ATTACHMENT G

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

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 (FILED MAY 31, 1991)	)))))))	PSC DOCKET NO. 91-20

FINDINGS, OPINION AND ORDER OF THE COMMISSION

ORDER NO. 3389

BEFORE COMMISSIONERS:
NANCY M. NORLING, Chairman
JOSHUA M. TWILLEY, Commissioner
JOHN R. McCLELLAND, Commissioner
DONALD D. PHILLIPS, Commissioner

APPEARANCES:

On behalf of the Public Service Commission:

JAMES McC. GEDDES, ESQ., Rate Counsel
REGINA A. IORII, ESQ., Rate Counsel
MICHAEL M. TISCHER, ESQ., General Counsel
DONALD B. COATES, Chief, Finance and Accounting
BETTIANN SCOTT, Secretary

On behalf of the Applicant, Delmarva Power & Light Company:

SAMUEL M. SUGDEN, ESQ., LeBouef, Lamb, Leiby & MacRae
DALE G. STOODLEY, ESQ., General Counsel
JAMES R. WITTINE, General Manager-Regulatory Practice

On behalf of the Office of the Public Advocate:

PATRICIA A. STOWELL

On behalf of the Intervenor, Delaware Energy Users Group:

HENRY R. MacNICHOLAS, ESQ., and JAMES P. DOUGHERTY, ESQ., McNees, Wallace & Nurick

On behalf of the Intervenor, Perdue Farms, Inc.

EDWARD G. BANKS, JR., ESQ., Banks, Nason, Hickson & Sullivan, P.A.

TABLE OF CONTENTS

I. PROCEDURAL HISTORY

1. On May 31, 1991, Delmarva Power & Light Company ("Delmarva" or "the Company") filed an application with the Delaware Public Service Commission ("the Commission"), requesting an increase in its electric base rates, and for certain modifications to its electric tariff. The Company sought to increase its annual revenues by $30,893,671, or 7.35%, based on a partially-forecasted "3+9" test period consisting of the actual results for the three months from October 1, 1990 through December 31, 1990, and projections for the nine months from January 1, 1991 through September 1991. (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 at 2) (hereafter cited as "Application"). The Company requested the Commission to permit its proposed rates and changes to its rules and regulations to become effective for service rendered on and after July 31, 1991, with proration. If the Commission elected to suspend the filed rates for the seven-month period allowed by 26 Del.C. §306(a)(1), however, the Company indicated its intent to place into effect under bond, 60 days after its filing, interim rates designed to produce $1 million in additional annual revenue, as permitted by 26 Del.C. §306(c). In connection therewith, the Company

requested the Commission to waive the surety required by 26 Del.C. §306(b). (Applicant at 2).

2. On June 18, 1991, in Order No. 3281, the Commission suspended the Company's filed rates and ordered that evidentiary hearing be held on the justness and reasonableness of the proposed new rates, rules and regulations. The Commission designated G. Arthur Padmore as Hearing Examiner and directed him to conduct the necessary evidentiary hearings and to report his findings and recommendations to the Commission. The Commission waived the requirement of a surety for the Company's proposed interim rates, which would become effective on July 31, 1991. Finally, the Commission established a deadline of July 31, 1991 for the submission of intervention petitions conforming to Commission Rule 11.

3. Petitions for leave to intervene were submitted by the Office of the Public Advocate ("OPA"), Perdue Farms, Inc., Delaware Energy Users Group ("DEUG"), and Destec Energy, Inc. ("Destec"). In order No. 3293, dated July 30, 1991, the Commission granted the petitions of the first three applicants, which were unopposed. Destec's petition to intervene was opposed by both Delmarva and Staff, and was denied by the Commission after oral argument on September 10, 1991. (See Order No. 3324, dated September 24, 1991).

4. Delmarva presented the prefiled testimony of its witnesses on September 18-20 and October 11, 1991, and those witnesses were cross-examined by Staff and the intervenors.[1]

5. On October 4, 1991, Staff submitted the prefiled testimonies of Robert J. Henkes and Richard W. LeLash of the Georgetown Consulting Group on the accounting issues. On behalf of the OPA, Michael A. Bleiweis and Thomas E. Knudsen of the Woodside Group likewise submitted prefiled testimonies on the accounting issues. These witnesses were cross-examined by the parties at evidentiary hearings held on October 21 and 22, 1991.[2]

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[1] Delmarva presented the prefiled direct testimony of the following witnesses:

-- H. Ray Landon, Executive Vice President of Delmarva (the Company's chief policy witness);
--Kenneth K. Jones, Delmarva's Vice President-Planning;
--Louise M. Morman, General Manager of Marketing for Delmarva;
--Joseph F. Brennan, Chairman of the Board of AUS Consultants-Utility Services Group;
--Paul S. Gerritsen, Vice President and Chief Financial Officer of Delmarva;
--Barbara S. Graham, Delmarva's Treasurer;
--James R. Wittine, the Company's General Manager of Regulatory Practice;
--David G. Dougher, Delmarva's Manager of Reports and Budgets;
--Arturo F. Agra, Manager of Financial Analysis for the Company; and
--William R. Moore, Jr., Manager of Revenue Analysis in the Company's Regulatory Practice Department.

[2] On behalf of the DEUG, Donald E. Johnstone of Drazen-Brubaker & Associates, Inc. submitted testimony concerning the

6. On October 7, 1991, the parties filed testimony on the rate design and cost allocation issues. Staff submitted the testimony of Bruce R. Oliver, President of Revilo Hill Associates, Inc. Intervenor Perdue Farms, Inc. submitted the testimony of Michael I. Wheatley, a supervisor of regulatory practice with Downes Associates, Inc. DEUG submitted additional testimony from Mr. Johnstone, as well as testimony from four other witnesses: Samuel J. Dwyer, IV of Drazen-Brubaker & Associates, Inc.; Frederick L. McCoy of Ernst & Young; Warren P. Bieger of CitiSteel, and Robert E. Baker of Occidental Chemical Corporation. (The OPA did not sponsor any testimony on rate design or cost allocation issues). These witnesses were cross-examined at the evidentiary hearings held on October 28 and 29, 1991.

7. On October 30 and 31, 1991, Delmarva submitted the prefiled rebuttal testimony of eleven witnesses on the accounting, rate design, and cost allocation issues.[3] In this

(..continued)
revenue requirement of his preferred production plant cost allocation methodology versus that generated by the Company's methodology. The DEUG did not sponsor any testimony on the accounting issues.

[3] Rebuttal testimony was sponsored by Messrs. Wittine, Landon, Gerritsen, Brennan, Agra and Dougher and Ms. Graham, all of whom had also filed direct testimony. In addition, Delmarva also submitted rebuttal testimonies from Joseph L. Colla, a Company engineer; Dennis J. Mohan and Robert L. Kolkka of United Engineers & Constructors, the Company's engineering consultant; and John S. Ferguson, an accountant with Deloitte & Touche.

testimony, the Company reduced its revenue requirement to $23,929,000, based on updated "11+1" information. The Company's rebuttal witnesses were cross-examined by the parties at evidentiary hearings held on November 6 and 7, 1991.

8. Staff witness Oliver and DEUG witness Johnstone filed surrebuttal testimony, which they presented at an evidentiary hearing on November 13, 1991. Company witness Wittine also offer oral surrebuttal testimony at that hearing. At the conclusion of this hearing, the record (consisting of 70 exhibits and 2154 pages of transcript) was closed.

9. The seven-month suspension period imposed pursuant to 26 Del.C. §306 expired on December 31, 1991. The Company placed its proposed rates into effect, under bond, on an interim basis subject to refund, beginning on January 1, 1992.

10. After the evidentiary hearings had been completed, the parties submitted briefs to the Hearing Examiner. On January 31, 1992, the Hearing Examiner issued his Findings and Recommendations. All parties took exceptions to various of the Hearing Examiner's findings and recommendations. These exceptions were filed with the Commission on February 20, 1992.

11. On February 25, 1992, the Commission met to hear oral argument from the parties and to deliberate on the issues involved in this case. This is the final Findings, Order and

Opinion of the Commission reflecting the Commission's deliberations and decisions in this docket.

II. FINDINGS AND OPINION

A. TEST YEAR AND TEST PERIOD

12. The Company selected a test year consisting of the actual 12-month period ending December 31, 1990 and a test period consisting of the 12-month period ending September 30, 1991 (Exh. 25 (Wittine) at 6).[4] There were no objections to either the test year or the test period selected by the Company. The Hearing Examiner concluded that the test year and test period selected were reasonable and recommended that the Commission approve them for use in this case. (HER at 7). We agree with the Hearing Examiner's recommendation (3-0, Commissioner Twilley not present during vote).

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[4] References to the Hearing Examiner's Findings and Recommendations will be cited as "HER at ___"; references to the exhibits introduced at the evidentiary hearings will be cited as "Exh. ___ (witness' name) at ___" for direct testimony; "Exh. ___ (witness' name-R) at ___" for rebuttal testimony and "Exh. ___ (witness' name-S) at ___" for surrebuttal testimony; references to the transcripts of the evidentiary hearings will be cited as "Tr. at ___". The parties' briefs will be cited as follows:

-Delmarva's Opening Brief to the Hearing Examiner: "COB";
-Staff's Answering Brief to the Hearing Examiner: "SAB";
-OPA's Answering Brief to the Hearing Examiner: "OPA AB";
-DEUG's Answering Brief to the Hearing Examiner: "DEUG AB";
-Delmarva's Reply Brief to the Hearing Examiner: "CRB";
-Delmarva's Brief on Exceptions: "CBOE";
-Staff's Brief on Exceptions: "SBOE";
-OPA's Brief on Exceptions: "OPA BOE"; and
-DEUG's Brief on Exceptions: "DEUG BOE".

B. RATE BASE ISSUES

1. CWIP/AFUDC

13. The Company included approximately $33 million of CWIP in its test period rate base. Most of the $33 million was related to projects for which the Company accrued an offsetting non-cash AFUDC. The Company accrues AFUDC on all property eligible for AFUDC. (Exh. 60 (Dougher-R) at 24). In such cases, the Company noted, there was no impact on revenue requirements. (Tr. at 2226). Some of the CWIP, however, is related to projects which will be placed in service in the near term and for which AFUDC is not being accrued. (Exh. 60 (Dougher-R) at 25; Tr. at 2230-31). The OPA observed that four of the ten "major" projects comprising Delmarva's CWIP balance would not be placed in service until December 1992 at the earliest, and that the Hay Road Unit 4 project (which has the largest CWIP balance) would not come on line until May 1993. Thus, the OPA argued that, to be consistent with its decision in In the Matter of the Application of Artesian Water Company, Inc. for an Increase in Water Rates, PSC Docket No. 90-10, Findings, Order and Opinion No. 3274 (Del. PSC May 28, 1991), the Commission should exclude all CWIP and associated AFUDC from Delmarva's test period rate base and earnings. (Exh. 30 (OPA) at 23). The OPA therefore made an adjustment to remove $44.472

million of CWIP from the Company's test period rate base and $3.469 million of AFUDC from test period earnings. (Id.; see also Exh. 38 at Revised Sched. MAB-3 and MAB-6).

14. The Hearing Examiner concluded that the Commission should adopt the Company's position. (HER at 15). Initially, he acknowledged that the decision to include CWIP in rate base is a matter of discretion. (Id., citing 26 Del.C. §102(3) and Re Artesian Water Co., 101 PUR 4th 451, 461 (Del. PSC 1989)). He noted that in prior cases, the Commission had exercised its discretion to allow a utility to include both long- and short-term CWIP in its test period rate base. (Id. at 11-12 and n.9). Indeed, the Commission permitted the Company to include CWIP in its test period rate base in Docket No. 86-24, the Company's last base rate case. (Id.) In this docket, the Hearing Examiner observed that most of the Company's CWIP claim was offset by an income credit for AFUDC. (Id. at 12). Moreover, he found that the Company had presented "credible testimony" that the CWIP on which it currently earns a return was limited to: (1) plant items that were "'immediately'" ready for service; (2) plant already in service but not yet transferred to plant-in-service on its books; or (3) plant associated with routine construction normally completed within a few days. (Id., citing Exh. 60 (Dougher-R) at 25).

15. The Hearing Examiner also identified a number of policy reasons for approving Delmarva's treatment of CWIP in this case. First, he noted that in recent years, regulators have moved away from a strict exclusion of CWIP from rate base on the ground that such projects are not used and useful at the time rates are set. According to the Hearing Examiner, there is a "clearly discern[ible] trend toward a more flexible approach to CWIP." (Id., citing FERC Order No. 298 (May 16, 1983); J. BONBRIGHT, A. DANIELSON, and D. KAMERSCHEN, Principles of Public Utility Rates, at 251-53 (2d ed. 1988)). As stated by Professor Bonbright, Order No. 298 allowed utilities to include both CWIP and associated AFUDC in rate base, regardless of the utilities' financial condition. (Id. at 252). Order No. 298 had three main purposes, which were intended to balance the competing interests of the electric utility industry and the ratepayers:

(1) to mitigate any bias which may discourage additional capital investment in needed facilities;

(2) to enable the need for those facilities to be more accurately evaluated by price signals which reflect today some of the costs associated with future facilities; and

(3) to mitigate the sudden price increases which tend to result under an AFUDC policy thereby furthering the goal of rate stability.

(HER at 13, quoting Bonbright, supra at 253).

16. The Hearing Examiner also relied upon "leading utility accounting authorities" as support for his recognition that state regulatory commission have been departing from their traditional treatment of CWIP:

> ... [S]ome commission have effectively allowed a partial return on CWIP investment through a procedure whereby CWIP is allowed in the rate base, while the capitalization of AFUDC continues with the AFUDC earnings included above-the-line in operating income.

R. HAHNE & G. ALIFF, Accounting for Public Utilities, ¶ 4.04[4], at 4-23 (8th ed. 1990). He observed that Messrs. Hahne and Aliff had found 31 state commissions which had approved some rate base recognition of CWIP, either as a matter of course or on a case-by-case basis. (Id.). Thus, the Hearing Examiner concluded that the Commission "would not be out of step" with other regulatory commissions if it continued to follow the position it took in Docket No. 86-24. (Id. at 14).

17. The Hearing Examiner rejected the OPA's contention that the Commission should follow the Pennsylvania Public Utilities Commission and disallow CWIP from Delmarva's rate base, because the Pennsylvania Public Utility Code specifically constrains that commission's treatment of CWIP. (Id. at 14 and n.11). He also rejected the OPA's argument that the Commission should follow its decision in Matter of Artesian, PSC Docket No.

90-10, Order No. 3274. The Hearing Examiner observed that in Artesian, the utility sought to include CWIP in its rate base for projects that would not be placed in service until well after the test year, but did not propose a corresponding AFUDC offset. (Id. at 14, quoting CRB at 39). Here, however, Delmarva had included an AFUDC offset to income; thus, the Hearing Examiner did not perceive the Artesian decision as representing an abandonment of the Commission's previous practice of exercising discretion in reviewing CWIP claims on a case-by-case basis. (Id. at 14). Similarly, the Hearing Examiner found no support for the OPA's contention that cash flow problems provided the rationale for the Commission's decision to include CWIP in a utility's rate base in previous proceedings. (Id. at 15). Consequently, the Hearing Examiner concluded that the record contained adequate support for including CWIP in its rate base in this case. (Id.).

18. The OPA excepted to the Hearing Examiner's recommendation. It contended first that the Artesian decision was a proper precedent for denying rate base treatment of CWIP in this case, because that decision acknowledged that a utility is not entitled to earn a return on projects which are not used and useful during the test period. (OPA BOE at 2). The OPA argued that CWIP projects, "by definition," will not be used and

useful until after the end of Delmarva's test period in this case. (Id.). It further noted that Delmarva had not made any adjustment to include revenues associated with the revenue-producing CWIP in its test period revenues, unlike other utilities. (Id. at 3). The OPA recognized that commissions had historically included CWIP in rate base as an attrition adjustment; however, the OPA claimed no such allowance was necessary here given Delmarva's healthy financial condition. (Id.).

19. **Discussion.** This Commission has repeatedly recognized that it is not required to allow or disallow CWIP in a utility's rate base as a matter of course. Rather, we have the discretion to make that determination based on the circumstances of each case. See Artesian, PSC Docket No. 90-10, Order No. 3274, at 7; Artesian, 101 PUR 4th at 461. We agree with the Hearing Examiner that this record supports a decision to allow the Company to include CWIP in rate base, with a corresponding AFUDC offset to income. While we acknowledge that the AFUDC being included in the Company's test period income does not match precisely with the CWIP being included in test period rate base, we are satisfied that the asymmetry results primarily from the inclusion of the CWIP for the short-term projects which will be transferred to plant in service within

the rate effective period, and which are not presently accruing AFUDC. (Tr. at 2229-31, 2233). The long-term projects, which will not be placed in served until December 1992 and beyond, are currently accruing AFUDC in an amount which offsets the amount of CWIP included in Delmarva's test period rate base. (Tr. at 2227-33).

20. We also agree with the Hearing Examiner that the situation presented in this case is different from that presented in the most recent Artesian case, Docket No. 90-10. In that case, Artesian sought to include CWIP for long-term projects in its test period rate base and to earn a return on it, but did not make a corresponding adjustment to increase its test period income with an AFUDC offset. Consequently, in that situation, approval of Artesian's CWIP in its rate base would effectively have allowed Artesian a current cash return on its CWIP investment. Here, however, Delmarva has made the necessary adjustment to increase its test period income by the amount of corresponding AFUDC so that it will not be earning a current cash return on the CWIP associated with its long-term projects. We believe this distinction justifies a different result in this case from the one we reached in Artesian. Thus, we reject the OPA's invitation to disallow CWIP and the associated AFUDC from Delmarva's test period results in this case, and adopt the

Hearing Examiner's recommendation for the reasons stated herein and in his Findings and Recommendations, (3-1, Commissioner Twilley voting nay.)

2. DELAWARE CITY UNIT 3

21. In January, 1989, Star Enterprises ("Star") notified the Company that it intended to exercise a long-standing option to purchase the Delaware City 3 ("DC3") generating unit from Delmarva at net book value. The sale was to be completed on or before December 31, 1991[5]. Pursuant to a management contract with Star, the Company will continue to operate the entire Delaware City power plant now owned by Star through mid-1995. Under that contract, Star will reimburse Delmarva for all direct and indirect operating expenses, and, furthermore, will pay Delmarva an annual management fee of $660,000.[6] Delmarva will credit this management fee to its unregulated refinery operations.

22. Additionally, pursuant to a solicitation for non-utility generating ("NUG") capacity, Delmarva selected Star to provide 48 MW of NUG capacity beginning in June 1992. The

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[5] The sale of DC3 did in fact take place as scheduled, and Star is now the owner of the DC3 unit.

[6] The amount of the annual management fee can vary from year to year depending upon unit availability and other warranty factors. (Exh. 59 (Agra - R) at 5).

parties executed a 26-year contract whereby Star will provide capacity from the DC3 unit to Delmarva. Under the terms of this contract, Delmarva will incur monthly capacity charges which are capped at $3,369,600 annually. The actual amount of Delmarva's payments, however, will depend on the unit's availability. These capacity payments will be charged to Delmarva's electric operations.

23. Staff observed that the Company had included the plant investment and operating expenses associated with the DC3 unit in its test period rate base and operating expenses, even though the DC3 unit would not be part of the Company's electric operations during the rate effective year. Thus, Staff removed the plant investment ($954,000) and operating expenses ($325,000) for DC3 from the Company's test period results. (Exh. 32 (Henkes) at 24-26).

24. Staff also proposed to credit the portion of the management fee attributable to Delmarva's operation of DC3 to its regulated electric operations, to offset the profit component inherent in the charges for the capacity Delmarva receives from DC3. (Id. at 29). Staff contended that the amount of the management fee to be allocated to Delmarva's electric operations should be determined by the same performance criteria on which the annual fee and the rewards and penalties associated

with that fee are based. (SAB at 106).

25. The Company argued that DC3 was a proxy for the Star capacity contract, and asserted that if the DC3 plant investment and operating expenses were removed from its test period results, then the operating expenses associated with the Star capacity contract should be included in its test period results. (COB at 51). The Company argued that the revenue requirement of including the DC3 unit is $436,000 less than the capacity charges for the rate effective year. Staff opposed the inclusion of these capacity charges in Delmarva's test period operating expenses because: (1) the amount of the payments was not sufficiently known and measurable; (2) the Company would earn incremental revenue from post-test period customer growth, for which it had not proposed any adjustment; (3) the capacity payments would not commence until June 1992, and it was inappropriate to begin charging the ratepayers now for something they would not receive until later; and (4) if the Commission accepted Staff's proposal to allocate the portion of the management fee attributable to Delmarva's operation of the DC3 until to its electric operations, this amount could also be used to offset the capacity payments. (Exh. 32 (Henkes) at 24-30; SAB at 93-100).

26. The Company objected to Staff's proposal to allocate

the portion of the management fee attributable to its operation of DC3 to its electric operations. Delmarva stated that it did not believe the management fee had any impact on Star's bid in the NUG solicitation (Exh. 59 (Agra-R) at 2); that Star would have had to pay someone a management fee to operate the plant (COB at 56); and that its regulated operations should be kept separate from its unregulated operations. (Id. at 55 and n.6). Staff responded first that Star knew it would have to pay someone a management fee, and that it was reasonable to assume that Star did take this cost of doing business into account when it formulated its bid for Delmarva's NUG solicitation. Second, Staff argued that the Company ignored the rationale supporting Staff's proposal: that Delmarva was going to earn a profit on its operation of the very same unit from which the capacity it would purchase from Star would be generated. Last, Staff observed that the Company was not maintaining the distinction between its regulated and non-regulated operations since the management contract and purchased power contracts were so intimately related. Moreover, the Company proposed to continue to keep the plant investment and operating expenses associated with DC3 in its test period results and to establish rates based in part on that plant and those expenses, notwithstanding that DC3 was no longer subject to regulation. (SAB at 104-06).

27. Finally, the Company contended that if Staff's proposal was accepted, the portion of the management fee to be assigned to Delmarva's electric retail operations should be based solely on steam output. Using this criterion, the Company calculated that the portion of the management fee to be credited to the electric operations was $46,800. (COB at 57).

28. The Hearing Examiner recommended that the Commission approve the Company's proposal to include the plant investment and operating expenses associated with DC3 in rate base and expenses. (HER at 18). He concluded that the record established that the Star contract was "'essentially a replacement for the loss of capacity associated with the sale of DC-3,'" and that the Star contract and sale of DC3 would "basically" have no material effect on Delmarva's installed capacity." (Id. at 18-19, quoting Exh. 66 (Wittine-R) at 29). He also agreed with Delmarva that it was reasonable to use DC3 as a proxy for the Star contract because the revenue requirement associated with DC3 was "significantly smaller" than that associated with the Star contract. (Id. at 20).

29. In the event the Commission found that the DC3 plant investment and operating expenses should be removed from Delmarva's test period results, the Hearing Examiner agreed with the Company that the Star capacity payments should be included

in its test period operating expenses. (HER at 19). The Hearing Examiner rejected Staff's contention that the costs associated with the Star contract were not sufficiently known and measurable, finding that the Company's 30 years of experience with DC3 provided an adequate basis on which to calculate the amount of payments the Company would make to Star during 1992. (Id.). He also rejected Staff's contention that the Company had ignored post-test period revenue growth, finding that such growth was irrelevant because it would have to be met with additional capacity and/or DSM investment. (Id. at 20). The Hearing Examiner found that if neither the DC3 costs nor the Star contract costs were recognized in this proceeding, ratepayers would effectively be relieved of cost responsibility for the DC3 unit. (Id. at 19).

30. The Hearing Examiner acknowledged that Staff had proposed to credit the portion of the management fee associated with the Company's operation of DC3 to Delmarva's electric operations. (Id. at 16-17). He did not, however, make any recommendation to the Commission to accept or reject that proposal.

31. Staff excepted to the Hearing Examiner's recommendations. It argued that the plant investment and operating expenses associated with DC3 should be removed since

DC3 would not be part of Delmarva's operations during the rate effective period. (SBOE at 7-8). It also objected to including the Star capacity payments in test period operating expenses if DC3 was removed because: (1) the amounts were not known and measurable; (2) Delmarva had not included a corresponding adjustment for post-test period revenues which it would receive; and (3) requiring ratepayers to pay for the Star capacity before they began receiving it was unfair. (Id. at 9-13).

32. **Discussion**. After consideration of both the written and oral arguments presented by Delmarva and Staff, we agree with the Hearing Examiner that the plant investment and operating expenses associated with the DC3 unit should be included in Delmarva's test period results for purposes of this proceeding, and so adopt his recommendation for the reasons he expressed. As the Hearing Examiner observed, the Company has indicated its intent to file another rate case toward the end of this year, and we agree that the Company should fully reflect the removal of DC3 from its rate base in that filing.

33. We reach no decision in this docket on Staff's proposal to credit the Company's electric operations with the portion of the management fee attributable to Delmarva' operation of the DC3 unit for Star. We caution the Company, however, that we do not consider ourselves to be precluded from

revisiting the management fee issue in the next rate case, by which time Delmarva will be receiving the monthly management fee payments from Star. Our decision in this docket, therefore, should not be construed as a rejection of Staff's proposal or as an acceptance of the Company's position. (3-1, Commissioner Twilley voting nay).

3. INDIAN RIVER COOLING TOWER

34. In November 1989, the Company placed a new cooling tower in service at Indian River Unit 4. This tower replaced the original cooling tower for the unit, which had been placed in service in October 1980 and had been retired prematurely in May 1990. Consultants retained by the Company conducted studies which revealed that the primary reason for the original cooling tower's failure was differential foundation settlement -- i.e., the pilings on which the tower rested had settled at different rates. A secondary reason for the failure of the original cooling tower was chloride corrosion caused by the exposure of tower components to salty water.

35. With Commission approval, the Company uses the group depreciation method in determining depreciation rates for utility assets. Under this method, depreciation rates are selected for a particular group of assets rather than for each individual asset, and a depreciation reserve accumulates over

time for each asset group. When an individual asset is retired, it is considered to be fully depreciated, irrespective of whether the retirement occurs before or after the end of the asset's useful life. (Tr. at 2044).

36. The Company treated the retirement of the original cooling tower as an "ordinary" retirement. From an accounting perspective, use of this approach effectively removed the entire cost of the original cooling tower from both the Company's utility plant in service account and the accumulated reserve for depreciation.

