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 ELECTRIC BASE RATES (Filed March 22, 2013)	))))	PSC DOCKET NO. 13-115

CERTIFICATE OF SERVICE

I hereby certify that on January 21, 2014 I caused the attached **THE DIVISION OF THE PUBLIC ADVOCATE'S POST-HEARING ANSWERING BRIEF** to be served upon all parties on the attached service list in the manner indicated thereon.

/s/ *Regina A. Iorii*

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Dated: January 21, 2014

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PRELIMINARY STATEMENT

Q: (to Delmarva witness Frederick J. Boyle): Is it your testimony that this Commission should only be concerned with the effect that its decision will have in the eyes of rating agencies and the investment community?

A: (by Mr. Boyle): *No. I think the Commission decision under the regulatory compact is a balance between customers and the company itself, which is your debt and equity investors,* the regulatory compact, at least as I understand it, based on a lot of years involved in the industry.

So I think there's a balance there. And the company has an obligation to provide safe and reliable power. And it needs to, or deserves to then have the opportunity to earn reasonable rate of return consistent with the risk involved with the company and with other companies that experience similar risk, risk profile.

So I don't think it's just purely what's the company's ratings. *From the investor perspective, above all, I think there needs to be an overall balance.*

(Tr. at 189) (emphasis added).[1]

Mr. Boyle is correct: there *should* be an overall balance. But there is *none* in Delmarva Power & Light Company's ("Delmarva" or "DPL") requested rate increase. Delmarva stands firmly on the side of its investors. It piles millions upon millions of dollars into rate base by including what it estimates it will spend on "reliability" not just during the test period but for an entire year after the end of that test period and including assets that are not used and useful. It loads up operating expenses by including increases that will occur – if at all – well after the end of the test period and by including one-time expenses incurred years ago. It urges the Commission to authorize an inordinately high return on equity by conjuring up an ominous spectre of higher capital costs and more onerous terms for obtaining that capital, not to mention possible downgrading. And it exhorts the Commission to adopt its positions on these issues

[1]References to the exhibits admitted into evidence during the evidentiary hearings will be cited as "Ex. __." The transcript of the evidentiary hearings will be cited as "Tr. at page number." Delmarva's Opening Brief will be cites as "DOB at __."

despite the United States Supreme Court's instruction to regulators that they "cannot confine [their] inquiry either to the computation of costs of service or to conjectures about the prospective responses of the capital markets." *In re Permian Basin Area Rate* Cases, 390 U.S. 747, 791 (1968).

Including the interim rate increase currently in effect in this case, Delmarva has increased its electric and natural gas rates by more than $70 million since February 1, 2011. During this same period, the average Delmarva residential electric and natural gas customer has experienced an almost $20 per month increase. In Docket No. 09-414, Delmarva received a $16.7 million increase effective February 1, 2011, which resulted in a monthly bill increase of $3.69 for the average residential customer. In Docket No. 11-528, Delmarva received a $22 million increase effective January 1, 2013, which resulted in a monthly bill increase of $4.49 for the average residential customer. In this case, Delmarva requested a $42 million rate increase in March 2013 (reduced to $38 million in its September 2013 rebuttal testimony); on November 1, 2013 Delmarva placed a total of over $27 million of interim rates into effect (including the interim rate increase after 60 days), resulting in an additional $5.36 increase to the average residential customer. If Delmarva's full requested increase is granted, ratepayers will pay another $2.24 per month (Tr. at 190), not including the phasing-in of the AMI regulatory asset recovery. In addition, approximately 120,000 of Delmarva's electric customers are also Delmarva natural gas customers; in Docket No. 12-546, Delmarva received a $6.8 million increase business effective November 2013, which resulted in a $5.34 monthly increase to the average residential customer. All of these increases add up to almost an additional $240 annually for the average residential customer. As many of Delmarva's ratepayers struggle to make ends meet, PHI's top executives take home millions in salary, benefits, stock options and incentives, and Delmarva's employees get a raise and incentive pay almost every year.

Delmarva invokes its obligation to provide safe and adequate utility service as justification for its inflated revenue requirement, claiming that the "primary driver" of this case is the revenue effect its ongoing investments in infrastructure to "maintain and enhance reliability" to "prevent and shorten outages to meet the needs of an increasingly digital society" have had. (Ex. 17 at 3; Ex. 30 at 4-6). Indeed, its opening brief in this case devotes 21 pages (of 110) discussing its spending on alleged reliability plant. (DOB at 10-31). But its decreased revenues are not attributable solely to increased spending on reliability plant. Delmarva's revenues include supply costs (Tr. at 637-38), which comprise the majority of sales revenues, and supply revenues have been decreasing because supply costs are decreasing.

The record demonstrates that Delmarva has not supported its claimed need for $66 million of *post-test period* reliability spending in this case. It has exceeded the minimum System Average Interruption Duration Index ("SAIDI") by a wide margin for years. (Ex. 14 at Schedule DED-2). And despite its claim that its reliability investment has shown "real and measurable results for its customers" (DOB at 2), the average length of an outage that an individual customer experiences (the Customer Average Interruption Duration Index, or CAIDI") has not changed appreciably: Delmarva's CAIDI was 128 minutes in 2002, and it was 120 minutes in 2012. (Tr. at 371). Perhaps most telling, Delmarva does not explain how its investment of millions upon millions of Delaware ratepayers' dollars will make service to them *any more reliable than it already is*. One can only wonder how much of this investment is an attempt to leverage PHI's well-known and extensive reliability issues in Maryland and the District of Columbia into Delaware (where it had no such reliability problems), or how much is related to its contention that customer growth and usage are static.[2] Gold-plating a distribution system that does not require it – and making customers financially responsible for it – is not a reasonable approach.[3]

Delmarva's one-sided view of the regulatory compact is unacceptable. But it is understandable: in every rate case since Docket No. 91-20 the Commission has allowed Delmarva to include more and more post-test period plant, and more and more estimates, in its revenue requirement, which has emboldened it to request even greater departures from longstanding regulatory principles.

"An agency is not forever bound by its prior determinations and may change its mind if such change will aid it in accomplishing an appointed task, since its view of what is in the public interest may change, even if the circumstances do not." *Eastern Shore Natural Gas Co. v. Delaware Public Service Commission*, 635 A.2d 1273, 1283 (Del. Super. 1993), *aff'd*, 637 A.2d 10 (Del. Supr. 1994), *overruled on other grounds by Public Service Water Co. v. DiPasquale*, 735 A.2d 378 (Del. Supr. 1999). But the law does require it to provide a rational basis for departing from prior decisions. *Id.; see also United Water Delaware, Inc. v. Public Service Commission*, 723 A.2d 1172, 1177 (Del. Supr. 1999). One reason that justifies a departure from previous decisions is changed circumstances. In this case, Delmarva asks the Commission to reconsider its decisions on certain issues, but proffers no new or different facts or arguments that would support the Commission in departing from its prior decisions on those issues. The DPA also asks the Commission to reconsider its decisions on certain issues, but *does* proffer new and/or different facts and arguments that would justify different decisions – decisions that take

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[2]Except for Delmarva's admission that the Middletown-Odessa-Townsend area, the corridor between Dover and Harrington, and the coastal areas in Sussex County are all experiencing sufficient growth "to require action on the part of Delmarva to avoid a degradation in reliability." (DOB at 20).

[3]Delmarva states that there has been no assertion that its investment expenses are not in the best interests of its customers." (DOB at 2). With all due respect to Delmarva, we are not talking about past investment, but about projected investment. And the DPA did make such an argument in its testimony, as will be discussed *infra*.

into account the effects that Delmarva's proposed ratemaking treatment has on ratepayers. In short, the DPA asks this Commission to consider Delmarva's *customers'* interests - as well as Delmarva's stockholders - in reaching its decisions on the contested issues.

NATURE AND STAGE OF THE PROCEEDINGS

On March 22, 2013, Delmarva filed an application with the Delaware Public Service Commission ("Commission") to increase electric distribution base rates by $42,044,000 (an overall 4.97% increase in a customer's total bill but a more than 23% increase in the regulated electric distribution portion of the bill). (Ex. 1 at 3, ¶5; Ex. 16 at Ex. NP-5, p. 101). It also submitted prefiled testimony from Frederick J. Boyle, Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc. ("PHI"); Robert B. Hevert, President of Sussex Economic Advisors, LLC; Michael W. Maxwell, PHI's Vice President Asset Management; Jay C. Ziminsky, Manager, Revenue Requirements for PHI's Regulatory Affairs Department; Marlene C. Santacecelia, Regulatory Affairs Lead in PHI's Rate Economics Department; Kathleen A. White, Assistant Controller of PHI; and Elliott P. Tanos, PHI's Manager of Cost Allocation.

By Order No. 8337 dated April 9, 2013, the Commission suspended the application pending evidentiary hearings and a final decision concerning the justness and reasonableness of the proposed rates, tariffs and rate design. The Commission authorized Delmarva, pursuant to 26 *Del. C.* §306(c), to implement an annual $2.5 million increase in intrastate operating revenues effective June 1, 2013, on an interim basis and subject to refund; waived the statutory surety bond requirement in connection with those interim rates in light of Delmarva's representation that it would comply with any refund order; and waived certain Minimum Filing Requirements ("MFRs"). The Commission assigned the docket to Hearing Examiner Mark Lawrence, directing him to: (1) conduct public comment sessions and evidentiary hearings necessary to produce a full and complete record concerning the justness and reasonableness of the proposed increased rates, tariffs and rate design; (2) submit proposed findings and recommendations to the Commission; (3) rule on intervention and pro hac motions; and (4) determine the form and manner of public notices. The Commission established May 7, 2013 as the intervention deadline, and instructed DPL to publish notice of its application in *The News Journal* and the *Delaware State News* newspapers on April 23 and 25, 2013, respectively.

The Office of the Attorney General, acting for the Division of the Public Advocate ("DPA") during the vacancy in that office, moved to intervene on March 28, 2013. The Hearing Examiner granted that motion on April 11, 2013. On July 2, 2013, the Attorney General withdrew his appearance and David L. Bonar, the new Public Advocate, entered his appearance.

The Delaware Energy Users Group ("DEUG"), the Delaware Department of Natural Resources and Environmental Control ("DNREC") and the Caesar Rodney Institute ("CRI") filed motions to intervene, which were granted without objection.

On August 5, 8 and 13, 2013, the Hearing Examiner conducted public comment sessions in Wilmington, Georgetown, and Dover, Delaware, respectively. Six people commented at the Wilmington session; three people spoke at the Georgetown session; and one person attended the Dover session. The majority of the comments were from customers who were already struggling to make ends meet and feared the requested increase would have an extremely detrimental impact on their households. In addition, the Commission received more than 60 written comments from the AARP, twenty members of the Delaware House of Representatives, and Delmarva customers. The AARP and the House members urged the Commission to examine Delmarva's rate increase carefully in light of the fact that this was its third request for a rate increase in three years and the effect that the increase would have on residential customers. The comments exhorted the Commission to deny Delmarva any rate increase for one or more of the following reasons: (1) the state of the economy; (2) the effect that any rate increase would have on customers living on fixed incomes; (3) the increases in salaries being paid to top management while the salaries of customers stagnate; (4) Delmarva's rates are already some of the highest in the country and significantly higher than the Delaware Electric Cooperative's rates; and (5) Delmarva has already received rate increases in each of the past two years.

On August 16, 2013, the DPA filed direct testimony from Andrea C. Crane, Principal of The Columbia Group, Inc., who has testified in more than 350 regulatory proceedings in various states (Ex. 13 at 2 and Appendix A); David E. Dismukes, Ph.D., Consulting Economist with the Acadian Consulting Group, who has testified in numerous regulatory proceedings (including other Delmarva and Pepco matters in Maryland and the District of Columbia) and has authored hundreds of publications and made numerous presentations addressing public policy and regulatory issues in the energy industry (Ex. 14 at 1 and Attachment A); and David C. Parcell, President and Senior Economist of Technical Associates, Inc., who has testified in approximately 500 cases before various state and federal regulatory agencies (Ex. 15 at 1 and Attachment 1). Staff submitted prefiled direct testimony from David E. Peterson, a Senior Consultant with Chesapeake Regulatory Consultants, Inc.; Karl R. Pavlovic, Ph.D., a Senior Consultant with Snavely King Majoros & O'Connor, Inc.; and Stephanie L. Vavro, Principal of Silverpoint Consulting LLC. DEUG filed direct testimony from Nicholas Phillips, Jr., Managing Principal of Brubaker & Associates, Inc. Neither DNREC nor CRI submitted any direct testimony.

