarva Power to promote any demand resource initiatives and, in fact, there is disincentive by virtue of lost revenues.

(*Id.*)

300. Mr. Howatt recognized that because a utility's revenues relate directly to customer usage, development of demand resource initiatives was a problematic one for utilities, ratepayers and commissions. He testified that a well-designed pricing mechanism should provide the opportunity for the distribution utility to fully recover its investment, regardless of energy flow through, but that it could also help to reduce costs if demand resource programs are implemented successfully. (*Id*. at 3.) In his view, the efforts underway in the Mid-Atlantic Demand Resources Initiative ("MADRI") will "continue to be unsuccessful until energy flow through is de-coupled from revenues and financial disincentives are removed." (*Id*.).

301. Consequently, Mr. Howatt recommended that the Commission require the Company to work with the Staff and other interested parties to explore a delivery rate structure that provides for an appropriate and cost-aligned level of revenue recovery while removing any demand resource disincentives related to flow-through pricing. He observed that there are already several different rate structures that de-couple energy flow through and revenue, mostly in the gas industry, and that the gas industry and MADRI recommendations could provide examples for further discussion. (*Id*. at 3-4.) Mr. Howatt proposed an overall three-year time frame for the parties to complete the investigation as follows (although he acknowledged that he would support prolonging the time period if ongoing discussions were productive but incomplete at the three-year deadline).

May 1, 2006	Docket 05-304 rates and SOS costs are implemented – first step in aligning rate class costs and revenues. Also, PSC establishes requirement for public notice and workshops to propose new rate designs and formulate approach to more fully aligning rate class costs and revenues, and for consideration and discussion of same.
October 1, 2006	Delmarva files Phase I revised rate design for PSC consideration.
May 1, 2007	PSC decides on Phase I of new rate design.
October 1, 2007	Delmarva files Phase II revised rate design for Commission consideration.
May 1, 2008	PSC decides on Phase II of new rate design.

(*Id*. at 4 and Ex. RJH-1; Tr. at 1086-87.)

302. Delmarva witness Wathen testified that Delmarva understood that many stakeholders were interested in the impact of demand response initiatives; that Delmarva recognized the potential value of demand response initiatives; and that the Company would meet with any stakeholders to discuss any issues relating to demand response initiatives. (Exh. 2 (Wathen) at 19; Exh. 3 (Wathen-R) at 14.) In his direct testimony, Mr. Wathen recommended that the Commission convene a working group comprised of interested stakeholders to consider modifying or adding to Delmarva's existing electric demand response programs. Mr. Wathen testified that the working group would examine the costs and benefits of any changes to the Company's programs and identify an appropriate method of funding any recommended expansion of the programs. At the conclusion of the working group's discussions, the group would submit a report containing its recommendations to the Commission. (Exh. 2 (Wathen) at 19.)

303. The Company, however, objected to the Commission "ordering" it to meet with Staff and other interested stakeholders on this matter, and objected to Mr. Howatt's recommendation that the Commission do so. Mr. Wathen pointed out that the Company has actively participated in MADRI and has done so for some time without having been ordered to do so by the Commission. (Exh. 3 (Wathen-R) at 15.)

304. Staff witness Howatt acknowledged that the Company has participated in MADRI and that Staff appreciates that participation. But as he testified, the participants in MADRI had been meeting for approximately 2-½ years; they were still working on conclusions; and there was no end in sight. (Tr. at 1083-84.) That was not necessarily surprising given the number of participants and the concerns that each participant brings to the group. From Staff's perspective, it was important to get the process moving forward and to eliminate or reduce the possibilities for delay. Staff believed that imposing a deadline for the submission of rate designs that address demand-side initiatives (which only the Commission can do) would cause the stakeholders in Delmarva's service territory that choose to participate to work together more quickly and reduce the incentive for delay. (Tr. at 1093.)

305. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner found that demand-side initiatives may prove to be very important in this time of rising energy costs. He expressed sympathy for the Company's desire not to be required to participate in discussions regarding demand-side initiatives, but was persuaded by

Staff’s concern that things do not seem to move unless there is a deadline in place. Therefore, he recommended that the Commission direct the Company to meet with interested stakeholders to discuss the issue and to establish a proposed schedule designed to culminate with the submission of rate design proposals that incorporate demand-side initiatives by some date certain. The Hearing Examiner recognized that “in reality, the Commission cannot physically force the Company to meet with Staff (or force Company representatives to talk once they do meet), but the Commission certainly can take the Company’s level of participation into account in any future deliberations concerning demand-side initiatives.” (HER at 121.)

306. **Exceptions.** The Company, which was the only party to contest Staff’s position, did not except to the Hearing Examiner’s findings and recommendations. Thus, we adopt the Hearing Examiner’s findings and recommendations. (Unanimous.)

XIII. NEW SERVICES (RDCS, S AND UT)

A. Reserved Delivery Capacity Service (“RDCS”)

307. According to the Company, Delmarva’s proposed RDCS Rider is based on the same principle as its proposed Standby Service Rider S: customers that cause particular costs to be incurred should pay those costs. (Delmarva PHB at 182.) Rider RDCS is a voluntary service for those customers that desire a redundant delivery service. Christiana Care Health System (“Christiana”) witness Cohen and DEUG witness Chalfant oppose Rider RDCS. Staff did not oppose the implementation of either proposed rider, but did not take a position one way or the

other on their approval by the Commission. (Exh. 28 (Kalcic) at 15, 17.)

308. Delmarva witness Bumgarner stated that the proposed Rider RDCS was filed to provide for a separate Company-provided source of supply that would give enhanced reliability to customers that want enhanced reliability. (Exh. 48 (Bumgarner at 12; Exh. 50 (Bumgarner-R) at 8.) He stated that there will probably be more of a demand for enhanced reliability in the future and that was one of the reasons that the Company is offering this new Rider. (Tr. at 763.)

309. Mr. Bumgarner noted that in the event of an outage on the normal delivery circuit, the customer would be automatically or manually switched to the alternate delivery source to provide continuity of service. (Exh. 48 (Bumgarner) at 12; Tr. at 706-07.) He also stated that capacity to cover the customer's full load must be reserved on the alternate source to avoid overloaded conditions when that capacity is actually used. He noted that the costs of providing this reserved capacity should be recovered through separate reserved delivery capacity charges since those charges are not directly recovered from those customers through the normally applicable distribution rates and should not be paid for by other customers. (Exh. 48 (Bumgarner) at 12; Tr. at 764-65, 774.)

310. Mr. Bumgarner listed the major elements of Rider RDCS as follows:

> (1) RDCS would generally be required for customers that desire reserved capacity from a second source on the Company's delivery system;
>
> (2) A contract reserved demand will initially be set at a level mutually agreed upon by the customer

and Company. If the demand actually used on the alternate source exceeds that contract level, the contract level will be reset to the higher level;

(3) The monthly charges for Rider RDCS are based on the full delivery service billing determinants applied to the normally applicable tariff, except that for schedules with a demand charge, a contract demand is substituted for the billing demand;

(4) A discount will be applied to the total RDCS monthly bill to reflect the fact that certain costs recovered through the standard rate are not incurred for RDCS; and

(5) The customer is required to make a Contribution in Aid-of-Construction ("CIAC") for any additional facilities required to provide RDCS.

(Exh. 48 (Bumgarner) at 13.) The "certain costs" referenced above in (4) are the demand-related operating and maintenance (O&M) costs associated with the alternate supply service. (Exh. 50 (Bumgarner-R) at 7; Tr. at 705, 710-11, 777.)

311. Mr. Bumgarner stated that there are 57 customers[32] that would currently be eligible for Rider RDCS. (Exh. 48 (Bumgarner) at 13.) He stated that if the delivery capacity was not reserved, then the existing second feed was usable only on an as-available basis and could become completely unavailable to the customer to the extent that other customers' loads served by the alternate delivery source grows. (*Id.* at 13-14.) He further stated that the estimated annual Rider RDCS revenue would be about $1.6 million for those customers with reserved capacity. (*Id*; Tr. at 708-09.) He also stated that an

[32]On cross-examination, Mr. Bumgarner agreed that the number of customers is less than 57 because some customers have more than one account. Tr. at 717-18. The Hearing Examiner found that the difference was immaterial to whether Rider RDCS should be approved and therefore he used "customers" in the context of this discussion.

adjustment had been made to the appropriate class billing determinants in developing the commercial class rate designs. (Exh. 48 (Bumgarner) at 14.)

312. Mr. Bumgarner described the charges for Rider RDCS. He testified that the alternate delivery facilities in place beyond the service connected to serve the RDCS customer's portion of the load were the same as those in place to serve full-requirements' customers with the same total load characteristics. (*Id*.). He explained that this is because if the customer transfers load to the reserved facilities, those facilities would be called on to supply the load whenever it occurs. Therefore, the attendant costs of owning and operating those facilities, with the exception of certain customer-account-related costs and plant-related costs, are the same as for a full-requirements customer. Consequently, he testified that the RDCS customer should bear a fair share of the cost responsibility. (*Id*.). He added that failure to recover those costs in the RDCS Rider would mean that all other customers would have those costs included in their rates. (*Id*.). He testified that this result is inconsistent with the principle that those who cause costs to be incurred should pay for them. At a minimum, he said the RDCS customer should pay at least the demand-related O&M costs associated with the reserved facilities. (*Id.;* Tr. at 710-11, 777-78.)

313. Finally, Mr. Bumgarner stated that the 63% discount to the monthly rate applied to the RDCS billing determinants is a way of more accurately reflecting cost causation through the RDCS rate, by eliminating possible double-recovery of costs. He stated that this

amount of discount was determined judgmentally based on the appropriate O&M components in the COSS. (Exh. 48 (Bumgarner) at 14-15.)

314. Christiana witness Cohen testified that he was aware of only one utility in New Jersey that had a charge similar to that which Delmarva was proposing. (Exh. 58 (Cohen) at 3-4.) Mr. Bumgarner stated that the proposed RDCS Rider was consistent with the rate design trend toward unbundling of services in order to eliminate cross-subsidization and encourage economically efficient choices by customers. (Exh. 50 (Bumgarner-R) at 5.) Mr. Bumgarner also disagreed with Dr. Cohen’s calculation that Rider RDCS would increase Christiana’s distribution costs by $150,000 annually, claiming that the net increase to Christiana would be $84,000. (Exh. 50 (Bumgarner-R) at 5-6 and Sch. JRB R-1); Exh. 58 (Cohen) at 4.) Absent approval of Rider RDCS, the general body of GS-P customers would pay that $84,000 and that, Mr. Bumgarner states, was a subsidy. (Tr. at 764-65, 774.)