37. Staff contended that the retirement of the original cooling tower was "extraordinary" as that term is used in utility accounting treatises. Staff also maintained that Delmarva's pro forma test period rate base included $8.1 million of investment and removal costs associated with the original cooling tower, in addition to the $23 million investment in a replacement cooling tower. Staff proposed that the remaining $8.1 million investment in the original cooling tower be excluded from Delmarva's rate base because that investment was no longer, and would never again be, used and useful in providing service to the Company's ratepayers. In its brief on exceptions, Staff further recommended that the Company be permitted to recover its investment in the original cooling

tower through an amortization over a reasonable period of time.[7]

38. Delmarva argued that it had properly classified the retirement of the original Indian River cooling tower as "ordinary," with the result that, except for cost of removal expenses, there was no rate base impact from the retirement. (CRB at 24). The Company also maintained that, under 26 Del.C. §102(3)b, the accumulated reserve for depreciation simply must be "related" to plant which was previously "used and useful" in providing service to customers. (Id. at 25). Delmarva defended the actions taken with respect to the original cooling tower, asserting that those actions met the applicable legal standard. (Id. at 27-30).

39. Assuming, arguendo, that Staff's analytical approach were adopted in this case, Delmarva pointed out that the Commission possesses discretion under 26 Del.C. §102(3)g to add items to rate base even though they are not currently "used and useful," and in fact, kept one Edgemoor oil storage tank in rate base in Docket No. 82-22 in explicit reliance on that statutory

[7] Originally, Staff had suggested that the Commission might find it appropriate to deny Delmarva a return of its investment as well as a return on that investment because Staff believed the evidence would support a finding that Delmarva controlled the construction of the original cooling tower. Staff has abandoned its suggestion that we consider disallowing a return of the Company's investment, however, so we need not consider this contention further here.

provision. The Company distinguished the Commission's action in Docket No. 86-24 with respect to the then-retired Edgemoor oil storage tank as an exercise of discretion under 26 Del.C. §102(3)g. (Id. at 26, n.9). Similar treatment of the retired cooling tower was "necessary" in this case (as that term is used in the statute) because of the substantial adverse effect a write-off would have on important financial coverages. (Id. at 30).

40. During oral argument, Delmarva contended that, if Staff's analytical approach to this issue were adopted, the question of the proper amortization period for the Company's investment in the original cooling tower involved the Commission's exercise of its discretion.

41. The Hearing Examiner concluded that the Company's position was "more persuasive" than the one advocated by Staff and recommended that Delmarva's position be adopted. (HER at 24, 26). He did not address Staff's contention that the cooling tower should be removed from rate base because it was not used and useful. The Hearing Examiner focused his discussion on the propriety of "ordinary" versus "extraordinary" retirement accounting. He found that the original cooling tower was part of a depreciable property group and that the group depreciation concept deemed the original cooling tower fully depreciated,

regardless of the tower's age at retirement. (Id. at 2025). He then determined that the appropriate criterion for using ordinary versus extraordinary retirement was whether the retirement caused the accumulated depreciation reserve to "go negative." (HER at 25, quoting Tr. at 2048). Since the retirement of the original cooling tower did not cause the reserve to "go negative," the Hearing Examiner rejected Staff's contention that the retirement should have been classified as "extraordinary." He also concluded that Staff had not met the legal standard necessary to disallow the investment associated with the retired cooling tower. (Id. at 26-27). Thus, he recommended rejection of Staff's proposed adjustment. (Id. at 27).

42. Staff excepted to the Hearing Examiner's recommendation.[8] Staff contended that the Hearing Examiner had failed to address the contention that the retired cooling tower was no longer, and never again would be, used and useful. Staff argued that in Docket No. 86-24, the Company's last base rate case, the Commission removed the remaining investment in the retired Edgemoor oil storage tank from Delmarva's rate base because the tank was no longer used and useful, notwithstanding

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[8] The OPA also excepted to the Hearing Examiner's recommendation on this issue. (OPA BOE at 3-5).

that Delmarva had treated the storage tank retirement as "ordinary" for book accounting purposes. Thus, Staff asserted that the accounting treatment chosen by Delmarva was not controlling. (SBOE at 21-28). Staff also contended that the Hearing Examiner had misinterpreted Staff's argument with respect to alleged "waste, bad faith, or abuse of discretion" as a basis for denying recovery of the remaining cooling tower investment. (Id. at 28-30).

43. **Discussion**. We believe that Staff's position on this issue is the correct one. Under 26 Del.C. §102(3)a, as a general principle, utility property or investment must be "used and useful" to be included in rate base. Here, the evidence is undisputed that the retired cooling tower is no longer providing service to Delmarva's ratepayers. Moreover, the Company's ratepayers are already paying a return on the Company's $23 million investment in the new cooling tower. We do not believe the ratepayers should also pay a return on the remaining $8.1 million investment in the retired cooling tower as well.

44. Since we have found that the Company's remaining investment in the retired cooling tower must be removed from the Company's rate base, it necessarily follows that the Company must use whatever accounting treatment is necessary to comply with our decision. We are aware that such accounting treatment

may not be "proper" from a strict accounting perspective, but we do not believe that we are constrained by the Company's book accounting treatment for ratemaking purposes. We have ordered utilities in the past to take action which was not in accordance with generally accepted accounting principles; indeed, in Docket No. 86-24 the Company was required to remove the oil storage tank from rate base by classifying the retirement as extraordinary, even though Delmarva had retired the tank using ordinary retirement accounting. Moreover, we note that other state regulatory commissions have refused to adhere to generally accepted accounting principles in the ratemaking context. See Re Consumers Power Co., 86 PUR 4th 170, 184 (Mich. PSC 1987); Re Commonwealth Edison Co., 70 PUR 4th 107, 111 (Ill. Commerce Comm'n 1985).

45. To summarize, we hold that the Company's investment in the retired cooling tower must be removed from rate base because it is no longer, and never again will be, used and useful. We further hold that if the only way this investment can be removed from rate base is to treat it as an extraordinary retirement, then the Company must treat the retirement as extraordinary. (Unanimous).

46. We next address the issue of whether the Company should be permitted to recover its remaining investment in the

retired cooling tower through amortization, and, if so, the appropriate period over which the investment should be amortized.[9] Although Staff originally suggested that it might not be inappropriate to deny the Company both a recovery of and a return on the remaining investment, it revised its position in its brief on exceptions to recommend that the Company be permitted to recover its investment. We agree that it is appropriate to allow Delmarva to recover its remaining investment in the retired cooling tower through amortization, with no return on that investment. Such treatment is consistent with the treatment we authorized for the Company's remaining investment in the oil storage tank in Docket No. 86-24.

47. The evidence shows that the cooling tower had an expected service life of approximately 30-40 years. (Tr. at 1837-38). As discussed earlier, the tower was retired after only nine years of service. We believe that it is proper to select an amortization period which approximates the remaining number of years in which the tower was expected to provide service had it not failed. This will afford Delmarva recovery

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[9] During oral argument it was suggested that the Company might be able to recover the investment through the depreciation rates which this Commission approved in Docket No. 90-25. It appears, however, that this is not a viable option because the gross plant balances do not reflect the requirement associated with the cooling tower. (Tr. at 2321).

of the investment over approximately the same time period over which it would have recovered the investment through depreciation, rather than permitting recovery faster than would have occurred if the tower had not failed. We conclude that a reasonable amortization period is 20 years. Thus, we authorize Delmarva to amortize the remaining $8.1 million investment in the retired cooling tower over 20 years, beginning with the rate effective date of this case, with no return on the investment. (3-0, Commissioner Twilley not voting).

4. INDIAN RIVER TALL STACK

48. In order to comply with the Environmental Protection Agency's 24-hour National Air Ambient Quality Standard, the Company constructed a high-profile chimney at its Indian River generating facility. The "Tall Stack," which is designed to reduce the ground level concentration of sulfur dioxide emitted by the Indian River facility, was placed in service in two stages: approximately $21 million was placed in service in November 1991, and the balance of $9 million was placed in service in February 1992.[10] The Company proposed to include the cost associated with the Tall Stack, a non-revenue producing

[10] The Delaware Department of Natural Resources and Environmental Control, which approved the installation of the Tall Stack in 1989, established a deadline of March 1, 1992 by which the Tall Stack was to be fully in-service.

asset, in its test period rate base and depreciation expense. (Exh. 16 (Dougher) at 58; Exh. 25 (Wittine) at 19). This increased Delmarva's test period rate base by $5.514 million and decreased its test period earnings by $1.357 million.

49. The OPA objected to the Company's proposal to include the Tall Stack in its test period results. The OPA's objection was based on its position that the Commission should adhere to a strict test period, and thus disallow any adjustments which reached beyond the end of the test period. The test period in this docket ended on September 30, 1991. Since the Tall Stack was not placed in service until after the test period had ended, the OPA recommended disallowance of the adjustment to include the Tall Stack in Delmarva's test period results. (Exh. 30 (OPA) at 21; Tr. at 990).

50. The Hearing Examiner found the OPA's position of strict adherence to the test period concept to be too restrictive, and therefore inappropriate. (HER at 29). First, the Hearing Examiner acknowledged that this Commission has frequently allowed out-of-period adjustments under certain circumstances when the adjustments are known and measurable and when the changes are of such magnitude that the test period will no longer be representative of the utility's operations. (Id., quoting Re Diamond State Telephone Co., 87 PUR 3rd 174, 177

(Del. PSC 1970)). The Commission's Minimum Filing Requirements also confirm that a utility may adjust test period data to reflect known and measurable changes to future rate base items. (HER at 30-31). The Hearing Examiner found the Tall Stack to be one of the situations in which an out-of-period adjustment should be permitted because: (1) the Tall Stack is a non-revenue producing investment that was made to comply with federal and state environmental requirements; (2) the costs associated with the Tall Stack were reasonably known and measurable; (3) the annual Delaware retail revenue requirement associated with the Tall Stack is $3.5 million; and (4) the Tall Stack would be fully placed in service by March 1, 1992. (Id. at 30). He was also persuaded by Delmarva's contention that if the Tall Stack costs were excluded from test period rate base and expenses, the accuracy of Delmarva's cost of service during the rate effective period would be materially affected. (Id. at 31). Thus, the Hearing Examiner concluded that the Company's proposed adjustment was appropriate because the costs were known and ascertainable; would occur between the test year and the rate effective period, and were of such magnitude as to significantly impact Delmarva's ability to earn its authorized rate of return during the rate effective period. (Id. at 30). He therefore recommended that the OPA's proposal to disallow these costs be rejected.

51. The OPA excepted to the Hearing Examiner's recommendation, based on its principle of strict adherence to the test period concept. It further argued that Delmarva's ratepayers had "funded the Company's excess earnings" in the 1980s, and that the Tall Stack adjustments were another example of Delmarva's "violation" of the test period and matching principles. It also contended that Delmarva's expressed intent to file another base rate case before the end of this year supported its proposal to disallow this adjustment in this rate case. (OPA BOE at 5-7).

52. **Discussion**. We agree with the Hearing Examiner, and adopt both his recommendations and his supporting reasons therefor. In doing so, we observe that under Delaware law, we may not arbitrarily refuse to consider accurate post-test period information in setting a utility's rates. See e.g., In re Delmarva Power & Light Co., Del. Super., 337 A.2d 517 (1975). Indeed, as the Hearing Examiner noted, our Minimum Filing Requirements state that we will consider post-test period changes under certain circumstances. We believe that the Company's adjustment to its test period results to include the costs associated with the Tall Stack satisfies the criteria identified by the Hearing Examiner for permitting out-of-period

adjustments. The Tall Stack costs are reasonably known and measurable; they have already been incurred; and their inclusion makes the test period more representative of the rate effective period. Furthermore, we observe that Delmarva was required to construct the Tall Stack to comply with federal environmental regulations. We, therefore, adopt the Hearing Examiner's recommendation, and reject the OPA's proposal to disallow the Tall Stack costs from the Company's test period results. (Unanimous).

5. **MERRILL CREEK**

53. The Company sold its interest in the Merrill Creek reservoir in June 1988. It proposed to reduce its test period rate base by $2.043 million to reflect the unamortized deferred gain from the sale (net of the related deferred taxes), plus the cumulative 1992 spread between the amounts expensed for Merrill Creek rent and the amounts actually paid to the lessor. (Exh. 16 (Dougher) at 20).

54. The OPA did not object to the Company's proposed rate base treatment of the Merrill Creek transaction. Consistent with the OPA's adherence to the strict test period principle, however, OPA witness Knudsen adjusted Delmarva's proposed rate base adjustment to reflect only test period balances. This resulted in a reduction to the Company's test period rate base

of $2.011 million. (Exh. 30 (OPA) at Schedule MAB-20).

55. Based on his discussion of the underlying principles in relation to the Tall Stack, the Hearing Examiner recommended that the Company's position be adopted. He observed again that the OPA's restrictive approach was unwarranted in this instance. Moreover, he noted that the difference between the Company's and the OPA's adjustments was de minimis and Delmarva's adjustment would not adversely affect the ratepayers. (HER at 32). The OPA did not except to the Hearing Examiner's recommendation, but advised the Commission during oral argument that its proposal was based on its adherence to the strict test period concept. (Tr. at 2251).

56. **Discussion.** We agree with the Hearing Examiner and adopt both his recommendation and his reasoning. Again, we decline the OPA's invitation to take the restrictive approach to the test period which it advocates. We believe, as did the Hearing Examiner, that the better position in this instance is to adopt the Company's proposed adjustment. (3-0, Commissioner Twilley not present during vote).

6. NANTICOKE

57. In the late 1970s and early 1980s, Delmarva incurred costs in connection with the proposed construction of a 400-600 MW coal plant at its Nanticoke site. Subsequent severe changes

in load growth resulted in several construction postponements and an eventual downsizing of the proposed plant to approximately 200 MW. The Company finally stopped all work on the Nanticoke project in 1982, after having invested $14.4 million in it. (Exh. 25 (Wittine) at 14-15; Exh. 32 (Henkes) at 17-18).

58. Due to repeated construction deferrals and changing environmental requirements, the Company concluded in 1986 that $8.1 million of its Nanticoke investment no longer had value, and transferred that amount to its "unrecovered plant and study costs" account. In Docket No. 86-24, the Company requested amortization of this $8.1 million investment over six years, with rate base treatment for the unamortized balance. The Hearing Examiner recommended, and we adopted, a six-year amortization period for the $8.1 million investment, with no rate base treatment of the unamortized balance. See In re Delmarva Power & Light Co., 85 PUR 4th 122, 146 (Del. PSC 1987).

59. The Company kept the remaining $6.3 million Nanticoke investment in its "plant for future use" account because it still intended to construct a smaller plant on the site. Due to additional investments for environmental studies and a Route 50 bridge bypass, a land transfer to a non-utility, and a sale of an easement to C & P Telephone, the amount of Delmarva's

Nanticoke investment grew from \$6.3 million to \$7.5 million. Since 1986, however, a number of factors (primarily environmental regulations) led the Company finally to conclude that it was "unlikely" that a plant could ever be built at the Nanticoke site. Consequently, in 1989 Delmarva made a decision to write off the remaining investment in the Nanticoke site. (Exh. 25 (Wittine) at 17; Exh. 32 (Henkes) at 19).

60. In this case, the Company proposed to recover the remaining \$7.5 million investment over five years, with rate base treatment for the unamortized balance. (Exh. 25 (Wittine) at 16). According to Delmarva, such treatment should be adopted because it results in an allocation of the costs between stockholders and ratepayers similar to that which the Commission permitted in Docket No. 86-24. (COB at 59). In the event that the Commission determined that the unamortized balance should be excluded from rate base, the Company contended that it should be permitted to achieve the level of sharing implicit in the decision in Docket No. 86-24 by recovering approximately \$1.1 annually for five years, based upon Delmarva's requested overall rate of return of 10.19%. (Exh. 66 (Wittine-R) at 16).

61. Both Staff and the OPA opposed Delmarva's proposed treatment of the remaining Nanticoke investment. While Staff did not object to the Company's proposal to amortize the

remaining investment over five years, it did object to the Company's proposed rate base treatment of the unamortized balance. Staff argued that the Nanticoke investment never was, nor would it ever be, used and useful in providing service to Delmarva's ratepayers, and thus it was improper to include the unamortized balance in rate base where Delmarva would earn a return on that amount. Thus, Staff recommended that the Company be permitted to amortize the remaining Nanticoke investment over five years, but that the unamortized balance be excluded from rate base. This treatment, Staff contended, was consistent with this Commission's decision in Docket No. 86-24 and with the regulatory treatment afforded similar write-offs in other jurisdictions. (Exh. 32 (Henkes) at 20-22).

62. Staff also objected to the Company's proposal to recover an annual amount of $1.1 million to effectuate the "implicit" sharing percentages resulting from Docket No. 86-24. It argued that this was an attempt by the Company to circumvent the "used and useful" requirement which otherwise would bar the Company from earning a return on the investment. Staff further contended that the Commission's decision in Docket No. 86-24 did not establish a precedent for calculating precise sharing percentages; rather, it established the precedent that Delmarva was entitled to a return <u>of</u> its investment but no return <u>on</u> that

investment. (SAB at 89-90) (emphasis in original).

63. Like Staff, the OPA did not oppose Delmarva's proposal to amortize the remaining unrecovered Nanticoke investment. The OPA did, however, object to the five-year amortization period and the proposed rate base treatment of the unamortized balance. According to the OPA, there were "disquieting" environmental developments of which the Company was aware during its last base rate case, yet it still proceeded with activities and studies related to the site. Moreover, the OPA perceived an equitable issue in Delmarva's delay in seeking recovery of these costs until this base rate case, particularly since Delmarva's earnings had exceeded authorized levels in the years between Docket No. 86-24 and this case. Thus, the OPA recommended a 10-year amortization period for the remaining Nanticoke investment with no rate base treatment for the unamortized balance. (Exh. 30 (OPA) at 38-40).

64. The Hearing Examiner concluded that there was no legal or equitable basis for permitting the Company to earn a return on the unamortized balance of the Nanticoke investment, and recommended that the Company's proposal be rejected. (HER at 35). First, he determined that as a general proposition under Delaware law, a utility may earn a return only on investment "used and useful" in providing utility service. (Id.

at 36, citing 26 Del.C. §102(3)a). Since the Nanticoke investment had never been used and useful in providing utility service, the Hearing Examiner found that there was no basis for including it in rate base. (Id.).

65. The Hearing Examiner also rejected as "without merit" Delmarva's contention that the Commission authorized an "equitable sharing standard" resulting from its adoption of the Hearing Examiner's recommendation in Docket No. 86-24. (Id.). He concluded that there was nothing in this record, in the Hearing Examiner's report in Docket No. 86-24, or in the Commission's final order in Docket No. 86-24 to indicate that the sharing percentages which resulted from that docket were "anything more than coincidental" to the amortization approach recommended and approved in that docket. (Id. at 37). Furthermore, the Hearing Examiner found no evidence indicating that the Commission intended to establish a precedent of specific sharing percentages between Delmarva's stockholders and ratepayers. (Id.).

66. The Hearing Examiner further observed that allowing Delmarva to earn a return on the unamortized balance of the Nanticoke investment in Docket No. 86-24 would have unfairly burdened the ratepayers with the costs associated with investment risks that are more properly borne by Delmarva's

stockholders. (Id.). While he acknowledged the precedent set in Docket No. 86-24 for allowing Delmarva a return of its investment, he concluded that there was no basis in this record for allowing it a return on that investment. (Id. at 39). Similarly, the Hearing Examiner rejected Delmarva's proposal to recover $1.1 million annually in expenses to achieve "equitable sharing" and to recognize the time value of money as an attempt to achieve indirectly what it could not obtain directly. (Id.).

67. Last, the Hearing Examiner recommended that the Commission approve a five-year amortization period for the recovery of the Nanticoke investment. He rejected the OPA's proposal for a 10-year amortization period, finding the Company's explanations for deferring the remaining costs and incurring the additional costs since Docket No. 86-24 to be "credible and reasonable." (Id. at 40).

68. Delmarva excepted to the Hearing Examiner's recommendation. First, it claimed that "[n]othing has transpired since Docket No. 86-24 which would justify ... a change in the sharing ratio" from that "effectively adopted" in Docket No. 86-24. Second, it contended that whether the investment was used and useful was not controlling; rather, the Commission could include this amount in rate base pursuant to 26 Del.C. §102(3)g. Third, it asserted that the costs which it

sought to recover in this proceeding arose from the same investment addressed in Docket No. 86-24, in which the Hearing Examiner found that the shareholders had already been carrying the costs of the investment since 1982, and that the sharing percentages authorized in that docket had been presented to the Hearing Examiner and the Commission and were not "coincidental." (CBOE at 17). Fourth, the Company argued that the California Commission decision which the Hearing Examiner used to support his conclusion in this case was actually consistent with Delmarva's proposal. (CBOE at 15-18).

69. The OPA also excepted to the Hearing Examiner's recommended five-year amortization period. (OPA BOE at 8). The OPA argued again that Delmarva ignored "disquieting" environmental developments since Docket No. 86-24 and proceeded to pursue activities and studies related to the Nanticoke site. (Id.). The OPA urged the Commission to consider that Delmarva should have cut off further spending on the site at an earlier time, and could have started amortizing the deferred expenses earlier. (Id. at 9). The OPA further argued that the Company could have absorbed some of the risks of this investment over the past five years, during which time, the OPA observed, Delmarva was earning in excess of its rate of return. (Id.).

70. **Discussion.** We approve the Hearing Examiner's

recommended treatment of the remaining Nanticoke investment. We believe the Hearing Examiner properly recognized the generally applicable statutory prohibition on including in rate base property or investment which is not used and useful. Furthermore, his recommendation is consistent with the treatment which this Commission approved for the first $8.1 million of Nanticoke investment in Docket No. 86-24. Thus, we will allow Delmarva to amortize its remaining $7.5 investment in the Nanticoke site over five years, but we will exclude the unamortized balance of that investment from the Company's rate base.

71. It is undisputed that the Nanticoke investment never was, and never will be, used and useful in providing electric service to Delmarva's ratepayers. We reject Delmarva's proposal to include the unamortized portion of the investment in rate base because it fails to recognize the statutory "used and useful" requirement set forth in 26 Del.C. §102(3)a.

72. We further reject Delmarva's argument that its initial investment decision and its decision to cancel its plans were reasonable when made, so that it is entitled to a return on its investment. (COB at 60). There is no requirement that the investment be included in rate base, because the investment was never used and useful and never will be used and useful. As a

matter of discretion under 26 Del.C. §102(3)g, we decline to include the Nanticoke investment in rate base.

73. We also reject Delmarva's characterization of its proposed rate base treatment for the unamortized balance of the investment as a "ratemaking construct that allows an equitable sharing of the costs." (COB at 60). We agree with the Hearing Examiner that no matter what it is called, the effect of Delmarva's proposal is to allow it a return on an investment which is not and will never be used and useful. As a matter of discretion under 26 Del.C. §102(3)g, we decline to allow such a ratemaking construct for the Nanticoke investment.

74. Similarly, we reject the Company's contention that we authorized any sort of specific sharing percentage between Delmarva's stockholders and ratepayers in Docket No. 86-24. It is true that one can mechanically calculate a specific sharing percentage which resulted from our decision to permit amortization over six years with no rate base treatment in Docket No. 86-24. That, however, is all it is: a result. There is nothing in our final order in that docket (or in the Hearing Examiner's recommendation which we approved) which indicates that we were establishing any precedent with respect to specific sharing percentages. Since we did not authorize specific sharing percentages in that docket, we are not bound to approve

a ratemaking treatment which achieves the same or similar sharing percentages here.

75. Finally, we decline to accept Delmarva's proposal to allow it $1.1 million as an annual expense to recognize the time value of money. We view this proposal as an attempt by the Company to achieve indirectly that which we have determined should not be achieved directly -- i.e., a return on its investment.

76. As for the appropriate amortization period, we agree with Staff and the Company that five years is a reasonable period. We note, as did Staff, that this period is consistent with our approval of a six-year amortization period in Docket No. 86-24. We further observe, however, that the Company is still amortizing the first $8.1 million of Nanticoke investment as authorized in Docket No. 86-24. Because those costs will not be fully amortized until April 1993, they are included in the Company's request for rate relief in this docket. Unless the Company applies for rate relief prior to April 1993, the amortization of that portion of the Nanticoke investment will continue to be recovered in rates, notwithstanding that it will have been fully amortized in April 1993. Thus, there is the potential that the Company will recover more than its actual investment.

77. The Company has indicated that it plans to file another rate case toward the end of 1992. If it does, then the potential of over-recovery of the Nanticoke investment is diminished. We believe, however, that to eliminate any possibility of over-recovery, the wiser course of action is to add the balance currently remaining on the $8.1 million investment to the $7.5 million amount which we have authorized for amortization herein, and to amortize that total over five years.

78. To summarize, we hold that the Company is entitled to a return <u>of</u> its remaining investment in the Nanticoke site, but not to a return <u>on</u> that investment. Thus, we will allow the Company to recover its remaining Nanticoke investment through amortization over a five-year period, with no rate base treatment of the unamortized balance. Furthermore, to eliminate the potential for over-recovery on the Company's currently existing amortization of the $8.1 million investment authorized in Docket No. 86-24, we direct the Company to add the remaining unamortized balance of the $8.1 investment to the $7.5 million investment, and to amortize that total amount over five years. (Unanimous).

7. **CONSOLIDATED TAX RETURN**

79. Delmarva filed a consolidated income tax return with its four subsidiaries. For purposes of this rate case, however, Delmarva calculated its federal income taxes on a "stand alone" basis. The OPA contended that Delmarva benefits from its consolidated tax filing because the net taxable income from the consolidated entity is lower than it would be if each subsidiary filed an individual income tax return. (Exh. 30 (OPA) at 25). Thus, the OPA proposed that the tax savings Delmarva receives from its consolidated filing should be reflected in the calculation of its revenue requirement in this case. OPA witness Bleiweis therefore calculated an adjustment of approximately $99,000, which he subtracted from Delmarva's test period rate base as "cost-free capital." (Id. at 27).

80. Delmarva opposed the OPA's adjustment on several grounds. First, the Company pointed out that the OPA's adjustment only attributes the tax benefits generated by the subsidiary losses to the ratepayers, even though it was the Company's stockholders who bore the losses. (Exh. 56 (Gerritsen-R) at 13-20). Second, the Company contended that because the proposed IRS regulation on which OPA witness Bleiweis relied had been withdrawn, the OPA's proposed treatment could violate IRS normalization requirements. (Exh. 58 (Graham-

R) at 3-6).

81. The Hearing Examiner acknowledged that Pennsylvania had adopted the OPA's approach, but concluded that such an adjustment should not be approved in this case. (HER at 42-43). The Hearing Examiner found that the OPA's approach was "short-sighted," and that it violated the "fundamental" ratemaking principle that a utility's costs and revenues should be kept separate from those of its non-regulated subsidiaries. (Id. at 42). As a matter of policy, the Hearing Examiner opined that "breaching the wall between regulated and unregulated activities is fraught with a potential for mischief which once released may do more harm to ratepayers in the long-term than any short-term benefit that they may otherwise receive." (Id.).