On September 20, 2013, Delmarva filed rebuttal testimony from Messrs. Boyle, Hevert, Maxwell, Ziminsky and Ms. Santacecelia.

On October 22, 2013 pursuant to 26 *Del. C.* §306(b), Delmarva placed an additional interim rate increase of $25,155,265 into effect under bond and subject to refund. (Order No. 8466 dated Oct. 5, 2013).

On October 2, 2013, Delmarva filed an application requesting consideration of a proposed forward-looking rate plan (the "FLRP"). In connection with its proposed FLRP, Delmarva requested the Commission to stay this case pending resolution of the FLRP, which, Delmarva argued, would also resolve this case. The DPA objected to the requested stay and, after hearing oral argument and deliberating at its public meeting on October 22, 2013, the Commission denied Delmarva's requested stay. (Order No. 8475 dated Nov. 5, 2013).

On November 12, 2013, one day prior to the commencement of evidentiary hearings, Delmarva submitted revised schedules and a letter from counsel explaining that it had mistakenly included deferred taxes in its adjustment to include post-test-year reliability plant and that it was in jeopardy of losing its eligibility to apply its net operating loss carryforward unless it removed the deferred taxes ("NOLC issue"). (Ex. 25).

The Hearing Examiner conducted evidentiary hearings on November 13, 14 and 18, 2013. During the proceedings, Delmarva sought to introduce the revised schedules into evidence; however, both the DPA and the Commission Staff objected on the grounds that they had not been given sufficient time to review the alleged issue giving rise to the proposed schedules and were unable to determine whether it was legitimate. The Hearing Examiner marked the schedules for identification but reserved decision on admitting them into the record; instead, the parties agreed that Staff and the DPA would be given time to examine the issue and would report back to the Hearing Examiner on the status of their examination via teleconference on December 9 (subsequently postponed to December 16). At the conclusion of the evidentiary hearings on

November 18, 2013, the Hearing Examiner and the parties agreed to a briefing schedule providing that Delmarva's opening brief was due on December 30; the intervenors' answering briefs were due on January 21; and Delmarva's reply brief was due on February 3. Meanwhile, on December 5, 2013, pending the teleconference, both the DPA and Staff issued discovery to Delmarva on the NOLC issue, to which responses were due on December 20.

During the December 16 status teleconference, the parties agreed that Staff and the DPA would file procedural objections regarding the NOLC issue on or before January 6, 2014 and that they would hold another teleconference with the Hearing Examiner on January 7 to discuss the procedural issues and determine whether there were any substantive issues requiring further proceedings. Delmarva also agreed to provide responses to certain of the discovery questions on or before December 18 to enable Staff and the DPA to determine whether they had procedural objections to the admission of the revised schedules.

Staff and the DPA filed procedural objections to the admission of Ex. 25 on January 6. In addition, in response to the Hearing Examiner's email correspondence seeking to close the record no later than January 24, DPA counsel advised the Hearing Examiner and the other parties that it would have a substantive response regarding Ex. 25 and expressed doubt that the record could be closed by January 24. The Hearing Examiner conducted a teleconference on January 7, during which he authorized Delmarva to file a response to the objections on or before January 13 and scheduled a further conference call for January 15. Delmarva filed its response on January 13. Less than 24 hours later, the Hearing Examiner issued a recommendation accepting all of Delmarva's arguments, denying Staff and the DPA's procedural objections, canceling the January 15 teleconference and ordering an evidentiary hearing on the ADIT issue. (January 14, 2013 Recommendation Denying Procedural Objections and Ordering Evidentiary Hearing as to the Admissibility of Exhibit 25 Proffered by Delmarva Power & Light Company). On January 17, Staff and the DPA jointly filed an interlocutory appeal of the Hearing Examiner's recommendation with the Commission.

As of the deadline for the DPA's Answering Brief, the record remains open.

This is the DPA's Answering Brief to the Hearing Examiner.

UNCONTESTED ISSUES

The DPA does not contest Delmarva's proposed test period consisting of the twelve months ending December 31, 2012, although, as will be discussed *infra*, he does contest several of its rate base and operating expense adjustments.

The DPA does not contest the following revenue requirement issues in this case:

- Rate Change from Docket No. 11-528 (Company Adjustment #1)
- Weather Normalization (Company Adjustment #2)
- Bill Frequency (Company Adjustment #3)
- Injuries & Damages Expense Normalization (Company Adjustment #6)
- Uncollectible Expense Normalization (Company Adjustment #7)
- Remove Employee Association Expense (Company Adjustment #9)
- Removal of Executive Incentive Compensation (Company Adjustment #11)
- Removal of Certain Executive Compensation (Company Adjustment #12)
- Storm Restoration Expense Normalization (Company Adjustment #13)
- Proform Advanced Metering Infrastructure ("AMI") Operations & Maintenance ("O&M") Expenses (Company Adjustment #17)
- Proform AMI O&M Savings (Company Adjustment #18)
- Proform AMI Depreciation and Amortization Expense (Company Adjustment #19)
- Normalize Other Taxes (Company Adjustment #25)

- Amortization of Actual Refinancing Costs (Company Adjustment #27)
- Remove Qualified Fuel Cell Provider Project Costs (Company Adjustment #28)
- Remove Post-1980 Investment Tax Credit Amortization (Company Adjustment #30)
- Removal of Renewable Portfolio Standards Labor Charges (Company Adjustment #32);
- Interest Synchronization (in concept) (Company Adjustment #33);[4]
- Proform Other Post-Employment Employee Benefits Expense (Company Adjustment #35); and
- Income Tax Factor and Revenue Multiplier.[5]

The DPA *does* object to Delmarva's request that the Commission specifically recognize the uncontested adjustments "to allow [it] and the participants in future proceedings to appropriately reflect accepted Commission ratemaking practices." (DOB at 50-57). Delmarva asked the Commission to do the same thing in Docket No. 09-414, but the Commission specifically declined Delmarva's invitation:

> We approve these uncontested adjustments, but, like the Hearing Examiner, we decline to specifically approve the ratemaking treatment of those uncontested matters. There are many reasons why a party may choose not to challenge a particular adjustment in a particular case. We do not wish to preclude any participant from challenging the proposed ratemaking treatment of any of these uncontested issues in a future case. Therefore, although we approve the amount of the uncontested adjustments for cost of service purposes in this case, we will not tie the participants' hands in future cases by also approving the ratemaking treatment of those issues.

[4]The DPA accepts in this case the conceptual basis of the interest synchronization adjustment, but the amount of his adjustment differs from Delmarva's because of their positions on other issues. (Ex. 13 at 57).

[5]The DPA accepts in this case the income tax factor and revenue multiplier that Delmarva used, but the amount of his adjustment differs from Delmarva's because of their different revenue requirements. (Ex. 13 at 57-58).

In the Matter of the Application of Delmarva Power & Light Company for an Increase in Electric Rates and Miscellaneous Tariff Changes, PSC Docket No. 09-414, Order No. 8011 (Del. PSC August 9, 2011) at ¶37.[6]

The DPA respectfully requests the Hearing Examiner to do the same in this case. Not only should the parties' hands not be tied in future proceedings, but the Commission should not be deemed to have rendered a decision on an issue that it did not specifically address.

The DPA does not contest Delmarva's proposed capital structure or cost of long-term debt in this case, although it contends that if the Commission accepts DPL's adjustment to include the costs of its credit facility in the revenue requirement, it should also include the short-term debt that that facility represents in the capital structure.

ARGUMENT

I. *DELMARVA* – NOT THE DPA AND NOT THE COMMISSION STAFF - BEARS THE BURDEN OF ESTABLISHING THAT ITS PROPOSED RATES ARE JUST AND REASONABLE.

Section 311 of the Public Utilities Act of 1974 (26 *Del. C.* §101 et seq.) (the "Act") obligates the Commission to consider a utility's revenue needs and its past and projected rates of return in establishing just and reasonable rates. 26 *Del. C.* §311. But the utility must justify "every accounting entry of record questioned by the Commission ...," 26 *Del. C.* §307(b), and the *utility* – not the DPA, not Staff, and not any other party - ultimately bears the burden of proving that its proposed rates are just and reasonable:

> ... [U]pon application of a public utility, involving any proposed or existing rate of any public utility or any proposed change in

[6]http://depsc.delaware.gov/orders/8011.pdf . In an attempt to reduce the amount of paper accompanying this brief, the DPA is including links to the cases cited in this brief in support of its arguments. The page reference is to the page in the linked document rather than the Westlaw citation. If there is no link to a commission decision, the DPA will include only the pages of the order or opinion pertinent to the particular issue, since some of these orders and decisions are quite long. The DPA will attach copies of the unreported Delaware court cases cited in this brief, but copies of cases available from the West reporting system (such as Atlantic, North Eastern, Pacific, etc. Reporters) are not being provided.

> rates, the burden of proof to show that the rate involved is just and reasonable is upon the public utility.

26 *Del. C.* §307(a); *see also Matter of Slaughter Beach Water Co.*, 427 A.2d 893, 895 (Del. 1981).

This is important, because in its opening brief Delmarva seems to suggest that a party opposing an adjustment or proposing an adjustment to a rate base or operating expense item has the burden of persuading the Commission that it is correct.[7] Not so. The utility *always* bears the burden of establishing that any expense item that a party challenges is not the result of waste, bad faith or an abuse of discretion or does not violate the Act, and ultimately convincing the Commission that its proposed rates are just and reasonable:

> 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.

In the Matter of the Application of Artesian Water Co., Inc. for an Increase in Water Rates, Docket No. 90-10, Findings and Recommendations of the Hearing Examiner, March 8, 1991 at 34-35. The Commission affirmed the Hearing Examiner's recommendation. *Artesian Water,* Order No. 3274 (May 28, 1991).

Moreover, Delmarva's sole reliance on testimony and schedules is insufficient. As the Utah Supreme Court has stated:

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[7] *See, e.g.*, DOB at 79 (rate case expense); 96 (non-executive incentive compensation); 98 (corporate governance expenses).

> The company must support its application by way of substantial evidence, and the mere filing of schedules and testimony in support of a rate increase is insufficient to sustain the burden. Rate making is not an adversary proceeding in which the applicant needs only to present a prima facie case to be entitled to relief.

Utah Department of Business Regulation, Division of Public Utilities v. Public Service Commission, 612 P.2d 1242, 1245-46 (Utah Supr. 1980); *see also The C & P Telephone Co. of W. Va. v. Public Service Commission of W. Va.*, 307 S.E.2d 798, 807 (W. Va. Supr. Ct. App. 1983) (commission has duty to go beyond company's schedules and submissions).

The DPA will demonstrate that Delmarva has failed to carry its burden on the issues the DPA is contesting, and thus its proposed rates are neither just nor reasonable.

II. OVERVIEW OF THE PARTIES' REVENUE REQUIREMENTS POSITIONS

Delmarva selected a historical test year and test period consisting of the twelve months ended December 30, 2012. (Ex. 2 at 4). After making several adjustments to include post-test-period rate base additions and post-test-period expense increases (but not post-test-period revenue increases, it calculated a revenue deficiency of $38,976,366, derived from a rate base of $745,604,175; an overall rate of return of 7.53% and cost of equity ("COE") of 10.25% on a capital structure consisting of 50.78% long-term debt and 49.22% common equity; and pro forma operating income of $33,298,159. (Ex. 2 at 4, 6; Ex. 20 at Sch. (JCZ-R)-1, p. 3).