315. Dr. Cohen testified that it would be unreasonable for Delmarva to impose an “’additional unjustified charge’” at a time when supply costs are increasing. (Exh. 58 (Cohen) at 4-5.) Delmarva witness Bumgarner noted, however, that application of Rider RDCS to Christiana would not result in additional charges collected by Delmarva because the additional revenue would be offset by an equal reduction in revenue from the other GS-P customers. (Exh. 48 (Bumgarner) at 14; 50 (Bumgarner-R) at 6.) DR. Cohen’s allegedly unjustified charge was justified, according to Mr. Bumgarner, because

RDCS customers impose that additional cost and in return will receive a higher degree of reliability from the reserved second capacity source. (Exh. 50 (Bumgarner-R) at 7.) He further pointed out that Rider RDCS is designed to recover only the demand-related O&M costs associated with the second capacity source requested by customers like Christiana and that absent customers like Christiana paying those costs, Christiana will continue to be subsidized by other GS-P customers. (*Id*.).

316. Dr. Cohen testified (and the Company acknowledged) that the second capacity sources identified by Delmarva are not dedicated facilities but are shared with other customers. (Exh. 58 (Cohen) at 6; Tr. at 748.) He argued that if Delmarva is not recovering its costs associated with those dual services, it should not be proposing a decrease in distribution rates to all customers except for the dual services like Christiana. (Exh. 58 (Cohen) at 6.) Mr. Bumgarner pointed out, however, that that capacity for which a customer would pay under Rider RDCS is reserved for that customer's use only. (Exh. 50 (Bumgarner-R) at 8.) Furthermore, he contended that Dr. Cohen conceded that customers like Christiana were being subsidized by those customers that have shared use of the facilities providing the reserved capacity and who, through their rates, contribute to the O&M of those facilities, while customers like Christiana reserving the capacity only pay for the primary supply source. (*Id).*

317. Dr. Cohen contended that because Rider RDCS states that continuous service was not guaranteed, the additional payments required thereunder do not impose any greater reliability of supply

obligation on the Company. (Exh. 58 (Cohen) at 7.) Mr. Bumgarner testified that Rider RDCS is voluntary and if a customer believes that it provides no additional value, the customer need not subscribe to it. (Exh. 50 (Bumgarner-R) at 8.) He testified that there was a definite enhancement to reliability, and Dr. Cohen agreed that anytime there is a redundant service, there is a greater degree of reliability. (*Id.* at 9, citing Christiana response to data request.)

318. Dr. Cohen objected to paragraph C. of Rider RDCS, which requires the customer to make a CIAC in the event that existing facilities providing the reserved delivery capacity have to be replaced. (Exh. 58 (Cohen) at 7.) Mr. Bumgarner noted that Dr. Cohen himself had recommended a rate increase if Delmarva needed additional distribution-related revenues or facilities due to load growth or other system issues, and thus Christiana was suggesting that RDCS customers continue to be subsidized by others for both O&M and capital costs. (Exh. 50 (Bumgarner-R) at 10). He urged that Paragraph C. be approved as proposed because it was consistent with the overall philosophy behind the Rider of eliminating subsidization. He also testified that Paragraph C. reflects that distribution facilities do not have infinite lives and while a customer may make a CIAC for the original installed facilities, at some time those facilities will require replacement. (*Id.).*

319. Alternatively, Dr. Cohen argued that if Rider RDCS is approved, it should not apply to hospitals and critical care facilities. (Exh. 58 (Cohen) at 9.) On cross-examination, he stated that the value to the community of hospitals and critical care

facilities was the basis for this position, and that hospitals were "unique." (Tr. at 802-03.)

320. Mr. Bumgarner objected to such a preference for hospitals and critical care facilities. He pointed out that the Company makes special efforts to communicate with hospitals both before storms and during restoration efforts, and that critical care facilities are given priority in restoration. Delmarva contended that policy decisions to exempt particular customers from a rate schedule that would otherwise apply to them should be left to the legislature. (Exh. 50 (Bumgarner-R) at 10.)

321. Dr. Cohen recommended that the Company apply the same revenue credit test to capital contributions for dual service customers under proposed Rider RDCS that it does for primary feeds under its existing tariff. (Exh. 58 (Cohen) at 9-10.) Mr. Bumgarner argued that the revenue credit test is appropriate for primary source supply capital contributions because it recognized that the customer was making a capital contribution and will pay rates that are designed to recover capital-related costs as well as O&M expenses, thus mitigating possible double-recovery of the capital costs. (Exh. 50 (Bumgarner-R) at 11-12.) He testified that Rider RDCS is only designed to recover the demand-related O&M expenses. (*Id*. at 12.) He concluded that to give a revenue credit for the RDCS facilities would not properly match the capital contribution with the cost items recovered through the RDCS rate. (*Id*.).

322. DEUG witness Chalfant argued that it is discriminatory to charge customers for the reserved capacity requested by those

customers from a second delivery source when no such charge is applicable to customers served by the Company's network system in Wilmington. (Exh. 26 (Chalfant) at 14-15.) Mr. Bumgarner testified that there was a critical distinction between RDCS service and network service: network service is provided to customers in downtown Wilmington as a necessary consequence of the design of the distribution system. Because much of the downtown distribution system is underground, generally under paved areas and in duct banks and sometimes on customer property, both normal maintenance and the repair of unplanned outages are much more complicated than for overhead and residential underground. Without the network configuration, work on any single circuit in the downtown area would require lengthy outages for all customers on that circuit. On the other hand, because each network customer has two supply sources, the Company can provide continuous service while working on the other supply. Mr. Bumgarner stated that the Company instituted the network design as a standard in downtown Wilmington to avoid taking large numbers of customers out of service when performing maintenance and repair. He emphasized that RDCS would be provided at the option of the customer desiring greater reliability, which is the distinction that justifies the different rate treatment for the types of services. (Exh. 50 (Bumgarner) at 11-13.)

323. Mr. Chalfant next argued that RDCS was discriminatory because it would charge customers regardless of whether they had already made a CIAC. (Exh. 26 (Chalfant) a6 16.) The Company reiterated that RDCS is designed based on the COSS to recover

continuing O&M costs related to the reserved facilities, not the capital-related costs of those facilities. Therefore, there was no issue of the Company trying to double-recover any capital-related cost. (Exh. 50 (Bumgarner) at 13.)

324. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that the Commission approve Rider RDCS. (HER at 131.) First, he noted that it was a voluntary service for customers who choose it. The service is designed to recover the O&M costs from the customers who cause those costs to be incurred as opposed to other customers; thus, the Hearing Examiner found it was reasonable and non-discriminatory. He also agreed that exempting hospitals in order to reduce their rates would be unduly discriminatory, and opined that subsidies based on societal considerations such as that requested by Christiana were best left to the legislature. (*Id*.).

325. **Exceptions.** Both Christiana and DEUG excepted to the Hearing Examiner's findings and recommendations. First, Christiana argued that dual-feed service was properly a part of rate base and should not be subject to the RDCS Rider. (Christiana Brief on Exceptions at 2.) Christiana contested the Hearing Examiner's reliance on Delmarva witness Bumgarner's testimony, arguing that the second capacity sources were not dedicated facilities but were shared with other customers; therefore, the backup line for one customer is the primary line for another customer. (*Id*.). Furthermore, Christiana pointed out that all equipment required to switch from the primary line to the secondary line is paid for and maintained by the

customer, not by Delmarva. Therefore, Christiana concluded, Delmarva is already recovering its O&M costs for the dual feed lines because other customers are being served off those same lines and are contributing to their upkeep. (*Id*. at 2-3.)

326. Christiana next argued that the RDCS Rider is discriminatory because some Delmarva customers would be charged for a service that others receive for free, pointing to the Company's network system in downtown Wilmington. (*Id*. at 3.) Christiana claimed that the Hearing Examiner was untroubled by this clear discrimination, apparently because Rider RDCS is voluntary. According to Christiana, however, the "critical distinction" is not that RDCS service is optional, but rather that if Rider RDCS is implemented, one Delmarva customer will receive the service for free while another will be forced to pay for the very same service. (*Id*.).

327. Third, Christiana argued that there was no precedent justifying the RDCS Rider. (*Id*. at 4.) It noted that despite the trend toward unbundling of services, Christiana had only been able to locate one other utility (in New Jersey) that had such a service. Thus, Christiana argued, the trend toward unbundling did not support the imposition of this "novel" tariff. (*Id*.).

328. Next, Christiana contended that the RDCS Rider did not guarantee service and so Delmarva should not be permitted to impose a charge when there was no requirement that it provide the service for which customers would be charged. (*Id*.).

329. Fifth, Christiana argued that although the Hearing Examiner did not discuss this issue, Delmarva receives certain benefits from

its dual-service customers. It noted that Delmarva can switch its loads from the primary to the secondary line in the event it needs to repair or maintain the primary line, citing an example of when Christiana switched to its secondary line at Delmarva's request and took service off that line for one entire month. (*Id*. at 4-5.) Second, it claimed that Delmarva benefits from an increase in overall system reliability by providing dual service to its customers. Third, Christiana stated that the public has a more positive perception of Delmarva because customers are not without power for extended periods of time. Lastly, Delmarva does not lose revenue from dual-feed customers in the event that the customer's service is disrupted. (*Id*. at 5.)

330. Alternatively, Christiana argued that if the Commission approved Rider RDCS, it should be implemented subject to the three times revenue test. Because the CIAC in Rider RDCS is not subject to a revenue test, there is no recognition that a customer receiving dual service is simultaneously generating revenue for Delmarva on its primary line; consequently, the cost associated with these services should be subject to the revenue test. (*Id*.).

331. Also alternatively, Christiana took issue with the Hearing Examiner's recommendation not to exempt hospitals and critical care facilities from Rider RDCS. It argued that hospitals and critical care facilities have special needs that other electric customers do not, and "no other single customer is in the position of a hospital and plays that kind of vital role to a community." (*Id*. at 6, quoting Tr. at 804.) Christiana noted that it has been taking dual feed

service from Delmarva to ensure that if there is a problem on its primary line, it can take service on the backup line. Christiana noted that many other critical care facilities in the area (such as Thomas Jefferson University Hospital, Methodist Hospital, Albert Einstein Medical Center, Germantown Hospital, Frankford Hospital, Magee Rehabilitation Hospital, Lankenau Hospital, Bryn Mawr Hospital, Paoli Hospital, and Bryn Mawr Rehabilitation Center) receive this type of backup service to ensure patient safety, but none of them is subject to this type of dual service tariff. (*Id*. at 6.)

