DELMARVA POWER & LIGHT COMPANY

BEFORE THE
DELAWARE PUBLIC SERVICE COMMISSION
REBUTTAL TESTIMONY OF FREDERICK J. BOYLE
DOCKET NO. 13-115

Q1. Please state your name and position.

A1. My name is Frederick J. Boyle. I am Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc. (PHI). I am testifying on behalf of Delmarva Power & Light Company (Delmarva or the Company).

Q2. What is the purpose of your Rebuttal Testimony?

A2. As the Company's overall policy witness, I will summarize the Company's rebuttal presentation and I will also rebut portions of the direct testimonies filed by the Staff of the Public Service Commission (Staff) and the Division of Public Advocate (DPA), with a specific focus on the policy and financial implications of their recommendations.

Q3. Please identify the Company's Rebuttal Witnesses.

A3. Company Witness Robert B. Hevert rebuts the recommendations of the witnesses for the Staff and DPA on rate of return and cost of capital issues.

Company Witness Michael W. Maxwell rebuts the recommendations of the witnesses for the Staff and DPA regarding the Company's Reliability Enhancement Plan and capital projects.

Company Witness Jay C. Ziminsky addresses revenue requirement issues and attrition analysis, including rebutting certain recommendations of the witnesses for the Staff and DPA.

Company Witness Marlene C. Santacecilia rebuts the recommendations of the witnesses for the Staff and DPA on rate design.

Company Witness Elliott P. Tanos rebuts the recommendations of the witnesses for the Staff, the Delaware Energy Users Group, and DPA on the Company cost of service studies.

Q4. Please comment on the financial proposals of the Commission Staff and DPA.

A4. Based on the $38.976 million increase proposed by the Company in its Rebuttal filing, the Staff recommends a reduction to the Company's overall revenue requirement request to $11.4 million and the DPA similarly recommends a reduction to the Company's overall revenue requirement request to $7.3 million.

As I stated on page 5 of my Direct Testimony, the Company continues to make significant investments in its Delaware electric system and plans to make infrastructure investments of approximately $400 million over the next five years to address infrastructure replacement and to enhance and maintain the reliability of the Company's system to better serve and meet the expectations of Delmarva's customers. However, at the currently approved rates, Delmarva's adjusted rate of return on equity (ROE), based on the analysis presented by Company Witness Ziminsky in his Direct Testimony, is only 5.59%, which is significantly below the currently authorized ROE of 9.75%.

At this 5.59% rate of return, the Company is at a competitive disadvantage to obtain the lowest cost when it comes to raising necessary capital on reasonable terms to continue to make important investments in the electric distribution system. The Company's rates for distribution service should reflect the current costs of providing service. If the recommendations of the Staff and DPA are adopted by the Commission, not only would Delmarva not have the opportunity to earn a fair return on its capital investments but these proposals would be viewed negatively by both the capital markets and the rating agencies. This outcome may make it more difficult and costly to the Company to raise additional capital on reasonable terms, which will result in higher costs for Delmarva's customers.

Q5. What significant recommendations of the Staff and DPA will have the most detrimental impacts on the Company and its customers?

A5. The most significant recommendations of the Staff and DPA that will have a detrimental impact on the Company, if adopted, are 1) the out-right removal of the Company's rate base adjustments for 2013 reliability plant closings and 2) the unreasonably low rate of return recommendations.

As I described in my Direct Testimony, the primary driver for the Company filing this rate case is its on-going investment in infrastructure to maintain and enhance reliability in its electric distribution system for its customers. This investment will provide a more reliable electric grid that will prevent and shorten outages to meet the needs of Delmarva's customers in the increasingly digital society. This investment is not without cost however, and the Company is seeking recognition of these costs. As set forth in the Rebuttal Testimony of Company Witness Ziminsky, over 60% of the 2013 forecasted reliability closings have been closed to plant as of the end of August 2013, and will be serving customers during the rate effective period. The proposed adjustment for 2013 reliability additions are appropriate, and, at a minimum, recognition of the additions through August 2013 should be recognized. This is consistent with prior Commission precedent, as stated in the Rebuttal Testimony of Company Witness Ziminsky.