82. Additionally, the Hearing Examiner identified other problems with a consolidated tax adjustment. First, he noted that there was confusion as to the appropriate methodology for calculating the adjustment. As an example of this confusion, he cited the OPA's own adjustment, which used a tax loss for one subsidiary but excluded a larger loss for a second subsidiary. (Id. at 43 and n.35). Second, he observed that the IRS was still in "a state of flux" with respect to regulations addressing such an adjustment. (Id. at 43). Thus, the Hearing Examiner recommended that the Commission defer any decision at this time with respect to a consolidated tax adjustment, and to

continue with Delmarva's stand-alone calculation of federal income taxes. (Id.). He further recommended, however, that the Commission revisit this issue in Delmarva's next base rate case, prior to which the issue would "hopefully" be clarified. (Id. at n.36).

83. The OPA excepted to the Hearing Examiner's recommendation. First, it argued that other regulatory commissions had made such an adjustment. The OPA advocated the "actual taxes paid" doctrine followed by these commissions, which it contended "works equally both ways to the advantage of neither" stockholders nor ratepayers. The OPA also disputed Delmarva's position that such an adjustment might violate normalization requirements, citing the IRS chief counsel's comments indicating a contrary conclusion. (OPA BOE at 10-13).

84. **Discussion**. We agree with the Hearing Examiner and the Company that we should not adopt the OPA's recommended consolidated tax adjustment in this case. We believe that the Company's position is sound.

85. The Hearing Examiner also recommended that the Commission revisit this issue in Delmarva's next rate case. By this order, the Commission does not preclude this issue from being revisited. (Unanimous).

8. NEW DEPRECIATION RATES

86. The Company originally calculated its test period rate base and earnings using the depreciation rates which it proposed in Docket No. 90-25. After the Staff and the OPA protested, the Company recalculated its test period rate base and earnings using the depreciation rates then currently in effect. All parties agreed, however, that if the Commission entered an order in Docket No. 90-25 approving new depreciation rates before the rate effective date of this case, the test period rate base and earnings should be restated to reflect the results of the Commission's order. (See COB at 33; SAB at 16; OPA AB at 36). The Hearing Examiner recommended approval of this proposal as a fair and reasonable means of resolving the issue. (HER at 41).

87. **Discussion**. On February 25, 1992, the Commission entered an order in Docket No. 90-25 approving new depreciation rates for Delmarva. We agree with the Hearing Examiner that the Company's test period rates and earnings should be restated to reflect the new depreciation rates approved in our February 25, 1992 order. These now-known and measurable depreciation rates will be in effect during the rate effective period; thus, test period results which reflect these new rates will be more representative of the period during which electric rates will be in effect. We, therefore, adopt the Hearing Examiner's

recommendation. The application of the new depreciation rates will reduce Delmarva's test period rate base by approximately $46,000. (Unanimous).

9. **SUMMARY OF RATE BASE ADJUSTMENTS**

88. The following table summarizes the results of the positions of the parties, the Hearing Examiner's recommendations, and our deliberations and decisions in this docket. As can be seen from that table, our decisions result in a fully adjusted test period rate base of $801,762 for Delmarva.

RATE BASE ADJUSTMENTS

$000's

ISSUE	DELMARVA (after exceptions)	STAFF (after exceptions)	OPA (after exceptions)	HEARING EXAMINER'S RECOMMENDATION	PSC DECISION
Uncontested Adjusted	$802,301	$802,301	$802,301	$802,301	$802,301
<u>Contested Issues:</u>					
Merrill Creek	($2,043)	($2,043)	($2,011)	($2,043)	($2,043)
Tall Stack	$5,514	$5,514	$0	$5,514	$5,514
Nanticoke	$2,528	$0	$0	$0	$0
Cash Working Capital	$55	$114	$114	($34)	$2
Removal Old Cooling Tower	$0	($4,766)	($4,766)	$0	($4,766)
Sale DC#3	$0	($954)	$0	$0	$0
Remove CWIP	$0	$0	($44,472)	$0	$0
Consolidated Tax	$0	$0	($99)	$0	$0
Fully Adjusted Rate Base	$806,333	$800,166	$755,833	$805,738	$801,008
Remove Cooling Tower - Deferred Taxes		$800	$800	$0	$800

Docket 90-25 Depreciation Rates	($46)	($46)	($46)	($46)	($46)
Revised Rate Base	$808,309	$800,920	$751,821	$805,692	$801,762

C. **EARNINGS ISSUES**

1. **INDIAN RIVER TALL STACK**

89. As discussed previously, the Company included the depreciation expenses associated with the Indian River Tall Stack in its test period operating expenses. This adjustment reduced Delmarva's test period earnings by $1,357,000. The OPA recommended disallowance of this adjustment based on its adherence to a strict test year principle. We have already rejected the OPA's recommendation and adopted the Hearing Examiner's recommendation in connection with Delmarva's rate base (see supra at pages 33-34). Likewise, we adopt the Hearing Examiner's recommendation in connection with the Company's earnings for the same reasons we stated previously. (Unanimous).

2. **INJURIES AND DAMAGES EXPENSES ("I&D")**

90. The Company maintains a reserve for I&D expenses which represents its accruals for self-insurance coverage for worker's compensation and auto and general liabilities. According to Delmarva, it increased its accruals by $1,115,000 in December 1990 after reviewing its outstanding claims for asbestos-related injuries and auto and general liabilities. (Exh. 22). When the Company updated its test period I&O expenses to reflect "11+1" figures, it included an additional $900,000 in I&D expenses.

(Tr. at 985). Thus, it sought to include test period I&D expenses of $4,526,302 in its operating expenses.

91. OPA witness Bleiweis examined the Company's I&D accruals for each year from 1986 to 1990 and for the test period. He asserted that the test period expenses were not representative of actual I&D accruals in the past, and there was no way of knowing whether the test period expenses would be representative of future accruals. The OPA concluded that an adjustment to normalize the test period I&D expenses was appropriate, and calculated a normalized level of test period I&D expenses using the average of the four years of actual accruals from 1986 through 1989. The OPA did not include Delmarva's 1990 I&D expenses in its calculation because the Company provided little explanation for the $1.15 million additional accrual which occurred in 1990, and no explanation for the additional $900,00 accrual during the test period. (Exh. 30 (OPA) at 14-15). The OPA's adjustment increased Delmarva's test period earnings by $435,000. Staff witness Henkes testified that he had reviewed the OPA's proposed normalization adjustment and agreed that it was appropriate. (Tr. at 1087-89).

92. On rebuttal, the Company agreed to normalize its I&D

expense for purposes of this rate case only. It contended, however, that the normalization adjustment should be calculated using the 1990 I&D expenses, and that the historical costs should be adjusted for inflation. (Exh. 60 (Dougher-R) at 19-20). The Company proposed to use the GNP implicit price deflator to calculate the inflation adjustment to its historical I&D costs. (Id. at 20). The Company's proposed adjustment increased its test period earnings by $224,000.

93. The Hearing Examiner observed that under generally accepted ratemaking principles, a normalization adjustment in appropriate when the level of a utility's test period expense is out of line with its past experience so as not to be representative of the future level of those expenses. (Her at 52-53). The Company's test period I&D expenses were $4,526,302. Previously, its I&D expenses ranged from a low of $3,044,654 in 1989 to a high of $3,752,820 in 1988. (Exh. 60 (Dougher-R) at Schedule DGD-8). Based on the Company's previous experience, the Hearing Examiner agreed with the OPA that the Company's level of test period I&D expenses warranted a normalization adjustment. (HER at 53).

94. The Hearing Examiner, however, did not recommend either of the proposed normalization adjustments advanced by

Delmarva or the OPA/Staff. He rejected the OPA/Staff normalization adjustment because it excluded the I&D expenses actually incurred during the test year, and neither the OPA nor Staff had presented evidence that those costs were not incurred in good faith. (Id.). Furthermore, he stated that excluding the test year I&D expenses would render the proposed average unrepresentative of the anticipated future expense level. (Id.). The Hearing Examiner also rejected the Company's proposal because it contained an inflation factor. The Hearing Examiner recognized this Commission's practice of denying attempts to inject inflation adjustments into the ratemaking calculus, and found no evidence to support a departure from that practice here. (Id. at 53-54). Moreover, he observed that Delmarva had used the GNP price deflator to calculate its proposed adjustment, which was "'an average of the indexes of prices of all the goods and services which make up the GNP, weighted by the composition of GNP in the current period.'" (Id., quoting OPA Answering Brief at 31). The Hearing Examiner found that this "broad-based measure" confirmed the basis for the Commission's previous rejection of inflation adjustments as "'speculative.'" (Id. at 54).

95. The Hearing Examiner thus calculated his proposed

normalization adjustment by averaging the I&D costs from 1986 through the test period. He believed this approach to be reasonable because it reflected the highs and lows of the Company's I&D expenses over a five-year period, and recommended that the Commission adopt it. (Id.). The Hearing Examiner's adjustment increased Delmarva's test period earnings by approximately $348,000.

96. The OPA and Staff accepted the Hearing Examiner's proposed normalization adjustment. The Company, however, excepted to the Hearing Examiner's refusal to apply the Company's proposed inflation adjustment. (DBOE at 27). It distinguished its proposed inflation adjustment from those which the Commission had rejected in the past by claiming that its adjustment "simply incorporates actual past inflation effects into the averaging process." (CBOE at 27) (emphasis in original). Moreover, it claimed that if the Hearing Examiner's recommendation was adopted, Delmarva would be denied full recovery of its legitimate expenses. (Id. at 28).

97. **Discussion**. After consideration of both the written and oral arguments presented, we agree with the Hearing Examiner that the normalized level of I&D expenses should be based on the average of I&D expenses for the past 5 years, including the test

period, and without an adjustment for the general level of inflation that occurred over that period. (Unanimous).

3. MERRILL CREEK DEFERRED LEASE EXPENSES

98. In 1988, the Company owned an 11.91% interest in the Merrill Creek reservoir. The Company, and the other utilities who owned interests in the reservoir, decided to sell their ownership interests and lease them back.

99. On April 11, 1988, Delmarva filed an application with the Commission pursuant to 26 Del.C. §215 seeking approval of a sale/leaseback of its interest in the reservoir. (Exh. 60 (Dougher-R) at Reb. Exh. DGD-1, Schedule 2). At the time of the Company's application, Delmarva was reviewing eight bids which had been submitted by prospective purchasers. (Exh. 59 (Agra-R) at 7). On May 3, 1988, the winning bid was selected. (*Id.* at Reb. Exh. AFA-2). The bid contained a provision which allowed Delmarva to postpone rental payments for the first two years of the 44-1/2 year lease term.

100. On May 10, 1988, Delmarva refiled its Section 215 application with the Commission, and on May 16, 1988 the Company sent a letter to the Commission describing the terms and conditions of the commitment letter. Attached to the May 16, 1988 letter was, *inter alia*, a memorandum discussing the

proposed accounting treatment for the rental expenses associated with the leaseback. (Exh. 60 (Dougher-R) at 7 and Reb. Exh. DGD-2, Schedule 2).

101. On May 27, 1988, the Commission issued Order No. 2947, in which it approved the sale and leaseback transaction. However, the Commission specifically stated that it was not approving the ratemaking treatment of the transaction:

> ...[T]he Applicant is hereby put on notice that the Commission in determining the appropriate ratemaking treatment for the expenses associated with this transaction, may limit the recovery of such expenses to a level which would protect the ratepayers from any effects of this transaction that would not have occurred had Delmarva retained ownership of the facility.

(Exh. 60 (Dougher-R) at Reb. Exh. DGD-3, Schedule 3).

102. The Company completed the sale and leaseback of its interest in Merrill Creek in June 1988. By letter dated December 29, 1988, the Company requested Edwin Carlson, then the Commission's Chief of Accounting and Finance, for approval of its proposed deferred accounting for the rent liability accruals over the first two years of the lease. (Exh. 60 (Dougher-R) at Reb. Exh. DGD-4). On February 22, 1989, Mr. Carlson responded in pertinent part as follows:

> The accounting described above for the Merrill Creek sale-leaseback is consistent with the treatment presented in Delmarva's filing in

> PSC Docket No. 88-10, and I approve of this accounting to provide for a levelized expensing of the rental costs over the same period that the rental payments will be made.
>
> However, such approval is not to be construed as approving any Delmarva proposed ratemaking treatment of this transaction. The ratemaking treatment of this transaction will be decided by the Commission in Delmarva's next electric base rate case.

(Exh. 60 (Dougher-R) at Reb. Exh. DGD-5).

103. The Company is now amortizing $8,042,270 of deferred lease expenses over the remaining 42-1/2 years of the lease. (Exh. 32 (Henkes) at 51). The Company's pro forma test period operating expenses included $189,230 of amortized expenses relating to the deferred lease payments, for which the Company sought recovery in rates. (Id.).

104. Both Staff and the OPA objected to the Company's proposed ratemaking treatment for the deferred lease expenses. Both parties contended that the Company's proposal violated the intent of Commission Order No. 2947. (Exh. 30 (OPA) at 34; Exh. 32 (Henkes) at 53). Staff witness Henkes argued that had the Company retained its ownership interest in the reservoir, it would have been booked as a normal plant addition in 1988. (Id.; Tr. at 517-18). Had this occurred, Staff claimed, Delmarva's ratepayers would not now be faced with the revenue requirement associated with the plant for the two years ended

June 1990. (Exh. 32 (Henkes) at 53). Thus, both the Staff and OPA adjusted the Company's test period earnings to remove the amount associated with the deferred lease payments. (Id. at 54 and Schedule 8; Exh. 30 (OPA) at 34 and Schedule MAB-20). If the Staff's and the OPA's proposal was adopted, the Company's test period earnings would increase by $65,000.

105. The Hearing Examiner recommended that the Commission reject the Staff's and OPA's proposal to disallow the Merrill Creek deferred lease expenses. (HER at 57). First, the Hearing Examiner found that Delmarva's proposed treatment matched the payment of the lease expenses with their recovery from ratepayers. (Id. at 57). Second, he observed that the sale/leaseback transaction resulted in a smaller overall net present value revenue requirement than that which would have resulted if the Company had retained its ownership interest in the reservoir. He concluded that the sale/leaseback, viewed in its entirety, did not adversely affect ratepayers, and thus satisfied the Commission's standard set forth in Order No. 2947. (Id. at 58). Finally, the Hearing Examiner found no evidentiary support for the contention that Delmarva had "manipulated" the test period concept insofar as the Merrill Creek transaction was concerned, because the two-year rent holiday had been suggested by the winning bidder, not by the

Company. (Id. at 59).

106. Staff and the OPA excepted to the Hearing Examiner's recommendation. Staff argued that allowing Delmarva to recover the deferred lease payments in its rates was inconsistent with the intent of Order No. 2947. (SBOE at 33). Staff pointed out that the Company had provided the Commission with an updated analysis of the revenue requirements associated with retaining ownership versus the sale/leaseback before the Commission's deliberations and decisions in Docket No. 88-10. Thus, Staff concluded, if the Commission had intended to look only to the respective revenue requirements of the two options, its reservation of its right to limit recovery of those expenses in a future ratemaking proceeding would have been unnecessary. (Id. at 33-34). Second, Staff argued that the matching of expenses with the recovery of those expenses should not be a deciding factor because the Commission's then-chief accountant recognized that some matching would occur when he approved Delmarva's requested accounting treatment. (Id. at 35). In any event, however, Staff did not agree that the Company's proposed ratemaking treatment resulted in a perfect matching of expenses with their recovery. (Id. at 35-36). According to Staff, allowing Delmarva to defer expenses incurred between rate cases, while simultaneously accruing those expenses on its books, was

inconsistent with the concept of setting rates based on the utility's revenues, plant investment, and operating expenses at a particular point in time. (Id. at 36). Last, Staff contended that the Company's rate application, taken as a whole, demonstrated a consistent pattern of reaching outside the test year for adjustments which would increase its revenue requirement, while ignoring out of period adjustments which would decrease its revenue requirements. (Id. at 37).

107. The OPA argued that the Hearing Examiner had approached this issue from the wrong perspective. (OPA BOE at 15). The OPA identified the contested issue here not as the entire transaction, but rather as "whether the Company should be permitted to enhance its earnings performance in one fiscal period at the expense of ratepayers in subsequent periods." (Id.). The OPA contended that Delmarva had not filed a new rate case in 1988 to recognize the deferred charges; "[t]herefore, ratepayers would never have had, and should not have now, any obligation relating to this matter until the basic lease expense is recognized in base rates..." (Id., quoting Exh. 30 (OPA) at 33). Thus, the OPA concluded that Delmarva could have, and should have, absorbed the interim deferred lease expenses. (Id. at 16).

108. **Discussion**. Although we are sympathetic to the

arguments made by Staff and the OPA in support of their proposal to disallow recovery of the two years of deferred lease expenses, we nevertheless conclude that we must allow the Company to recover the deferred lease expenses in its rates. We agree with the Hearing Examiner that the Company's proposed treatment matches the cost incurrence with its recovery from ratepayers; however, we also find that we are constrained in our ability to authorize other treatment by the Commission's then-chief accountant's specific approval of Delmarva's requested deferred accounting treatment. Had Mr. Carlson not specifically approved Delmarva's requested accounting treatment in February 1989, we might have reached a different conclusion. We believe, however, that our hands are tied by Mr. Carlson's approval of Delmarva's deferred accounting treatment and the Company's reliance on that approval. Thus, we adopt the Hearing Examiner's recommendation and allow the Company to recover the $8 million of deferred Merrill Creek lease expenses in rates. (3-0, Commissioner Twilley not voting).

4. NANTICOKE

109. As discussed previously, we have approved a five-year amortization period for the remaining $7.5 million of unrecovered Nanticoke investment. We have also directed that the remaining balance of the $8.1 million being amortized

pursuant to our decision in Docket No. 86-24 be added to that $7.5 million, and that this entire amount be amortized over five years. (See supra at 41-45). This latter decision results in a different impact on test period earnings than was calculated by the parties based on their positions after exceptions. Our decision decreases the Company's test period earnings by approximately $227,000. (See chart appearing at end of our discussion of earnings issues at 95-96). (Unanimous).

5. **NEW DEPRECIATION RATES**

110. As discussed previously in connection with the rate base issues, we have approved new depreciation rates for the Company, and have ordered that the Company's rate base be restated to reflect the application of these new depreciation rates. (See supra at 49). Consistent with that decision, Delmarva's earnings should also be restated to reflect the application of the new depreciation rates. The application of the new depreciation rates reduces Delmarva's test period earnings by $91,000. (Unanimous).

6. **RATE Q CONTROLLABLE REVENUES**

111. The Company made a pro forma adjustment to its test period Delaware retail revenues to remove a portion of the Rate Q Controllable service revenues. (Exh. 15 (Moore) at 9). The Company claimed that this adjustment was required by prior FERC

orders. (Id.). Delmarva's adjustment reduced its test period earnings by approximately $103,000.

112. Staff witness Oliver explained that Delmarva uses the 12 month coincident peak ("12MCP") allocator in FERC proceedings. The 12MCP exempts non-firm (Q-Controllable) demands from any responsibility for production capacity costs. An adjustment such as the Company made here was warranted in FERC proceedings, according to Mr. Oliver, in order to compensate Delmarva's full-requirements retail and resale customers for use of plant capacity to service Q-Controllable load; otherwise, under the 12MCP allocator, Q-Controllable service would not make any contribution to the capacity costs incurred by Delmarva to provide that service. (Exh. 37 (Oliver) at 37).

113. In Delaware, however, Delmarva uses the Modified Peak and Base ("MPB") methodology to allocate production capacity costs. Unlike the 12MCP, the MPB methodology does allocate a portion of production capacity costs to Q-Controllable service on the basis of that class' average demands. Thus, Mr. Oliver testified, the MPB methodology does not wholly exempt Q-Controllable loads from responsibility for production capacity costs. Hence, Staff recommended that the Company's adjustment be reversed. (Id. at 39-40 and Schedule BRO-2; see also Exh. 32

(Henkes) at 43 and Schedule 3).

114. The Hearing Examiner recommended that the Commission adopt Staff's proposal to eliminate the Company's adjustment for Rate Q-Controllable revenues. (HER at 62). He rejected Delmarva's argument that its proposed adjustment makes it "whole" since the way FERC treats Q-Controllable revenues results in a reduction of Delmarva's wholesale revenue requirement. The Hearing Examiner accepted Staff's explanation that Delmarva allocated its Delaware jurisdictional revenue requirement according to the results of the MPB method and, therefore, in that context, it was irrelevant whether the Company set its rates for the Rate Q-Controllable class based on the results of the MPB method. The Hearing Examiner found that Delmarva's proposed adjustment could result in the Company's retail customers being charged twice for a portion of Rate Q loads. Thus, he concluded that it would be inappropriate under these circumstances to require Delaware ratepayers to make Delmarva "whole." (Id.).

115. The Company excepted to the Hearing Examiner's recommendation. (CBOE at 29-30). It contended that its adjustment is necessary to ensure that its Rate Q-Controllable costs are recovered once, since FERC's decision to allocate a portion of the Rate Q revenues to Delmarva's resale jurisdiction

reduces Delmarva's wholesale revenue requirements. (Id. at 30). According to the Company, the Hearing Examiner's recommendation would also reduce its Delaware retail revenue requirements. Since the costs are being incurred in the Delaware jurisdiction, Delmarva argued that they should also be recovered here. (Id.). The Company also observed during oral argument that it has made this adjustment unopposed in the past. (Tr. at 2254).

116. **Discussion**. We believe that the Hearing Examiner correctly recommended rejection of Delmarva's adjustment. We agree with the Hearing Examiner that the Company's method of determining class revenue requirements is irrelevant to its determination of jurisdictional revenue requirements, which is the issue here. We also agree with the Hearing Examiner that to adopt Delmarva's adjustment, and thus remove a portion of the Rate Q-Controllable revenues from Delmarva's test period revenues, could result in Delmarva's retail customers paying twice for a portion of Rate Q loads. Thus, we adopt the Hearing Examiner's recommendation, and reject Delmarva's proposed adjustment. (3-0, Commissioner Phillips not voting).

7. SALEM NUCLEAR FUEL LEASE FINANCE CHARGES

117. In October 1990, Delmarva sold and leased back its interest in the nuclear fuel used at the Salem generating station. Since that time, the Company has been paying finance

charges on the lease. The test period finance charges amounted to approximately $742,000 on a system-wide basis.

118. The Company currently recovers the finance charges through its base rates. In its last electric fuel clause adjustment proceeding (Docket No. 90-35F), Delmarva proposed to recover those finance charges through the fuel clause. Consistent with this position, Delmarva made a "pre-cost study" adjustment in this case to remove the finance charges from its revenue requirement.

119. In Docket No. 90-35F, Staff took the position that the finance charges were more appropriately recovered in base rates. Thus, in this proceeding, Staff added the finance charges back into Delmarva's test period operating expenses, which increased the Company's earnings by approximately $271,000. (Exh. 32 (Henkes) at Schedule 3).

120. On December 17, 1991, after the briefing in this rate case was completed, the Commission issued its order in Docket No. 90-35F. In that Order, the Commission adopted the Hearing Examiner's recommendations in their entirety, including the recommendation that Delmarva be permitted to recover the nuclear fuel lease finance charges through its fuel clause. (See PSC Docket No. 90-35F, Order No. 3359, December 17, 1991; Findings and Recommendations of the Hearing Examiner, dated October 24,

1991, at 26-29). Thus, the Hearing Examiner concluded that in light of the Commission's decision, Staff's proposal was not appropriate. (HER at 65).

121. **Discussion**. We agree with the Hearing Examiner that our decision in Order No. 3359 adopting the Hearing Examiner's recommendation is dispositive of this issue. In light of that decision, Staff's proposed adjustment is inappropriate. We therefore adopt the Hearing Examiner's recommendation that it be rejected. (Unanimous).

8. SALE OF DELAWARE CITY 3

122. As discussed previously in connection with the rate base issues, because the DC3 generating until will not be part of the Company's operations during the rate effective period, Staff witness Henkes proposed to remove the operating expenses associated with the DC3 unit from Delmarva's test period results. We have, however, adopted the Hearing Examiner's recommendation with respect to the removal of DC3 from test period rate base and operating expenses (see supra at 20-21). (3-0, Commissioner Twilley not voting).

9. SPARE PARTS CREDIT AMORTIZATION

123. In 1988, the Internal Revenue Service ("IRS") initiated an investigation of Georgia Power Company's accounting practices for spare parts and materials and supplies ("M&S"),

claiming that the utility was inappropriately expensing certain categories of these items rather than capitalizing them to inventory. This investigation prompted Delmarva to review its own spare parts and M&S accounting practices. As a result of this review, Delmarva determined that $3,875,477 of spare parts and M&S at its Conemaugh, Keystone, and Salem generating stations had been expensed rather than capitalized to inventory. Consequently, Delmarva reclassified the $3.9 million by increasing its capitalized inventory account by $3.9 million and simultaneously decreasing expenses by the same amount through two separate bookings in May and September 1989. The $3.9 million decrease in expenses increased Delmarva's 1989 Delaware retail electric operating income by approximately $1,377,000. (Exh. 32 (Henkes) at 56-57).

124. The Company advised the Commission that, for tax purposes, it was requesting the IRS to approve an amortization of the decrease to expenses beginning January 1, 1989. For regulatory purposes, the Company would report a three-year amortization commencing January 1, 1989. Pursuant to this decision, Delmarva is currently booking an annual increase of $459,000 in Delaware retail electric operating income. (Id. at 57). Delmarva did not, however, reflect any of the expense credit amortization in its pro forma test period operating

results because the rate effective year started after the three year amortization expired. (Id. at 58).

125. Both Staff and the OPA recommended that the expense credit booked in 1989 be amortized to the ratepayers over three years beginning with the rate effective date of this proceeding. Staff argued that its proposed treatment was identical to that which Delmarva sought for other items such as the Nanticoke investment and refinancing costs. (Exh. 32 (Henkes) at 61). Furthermore, Staff observed that the $3.9 million increase in Delmarva's M&S level which resulted from the one-time adjustment in August 1989 continued to be reflected in Delmarva's test period M&S level. (Id. at 58-60). The OPA argued that the credit occurred during the test period and was known and measurable, and thus should be reflected in Delmarva's test period results. (Exh. 30 (OPA) at 24). The Staff's and the OPA's proposed adjustment increased the Company's test period earnings by $459,000.

126. The Company argued that it properly did not include the spare parts credit amortization in its test period results because the spare parts which were the subject of the credit were no longer in inventory, based on its use of a three-year inventory turnover period. The Company also contended that the Commission was aware of Delmarva's proposed amortization, and

did not object to it. (COB at 86-89).