332. DEUG argued that the Hearing Examiner's sole reason for recommending approval of Rider RDCS was that it was a voluntary service whereby customers so choosing are provided a redundant delivery service and that RDCS will recover costs from the customers who cause those costs to be incurred. (DEUG Brief on Exceptions, citing HER at 131.) DEUG set forth four reasons why the Hearing Examiner's recommendation and the proposed Rider RDCS should be rejected. (*Id*.).

333. First, DEUG argued that the Rider RDCS was *not* a voluntary service, but rather represented a 37% increase for existing distribution service. (*Id*. at 5-6.) DEUG noted that Delmarva has 57 GS-P accounts that have dual feeds that may be forced to pay a second demand charge (which would increase the price they pay for the same demand service by 37%) or have their existing service quality reduced. (*Id*. at 5.) DEUG noted that Delmarva witness Bumgarner testified that if one of the 57 accounts did not pay the RDCS charge, Delmarva would leave the switch for the existing alternate feed "open," which would

prevent the alternate feed from providing electric service to the customer if the primary feed failed. (*Id).* Thus, even though such customers have been receiving dual feed service for years, Delmarva proposes to no longer provide the alternate feed unless the customer pays a second demand charge applied to the customer's total demand. DEUG contended that this is not "voluntary" service but rather is a 37% increase for existing service, on top of the 118% increase that GS-P customers will experience in supply rates. (*Id.).*

334. Second, DEUG argued that the RDCS Rider would discriminate against certain customers with dual feeds in four ways: (a) it ignored differences between existing customers as to whether they have made CIACs; (b) it ignores that other customers would continue to receive dual feed service without the additional charge; (c) it ignores that Delmarva cannot document whether existing feeds were added at Delmarva's convenience or the customer's request; and (d) it proposed to charge the same surcharge regardless of whether the customer has an automatic switch. (*Id.* at 6, 9.) As for the first reason, DEUG noted that some of Delmarva's dual feed customers have already made CIACs toward the capital and other costs of an existing second feed – but Delmarva cannot identify who those customers are. Furthermore, it proposes to eliminate service from the second feed even if the customer has made a CIAC for that line. (*Id*.). Delmarva's explanation that the RDCS charge is based on fixed O&M costs, DEUG contends, "does not take away from the fact that it is proposing to discriminate against customers that have made contributions in-aid-of construction toward the capital and other costs (presumably at least

63% of the costs) for a second feed." (*Id*. at 6-7.) DEUG argued that Delmarva had failed to explain why the difference between customers that have made CIACs for the larger cost category (capital costs) and customers with dual feeds that have made no CIACs should not be recognized in rate design or quality of service. DEUG contended that Delmarva had not met its burden of showing that the RDCS Rider results in greater equity among the GS-P customers, and without a study of CIACs, that could not be known. (*Id*. at 7.)

335. Next, DEUG observed that Delmarva has at least 46 GS-P dual feed customers that may have dual feed service due to Delmarva's desire to enhance its system. Moreover, Delmarva has at least 508 GS-P customers that receive network service. DEUG contends that it is discriminatory to charge any of the 57 RDCS customers a second demand charge because their power can flow from two different directions or cut off their second feed, when Delmarva does not propose to charge all dual feed or networked customers the same charge. (*Id*. at 8.)

336. Third, DEUG noted that Delmarva lacks the records to ascertain whether dual feeds were installed for Delmarva's convenience or at the customer's request. (*Id*. at 8-9). DEUG argued that Delmarva's reliance on the memories of its large account representatives was insufficient for Delmarva to carry its burden of proof. (*Id*. at 9.)

337. Fourth in this area, DEUG noted that unless a customer has a secondary feed connected to an automatic switch, the customer will suffer an outage if the primary feed has a fault. Only with an automatic switch will the secondary feed pick up automatically. Only

45 of the 57 accounts have automatic switches; the remaining 12 will suffer power failures if there is a fault in the primary feed. DEUG argued that Rider RDCS is discriminatory because it proposes to charge the same surcharge to customers that will suffer power interruptions if their primary feed faults as it will charge customers with an automatic switch that will suffer no power loss. (*Id*. at 9-10.)

338. Next, DEUG contended that Delmarva had failed to prove that Rider RDCS was necessary because: (a) it had not shown that its existing line extension tariff was insufficient; (b) no GS-P customer had asked for this tariff; and (c) its argument regarding class cross-subsidization was undercut by the fact of DEUG's opposition to the tariff. (*Id.* at 10-14.) First, DEUG argued that the requirement that a customer requesting installation of facilities that are more costly than those proposed to be furnished by the Company be required to pay the difference between the facilities is already contained in the current tariff at 2nd Revised leaf No. 35. (*Id*. at 11-12.) DEUG further argued that the Company's tariff would permit the assessment of a "facilities charge" to cover the situation whereby a customer requesting more than normal service would pay an added maintenance charge each month. (*Id*. at 12.) DEUG posited a hypothetical which it claimed showed that in certain situations a customer would be paying an additional fee for the exact same service it was currently receiving (and paying for). (*Id*. at 13.)

339. Second, DEUG observed that Mr. Bumgarner had conceded that no GS-P customer had asked Delmarva to propose the implementation of

this rider, and that GS-P customers have only complained about or opposed it. (*Id*. at 14, citing Tr. at 704.)

340. Third, the fact that DEUG (representing GS-P customers) and Christiana (a GS-P customer) were united in their opposition to the proposed rider undercut the Company's rationale for implementing the tariff: the subsidization of some GS-P customers by other GS-P customers. (*Id*. at 14.)

341. Finally, DEUG argued that this was not an appropriate time to be imposing additional costs on GS-P customers, since they would be the ones experiencing the greatest increases as a result of the SOS rates. Moreover, DEUG contended that it was clear that there were numerous unanswered questions surrounding this rider, and that it was not clear what additional reliability RDCS customers would be receiving from the service. (*Id*. at 14-15.)

342. **Discussion and Decision.** Our review of the record and the arguments presented to us prior to our deliberations convince us that we should not approve Rider RDCS at this time. We note initially that this issue does not involve a gain or loss of revenue to Delmarva; it is revenue-neutral as to Delmarva. Rather, it is a question of whether all customers in the GS-P class are paying costs that only some customers are causing and who should be paying for them.

343. We credit the evidence that no GS-P customer has requested Delmarva to implement this service. This suggests to us that GS-P customers are not as concerned about potentially subsidizing other class members as Delmarva may have thought. We find it telling that

DEUG represents several GS-P customers and DEUG’s position was to oppose the proposed rider.

344. We are also concerned that Delmarva was unable to identify which GS-P customers had made CIACs for their dual feeds and which had not. We understand Delmarva’s contention that the CIACs refer to initial capital costs of installation, and that the proposed rider addressed ongoing O&M costs. But it does seem to us that the GS-P customers that have made CIACs for their second feeds would be paying an additional fee for the same service they are already receiving.

345. This is not to say that Delmarva cannot present Rider RDCS for approval in its next base rate case. We simply believe that on this record, there are too many questions associated with it to approve it at this time. Thus, we reject the Hearing Examiner’s recommendation to approve Rider RDCS. (Unanimous.)

B. <u>Standby Service S</u>

346. Mr. Bumgarner sponsored the Company’s proposed new Standby Service “S.” He explained that customers with behind the meter generation operating in parallel with the Company require the Company to maintain facilities capable of providing service for their total load, even though the customer’s generation normally provides all or a portion of its load. (Exh. 48 (Bumgarner) at 8; Tr. at 695.) He testified that the amount of delivery capacity available to the customer but normally supplied by the operation of the customer’s generator is standby delivery capacity. (Exh. 48 (Bumgarner) at 8; Tr. at 695-96.) He stated that the costs of providing this standby capacity, including capital and O&M related costs, must be recovered

through a separate charge, since they are not recovered directly from customers with behind the meter generation through the normally applicable distribution rates. (*Id*.). Initially, this rider would have applied only to two customers served at transmission voltages. (*Id*. at 10; Tr. at 690.) Following its review of DEUG witness Chalfant's testimony in which he objected to the application of the rider to customers served at transmission voltages, the Company agreed to limit its applicability to customers served at distribution voltages. (Exh. 50 (Bumgarner-R) at 13-14.) Accordingly, at this time no customers will be subject to Rider S. (Id.; Tr. at 690-91.)

347. During public comment, Brian Gallagher, representing the Delaware Energy Office, recommended that the Commission exempt renewable generators (smaller than 1 MW) from Rider S. He contended that the charge would discourage on-site renewable generation and that Delmarva had not shown that such customers cause sufficient costs to warrant being classified under the service. Mr. Gallagher reiterated those concerns during the April 25, 2006 Commission meeting. (Tr. at 1375.)

348. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner found that even though no customers would currently be subject to the Rider, it was "prudent" to implement it so that any such future customers would pay the costs they cause the Company to incur instead of all customers paying for those costs. (HER at 133.) He noted that the Company had not addressed the Delaware Energy Office's comments and that no other party had advanced that contention. The Hearing Examiner concluded that whether there should

be an exemption for small renewable self-generation was a question best left to the legislature. (*Id*.).

349. **Exceptions.** DEUG was the only party to except to the Hearing Examiner's findings and recommendations. It noted that this rider was "[s]upposedly … for distribution capacity that is sufficient to serve the customer's entire load in the event of an outage of the customer's generation." (Exh. 26 (Chalfant) at 9-10.) DEUG contended that Rider S was "unreasonable and discriminatory" and should be rejected for several reasons. (DEUG Brief on Exceptions at 15-16.)

350. First, DEUG contended that assessing a surcharge to customers with self-generation is a significant departure from past practice. (*Id*. at 16.) Generally, DEUG observed, Delmarva assigns customers to a particular rate schedule according to voltage, and within each such classification, Delmarva does not discriminate among customers as to either customer or distribution demand charges. With Rider S, however, there would be such discrimination because all customers in a particular classification that have self-generation would be assessed a demand surcharge. (*Id*.). DEUG explained that all GS-P customers currently pay the same customer charge even though some are served at a much higher demand level and may therefore require a larger, more expensive meter than other GS-P customers. (*Id*.). Delmarva's distribution demand charges are based on the customer's measured demand at the meter and do not treat customers that have self-generation differently. (*Id*. at 17). This does not mean that increased measured demand caused by the outage of a generator behind the meter is not included; the tariff defines measured demand as the

greater of the maximum demand at the meter established by the customer during any 60-minute period of the month during on-peak hours as measured by the demand meter, or ½ of the maximum demand established during any 60-minute period of the month during off-peak hours. If a customer with 4 MWs of installed self-generation does not operate its self-generation during any 60-minute period of the month, it will be charged that month for its 4 MWs of absent self-generation if it is using more than 4 MWs at the time, under the current and proposed tariff. (*Id.*).