The DPA calculated a revenue deficiency of $7,475,510[8] on a rate base of $553,669,028; an overall rate of return of 7.09% and COE of 9.35% on a proposed capital structure consisting of 50.78% long-term debt and 49.22% common equity; and operating income at present rates of

[8] Ms. Crane testified at the evidentiary hearing that in rebuttal Delmarva established to her satisfaction that it had not included in its initial filing certain corporate governance expenses to which she had objected, so her adjustment to remove such expenses required correction. (Tr. at 543-46 and Ex. 13 at Schedule ACC-31; Ex. 99). With that correction, the DPA's recommended revenue deficiency increased to $7,475,510.

$34,970,409. (Ex. 13 at 4 and Schedules ACC-1, ACC-2 and ACC-16; Ex. 15 at 2 and Schedule DCP-1; Ex. 99).

Staff calculated a revenue deficiency of $11,442,413 on a rate base of $577,744,302; an overall rate of return of 7.09% and COE of 9.35% on Delmarva's proposed capital structure;[9] and operating expenses under present rates of $34,318,925. (Ex. 11 at 5 and Ex. 11 (DEP-1), Schedule 1, p. 1).

III. RATE BASE ISSUES

A. The Commission Should Reject Delmarva's Attempt to Include a Full Year of "Reliability" Additions Beyond the End of the Test Period That *It* Selected.

In its direct testimony, Delmarva proposes Adjustment 26 ("Adjustment 26"), which includes in rate base $66,794,140 of so-called "reliability" improvements and enhancements that it expected to make during the calendar year 2013 – one full year beyond the close of the test period. (Ex. 5 at 27-28 and Schedule (JCZ)-25). Delmarva claims that it is necessary to include the Adjustment 26 plant in rate base to mitigate what it calls the negative effects of regulatory lag. (Ex. 14 at 5-6, citing PHI Second Quarter 2013 Earnings Call, August 7, 2013 at p. 8; Ex. 17 at 6). In rebuttal, Delmarva separates Adjustment 26 into two parts: Part (a) seeks recovery of the "actual" reliability investment from January through August 2013, and Part (b) seeks recovery of the estimated reliability investment that it expects to place into service by the end of 2013, which Delmarva claims is the rate effective period. (Ex. 20 at 52-56 and Schedules (JCZ-R)-6 and (JCZ-R)-7). Adjustment 26 has one of the largest effects on Delmarva's revenue requirement in this case and is one of the most hotly contested adjustments.

The DPA respectfully submits that the Commission should reconsider its prior decisions with respect to including post-test period plant in rate base and should reject Adjustment 26 in its

[9] Staff relied on DPA witness Parcell's return recommendations in determining Staff's overall revenue requirement. (Ex. 11 at 5).

entirety based on the circumstances of this case. As we will show, the real driver of this reliability spending is Delmarva's desire to avoid the fate that befell its affiliate Pepco in Maryland. But Delmarva's performance in Delaware is very, very different from Pepco's in Maryland; Delmarva's performance in Delaware has blown away the Commission's reliability standards. While the DPA acknowledges that Delmarva must maintain and replace its equipment in order to satisfy its statutory obligation to furnish safe, adequate and proper service,[10] its proposal to include $66.8 million of post-test period "reliability" plant – with *no evidence other than its say-so that customers will see any increase in reliability from that $66.8 million* – is unsupported and unjustified.[11]

1. <u>All Plant Is "Reliability" Plant to Some Degree.</u>

Delmarva chastised Staff (and to a lesser degree, the DPA) for making a distinction between "REP projects and "non-REP" projects because all of the projects will maintain, improve or enhance reliability. (Tr. at 376-77). If this is so, then why did Delmarva itself specifically call the projects "reliability" projects in its direct case? (*See* Ex. 2 at 10; 4 at 2-3; Ex. 5 at 27-28). Moreover, Delmarva itself used those designations. *See* Ex. 14 at 18-19 and Sch. 18, PSC-REL-8:

> Please refer to AG-REL-3 Attachment A and Attachment B.
>
> (a) Please explain what distinguishes a project that the company identifies as non-REP (Attachment B) versus REP (Attachment A).
>
> * * *
>
> a. The REP is a way to combine the efforts into one program that discuss the commitment that the Company is making to continuously improve its reliability

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[10] DOB at 8, quoting 26 *Del. C.* §209(a)(2).

[11] DPL correctly notes that the DPA is not challenging the additions to rate base made during the test period. (DOB at 10 n.25). But it is important to set the stage of how Delmarva got to where it is in this case.

> performance. The REP is an integral part of the Company's overall expansion-related efforts. REP work is identified based on the following work criteria, Priority Feeder Upgrades, Underground Residential Cable Upgrades (URD), Distribution Automation, Feeder Reliability Improvements, Conversions, Substation Reliability Improvements, Feeder Load Relief. Non-REP projects are comprised of all other work.

A cynic might suggest that Delmarva's designation of the Adjustment 26 plant as "reliability" plant was deliberately chosen to persuade the Commission of the importance of *these* projects compared to other projects. The DPA will take Delmarva at its word that *all* of its projects are intended to maintain, improve or enhance reliability – which means that the Adjustment 26 projects are no more or less important than projects that did not make the REP.

2. <u>Delmarva Plans to File Annual Rate Cases, So the Post-Test Period Plant That It Attempts to Include in This Case Will Be Included in Its Next Case.</u>

Before addressing the substantive arguments that justify rejecting Delmarva's overreaching in including a full year of post-test period "reliability" plant in rate base in this case, the DPA respectfully submits that the adjustment can be denied based on a single change in circumstances: Delmarva now intends to file annual rate cases.

Delmarva attempts to justify Adjustment 26 by saying that the Commission allowed post-test-period adjustments in prior cases. (Ex. 20 at 53-54). Delmarva is correct: the Commission *did* allow post-test period adjustments in prior cases. But the Commission in Docket No. 09-414 emphasized that its decision was based on the circumstances presented in that case. *Delmarva Power*, Order No. 8011 at ¶60; *see also* Ex. 13 at 7. The factual circumstances under which the Commission allowed such adjustments in previous cases are *very* different from those presented in this case.

Perhaps most importantly, in those cases Delmarva was not on record as saying that it would file rate cases every nine to twelve months. Compare the length of time between cases since Docket No. 91-20, the first case Delmarva discusses in which the Commission approved a post-test period plant addition, and this case:

- Between Docket No. 91-20 and next case, Docket No. 05-304: 15 years[12]
- Between Docket No. 05-304 and next case, Docket No. 09-414: 4 years
- Between Docket No. 09-414 and next case, Docket No. 11-528: 2 years

The time between cases perhaps provided some justification for including certain post-test-period adjustments in the revenue requirement because there was no guarantee that Delmarva would file another rate case within a short period of time.

But we *have* that guarantee in this case. Frederick Boyle, PHI's Chief Financial Officer and Delmarva's policy witness in this case, confirmed that PHI intends to file rate cases every nine to twelve months:

> Q: Am I also correct that the company is committed, and by company, I mean PHI, to filing rate cases every nine to twelve months?
>
> A: Yes. The company has been clear that given the level of spend we have, in all of our jurisdictions, and the lack of customer growth, that the combination of those where we're going to have rate base increasing in the eight to ten percent range, with very little, if any, customer or load growth, that the combination of those will drive the need to file rate cases on an annual basis barring some change in the regulatory paradigm.

(Tr. at 257; *see also* Ex. 34 at 8 (June 2013 investor meeting presentation references "frequent rate case filings")).

Here, Delmarva used a test period consisting of the historical twelve months ended December 31, 2012. It also used an historical test period in Docket Nos. 11-528, 09-414, and 05-304. Past history suggests that Delmarva will use a calendar year 2013 test period when it files its 2014 case. Thus, its rate effective period in this case is likely to be the same period as its test

[12]The DPA notes that a rate freeze was in effect from 1999 until May 1, 2006.

period in the next case. Under the circumstances of *this* case, there is no need to include Adjustment 26's post-test period plant in rate base in this case because they will be in the test period in Delmarva's next case.

Second, in Docket Nos. 05-304 and 09-414, DPL did not seek to include an entire year's post-test period projected rate base additions. In Docket No. 05-304, it sought to include plant additions only four months beyond the end of the test period, and in Docket No. 09-414 it sought to include additions nine months beyond the end of the test period. In Docket No. 11-528, it asked for a full year of post-test period additions, but that case was settled with no specific Commission discussion of the plant additions. *See In the Matter of the Application of Delmarva Power & Light Company for an Increase in Electric Base Rates and Miscellaneous Tariff Changes*, Docket No. 11-528, Order No. 8265 (Dec. 18, 2012) (adopting Hearing Examiner's Report recommending approval of settlement agreement).[13] So while Delmarva is correct that the Commission has allowed post-test period additions to plant, it is *incorrect* in suggesting that the Commission has approved this specific adjustment.[14] The Commission has never approved an entire year's worth of post-test period plant as Delmarva seeks here.

3. AMI Was Supposed to Improve Reliability.

In 2007, Delmarva filed an application with the Commission called Blueprint for the Future seeking authority to implement AMI (among other things). One of its selling points for AMI was that it would improve reliability and potentially delay or obviate investment in Delmarva's transmission and distribution system:

> Delmarva is deploying a number of innovative technologies. *Some, such as the automated distribution system, will help to improve reliability….*

[13]http://depsc.delaware.gov/orders/8265.pdf

[14]Delmarva implicitly admitted this in its rebuttal testimony when it divided its adjustment into two parts: actual additions through August 2013 and projected additions from September through December 2013. (Ex. 20 at 52-54).

*   *   *

> These savings estimates do not include potential additional customer benefits from reducing transmission losses, *improving reliability*, reducing rate volatility, enhancing market competitiveness, improving environmental quality, reducing energy prices by lowering the costs of environmental compliance, or *potentially obviating or delaying the need for investments in transmission and distribution* … .

In the Matter of the Filing By Delmarva Power & Light Company for a Blueprint for the Future Plan for Demand-Side Management, Advanced Metering, and Energy Efficiency, Docket 07-28, Business Case at 2, 24 (emphasis added) (Attachment A).

The Commission approved AMI implementation and also granted Delmarva regulatory asset treatment of the costs it incurred in implementing AMI. *In the Matter of the Investigation of the Public Service Commission Into Revenue Decoupling Mechanisms for Potential Adoption and Implementation by Electric and Natural Gas Utilities Subject to the Jurisdiction of the Public Service Commission*, Regulation Docket No. 59, and *In the Matter of the Filing by Delmarva Power & Light Company for a Blueprint for the Future Plan for Demand-Side Management, Advanced Metering, and Energy Efficiency,* Docket No. 07-28, Order No. 7420 (Del. PSC Sept. 16, 2008) ("Order No. 7420").[15] Delmarva began recovering the $39 million of AMI-related costs as a result of the settlement in Docket No. 11-528. *Delmarva Power*, Order No. 8265 (adopting Hearing Examiner's Report recommending approval of settlement agreement; Hearing Examiner's Report at ¶30). Thus, Delmarva ratepayers are already paying $39 million for plant and other costs associated with AMI that was supposed to, among other things, improve reliability and potentially delay or obviate the need for distribution investments. If millions upon millions of dollars are now required in Delaware to improve distribution reliability, then at least part of the justification for saddling Delaware customers with 100% recovery of the AMI costs was a false promise.

[15] http://depsc.delaware.gov/orders/7420.pdf

4. **The Real "Reliability" Investment Driver Is What Happened to Pepco in Maryland.**

The discussion in this section comes from the Maryland Public Service Commission's ("Maryland PSC") decision in *In the Matter of an Investigation Into the Reliability and Quality of the Electric Distribution Service of Potomac Electric Power Company,* Case No. 9240, Order No. 84564 (Md. PSC Dec. 21, 2011) ("*Investigation Case*").[16]

After receiving what it called "an unusually high number of complaints from customers and elected officials," the Maryland PSC initiated an investigation in August 2010:

> … to investigate, among other things, (i) the number of customers affected by recent power outages in the Pepco service territory, (ii) the root cause for the scope, frequency and duration of storm and non-storm outages, (iii) communication failures between Pepco and its affected customers, and (iv) Pepco's inability to communicate estimated times of restoration ("ETRs") to affected customers in a timely and accurate manner. …

Investigation Case at 5. It also directed Pepco to meet with PSC Staff to develop a request for proposals for an independent consultant to assess Pepco's distribution service reliability as well as other matters. (*Id.*).