In addition, Staff and DPA endorse an unreasonably low rate of return in this proceeding, recommending a 9.35% ROE. This recommendation is among the lowest electric ROEs authorized in the last 30 years. If adopted, the Company would be at a disadvantage as it competes in the capital markets to raise funding for necessary investments in its infrastructure. Company Witness Hevert provides additional detail regarding the parties' ROE recommendations.

Q6. Please comment on the importance of Delaware's regulatory environment and the Commission's adherence to reasonable, consistent and predictable ratemaking practices, specifically the Commission's acceptance of post-test period adjustments for rate base.

A6. The state regulatory environment is a very important factor to credit rating agencies. In S&P's publications entitled "Assessing U.S. Regulatory Environments," dated November 7, 2008 and republished on November 15, 2011, and "Business and Financial Risks in the Investor-Owned Utility Industry," dated November 26, 2008, and updated on March 11, 2010, S&P indicated that the regulatory climate is perhaps the most important factor it analyzes when evaluating investor-owned utilities. It noted that regulatory risk will continue to be evaluated based on the environments in which companies operate, as well as other factors, including ratemaking practices and procedures, cash flow support and stability, and political insulation. Actions by the Commission and departure from long established rate-making practices are closely monitored by both the rating agencies and investor community. In fact, on July 18, 2013, Fitch Ratings downgraded Delmarva's sister company, Pepco, to BBB from BBB+ due to the state regulatory environment and Pepco's rate case outcomes.

Ratemaking provides the utility the opportunity to recover its appropriate costs of providing service during the period when rates will be in effect, including the opportunity to earn its authorized rate of return. If regulatory commissions do not recognize expense increases and non-revenue producing rate base additions that occur during the period when rates will be in effect, the utility will be denied an opportunity to recover the cost of providing service to its customers and to earn its authorized rate of return. This Commission has recognized the principle by allowing test period costs to be adjusted by known and measurable changes to those costs. To not include costs that the Company will incur during the rate-effective period will virtually guarantee that Delmarva will fall short of its authorized rate of return.

Q7. DPA Witness Dismukes states that the Company's Reliability Pro Forma Adjustment No. 26 (Adjustment No. 26) removes the positive incentives created by regulatory lag. Please discuss this from a policy perspective.

A7. As more fully stated in the Rebuttal Testimony of Company Witness Ziminsky, Adjustment No. 26, as proposed in his Direct Testimony, is being separated into two adjustments. The first adjustment, Adjustment No. 26a details the reliability plant closings into the months which have been updated to actuals (January 2013 – August 2013) and the other adjustment (Adjustment No. 26b) covers the period (September 2013 – December 2013) which includes investments a majority of which will be placed into service prior to the time that the Commission issues a decision in this proceeding.

Regulatory lag is a serious obstacle to Delmarva's ability to earn its authorized ROE and is a major contributor to the Company's chronic underearning due to the amount of investment Delmarva has been making and plans to make to maintain and improve the reliability of the Company's electric system. As Company Witness Ziminsky demonstrates, the Company's net plant in service continues to grow as reliability investments are being made. At the same time, distribution revenue is not growing at a similar pace. The combination of increasing rate base and lower revenue growth results in regulatory lag that has contributed to the Company under-earning over the recent years. Continual under-earning with no opportunity to achieve the authorized rate of return is not a "positive incentive." In fact, the size of the regulatory lag can send a negative incentive that the Company consider revisions to its construction and replacement programs, which have been shown to be providing better service and improved reliability. Company Witness Ziminsky addresses this in more detail in his Rebuttal Testimony.