127. The Hearing Examiner found that Delmarva's treatment of the spare parts credit amortization was "reasonable" and recommended its approval. (HER at 68). He found that the Company's accounting treatment confirmed Delmarva witness Dougher's testimony that "after the spare parts were reclassified to inventory in January, 1989, the inventory account decreased and the expense account increased as the spare parts were issued from the Company's storeroom." (HER at 67, citing Tr. at 1744-45). The Company simultaneously began the credit amortization to offset the additions to the expense account. The Hearing Examiner accepted Delmarva's explanation that these spare parts had been expensed previously, so when they came back out of inventory it was necessary to match the expense and credit to prevent customers from paying twice for the same spare parts. (HER at 66, citing Tr. at 1743-44). The Hearing Examiner further observed that neither Staff nor the OPA had suggested that Delmarva's treatment was improper as a matter of "good regulatory practice." (Id. at 66).

128. The Hearing Examiner also rejected Staff's and the OPA's contention that the Company's proposed treatment constituted an example of "manipulation of the test period concept" or a "philosophy" to defer expense incurrences for

future recovery while retaining all benefits of expense credits. (Id. at 68, quoting OPA AB at 23 and SAB at 128). Last, the Hearing Examiner concluded that Staff and the OPA sought to capture for ratepayers in 1992 a benefit that was not available during that period. (Id. at 68). Thus, he recommended that Staff's and OPA's proposals be rejected.

129. Both Staff and the OPA excepted to the Hearing Examiner's recommendation. The OPA again argued that Delmarva's application was "replete with examples of how the Company 'manipulated the test period concept for its own benefit, at the expense of ratepayers.'" (OPA BOE at 17, quoting OPA AB at 23). The OPA acknowledged that it might have agreed with the Hearing Examiner if this issue were taken in isolation; however, it urged the Commission to examine the Company's application in its entirety. It contended that in the interest of fairness, out-of-period adjustments such as this should be included if other post-test period adjustments were included. (OPA BOE at 17).

130. Staff also urged the Commission to redirect its attention from the accounting techniques to the equities of its proposal in relation to the out-of-period adjustments made by the Company. (SBOE at 38-39). In that regard, Staff pointed to the inconsistency between the Company's decisions to defer recovery of its Nanticoke investments and for refinancing costs

going back to 1986 until this rate case, and the Company's decision not to defer the amortization of the spare parts credit. (Id. at 39-40). Staff further argued that it was irrelevant that the particular spare parts which gave rise to the credit were no longer in inventory. Rather, Staff contended, the key was that the expense credits permanently increased the Company's inventory account in 1989 by $3.9 million, and that Delmarva's M&S level would remain $3.9 million higher permanently. Thus, the ratepayers were faced with a higher revenue requirement resulting from the increased inventory level, but had not received any of the benefits associated with this accounting treatment. (Id. at 40-42).

131. **Discussion**. We agree with the Hearing Examiner that the Company's treatment of the spare parts credit amortization is proper and should be approved. The evidence shows that the credit was fully amortized as of December 31, 1991; the spare parts which gave rise to the credit are not longer in the Company's inventory; and there was a zero effect on Delmarva's earnings during the three-year amortization period. We, therefore, adopt the Hearing Examiner's recommendation. (Unanimous).

10. TREE TRIMMING EXPENSES

132. The Company's test period expenses include nearly

$3.5 million for tree trimming. OPA witness Bleiweis observed that these expenses had remained "fairly constant" from 1986 to 1989 at around $2.3 - $2.6 million, but that they increased to almost $3 million in 1990 and $3.5 million for the test period. Although he did not dispute that the expenditures were incurred, or that the reason for the increase was to improve reliability of service, he did question the absence of evidence (specifically, a cost-benefit analysis) that the increased expense improved service reliability. (Exh. 30 (OPA) at 12, Tr. at 1028-29). Mr. Bleiweis concluded that because of this lack of evidence, it was appropriate to normalize Delmarva's test period tree-trimming expenses by using a five-year average of actual expenditures from 1986 to 1990. The OPA's normalization adjustment increased the Company's test period earnings by approximately $538,000. (Exh. 30 (OPA) at 13).

133. The Company testified that its tree-trimming program was designed to help improve reliability of service, and that its test period expense level was appropriate. (Exh. 50 (Landon-R) at 12). It further argued that the OPA had not presented any evidence that the test period tree-trimming expenses had been incurred in bad faith, or as a result of waste or abuse of discretion. Thus, Delmarva concluded, the OPA had not rebutted the presumption of managerial good faith with respect to

actually incurred expenses. (COB at 84-85).

134. While he did not concede that Delmarva's level of test period tree-trimming expenses was improper, Company witness Dougher recalculated a normalization adjustment in which he averaged the expenses from 1986 through the test period and applied the GNP implicit price deflator to the Company's past expenses. (Exh. 60 (Dougher-R) at 23 and Schedule DGD-9). His recalculated normalization adjustment increased Delmarva's test period earnings by approximately $310,000. (Id. at Schedule DGD-9). The Company suggested that if the Commission agreed with the OPA that a normalization adjustment was proper, it should accept the amount as calculated by Delmarva. (Id. at 23).

135. The Hearing Examiner agreed with Delmarva that tree-trimming was a "key factor" in maintaining reliability of service. (HER at 69). He observed, however, that there was "undoubtedly a significant increase" in the test period tree-trimming expenses as compared to the expense levels for the preceding four years. (Id.) As he discussed with respect to Delmarva's I&D expenses, a test period expense level which is significantly different from a utility's past experience may not be representative of the future, and thus a normalization adjustment may be appropriate. (Id. at 69-70).

136. The Hearing Examiner rejected the Company's contention that the OPA's proposal should be rejected because of the presumption in utility rate cases that actually incurred expenses are reasonable. Rather, the Hearing Examiner found that presumption relevant only to the determination of the level of expense used for prospective ratemaking. (Id. at 70). The Hearing Examiner relied on the discussion of this issue in the Hearing Examiner's report in Artesian (which was adopted by the Commission):

> In the test year/test period process, there is a presumption that for purposes of estimating the future level of a recurring expense item, a prior level of actually incurred expenses associated with that item is reasonable. This presumption would satisfy the obligation of the utility to come forward with affirmative evidence as to the reasonableness of an actually incurred expense unless that presumption is questioned or challenged, in which event the utility, with the statutory burden of proof, would need to produce evidence that the expense was not the product of abuse of discretion, bad faith, or waste. In my view, any other conclusion would result in the Commission Staff or an Intervenor being required to affirmatively establish bad faith, waste, etc., and thereby improperly shift the burden of proof.

(Id. at 70-71, quoting Artesian Water Co., PSC Docket No. 90-10, Findings and Recommendations of the Hearing Examiner, March 8, 1991, at 34-35) (citation omitted).

137. Here, the Hearing Examiner noted, the OPA had challenged the reasonableness of the level of Delmarva's test period tree-trimming expenses. Thus, the presumption of reasonableness was inapplicable, and Delmarva was required to produce sufficient evidence to meet its burden of proof.

138. The Hearing Examiner found that Delmarva had presented no evidence justifying the significant increase in tree-trimming expenses over so short a time. (Id. at 71). He acknowledged the potential that a utility could defer expenses such as this to increase earnings in years when it has no rate case, and later make up the deficiency during a likely test period. While he did not attribute such behavior to Delmarva, he did find that the Company had not met its burden of establishing the reasonableness of the contested test period tree-trimming expense level and the appropriateness of that expense level for future periods, because the Company did not provide any specific explanation for the increase. Under these circumstances, the Hearing Examiner concluded that requiring the OPA to demonstrate affirmatively bad faith, waste, or abuse of discretion would improperly shift the burden of proof from the Company to the OPA. (Id. at 71).

139. The Hearing Examiner accepted the methodology by which Delmarva calculated its proposed normalization adjustment,

but once again rejected the inflation adjustment contained in its calculation. (Id. at 72). He noted that such an adjustment was speculative at best; moreover, to the extent there was an upward trend in these expenses, using an average level of expenses partly recognized the effect of inflation. (Id. at n.53). Thus, the Hearing Examiner recommended that the Commission use a normalized level of tree-trimming expenses for the test period, derived from averaging the Company's actual expenses from 1986 through the test period. (Id. at 72). This adjustment increased Delmarva's test period earnings by approximately $448,000.

140. While the OPA continued to believe that its calculation of the proposed normalization adjustment was proper, it did not except to the Hearing Examiner's recommendation for the purpose of limiting the number of contested issues in this case. The OPA emphasized, however, that it was only accepting the Hearing Examiner's recommended method of calculating the adjustment for this proceeding. (OPA BOE at 19). The Company also did not except to the Hearing Examiner's recommendation except insofar as the Hearing Examiner declined to adjust prior year expense levels for inflation to express these expenses in current dollars. (CBOE at 28). In this regard, Delmarva again argued that its adjustment did not violate the Commission's

policy of disallowing "speculative escalations to account for future price increases." (Id.).

141. **Discussion**. We adopt the Hearing Examiner's proposed normalization adjustment for Delmarva's test period tree-trimming expenses. A normalization adjustment is proper where the test period expenses are out of line with a utility's past experiences and where the test period expense level is not deemed to be representative of the future. Here, Delmarva's test period tree-trimming expenses were significantly higher than the expense levels for the four preceding years, and the Company produced no evidence from which we can conclude that the test period expense level is representative of the level to be attained in future years.

142. Similarly, for the reasons expressed by the Hearing Examiner, we reject the Company's application of the GNP implicit price deflator to restate the past tree-trimming expenses in current dollars. Last, we adopt the Hearing Examiner's inclusion of the expenses incurred by Delmarva through the test period in his calculation of the appropriate amount of the adjustment. (Unanimous).

11. UNCOLLECTIBLE EXPENSES

143. The Company's "11+1" updated per books test period results included $1,711,000 of system electric uncollectible

expenses. The uncollectible ratios (uncollectibles divided by system electric revenues) for the test period and calendar year 1990 were .23% and .24%, respectively. Compared to the Company's ratios for 1987, 1988 and 1989 of .13%, 12% and .15% respectively, the 1990 and test period ratios were 75-80% higher. (Exh. 32 (Henkes) at 62-63).

144. According to Delmarva, the primary reason for the increased uncollectibles was an increase in the number of bankruptcies. While most of the bankruptcies involved write-offs of $1,000-$2,000, one particular bankruptcy of a cogeneration facility associated with the Delaware Solid Waste Authority ("DSWA") resulted in a write-off of $267,000. (Id. at 63; Tr. at 533). This write-off related exclusively to the Delaware jurisdiction. (Tr. at 2017). Staff witness Henkes concluded that the Company's test period uncollectible expenses were out of line with previous years, and that a normalization adjustment was appropriate in this situation. He calculated the Company's 1987-1989 uncollectible average of .133% and used it to obtain a normal level of uncollectible expenses for the test period. This adjustment increased the Company's pro forma test period expenses by approximately $271,000. (Exh. 32 (Henkes) at 65-66) and Schedule 10).

145. Staff subsequently revised its calculation of the

proposed normalization adjustment to remove from the Company's test period expenses only the $267,000 associated with the bankruptcy of the DSWA's cogenerating facility. Thus, Staff recalculated an uncollectible ratio of approximately .19, rather than .133%, for its normalization adjustment. Staff removed the @67,000 write-off from Delmarva's test period expense level because Delmarva had made a "pre-cost study" adjustment to remove from its test period results the revenues associated with sales made to the DSWA which Delmarva claimed it would not have made absent the bankruptcy. (Tr. at 2007-08). This revision increased the Company's test period income by $161,000. (SAB at 32).

146. The Hearing Examiner rejected Delmarva's contention that the actual level of test period uncollectible expenses should be used to derive the test period uncollectible ratio because he found that it relied solely on test period data which included the write-off associated with the bankruptcy of a "very large customer." (HER at 73). While he acknowledged that it was possible that the number of bankruptcies could rise as a result of current economic conditions, the Hearing Examiner was not convinced that such increases would be of the same magnitude as the DSWA write-off, either singly or collectively. (Id.).

147. The Hearing Examiner agreed with Staff that a

normalization adjustment to Delmarva's test period uncollectible expenses was appropriate. He did not, however, agree with Staff's methodology of calculating that adjustment, since it excluded the DSWA write-off. (Id. at 73-74). Thus, consistent with his recommendations concerning the calculation of the normalization adjustments for Delmarva's test period I&D and tree-trimming expenses, the Hearing Examiner found it more appropriate to calculate the adjustment by averaging the historical and test period uncollectible expenses from 1989 through the test period. He found that the level so derived would be a reasonable proxy for the expected uncollectible expense level during the rate effective period, given current economic conditions. (Id. at 74). Consequently, the Hearing Examiner derived a test period uncollectible ratio of .20%, which increased Delmarva's test period earnings by $92,000. (Id. at 75).

148. Both the Company and Staff excepted to the Hearing Examiner's recommended test period level of uncollectible expenses. The Company contended that, given the Hearing Examiner's opinions in connection with other contested issues that Delmarva's rates should not reflect the stronger economic conditions of previous years, and given that its uncollectible expenses were directly related to general economic conditions,

the Commission should exclude "pre-recession" uncollectible levels from the determination of Delmarva's prospective level of uncollectible expenses. The Company contended that its proposal was more indicative of the uncollectible expenses it was likely to experience during the rate effective period than was the Hearing Examiner's, and asserted that "[a]n unrealistically low allowable expense for uncollectibles will simply deny the Company cost recovery." (CBOE at 29). It noted in this respect that since it intended to file another base rate case in the last quarter of 1992, the Commission would have an opportunity to revisit this issue. (Id. at n.18).

149. Staff excepted to the Hearing Examiner's recommendation to include the $267,000 write-off in the calculation of the average level of uncollectible expenses. Staff argued that its removal of that write-off from Delmarva's test period expenses was consistent with the Company's "pre-cost study" adjustment to its test period results to remove the revenues derived from sales to the DSWA during the test period. According to Staff, if the Company's adjustment to normalize test period revenues as if the bankruptcy had never occurred was proper, then it was likewise proper to normalize the Company's test period uncollectible expenses as if the bankruptcy had never occurred. (SBOE at 43-44). Staff further contended that

its proposed adjustment was more accurate than the Hearing Examiner's because it was based on Delmarva's most recent actual results within the Delaware jurisdiction, whereas the Hearing Examiner's adjustment averaged the Company's total system uncollectible results, and allocated the end result solely to the Delaware jurisdiction. (Id. at 45). Similarly, Staff argued that the Hearing Examiner's approach was based on Delmarva's average historic total electric system write-off experience, allocated to the Delaware electric retail jurisdiction pursuant to a composite allocation factor, whereas Staff's proposed adjustment was based on the Company's Delaware electric retail results, adjusted only for the write-off experience within the Delaware jurisdiction. (Id.).

150. **Discussion**. We conclude that the Hearing Examiner's recommended adjustment should be adopted for the reasons expressed in his Findings and Recommendations. We note that the very large write-off associated with the DSWA cogenerator's bankruptcy substantially increased Delmarva's test period uncollectible expenses over previous levels, and thus believe a normalization adjustment is proper. We also agree that the three-year average of Delmarva's uncollectible expense level from 1989 through the test period will serve as a reasonable proxy for the level which the Company can be expected to

experience during the rate effective period.

151. We also agree with the Hearing Examiner's rejection of Staff's proposed normalization adjustment. As we have discussed previously, we believe it is improper to exclude the test period expenses simply because they are higher than they have been in the past. Rather, these expenses must be included in the calculation of the average so as to obtain the most representative expense level.

152. We, therefore, adopt the Hearing Examiner's recommendation, and find that the appropriate test period uncollectible expense level is .20%. (Unanimous).

12. WAGES/FICA EXPENSES

153. The Company made an adjustment to its test period operating expenses to include, inter alia, a contractual wage increase for its Northern Division union employees which was to become effective on December 15, 1991. The total amount of Delmarva's adjustment for this increase, as well as three other wage and FICA increases which occurred during the test period, was $946,000, as updated to reflect "11+1" results. (See Exh. 15 (Moore) at 9).

154. The OPA did not object to Delmarva's adjustments for the wage increases during the test period. Consistent with its position of strict adherence to the test period concept,

however, the OPA recommended that the out of period December 1991 wage increase be disallowed. (Exh. 30 (OPA) at 10-12). The OPA's adjustment increased Delmarva's test period earnings by approximately $409,000. (Id. at 11).

155. **Discussion**. The Hearing Examiner recommended that the OPA's proposal be rejected for the same reasons he expressed in rejecting the OPA's recommendations on the Tall Stack issue. (HER at 76). As with the Tall Stack, the costs associated with the December 1991 wage increase were known and ascertainable, and were of such magnitude as to significantly affect Delmarva's ability to earn its authorized rate of return during the rate effective period. (Id. at 77). The OPA again pressed its arguments on exceptions (see OPA BOE at 19-20). We agree with the Hearing Examiner, however, and adopt his recommendation on this issue. (Unanimous).

13. EMPLOYEE INCENTIVE PLANS

156. Delmarva's test period operating expenses included budgeted amounts of $732,000 for a Management Incentive Program ("MIP") and $1,219,000 for a Corporate Performance Incentive Program ("CPIP"). Both programs are incentive reward systems for employees outside of the regular job review process. The programs become operative upon reaching a set percentage of projected earnings per share and at least four of eight pre-

established goals, and the extent of the payments thereafter depends on how well the employees perform within these parameters. Non-management employees receive a percentage of their salaries, while management employees receive a percentage of a predetermined bonus amount. (Exh. 30 (OPA) at 35).

157. OPA witness Knudsen objected to the inclusion of the $2 million budgeted for these incentive plans in Delmarva's test period operating expenses. First, the OPA argued that Delmarva had provided few solid performance improvement measures to demonstrate the value to ratepayers of these programs. (OPA AB at 32). Second, the programs were designed "essentially to raise the earnings per share performance...," and thus benefitted shareholders and management. (Id. at 36). Third, the OPA pointed out that the amounts payable under the programs were not known and measurable because the payments were based on how many of the goals the employees achieved. Thus, there was no certainty that Delmarva would attain the levels projected for the test period. In fact, the OPA contended, the 1991 financial indicators suggested that the Company would not be making payments under these plans at the levels it had budgeted for this period. (OPA AB at 35). While the OPA did not suggest that Delmarva's incentive plans should be abolished, it strongly objected to ratepayers being forced to fund them. (Id.).

Consequently, the OPA adjusted Delmarva's test period operating expenses to remove the $2 million of budgeted CPIP and MIP payments, which increased the Company's test period earnings by $698,000. (Exh. 30 (OPA) at MAB-17).

158. Delmarva contended that the $2 millon of budgeted payments for the CPIP and MIP programs was properly included in its test period expenses. Company witness Landon testified that these programs provided direct benefits to ratepayers in promoting efficiency and keeping operation and maintenance expense lower than they would otherwise be. (Exh. 50 (Landon-R) at 4). According to Delmarva, the CPIP and MIP programs "motivate employees," "save money directly and indirectly," and "foster more initiative and decision making at all levels of the organization." (Id. at 4-8). Moreover, the Company argued, the OPA had not met the legal standard for disallowing the CPIP and MIP expenses given the presumption of managerial good faith with respect to actually incurred expenses. (COB at 76-77).

159. The Hearing Examiner acknowledged Delmarva's contention that the CPIP and MIP programs contributed to employee motivation, productivity, and initiative, and stated his belief that these things should be encouraged. However, he was not persuaded that the programs benefitted ratepayers to the degree Delmarva suggested. Thus, he did not find the programs

"essential" to the provision of utility service, and concluded that it would be unreasonable for Delaware ratepayers to pay $2 million for the benefits allegedly resulting from the programs. (HER at 77-78).

160. With respect to the Company's argument that flat O&M costs were one of the reasons why rates had not increased since 1983, the Hearing Examiner also observed that Company witness Landon had testified that flat O&M costs plus significant load growth and increased productivity also result in higher corporate profits. Because customers are obligated to continue paying the authorized rates until new rates are established, they do not immediately benefit from the improvements in productivity and flat O&M costs. The utility, however, experiences an improvement in its rate of return, which, for Delmarva, exceeded its authorized rate of return from 1987 to mid-1990. (Id. at 78 and n.58). The Hearing Examiner concluded that it was shareholders who received "greater and more immediate benefits" from the incentive programs, so that they should bear some or all of the expense of the programs. (Id. at 78-79).

161. The Hearing Examiner rejected Delmarva's argument that the applicable legal standard for disallowance had not been met. He noted that that standard applied only to the expenses

which are a "legitimate and necessary" cost of doing business. He stated that the CPIP and MIP programs, however, were "not at all necessary for the provision of adequate and efficient utility service," and, thus, the standard for disallowance was inapplicable to these expenses. (Id. at 79) (emphasis in original).

162. The Hearing Examiner also considered the current economic conditions in concluding that Delmarva's ratepayers should not be required to bear the full costs of the CPIP and MIP programs. (Id. at 80). He observed that in circumstances where Delawareans were experiencing wage and salary freezes, it was "unreasonable, excessive, and very inappropriate" to "burden [them] with $2 million worth of management incentives...." (Id.). Furthermore, the Hearing Examiner viewed the incentive plans as "duplicative" of the wages and salaries Delmarva employees are already paid to perform their jobs. (Id.).

163. Nevertheless, the Hearing Examiner concluded that ratepayers benefitted "to some undefined extent" from the efficient management that the programs were "at least incidentally" designed to encourage. (Id.). Thus, he recommended that the Commission adopt the position taken by the Vermont Public Service Commission, and allocate the costs of the incentive programs equally between Delmarva's shareholders and

ratepayers. (Id. at 81). The Hearing Examiner's recommended resolution would increase Delmarva's test period earnings by approximately $349,000. (Id.).

164. Both the OPA and the Company excepted to the Hearing Examiner's recommended 50/50 sharing of the CPIP and MIP expenses. The OPA contended that the Hearing Examiner's "Solomonic compromise" was inconsistent with his recognition that the benefit of these programs to Delmarva's ratepayers had neither been defined nor determined and with his acceptance of the OPA's arguments supporting disallowance. (OPA BOE at 20-22). According to the OPA, the Company had provided no "clear indication" of the benefits ratepayers received from these programs, pointing to Company witness Landon's citation to "intuition." (Id. at 21). Furthermore, the OPA again observed that the actual amounts associated with the CPIP and MIP were not known and measurable because they depended on the number of program goals achieved. (Id.). The OPA also observed that the CPIP and MIP were not necessary for the Company to do business, and that their costs should not therefore be borne by Delmarva's ratepayers. (Id. at 22). Finally, the OPA argued that in light of the current economic conditions, it was "unconscionable and indefensible" to ask Delmarva's ratepayers "to pay for the Company's bonus plans for [its] employees, which primarily

benefit the utility's shareholders," especially given Delmarva's failure to provide any solid performance improvement measures to demonstrate the programs' value to ratepayers. (Id. at 23).

165. In support of its position to include the CPIP and MIP payments in its test period expenses, Delmarva argued first that the program participants put a percentage of their total compensation at risk. (CBOE at 20-21). The Company also contended that the presumption of reasonableness of actually-incurred test period expenses applied not to the incentive plans in isolation, but to its "total compensation package," of which the CPIP and MIP were a part. (Id. at 21-22). As such, according to the Company, the total compensation package could not be disallowed in the absence of bad faith, waste, or abuse of discretion, none of which had been alleged or demonstrated in this case. (Id. at 22). The Company further asserted that the CPIP and MIP were a necessary expense of doing business. Claiming that the record showed that the programs are "directly oriented toward customer service, improve the efficiency of service, and have substantial value for ratepayers," the Company pointed to the 1991 goals concerning work-related personal injuries, reducing absence due to personal illness, below-budget expenditures, customer favorability ratings, customer outage time, and power plant performance. (Id. at 22-23). It cited

the savings it achieved from meeting the wellness attendance goals, and acknowledged that the achievement of some goals improved service in ways that could not be quantified monetarily. (Id.). It argued that its O&M costs had remained flat over the past sever years, as compared to the industry average increase of 37% over the same time period. (Id.). The Company concluded that all of the above demonstrated that the programs did provide incentives to increase customer favorability, maintain reliable service, and control costs. (Id.).

166. The Company further argued that "[i]t is good management practice to encourage employees to keep costs lower than they otherwise would be," and asserted that "the result is directly related to rates through the regulatory process." (Id.). The Company also supported its position by referring to other utilities which have received regulatory approval for incentive programs "strikingly similar" to Delmarva's. (Id. at 23-25). Delmarva dismissed the Hearing Examiner's discussion of the profits resulting from increased productivity as "no more than a description of regulatory lag," and claimed that "[a]n attempt to resolve doubts concerning the equities of regulatory lag by denying rate recovery for the Company's legitimate business expenses would be improper and impermissible." (Id. at

25). Finally, the Company noted that the earnings per share level was merely the "trigger" for the availability of incentive compensation. (Id. at 26).

167. **Discussion**. We have reviewed the arguments of the OPA, Delmarva, and the Hearing Examiner, and we conclude that Delmarva's position should be accepted. We do not believe that we should require shareholders to share the costs of incentive plans for employees, because this will act as a disincentive for Delmarva to engage in such plans. We believe that ratepayers do benefit from the incentive plans when a new rate case is filed, because if nothing else the increased productivity has extended the time between rate case filings (except in the case of fuel-related improvements, in which the benefits to ratepayers are realized more quickly). However, in Delmarva's next base rate case we would like to see a better analysis of the costs and benefits of these programs than was provided in this proceeding. (Unanimous).

14. CWIP/AFUDC

168. As discussed previously in connection with the rate base issue, the Company increased its test period income for the AFUDC associated with the CWIP it sought to include in its test period rate base. The OPA, consistent with its proposal to disallow CWIP in Delmarva's rate base, removed the AFUDC from

Delmarva's test period income. We have already permitted Delmarva to include CWIP in its test period rate base because it also included an offsetting AFUDC adjustment (see supra at 13-14). For the reasons stated previously, we reject the OPA's adjustment to remove AFUDC from the Company's test period earnings. (3-1, Commissioner Twilley voting nay).

15. SUMMARY OF EARNINGS ADJUSTMENTS

169. After the adjustments necessitated by our findings on the contested earnings issues, we find that Delmarva's fully adjusted test period earnings are $68,700,000. The parties' positions and the effects of our decision are summarized on the following table.