On August 17, 2010, Pepco presented the elements of a Reliability Enhancement Plan ("REP") that proposed to invest approximately $250 million over five years to enhance system reliability. (*Id.* at 6 and n.6).

In October 2010, the Maryland PSC selected consultants to perform the assessment of Pepco's distribution service reliability and the other identified topics. (*Id.* at 7). The consultants filed their report on March 2, 2011, and various parties, including Pepco, filed testimony and

[16] http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\CaseNum\9200-9299\9240\107.pdf

reports. (*Id.* at 8-9).[17] The Maryland PSC conducted an evidentiary hearing and various parties filed post-hearing briefs. (*Id.* at 9).

The Maryland PSC began by observing that "Pepco offers myriad excuses for its performance, but we are not buying." (*Id.* at 1). Instead, it concluded that the evidence "demonstrates conclusively that Pepco has been operating at an unacceptably low level of reliability *for several years.*" (*Id.* at 28). It went on to state:

> ... Pepco's SAIFI figures that exclude significant weather related outages serve as particularly strong indicators of the utility's lack of inherent (day to day) reliability *during the last several years*. As Mr. Lanzalotta testified, "reliability indices excluding major events are typically considered to be more representative of the basic reliability in the design, construction and maintenance of a utility's electric system." The fact that Pepco's SAIFI figures, adjusted for major outages, declined every year from 2004 to 2010 speaks volumes about its steadily deteriorating level of reliability and coincides with its poor vegetation management practices ... We also find that Pepco's deteriorating level of reliability as measured by SAIDI and SAIFI reflect more than just anomalous weather conditions. As Mr. Lanzalotta explained, it is his expert opinion that "Pepco's overall reliability performance has exhibited a constant worsening of customer outage frequency in its Maryland service area over the past seven years" and that this deterioration "reflect[s] more than just variations in weather." Indeed, Mr. Lanzalotta testified that Pepco's history of poor vegetation management and lack of inspections made the Company's electric system highly vulnerable to the 2010 storms, greatly increasing the frequency and duration of interruptions "from what would have been expected in the event of adequate system maintenance."

(*Id.* at 28-29) (footnotes omitted).

The Maryland PSC summarily dismissed Pepco's contention that the reliability indices should be disregarded because there are normal yearly variations caused by external conditions such as weather:

> ... [T]he Consultants' Report and the parties' testimony that commented on reliability indices discussed the prolonged trend in Pepco's Maryland service territory, usually from 2004 to 2010, rather than focusing on one year. We

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[17]Delmarva witness Maxwell presented direct and reply testimony in the Investigation Case. *Investigation Case* at 17-19, 21-22.

> therefore reject the contention that the reliability indices are not indicative of reliability problems.

(*Id.* at 29).

It similarly rejected Pepco's contention that the data should be given little reliance because severe weather can have lingering effects on the electric system:

> *First*, as Mr. Gausman acknowledged, the Consultants and the parties analyzed reliability indices that excluded major storms and major event days. *Second*, Pepco should have conducted inspections to locate and remediate weakened or vulnerable infrastructure after major storms passed through its system to address the very threats Mr. Gausman articulated – a process that the Company failed to follow.

(*Id.* at 29-30) (emphasis in original).

The Maryland PSC was unpersuaded by Pepco's argument that reliability indices were not useful measures of its performance because of the "'substantial canopy of very mature trees'" in its service territory:

> *First*, as a matter of policy, each utility has an obligation to provide reliable service based on the particular circumstances and characteristics of its service territory. As Montgomery County states, "these reliability statistics are extremely important because what they are comparing is how well each utility has met the challenges it faces in order to provide its customers with reliable electric service, regardless of the fact that each utility faces different challenges." To the extent Pepco has a substantial mature tree canopy, it should be more active than other utilities n executing tree-trimming and after-storm inspections – it is not perpetually relieved from the obligations of maintaining a reliable system. *Second*, Mr. Lanzalotta found that the percentage of population-weighted urban tree canopy for BGE and Pepco service territories is identical. Moreover, when Mr. Lanzalotta examined the suburban-only population of the companies' service territories, he found BGE's urban tree canopy to be slightly higher than Pepco's. . . .

(*Id.* at 31) (emphasis in original) (footnotes omitted).

Addressing Pepco's argument that its implementation of an Outage Management System ("OMS") between 2002-03 caused the upward trends in SAIDI and SAIFI to be misleading, the Maryland PSC concluded:

> This argument is unpersuasive on its face. Pepco does not argue that its OMS over-reported, rather, the Company claims that the OMS *more accurately* measured reliability, which has been established to be in the bottom quartile for SAIFI and the bottom half for SAIDI. Therefore, even if we were to accept that Pepco's OMS reports substantially more outages than its prior system did in 2002 (and having received only unsupported allegations, we do not find that Pepco has established that fact), it would only demonstrate that Pepco was less reliable n 2002 than the Commission had previously believed.

(*Id.* at 31) (emphasis in original) (footnotes omitted).

The Maryland PSC rejected a contention from a non-employee Pepco witness that there was no evidence of reliability problems:

> ... [W]e reject Dr. Brown's bald assertion. Substantial evidence demonstrates that Pepco failed to provide adequate vegetation management and neglected to inspect its system, leading to declining reliability indices and heightened vulnerability to major storms. Mr. Gausman attempted to place a positive spin on a bad situation by stating that "things were stable." Nevertheless, as he later conceded during questioning, Pepco was only stable in the sense that in the years prior to 2010, it remained stagnated in fourth quartile performance with regard to SAIFI and bottom half performance regarding SAIDI, even excluding major storm events. Thus, in 2010, by any measure, the Company's performance deteriorated still further.

(*Id.* at 32) (footnotes omitted).

Next, it rejected Pepco's claim that customer expectations are "significantly different" than in the past as a result of their growing dependence on electricity at home: [18]

> ... [W]e find that the expectations of Pepco's customers were not unreasonable, nor were customer complaints limited to events surrounding the 2010 storms. Rather, the public comment hearings held in this proceeding, coupled with the findings of the Montgomery County Work Group and the public comments of Gaithersburg, demonstrate that customers have been unsatisfied with Pepco's level of reliability for years prior to 2010.

(*Id.* at 33) (footnotes omitted).

The Maryland PSC then discussed Pepco's vegetation management practices over the years and concluded that "reliability had deteriorated as a result of insufficient vegetation

[18]Company witness Maxwell makes the same assertion in his rebuttal testimony in the instant case. (Ex. 19 at 4).

management. (*Id.* at 42). It found that Pepco's vegetation management had been inadequate for quite some time and that Pepco had failed to meet its tree trimming goals or to adequately fund vegetation management. (*Id.* at 42-43). It also found that Pepco had failed to conduct either periodic inspections of its sub-transmission lines or after-storm inspections or patrols (indeed, it noted Pepco's admission that it had no procedure for specific periodic inspections of its overhead sub-transmission lines), and that this failure had resulted in a system highly vulnerable to storm damage. (*Id.* at 49-50).

As a result of its findings, the Maryland PSC imposed on Pepco a $1 million fine. (*Id.* at 57). It observed that a larger fine would have been justified, but it believed the money would be better spent on improving reliability than on additional penalties for past behavior. (*Id.* at 58-59). As it was, the Maryland PSC believed that the $1 million fine sent "an appropriately serious message." (*Id.* at 57). Later, in Pepco's next base rate case, the Maryland PSC disallowed $6.4 million of test period O&M costs that it found Pepco had spent to "catch up for its years of system neglect" and disallowed the $1.5 million of expert witness and outside counsel fees it had incurred in Case No. 9240. *In the Matter of the Application of Potomac Electric Power Company for Authority to Increase Its Rates and Charges for Electric Distribution Service,* Case No. 9286, Order No. 85028 (Md. PSC July 20, 2012) at 2, 39, 64.[19]

DPL witness Maxwell says that Delmarva learned from the Maryland experience and "is applying that knowledge across its sister companies," and that should be viewed positively. (Ex. 19 at 13). He dismisses the concern that Delmarva is leveraging its affiliates' reliability problems in other states in Delaware. (*Id.*). But he then goes on to testify that "[t]he REP projects that Delmarva Power is pursuing in Delaware are the same type of projects that Delmarva's affiliated

[19] http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\CaseNum\9200-9299\9286\117.pdf

utilities are conducting in Maryland." (*Id.* at 20). And the projects that Delmarva's affiliates put into their REPs in Maryland and the District of Columbia were a direct response to those affiliates' reliability problems in those jurisdictions. (Ex. 12 at 5).[20]

In Delaware, however, Delmarva had no such reliability problems. It was meeting the Regulation Docket No. 50 reliability standards with relative ease. (Ex. 14 at Sch. DED-2). And Delmarva has not identified any specific (or even general) events *in Delaware* that have caused any concern about Delmarva's reliability *in Delaware*. The DPA respectfully submits that there is only one logical conclusion to the question of why Delmarva has put spending on "reliability" projects in Delaware on hyperspeed. Understandably, it does not want what happened to Pepco in Maryland to happen to it in Delaware. But how realistic is that concern and how much should Delaware ratepayers have to pay in the rates approved in this case? There is no evidence that Delmarva neglected its maintenance and repair responsibilities in Delaware (as there was in Maryland). In light of the fact that Delmarva claims that its customer base is not growing fast enough to provide additional revenues, the only way it can increase revenues is to increase its rate base. Hence the attempt to include not only the significant amount of rate base added during the test period, but also a full year's worth of proposed additions for a full year thereafter.

4. **<u>Delmarva's Justifications for the Post-Test Period Additions Are Unavailing.</u>**

Delmarva proffers several justifications for including the $66.8 million of post-test period reliability expense in rate base in *this* case. First, it says that customers expect and need enhanced reliability because of their growing dependence on reliable electricity in an increasingly digital/electronic society and economy. (DOB at 12-13). Second, it says that the increase in the frequency and severity of storms poses new system reliability challenges to utilities. (*Id.* at 13-14).

[20]Staff witness Vavro noted that the District of Columbia's investigation into Pepco's reliability had been going on for more than a decade when Pepco filed its REP with that jurisdiction. (Ex. 12 at 5 n.2).

Third, it says it must replace aging infrastructure to avoid diminished system performance and increased customer outages. (*Id.* at 14-16). Fourth, it says that customer surveys have "consistently established" that system reliability and restoring service rapidly after outages are the most important issues to them. (*Id.* at 16-17). Fifth, it says its performance compared to its peers provides it with "another useful indicator" of the level of reliability for which it should strive. (*Id.* at 17-19). Sixth, it says it exercised professional judgment in selecting the initiatives it would pursue to maintain and enhance reliability. (*Id.* at 19-25). Last, it argues that Staff and its consultant have offered no evidence that (1) Delmarva failed to exercise professional judgment in determining that reliability should be improved or that the initiative it selected were "anything other than appropriate." (*Id.* at 25-31). None of these justifications is persuasive.

a. Customers Have Always Expected Reliable Service.

Delmarva first contends that customers expect greater reliability in an increasingly digital and electronic society. (*Id.* at 12-13). The DPA observes that customers pay Delmarva considerably for reliable service, so it is not unreasonable that that is what they expect to receive. They are not paying for, nor should they expect to pay for, *un*reliable service. And as the Maryland PSC found, customers' expectations have not changed in that regard.

b. Delmarva Has Not Adduced Any Evidence That Its 2013 Level of Projected Investment Will Improve or Enhance Reliability in Delaware.