351. Second, DEUG argued that Rider S constituted unreasonable discrimination against customers with self-generation because Rider S imposes a second demand charge on such customers. (*Id.*). It noted that Delmarva had agreed that a customer with a historic demand of 5 MW that reduced its demand by 4 MW because it shifted 4 MW worth of production to China would not pay a second demand charge for the 4 MW of lost load; however, if the customer installed 4 MW of self-generation, the customer would have to pay a second demand charge based upon that 4 MW of self-generation. (*Id.*). DEUG argued that self-generation is in the public interest because it represents disbursed generation in Delmarva’s service territory, which is transmission-constrained. (*Id.* at 18.). Furthermore, self-generation often has the characteristics of co-generation, which is recognized as a more efficient form of generation. The Rider S surcharge would discourage self-generation in Delaware and work against the benefits provided by self-generation. (*Id.*)

352. Third, DEUG argued that Delmarva had not shown that Rider S was necessary. It was originally designed to apply to two SG-T customers, but since the Company had conceded that it would be inappropriate to apply it to GS-T customers, it would now apply to no customers. (*Id.).* Second, Delmarva presented no evidence that any of its current GS-P of secondary voltage customers were likely to install self-generation. (*Id*. at 19.) Third, Rider S would have generated only $19,000 annually, which suggested that there was no pressing need to cure any intra-class subsidization. (*Id*.). Fourth, Delmarva had not shown that its current line extension tariffs did not adequately address situations where customers with self-generation requested more than normal facilities. (*Id*. at 19-20.) Fifth, DEUG argued that certain aspects of Rider S were unnecessary and duplicative. It would require the customer to buy a second meter (to measure the output of the self-generation so that Delmarva could charge the second demand charge based on that output), but no meter would be necessary in the absence of Rider S. (*Id.* at 20.) It would require the customer to enter into an interconnection agreement with Delmarva, although a self-generator is already required to enter into an interconnection agreement under PJM rules or, if not under such rules, then an interconnection agreement is unnecessary to be amplified to a larger set of circumstances. (*Id*. at 20-21.) Lastly, DEUG contended that the provision stating the customer's service classification is not needed because those service classifications depend upon the voltage at which each customer is served by Delmarva, not as to whether the customer has self-generation. (*Id*. at 21.)

353. Fourth, DEUG argued that the proposed Rider S had not been well developed on the record, and at most should be referred for further investigation. (*Id*.). Delmarva had not identified any customers that would be subject to this charge; it had not identified the demand-related costs that would form the cost basis for the surcharge (*id.* at 22); and it should be required to address whether the public policy benefits of self-generation exceed the minor inequities caused by not discriminating against self-generators. (*Id*. at 22-23.)

354. **Discussion and Decision.** In light of the fact that Rider S would not apply to any current customers, we see no need to approve a tariff that will not apply to any customer. We are also concerned that adoption of this rider would discourage self-generation. As DEUG points out, self-generation is beneficial in that it helps to alleviate the transmission constraints on the Delmarva peninsula, and the federal government has policies favoring cogeneration. Thus, we reject the Hearing Examiner's recommendation to approve Rider S, and rather will table consideration of its approval until Delmarva has a customer to which the Rider would apply. (Unanimous.)

C. Unmetered Telecommunications

355. Comcast witness Stinneford proposed a new tariff for cable power supply customers "and other constant use, high load factor customers." (Exh. 54 (Stinneford) at 2.). He defined CATV power supplies as "devices that provide electricity to all of the components along an integrated cable television network." (*Id*. at 5.) He explained that these devices are interconnected with the local electric

distribution system, either mounted on poles or in separate curbside units. Such devices operate 24 hours a day, seven days a week, 365 days a year and run at very high load factors (except for outages).[33] The majority of CATV power supplies have demands smaller than 1 kW and generally use fewer than 1,000 kWh per month. Although the load at any one particular station is relatively small, the load across an entire integrated CATV system can be significant. In Comcast's Delmarva service territory, he estimated that Comcast alone has between 600-700 kW of instantaneous demand associated with its nearly 1,100 CATV power supplies. (*Id*. at 5-6.)[34]

356. Mr. Stinneford testified that "[I]n many ways, [CATV power supplies] are thus ideal loads for an electric system. Not only are they a very high load factor, but the load is distributed across the entire distribution system, and not concentrated at one or two locations." (*Id*. at 6.) CATV power supplies are billed under the SGS-ND tariff, which consists of a monthly customer charge, a per kWh distribution charge, and two small per kWh charges to generate revenue for environmental and low-income funds. For an SOS customer, there are also per kWh transmission and ancillary service charges and a

[33]Comcast asserted that it has worked with PEPCO and Baltimore Gas & Electric ("BG&E") to establish load profiles for CATV power supplies. For PEPCO, CATV power supply loads were assumed to operate at a 100% load factor. For BG&E, Comcast paid for a load research study in which BG&E hung interval meters on a statistical sample of Comcast's locations; the resulting load factor was 91%. (Exh. 54 (Stinneford) at 8.)

[34]Mr. Stinneford testified that CATV operators also have office buildings, "head-end" facilities and other miscellaneous loads billed under several general service tariffs, but these were not a direct subject of his testimony. (Exh. 54 (Stinneford) at 6.)

seasonally-differentiated supply energy rate. Under the Company's proposal, the SGS-ND customer charge will increase by approximately 89% and the distribution charge will decrease by about 23%. While the average SGS-ND customer would experience a slight decrease in its monthly bill, CATV power supplies would see an increase because their monthly kWh consumption is generally below the class average; therefore, the impact of the higher customer charge will be greater than the impact of the lower per kWh distribution charge. (*Id*. at 7.)

357. Comcast claimed that Delmarva's proposed rate design was inappropriate for CATV power supplies because the nature of the typical loads served under SGS-ND is so much different than CATV power supplies. Mr. Stinneford asserted that the SGS-ND class load factor implied by the class demands and energies in Delmarva's COSS is only 54% (measured using 4MCP) as opposed to 100% for CATV power supplies. (*Id*. at 7-8.) Thus, CATV power supplies have been paying distribution (and will be paying SOS demand-related) costs greatly exceeding the cost to serve them. Under the Company's rate proposals, Mr. Stinneford stated, CATV power supplies would pay rates that generate a class rate of return that is 12 times that of the system as a whole. (*Id.* at 8.)

358. Mr. Stinneford acknowledged that customer classes were created because it was not feasible to give every customer its own tariff. However, he argued that some customers in a class are so different from the other customers that they merit a separate rate. He believes that CATV power supplies like outdoor lighting devices are different enough from other SGS-ND class members to warrant a separate rate. (*Id.* at 9.) He observed that other utilities (PEPCO, Commonwealth

Edison, Florida Power & Light, Detroit Edison, Georgia Power, Arkansas Power & Light, Consumers Power) have separate tariffs or riders for CATV power supplies. (*Id*. at 9-10.)

359. Mr. Stinneford testified that in general, he agreed with the Company's proposal to achieve rate parity. (*Id*. at 11.) He noted, however, that the Company's proposed rate design changes resulted in a distribution-only increase of approximately 4.2% for CATV power supply customers such as Comcast, based on the customer charge increasing from $5.78 to $10.93 per month while energy charges decrease (*Id*. at 12.) Provided that the Commission finds that the customer-related costs in Delmarva's COSS are accurate, Mr. Stinneford testified that he had "no problem setting the customer charge at a level to collect those costs on an annualized basis." (*Id*. at 14.)

360. Mr. Stinneford performed his own COSS to support Comcast's request for a separate tariff for CATV power supplies. First, he replicated Delmarva's Delaware jurisdictional distribution studies at present and proposed rates using his software. Then, he modified those studies by adding another customer class ("Unmetered Telecommunications" ("UT")). He did not change the nature of the Company's allocation factors or its methods for functionalizing and classifying costs, but he did recalculate certain allocation factors to separate the UT customers from the remaining SGS customers. (*Id*. at 14.) His COSS showed that UT customers generate a class rate of return at present rates of approximately 114%, more than 12 times more than the system average. Equalizing class rates of return as the Company and he support, the average decrease in proposed distribution

rates for UT customers would be 69.6%. (*Id*.).[35] For purposes of his COSS he assumed that: (a) there were 1,100 customers (the approximate number of all of Comcast's installed CATV power supplies in Delmarva's service territory); (b) power supply devices average 425 kWh/month as measured at the meter; and (c) the load factor was 100%. He calculated class demands based on Delmarva's loss factors, the assumed billing energy, and the assumed load factor. (*Id*. at 16.)

361. Mr. Stinneford pointed out two major differences between the design of his UT tariff and Delmarva's proposed SGS-ND. First, the UT tariff was designed for constant use (extremely high load factor telecommunications customers); therefore, it was assumed that a meter was unnecessary. Secondly, the per kWh distribution charge (designed to collect distribution demand-related cost) was lower, reflecting UT customers' high load factor. These aspects of his rate design were distinct from one another: whether UT customers are metered or unmetered, they were still entitled to receive the benefits of their higher load factor through the per kWh charge. (*Id*.). Otherwise, the proposed UT tariff was designed similarly to SGS-ND: it included a monthly customer charge ($4.93 as opposed to Delmarva's proposed $10.93)[36] and per kWh distribution, environmental fund and low

[35] Mr. Stinneford testified that the available data did not allow him to directly determine class loads for UT customers or identify the number of customers that might be eligible for the UT rate, and that the case schedule would not have allowed Delmarva to generate the load research necessary even if Delmarva agreed to do it. Thus, he used representative data from his previous work for Comcast as well as assumptions made by PEPCO. (Exh. 54 (Stinneford) at 15.)

[36] The difference reflects the absence of a meter investment charge and meter reading expense. (Exh. 54 (Stinneford) at 17.)

income fund charges. SOS customers would also pay per kWh transmission and ancillary service rates and the seasonally-differentiated per kWh charge for energy supply. He designed the UT tariff to generate Delmarva's requested overall 7.64% rate of return. (*Id*. at 17.)