EARNINGS

$000's

ISSUE	DELMARVA (after exceptions)	STAFF (after exceptions)	OPA (after exceptions)	HEARING EXAMINER'S RECOMMENDATION	PSC DECISION
Uncontested Adjusted	$71,986	$71,986	$71,986	$71,986	$71,986
Contested Issues:					
Tall Stack	($1,357)	($1,357)	$0	($1,357)	($1,357)
Injuries & Damages	$224	$348	$348	$348	$348
Merrill Creek	$0	$65	$65	$0	$0
Nanticoke	($562)	($562)	($409)	($562)	($227)*
Docket 90-25 Depreciation Rates	($91)	($91)	($91)	($91)	($91)
Rate Q Controllable	($103)	$0	($103)	($0)	($0)
Rate Q Penalty Waiver Adj.	$0	$0	$0	$0	$0
Sale DC#3	$0	$325	$0	$0	$0
Salem Finance Charge	$0	$0	$0	$0	$0
Spare Parts Amortization	$0	$459	$459	$0	$0

Tree Trimming	$310	$0	$448	$448	$448
Uncollectible Expense	$0	$161	$0	$92	$92
Wage & FICA	($946)	($946)	($491)	($946)	($946)
CPIP/MIP	$0	$0	$698	$349	$0
Remove AFUDC	$0	$0	($3,469)	$0	($0)

* Remaining unamortized balance of $8.1 million investment from Docket No. 86-24 plus $7.5 million investment authorized herein to be amortized over 5 years. Estimated impact on test period earnings = $206,000 decrease.

EARNINGS

$000's

ISSUE	DELMARVA (after exceptions)	STAFF (after exceptions)	OPA (after exceptions)	HEARING EXAMINER'S RECOMMENDATION	PSC DECISION
Interest Synch.	($1,250)	($1,369)	($2,157)	($1,292)	($1,355)**
Remove Cooling Tower	$0	$0	$0	$0	($198)***
Fully Adjusted Earnings	$68,211	$69,019	$67,284	$68,975	$68,700

** Fallout from our calculation of Delmarva's test period rate base and weighted cost of debt. See table entitled "Final Interest Synchronization Adjustments," infra at ___.

*** Based on 20-year amortization period ($3.966 million ÷ 20 = $198.3).

FINAL INTEREST SYNCHRONIZATION ADJUSTMENTS

$000's

ISSUE	DELMARVA	STAFF	OPA	HEARING EXAMINER	PSC DECISION
Rate Base	$808,309	$800,920	$751,821	$805,692	$801,762
Weighted Cost of Debt	4.04%	4.04%	4.04%	4.04%	4.04%
Pro Forma Interest	$32,656	$32,357	$30,374	$32,550	$32,391
Plus: Cust. Dep. Interest	$286	$286	$286	$286	$286
Total Pro Forma Interest	$32,942	$32,643	$30,660	$32,836	$32,677
Per Books Interest	$36,087	$36,087	$36,087	$36,087	$36,087
Net Adjustment	($3,145)	($3,444)	($5,427)	($3,251)	($3,410)
Combined Tax Factor	.39742	.39742	.39742	.39742	.39742
Income Decrease	$(1,250)	$1,369)	$(2,157)	$(1,292)	$(1,355)

D. RATE OF RETURN

1. INTRODUCTION

170. In its original filing in May 1991, the Company requested an overall rate of return of 10.30%, comprised as follows:

	% to Total	Cost Rate	Overall ROR
Long-Term Debt	48.51%	8.34%	4.05%
Preferred Stock	8.63%	6.59%	0.57%
Common Equity	42.86%	13.25%	5.68%
	100%		10.30%

(Exh. 8 (Gerritsen) at 3). In its rebuttal testimony, the Company reduced its requested overall rate of return to 10.19%, due to the reduction in its proposed cost of equity to 13%. (Exh. 56 (Gerritsen-R) at 12).[11]

171. Staff was the only other party to present testimony on the appropriate rate of return.[12] Its witness, Mr. LeLash, calculated an appropriate overall rate of return of 9.72%, comprised as follows:

[11] Company witness Brennan calculated the Company's cost of equity at 12.85% based on updated (early October 1991) money market information. (Exh. 51 (Brennan-R) at 1-2). According to Mr. Gerritsen, however, a 13.0% return on equity was appropriate because it would recognize management's efforts and would send a "clear positive signal" to the financial community about the level of supportive rate regulation available in Delaware. (Exh. 56 (Gerritsen-R) at 12).

[12] The OPA adopted Staff's positions on the rate of return.

	% to Total	Cost Rate	Overall ROR
Long-Term Debt	48.51%	8.32%	4.03%
Preferred Stock	8.63%	6.36%	0.55%
Common Equity	42.86%	12.00%	5.14%
	100%		9.72%

(Exh. 35 (LeLash) at Schedule 1, p. 1).

2. CAPITAL STRUCTURE

172. Company witness Gerritsen computed the Company's pro forma capital structure for the 12 months ended December 31, 1992. He selected a 12-month average 1992 pro forma capital structure because the rates set in this case will be in effect during 1992, and this structure would be more representative of the Company's capital mix during that period. (Exh. 8 (Gerritsen) at 14). As determined by Mr. Gerritsen, Delmarva's proposed capital structure consisted of 48.51% long-term debt, 8.63% preferred stock, and 42.86% common equity. (Id. at 3; Exh. 56 (Gerritsen-R) at 9). Staff witness LeLash agreed that this capital structure was appropriate. (Exh. 35 (LeLash) at 7-8).

173. The Hearing Examiner accepted Delmarva's explanation for its proposed capital structure and recommended that the Commission adopt it. (HER at 86). We agree that the capital structure proposed by Delmarva and accepted by Staff is appropriate for use in this case, and hereby adopt it. (3-0, Commissioner Twilley not present during vote).

3. <u>COST OF DEBT AND PREFERRED STOCK</u>

174. Mr. Gerritsen testified that the Company's cost of long-term debt and preferred stock for pro forma 1992 was 8.34% and 6.59%, respectively. (Exh. 8 (Gerritsen) at 3, 19-20); <u>see also</u> Exh. 56 (Gerritsen-R) at 9). Mr. Gerritsen used the same methodology the Company used in Docket No. 86-24 to calculate these costs for fixed rate issues: the weighted average of the effective cost rate of each individual series of long-term debt or preferred stock. He computed the effective cost rate of each series using the stated interest or dividend rate and the net proceeds per unit as the inputs. For the five issues having variable interest rates, Mr. Gerritsen determined the stated interest or dividend rate by averaging the rates actually experienced and the fees for each series for the three years ended December 31, 1990. (For 1988 and 1989 issues, Mr. Gerritsen calculated the average rates from the time of issue until December 31, 1990). According to Mr. Gerritsen, a three-year average provided a reasonable range of interest and dividend rates; more than three years can be stale, and less than three years potentially reflects abnormally high or low rates. (<u>Id.</u> at 18-19).

175. Staff witness LeLash disagreed with Mr. Gerritsen's use of the three-year averages to project the prospective costs

for the Company's variable-rate long-term debt and preferred stock issues. (Exh. 35 (LeLash) at 42). Mr. LeLash noted that there was no showing that the 1988-1990 averages were indicative of future rates, and that the money market rates for 1992-1994, as projected by Blue Chip Financial Forecasts, were substantially below the 1988-1990 averages. (Id. and Schedule 12, p. 2). According to Mr. LeLash, the three-month Treasury Bill rate was a reasonably comparable money market rate for determining the average interest or dividend rate for the Company's variable issues. (Exh. 35 (LeLash) at 42). Based on this rate, he found that the Company's prospective rate (and associated costs) for its variable rate bonds was too high given that the Treasury Bills were forecasted to be 5.9% in 1992-1994 versus their three-year average (1988-1990) of 7.5%. (Id. at Schedule 12, p. 2). Consequently, Mr. LeLash concluded that the Company's prospective estimates for variable rate bonds and preferred stock were unreasonable, and reduced these estimates by 50 basis points to 6.0% for bonds and 6.5% for preferred stock. Thus, he calculated that the Company's overall pro forma 1992 average cost of long-term debt was 8.32% and 6.36% for preferred stock. (Id. at 43).

176. The Hearing Examiner recommended approval of Staff's calculations for the cost of Delmarva's long-term debt and

preferred stock. (HER at 87-88). First, he found that Delmarva's use of purely historical data to project prospective cost rates was inappropriate because those data reflected a stronger economy. He therefore accepted Staff's projections, which were based on the average money market rates forecasted for 1992-94, the period during which rates would be in effect. (Id. at 88). In this regard, he noted that Delmarva planned to file another rate case later this year. (Id. at n.66). He rejected Delmarva's contention that a "modest" economic rebound would bring the cost of senior securities "in line with or above" Delmarva's proposed cost rates because predictions of a rebound were speculative at best; Staff's recommended cost rates were at the high end of the forecasts for the rate effective period; and, if there were a modest economic rebound, the cost of senior securities would be brought in line with Staff's recommended rates. (Id. at 88-89).

177. Although Delmarva disagreed with the Hearing Examiner's recommended senior securities cost rates, it did not except to that recommendation. (CBOE at 14).

178. **Discussion**. We adopt the Hearing Examiner's recommendations for the reasons he stated in his report. In this regard we note, as did the Hearing Examiner, that Delmarva will have an opportunity to revisit this issue when it files its next

base rate case, which it currently intends to do toward the end of this year. (3-0, Commissioner Twilley not present during vote).

4. COST OF EQUITY

a. The Company

179. In its original filing in May 1991, the Company argued that its cost of equity was 13.25%. (Exh. 5 (Brennan) at 2). In its rebuttal testimony, Company witness Brennan updated this recommendation to 12.85%, based on more recent information. (Exh. 51 (Brennan-R) at 1-2).[13] Company witness Brennan calculated this required equity return by averaging the results of three cost of equity methodologies -- discounted cash flow ("DCF"), risk premium, and capital asset pricing method ("CAPM") -- as applied to Delmarva and a barometer group of nine electric utilities. (Id. at 3).[14] Next, Mr. Brennan adjusted the

[13] Mr. Brennan testified that he calculated his updated cost of equity recommendation in the same manner as his original recommendation (Tr. at 1546, 1549); therefore, we will focus on Mr. Brennan's updated computations.

[14] The nine electric companies in Mr. Brennan's barometer group derived more than 90% of their operating revenues from electric operations and just over 8% from natural gas operations; had a 1989 capitalization between $1 billion and $5 billion; operated in the Northeast or Great Lakes area; had a bond rating of A or AA; had average 1990 revenues of $1.310 million; and were currently paying a dividend which had not been reduced within the past five years. (Exh. 5 (Brennan) at 7; Exh. 35 (LeLash) at Schedule 2, p.1).

Mr. Brennan also observed, but gave no weight to, results of his averaging process to recognize the investment risk differential between Delmarva and the average barometer group company. (Id.). Mr. Brennan also made another adjustment to incorporate the recovery of flotation costs associated with raising common equity. (Id.).

(1) DCF

180. To obtain his DCF-derived return on equity for the Company and the barometer groups, Mr. Brennan first computed an appropriate earnings growth rate. He arrived at his earnings growth rates of 3.4% for Delmarva, 3.8% for his barometer electric group, and 4.5% for his barometer gas distribution group by averaging the following figures: (1) Value Line's historical and projected five-year growth rates for dividends per share; (2) Value Line's five-year historical and projected growth rates for earnings per share; and (3) the I/B/E/S five-year projected growth in earnings per share. (Exh. 5 (Brennan) at 29-30); Exh. 52 at Schedule 16, p. 1). In calculating his averages, however, Mr. Brennan excluded the five-year historical earnings growth rate appearing in Value Line for Delmarva (which he did not do in his original direct testimony). (Exh. 52 at Schedule 16, p. 2, nn.6-9 and p. 3, nn.10-13).

(..continued)
comparable information for a barometer group of seven gas distribution companies. (Exh. 5 (Brennan) at 3).

181. Mr. Brennan calculated the dividend yield component of the DCF for Delmarva and his barometer companies using both closing prices and the high/low market prices for the three, six, nine, and twelve months ended April 30, 1991, as well as a "spot" point of May 13, 1991. (Exh. 5 (Brennan) at 30; Exh. 52 at Schedule 17). Since the constant growth DCF model requires an assumption that the price of stock reflects the next paid dividend, he adjusted the yield according to the calendar quarter in which each company traditionally increased its dividend. (Exh. 5 (Brennan) at 30-31; Exh. 52 at Schedule 17, pp. 1-4 and nn.2-5).[15] So calculated, Mr. Brennan's dividend yields based on closing market prices ranged from 8.0%-8.6% for Delmarva, 6.8%-7.5% for his average barometer electric company, and 6.3%-6.9% for his average barometer gas distribution company. The adjusted dividend yield range based on high/low average prices for Delmarva and the average barometer companies was nearly identical. (Exh. 5 (Brennan) at 31-32; Exh. 52 at Schedules 17 and 18).

182. Mr. Brennan then calculated his final DCF-derived[16]

[15] According to Mr. Brennan, if he had assumed that the dividend for all companies would be increased halfway through the next twelve months, the average adjusted yield would be "almost identical" to those he derived. (Exh. 5 (Brennan) at 31).

[16] Before adjusting for investment risk differentials and flotation costs.

cost of equity for Delmarva, his barometer electric companies, and his barometer gas distribution companies, using an average of the results derived by adding the growth rate to the adjusted dividend yields using closing and high/low prices. Accordingly, his DCF-derived cost of equity was 11.8% under both yield calculations for Delmarva; 11.0% and 11.1% respectively for his average barometer electric company; and 11.1% and 11.2% respectively for his average barometer gas distribution company. (Exh. 5 (Brennan) at 32-33; Exh. 52 at Schedule 19, pp. 1-2).

(2) CAPM

183. Mr. Brennan also used a CAPM[17] model to calculate the required cost of equity for the Company and his barometer groups. According to Mr. Brennan, the CAPM "attempts to describe the way prices of individual securities are determined in efficient markets where information is freely available and instantaneously reflected in security prices." (Exh. 5

[17] The CAPM formula is K=Rf + B (Rm-Rf). K is the required rate of return; Rf is the risk-free rate; B is the beta; and Rm is the required market rate of return. Thus, under the CAPM, a security's expected rate of return is determined by the risk-free rate of return and a market premium proportional to the non-diversifiable risk of the security. The non-diversifiable risk is obtained by applying a beta to the market premium. (Exh. 5 (Brennan) at 38-39). Beta is the measure of the risk of a security compared to the risk of the market as a whole. The beta for the market is always 1.00. Companies whose securities have a beta of less than 1.00 are considered less risky that the market and vice versa.

(Brennan) at 38). It is premised on the concept that risk-averse investors demand higher returns for assuming higher risk; hence, higher-risk securities are priced to yield higher returns. (Id. at 39).

184. In computing his cost of equity from the CAPM, Mr. Brennan used an 8.0% treasury bond yield as the risk-free rate. (Exh. 52 at Schedule 22, p. 2, n.2).[18] For his risk premium, he used the average of the historic premium (7.2%)[19] and the Value Line-forecasted premium (10.1%),[20] or 8.7% (Id. at 41). Delmarva's beta, as published by Value Line, was 0.60. Thus,

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[18] This is the December 1991 T-Bond future yield. As noted by Mr. Brennan, the 1991 Value Line forecast for T-Bond yields was 8.1%; Standard & Poor's forecasted a yield of 8.3%; and the Blue Chip Financial Forecasts of T-Bond futures marked for delivery in March 1993 predicted a yield of 8.4%. Thus, Mr. Brennan believed that an 8.0% risk-free rate was reasonable. (Exh. 52 at Schedule 22, p. 2, n.2).

[19] Mr. Brennan relied on data contained in the 1991 Ibbotson Associates Yearbook for Stocks, Bonds, Bills, and Inflation. That source showed a total market return of 12.1% for the 1926-1991 period. The average yield on long-term U.S. Government securities during that same time period was 4.9%. Thus, 12.1% - 4.9% = 7.2%. (Exh. 5 (Brennan) at 41; see also Exh. 52 at Schedule 22, p. 2, n.1).

[20] Value Line forecasted potential total market appreciation of 75% for the 1700 industrial stocks it covers. For a three- to five-year period, this translated into a four-year average annual appreciation of 15.02%. The indicated annual dividend yield for these stocks is 3.1%. 15.02% + 3.1% = 18.12%, which Mr. Brennan rounded down to 18.1%, for the prospective market return. Thus, 18.1% - 8.0% = 10.1%. (Exh. 52 at Schedule 22, p. 2, n.1).

the CAPM-derived cost of equity for Delmarva was 13.2% [8.0 + .60(8.7)],[21] and for his average barometer electric or gas distribution company was 13.8%. (Id. at 41-42; Exh. 52 at Schedule 22, p.1).

(3) Risk Premium

185. Mr. Brennan also calculated the cost of equity for Delmarva and his barometer group using the risk premium methodology. This methodology is premised on the assumption that different investment securities have different returns which are commensurate with the level of risk to which the security holder is exposed. (Exh. 35 (LeLash) at 31). Thus, the cost rate for common equity capital can be viewed as the cost rate investors will require for investing their capital in long-term government debt, plus a premium to recognize the additional risk to common stockholders. (Exh. 5 (Brennan) at 42).

186. In his risk premium analysis, Mr. Brennan used a company-specific market-derived cost rate for the yield for long-term debt at the end of each year from 1986 to 1990 for Delmarva and for computing the average for each of his barometer group companies. (Id.).[22] For the common equity cost component

[21] Before any adjustment for investment risk differential or flotation costs.

[22] Those prospective 1992 cost rates were 9.2% for Delmarva and the average barometer gas distribution company, and 8.9% for the average barometer electric company. (Exh. 52 at Schedule 1,

of his risk premium method, he employed a constant growth DCF cost rate for each company at the end of each year from 1986 to 1990. (Id.). The difference between the average long-term debt yield and the DCF-derived common equity cost rate for each year represented the market-derived risk premium for each company. (Id. at 42-43). As calculated by Mr. Brennan, the risk premiums for Delmarva, the average barometer electric company, and the average barometer gas distribution company were 3.2%, 3.3%, and 3.9%, respectively. (Id. at 43; Exh. 52 at Schedule 23). Adding the prospective 1992 yields for long-term debt to these risk premiums resulted in a cost of equity of 12.4% for Delmarva,[23] 12.2% for the average barometer electric company, and 13.1% for the average barometer gas distribution company. (Exh. 5 (Brennan) at 43; Exh. 52 at Schedule 1, p. 1).

(4) Average Of Results Of Cost Of Equity Methodologies Before Adjusting For Risk Differences Or Flotation Cost

187. Mr. Brennan averaged the results of his three methodologies to derive the cost of equity for Delmarva and his barometer groups. The average cost of equity was 12.5% for Delmarva, 12.4% for the average barometer electric company, and
(..continued)
p. 1).

[23] Before any adjustment for investment risk differential or flotation costs.

12.7% for the average barometer gas distribution company. (Exh. 52 at Schedule 1, p. 1). Mr. Brennan, however, made two additional adjustments to these results to recognize what he termed "investment risk differences" between Delmarva and the barometer group companies and to recognize selling and issuance expenses associated with the Company's proposed common stock offerings over the next three years.

(5) Mr. Brennan's Adjustment For Investment Risk Differences Between Delmarva And The Average Barometer Group Company

188. According to Mr. Brennan, Delmarva is more risky than his average barometer group company. (Exh. 5 (Brennan) at 26). He attempted to quantify the difference in investment risk through the use of two methods: (1) the cost differences between bond ratings; and (2) the difference in the common equity ratio employed by Delmarva and the barometer groups. (Id. at 45-46). As calculated by Mr. Brennan, the cost difference between Delmarva and the average barometer electric company based on their bond ratings was .12%. (Id. at 46).[24] Relying on a study

[24] Delmarva's current long-term debt bond rating is A2. The average bond rating for the barometer group of electric companies is Aa3, one-half of one rating notch above A2. The spread in yield between A and AA rated bonds for the five years ended 1990 was .25%; thus, the difference between Delmarva and the barometer group of electric companies was one-half of that, or .12%. The average bond rating for the barometer group of gas distribution companies is A1, which is very similar to Delmarva; consequently, Mr. Brennan opined that there was little investment

which concluded that for a utility having a common equity ratio between 40-50%, a 1% change in ratio causes an average change of 12 basis points in the cost of equity, Mr. Brennan calculated the difference between Delmarva and the average barometer electric company and Delmarva and the average barometer gas distribution company as 0.41% and 0.99%, respectively. (Id. at 46-47; Exh. 52 at Schedule 24, p. 1). Averaging the results of the two methods, Mr. Brennan concluded that the investment risk difference between Delmarva and the average barometer group electric company was 0.2%, while the difference between Delmarva and the average barometer group gas distribution company was 0.5% (Exh. 5 (Brennan) at 47).

(6) Mr. Brennan's Adjustment To Recognize Flotation Costs

189. Mr. Brennan testified that his equity cost recommendation included an adjustment of 0.3% to allow Delmarva to recover flotation costs for its recent and proposed stock issuances. (Id. at 47-49).[25] He asserted that there was no place in the regulatory model, except in the common equity cost rate, to recognize "out-of-pocket" costs that a utility incurs

(..continued)
risk difference. (Id. at 45-46).

[25] The Company presented testimony that earlier this year it completed a significant new equity issue, and that it plans to issue additional new common stock in 1992. (Exh. 8 (Gerritsen) at 16-17; Tr. at 221-22, 255-56).

when issuing and selling new common stock. (Id. at 48; Exh. 51 (Brennan-R) at 27). Thus, he concluded that Delmarva's cost of equity should be adjusted to include an allowance for flotation costs. (Exh. 5 (Brennan) at 49).

190. Mr. Brennan used two methods to calculate an "appropriate" flotation cost adjustment. The first, which was the same method used by the FERC to determine its benchmark return on equity, resulted in a 30 basis point adjustment for Delmarva, and an adjustment of between 20 and 40 basis points for the barometer electric and gas distribution companies. (Id. at 48-49). The second method, which assumed that an adjustment for flotation costs should not be applied to all of the utility's common equity because no selling and issuing expense was incurred raising retained earnings, produced an adjustment of approximately 30 basis points for Delmarva, 20 basis points for the barometer electric group, and 30 basis points for the barometer gas distribution group. Mr. Brennan adopted a 30 basis points adjustment for Delmarva and for the barometer groups since he was using them as a proxy for Delmarva. (Id. at 49).

(7) The Company's Recommended Cost Of Equity, Including All Adjustments

191. After incorporating his adjustments for investment

risk and flotation costs into the average cost of equity rates derived from his three methodologies, Mr. Brennan recommended a 12.85% return on equity for the Company. This was the midpoint between the 12.8% return on equity calculated for Delmarva and the 12.9% return calculated for the barometer electric group. (Exh. 5 (Brennan) at 49-50; Exh. 52 at Schedule 1, p. 1).

(8) Mr. Brennan's Checks On Delmarva's Recommended Return On Equity

192. As a check on the reasonableness of his recommended cost of equity for Delmarva, Mr. Brennan looked at Value Line's forecasts of returns on equity for a three to five year period. Since the Value Line forecasts were based on end-of-period equity, Mr. Brennan restated the forecasts to reflect average equity. (Exh. 5 (Brennan) at 51; Exh. 52 at Schedule 26). The Value Line returns on equity, as adjusted, were 13.4% for Delmarva; 13.1% for the average barometer electric group; and 13.6% for the average barometer gas distribution company. (Exh. 52 at Schedule 26).

193. Mr. Brennan also performed an interest coverage test to check the reasonableness of his recommended return on equity. Based upon the Company's proposed capital structure ratios, the cost rates of long-term debt and preferred stock, and the recommended 12.85% return on equity, he concluded that the

opportunity level of before income tax long-term debt interest coverage wold be 3.5x. (Exh. 52 at Schedule 27). According to Mr. Brennan, this level of interest coverage put Delmarva in a position to experience a strong A bond rating compared to other companies, assuming no attrition or lag. (Exh. 5 (Brennan) at 53).

194. Mr. Brennan's recommended equity cost rate, combined with Delmarva's projected cost of long-term debt and preferred stock, resulted in an overall rate of return of 10.13%. Company witness Gerritsen, however, urged the Commission to authorize an equity cost rate of 13.0% for Delmarva. He testified at length about the consequences that adverse regulatory treatment would have on investor and rating agency expectations as Delmarva embarked upon a construction program requiring significant external financing. (Exh. 56 (Gerritsen-R) at 2-9). He further contended that a 13% return on equity for Delmarva was appropriate because it would recognize management's performance and would send a "clear positive signal" to the financial community about the level of supportive regulatory treatment in Delaware. (Id. at 12).

b. Staff

195. Staff witness LeLash concluded that an appropriate cost of equity for the Company was 12.0%, based on an analysis

of DCF, CAPM, and risk premium calculations. (Exh. 35 (LeLash) at 7). He checked the reasonableness of his recommended return on equity by examining the prospective return requirement for an industrial composite and by reviewing the trend in returns on equity granted by other commissions.

(1) DCF

196. The DCF methodology for determining the cost of equity makes three assumptions: (1) the market price of a stock is equal to the present value of future dividends; (2) when the present value of future dividends equals the market price, the discount rate is equal to the cost of equity; and (3) dividends will grow at a constant compound rate over time. (Id. at 14). With these assumptions, the cost of equity is the rate that equates the future stream of dividends, once discounted, to the present market price. (Id.).[26]

[26] The DCF formula is D/P + G, where D is the expected dividend; P is the current market price, and G is the anticipated rate of dividend growth. (Exh. 35 (LeLash) at 14).

(a) Mr. LeLash's Composite Groups

197. Mr. LeLash applied the DCF to the Company[27] and to three composites. Since Delmarva was a regulated utility with its relevant revenues coming from electric and gas sales, Mr. LeLash stated that its operating characteristics, business risk, and investor return requirements were best analyzed by examining other combination utilities with similar risk profiles. (Id. at 15). Thus, Mr. LeLash selected three composites from electric utilities reported in Value Line. (Id. at Schedule 2, pp. 1-3).

198. Mr. LeLash acknowledged that Delmarva's risks could differ from those of the composites, and identified differences in specific financial risk measures and operational measures between Delmarva and his three composites. (See id. at 16-19). He observed that the Company's market-to-book and payout ratios were generally higher than those of the composites over the last ten years, and that its average return on equity was comparable to the range experienced by the composites. (Id. at 28 and Schedule 8, pp. 1-4). Furthermore, he noted that Merrill Lynch had evaluated Delaware as slightly more stockholder-oriented compared to the average of other federal and state jurisdictions. (Id. at 28 and Schedule 8, p. 5). Consequently,

[27] Mr. LeLash noted that the Company's non-utility operations could inflate the return requirement because of the higher risks of non-utility businesses. (Exh. 35 (LeLash) at 14).

Mr. LeLash concluded that the composites defined the major risk limits for Delmarva, and in fact may be a more accurate basis for determining the cost of equity for Delmarva because of the very nature of composites. (Id. at 28).

199. Mr. LeLash's first composite, called the "Brennan Electric" composite, was comprised of the electric and combination utilities which Company witness Brennan used as his barometer electric group. (See supra at n.18). (Id. at 15 and Schedule 2, p.1).

200. Mr. LeLash's second composite, designated the "Comparable Nuclear" composite, was comprised of six combination utilities having between 10-25% nuclear generation. The percentage of nuclear generation can have an impact on a utility's overall risk; thus, by analyzing this composite, Mr. LeLash sought to match Delmarva's generation risk. The utilities in this composite all had a Value Line financial rating of B+ or better, and had average 1990 revenues of $2.772 million. (Id. and Schedule 2, p. 2).