Delmarva says that another "significant factor" in its investment decisions is the increased frequency and severity of storms, which have posed new challenges to utilities. (*Id.* at 13). It cites the damage that Hurricanes Isabel and Sandy and the 2012 Derecho caused in neighboring jurisdictions. And it refers to the August 2013 report of the President's Council of Economic Advisors and the Department of Energy finding that outages from severe weather cost the U.S. economy billions of dollars annually. Delmarva concludes that modernizing the grid will save the economy billions of dollars and reduce hardships experienced by Americans. (*Id.* at 13-14).

The DPA does not dispute that Delaware was largely spared by Hurricane Sandy and the 2010 Derecho. Nor does it dispute that outages have a significant effect on the economy and that customers often experience hardships as a result of severe storms. But Delmarva has produced no *evidence* that the post-test period investment that it seeks to include in rate base in this case will result in any appreciable improvement in its reliability *in Delaware*. It provided no quantification of the benefits of the reliability improvements or enhancements in terms of avoided outages or reduced outage minutes. (Ex. 14 at 14-15; Tr. at 399). Dr. Dismukes testified that he had asked DPL to provide any evaluations or analyses performed to identify projects that would improve reliability. Delmarva responded that it did not "engage in traditional economic analysis of work because the costs, measured in dollars, and the benefits accrued, measured in reliability performance, do not lend themselves to those forms of analysis." *Id.* at 11, citing Delmarva's response to PSC-REL-18). Instead, it provided "its budgeting process, ... a Work Request process used to identify the scope of projects, ...its 'Asset Management/Asset Performance Planning and Equipment Condition Assessment' procedures, ... a document entitled 'Description of Delmarva Power's Planning Process,' and ... a list of approved expenditures." (Ex. 14 at 14). But as Dr. Dismukes pointed out, none of these documents contains a specific analysis of any of the Adjustment 26 projects, and none provides any discussion of how any of the projects would contribute to future reliability. (*Id.*).

This testimony apparently stung. Much of Mr. Maxwell's rebuttal testimony knocks down the straw man argument that it would not be feasible to perform a cost-benefit analysis on every project (despite the fact that Dr. Dismukes never testified that Delmarva should perform a cost-benefit analysis for every single project). Delmarva spent hours examining Mr. Maxwell on "redirect" about how PHI evaluates its projects for necessity and cost-effectiveness and introduced during that redirect numerous documents purporting to show PHI's policies on various activities and how PHI actually does assess the costs and benefits of projects. (Tr. at 700-56, 787-91; Exs. 72-84; DOB at 19-25). Dr. Dismukes already knew all of this, however. He had already reviewed the documents that Delmarva introduced on redirect: he testified that DPL stated that "it employs a variety of other methods to ensure that investments are developed in an 'economic' manner, such as: competitive bidding of materials and use of standard engineering design and work practices to ensure that the work is accomplished such that it meets all applicable standards." But, he testified, these are not cost-benefit analyses. (Ex. 14 at 10-11, 14 citing Delmarva's response to PSC-REL-18; *id.* at 14). Nothing that Delmarva introduced into evidence at the hearing addressed any of the specific reliability projects contained in Adjustment 26. If such evidence existed, wouldn't it be fair to assume that Delmarva would have addressed it in its rebuttal, or at the very least during its extended redirect examination of Mr. Maxwell?

Moreover, we know that cost-benefit analyses *can* be done; in fact, Delmarva's affiliate Pepco recently filed a cost effectiveness analysis of its proposed selective underground proposals in Maryland and the District of Columbia, in which it used the results of a 2008 Department of Energy meta-study to evaluate the reductions in outage costs for residential customers as a benefit associated with its selective undergrounding proposal and then compared those benefits to the undergrounding program costs. (Ex. 14 at 12). Furthermore, the Maryland PSC has explicitly directed electric utilities subject to its jurisdiction to include a cost-benefit analysis for every reliability improvement proposed in their short-term five-year plans, so Delmarva is going to have to perform cost-benefit analyses for the projects in its Maryland REP. *In the Matter of* *the Electric Service Interruptions in the State of Maryland Due to the June 29, 2012 Derecho Storm*, Case No. 9298, Order No. 85385 (Md. PSC Feb. 27, 2013) at 3-4 (Ex. 44). This belies Delmarva's contention that the traditional economic cost-benefit analyses cannot be done because the costs and benefits of its reliability plans do not lend themselves to such analysis.[21]

Essentially, Delmarva is saying "trust us on this." The DPA respectfully submits that "trust us" does not satisfy Delmarva's burden of proof. There is no evidence in this case that those projects will make its system performance any better during severe storms or even on blue-sky days. It performed no cost-benefit, cost-effectiveness or value of service studies for any of the post-test period projects contained in Adjustment 26, and provided no quantification of the benefits of any of the projects to customers who are being asked to pay for them.

c. **The ASCE Reports Do Not Support Adjustment 26.**

Delmarva says that it must replace aging infrastructure to avoid diminished system reliability and increased customer outages. In this section, it addresses its policies for replacing aging URD cable, substation transformers and substation switchgear, and refers to two American Society of Civil Engineers' reports from 2011 and 2013 (separately, the " 2011 Report" and the " 2013 Report," and

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[21]Mr. Maxwell says that Delmarva does not perform a cost-benefit analysis when a customer requests service because it has an obligation to serve. (Tr. at 381). But that is not always true, however. Section VII-B of Delmarva's electric tariff states:

> Where the Applicant requests the Company to install facilities which are more costly than those normally furnished, *and the Company agrees, the Applicant will be charged the difference in cost.* Where the Applicant, by virtue of site conditions, causes a more costly than normal installation or maintenance, the Applicant will be charged the difference in cost. The calculation of the difference in cost shall be based on a standardized costing approach that includes all costs, including but not limited to: actual expenses incurred for materials and labor (including both internal and external labor) employed in the design, purchase, construction and/or installation; costs of permits and rights-of-way acquisition; corporate overheads (including engineering, supervision and administrative and general costs) and other loading factors, and any applicable taxes associated with a Contribution in Aid of Construction or otherwise.

http://www.delmarva.com/_res/documents/DEMasterTariff.pdf (emphasis added). This suggests that Delmarva has done *some* cost-benefit analysis to determine what it normally furnishes.

collectively "the ASCE Reports") awarding a D+ to the nation's electric grid and discussing the harm to the nation's economy if the grid is not upgraded. (DOB at 14-15, 20-21 and Attachments 3 and 4).

The DPA agrees as a general matter that reliable electric power is vital to the nation as a whole and that aging infrastructure that has reached the end of its useful life should be replaced. But that is as far as the agreement goes on the evidence in this case.

First, DPL witness Maxwell specifically rejected the suggestion that equipment age alone determines whether it should be replaced. (Tr. at 316).

Second, Delmarva tied none of the policies that it discussed to specific Adjustment 26 projects.

Third, the ASCE Reports address the *national* grid, with specific emphasis on *transmission:*

> The electric grid *in the United States* consists of a system of interconnected power generation *transmission* facilities ...
>
> * * *
>
> With the addition of new gas-fired and renewable generation, the need to add new *transmission* lines has become even greater.
>
> * * *
>
> Congestion at key points in the electric *transmission* grid has been rising over the last five years, which raises concerns with distribution, reliability and cost of service. ... This congestion can lead to system-wide failures and unplanned outages. ... Utilities also often pass on "congestion charges" to consumers when *transmission* lines are overloaded.
>
> * * *
>
> New *transmission* lines are being planned in response to the need for integrating and delivering new energy sources. ... However, the permitting and siting of these *transmission* lines often meet with public resistance, which can result in significant project delays or eventual cancellations while driving up costs. ... The result is that while new *transmission* lines are needed, many are being delayed due to permitting issues.
>
> * * *

And the solutions that the ASCE proposes are *national* ones, not local:

> **Provide mechanisms for timely approval of transmission lines** to minimize the time from preliminary planning to operation.
>
> * * *
>
> **Design and construct additional transmission grid infrastructure** to efficiently deliver power from remote geographic generation sources to developed regions that have the greatest demand requirements.
>
> * * *
>
> **Continue research to improve and enhance the nation's transmission and generation infrastructure** as well as the deployment of technologies such as smart grid, real-time forecasting for transmission capacity, and sustainable energy generation which provide a reasonable return on investment.

(2013 Report at 60-64) (bold emphasis in original; italicized emphasis added). The 2011 Report similarly focuses on the *national* grid and the effects on the *national* economy if it is not upgraded:

> The purpose of this *Failure to Act* report series is to provide an objective analysis of the economic implications for the *United States* of its continued underinvestment in infrastructure.
>
> * * *
>
> This report illustrates the importance of electric power generation, transmission and distribution systems to the *national* economy.
>
> * * *
>
> The purpose of this study is to survey the economic effects of current infrastructure trends in *America's* energy infrastructure.
>
> * * *
>
> This study illustrates what could happen to the *national* economy if households and businesses do not have reliable energy service.

(2011 Report at 3, 4, 14, 48) (emphasis added).

The Commission does not have jurisdiction over interstate transmission, so this report offers little weight to Delmarva's arguments regarding reliability in Delaware. The Commission has jurisdiction over Delmarva's distribution system, and there is no indication that *its* grade is a D+.

Moreover, the ASCE Reports themselves are inconsistent: at the same time the 2013 Report says that national-level distribution investment has decreased since 2006, it also says that the increased adoption of smart grid technologies has led to additional investment in recent years, due in part to American Reinvestment and Recovery Act funds, Rural Utilities Service loans and matching contributions from local agencies and the private sector. (*Id.* at 62-63). The ASCE 2011 Report observes that investment in electric distribution infrastructure had *increased* and "now exceeds historical load growth. … ." (2011 Report at 34). And of course, Delmarva has *increased* its investment in its distribution facilities over this time period, not decreased it. Thus, nothing in the ASCE Reports supports Delmarva's inclusion of post-test period plant additions in this case.

d. Reliability *Is* Important, But at What Cost to Ratepayers – Especially When the Benefits to Them Have Not Been Quantified?

Delmarva contends that its customers repeatedly tell them that reliable service is important to them. (DOB at 16-17; *see also* Ex. 19 at 6; Tr. at 750-51, 754-55; Ex. 83). The DPA does not dispute that reliability and timely restoration after a major storm (or even on a blue sky day) is important to customers; indeed, we would submit that not even one (let alone quarterly) survey is necessary to establish this. But this does not tell the entire story. DPL witness Maxwell was "pretty sure" that the customers participating in the surveys are not told how much money Delmarva is planning to spend on the reliability improvements and enhancements. (*Id.* at 786).[22] The DPA daresays that customers might have a different opinion if they were told before answering that enhancing and improving their reliability was going to cost them $x number of

[22]As Mr. Maxwell admitted on cross-examination, the survey asks customers whether they believe Delmarva is providing reliable service – *not* whether reliable service is important to them. Similarly, customers are asked whether they believe Delmarva is restoring service in a timely manner - *not* whether restoring service in a timely manner is important to them. (Tr. at 785-86). Again, the DPA does not dispute that reliable service and quick restoration is important to customers. But there *is* a difference between the questions that are being asked and the conclusion that Delmarva reaches from the answers.

dollars a month every month for the foreseeable future and that Delmarva could not tell them how much more (if at all) reliability would improve or how much faster Delmarva would be able to restore service in the event of an outage.

Moreover, to the extent that the survey results from a few hundred customers each quarter have any significance, all the spending on plant that Delmarva has done since 2010 has had little effect on those results. Mr. Maxwell agreed subject to check that the responses to the question regarding reliable service was 85 in 2000, 86 in 2001, 90 in 2002, 84 in 2003 and 89 in 2004. (Tr. at 763). It was 86 in 2008, 84 in 2009, and 85 in 2010. (Ex. 83, 8th page of document). In 2011, when Delmarva apparently began conducting the surveys on a quarterly basis, the responses to the reliability question were 86 in Summer 2011, 84 in Fall 2011, 81 in the first quarter of 2012, 86 in the second and third quarters of 2012, and 92 in the fourth quarter of 2012. (*Id.*, 20th page of document). There is nothing in the record for 2013, which of course is the time period for the Adjustment 26 plant. Moreover, Delmarva's CAIDI – which measures the duration of the average customer interruption – has remained essentially unchanged despite all this new plant: the CAIDI was 128 minutes in 2002, and it was 120 minutes in 2012. (Tr. at 371). Finally, as previously pointed out, Delmarva does not provide any quantification of the additional benefits to customers from the $66 million of Adjustment 26 plant.