362. Mr. Stinneford testified that his results were consistent with Delmarva's results for other high load factor customers such as LGS-S customers, and that there was no reason why smaller customers with high load factors should not have access to tariffs like LGS-S that take into account high load factors or other similarly favorable load characteristics. (*Id*. at 18-19.) He claimed that a high load factor tariff for small customers was sensible because it would apply to customers with an "extremely high and predictable load factor." (*Id*. at 20.) He asserted that the energy supply rate in his proposed UT rate for SOS customers was the same as Delmarva's proposed SGS-ND rate, and that UT customers should get the benefit of their high load factor here as well. (*Id*.). In light of the time that had passed and the May 1, 2006 initiation date for SOS rates, Mr. Stinneford noted that approval of the UT tariff would require Delmarva to establish a separate load profile for UT customers, which would allow them to take advantage of their high load factor by shopping with alternate electric suppliers. (*Id*.).

363. Mr. Stinneford testified that the UT rate could be metered if necessary, but metering was not required. The Company would determine monthly kWh usage in a manner similar to that which PEPCO uses: the Company would select a statistically significant sample of

power supplies and conduct a field test of the amperage draws of the selected locations. Because some of those locations had been metered before, PEPCO was able to compare the kWh calculated from the instantaneous amperage readings with previous monthly metered usage to ensure that the method was accurate. The results were then applied to all of Comcast's power supply billings. (*Id*. at 21.)

364. Delmarva witness Bumgarner testified that Comcast's proposal would result in a 70% rate cut, reducing charges to Comcast (and Delmarva's revenues by $233,000) and that the actual revenue loss would be even higher assuming other Delaware cable companies took advantage of the lower rate. (Exh. 50 (Bumgarner-R) at 3-4.) He pointed out underlying flaws in Comcast's study, including assumption of a 100% load factor and no metering costs. (*Id*.). He recommended that the Commission not implement Comcast's proposal at this time. (*Id*. at 4.) Mr. Bumgarner further noted that if the Commission desired to consider such a proposal in the future, it should direct the Company to perform the necessary studies for incorporation in its next distribution base rate case. (*Id*.).

365. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner observed that both Delmarva and Comcast agreed that Comcast would save approximately $233,000 under its proposed UT rate. (Exh. 50 (Bumgarner-R) at 3; Exh. 54 (Stinneford) at Sch. RES-3, p. 1.) Because none of these reduced charges were associated with costs that would be avoided in the short-term, the Hearing Examiner found that the Company's revenue requirement would not be reduced and other customers' rates would have to be adjusted upward for the Company to

recover whatever revenue requirement the Commission ultimately approves in this case. (Delmarva PHB at 195.)

366. The Hearing Examiner noted that approximately 45% of Comcast's savings were due to its assumption that there would be no need to meter the service. (*Id.*). Long-term, the Hearing Examiner found that that would result in real savings for Delmarva and lead to a reduced revenue requirement. For the rate-effective period, however, the meters are already there and absent an agreement under which Comcast would pay Delmarva to remove the meters, the meter costs are not avoided in the short term. (HER at 140, citing Tr. at 791-93.) The remaining 55% of Comcast's savings were due to its assumption that the CATV power supplies operated at a 100% load factor, which results in reducing rates compared to what they would be at a lower load factor. The Hearing Examiner found that these savings to Comcast did not reflect any reduction to Delmarva's costs. (HER at 140, citing Delmarva PHB at 196.) Whatever benefits exist from higher load factor usage are spread across the entire SGS-ND customer class which, like all generally applicable service classifications, groups customers with certain similarities but a range of different load factors and usage profiles. The result of removing Comcast from this service classification would be to decrease the remaining customers' average load factor and increase their rates relative to where they would otherwise be. (HER at 140, citing Exh. 56.)

367. The Hearing Examiner credited Mr. Bumgarner's testimony that assuming that Comcast's equipment operated at a 100% load factor was not realistic; Comcast's own study done by BG&E showed that its

equipment operated at a 91% load factor. (HER at 140, citing Exh. 54 (Stinneford) at 8.) Furthermore, the Hearing Examiner observed that Me. Stinneford had testified that the 91% was not representative of the true average load factor of the equipment when viewed as a group rather than individually, and that the 100% assumption was inconsistent with Mr. Stinneford's testimony that the devices operated at load factors "approaching 100%." (*Id*., citing Tr. at 233 and Exh. 54 (Stinneford) at 5.)

368. The Hearing Examiner concluded that in order to develop a more accurate load factor for use in designing a rate for this service, a load factor analysis such as the one performed by BG&E should be undertaken. (HER at 141.) Such a study could better define the total customer base with equipment that would be eligible for the new service. Otherwise, without such information, the Hearing Examiner found that "it is impossible to design rates accurately to collect the Company's overall revenue requirement," and a built-in earnings attrition could be the result. (HER at 141.) Consequently, given these deficiencies, the Hearing Examiner recommended that the Commission reject Comcast's proposed UT rate at this time; however, he noted that "[t]o the extent Comcast remains interested, it should pursue an agreement with Delmarva to pay for a study that could be used to develop a proposal for consideration by the Commission in a future proceeding." (*Id*.).

369. **Exceptions.** Comcast excepted to the Hearing Examiner's findings and recommendations, noting that he "neglected to place any onus on the Company to perform the necessary load research study."

(Comcast Brief on Exceptions at 1.) In this regard, Comcast pointed to the record evidence of the Company's "history of dilatory treatment of the [UT] rate issue," noting that Comcast had pursued an agreement with the Company and offered to pay for such a study since 2002; that Delmarva refused to enter into any agreement until 2004, when PHI sent Comcast a letter stating that it would discuss the issues as part of its next round of rate cases that it planned to file; and that Comcast made several unsuccessful attempts to meet with PHI and Delmarva after receiving that letter. (*Id.* at 2, citing Exh. 53.) Comcast argued that further attempts on its part to pursue an agreement with the Company would be futile unless the Commission directed the Company to work with Comcast to perform the necessary load study. Comcast also expressed concern whether, even if the Company agreed to undertake the load research study, the Company would use the results of that study in future proceedings without specific direction from the Commission. (*Id*.). Comcast noted that it would not object to a proposal to implement a UT rate within the next 12-months, but based on the Company's past history, Comcast preferred a Commission Order requiring the Company to comply with the timing it itself suggested for implementing such a rate. (*Id*. at 2-3.) Thus, Comcast requested the Commission to reject the Hearing Examiner's recommendation and instead order the Company to conduct the necessary load research study for the UT rate and implement such a rate within one year from the date of the final Order in this case. (*Id*. at 3.)

370. **Discussion and Decision.** Delmarva represented on the record that it would be willing to participate in a load research

study, as long as Comcast paid for the study, and that it would be willing to implement a revenue neutral form of the rate resulting from the study. Comcast's representative responded that he did not have authority from his client to commit to Comcast's paying the entire costs of the study. We think it would be appropriate to table this issue until a load research study has been completed. At that time either party may bring the UT rate issue back to the Commission for an independent determination on implementation.

XIV. TARIFF CHANGES – LIMITATION OF LIABILITY

371. The Company seeks to modify the liability portions of its electric tariff. The current tariff language is as follows:

> The Company does not guarantee continuous uninterrupted service and shall not be liable for any loss, cost, damage or expense to any person occasioned by any change in, interruption or phase reversal of the Company's electric service due to any cause beyond the reasonable control of the Company.

372. The following is the Company's proposed modified tariff (the modifications are in bold type):

> The Company does not guarantee continuous uninterrupted electric service and, **except as provided herein,** shall not be liable for any **damages, including but not limited to** loss**es**, cost**s** or expense**s** to any person occasioned by any change in, interruption, **resumption** or phase reversal of the Company's electric service. **With respect to damages that immediately and proximately result from the occurrence of an act or omission of the Company and not as a consequence or effect of such act or omission ("Direct Damages"), the Company shall not be liable to Customers, their directors, officers, employees, agents, or contractors, for any such Direct Damages, including claims of loss, cost, damage, expense including attorneys' and experts' fees, or any other liability, except as caused by the negligence or willful misconduct of the Company and shall be limited to the extent set forth below in Section X.A.3. Under no circumstance shall the Company be liable to Customers,**

> **their directors, officers, employees, agents, or contractors, for indirect, incidental, special, consequential, ancillary, exemplary or punitive damages, lost profits, or loss of business opportunities (all of which together are hereinafter referred to as "Indirect Damages") whether arising in contract or in tort, or any other cause of action.**
>
> **The Company shall not be liable for Direct Damages for any delay of performance, failure to perform or failure of equipment for any cause other than the negligence or willful misconduct of the Company, and shall not be liable for Direct or Indirect Damages from** cause**s** beyond **its** reasonable control **including but not limited to: acts of God, storm, fire, flood, lightning, explosion or other catastrophes; any law, order, regulation, direction, action or request of the United States government or of any other government, including state and local governments having or claiming jurisdiction over the Company; acts or omissions of other entities; preemption of existing service in compliance with national emergencies; insurrections; wars; riots; unavailability of rights-of-way or materials, or strikes, lockouts, work stoppages or other labor difficulties.**
>
> **The Company shall not be liable for Direct or Indirect Damages resulting from any act or omission of any entity furnishing the Company or the Company's Customers goods, services, equipment or other products to be delivered through the Company's facilities or to be used in conjunction with goods, services, equipment of [sic] other products furnished by the Company. The Company shall not be liable for Direct or Indirect Damages due to the fault or negligence of the Customer or due to the failure or malfunction of Customer-provided equipment or facilities.**
>
> **The Company's potential liability for Direct Damages incurred by a Customer shall be limited to the lesser of: $2,000.00 or an amount paid by such Customer in customer and delivery charges for utility service over the 12 month period prior to the act or omission giving rise to the direct [sic] Damages.**

(Exh. 64) (emphasis added.)

373. Company witness Yourinson testified that two of the proposed changes "clarify" that: (1) only direct damages may be sought against the Company relating to outage-related incidents or other

events involving load fluctuations or voltage drops or surges; and (2) the Company is not liable for damages caused by acts beyond its control. (Exh. 59 (Yourinson) at 2-3). He claimed that "[t]he current tariff *perhaps* does so implicitly but certainly does not explicitly bar consequential or punitive damages," and the current tariff contains language that Delmarva is not responsible for damages caused by acts beyond its reasonable control but the modification provides a list of such things that are beyond its reasonable control. (*Id*. at 2-3) (emphasis added.) The other two changes made explicit that Delmarva is not liable for damages caused by others (including suppliers that it might hire) and that Delmarva is only liable for up to $2,000 in direct damages. (*Id*. at 3.)