201. The third composite, which Mr. LeLash called the "Comparable Equity" composite, was comprised of similarly-leveraged combination utilities having approximately the same financial rating as Delmarva. Mr. LeLash selected this composite to minimize the effect of leverage on the return

requirement, since an electric utility's equity ratio was a major risk element. The eight utilities included in this composite had a common equity ratio between 40.0%-45.0%, a Value Line financial rating of B+ or better, and average 1990 revenues of $741 million. (Id. and Schedule 2, p. 3).

202. Mr. LeLash calculated both the current and the prospective dividends yields for each of his composite groups. He noted that in times of stable rates, there was little difference between the measurement of an annual versus a spot yield. However, where rates are changing over annual periods by considerable percentages,[28] it was "more appropriate" to look to recent versus annual yields. According to Mr. LeLash, a current yield reflecting the actual annual dividend rate divided by the average stock price during the most recent quarter was the most reasonable measure, because it avoided aberrations which may be

[28] Mr. LeLash demonstrated that there had been a high degree of volatility in both short- and long-term market interest rates over the last 15 years. For example, the prime rate more than doubled between 1977 and 1981; it was currently close to its 1977 level. Likewise, the commercial paper rate had declined from about 15% in 1981 to about 8% in 1990. Moreover, short-term rates had been decreasing since 1989. One illustration was 90-day "T" bills, which had fallen from 8.83% in March 1989 to 5.60% in June 1990. There have been similar trends in the commercial paper and prime rates during the past two years. (Exh. 35 (LeLash) at 20; Schedule 4 at p. 1-2). The trend was comparable for long-term utility debt: A rated bonds averaged 15.95% in 1981, but now appeared to be stabilizing below 9.5%. (Id. at 21 and Schedule 4, p. 3).

present in stock data but also allowed a sufficiently long period of price history to ensure that the analysis captures the underlying market interest rate changes. (Id. at 19-20).

203. Mr. LeLash used the latest annualized quarterly rate in his calculation of the current dividend yield for his composite groups. His prospective dividend yield was based on the expected dividend for the upcoming 12-month period. According to Mr. LeLash, the prospective yield (which increases the current yield by ½ of the expected dividend growth rate) should be used in a DCF analysis to account for the quarterly payment of dividends. (Id. at 22). Thus, Mr. LeLash computed the following dividend yields for his composite groups:

Brennan Electric: 7.43% (Id. at Schedule 5, p. 1)
Comparable Nuclear: 7.12% (Id. at Schedule 6, p. 1)
Comparable Equity: 8.03% (Id. at Schedule 7, p. 1)

204. With respect to the determination of an appropriate growth rate, Mr. LeLash acknowledged that the nature of investors' growth expectations precluded using any single objective measure. Thus, for each of his composite groups, he considered: (1) historical and prospective earnings per share, dividends per share, and book value; (2) dividend and earnings growth forecasts published by Value Line and I/B/E/S;[29] and (3)

[29] These independent forecasts are widely available to investors, and Mr. LeLash believed that they were a good estimate of investors' growth expectations. (Exh. 35 (LeLash) at 25).

a retention-ratio derived growth rate. (Id. at 22-23 and Schedules 5-7).[30] Based on his analysis of these historical and prospective growth measures, Mr. LeLash concluded that the appropriate growth rates for his composites were as follows:

Brennan Electric:	3.75%	(Id. at Schedule 5, p. 1)
Comparable Nuclear:	4.00%	(Id. at Schedule 6, p. 1)
Comparable Equity:	3.75%	(Id. at Schedule 7, p. 1)

Using these dividend yield and growth rates, Mr. LeLash determined that the cost of equity was 11.18% for the Brennan Electric composite; 11.12% for the Comparable Nuclear composite; and 11.78% for the Comparable Equity composite. (Exh. 35 (LeLash) at 26-27; Schedules 5-7).

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30 The DCF model assumes that retained earnings will grow at the same rate as earnings and dividends. Dividend growth caused by retained earnings is thus expressed as the product of the anticipated return on equity (r) and the retention rate (b). (Exh. 35 (LeLash) at 23).

(2) **CAPM**[31]

205. Mr. LeLash duplicated Mr. Brennan's CAPM analysis to include both updated and corrected data. (Id. at 48). Specifically, he took issue with Mr. Brennan's use of an 18.1% average annual return for investors, rather than Ibbotson's common equity average of 12.1% for the 1926-1990 period. (Id. at 49). He pointed out that Mr. Brennan's 18.1% computation used an average appreciation of 15% for the next four years, premised on a implicit growth rate which was based on Value Line's 1994-1996 potential (not its estimate). Therefore, Mr. LeLash utilized a lower total market return for industrials of 12.87%, obtained by applying the DCF method to the Value Line Industrial Composite data. (Id. at Schedule 10, p. 5).[32] With this adjustment to Mr. Brennan's total market return and the substitution of updated prospective risk-free rates, Mr. LeLash obtained a CAPM-derived equity cost rate for industrials of 12.12% (Ibbotson) and 10.64% (Value Line). The average of the two measures was 11.38%. (Id. at 50 and Schedule 14, p. 2).

(3) **Risk Premium**

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[31] Mr. Brennan's particular CAPM methodology has not explicitly been accepted by any regulatory commission. (Tr. at 212; see also Exh. 35 (LeLash) at 48).

[32] The April 1991 Merrill Lynch Quantitative Profiles estimated a return requirement of 12.30% for the Standard & Poor 500. (Exh. 35 (LeLash) at 49).

206. Mr. LeLash similarly updated Mr. Brennan's risk premium analysis to use more recent forecasts. Using the same methodology employed by Mr. Brennan, Mr. LeLash calculated a risk premium of 3.1% for Delmarva. Adding that equity return to the 1992 forecasted yield of 9.1% contained in the Blue Chip Financial Forecasts, Mr. LeLash derived an adjusted equity return or 12.2%. (Id. at 50 and Schedule 14, p. 3).

(4) Delmarva's Cost Of Equity

207. Based on his evaluation of his composite groups, Mr. LeLash concluded that Delmarva's prospective cost of equity ranged between 11.50% and 12.00%. (Id. at 29 and Schedule 11, p. 1).[33] Nevertheless, he recommended that the Commission utilize a 12.0% return on equity as a "starting point" for calculating a fair return on equity for Delmarva. First, he observed that his Comparable Equity composite had the highest DCF-derived return. (Exh. 35 (LeLash) at 29). Second, he recognized that the determination of a utility's cost of equity requires consideration of factors besides simply the return

[33] Mr. LeLash considered several factors in developing this range: (1) the comparability of Delmarva's financial parameters to the composites'; (2) Delmarva's low cost of debt and its early debt retirement efforts, take-or-pay pass through allowance, and flow-back of contributions from non-firm sales; (3) his selection of values tending to increase the indicated equity return in developing his DCF growth component; and (4) the forecasts that A rated utility bonds were expected to decline to around 9.1% in 1992. (Id. at 29-30 and Schedule 9).

derived from equity valuation techniques. (Id. at 6). In this regard, he identified "adequacy of service" and "public interest" considerations as relevant considerations. (Id.). He also acknowledged that Delmarva plans extensive outside financing for its construction program, and cited its belief that investors and the market need a positive signal from the Commission. (Id. at 29-30).

(5) Checks On Mr. LeLash's Recommended Return On Equity

208. Mr. LeLash checked the reasonableness of his recommended 12.0% return on equity for Delmarva by reviewing comparable earnings for several industrial groupings. He noted that utilities are less risky than industrials, and therefore the returns for utilities should be lower. His analysis of the data for industrial composites demonstrated that they earned, on average, a 13.6% return on equity during the 1986-1990 time frame (which was a period of higher capital costs). (Id. at 37 and Schedule 10, p. 5). During the same time period, A rated utility bonds had an average return of approximately 10.0%. Currently-projected returns for the 1993-1995 time period ranged from 11.34% to 12.87% for industrials, and the 1992-1996 forecasts for returns on A rated utility bonds were about 9.2%. (Id. at 37-38 and Schedule 10, p. 5). Given that utilities have lower risks (and therefore lower returns) than industrials,

and given that industrials in a period of high capital costs only earned 13.6% on equity, Mr. LeLash concluded that his recommended 12.0% equity cost rate for Delmarva was reasonable. (Id. at 37).

209. Mr. LeLash also compared his recommended cost of equity with the returns granted to electric utilities by other state commissions during 1991. At the time Mr. LeLash filed his testimony, the average return on equity for the 29 reported cases up to July 1991 was 12.59%. (Id. at 44 and Schedule 13, pp. 1-2). Mr. LeLash surmised that these cases were based on data from late 1990, and noted that since that time interest levels had declined; thus, he projected that decisions issued later in 1991 would be lower, based on more recent data. (Id. at 45). Consequently, he concluded that his recommended return for Delmarva was compatible with the returns authorized during the first half of 1991. (Id.).[34]

210. Finally, Mr. LeLash examined the actual A rated bond yields for the second to fourth quarters of 1987 (the year of

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[34] Mr. LeLash also cited the FERC benchmark DCF-derived cost of equity, which at the time Mr. LeLash filed his testimony was 11.72%, and had since been revised to 11.47% for the November 1, 1991 -- January 31, 1992 quarter. (Id.; Tr. at 1555). While he acknowledged that it was generically-determined and that company-specific circumstances would have an effect on a utility's fair cost of equity, he nevertheless included it for comparison purposes. (Tr. at 1213).

the most recent Delmarva rate decision by this Commission) and the forecasted A rated bond yields for the same quarters for 1992. That examination showed that 1992 rates were projected to be more than 100 basis points lower than they were in 1987. Mr. LeLash therefore concluded that a reasonable current equity rate should be lower than the 12.50% return authorized by this Commission for Delmarva in the spring of 1987. (Id. at 46).

(6) The Propriety Of Adjustments For Investment Risk Differences

211. Mr. LeLash did not agree that an adjustment for investment risk differential was warranted. He observed that investors, in setting the market price for Delmarva's and other utilities' stock, factored in all risk considerations. Consequently, the market-derived cost of equity already reflected those differentials, making an adjustment unnecessary. (Id. at 52-53).

(7) The Propriety Of A Flotation Cost Adjustment

212. Mr. LeLash contended that the flotation cost proposed by Mr. Brennan was not necessary. (Id. at 51). Even if such an adjustment were proper, however, Mr. LeLash testified that the flotation cost adjustment which Mr. Brennan proposed was greatly overstated. (Id.).

213. Mr. LeLash noted that the Company plans to issue new

equity in four of the next 10 years. Thus, taking Delmarva's common equity balance forward to the year 2000, he calculated the Company's annual average equity issuance, expressed as a percentage of total equity, as 2.4% per year. (Exh. 35 (LeLash) at 51; Schedule 14, p. 4). He estimated the Company's retained earnings by multiplying 12.5% (the current authorized equity cost rate) by the beginning equity balance and by an assumed 30% retention rate. He concluded that over its planning period, Delmarva would issue annual average new equity of $26 million. (Exh. 35 (LeLash) at 51-52 and Schedule 14, p. 4). Using this annual flotation amount and the 3.5% "cost" of the Company's May 1991 offering, Mr. LeLash derived a flotation allowance of 8 basis points. (Id. at 52 and Schedule 14, p. 4).

214. Staff did not agree that the Company deserved a premium in its rate of return for the quality of its management. (SAB at 153). Staff acknowledged that the Commission had considered this factor in determining the appropriate rate of return for other utilities; however, it contended that such an adjustment was warranted here. Staff observed that the Company was only "average" in price per kWh in comparison to other utilities across the nation. (SAB at 153 and n.76). Staff also noted that the low level or the Company's O&M expenses was as attributable to rapid growth in its service territory as it is

to management efficiency. (Id. at 153). Staff also pointed to Delmarva's subsidiary write-offs; while Staff recognized that those write-offs did not directly affect Delmarva's core utility business, it did provide an indication of the quality of management's judgment. (Id. at 153-54).

c. The Hearing Examiner's Recommendation

215. After setting forth the applicable legal standards governing the Commission's obligation to establish just and reasonable rates (HER at 106), the Hearing Examiner turned to the recommendations made by the witnesses. He first discussed the various equity cost valuation methodologies. He found that of the three methodologies used by the witnesses, the DCF was the "most widely used and accepted among regulatory agencies." (Id. at 107). He noted that "[v]irtually all cost of capital witnesses" use the DCF method, and "most ... consider it their primary technique." (Id., citing Bonbright, supra, at 317-18). While he acknowledged that the risk premium methodology may be useful as a check on the reasonableness of a copy of equity calculation, he concluded that it should not be used as the principal methodology for such calculations because of the conceptual and measurement problems in its implementation. (Id., citing Bonbright, supra at 322-24). He further recommended that the CAPM calculation for the cost of equity

should be given "little, if any" weight in determining a utility's cost of equity due to the "theoretical and practical" problems inherent in that methodology. (Id. at 107-08, citing Bonbright, supra, at 327-28). Thus, the Hearing Examiner found the DCF methodology most appropriate for calculating a utility's cost of equity, and recommended that "the Commission give paramount consideration to the product of that methodology" in determining Delmarva's cost of equity in this case. (Id. at 108). He observed in this regard that this Commission had frequently relied on the DCF methodology in guiding its judgment as to the appropriate cost of equity, and found no record evidence to persuade him that the Commission should place greater reliance on the other methodologies the Company's witness used in this case. (Id.).

216. Having concluded that he would rely primarily on the results of the DCF method, the Hearing Examiner found Staff witness LeLash's cost of equity recommendation more appropriate because Mr. LeLash relied principally upon the DCF method. (Id. at 109). He rejected Company witness Brennan's equity cost recommendation because he found it to be "rather inflated" by Mr. Brennan's CAPM calculation and by the inclusion of a flotation cost adjustment. (Id.). Nevertheless, the Hearing Examiner recommended that the Commission maintain Delmarva's

currently authorized return on equity of 12.5%, based on several considerations.

217. First, the Hearing Examiner found a 12.5% return on equity "clearly" within the range of a reasonable cost rate supported by the record evidence. (Id.). Second, he recognized that Delmarva was entering a construction cycle which it anticipated would cost approximately $946 million through 1995. (Exh. 8 (Gerritsen) at 11; Exh. 9 (Graham) at 11, 13, 16). The Company expected that it would have to finance 49% of this amount, or $540 million, from external sources. (Exh. 2 (Landon) at 6-7; Exh. 8 (Gerritsen) at 5-7; Exh. 9 (Graham) at 3). In order to complete a project of this magnitude, the Hearing Examiner determined that Delmarva should be afforded a reasonable opportunity to maintain its "A" bond rating. (HER at 110). The Hearing Examiner concluded that granting the Company the same return on equity as currently authorized should help the Company to reach its outside financing goal, with "concomitant" longer term benefits to ratepayers. (Id.).

218. The Hearing Examiner also determined that Delmarva was "reasonably well-managed." (Id. at 111). He concluded that the recommended 12.5% return on equity sufficiently recognized management's efficiency. (Id.). Finally, the Hearing Examiner opined that the recommended 12.5% equity cost rate should

account for any tendency of the DCF methodology to understate the appropriate cost of equity under current money market conditions, and should also dispel any concerns about a lack of regulatory support as the Company entered into its construction program. (Id.).

219. Last, the Hearing Examiner recommended that the Commission reject Delmarva's request to build a flotation cost allowance into the authorized return on equity. He noted the Commission's reluctance to approve such allowances in previous rate cases due to their speculative nature, and observed that other commissions had adopted varying positions on the issue. (Id. at 112). He relied on Professor Bonbright's opinion that the need for such an adjustment was "'less urgent when utility stocks are selling above book value,'" as the Company's stock currently was. (Id., quoting Bonbright, supra at 333). Nevertheless, the Hearing Examiner found that "flotation costs are very real expenses," and therefore recommended that once the Company's flotation costs became known and measurable, the Commission treat them as a deferred above-the-line expense and allow Delmarva to amortize them over a reasonable period in its next base rate case. (Id.).

220. Based on his recommended capital structure and cost rates of 8.32% for long-term debt, 6.36% for preferred stock,

and 12.5% for common equity, the Hearing Examiner derived an overall rate of return for Delmarva of 9.95%. (Id. at 113). He recommended that the Commission adopt this rate of return as appropriate for Delmarva in this case.

221. Staff did not except to the Hearing Examiner's recommended capital cost rates or his recommended overall rate of return. Staff did, however, object to the Hearing Examiner's recommendation to allow Delmarva to recover its flotation costs in its next base rate case. (SBOE at 48). Staff argued that the 12.5% return on equity recommended by the Hearing Examiner was 70 basis points greater than the highest DCF-derived equity cost rate in this proceeding, and that the Hearing Examiner had found that this allowance would account for several non-quantified factors. Staff contended that the constant addition of one non-quantified allowance on top of another served only to move the resulting cost of equity further away from the DCF's direct measure of the investor-required return, which Staff believed was the only appropriate basis for the authorized return. (Id. at 49-50). Thus, Staff opposed any recovery of the flotation costs, now or in the future. (Id. at 50).

222. The Company excepted to the Hearing Examiner's recommended return on equity and, consequently, to his recommended overall rate of return. Initially, the Company

observed that the "allowed return on equity has the largest impact on the Company's earnings of all the individual issues in this case." (CBOE at 7). It disagreed that the recommended 12.5% return on equity would dispel the financial community's concerns about the Commission's support for Delmarva's planned capital expenditures, and argued that a return of equity of "no less than" 13.0% was necessary to compensate it for the risks it faced as it entered a new construction cycle. (Id. at 7-8).

223. Delmarva first took issue with the Hearing Examiner's use of Staff witness LeLash's 12.0% equity cost rate as a starting point, asserting that the 12.0% level was too low. It argued that under current market conditions, a "sizable adjustment" was necessary "to correct for the understatement inherent in the DCF model" when interest rates are "exceptionally low." (Id. at 9). Second, it challenged Mr. LeLash's use of the FERC benchmark rate of return to check the reasonableness of his DCF-derived result, on the ground that FERC has since abolished this benchmark return in favor of case by case examinations. (Id.). In that regard, it also observed that recent regulatory commissions in other jurisdictions had granted returns on equity for electric utilities ranging from 12.65% to over 13%. (Id. at 10). Third, Delmarva claimed that "studies comparing actual market returns with DCF-indicated

costs of equity calculations have led some experts to conclude that the DCF analysis does not satisfy either the attraction of capital standard or the comparable earnings standard" established by Hope Natural Gas and Bluefield Water Works. (Id. at 11-12, citing Whittaker, The Discounted Cash Flow Methodology: Its Use In Estimating A Utility's Cost Of Equity, 12 Energy Law Journal 265 (1991)).

224. The Company concluded that adherence to a "pure" DCF-based cost of equity was inappropriate for a "well-managed utility entering into a major construction cycle." (Id. at 11). It contended that such a finding "would not violate the Commission's expressed preference for the DCF model," but rather would acknowledge "the limitations of that model in Delmarva's current circumstances." (Id.). Thus, Delmarva urged the Commission to use Mr. Brennan's "bare-bones" equity cost rate of 12.5% as the appropriate starting point for the determination of the appropriate cost of equity for Delmarva. (Id.).

225. The Company also excepted to the Hearing Examiner's recommendation with respect to flotation costs. (Id. at 12). The Company argued that, given the Hearing Examiner's recognition that these costs are "very real expenses," it should be entitled to recover those costs in this case, either by an upward adjustment of 30 basis points to its authorized return on

equity, or through amortization over the 16-month rate effective period of this case. (Id.). According to Delmarva, amortization of the costs over the life of the common stock issue was unreasonable because "stock is permanent and has no determinate life." (Id.).

226. Last, the Company excepted to the Hearing Examiner's failure to aware it a specific allowance for "good management" in its authorized return on equity. The Company pointed to the Commission's specific recognition of this factor in the Chesapeake and Artesian rate cases. (Id. at 13). It asserted that the record was "replete with evidence of Delmarva's solid management performance," such as: it had not had a rate increase since 1983; its rates were lower now than in 1983 on both a nominal and a current basis; its O&M expenses per kWh were 20% less that the national average and had remained flat for seven years despite "substantial" load growth; Hay Road units 1-3 were completed on time at below-market cost; the success of its Challenge 2000 strategy; and its high customer favorability rating. (Id. at 13-14). Thus, it contended that the Commission should "recognize these achievements" with a specific allowance in its return on equity. (Id. at 14).

227. **Discussion.** The requirement of a fair return recognizes that utilities compete with other investments to

obtain capital. Accordingly, the return which a utility investor can expect should be commensurate with the returns that could be expected on other investments of comparable risk. See Bonbright, supra at 316. Thus, the United States Supreme Court and the Delaware Supreme Court have both held that the return to a utility should be sufficient to assure confidence in the utility's financial integrity, to maintain its credit, and to attract capital. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944); Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 579 (1923); Application of Wilmington Suburban Water Co., Del. Supr., 211 A.2d 602 (1965).

228. We reaffirm our position that the DCF methodology should be afforded paramount consideration in determining a utility's cost of equity. See Matter of Chesapeake Utilities Corp., PSC Docket No. 90-14, Order No. 3299 at 14 (Del. PSC July 30, 1991; Re Wilmington Suburban Water Corp., 88 PUR 4th 234, 238 (Del. PSC 1988). As the Hearing Examiner observed, the DCF methodology is the one used by a majority of regulatory commissions and by most cost of capital witnesses in calculating a utility's cost of capital. We continue to believe that the DCF methodology is the most appropriate one, and adopt the Hearing Examiner's recommendation that we afford it primary

reliance in determining Delmarva's cost of equity in this case. Thus, we agree with the Hearing Examiner's use of Staff's DCF-derived 12.0% equity cost rate as a starting point in ascertaining an appropriate return on equity for Delmarva.

229. We adopt the Hearing Examiner's recommendation to maintain Delmarva's current equity cost rate of 12.50%. We agree that the 50 basis point addition to the cost of equity derived from Mr. LeLash's DCF calculation recognizes the factors which Delmarva has argued should be considered in determining its appropriate return on equity, such as: the perception of regulatory support as Delmarva enters its construction cycle; the need to maintain its "A" bond rating; any alleged tendency of the DCF methodology to understate the cost of equity; and the performance of Delmarva's management. In this regard, we observe that 12.50% is 70 basis points greater than Mr. Brennan's DCF-derived cost of equity of 11.80%. We further observe that a 12.50% return on equity is liberal in terms of the rates of return in other markets at this time.

230. We reject Delmarva's argument that it should receive a specific allowance in its return on equity for good management. We acknowledge that we have explicitly recognized good or poor management as a factor in determining appropriate returns on equity for other utilities in other rate cases. We

believe, however, that the 50 basis point increase which we have added to the DCF-derived cost of equity in this case adequately encompasses this factor such that no specific additional allowance is required in this case.

231. We also reject Delmarva's request for a 30-basis point increase in its return on equity for flotation costs. Although we acknowledge that there is probably some undefined amount of flotation costs buried in the 12.50% return on equity we have authorized, we believe it is neither necessary nor appropriate to include a specific allowance for such costs in Delmarva's return on equity. We have been loath to allow such adjustments in the past, see, e.g., Re Wilmington Suburban Water Corp., 88 PUR 4th at 240, and we see no reason for departing from our practice in this case. For the same reason, we decline to accept the Hearing Examiner's recommendation to treat these costs as a deferred above-the-line expense item and allow Delmarva to recover the costs in its next base rate case over a reasonable amortization period. We should not be construed as inviting Delmarva to propose such treatment for flotation costs because we do not believe that these costs should be recovered in rates.

232. In summary, we approve the following costs of capital for Delmarva in this rate case: 8.32% for long-term debt; 6.36%

for preferred stock; and 12.50% for common equity. Based on Delmarva's capital structure of 48.51% long-term debt, 8.63% preferred stock, and 42.86% common equity, the resulting overall rate of return for Delmarva which we authorize in this proceeding is 9.95%. (3-0, Commissioner Twilley not present during vote).

5. SUMMARY OF RATE BASE AND EARNINGS ADJUSTMENTS; REVENUE DEFICIENCY

233. The following table shows a resulting test period revenue deficiency of $18,473,000 for Delmarva, after incorporation of our decisions on the rate base and earnings issues and the appropriate rate of return:

Type of Capital	% of Total	Cost Rate	Overall ROR
		HEARING EXAMINER'S RECOMMENDATION	
Long-Term Debt	48.51%	8.32%	4.04%
Preferred Stock	8.63%	6.36%	0.55%
Common Equity	42.86%	12.5%	5.36%
	100.00%		9.95%
		DELMARVA'S RECOMMENDATION (AFTER EXCEPTIONS)	
Long-Term Debt	48.51%	8.32%	4.04%
Preferred Stock	8.63%	6.36%	0.55%
Common Equity	42.86%	13.00%	5.57%
	100.00%		10.16%
		STAFF'S RECOMMENDATION (AFTER EXCEPTIONS)	
Long-Term Debt	48.51%	8.32%	4.04%
Preferred Stock	8.63%	6.36%	0.55%
Common Equity	42.86%	12.5%	5.36%
	100.00%		9.95%
		PSC DECISION	
Long-Term Debt	48.51%	8.32%	4.04%
Preferred Stock	8.63%	6.36%	0.55%
Common Equity	42.86%	12.50%*	9.95%
	100.00%		9.95%

* No allowance for flotation costs; no amortization in the future.

RATE OF RETURN AND REVENUE DEFICIENCY
(INCLUDING 90-25 DECISION)

$000's

ISSUE	DELMARVA (after exceptions)	STAFF (after exceptions)	OPA (after exceptions)	HEARING EXAMINER'S RECOMMENDATION	PSC DECISION
Adjusted Earnings	$68,211	$69,019	$67,284	$68,975	$68,700
Adjusted Rate Base	$808,309	$800,920	$751,821	$805,692	$801,762
Adjusted Rate of Return	8.44%	8.62%	8.95%	8.56%	8.57%
Proposed Rate of Return	10.16%	9.95%	9.95%	9.95%	9.95%
Required Earnings	$82,124	$79,692	$74,806	$80,166	$79,775
Earnings Deficiency	($13,913)	($10,673)	($7,522)	($11,191)	($11,075)
Revenue Conversion Factor	1.66797	1.66797	1.66797	1.66797	1.66797
Revenue Deficiency	$23,206	$17,802	$12,546	$18,666	$18,473

E. RATE STRUCTURE

1. COST ALLOCATION METHODOLOGIES

a. Production Capacity Cost Allocation

234. The Company, Staff, and the DEUG all submitted testimony on the appropriate methodology for allocating production capacity costs to Delmarva's customer classes in this proceeding. The Company prepared its embedded cost of service studies[35] using the Modified Peak and Base ("MPB") method, which this Commission first approved in Docket No. 82-23 and reaffirmed in Phase II of Docket No. 86-24, to allocate these costs of providing service to the Delaware retail jurisdiction and for quantifying the individual class rates of return within Delaware. (Exh. 25 (Wittine) at 9; Exh. 37 (Oliver) at 20). The MPB methodology recognizes that production capacity costs are incurred to meet both the peak demand and energy requirements of Delmarva's customers. (Exh. 25 (Wittine) at 5). In its cost of service studies for this case, the Company assigned 65% of the production capacity costs on the basis of its four monthly coincident peak ("4MCP") allocator ("peak") and 35% of the costs on the basis of annual energy requirements at the generation level ("base"). (Tr. at 715-17).