Reliability *is* important. But Delmarva has not established that there is any additional bang for the customers' post-test period plant bucks, let alone a significantly quantifiable bang for those bucks that justifies a Tesla distribution system versus a Nissan Leaf distribution system.

e. Comparison to Other Utilities' Performance Is Not Particularly Useful for Determining Whether the Post-Test Period Plant Should Be Included in Rate Base in This Case.

Delmarva says that it also determines an appropriate reliability level for which to strive by comparing its actual performance to that of other utilities in the Institute of Electrical and Electronics Engineers' ("IEEE") annual reliability surveys. (DOB at 17-19). It says that a utility with a 295-minute SAIDI would be among the worst-performing in the nation, and only five of the 106 utilities participating in the IEEE survey would not have met that standard. (*Id.* at 17-18). It says that its investments have resulted in improved reliability because its SAIDI has decreased from 199 minutes in 2010 to 192 minutes in 2011 to 146 minutes in 2012, and that had it not increased its reliability investments and its SAIDI had remained at 192-199, its performance would be among the worst in the IEEE survey. (*Id.* at 18-19).

Delmarva's claim that its investments have resulted in improved reliability (even assuming it is true) does not establish that the projected *post-test period* investments will improve reliability. And in any event, that claim is nothing more than an assumption. AMI for electric customers went into effect on a system-wide basis in 2011. Since AMI was supposed to help improve reliability and postpone or obviate the need for reliability spending, it is just as likely that AMI implementation had something to do with its SAIDI improvement between 2011 and 2012.[23] And a 50/50 likelihood that Delmarva is wrong does not satisfy its burden of proof.

Delmarva says that Regulation Docket No. 50's 295-minute SAIDI standard is a minimum standard and it would not be satisfied with only meeting that standard. (DOB at 9, citing 26 *Del. Admin. Code* §3007.1.3; DOB at 11-12; *see also* Ex. 19 at 4, 8). The DPA agrees that SAIDI is a minimum standard and that only meeting it would be disappointing (though it

[23]Mr. Ziminsky testified that AMI allows Delmarva to "ping" a customer's meter to determine actual outages and reduce restoration times. (Ex. 5 at 21-22).

would constitute compliance). This is particularly so given the more than $40 million ratepayers will pay for AMI, which the Commission approved in part because of Delmarva's assurances that AMI would improve reliability and potentially defer or eliminate the need for distribution improvements. But Delmarva is silent on AMI's effect on its improvement in SAIDI.

Second, Delmarva's comparison of its current performance to other unidentified utilities provides no evidence that the *post-test period* plant investments will improve its reliability vis-à-vis other utilities. Remember that the issue here is *post-test period* plant: not plant previously placed into service that no one is challenging. There is no evidence that the projected plant additions will have any effect on Delmarva's performance compared to its own previous performance, let alone its performance compared to other unidentified utilities.

Finally, that the 295-minute SAIDI minimum represents poor performance at this point probably means that the bar is now too low. That is an issue for another proceeding. But the current Commission standard is 295 minutes, and it is undeniable that Delmarva has met that standard for many years running. (Ex. 14 at Sch. DED-2).

f. Delmarva's Professional Judgment Is Not At Issue With Respect to Including Post-Test Period Plant in This Case's Test Period Rate Base.

Delmarva spends a substantial amount of its brief explaining how it exercised its professional judgment in determining what to invest in to meet its reliability objectives. (DOB at 19-25). Again, however, none of this justifies including the post-test period plant in this case's rate base.

With respect to new load growth, Delmarva asserts that it is experiencing "significant" load growth in certain parts of its service territory that requires action to avoid degradation in reliability. (*Id.* at 20).[24] If so, then why didn't it include that growth in the revenues that it used to determine its

[24]These are the Middletown-Odessa-Townsend area, the corridor between Dover and Harrington, and the coastal Sussex area.

revenue requirement? If overall load growth is low notwithstanding the "significant" load growth in these areas, then including it would not affect the revenue requirement much. But if the load growth in these areas really is significant, then Delmarva's failure to include it is understandable – because it undercuts the argument that overall load growth is low. The DPA does not believe that any post-test period adjustments are appropriate under the circumstances of this case, but if Delmarva wants the Commission to include a full year of post-test period plant, then it is not too much to ask that the Delmarva also include a full year of post-test period revenues from new customer growth.

Next, Delmarva claims that its aging infrastructure makes monitoring and testing its equipment to prevent load-related failures and to increase the system's capacity to handle growing load crucial, and that it practices "'reliability centered maintenance'" to do so. (*Id.*). It then proffers a prolonged explanation of how its equipment condition assessment does this. (*Id.* at 20-21). But this simply proves the DPA's contention that much of this may already be in DPL's rate base in the form of materials and supplies. (Tr. at 525-27).[25]

Delmarva next addresses feeders. Docket 50 regulations require DPL to report individual feeder reliability performance and designate a group of the ten worst performing feeders for corrective action. (Ex. 19 at 21). Delmarva says that it developed a Feeder Improvement Program to address more than just the ten worst performing feeders. (*Id.* at 22). It says that the feeders identified for improvement under this program "have not yet reached the level of degraded performance that puts them into the Docket 50 minimum mandatory 10 worst performing Priority Feeder program," but failing to address any other worse-performing feeders would not meet customers' expectations and needs, so it has identified them for work under the Program. (*Id.* at 22-23).

[25]According to DPL witness Maxwell, much of these materials and supplies have a long lead time. (Ex. 19 at 22). Therefore, if Delmarva needs them for replacement or maintenance, it must have them in stock – and therefore their cost must already be included in rate base. Are ratepayers paying twice? One cannot tell from the filing.

But it hasn't, not really. Delmarva acknowledged in its opening brief that 32 individual feeders' SAIDIs exceed the Regulation Docket No. 50 standard of 295 minutes. (*Id.* at 22; *see also* Tr. at 782; Ex. 81 at 8-19).[26] Mr. Maxwell testified that Delmarva may or may not fix all 32 of these poorly performing feeders in 2013. (Tr. at 783-84). And although some of the feeders with high SAIDIs have been identified as candidates for corrective action in the immediate future, *most have not*. (Ex. 81 at 21-31). Delmarva's assertion that it exercised its "professional judgment to determine that failing to address any feeders above the Docket 50 worst performing would not meet the reasonable reliability expectations and needs of customers" (*id.* at 22-23) is belied by its own documents.

Next, Delmarva identifies its URD cable replacement, substation transformers and switchgear policies. (*Id.* at 23). But all it does is identify these general items: it does not indicate what the problems with these items in Delaware are, and does not identify which of the projected projects in its Adjustment 26 will remedy the unidentified problems.

Last, Delmarva offers Distribution Automation ("DA") as part of its commitment pursuant to Regulation Docket 50's directive to effect reliability improvements. (*Id.* at 24-25). Most of its discussion centers on what exactly DA is and what it does. But Delmarva also points out that it has been required to do this since September 2006, when the Commission adopted the electric service reliability and quality standards. (*Id.* at 8, 23-24). Delmarva also identified DA as an important benefit associated with AMI in Docket No. 07-28. (*See* February 6, 2007 *Blueprint*

[26]The DPA understands that the SAIDI by which Delmarva's performance is judged is systemwide rather than asset-specific; however, these statistics are included in Delmarva's 2012 annual Regulation Docket 50 Report. *See* Ex. 81 at 8-19, which identifies the following poorly-performing feeders: Christiana Ckt. DE0016 (1,479 SAIDI); Christiana Ckt. DE0019 (422 SAIDI); Christiana Ckt. DE0108 (610 SAIDI); Christiana Ckt. DE0112 (647 SAIDI) ; Christiana Ckt. DE0160 (899 SAIDI); Christiana Ckt. DE0163 (514 SAIDI); Christiana Ckt. DE0167 (752 SAIDI); Christiana Ckt. DE0193 (2,026 SAIDI); Christiana Ckt. DE0218 (540 SAIDI); Christiana Ckt. DE0231 (779 SAIDI); Christiana Ckt. DE0244 (498 SAIDI); Christiana Ckt. DE0263 (604 SAIDI); Christiana Ckt. DE0659 (1,080 SAIDI); Christiana Ckt. DE0727 (1,014 SAIDI); Christiana Ckt. DE2542 (815 SAIDI); Christiana Ckt. MD3324 (702 SAIDI).

for the Future Application and Plan at 8-9 (Attachment B);[27] *Blueprint for the Future* Business Case at 2). *These* dockets were the genesis for the DA investment – not the REP.

Delmarva's silence on other issues is deafening. Its 2012 annual report identified a total of 5,006 interruptions for transmission, substations and distribution. The cause of almost 25% of the interruptions was "unknown." (Ex. 81 at 37). If the causes of almost one-quarter of interruptions in Delaware are unknown, then how does Delmarva decide on what to spend for reliability investment, and how does the Commission know how to assess it? Similarly, the next highest cause of interruptions (almost 20%) is "Tree." If the DPA interprets the report correctly, one-fifth of interruptions are caused by vegetation management, which suggests that ratepayers are already paying through the tree trimming expense for some of the reliability investment. Thus, almost 45% of Delmarva's outages are the result of things that either ratepayers may already be paying for or for which Delmarva does not know the cause.

g. <u>Delmarva Ignored Adjustments That Reduce Rate Base and Increase Revenues.</u>

In previous rate cases, Delmarva used average plant balances to develop its claimed rate base. Here, however, it used end of test period plant balances, which are already more prospective than those used in prior cases. The DPA does not object to using end of test period plant balances; however, including the proposed post-test period adjustments burdens ratepayers with an additional $9.17 million of rates without considering other components that will offset the revenue requirement. For example, during the test year, Delmarva added $27.44 million of depreciation to its accumulated depreciation reserve. This reduces rate base and likewise reduces the revenue requirement, but Delmarva did not make an adjustment to reflect this reduced

[27]Delmarva identified DA as related to AMI and stated that "[a]lthough not part of this filing, because of the linkage to the proposed technology changes, we plan on following up with a distribution automation filing in the near future as it is very interrelated to the advanced meters and enhanced communication networks." (February 6, 2007 *Blueprint for the Future* Application and Plan at 9) (Attachment B).

revenue requirement.[28] (Ex. 13 at 7). Similarly, the deferred income tax reserve offsets the revenue requirement associated with plant additions because it is also a rate base deduction, but Delmarva made no adjustment to reflect the additional deferred income tax. (*Id.* at 7-8). *These adjustments are required regardless of whether the Commission includes the Adjustment 26 plant in rate base or not, because they are attributable to uncontested 2012 plant additions.*

Finally, increases in customers and usage would offset the increased revenue requirement associated with the additional plant, but Delmarva did not make an adjustment to reflect increased customers or increased usage. (*Id.* at 8). This is particularly offensive in light of the "significant load growth" it is experiencing in the Middletown-Odessa-Townsend area, the corridor between Dover and Harrington, and the coastal Sussex areas that require action to "avoid a degradation in reliability." (DOB at 20, citing Ex. 19 at 14). If growth in those areas is so significant that it requires reliability investment, then it is significant enough to require Delmarva to include that growth in its revenues to determine the revenue requirement. Its failure to do so suggests that it would have reduced its revenue requirement too much to include it.[29]

h. Delmarva Could Have Used a Partially Projected Test Period, But Chose Not To.