374. Mr. Yourinson claimed that it is "critically important" that Delmarva be protected from consequential or indirect damages, because they expose the Company to "millions of dollars of potential liability." (*Id*.). He observed that the current language dates back to the 1950s, before society became "more litigious" and when customer expectations were not as great. (*Id*. at 5.) As an example, he described the Company's experience with Hurricane Isabel: over 230 claims were filed, and "[a]lthough most of those claims were ultimately denied, costs were still incurred to investigate each circumstance, process and complete the claims handling." (*Id*. at 5-6.) Mr. Yourinson asserts that each claim, valid or not, cost the Company approximately $3,000 to handle, and that "there are probably several totally meritless claims made each year involving outages

caused by storms and other natural events that we believe might not be made under the proposed tariff language." (*Id*. at 7.)

375. Mr. Yourinson testified that in 1998 Delmarva sought to modify its limitation of liability tariff but withdrew its application. He noted that at that time, Delmarva had included language that would limit its liability in all circumstances except where it was found to be grossly negligent or had engaged in willful misconduct. He claimed that the current proposed modification "tries to take into consideration some of the comments that we received from the other parties in the prior proceeding." (*Id*. at 7-8.)

376. Staff and DEUG objected to Delmarva's proposed modification to its liability tariff. Staff witness Dillard observed that the Company's modification would limit its responsibility for damages to a maximum of $2,000, even if the Company was grossly negligent. (Exh. 66 (Dillard) at 3.) She testified that to the extent that the potential for catastrophic liability affects the Company's risk profile, it should be addressed in the context of return on equity. There was nothing in the Company's testimony, however, regarding the effect that this potentially unlimited liability had on investors' perception of Delmarva's risk. In addition, she testified that the Commission should carefully study the policy considerations that Delmarva raised, and that a separate proceeding involving all utilities would be a better forum for that discussion. (*Id*. at 3-4.)

377. DEUG witness Gorman testified that, from the standpoint of commercial and industrial customers, the $2,000 maximum liability "would effectively [ ] completely absolve[] [Delmarva] of

responsibility for its own wrongdoing" because larger customers would almost never have damages that small, and even if they did it would not be cost-efficient to pursue them. (Exh. 16 (Gorman) at 36.) Mr. Gorman contended that the Company failed to establish that the costs it incurs were significant and that the proposed tariff modification was necessary to reduce its costs. He further contends that the Company did not prove that its proposal would result in material reductions in its cost of service. In addition, Mr. Gorman asserted that such a limitation would provide a "significant disincentive" to Delmarva to provide "high quality, reliable electric service." (*Id*. at 37.)

378. In response, the Company asserts that: (a it cannot choose its customers (Exh. 59 (Yourinson) at 9); (b) these limitations are "pervasive" in contracts involving competitive services, so that contending that Delmarva should be denied such protection "is tantamount to arguing that a customer should be uniquely able to sue its utility for consequential and other types of damages for which it could not sue its other suppliers" (*id*. at 11); (c) customers are in a better position to determine their level of potential damage and to protect themselves accordingly, whether by the purchase of insurance or backup equipment (*Id*.); (d) a widespread outage of a day or more could result in "hundreds of millions of dollars in claims" (*Id*. at 12); (e) all utility ratepayers pay for claims that are disproportionately made by commercial and industrial customers (*Id*. at 8, 14); (f) an unregulated company has greater flexibility to price its product to take account of its liability risks, and that because

Delmarva's return on equity is restricted to that allowed by the Commission, its liability for damages should likewise be limited (*Id*. at 8); (g)limitations on liability are "exceptionally common" in general commercial contracting and the utility industry (*Id*. at 9); and (h) the modifications "might help avoid premium increases or acceptance of much higher self insurance deductibles" (*Id*. at 15.)

379. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended that the Commission reject the proposed modification. (HER at 146.) First, he acknowledged that it was true that the Company cannot choose its customers, but neither could most of its customers choose a different utility, and none of its customers could choose a different distribution utility. (Staff PHB at 110.) As DEUG illustrates, the regulatory process attempts to make service prices, terms, and conditions fair to both the utility and its customers. (HER at 147, citing Exh. 16 (Gorman) at 40.)

380. Delmarva responded that it is becoming "increasing[ly] the norm in the utility industry to have limitations on liability," and therefore if a customer could pick among multiple utilities, those utilities would likely have such a limitation of liability. (Exh. 59 (Yourinson) at 10.). The Hearing Examiner, however, noted that Mr. Yourinson had provided no evidence of the number of electric utilities operating in the United States that have such limitations vis-à-vis the total number of electric utilities operating in the United States, and therefore found that there is no evidence other that Mr. Yourinson's testimony whether it really is becoming "increasingly the norm." Furthermore, the Hearing Examiner observed

that the tariff pages of the six or seven other utilities that were attached to Mr. Yourinson's direct and rebuttal testimonies and introduced as Exhibits 61 through 63 did not contain any *monetary* limitation as the Company proposed here. Not even the Verizon tariff that this Commission approved contains such a limitation. Therefore, the Hearing Examiner found that it could not be said that customers would be subject to the same provisions if they did have a choice of utilities. (HER at 147.)

381. Next, the Hearing Examiner rejected Delmarva's contention that such limitation of liability provisions were "pervasive" in contracts involving competitive services. He observed that Mr. Yourinson did not provide any evidence of any such contracts, but rather offered only an "example" (which Staff likened to a hypothetical) of a trucking company that limits its liability to no more than the amount the trucking company receives for its service. (HER at 147-48, citing Exh. 59 (Yourinson) at 9-10.) The Hearing Examiner found it "instructive" that, given Mr. Yourinson's position at Delmarva, he could not locate any contracts that contained similar limitations on liability as proposed by Delmarva. (HER at 148.)

382. Furthermore, the Hearing Examiner found that even if Mr. Yourinson's assertion that commercial contracts routinely include such a provision were true, that did not address the limitation as it applied to residential customers. The Hearing Examiner observed that more and more residential customers have sensitive equipment in their homes, and given the proliferation of large estate homes that have been built in Delmarva's service territory, it was likely that there

were at least *some* residential customers that may be billed more than $2,000 over a 12-month period for their electric service. The Company’s proposed limitation would potentially preclude those customers from being made whole. (HER at 148.)

383. The Hearing Examiner rejected Delmarva’s claims that it “cannot be an expert in all the businesses its customers run,” but the customers *do* know their own processes and can assess the potential damage that they would experience from a lengthy outage or voltage fluctuations and could install backup equipment or purchase insurance accordingly. (HER at 148-49, citing Exh. 59 (Yourinson) at 11), finding that Delmarva had not shown what the costs to these customers would be for such protection. The Hearing Examiner accepted DEUG witness Gorman’s argument that Delmarva had been unable to identify capital and operating costs for commercial and industrial customers for installing backup or protective equipment, nor was the Company able to say whether insurance coverage for damages occasioned by service interruptions or poor service quality would be available to commercial and industrial customers. (*Id*., citing Exh. 16 (Gorman) at 41.)

384. As for residential customers, the Hearing Examiner noted that while the cost of some protective equipment (e.g., a surge protector) might be relatively small, the cost of other protective or backup equipment (e.g., gas-fired generators) was not. (HER at 149, citing Staff PHB at 112.) As between this customer class and Delmarva, Delmarva clearly is in a position to determine their potential damage levels. And the residential class – not the

commercial and industrial customer classes – has the largest number of customers. (HER at 149.)

385. Finally, the Hearing Examiner stated that even if a “widespread, extended outage” actually occurs, Delmarva has $150 million of insurance coverage (after the payment of a $2 million deductible), which covers most types of damages caused by sudden events. (HER at 149, citing Exh. 59 (Yourinson) at 12-13; Tr. at 869).) He found that Delmarva had been able to secure such insurance at a reasonable price without this liability limitation to date, and that at least over the last 5 years it has never come close to exhausting its deductible. (*Id.*, citing Staff PHB at 114.) Over the last 5 years, the most the Company has paid in settlements is $80,400, and it has averaged less than $42,000 annually over those 5 years. (*Id.*, citing Exh. 16 (Gorman) at 42.)

386. In its post-hearing brief, Staff set forth the colloquy between its counsel and Mr. Yourinson that it claims demonstrated just how unfair the Company’s proposal was to commercial and industrial customers. The Hearing Examiner set forth the lengthy excerpt as illustrative of that unfairness. In light of the Company’s decision not to except to the Hearing Examiner’s recommendation as it related to the proposed limitation on direct damages, however, we will not set it forth here.

387. The Company claimed that commercial and industrial customers submit a disproportionate number of the claims that are filed, but that all ratepayers bear the costs of claims paid, the cost of insurance, and the costs to investigate and litigate claims. (Exh.

59 (Yourinson) at 14.) Commercial and industrial customers, Mr. Yourinson says, “often suffer little or no direct damages because they typically have safety devices at their meter or on individual pieces of equipment; but these customers are far more likely to claim consequential damages in the form of lost sales or lost product.” (*Id*.).

388. The Hearing Examiner agreed that Delmarva includes these costs of doing business in its revenue requirement, but noted that, as DEUG witness Gorman pointed out, Delmarva’s position was not based on any class allocation study in this record, and it was not suggesting a different allocation of insurance premiums and settlement costs among rate classes. Consequently, the Hearing Examiner found that there was no evidence that commercial and industrial customers are not paying rates that fully recover insurance and investigation costs. Furthermore, the Hearing Examiner found that the Company’s proposal would have a disproportionate impact on commercial and industrial customers by essentially denying them any recovery of legitimate damages. As Mr. Yourinson admits, the $2,000 maximum liability level “’would act to limit the amount of claims from commercial customers ….’” (HER at 153, citing Exh. 16 (Gorman) at 43.)

389. With respect to how Delmarva is viewed in terms of risk by the ratings agencies, the Hearing Examiner was persuaded by Staff’s point that the lack of such a limitation on liability had not adversely affected the Company: Delmarva is well within the benchmarks for an A-rated utility and has a business position of 3, and S&P has observed that Delmarva’s ratings are adversely affected by the ratings

of its parent, PHI. (HER at 154, citing Staff PHB at 118, (citing Exh. 16 (Gorman) at 20-21, 46-47; Exh. 22 (Parcell) at 32-33; Exh 92 (Parcell-R) at 2-3).) The average business position of proxy companies, some of which may have a limitation on liability, is 5. (HER at 154, citing Exh. 16 (Gorman) at Ex. MPG-2.) Therefore, the Hearing Examiner concluded, the ratings' agencies perceive Delmarva as less risky even though it lacks this limitation on its liability. If it did have such a limitation, then it would be entirely appropriate to decrease its allowed return on equity. (HER at 154.)