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[35] Delmarva prepared one study for the test year (calendar year 1990) and one study for the "3+9" test period ending September 30, 1991. (Exh. 37 (Oliver) at 20).

235. Staff supported the continued use of the MPB methodology to allocate production capacity costs. (Exh. 37 (Oliver) at 13). Staff witness Oliver testified that the appropriateness of Delmarva's cost allocation methods should be assessed in terms of the ability of those methods to depict the Company's actual patterns of cost incurrence. (Id. at 27). He testified that two measures of customer usage directly influence Delmarva's production capacity planning decisions: demands during system peak hours and annual energy use. (Id. at 28). The MPB method allocates the Company's production capacity costs in proportion to the jurisdictional and class contributions to these two usage measures.

236. Staff, however, recommended that the Company change the weighting of the peak and base components. The 35% weighting which Delmarva currently uses for the base component is based on the average relationship between the minimum and maximum loads, which has ranged between 33-37%. (Exh. 66 (Wittine-R) at 67). The Company said that it expects this relationship to continue, and also contended that it was desirable to maintain stability from year to year in the production cost allocator.

237. Staff recommended that the weight of the base component should be based on the actual (not the average)

minimum load during the annual period for which the cost allocation study was performed. (Exh. 37 (Oliver) at 30). Mr. Oliver testified that the Company had only compared system minimum demand with demands for a single annual system peak hour. (SAB at 160). According to Mr. Oliver, if Delmarva had computed system minimum demand as a percentage of the average of its four highest monthly coincident peak demands (consistent with the measure of peak demand used in its MPB method), the resultant weightings for the base component would consistently exceed 35%. (Id.). Using this computation, the relationship between the Company's annual minimum and maximum loads ranged from 36.02% to 41.57%. (Exh. 68 (Oliver-S) at Reb. Exh. BRO-1). Thus, Staff recommended that Delmarva use a 63% peak/37% base weighting for the MPB components in its cost of service studies for its next base rate case. The Company acquiesced in Staff's recommendation, and supports a 63%/37% weighting prospectively. (CRB at 51).

238. The DEUG proposed adoption of a 4MCP method to allocate production capacity costs, with the remaining (variable) production costs allocated among the jurisdictions pursuant to the number of kilowatt hours of energy provided to each jurisdiction. (Exh. 41 (Johnstone) at 2; Exh. 42 (Johnstone) at 8). According to DEUG witness Johnstone, a 4MCP

method was appropriate because it recognizes only demand-related costs and because it would reduce Delmarva's revenue requirement for the Delaware jurisdiction by $3.9 million. (Exh. 42 (Johnstone) at 6). DEUG argued that the MPB method was no longer appropriate because the circumstances which supported the use of the MPB method in Delmarva's two previous rate cases had changed. Specifically, DEUG contended that Delmarva's load had grown significantly relative to capacity; that the nature of Delmarva's planned capacity additions had shifted away from base loaded additions to peaking-type facilities such as the Hay Road units; and that the cost differentials among fuels had decreased. (Id. at 2, 3, 8).

239. The Hearing Examiner recommended that the Commission again approve the MPB methodology for allocating Delmarva's production capacity costs among its customer classes, and reject the DEUG's proposal to use a 4MCP methodology. (HER at 119). He disagreed with the DEUG's claim that circumstances had changed and thus adoption of its 4MCP methodology was warranted. First, he accepted Delmarva's contention that the shape of its load curve, rather than its reserve margin, determined the size and type of facilities required, and observed that the characteristics of Delmarva's load had not changed since 1982 to the degree that would warrant a change in the cost allocation

methodology. (Id. at 117). In this regard, the record established that although the Company's load had increased by 37.5% since 1982, its load factor was only .6% less in 1991 than it was in 1983. (Id. at 117 n.93). Second, the Hearing Examiner did not find a trend toward an increasing use of peaking units, nor was there any evidence that Delmarva's integrated resource plan included additional peaking units. (Id. at 117). He pointed to the record evidence which demonstrated that the Hay Road units are not "ordinary" peaking units in that they currently operate more than 1000 hours annually, and will run over 3000 hours annually once they are converted to combined cycle operation in mid-1993. (Id. at 117-18 and n.94). He also noted that DEUG witness Johnstone had conceded that the Hay Road units would not operate as peaking units after their conversion; that Delmarva did not propose construction of additional peaking-type units; and that the installed costs per kW of the Hay Road units, considered together, was less than the system average cost per kW. (Id.). Third, the Hearing Examiner found that the record "clearly" established that Delmarva still recognized significant fuel savings using coal or nuclear fuel instead of oil or gas to generate electricity, notwithstanding the decline in fuel prices between 1982 and 1990. (Id. at 118).

240. The Hearing Examiner likewise rejected the DEUG's

argument that the $3.9 million reduction in Delmarva's revenue requirement resulting from a 4MCP methodology as compared to the MPB methodology warranted adoption of a 4MCP. He found persuasive the Company's argument regarding the purpose of cost allocation, and concluded that a cost allocation methodology should not be selected solely because the result will favor a particular jurisdiction or class. (Id. at 118-19). Keeping in mind the goal of an embedded cost of service study -- the appropriate distribution of responsibility for test period costs of service among jurisdictions and service classes -- the Hearing Examiner found that the MPB methodology effectively performed the tasks of functionalization, classification, and allocation. (Id. at 119).

241. DEUG also objected to Staff's proposal to increase the weight of the base component of the MPB methodology from 35% to 37%. The Hearing Examiner found that the record supported the appropriateness of Staff's recommendation, and so recommended it for application in Delmarva's cost of service studies in its next base rate case. (Id. at 120).

242. The DEUG excepted to the Hearing Examiner's recommendation. It continued to argue that the MPB methodology "unload[s]" the responsibility for $3.9 million in revenue from Delmarva's non-jurisdictional customers and places it on the

Company's Delaware customers, notwithstanding that its Delaware customers use the capacity more efficiently. (DEUG BOE at 2). The DEUG contended that there was no justifiable reason for this result, nor was there any "accurate and verifiable substance" to support an increase in the weight applied to the base component of the MPB methodology. (Id. at 3). In connection with this argument, DEUG asserted that the Hearing Examiner "ignored[d] the apparent impact of system growth," which in Delmarva's case occurred primarily in its residential and commercial sectors, rather than the industrial sector. The DEUG concluded that industrial ratepayers were "penalized" by the use of the MPB methodology, and their "injury" was "further aggravated" by the recommended increase in the base weight. (Id. at 3-4).

243. **Discussion**. The issue of the proper method for allocating Delmarva's production costs has been before this Commission in tow prior proceedings (PSC Docket Nos. 82-23 and 86-24). We agree that the selection of a particular cost allocation methodology should not be guided by the results that one methodology or another produces in terms of a utility's jurisdictional revenue requirement or on specific class rates of return. Rather, we believe that our decisions as to the appropriate cost allocation methodology have been and should be based on the principles and philosophies of the various

methodologies, rather than the "bottom line" results produced by their application. We acknowledge that use of the MPB methodology to allocate Delmarva's production capacity costs results in a Delaware jurisdictional revenue requirement which is $3.9 million higher than that produced by the 4MCP methodology advocated by the DEUG. The record evidence is clear, however, that Delmarva's production capacity planning decisions are substantially influenced by annual energy usage. The MPB methodology recognizes that influence; the 4MCP methodology does not. DEUG's arguments that the Commission's long-standing acceptance of the MPB methodology should be reversed based on Delmarva's load growth relative to capacity, a shift in the Company's base load to peaking units and the reduction in cost differentials among fuels are without merit for the reasons noted by the Hearing Examiner. Thus, for these reasons, as well as those expressed by the Hearing Examiner, we find that the MPB methodology is the appropriate methodology for allocating Delmarva's production capacity costs in this proceeding. We also find, as the Hearing Examiner did, that the record supports an increase in the weight applied to the base component of the MPB methodology from 35% to 37%, and adopt the Hearing Examiner's recommendation to apply the 63%/37% weightings in the Company's cost of service studies for its next base rate case. (2-1, Commissioner McClelland voting nay).

b. Transmission Capacity Cost Allocation

244. In this case, Delmarva used a 4MCP methodology to allocate its transmission capacity costs among its customer classes. (Exh. 66 (Wittine-R) at 68). Staff proposed to use the MPB methodology to allocate transmission capacity costs. (Exh. 37 (Oliver) at 34). According to Staff, annual energy usage influences the Company's investment in transmission capacity, as it does with respect to Delmarva's production capacity. Since the selection of a cost allocation methodology should be guided by the determination of which methodology best depicts a utility's patterns of cost incurrence, Staff argued that the 4MCP methodology currently utilized by Delmarva for allocating transmission capacity costs was inappropriate because it allocates those costs exclusively on the basis of peak demand. (Exh. 37 (Oliver) at 34-35; Exh. 68 (Oliver-S) at 6-9; SAB at 162-166).

245. The Company responded that several design and planning factors must be assessed in determining the proper apportionment of transmission facilities. (Exh. 66 (Wittine-R) at 72-75). It stated that it was currently studying this issue, and that it would address it in its next base rate case. (Tr. at 2126-27). Consequently, it urged the Commission to reject

Staff's request to direct the Company to use the MPB methodology to allocate transmission capacity costs in its next base rate case cost of service studies. The DEUG also opposed Staff's recommendation, contending that use of the MPB methodology to allocate Delmarva's transmission capacity costs would have increased the Delaware jurisdictional retail revenue requirement by approximately $1 million in this case. (See Tr. at 1324; DEUG AB at 9).

246. The Hearing Examiner found that "in view of Staff's apparent agreement that this matter should be the subject of future study and its recommendation to consider changing the methodology prospectively...," it was unnecessary to make a decision on this issue in this case. (Her at 121-22). He accepted Delmarva's proposal to defer a decision at this time to give all parties an opportunity to "'systematically and methodically review the appropriateness of alternative methodologies.'" (Id. at 122, quoting CRB at 52). Thus, he recommended that the Commission make no decision at this time. (Id. at 122).

247. Staff excepted to the Hearing Examiner's recommendation. It disputed that it had agreed that this issue should be studied further. Rather, Staff contended that the issue had been thoroughly litigated and briefed, and that the

record supported a determination that the MPB methodology should be used to allocate transmission capacity costs in Delmarva's next base rate case. The only issue which needed further study, Staff argued, was the appropriate weighting of the peak and base components. (SBOE at 51-53).

248. **Discussion**. We agree with the Hearing Examiner that we need not resolve this issue at this time. The Company has stated that it will address this issue in its next base rate case, and that it would not be difficult or expensive to present studies using both the 4MCP and the MPB methodologies. Thus, we adopt the Hearing Examiner's recommendation to defer a decision on the appropriate cost allocation methodology for transmission capacity costs. (Unanimous).

c. Demand-Side Management Cost Allocation

249. Company witness Jones testified that Delmarva initiated two demand-side management ("DSM") programs in 1988: the Energy for Tomorrow ("EFT") program, which is available to residential customers, and the Peak Management program, which is available to commercial customers served under the MGS-S, LGS-S, GS-P, and GS-T rates. (Exh. 11 (Jones) at 3-4; Exh. 26 at JRW-5, Fourth Revised Leaf No. 82 and Sixth Revised Leaf No. 84). According to the Company, the principal costs associated with the DSM program are the capital and O&M costs that Delmarva

incurs, and the dollar amount for discounts that the Company provides to participants. (Exh. 66 (Wittine-R) at 76). In this case, the Company assigned the responsibility for these costs directly to the jurisdictions and then allocated them to the rate classes from which the participants were drawn based on the number of participants in each class. (Exh. 37 (Oliver) at 42).

250. Staff witness Oliver testified that he was unable to assess the reasonableness of the Company's DSM cost allocation among rate classes. (Id. at 41, 43). He noted, however, that pursuant to this allocation, Delmarva assigned approximately 68% of its DSM costs to the Delaware residential classes. (Id. at 42). According to Mr. Oliver, DSM credits were "netted against the base revenues by class and were attributed directly to the rate classes to which the credits were applied." (Id.).

251. Staff recommended that Delmarva separately identify the costs of its DSM programs and allocate them across jurisdictions and customer classes using its 4MCP methodology. (Id. at 45, 47-48). Staff argued that this method of allocation was consistent with the Company's original justification of the DSM programs as benefitting all customer classes. Moreover, since the Company probably would not allocate the costs of a peaking unit across just a few classes, and the DSM programs were the functional equivalent of a peaking unit, the DSM costs

should not be allocated solely to the few classes from which the participants were drawn. (SAB at 169-70).

252. Staff also recommended that the Company adjust its class 4MCP data to remove load that could have been, but was not, controlled during each of the four monthly coincident system peak hours used in developing the Company's MPB allocators. (Exh. 37 (Oliver) at 30-31). Mr. Oliver testified that, like Rate Q, the EFT and PM programs are load-shifting programs. The Company currently removes from the class 4MCP data Rate Q load that it could have controlled but did not during the four monthly coincident system peak hours; thus, Mr. Oliver testified, it should do the same for DSM load. (Id.).

253. The Company acknowledged that it had no "conceptual" problem with allocating DSM costs according to its 4MCP allocator, but contended that the Commission should not change the present allocation method because the DSM programs were only in a "start-up mode" in 1988 and 1989, and Delmarva was still analyzing the summer 1991 data. (Exh. 66 (Wittine-R) at 76, 79-80). The Company contested Staff's recommended adjustment to the class 4MCP data, however, arguing that the class 4MCP data should be adjusted upward to reflect load that was controlled during the four system peak hours. (Id. at 77-78).

254. Staff responded that what the Company did with the

results of its cost of service study in terms of setting class rates was irrelevant to how it arrived at the results of its cost of service study in allocating costs of jurisdictions. In preparing its cost of service study, Delmarva removed the Q-Controllable load that it could have controlled, but did not; since the DSM programs also are load-shifting, Staff argued that it should do the same with respect to the DSM loads that could have been controlled, but were not. (SAB at 169).

255. The Hearing Examiner concluded that it was appropriate to defer these issues until Delmarva's next base rate case, when the Company and Staff should have better data about the costs and benefits of the DSM programs. Thus, he recommended that the Commission defer a decision on these issues at this time. (HER at 123-24).

256. Staff excepted to the Hearing Examiner's recommendation to defer a decision on this issue. It argued that the Company had agreed conceptually with the use of the 4MCP methodology to allocate DSM costs, and that its proposal was consistent with how the Company would allocate the costs of a peaking unit as well as with the arguments with which Delmarva initially justified the DSM programs. Staff also advanced again its proposal to remove the DSM load from the class 4MCP data used in the Company's MPB methodology to be consistent with

Delmarva's removal of Rate Q load from those data. (SBOE at 53-59).

257. **Discussion**. We adopt the Hearing Examiner's recommendation with respect to the allocation methodology to be used for DSM costs. We believe it is appropriate to defer decision at this time to enable the parties to obtain more complete data on which to make their recommendations in Delmarva's next base rate case. Thus, we decline to decide this issue in this case. (Unanimous).

258. We also decline to decide whether, and to what extent, an adjustment to Delmarva's class 4MCP data should be made in this case. Again, we will defer a decision until Delmarva's next base rate case, when better information on the Company's DSM costs will be available. (3-1, Chairman Norling voting nay).

2. REVENUE INCREASE DISTRIBUTION

259. To determine the proposed distribution of its rate increase among its customer classes, Delmarva followed three general guidelines:

1. The overall revenue level derived from each firm service classification should be sufficient to produce a rate of return for that classification that is within ±10% of the overall jurisdictional rate of return being requested. Thus, with the overall jurisdictional return set at an index value of 100, the individual class rates of return should fall within a range of 90-

> 110. Under present rates, the returns as determined from the MPB methodology for the residential and GS-S classes are greater than 90, and the returns for the GS-P, GS-T, and OL classes are less than 90.
>
> 2. The level of additional revenue from each customer class should be set to move the class relative rates of return towards unity (the overall jurisdictional return).
>
> 3. The overall increase to each firm service customer classification should be limited so that no class experiences an increase of more than two percentage points above the overall increase being sought.

(Exh. 25 (Wittine) at 22-24).

260. The Company proposed to limit the increase to any particular customer class to no more than approximately two percentage points over the overall increase sought in this case. Thus, based on the Company's originally proposed 7.35% overall increase, no customer class would receive an increase of more than 9.50%. The Company justified its limitation of the increase to individual classes on the basis of rate moderation, given that it had not had a rate increase in nine years. (Id. at 21-24, 27). It also asserted that its proposal moved the class relative rates of return closer to unity, notwithstanding the referenced cap for individual rate classes. (Id. at 22-24).

261. Staff supported the manner in which Delmarva differentiated the percentage increase applied to each class. (Exh. 37 (Oliver) at 52). It disagreed, however, with the

Company's proposed cap on the level of the percentage increase for individual rate classes. Staff therefore recommended that the Commission set the limit for those increases at 1.5 times the overall increase. (Id. at 56). For purposes of maintaining that limit, Staff also recommended that the Q-Firm and Q-Controllable classes be considered as one rate class to allow Delmarva to place a greater portion of the overall increase on its Q-Firm service. (Id. at 73). If the Commission did not grant Delmarva all of its requested revenue relief, Staff recommended that Delmarva distribute the revenue increase in a way that would promote the effort to narrow the disparity between class rates of return. (Id. at 56-57). Furthermore, Staff recommended, even if the Commission granted no revenue increase, Rate Q should be adjusted upward because of its "extremely low" rate of return. (Id. at 57).

262. The DEUG asserted that, under Delmarva's proposed distribution of the revenue increase and the use of the class rates of return under the MPB methodology, residential customers were being "subsidized" by other customer classes. (Exh. 42 (Johnstone) at 9). Thus, the DEUG proposed to shift costs to residential customers and reduce the Company's recommended increase for high load factor customers served under rates GS-P, GS-T, and Q. The DEUG also suggested that in the event the

Commission did not grant Delmarva's full requested revenue increase, then the relationship of each class to the cost of service should be maintained by adjusting the non-fuel portion of the revenues pro rata. (Exh. 43 (Johnstone) at Exh. DEJ-2, Schedule 3). After excluding the cost of fuel (because only non-fuel costs were being considered in this case), the DEUG proposed to apply the approved increase to each of the components of the rates for GS-P, GS-T, and Q classes on an equal percentage basis. (Exh. 42 (Johnstone) at 12).

263. Additionally, representatives of two of the DEUG's membership commented on the record concerning the Delmarva rate design proposals. Mr. Robert E. Baker (Exh. 46) testified on behalf of Occidental Chemical Corporation, and Mr. Warren P. Bieger (Exh. 36) testified on behalf of CitiSteel, Inc. Both Occidental and CitiSteel are Rate Q-Controllable customers. Essentially, the thrust of their comments was that the Commission not sanction an increase in rates for the Q-Controllable class because continuation of Delmarva's current rate structure was "critical" to the long-term health, viability and competitiveness of their businesses and "essential" to "the approval of any significant new investment." (Exh. 36 (Bieger) at 4; Exh. 46 (Baker) at 6).

264. The Hearing Examiner found that Delmarva's proposed

distribution, which capped the increase to any individual class at two percentage points above the overall increase, best satisfied the goals of rate moderation, and of moving class rates of return closer toward unity. (HER at 128-30). The Hearing Examiner agreed with Delmarva that the size of Staff's proposed increase violated rate moderation principles and was likely to cause "unnecessarily adverse customer reaction" (Id. at 128, quoting CRB at 54-55), citing specifically the testimonies of the two Rate Q customer witnesses. The Hearing Examiner also rejected the DEUG's distribution proposals because one was based on the results of the rejected 4MCP methodology, and the other did "nothing to move class rates of return in the direction of unity." (Id. at 129). Moreover, he found the DEUG's rationale for its proposed class rates of return "confusing." (Id. at 129-30).

265. The Staff was the only party to except to the Hearing Examiner's recommendation. Staff argued that rate moderation was important, but that the overriding goal should be achieving unity in class relative rates of return. It noted the large differentials in class rates of return both historically and under Delmarva's proposed revenue distribution, and observed that Delmarva had not followed its own guidelines for the Rate Q and outdoor lighting classes. (SBOE at 60). Last, Staff

contended that the Commission should not be "held hostage by vague references to plant relocations or closings" made by the Rate Q customer witnesses. (Id. at 61).

266. **Discussion.** We adopt the Hearing Examiner's recommendation to approve the Company's proposed distribution of the revenue increase among its customer classes. We agree that rate moderation is an important goal. We also note, however, that moving the class rates of return toward unity is also important, and we direct the parties to keep this latter goal in mind in devising their revenue distribution proposals in Delmarva's next base rate case. Moreover, we observe that in this case, based on an overall 4.50% revenue increase, the difference between the Company's 2% cap on individual class increases and Staff's proposed cap of 150% of the overall increase is relatively minor. (See Tr. at 2394-96). Thus, we approve Delmarva's proposed revenue distribution for use in this case. (Unanimous).

3. RATE DESIGN, TARIFF LANGUAGE, AND SERVICE RULES

a. On-Peak Hours

267. The Company's current on-peak hours are 9:00 a.m. - 10:00 p.m. when Daylight Savings Time is in effect from Monday through Friday, and 8:00 a.m. - 9:00 p.m. Monday through Friday when Eastern Standard Time is in effect. (Exh. 25 (Wittine) at

36). Based on its review of its load characteristics, the Company proposed to expand its on-peak hours to 6:00 a.m. - 10:00 p.m. from Monday through Friday when EST is in effect. (Id.)

268. Staff supported the Company's proposed redefinition of its winter on-peak hours. (Exh. 37 (Oliver) at 62). Mr. Oliver observed, however, that in July 1991 the Company experienced what were then all-time system peaks on weekend days. Mr. Oliver suggested that the probability of the Company experiencing a system peak on a summer weekend day may have increased, and that summer on-peak hours may also need to be redefined. Therefore, he recommended that the Company be required to prepare and submit assessments of: (1) the relative probability of experiencing a peak on a summer weekend day; (2) the trends in relative levels of peak hour loads on summer weekend days; and (3) the merits of alternative approaches to including some or all summer weekend periods in its definitions of on-peak periods. (Id. at 62-63). The Company agreed that these items should be examined. (Exh. 66 (Wittine-R) at 83).

269. Intervenor Perdue Farms objected to Delmarva's proposal to change its on-peak hours. In his prefiled direct examination, Perdue witness Wheatley testified that Delmarva's proposal would more than double Perdue's annual billings. (Exh. 47 (Wheatley) at 5). During his direct examination, however, Mr.

Wheatley corrected that testimony to reflect that Delmarva's proposal would have an effect of increasing the charges by only $252 to Perdue. (Exh. 48; Tr. at 1462). Mr. Wheatley explained that he had based his original calculation on a document supplied by Delmarva which had erroneously identified the sum of on- and off-peak demand as "measured demand." (Tr. at 1460-61). Nevertheless, Mr. Wheatley argued that the proposed three-hour per day expansion of winter on-peak hours was not necessary. He testified that he had reviewed Delmarva's monthly system peaks over the last 45 months and had found no system peaks occurring between 6:00 a.m. and 7:00 a.m. or between 8:00 p.m. and 10:00 p.m. (Id.). Conceding that Delmarva often peaks between 7:00 a.m. and 8:00 a.m. during the winter, Mr. Wheatley recommended that the Company should only add the hour between 7:00 a.m. - 8:00 a.m. to the winter on-peak rating period, and that there should be continuing "dialogue" over the next 1½-2 years on the appropriate on-peak hours, including consideration of alternatives such as seasonal variations or shoulder periods. (Exh. 47 (Wheatley) at 6).

270. The Hearing Examiner recommended that the Commission approve the Company's proposal to expand its on-peak hours when Eastern Standard Time is in effect. He found that the record established that weekday winter peaks occurred regularly between

7:00 a.m. and 8:00 a.m., and that the Company typically was within 90% of the peak for a typical day during 6:00 a.m. to 7:00 a.m. and until the hour ending at 10:00 p.m. He observed, however, that the greater the extension of on-peak hours, the more difficult it was for customers to change their usage patterns to shift to off-peak consumption. (HER at 133).

271. **Discussion**. We agree with the Hearing Examiner that the record supports the need for Delmarva's proposed extension of its winter on-peak hours. Thus, we adopt his recommendation to approve Delmarva's proposed extension of its winter on-peak hours to include the hours from 6:00 a.m. to 8:00 a.m. and 9:00 p.m. to 10:00 p.m. when Eastern Standard Time is in effect. (Unanimous).

b. Off-Peak Demand Provision

272. The Company's present tariff provides that customers classified as LGS-S, GS-P, and GS-T incur demand charges based exclusively upon the loads they impose during on-peak hours. If these customers only use electricity during off-peak hours, they do not incur any demand charges. According to Mr. Wittine, the off-peak energy charges (which reflect average energy costs), by themselves, do not reasonably recover the Company's cost of serving these customers. As Mr. Wittine pointed out, under the circumstances, the rates collected from LGS-S, GS-P, and GS-T

customers taking service off-peak do not provide a contribution to the Company's fixed costs associated with the production and transmission distribution facilities necessary to serve those customers. (Exh. 25 (Wittine) at 37-38). The Company, therefore, proposed a new billing provision providing that measured demand for billing purposes will be the greater of the on-peak measured demand or one-third of off-peak measured demand.

273. Staff supported the concept of off-peak demand charges. (Exh. 37 (Oliver) at 64-65). Mr. Oliver observed, however, that the provision as proposed by the Company would only apply when a customer's off-peak demands exceeded its maximum on-peak demand by 300%. (Id. at 63). According to Mr. Oliver, the Company's data showed that if this provision had been in effect during 1990, it would have applied in only one month to each of two customers; thus, it would only deter a few extreme instances of off-peak demand utilization. (Id. at 66-67). Furthermore, Mr. Oliver asserted, the Company did not provide any justification for exempting from the demand charge off-peak loads that fall between 100%-300% of the customer's maximum on-peak demands. (Id. at 66). Recognizing that Delmarva must size its distribution facilities to meet the customer's maximum demand regardless of when those demands occur, Mr. Oliver reasoned that any off-peak demand in excess of the customer's on-peak demand

should be assessed additional cost responsibility. (Id.). Therefore, Mr. Oliver recommended that the Commission direct the Company to modify its proposal so as to apply off-peak demand charges to 1/3 of all kW of off-peak maximum demand which exceeded the level of the customer's on-peak maximum demand for the same billing month. (Id. at 65).