The Commission's regulations allow Delmarva to file a rate case using a partially forecasted test period, which would have allowed it to use a test period comprised of three months actual data and nine months projected data, to be updated as the case progressed. *See* 26 *Del. Admin. Code* §§1002.1.2.2.1, 1002.1.2.3.1. This would have allowed it to project its plant

[28]Delmarva *did* include additions to both the depreciation and deferred income tax reserves associated with the post-test-period plant, but *failed* to include reserve additions associated with the plant that was in service at the end of 2012, the test period. (Ex. 13 at 7 n.3).

[29]And lest Delmarva suggest in its reply brief that the DPA could have proposed such an adjustment, we remind the Hearing Examiner and the Commission that DPL suggested that the growth is "significant" enough to require the plant additions. Delmarva cannot have it both ways. Either the growth is significant enough to require the plant additions, or it is not significant enough to include it in revenues.

additions nine months out, but also would have required it to project its revenues nine months out. Delmarva chose not to file its case using a partially projected test period, but rather relied on an historical test period, which it then adjusted for cherry-picked projected additions. As discussed above, it did not adjust other elements of the regulatory triad that would decrease its revenue requirement. The unreliability of projections is exactly why this Commission abandoned the use of a fully-forecasted test period.

Delmarva should not be permitted to sneak in through the back door a fully-forecasted test period that it cannot file directly. Nor should it be permitted to obtain the benefit of a partially-projected test period without including the adjustments to the other portions of the regulatory triad. The Commission should follow its own rules: it should reject Delmarva's attempt to use a fully-forecasted test period for plant since this Commission's regulations do not permit fully-forecasted test periods, and it should reject Delmarva's attempt to use a partially-projected test period without adjusting for the other elements of the regulatory triad that would reduce the revenue requirement.

i. The Post-Test Period Plant Is Not Reasonably Known and Measurable.

Assuming that the Commission does not accept any of the foregoing arguments, the DPA submits that the proposed plant additions are not reasonably known and measurable, which has long been the standard for post-test period adjustments of any kind and indeed is reflected in the Commission's MFRs (*see* 26 *Del. Admin. Code* §1002.1.3.1). At the time of its filing, Delmarva's proposed post-test period plant additions were based solely on its *projections* of what it expected to place in service. (Ex. 13 at 8; Ex. 14 at 5). And if history is any guide, those projections will not be correct. As DPA witness Dr. Dismukes observed, DPL underspent its capital budget by an average of 3.5% per year from 2007 through 2012. (Ex. 14 at 7). Even after

Delmarva split Adjustment 26 into two parts to reflect actual costs through August 31, 2013 and projected costs from September through December 2013, Dr. Dismukes testified without contradiction that the actual costs through August 31, 2013 were 20% *less* than what Delmarva had projected. (Tr. at 524-25, 532). He also testified without contradiction that: (1) Adjustment 26 contains almost $10 million for 14 reliability projects that Delmarva had budgeted for previous years but which were included in the 2013 projections (Ex. 14 at 9 and Sch. DED-6);[30] and (2) there have been large variances in Delmarva's capital budgets: in 2007, it went over budget on reliability investments by 25%; in 2009, it was over budget by 12.1%; and in 2012 it was over budget by 6.7%. (*Id.* at 8 and Sch. DED-4). There have also been large variances within individual projects: the Millsboro District Priority Circuit project, which is part of Adjustment 26, was over budget by 182.5% in 2011 and was under budget by 46.8% in 2012, and the 2012 Christiana District Distribution Automation project was budgeted at $1.5 million but cost $3.4 million – a variance of 131%. (*Id.* at 8 and Sch. DED-5). Delmarva projected closing 95 projects to plant from January-March 2013, but only closed 55 of those projects during that time frame. (*Id.* at 10 and Sch. DED-7). And the amount Delmarva closed to plant from January-March 2013 was $9.4 million compared to the forecast of $21 million. (*Id.* at 10 and Sch. DED-7).

Delmarva claims that its proposed adjustment for projected plant closings is consistent with Commission precedent and Delaware law. (DOB at 64). It is neither. As Delmarva knows, the Commission has not authorized including a full year of post-rest period rate base. And Delaware law only requires the Commission to consider reasonably known and measurable

[30]Examples include: (1) $145,745 for the Millsboro Sub Subscriber – BBW project, which was contained in 2011 and 2012 budgets but went unspent in those years; (2) $1.0 million for DA in the Christina District, which was contained in Delmarva's 2012 budget but only $184,726 was spent in 2012; Delmarva has included $1.5 million for this project in 2013; and (3) $2.5 million for the Millsboro District Priority Circuit Improvements, which went unspent and has been included in Adjustment 26. (Ex. 14 at 8-9 and Sch. DED-6).

changes to test period expenses. As we have shown above, Delmarva's projections are not reasonably known and measurable: they have been wrong. And they have generally been wrong *high*, so customers would be paying more than necessary had they been included in rates.

Delmarva's projections are unreliable. They could be wrong high, they could be wrong low, but they are going to be *wrong,* period. Other commissions have recognized the problem with projections. *See* In *In the Matter of the Application of Baltimore Gas & Electric Company for Adjustments in Its Electric and Gas Base Rates*, Case No. 9299, Order No. 85374 at 37 (Md. PSC Feb. 22, 2013),[31] the Maryland PSC concluded that "it would not be just and reasonable to saddle customers with almost $20 million in additional utility costs based upon estimates that are not fully reliable." And again, the unreliability of projections was a major reason why the Commission abandoned the use of fully-forecasted test period for ratemaking purposes. Delmarva's actual results, compared to its projections, show that the Commission was correct in abandoning the future test period, and that it would be correct in rejecting Adjustment 26 here.

j. Delmarva Performed No Attrition Analysis to Support Its Claim of Regulatory Lag.

Delmarva claims that it needs Adjustment 26 to combat regulatory lag. (Ex. 2 at 5). However, it provided no detailed earnings attrition analysis that directly links underearning with its reliability investment requirements. (Ex. 14 at 5, citing Delmarva's responses to AG-REL-36 and AG-REL-37). Dr. Dismukes testified that regulators have long recognized that regulatory lag can be key to the overall regulatory process because it imposes discipline on utility operational and investment decisions. (*Id.* at 15). Contrary to Delmarva's suggestion, regulatory lag is not bad in and of itself: it can lead to both costs and benefits for a utility because it creates opportunities for gains as well as losses. (*Id.* at 15-16). Delmarva's proposal shifts regulatory,

[31] http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\CaseNum\9200-9299\9299\78.pdf

investment and performance risk away from it and onto ratepayers. This is because utilities typically control when they file rate cases, so they not only have the ability to request rate increases but also are protected in time of overearning unless and until their commissions bring them in for a rate decrease. Allowing Delmarva to include its projected investments exacerbate these timing risks by allowing it to increase rates for projects that may never be completed and, even if they are, may never be evaluated for reasonableness and appropriateness. (*Id.* at 16).

* * *

"A review of the evidence in this docket leads to one conclusion:"[32] Delmarva has not established that including the projected post-test period investments were "necessary to both maintain and enhance reliability."[33] Nor has it established that it cannot meet its obligation to provide safe, reliable and adequate service without these investments. The only thing it has established is that ratepayers will pay more. Delmarva has not met its burden of proving that the Commission should include its post-test period plant in rate base in this case. For the myriad reasons discussed above, the Commission should summarily reject Delmarva's request to include Adjustment 26's $66.8 million of alleged "reliability" investments in rate base.[34]

B. The Commission Should Reject Delmarva's Attempt to Include Construction Work in Progress ("CWIP") in Rate Base.

Delmarva has included $70,154,772 of CWIP in rate base and a corresponding $965,309 Allowance for Funds Used During Construction ("AFUDC") offset to earnings. (Ex. 5 at 31-33; Ex. 13 at 10). The DPA objects to including CWIP in rate base. (Ex. 13 at 11).

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[32]DOB at 19.

[33]*Id.*

[34]The DPA made an adjustment to depreciation expense to reflect its exclusion of the entire Adjustment 26 plant from rate base. (Ex. 13 at 56). We have not calculated the adjustment to depreciation expense that will be required if the Commission includes some but not all of the Adjustment 26 plant, but that calculation can be easily made once the Commission has rendered a decision.

Delmarva asserts that the Commission should reconsider its prior decisions excluding CWIP from rate base. Calling the DPA's objections "meritless" and as "plac[ing] form over substance" (DOB at 76-77), it asserts that the CWIP is used and useful, is serving customers, and should be treated as plant in service for rate base purposes. (Ex. 5 at 32). It contends that it follows Federal Energy Regulatory Commission ("FERC") guidelines for accruing AFUDC, and that under those guidelines not all of the CWIP projects not eligible to accrue AFUDC. (*Id.* at 32; DOB at 76). It claims that if the Commission does not include CWIP in rate base, it "inappropriately" bears the burden of those carrying costs, and it is "unfair" not to compensate it for those investments. (Ex. 5 at 32).

Recognizing that its pleas to include CWIP will likely be insufficient to persuade the Commission to reverse its previous decisions, Delmarva proposes an alternative that it claims "should be acceptable to all parties," which is to record AFUDC on all CWIP and treat the difference between the actual accrued AFUDC and the full calculated AFUDC as a regulatory asset that would be treated in Delmarva's next base rate case as if it were actually accrued AFUDC and amortized over an assigned life and included in rate base as if it had been capitalized. (*Id.* at 32-33; Ex. 20 at 63). Calculation of the full AFUDC would begin on the effective date of the new rates from this case. In the next base rate case, the balance of the regulatory asset would be determined from the effective date of the rates from this case through the end of the test period in the next base rate case and would be amortized using the average book life. The next regulatory asset would begin to accrue at the end of the test period in Delmarva's next base rate case. (Ex. 5 at 33; Ex. 20 at 64).[35]

[35]Delmarva has apparently abandoned this alternative, since it does not discuss it in its Opening Brief. *See* DOB at 76-77). In the event it has not abandoned the proposal, the DPA discusses it *infra*.

While the DPA acknowledges that the Commission has discretion to include or exclude CWIP from rate base, the Commission has chosen to exclude CWIP from rate base in Delmarva's last two litigated cases (Docket Nos. 05-304 and 09-414) based on the same arguments and facts that the DPA proffers here. Apparently the Commission did not find them "meritless" or "plac[ing] form over substance." Since the Commission has excluded CWIP from rate base in the last two cases under virtually identical circumstances, and since Delmarva bears the burden of proof, one would think Delmarva would have proffered some new argument or facts to support its request to include CWIP In rate base. But it didn't. A review of its testimony and briefs on this issue in Docket Nos. 05-304 and 09-414 shows that it trotted out the same tired arguments as it does in this case. The arguments were unpersuasive then, and they still are.

Delmarva's inclusion of CWIP in rate base increases its revenue requirement by approximately $7.71 million and represents almost 20% of the revenue requirement requested in this case. (Ex. 13 at 9). That number bears repeating – *almost 20%* of Delmarva's requested revenue requirement is attributable to this one item.

Moreover, as in prior Delmarva cases, the amount of AFUDC as a percentage of CWIP in this case is less than 2%: here, it is 1.37%. (Ex. 13 at 10-11). The Commission found this fact significant in both Docket Nos. 05-304 and 09-414, and it is no less significant here. *See Delmarva* Power, Order No. 8011 at ¶67; *In the Matter of the Application of Delmarva Power & Light Company for Approval of a Change in Electric Distribution Rates and Miscellaneous Tariff Changes*, Docket No. 05-304, Order No. 6930 (Del. PSC Jun. 6, 2006) at ¶48.[36] Thus, just as in the prior two litigated cases, including CWIP in rate base will have a considerable adverse effect on the revenue requirement.

[36] http://depsc.delaware.gov/orders/6930.pdf

Furthermore, under Delaware law, only plant that is used and useful in providing service to ratepayers during the test period may be included in rate base. 26 *Del. C.* §102(3).[37] CWIP is construction work *in progress*, and so by definition is not used and useful. The DPA questions how it is fair for customers to pay for plant that is not providing them with any benefit.