While approval of Adjustment No. 26a and 26b would have a mitigating effect on regulatory lag, the adjustments are not offered as nor do they have the sole purpose of acting as a regulatory lag mechanism. The adjustments represent sound ratemaking in that they seek to include in rate base the full value of known and measurable non-revenue producing reliability assets. These projects will be serving current customers during the rate effective period.

Credit Facilities Expense

Q8. Please describe the credit facility expense adjustment as proposed by the Company.

A8. Following the ratemaking precedent set in Docket No. 09-414 (reference paragraph No. 75 in Order No. 8011), this adjustment allows the Company to recover the costs related to its credit facility. These are annual period costs associated with setting up and maintaining the credit facility and they are not costs tied to the amount of borrowings made using the facility.

Q9. Staff Witness Peterson recommends that the proper treatment of these costs is to recognize them as an increase in the effective cost of short-term debt in the calculation of Delmarva's AFUDC rate. Do you agree?

A9. No. As noted above the costs are period costs not associated with the level of borrowing. The principle behind AFUDC is to capitalize incremental financing costs incurred to fund capital construction projects. Period costs incurred even if no funds are borrowed using the credit facility are not incremental financing costs and should not be a component of the AFUDC calculation. Rather the costs should be recovered through cost of service as the Company has proposed.

Q10. DPA Witness Crane recommends that credit facility costs should only be included in the Company's revenue requirement if short-term debt is included in its capital structure. Do you agree?

A10. No. DPA Witness Crane's recommendation ignores the important benefits the credit facility provides.

Q11. Please summarize the purposes of the credit facility.

A11. First, the Company uses short-term debt to temporarily fund its construction program and fluctuations in its working capital requirements. When the level of short-term debt is such that the Company can efficiently issue long-term debt, long-term debt is issued and the short-term debt is paid down.

Second, the credit facility is required by underwriters to support the Company's commercial paper program. The commercial paper program is separate from the credit facility and allows the Company to issue short-term debt at a cost lower than borrowing on that facility.

Third, the credit facility provides vital liquidity for Delmarva that is a key consideration in the rating agencies' assessment of the Company's long-term credit rating. In general, the facility provides assurance that the Company's obligations will be paid even during unforeseen and prolonged periods of stress in credit markets. If Delmarva did not maintain its credit facility, the rating agencies would not support the current long-term credit ratings of Delmarva and the Company's costs to issue long-term debt would increase.

Since the credit facility enables the Company to obtain a higher credit rating than it would otherwise be able to obtain, the Company can obtain long-term financing at lower rates and negotiate better terms and conditions from its vendors, all of which provide a direct benefit to the customer. In addition, the credit facility provides flexibility to Delmarva's long-term financing program because the credit facility can be used to bridge the timing gap between the required due date of maturing debt and the issuance of new debt when the market is accessible or when terms are most favorable.

Q12. Is it appropriate to have the Company's need for a credit facility, and therefore the recovery of its related credit facility costs, contingent upon including short-term debt in Delmarva's capital structure?

A12. No. To support its long-term credit ratings and operations, the Company would be required to maintain a credit facility whether or not it issued short-term debt. The Company relies on a combination of long-term debt and equity to permanently finance its long-lived distribution assets, and only uses short-term debt for temporary financing of new construction and fluctuations in working capital. For these reasons, and the reasons provided in the Company's response to Q11, DPA Witness Crane's recommendation to link credit facility cost recovery to the inclusion of short-term debt in the Company's capital structure is inappropriate.

<u>Incentive Expense</u>

Q13. What are the other parties' positions on the Company's proposed treatment of Non-Executive Incentives?

A13. The Company seeks to include in cost of service, the costs associated with non-executive incentive compensation. Both Staff and DPA propose removing some level of the non-executive incentive expense, which is mainly comprised of Annual Incentive Plan (AIP), from the cost of service. The Company disagrees with these recommendations.

Q14. What is the Company's position on non-executive incentive expense?