274. The Hearing Examiner recommended that the Commission approve Delmarva's proposed off-peak billing demand provision for implementation. (HER at 136). He found that the Company's intent in proposing this provision was to deal with "extreme" off-peak usage and to prevent "free-riders," not to "punish" customers who benefit the system by shifting to off-peak usage. (HER at 135-36). Furthermore, he accepted the Company's contention that the provision was designed to be revenue-neutral. (Id. at 136). Additionally, he found that Delmarva had solved its free-rider problem by proposing to measure demand for billing purposes as the greater of measured demand during on-peak hours or one-third of the measured demand during off-peak hours. (Id.). Last, he accepted the Company's argument that Staff's proposal would result in increased rates to these customers on top of the overall base rate increase, and that such increases would not be "insignificant." (Id.).

275. Staff excepted to the Hearing Examiner's

recommendation. First, Staff argued that the Company's justification for its proposal was to capture at least some of the fixed costs associated with the production and distribution facilities required to serve these customers, but the Company's proposal would not achieve that purpose. (SBOE at 64-65). Second, Staff contended that recovering a greater portion of the cost of serving the LGS-S, GS-P, and GS-T customers from these customers was not punishment. (Id. at 65). Third, Staff noted that the rate increases to be experienced by the vast majority of these customers resulted from the proposed minimum monthly charges to be assessed against these customers, not from the off-peak billing demand provisions. (Id. at 65-66). Even so, however, only 3% of these customers would experience an increase of more than 25%, and only two customers would experience an increase of more than the annual amount of Staff's proposed minimum monthly charge. (Id. at 66).

276. **Discussion**. We agree with the Hearing Examiner that Delmarva's proposed off-peak demand billing provision is reasonable. Thus, we adopt the Hearing Examiner's recommendation to approve the implementation of the off-peak billing demand provision proposed by Delmarva, for the same reasons as expressed by the Hearing Examiner. (3-0, Commissioner Phillips not voting).

c. Minimum Monthly Charges For LGS-S, GS-P, and GS-T Customers

277. The Company proposed to establish minimum monthly charges of $25 for all customers taking service under the LGS-S, GS-P, and GS-T rates. Staff opposed the Company's proposed minimum charge, because according to Staff witness Oliver, the $25 charge was inadequate to recover "basic" customer-related costs the Company incurs to provide service to these customers. (Id. at 69; Schedule BRO-6).[36] His "conservative" assessment of these "basic" monthly costs of providing service, as reflected in the Company's cost of service study, was $162.51 for GS-P customers and $402.02 for GS-T customers. (Id. at 69 and Schedule BRO-6). Mr. Oliver therefore recommended establishing separate monthly customer charges for LGS-S, GS-P, and GS-T customers, and further recommended that the levels of these charges be set at $120 for LGS-S, $160 for GS-P, and $400 for GS-T. (Id. at 70-71). He also rephrased the proposed tariff provisions for these rate classes to state that "the minimum monthly charge shall be the customer charge." (Id. at 70-71).

278. The Company has agreed to implement a minimum monthly

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[36] Mr. Oliver defined "basic" costs as metering and billing costs and plant-related costs directly associated with the customer's meter and service line. He excluded costs which may be considered customer-related in the Company's cost of service study but which were only indirectly associated with providing service to any individual customer, such as uncollectible accounts expenses, administrative and general expenses, and the like. (Exh. 37 (Oliver) at 69).

charge at the levels proposed by Staff, and to incorporate Staff's proposed customer charge language into its proposed tariff provisions. (Exh. 66 (Wittine-R) at 86-87).

279. **Discussion**. Given the Company's agreement to Staff's proposal and the failure of any other party to object to it, the Hearing Examiner concluded that this matter was no longer at issue. He found Staff's proposal reasonable and recommended that the Commission adopt it. (HER at 137-38). We adopt the Hearing Examiner's recommendation on this issue and authorize the establishment of customer charges of $120 and $400 for LGS-S and GS-T customers, respectively. (Unanimous). As a result of a further analysis performed to quantify the effects of our decisions in this proceedings, however, we have learned that adoption of the proposed minimum monthly charge of $160 for Delmarva's GS-P customers will result in substantial increases in the bills of some of these customers. Accordingly, we remand this issue and direct the Hearing Examiner to consider possible alternatives to increasing the GS-P customer charge so substantially at this time and, after any necessary hearings on the subject, to report back to the Commission promptly. In this connection, we note our support for Staff's proposal as well as the need for rate moderation with respect to implementation of the change Staff suggests is necessary. (Unanimous).

d. **Design Of Rate Q Charges**

280. Mr. Wittine testified that attempting to quantify the cost of service for Rate Q service posed "special problems" because it is a non-firm service. (Id. at 25). According to Mr. Wittine, traditional cost allocation methodologies did not provide a "true" measure of the costs incurred in meeting non-firm load; rather, they only provided the results of controllable rate prices and the selected cost allocation methodology. (Id. at 31-32).

281. Delmarva did not offer in its direct case any assessment of the "true" costs of service non-firm load nor any indication of what methods should be used to determine the "true" costs of serving such loads. (Id.). Instead, it used an "iterative" process which compared the character of service provided under Q-Firm to other firm customers with similar loads taking service at the same voltage level. (Id.). The Company asserted that such similarly-situated customers would be taking service under the GS-T rate. (Id.). Thus, Delmarva used the GS-T rate as an appropriate measure of firm demand for the Q-Firm rates.

282. Staff witness Oliver disagreed with Mr. Wittine's opinion that conventional cost allocation methodologies are an inadequate means for measuring the "true" costs of non-firm load.

He testified that in the absence of a "reasonable and verifiable" alternative measure for determining the adequacy of cost recovery from non-firm customers, a "properly performed conventional fully allocated" cost of service study provided the only meaningful measure of class rates of return available to the Commission. (Exh. 37 (Oliver) at 53). Although Staff agreed with the Company that the GS-T rate was an appropriate firm rate on which to develop Q-Firm charges for this case (Staff at 79), Staff argued that the Company's proposal did not go far enough to improving the large difference that still remained between GS-T and Rate Q demand charges. (Id. at 180). Staff, therefore, recommended that the Company achieve a greater narrowing of the differences between the GS-T and Q-Firm demand charges by allocating a larger portion of the revenue increase to the Q-Firm class rather than the Q-Controllable class, and by recovering that amount fully through the Q-Firm demand charge. (Id. at 181).

283. DEUG witness McCoy concurred with Mr. Wittine's assessment of the limited usefulness of traditional cost allocation studies in determining the appropriate cost of interruptible power. (Exh. 49 (McCoy) at 16-17). He calculated

the Company's cost of interruptible power using three methods: (1) peak offset; (2) system lambda; and (3) selective allocation. (Id. at 8). He testified that the results of each of the pro forma revenue calculations produced a revenue requirement for Q-Controllable ranging from 65%-78% of the Q-Firm revenue requirement. (Id. at 16 and Exh. FLM-9). According to Mr. McCoy, under Delmarva's allocation of energy costs, any rate greater than 68% of the Q-Firm rate made a contribution to margin in excess of average energy costs; therefore, Mr. McCoy asserted, the Company's proposed rate (which is 76% of Q-Firm) was at the high end of the range. (Id. at 17).

284. The Hearing Examiner concluded that the Company's proposal was the most reasonable of the three approaches to designing Rate Q charges. (HER at 140). He called Staff's goal of moving closer to unity (rate parity) "commendable," but found that Staff's proposal conflicted with the requirements of rate moderation. (Id.). He found that Delmarva's proposal moved in the same direction as Staff's but with a greater degree of moderation. In this regard, he observed that the Company expected Rate Q to reach rate parity within the next five years under Delmarva's schedule of planned rate filings. (Id., citing Tr. at 2146-47). Thus, he concluded that it would be better to give Delmarva and the Rate Q customers "the benefit of the doubt"

and reject Staff's proposal at this time. (Id. at 140).

285. The Hearing Examiner also rejected the DEUG's proposals for Rate Q charges. He admitted to having "several reservations" about Mr. McCoy's costing methods, observing that Mr. McCoy had not identified any commissions which utilized the system lambda or selective allocation methods. Furthermore, he noted that under Mr. McCoy's methods, non-firm customers were wholly exempt from production capacity costs, but firm customers were not exempt at all. He accepted Delmarva's contention that this approach was basically unfair because it allowed customers who did not share the cost of production to enjoy the benefits of lower average energy costs. (Id.). Thus, he recommended that the Commission adopt Delmarva's proposed design of Rate Q charges. (Id.).

286. Staff excepted to the Hearing Examiner's recommendation. It argued that Delmarva's proposed Q-Firm rate was constrained by its "implicit assumption" that Q-Firm and Q-Controllable should receive the same percentage increase. The Company's cost of service study showed a negative test period rate of return for Q-Firm, which could be remedied more quickly by assessing a larger portion of the total revenue increase for Rate Q against the Q-Firm class through the demand charge. This would still give Delmarva and the Rate Q customers "the benefit of the doubt," since the overall percentage increase to Rate Q would not change. (SBOE at 70). Staff further contended that if the cost of service continued to outpace the percentage increases to Rate Q, parity would not be achieved within the next five years. (Id. at 71).

287. **Discussion**. As discussed previously, we agree that moving class rates of return closer to unity is an important goal. We also believe, however, that rate moderation is an important goal. We find the Company's proposal better achieves these goals than Staff's or the DEUG's. Thus, we adopt the Hearing Examiner's recommendation to approve Delmarva's design of Rate Q charges for the same reasons expressed by him.

(Unanimous).

e. Rate Q Non-Compliance Penalties

288. In his original direct testimony, Mr. Oliver observed that over the previous four years Delmarva had failed to assess penalties permitted by the Rate Q tariff in a number of instances where Rate Q customers had not fully complied with load curtailment requests. Mr. Oliver attacked the Company's inaction because: (1) the Rate Q tariff did not authorize the Company to waive penalties; (2) the failure to assess penalties was equivalent to providing firm service at controllable rates; and (3) given the already low return on Rate Q service, additional subsidies through penalty waivers were unjustified. (Exh. 37 (Oliver) at 74-75). Mr. Oliver therefore recommended an adjustment to the Company's test period revenues for the amount of the waived penalties, which he calculated to be $36,022. (Id. at 75; Exh. 68 (Oliver-S) at 13; Reb. Schedule BRO-7). Mr. Oliver also recommended that the Company modify Paragraph L of the Rate Q tariff language to require assessment of non-compliance penalties on the basis of the maximum amount of non-compliance load recorded for that customer during each load curtailment event. (Exh. 37 (Oliver) at 78).

289. Subsequent to the filing of Mr. Oliver's prefiled direct testimony, the Company agreed to modify Paragraph L as recommended by Staff, and also took corrective action to protect against future occurrences of the penalty waiver. (SAB at 186-87). Staff then withdrew its recommendation to include the amount of waived penalties in Delmarva's test period revenues. (Id. at 187; Exh. 68 (Oliver-S) at 14).

290. The DEUG opposed Staff's proposed modification of Paragraph L. It asserted that the expansion of Rate Q penalties was not sufficiently substantiated, and would "obstruct the benefits of this load management tool." (DEUG AB at 16).

291. The Hearing Examiner agreed with Delmarva that strict enforcement of the Rate Q compliance provisions should assure that the benefits of Rate Q were actually available to other customers. (HER at 142). He rejected the DEUG argument as suggesting that non-compliance may be viewed by some as a benefit, such that stricter enforcement would reduce participation in Rate Q. The Hearing Examiner found that the record "clearly establishe[d]" that non-compliance was a problem, which the Hearing Examiner found should be addressed, and that Staff's proposal did not require Rate Q participants to do any more than they had already agreed to do under the terms of the Rate Q tariff. Thus, he recommended that the Commission approve

the proposed modification to Paragraph L Rate Q. (Id.).

292. The DEUG excepted to the Hearing Examiner's recommendation to approve the modified Rate Q penalty provisions, incorporating by reference its previous arguments in its Answering Brief. (DEUG BOE at 4).

293. **Discussion**. We adopt the Hearing Examiner's recommendation to approve the proposed modifications to Paragraph L of the Rate Q tariff. We agree with the Hearing Examiner that non-compliance with load curtailment requests has been a problem in the past, and that the modified language should help to ensure that Rate Q customers comply with load curtailment requests. We also agree with the Hearing Examiner that the modification does not impose any different obligations on Rate Q than those to which they have already agreed. Thus, we approve this proposed modification. (Unanimous).

f. Rate Q On-Peak Hours

294. The Company's Rate Q tariff language currently provides that Delmarva can only control Rate Q load during periods which are defined as on-peak for billing purposes. (See Rate Q tariff, Section J). In July 1991, Delmarva experienced what was then an all-time system peak on a weekend day, which is considered off-peak for billing purposes. The Company was unable to avoid the system peak by curtailing Rate Q load. Its

inability to curtail Rate Q load also prevented it from controlling Airco Class 3 load, because the Airco contract provides that Delmarva cannot control Airco Class 3 load until all Rate Q load has been controlled. (Exh. 37 (Oliver) at 77-78). Thus, Staff recommended that Section J of the Rate Q tariff be modified to delete the phrase "during on-peak hours" to enable the Company to curtail Rate Q load to avoid a new system peak or to prevent or minimize an emergency condition. (Id.).

295. Both Delmarva and the DEUG opposed Staff's proposal. The Company contended that such a modification would make Rate Q less attractive to customers, and that there was no need for this change at the present time. (Tr. at 1845).

296. The Hearing Examiner agreed with Delmarva, and recommended that Staff's proposed modification to Section J not be approved. He observed that the Company had only experienced one peak on a weekend, and that Delmarva had represented that it was presently studying its weekend load. (Id. at 1872). (HER at 133-34).

297. Staff excepted to the Hearing Examiner's recommendation. Staff argued that the Company should not be impeded in its attempts to avoid new all-time system peaks simply because they occurred on weekends. (SBOE at 72-73). Staff pointed out that its proposal was designed to prevent future

problems from occurring. It noted that if no weekend peaks occurred, then there would be no adverse effect on Rate Q customers. If weekend peaks did occur, however, Staff contended that it could be costly to Delmarva in terms of its inability to curtail Rate Q and Airco Class 3 load. (Id. at 73).

298. **Discussion.** We adopt the Hearing Examiner's recommendation to reject Staff's proposed modification to the Rate Q load curtailment provisions at this time. The Company has represented that it is monitoring its weekend load, and that if it perceives a pattern of increasing weekend peaks, it would take action at that time to address it. (See Tr. at 2405-06). In this regard, we observe an apparent inconsistency between Delmarva's cost allocation methodology and its Rate Q curtailment policy, which we believe should be addressed in Delmarva's next base rate case. (See discussion at Tr. 2410-11). In this case, however, we will reject Staff's proposal to modify the Rate Q tariff language to permit Delmarva to control Rate Q during off-peak hours. (3-1, Chairman Norling voting nay).

g. DSM Tariff Language

299. The Company proposed several tariff language changes for EFT[37] and PM. First, it sought to institute a "Demand Free

[37] The change in the EFT tariff language is a clarification, not a substantive change.

Billing Period" for its PM participants to provide that the remaining on-peak hours after a PM event will be demand-free for a PM customer. According to the Company, this modification was warranted because approximately 10 of the 71 customers currently participating in the PM program may experience demand charges of approximately 5-10% more as a result of ramping their operations back up after a PM event than they would have if they were not PM participants. (Exh. 66 (Wittine-R) at 89: COB at 106). Second, Delmarva sought to add the language "Peak Management Billing Month" to the PM tariff language. (Exh. 37 (Oliver) at 85).

300. Staff opposed the Company's proposed amendments to the PM tariff language. With respect to the "Demand Free Billing Period," Staff argued that the Company has produced no evidence that PM participants had incurred or would incur such higher demand charges. (Exh. 37 (Oliver) at 84; SAB at 188-89). As for the addition of "Peak Management Billing Month" to the PM tariff, Staff contended that this term was not defined in the PM tariff, nor was Company witness Jones able to define it; thus, there was insufficient support for it. (SAB at 189).

301. Additionally, Staff advocated eliminating the current distinction between PM Option 1 and Option 2 participants because Delmarva's data did not show any appreciable difference in the frequency or duration of curtailments under the two options.

(Id. at 84-85). Subsequent information regarding Delmarva's 1991 summer experience with PM (which Mr. Oliver had sought prior to filing his direct testimony) demonstrated a "noticeable" difference between the Company's use of Option 1 and Option 2 curtailments. (Exh. 68 (Oliver-S) at 20). Consequently, Staff withdrew its recommendation to eliminate the distinction between the two options. (Id.; Tr. at 2071).

302. The Hearing Examiner recommended that the Commission approve both of Delmarva's proposed modifications to the PM tariff. (HER at 144-45). As to the "Demand Free Billing Provision," the Hearing Examiner found it reasonable to take preventive measures to avoid a potential problem. As to the addition of "Peak Management Billing Month," he found that the language already existed in the tariff, and that it was "'merely a clean-up change for consistency.'" (Id. at 145). Staff excepted to the Hearing Examiner's recommendation on the same grounds discussed previously. (SBOE at 74-75).

303. **Discussion.** We adopt the Hearing Examiner's recommendation for the reasons expressed by him, and hereby approve Delmarva's proposed modifications to the EFT and PM tariff language. (Unanimous).

h. Service Rules And Regulations

304. Most of the Company's modifications to its service

rules and regulations were of a clarifying or housekeeping nature. (Exh. 25 (Wittine) at 38-41 and Exh. 26 at Exh. JRW-8). Staff reviewed the proposed changes and found most of them to be reasonable and appropriate. However, Mr. Oliver objected to Delmarva's proposal to reduce the length of service lines installed at no charge for a residential customer. Mr. Oliver observed that the Company had not provided any supporting data or analysis for this proposed change, and so recommended that the Commission consider withholding approval of this change until the Company provided appropriate supporting data and analysis for Staff's review. (Exh. 37 (Oliver) at 83). The Company subsequently concurred with Mr. Oliver's assessment. (Exh. 66 (Wittine-R) at 88). The Hearing Examiner recommended that Delmarva be directed to follow up on this issue in its next base rate case. (HER at 145). We agree, and hereby so direct the Company. (Unanimous).

i. **<u>Cost Of Service Study Format</u>**

305. Staff witness Oliver proposed several modifications to the form in which Delmarva presents its cost of service studies. The Company claims that it welcomed "constructive suggestions" in this regard and made some minor changes to its presentation; however, the Company declined to adopt the larger part of the Staff proposal, <u>i.e.</u>, to modify the basic mainframe computer

program that it currently employs. Mr. Oliver characterized the product of the mainframe computer as "unnecessarily cumbersome" and asserted that it is perceived as a "black box" rather than a useful analytical tool that facilitates understanding of cost allocation issues. (Exh. 68 (Oliver-S) at 21). Mr. Oliver proposed, therefore, that the Company be required to convert the current format of the allocation portion of the program to an electronic spreadsheet format and also to revise the detail of the allocations "to show the class and jurisdictional allocation of costs to each FERC account and major subaccounts." (Id.).

306. The Company contended that the use of software written for personal computers ("PCs") would not "be an improvement." (COB at 109). Moreover, according to the Company, Staff had not provided a reasonable basis for "totally restructuring the Company's cost of service study format." The Company testified that it surveyed eight multi-jurisdictional utilities and found that the use of a mainframe computer is not a rare occurrence among those utilities.[38]

307. The Hearing Examiner had "no doubt" that the Commission had statutory authority to prescribe the format in

[38] According to the Company, seven of the eight utilities surveyed use a mainframe computer "exclusively or partially," and like Delmarva, five or the eight utilities use Fortran as the mainframe software language. (Exh. 66 (Wittine-R) at 65).

which a utility provides information and reports to the Commission pursuant to 26 Del.C. §205. He characterized the issue here as a policy matter rather than a legal question, however. While he understood Staff's desire to have the cost of service data available in a PC-compatible format, and recognized the burdens which traveling to Delmarva's offices imposed upon Staff and Intervenor consultants and analysts, he also acknowledged that it was impractical to require Delmarva to "scrap" its mainframe computer. (HER at 146).

308. The Hearing Examiner observed that given the rapid advancements in the field of computer technology, it was very probable that in the very near future PCs should be able to execute most, if not all, of the functions of today's mainframe programs. He noted that as the regulated entity, the onus of providing data to the Commission was on the Company. Therefore, he found that the Company should seek to make this technological event occur sooner, rather than later. In the Hearing Examiner's opinion, the most reasonable approach to resolving this issue in the interim was for both Staff and the Company to work together in a good faith attempt to find some common ground whereby the needed information would be provided in an acceptable format. He therefore recommended that the Commission encourage the Company

and the Staff to take this route. Staff excepted to the Hearing Examiner's recommendation, and urged the Commission to direct Delmarva to prepare its cost of service studies for its next base rate case in a PC-compatible format. (SBOE at 76-79). (Id. at 147).

309. **Discussion**. We adopt the Hearing Examiner's position on this issue, and hereby direct the Company and Staff to work together to resolve this issue amicably. (Unanimous).

F. UNCONTESTED MATTERS

310. The question of deductions for contributions to Delmarva's qualified nuclear decommissioning trust fund was not contested in these proceedings. According to Delmarva, the IRS requires a specific ruling authorizing such deductions. (COB at 110). The Company therefore requested the Commission to make specific findings regarding the question of Delmarva's nuclear decommissioning trust fund. Based upon the record of this proceeding, we make the following findings:

- Based on the testimony set forth in Exh. 16 (Dougher) at 31-57 and Schedules DGD-9 through DGD-18, we determine that $2,311,000 is to be included in Delmarva Power & Light Company's cost of service annually for nuclear decommissioning expenses as follows: Peach Bottom Unit No. 2 - $591,000 in a qualified fund and $149,000 in a non-qualified fund; Peach Bottom Unit No. 3 - $591,000 in a qualified fund and $149,000 in a non-qualified fund; Salem Unit No. 2 - $388,000 in a qualified fund and $28,000 in a non-qualified fund; Salem

Unit No. 1 - $351,000 in a qualified fund and $64,000 in a non-qualified fund.

- As set forth in Exh. 16 (Dougher) at Sched. DGD-12, the estimated years in which substantial decommissioning costs will first be incurred are 2014 for Peach Bottom Unit Nos. 2 and 3, 2016 for Salem Unit No. 1, and 2020 for Salem Unit No. 2.

- The total Delmarva electric system estimated costs of decommissioning the Company's share of the plants, expressed in current (1990) dollars are as set forth in Exh. 16 (Dougher) at Sched. DGD-10: $13,679,000 for Peach Bottom Unit No. 2, $13,679,000 for Peach Bottom Unit No. 3, $11,111,000 for Salem Unit No. 1, and $11,111,000 for Salem Unit No. 2.

- The total Delmarva electric system estimated costs of decommissioning the Company's share of the plants, expressed in future dollars as of the date decommissioning will commence are set forth in Exh. 16 (Dougher) at Sched. DGD-10: $46,728,000 for Peach Bottom Unit No. 2; $46,728,000 for Peach Bottom Unit No. 3; $44,005,000 for Salem Unit No. 1; and $50,035,000 for Salem Unit No. 2.

- The methodology used in converting the estimated cost of decommissioning expressed in current (1990) dollars to the estimated cost of decommissioning expressed in future dollars is to take the current dollar figure multiplied by 1.05 raised to an exponent equal to the years remaining from 1990 until the year in which substantial decommissioning expenses are first expected to occur.

- The assumed after-tax rate of return to be earned by each of the qualified funds is 6 percent; the assumed after-tax rate of return to be earned by each of the non-qualified funds is 9 percent.

- The estimated dates on which each of the nuclear power plants will no longer be included in the Company's rate base for ratemaking purposes as determined in this proceeding are: 2014 for Peach

Bottom Unit Nos. 2 and 3; 2016 for Salem Unit No. 1; and 2020 for Salem Unit No. 2.

(Unanimous).

III. FINAL RATES/REFUND

311. Because the revenue relief we have approved for the Company is lower than the additional revenue produced by the rates the Company placed into effect under bond on January 1, 1992, a refund is necessary. In its proposed "Final" Rate filing and Refund Plan which the Company forwarded to all parties on March 17 and 23, respectively, the Company proposed to refund the difference between the "Final" and under-bond rates. No party has objected to those proposals and we herein adopt the Final Rates and Refund Plan which are appended hereto.

IV. SUMMARY OF FINDINGS

The following summarizes the Commission's findings in this proceeding:

(a) The appropriate test period for this proceeding is the twelve-month period ended September 30, 1991.

(b) The Company's test period rate base is $801,762,000.

(c) The Company's test period earnings are $68,700,000.

(d) A return on equity of 12.50% and an overall rate of return of 9.95% is just and reasonable.

(e) The Company's test period revenue deficiency is $18,473,000.

(f) The rates proposed by the Company to generate its test period revenue requirement are just and reasonable.

(g) The Company is authorized to continue using the Modified Peak and Base cost allocation methodology to allocate its production capacity costs to its customer classes in its cost of service study for this case.

(h) The Company is authorized to implement expanded winter on-peak hours from 6:00 a.m. to 10:00 p.m. Mondays through Fridays when Eastern Standard Time is in effect.

(i) The Company is authorized to implement an off-peak billing demand provision imposing the current demand charge on LGS-S, GS-P, and GS-T customers whose monthly off-peak usage exceeds 300% of that customer's maximum on-peak usage for the same billing month.

(j) The Company is authorized to implement a monthly minimum customer charge of $120 for LGS-S customers and $400 for GS-T customers. The Company is hereby directed to modify the tariff provisions for these customer classes accordingly. We remand the issue of a proposed $160 customer charge for GS-P customers and direct the Hearing Examiner to reconsider this issue and, after any necessary hearings on the subject, to report back to the Commission promptly. Until this issue is resolved, we direct that Delmarva's "under-bond" rates for GS-P customers remain in effect.

(k) The Company is authorized to modify its Rate Q tariff language to clarify the basis on which penalties for non-compliance with load curtailment requests will be imposed.

(l) The Company is authorized to modify its PM tariff provisions as proposed by it.

V. ORDER

AND NOW, this 31st day of March, 1992, IT IS ORDERED:

1. A reasonable increase in Delmarva's revenue requirement of $18,473,000 is just and reasonable, and is reflected in the tariffs attached hereto as "Exhibit A."

3. The Company will promptly make the required refund in accordance with the procedure outlined in the Refund Plan.

4. The Commission reserves jurisdiction and authority to enter such further orders in this matter as may be deemed necessary or proper.

BY ORDER OF THE COMMISSION:

Chairman

Commissioner

Commissioner

Commissioner

ATTEST:

Secretary