390. Next, the Hearing Examiner noted that the Company admitted that its insurance costs would not decrease if its proposed modifications were implemented (although it asserted that increases in its deductibles or premiums could be staved off). The Hearing Examiner was not persuaded, observing that insurers can increase premiums (and cause an insured to increase the deductible to reduce the premium) for many reasons, only one of which might be that the customer does not have a provision limiting its liability. Consequently, the Hearing Examiner concluded that whether the Company's proposed limitation of liability would delay increases in premiums or deductibles was speculative. (HER at 154.)

391. The Hearing Examiner noted that the amount by which the Company proposed to decrease its cost of service was only $25,000. As Staff pointed out, this was less than the annual average that the Company has spent on settlements for the last 5 years, and represented the cost of investigating 8-1/3 claims. (HER at 154-55, citing Staff PHB at 120 (citing Exh. 16 (Gorman) at 42; Exh. 59 (Yourinson) at 7).)

According to the Company, in the last 5 years the number of claims made against it has ranged from 252-459. (HER at 155, citing Exh. 65, response to DEUG 2-4.) If the Company truly expected to reduce the number of claims that it is forced to investigate and resolve, it would seem that the amount of the reduction in the cost of service would exceed $25,000. (HER at 155.)

392. For all the foregoing reasons, the Hearing Examiner recommended that the Commission reject the Company's proposed modifications to its tariff language on limitation of liability.

393. **Exceptions.** The Company was the only party to except to the Hearing Examiner's findings and recommendations. In its exceptions, the Company withdrew its proposed modification to cap direct damages at the lesser of $2,000 or the amount paid by the customer in customer and delivery charges for utility service of the preceding 12-month period. (Delmarva Brief on Exceptions at 67.) It continued to maintain that the other three modifications should be approved.

394. First, the Company argued that by relying on arguments made by other parties opposing the modification, the Hearing Examiner "has created a new standard of proof …. It is apparently no longer sufficient to have the unrebutted sworn testimony of an expert witness, but instead, every statement made by that expert witness must be supported by a stack of paper supporting the statement." (*Id.*). The Company argued that the Hearing Examiner had demanded an "unreasonable and inappropriate level of proof" and that unrebutted expert testimony could not be "lightly disregarded." (*Id.* at 68.)

Furthermore, the Company contended that the Hearing Examiner "missed the point" of the several cases from around the country that it had cited in its brief regarding the propriety of limitations on a utility's liability so as not to expose the utility to potentially catastrophic losses – that such provisions are ultimately for the protection of the utility's customers and further the public policy goal of maintaining utility rates at reasonable levels. (*Id.* at 68-69.)

395. The Company contended that neither DEUG nor Staff had presented any opposition to the Company's proposals to clarify that the provision excludes liability for damages caused by acts beyond the control of the Company or the illustrative listing of particular events that are beyond the Company's control, or the exclusion from liability for damages caused by the acts of third parties, and they should therefore be approved. (*Id.* at 70.) The Company contended that at the evidentiary hearings, Staff's and DEUG's witnesses "appeared to agree" that the Company should not be liable for damages caused by others' negligent acts or by acts of God. (*Id.*). Nevertheless, the Hearing Examiner rejected all of the proposed modifications, although he did not state any specific reasons for rejecting the changes that would result in no liability for acts beyond the Company's control (and the accompanying illustrative list) and for damages caused by acts of others. (*Id.*).

396. The Company took issue with the Hearing Examiner's rejection of its argument that it cannot choose its customers and the Hearing Examiner's acceptance of DEUG's contention that the regulatory

process attempts to make service prices, terms, and conditions fair for both the utility and customers. The Company contends that it cannot "unilaterally change its tariff" and has not attempted to do so here; but that the public policy reasons cited in the other states' decisions provide support for the changes the Company seeks to make. (*Id*. at 71.).

397. The Company dismissed as "patently unreasonable" the Hearing Examiner's criticism that the Company provided no evidence of the number of utilities nationwide that have a limitation of liability provision similar to that the Company sought to implement, claiming that it provided "several illustrative examples." (*Id*.). The Company similarly derided the Hearing Examiner's criticism that it had not provided any examples of limitations of liability provisions in contracts, claiming that its witness's "uncontroverted testimony," based on his knowledge of the insurance industry, should have been sufficient. (*Id*. at 71-72.)

398. Next, the Company claimed that the Hearing Examiner's criticism that the Company had not quantified what it would cost customers to protect themselves from the ramifications of an outage or voltage fluctuation was "meritless." (*Id.* at 72.) The Company claimed that its witness's testimony that he did not need a study to tell him what he already knew – lost profits and business interruption insurance is available - was sufficient, given his "extensive experience" in the industry. The Company claimed that it could not possibly know what its customers would need because it could not be

expected to know every detail of its customers' businesses, a claim that at least one other commission accepted. (*Id*. at 72-73.)

399. The Company next argued that the fact that it has insurance and that its settlement costs have averaged $42,000 annually over the last 5 years "prove[] nothing." (*Id*. at 73.) Noting that the Company would be justly criticized if it did not have general liability insurance, the Company claimed that this had nothing to do with the proposed tariff modifications. It asserted that the Hearing Examiner (and the parties opposing the modifications) "miss the point" that the proposed changes are designed to limit what could be catastrophic losses and unnecessary higher rates, and posited that the Hearing Examiner's (and Staff's and DEUG's) view seemed to be that there is no need for Delmarva to protect itself against this eventuality since it has not happened yet. (*Id*.).

400. The Company asserts that Staff's hypothetical – cited approvingly by the Hearing Examiner – actually demonstrated that it was not difficult for a party to assert negligence. (*Id*. at 73-74.)

401. Next, the Company took issue with the Hearing Examiner's statement that if the limitation of liability provision was accepted, it would be appropriate to reduce Delmarva's approved return on equity to account for the reduced risk, calling it "absurd." (*Id*. at 74.) Delmarva noted that it has such a provision in Maryland, and that several of the companies that Staff witness Parcell used as a proxy group for Delmarva had tariffs limiting their liability for damages. (*Id*.).

402. Finally, the Company argued that the Hearing Examiner missed the point by saying that the limitation on liability would not reduce the Company's insurance costs or reduce its deductible. It claims that the Hearing Examiner seemed to be willing to wait until something terrible happened before taking any action, which was not the appropriate way to proceed. (*Id*. at 75.)

403. **Discussion and Decision.** As noted, after the Hearing Examiner issued his proposed findings and recommendations, the Company withdrew its request to modify the limitation of liability tariff to place a limit on the amount of direct damages that can be obtained by a customer in the event of negligence, gross negligence, or willful misconduct on Delmarva's part. As for the provisions that purport to "clarify" the Company's current tariff, we believe that the tariff's current language adequately addresses that the Company will not be liable for acts beyond its reasonable control, and that we should not be determining in the abstract what actions might be beyond the Company's reasonable control. As for the Company's proposed modification to eliminate its liability for consequential damages, we agree with the Hearing Examiner that the Company has not borne its burden of proof with respect to establishing that this limitation is needed. As DEUG points out, these are very real damages to a customer that sustains them, and we should be cautious in limiting a customer's ability to recover for any damages that that customer can prove were caused as a result of the Company's negligence, gross negligence, or willful misconduct. Furthermore, we reject Delmarva's contention that the Hearing Examiner and we were somehow obligated to accept what it

called Mr. Yourinson's unrebutted testimony. As DEUG pointed out, there is no requirement that we accept the testimony of any expert witness, unrebutted or not, and, in any event, Staff and DEUG did indeed take issue with Mr. Yourinson's claims. Therefore, for the foregoing reasons and those set forth in the Hearing Examiner's findings and recommendations, we adopt the Hearing Examiner's findings and recommendations, and reject the Company's proposed modifications to its limitation of liability tariff language. (Unanimous.)

XV. ORDER

AND NOW, this 6th day of June, 2006, **IT IS HEREBY ORDERED:**

1. That the Hearing Examiner's recommendation that Delmarva Power & Light Company shall not be permitted to include Construction Work in Progress in its rate base, and that the AFUDC credit be reversed, is approved.

2. That the Hearing Examiner's recommendation that Delmarva Power & Light Company's pre-paid pension asset be included in rate base is approved.

3. That the Division of the Public Advocate's proposal with respect to the deferred income tax reserve be rejected.

4. That the Hearing Examiner's recommendation that depreciation and amortization expense be excluded from Delmarva Power & Light Company's lead-lag study performed to determine its cash working capital requirement is approved.

5. That the Hearing Examiner's recommendation that the costs associated with Delmarva Power & Light Company's proposed Conservation

Information Program be excluded from rate base and operating expenses is approved.

6. That the Hearing Examiner’s recommendation that no adjustment be made to rate base to reflect the implementation of new depreciation rates is approved.

7. That the Hearing Examiner’s recommendation that the appropriate normalization period for Injuries & Damages and Storm Restoration expenses be 3 years is approved.

8. That the Hearing Examiner’s recommendation that Delmarva Power & Light Company not be permitted to include $1.08 million of test period Incentive Compensation expenses in its operating expenses, relating to plans that are primarily related to achieving financial goals, is approved.

9. That the Hearing Examiner’s recommendation that Delmarva Power & Light Company be permitted to include all educational advertising expenses in its operating expenses is approved.

10. That the Hearing Examiner’s recommendation that Delmarva Power & Light Company be permitted to include in rate base and operating expenses its actual merger costs related to the 1998 merger between Delmarva and Atlantic City Electric Company be approved.

11. That the Hearing Examiner’s recommendation that Delmarva Power & Light Company be permitted to include in operating expenses the wage and salary increases taking place in 2005, 2006, and 2007 is approved.

12. That the Hearing Examiner’s recommendation that Staff’s proposal to amortize the $58.235 million cost of removal reserve back to ratepayers over 5 years be rejected is approved.

13. That the Hearing Examiner’s recommendation that Staff’s and the Division of the Public Advocate’s proposals to apply FAS 143 to Delmarva Power & Light Company’s cost of removal reserve for ratemaking purposes be rejected is approved.

14. That the Hearing Examiner’s recommendation that the Division of the Public Advocate’s proposal to separate removal costs from depreciation rates and recover removal costs on a 5-year normalized historical average be accepted is approved.

15. That the Hearing Examiner’s recommendation that Staff’s proposed plant depreciation rates (minus the portion of the rate associated with the removal cost reserve) be accepted is approved.