A14. In Docket No. 05-304, the Commission limited the recovery of non-executive incentive expense to those costs related to safety, reliability or customer service goals. Prior to Docket No. 05-304, the Commission recognized the full amount of these costs in rates. While Delmarva acknowledges the Commission's ruling on this issue in Docket No. 05-304, it respectfully requests that it be permitted to recover the full amount of its non-executive incentive/AIP compensation expense, including the amount associated with financial-related items, which in this case is $797,521.

Incentive compensation is an important part of the overall compensation of employees that both (1) allows Delmarva to attract and retain skilled employees and (2) creates incentives to attain levels of performance that benefit customers. Delmarva's parent company, Pepco Holdings, Inc., (PHI), periodically benchmarks employees' salaries by using a third-party consultant and sets salary ranges at the median of the companies that PHI competes against for staffing resources. Consistent with peer practices, a portion of employee compensation is "at risk." In other words, a portion of the compensation available to employees is in their base salary, and the remainder must be earned by achieving performance goals. If those performance goals are not attained, employees will not receive the total compensation available to them. Alternatively, a portion of potential compensation that has been set aside as part of the incentive compensation plan could have been included in base compensation. Instead, it was determined that it is more appropriate to incentivize employees to achieve their best performance by making a portion of their compensation contingent upon achieving a balanced set of performance goals. The use of incentive compensation is a prevalent and well-established practice in the industry designed to achieve the goals of making compensation competitive while at the same time, incentivizing employees to achieve their best performance to the benefit of both customers and Delmarva.

Q15. How does incentive compensation benefit customers?

A15. The AIP, while including financial thresholds, creates incentives for employees to perform their duties in a way that protects the interests of customers. Including financial targets is not designed to simply increase profits. For example, requiring employees not to exceed budgets certainly benefits customers. The more economically efficient the Company's workforce operates, the lower the costs that will be in the Company's cost of service. This includes not only the various expenses for which the Company seeks recovery, but also is seen in the Company's financial metrics, thus lowering the cost at which the Company can attract capital.

The concept offered by Witnesses Peterson and Crane - that any incentives related to financial benefit to the Company should be denied as not beneficial to customers - is clearly unsupported. The financial metrics included in the Non-Executive AIP plan relate to O&M and capital spending. These metrics incentivize our employees to control spending and seek opportunities to save money in order to meet their budgets on an annual basis. If spending is controlled, the customers will benefit through lower expenses reflected in the cost of service. As a result, any suggestion that financial metrics that are used in the AIP have no benefit to customers and should be disallowed is without merit. A Company that incents its employees to contribute to the financial health of the Company benefits the customers through lower rates.

Because the Company's AIP is carefully designed to make the Company more economically efficient, safe and reliable, 100% percent of the costs associated with the AIP should be included in cost of service, consistent with the Commission's treatment of the expense prior to Docket No. 05-304.

To the extent that the Commission determines that not all of the incentive payments promote customer benefits, it should not disallow 100% of the costs as suggested by Staff Witness Peterson. The Commission should, at the very least, approve inclusion in the cost of service of the portions that have been identified as related to solely safety, reliability and customer service goals as it did in Docket No. 05-304. Company Witness Ziminsky provides additional detail regarding the parties' positions on the treatment of Non-Executive Incentives included in the test period.

Attrition Analysis

Q16. On Page 5 of his Direct Testimony, DPA Witness Dismukes discusses the concept of an attrition analysis. Please discuss this from a policy perspective.

A16. As further explained in the Rebuttal Testimony of Company Witness Ziminsky, attrition represents the financial erosion of a utility's rate of return on its investment and occurs when the regulatory triad (revenues, expenses and rate base) is not in balance. In recent times, attrition is mainly attributable to the growth in costs for expenses and rate base outpacing growth in revenues. This scenario is the case with Delmarva, as it has been unable to earn its authorized ROE as a result of the regulatory lag driven by its pace of capital investment exceeding its growth in revenues. Company Witness Ziminsky addresses this in detail in his Rebuttal testimony.

Q17. Does this conclude your Rebuttal Testimony?

A17. Yes, it does.