16. That the Hearing Examiner’s recommended 10% return on equity is approved.

17. That the Hearing Examiner’s recommendation that Staff’s rate design and revenue distribution proposals be accepted is approved.

18. That the Hearing Examiner’s recommendation to direct Staff, Delmarva Power & Light Company, and other interested stakeholders to convene for discussion of cost-effective demand-side initiatives and to establish a schedule acceptable to the stakeholders for Delmarva Power & Light Company to submit rate design proposals addressing demand-side initiatives is approved.

19. That Delmarva Power & Light Company’s proposed Reserved Delivery Capacity Service Rider (“Rider RDCS” be rejected.

20. That the Commission’s consideration of Delmarva Power & Light Company’s proposed Standby Service Rider (“Rider S”) be tabled until Delmarva Power & Light Company has a customer to whom Rider S would apply.

21. That the Commission reject Delmarva Power & Light Company’s proposed modification to its limitation of liability tariff.

22. That the Commission hereby approves all items that were not contested by the parties, as identified by the Hearing Examiner, to the extent not specifically discussed in this Findings, Opinion, and Order.

23. That the revenue requirement resulting from the Commission’s decisions in this docket is negative ($11,103,000), as shown on Exhibit “B” hereto.

24. That the Commission reserves the jurisdiction and authority to enter such further Orders in this docket as may be deemed necessary or appropriate.

BY ORDER OF THE COMMISSION:

/s/ Arnetta McRae
Chair

/s/ Joann T. Conaway
Commissioner

/s/ Jeffrey J. Clark
Commissioner

/s/ Jaymes B. Lester
Commissioner

Commissioner

ATTEST:

/s/ Karen J. Nickerson
Secretary

Exhibit A

DELMARVA POWER AND LIGHT COMPANY
DPSC Docket No. 05-304
Analysis of Approved Depreciation Rates

	December 2004	Commission Decision			Cost of Removal	Total
	Plant in Service	Plant Accrual Rate	COR Accrual Rate	Accrual Rate	Accrual	Deprec Accrual
		Exh MJM-10 Sch 3	Exh RCS-1, Col G		Exh RCS-1, Col G	
		Exh MJM-10 Sch 5	calculated			
Distribution - Delaware						
3602	$3,136,122	2.08%	0.00%	2.08%	$0	$65,231
3610	$8,715,145	1.25%	0.00%	1.25%	$0	$108,939
3620	$107,170,241	1.74%	0.13%	1.87%	$134,652	$1,999,414
3640	$44,771,910	1.88%	0.45%	2.33%	$200,788	$1,042,500
3650	$59,329,925	1.69%	0.55%	2.24%	$326,590	$1,329,266
3660	$14,799,376	0.91%	0.00%	0.91%	$0	$134,674
3670	$118,779,898	1.81%	0.14%	1.95%	$164,051	$2,313,967
3680	$127,871,020	2.57%	1.25%	3.82%	$1,598,603	$4,884,888
3691	$11,443,306	1.65%	0.10%	1.75%	$11,874	$200,689
3692	$57,843,512	2.34%	0.04%	2.38%	$22,975	$1,376,513
3700	$52,409,813	2.27%	0.47%	2.74%	$246,629	$1,436,332
3712	$11,633,195	3.22%	0.78%	4.00%	$90,502	$465,091
3713	$9,337,864	12.55%	0.00%	12.55%	$0	$1,171,902
3730	$37,874,126	2.09%	0.32%	2.41%	$122,194	$913,763
Distribution - Delaware	$665,115,453				$2,918,858	$17,443,170
						2.62%
Distribution - Maryland						
3602	$3,242,354	2.08%	0.00%	2.08%	$0	$67,441
3610	$6,493,207	1.25%	0.00%	1.25%	$0	$81,165
3620	$43,138,826	1.74%	0.13%	1.87%	$54,201	$804,817
3640	$51,126,942	1.88%	0.45%	2.33%	$229,288	$1,190,475
3650	$59,259,867	1.69%	0.55%	2.24%	$326,204	$1,327,696
3660	$790,082	0.91%	0.00%	0.91%	$0	$7,190
3670	$81,536,682	1.81%	0.14%	1.95%	$112,613	$1,588,427
3680	$105,497,296	2.57%	1.25%	3.82%	$1,318,894	$4,030,174
3691	$6,279,631	1.65%	0.10%	1.75%	$6,516	$110,130
3692	$60,841,588	2.34%	0.04%	2.38%	$24,166	$1,447,859
3700	$15,549,439	2.27%	0.47%	2.74%	$73,172	$426,144
3712	$5,596,158	3.22%	0.78%	4.00%	$43,536	$223,732
3713	$4,036,533	12.55%	0.00%	12.55%	$0	$506,585
3730	$7,935,021	2.09%	0.32%	2.41%	$25,601	$191,443
Distribution - Maryland	$451,323,626				$2,214,192	$12,003,278
Distribution - Virginia						
3602	$558,133	2.08%	0.00%	2.08%	$0	$11,609
3610	$728,263	1.25%	0.00%	1.25%	$0	$9,103
3620	$5,889,152	1.74%	0.13%	1.87%	$7,399	$109,871
3640	$8,174,550	1.88%	0.45%	2.33%	$36,660	$190,342
3650	$5,986,695	1.69%	0.55%	2.24%	$32,955	$134,130
3660	$0	0.91%	0.00%	0.91%	$0	$0
3670	$8,009,421	1.81%	0.14%	1.95%	$11,062	$156,033
3680	$10,225,478	2.57%	1.25%	3.82%	$127,836	$390,630
3691	$1,127,250	1.65%	0.10%	1.75%	$1,170	$19,769
3692	$6,919,706	2.34%	0.04%	2.38%	$2,748	$164,670
3700	$1,688,401	2.27%	0.47%	2.74%	$7,945	$46,272
3712	$739,285	3.22%	0.78%	4.00%	$5,751	$29,556
3713	$299,026	12.55%	0.00%	12.55%	$0	$37,528
3730	$802,337	2.09%	0.32%	2.41%	$2,589	$19,357
Distribution - Virginia	$51,147,696				$236,115	$1,318,870
Total Distribution	$1,167,586,775				$5,369,165	$30,765,318
General						
3903	$21,766,872	3.74%	-0.07%	3.67%	($15,237)	$798,844
3913	$4,846,424	25.32%	-0.22%	25.10%	($10,662)	$1,216,452
3920	$156,511	21.26%	-7.40%	13.86%	($11,582)	$21,692
Total General	$26,769,807				($37,481)	$2,036,989
Common						
C3903	$37,060,649	6.72%	0.35%	7.07%	$129,712	$2,620,188
Electric Common @ 84%	$31,130,945				$108,958	$2,200,958
				Total Delmarva Electric	$5,440,642.40	$35,003,264.65

Exhibit B

Commission Decision
Page 1 of 3

Delmarva Power & Light Company
DPSC Docket No. 05-304
Uncontested
Commission Decision - Rate Base Issues
(000's)

(1)	(2)	(3)	(4)
		Uncontested	
Line No.	Item	Earnings	Rate Base
1	**Per Books - 12 m/e March 2005**	$36,044	$392,080
2			
3	**Uncontested Adjustments by all Parties**		
4	Weather Normalization	$337	$0
5	Bill Frequency	$0	$0
6	Remove Employee Association Exp	$15	$0
7	Regulatory Commission Exp Normalization	($60)	$0
8	Proform OPEB Costs	$498	$0
9	Remove Severance Costs	$820	$0
10	Plant Closing Adjustment	($700)	$18,356
11	Actual Refinancings	($404)	$4,188
12	Remove Prior Period Property Taxes	($338)	$0
13	Remove Supply & Transm Other Taxes	$836	$0
14	Remove Supply & Transm Regulatory Assessment	$508	$0
15	Increase DPSC Regulatory Assessment	($97)	$0
16	Remove Post-80 ITC Amortization	($254)	$0
17	IOCD Adjustment	($18)	$0
18	Remove Billing Expert	$61	($118)
19	Remove selected PHFFU investment	$0	($448)
20	Restate Revenue Lag in CWC	$0	($1,681)
21	Remove Working Funds	$0	($49)
22	Uncollectible Expense Normalization - 3 yr	($206)	$0
23	Proform Pension Expense	($456)	$0
24			
25	**Subtotal - Uncontested Adjustments**	$36,586	$412,328

Delmarva Power & Light Company
DPSC Docket No. 05-304
Contested
Commission Decision - Rate Base Issues

(1)	(2)	(3)	(4)
		Commission Decision	
Line No.	Item	Earnings	Rate Base
1	**Uncontested Adjustments by all Parties**	$36,586	$412,328
2			
3	**Contested Adjustments**		
4	Decreased Liability O&M Expense	$0	$0
5	Restate Association Dues	($14)	$0
6	Injuries & Damages Exp Normalization	($76)	$0
7	Wage and FICA Adjustment	($877)	$0
8	Storm Restoration Exp Normalization	($1,092)	$0
9	Delaware Conservation Information	$0	$0
10	New Depreciation Rates – Plant	$1,627	$0
11	New Depreciation Rates - Cost of Removal	$246	$0
12	New Depreciation Rates - Plant Closing Adj	$169	$169
13	Merger Adjustment	($837)	$2,859
14	Increase in Reconnect/Premise Revenues	$211	$0
15	Transmission Uncollectible Exp to Supply	$81	$0
16	Remove CWIP-AFUDC	($40)	($13,470)
17	Remove Prepaid Pension Asset	$0	$0
18	Depreciation in CWC	$0	($2,981)
19	Remove certain Incentive Program expense	$714	$0
20	Remove Education Advertising	$0	$0
21	Remove Peach Bottom litigation costs	$61	$0
22	Interest Synchronization	($476)	$0
23	Cash Working Capital	$0	$131
24	Tax Change - Supplemental Testimony	$0	$15,657
25	Removal Cost Amortization	$0	$0
26			
27	Total Contested Adjustments	($303)	$2,365
28	Adjusted Test Period	$36,283	$414,693

Delmarva Power & Light Company
DPSC Docket No. 05-304
Revenue Requirement Summary

(1) Line **No.**	(2) **Item**	(3) **Commission Decision**
1	Pro Forma Rate Base	$414,693
2	Rate of Return	7.17%
3	Required Return	$29,734
4	Pro Forma Operating Income	$36,283
5	Return Deficiency (Excess)	($6,550)
6	Revenue Conversion Factor	1.69511
7	Required Rate Increase	($11,103)