Finally, including this plant in rate base violates the longstanding regulatory principle of matching assets with the customers they are serving. As discussed previously, Delmarva has not made adjustments to include out of period revenues that flow from the out of period investment. Staff witness Peterson testified that the when the CWIP is eventually placed in service, it will serve new customers or new loads, will increase operating efficiency or service reliability, or will decrease maintenance requirements on both new and existing facilities. (Ex. 11 at 13).

If Delmarva believes that its current accrual of AFUDC is insufficient to compensate shareholders during construction, then it can change its policies regarding when to accrue AFUDC. Nothing in the FERC regulations prevents it from doing this: Staff witness Peterson testified that the FERC regulations are guidelines rather than strict requirements (Tr. at 507), and DPL witness rebutted this testimony.[38]

Delmarva's alternative proposal to create a regulatory asset for the full amount of AFUDC is a non-starter. As the Commission is well aware, regulatory asset treatment is reserved for large, non-recurring expenses that have the potential to impair a utility's financial well-being and do not contribute to rate base. *In the Matter of the Application of Delmarva Power & Light Company for an Increase In Its Retail Rates for the Distribution of Electric Energy*, Case No.

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[37]The Act defines rate base as "[t]he original cost of all *used and useful* utility plant and intangible assets either to the first person who committed said plant or assets to public use or, at the option of the Commission, the first recorded book cost of said plant or assets … ." 26 *Del. C.* §102(3) (emphasis added).

[38]The best Delmarva could offer on this subject was that it is following FERC's guidelines, but Mr. Ziminsky admitted that the guidelines are simply that, and Delmarva is not required to follow them. (Tr. at 627).

9192, Order No. 83085 (Md. PSC Dec. 30, 2009) at 15-16.[39] CWIP and AFUDC are classic, ongoing costs of running a utility and should not qualify for regulatory asset treatment.

In short, Delmarva has not provided any new reasons or suggested any changed circumstances that would justify this Commission in reversing its position on including CWIP in rate base. The DPA respectfully requests the Commission to remove CWIP from rate base (and reverse the earnings adjustment for AFUDC as well).[40]

C. The DPA's Adjustment to Delmarva's Cash Working Capital ("CWC") Calculation Should Be Accepted.

CWC is the amount of cash a utility needs to cover cash outflows between the time it received revenue from customers and the time it must pay expenses. (Ex. 13 at 11). Delmarva requested a CWC allowance of $10,911,605 derived from a lead/lag study in which its individual expense lag days were based on 2010 calendar year invoices. (*Id.*). Expense lags have three components: a service lag, a billing lag and a payment lag. The service lag reflects the midpoint of the service period; thus, in the case of monthly billing, the service lag will be 15.21 days (365 days÷12÷2). (*Id.* at 12). The billing lag represents the amount of time after the end of the service period that a utility is billed. (*Id.* at 12-13). Finally, the payment lag is the amount of time after receiving a bill that payment is made. (*Id.* at 13).

In this case, Delmarva calculated the net operating and maintenance ("O&M") lag by examining three types of O&M costs: payroll, affiliated transactions, and other O&M. It used expense lags of 15.96 days for payroll, 14.43 days for affiliated transactions, and 35.19 days for other O&M. (*Id.* at 13, citing Delmarva response to PSC-RR-10). The expense lag for affiliated

[39] http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\CaseNum\9100-9199\9192\064.pdf

[40] The DPA made a corresponding adjustment to remove AFUDC earnings of $965,309 from Delmarva's revenue requirement to correspond with the elimination of CWIP from rate base. (Ex. 13 at 56-57).

transactions in Delmarva's lead/lag study reflects twice-monthly payments for Service Company expenses. (Ex. 11 at 17-18).

But Delmarva is not required to pay the Service Company twice a month. Its agreement with the Service Company provides that it will render a bill only once a month. (Ex. 11 at 17). Transactions between Delmarva and its affiliates, including the Service Company, are settled each month through the PHI money pool on approximately the 15th business day of the next month. (Ex. 13 at 13, citing Delmarva response to PSC-RR-94). The effect of using a different expense lag in this case is significant because nearly 70% of Delmarva's distribution O&M expenses are Service Company charges. (Ex. 11 at 19). Both the DPA and Staff took issue with Delmarva's expense lag for affiliate transaction O&M costs, and specifically with the expense lag it used for its payments to the Service Company. (Ex. 11 at 17; Ex. 13 at 12). DPA witness Crane recommended a 30.21-day expense lag for affiliated transaction payments, based on a service period of 15.21 days and a combined billing and payment lag of 15 days. (Ex. 13 at 13). Ms. Crane's recommendation decreases Delmarva's CWC claim by $1.89 million. (*Id.*).

Delmarva contends that the lead/lag study is related to Delmarva-specific transactions reflected on its books and records showing when the expenses were recorded on Delmarva's books. (Ex. 20 at 60; DOB at 75). Delmarva says it is irrelevant when those transactions are actually settled because CWC focuses on recognizing expenses when cash is actually expended for them (cash basis of accounting), as opposed to matching expenses when goods and services are provided rather than when they are paid (accrual basis of accounting). (Ex. 20 at 60). It also claims in its brief that applying the Intercompany Money Pool Balance settlement frequency that Staff and the DPA recommend would require the entire lead/lag study to be repeated to account for other information, and since neither Staff nor the DPA performed such an analysis, doing so here would be "arbitrary." (DOB at 75-76).

Delmarva's arguments do not withstand analysis. Other commissions have recognized that a utility's arrangements with its affiliates can be manipulated. In *Pennsylvania Public Utility Commission Office of Consumer Advocate, et al. v. PPL Electric Utilities Corp.*, 2012 WL 6758304 (Pa. PUC Dec. 28, 2012),[41] the Pennsylvania PUC considered a situation in which the utility's agreement with its affiliate provided for a 60-day payment period, but it used a 35-day lag period in its CWC lead/lag study. PPL argued that it treated its payments to affiliates in the same manner that it treated its payments to non-affiliated vendors, and that it should not discriminate in favor of, or against, its affiliates. (*Id.* at 10). The PUC's Bureau of Investigation and Enforcement challenged PPL's affiliate payment lag, arguing that it unnecessarily paid its affiliate substantially in advance of the required due date under the service agreement with its affiliate. The PUC agreed, stating:

> We agree with the ALJ's decision to adopt I&E's recommended $13.021 million O&M reduction to the CWC component of the Company's claimed rate base. PPL did not meet its burden of proving that its expense lag days for payments to its affiliate are reasonable. Since PPL has up to sixty days to pay its affiliate under the agreement, it would have been reasonable for PPL to take advantage of the longer payment period and, by doing so, to minimize the rate impact on its customers. PPL has control over when it pays its affiliate and can alter its computerized system to change the date on which it pays its affiliate. The evidence presented by I&E demonstrated that PPL's choice to pay its affiliate forty days early resulted in an annual ratepayer CWC contribution of $1.1 million. I&E St. 2-SR at 62. PPL's customers should not be burdened with this expense when it can be avoided. For these reasons, we shall deny PPL's Exception and adopt the ALJ's decision on this matter.

(*Id.* at 15).

[41] http://www.puc.pa.gov//pcdocs/1206360.docx

In *Re Southern Connecticut Gas Company*, 2009 WL 2407560 (Conn. DPUC July 17, 2009),[42] the Connecticut Department of Public Utility Control concluded:

> While the lead/lag study result was based on the measured timing of payments from Southern to affiliates for service rendered, OCC argued that contractual obligations between Southern and its affiliates better represents the cash working capital requirements associated with this expense category. The Department agrees. For transactions between affiliated entities, where incentives to best manage a company's cash flow is diminished, contractual obligations often provide a better measure of working capital needs than past practice.

(*Id.* at 65).

The Arizona Corporations Commission also rejected a utility's use of an expense lag reflecting its actual payments to its affiliated management company: "We fully agree with RUCO and Staff that the Company's internal arrangement with its unregulated affiliate should not dictate its need for cash working capital." *Re Arizona-American Water Company*, 2011 WL 121179 (Ariz. C.C. Jan. 6, 2011)[43] at 18. Finally, in *Re Southern California Edison Company*, 1991 WL 501681 (Cal. PUC Dec. 20, 1991), the California Public Utilities Commission concluded that "[e]arly payments to utility affiliates and subsidiaries should not be considered in working cash calculations." (*Id.* at 68) (Attachment C).

Delmarva does not dispute that the terms of its agreement with its service company provide for monthly, rather than twice-monthly, payments. Delmarva – not its ratepayers - chooses to make payments more frequently than required under the agreement with its service company. There is no indication that Delmarva pays non-affiliated vendors earlier than required under the terms of its agreement with those vendors, and the affiliated service company should not be treated more favorably than non-affiliates – especially when the result of such favorable treatment is an increase in Delmarva's rate base.

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[42] http://www.dpuc.state.ct.us/FINALDEC.NSF/0d1e102026cb64d98525644800691cfe/449872c5789bffba852575fc0049acd3/$FILE/081207-071709.doc

[43] http://images.edocket.azcc.gov/docketpdf/0000122361.pdf

Delmarva's contentions that it would be improper to change one of the expense lags without examining other lags and that the study would have to be repeated are unworthy of discussion. It cites no authority to support its contention that it is improper to change one lag without re-examining others, and the commissions identified above that rejected the utilities' proposed expense lag for affiliated transactions did not find it improper. And the fact that the lead/lag study will have to be repeated is a problem of Delmarva's own making. Had it followed the terms of its agreement with the service company rather than taking it upon itself to make payments more frequently than required, this would not be an issue. Delmarva cannot be heard to complain that its own actions cause it additional work.

It is unreasonable for Delmarva to force ratepayers to shoulder a larger CWC requirement than required by the terms of its own agreement with its affiliate. Its proposed expense lag for affiliated transactions should be rejected.

D. Delmarva's Prepaid Pension Asset and OPEB Liability Should Be Removed from Rate Base.

In its original filing, Delmarva included three prepaid assets in rate base: $61,581,370 of pension costs; ($8,176,221) of accrued OPEB liability; and $41,431 of insurance. (Ex. 13 at 14). It conceded that it double-counted the prepaid insurance asset by including it both in rate base and its CWC requirement, and removed it from rate base in its rebuttal testimony. (Ex. 13 at 17-18; Ex. 20 at 65). This leaves the prepaid pension and accrued OPEB liability balances, both of which should be removed from rate base.

Some background is in order. Since the adoption of Financial Accounting Standards Board Statement Nos. 87 and 106 ("SFAS 87" and "SFAS 106"), pension and OPEB expense have been determined on an actuarial basis using the accrual method of accounting. The accrual method seeks to recover pension and OPEB benefit costs over the working lives of the employees who receive such benefits based on assumptions regarding salary levels, earnings on fund balances, mortality rates and other factors. A separate calculation determines funding requirements. The actuarial valuation may be positive or negative in any given year. (Ex. 13 at 14-15).[44] A prepaid pension asset occurs when the accumulated contributions and growth in the pension plan exceed the accumulated expenses associated with the pension obligations. An OPEB liability occurs when the accumulated costs of the OPEB obligations are greater than the associated contributions and growth of the plan assets. (Ex. 20 at 71).

Section102(3) of the Act defines rate base as "[t]he original cost of all used and useful utility plant and intangible assets ..." less related accumulated depreciation and amortization; customer advances and contributions in aid of construction ("CIAC"); and accumulated deferred and unamortized income tax liabilities and investment credits, accumulated depreciation of customer advances and CIAC. Rate base does not include any asset that is not "*used and useful.*" And as can be seen from the statutory deductions to rate base, it does not include plant and/or intangible assets supplied by any entity other than utility investors. The prepaid pension asset and OPEB liability at issue here are not used and useful in the provision of utility service. Even if they were, Delmarva cannot satisfy its burden of establishing that shareholders, rather than ratepayers or the market, contributed the funds that comprising them. The Commission did not consider either of these arguments in its previous dockets, but both support a reversal of its prior

[44]If the assumptions underlying the actuarial methodology were always accurate, there would be positive pension and OPEB expense each year, and an employee's benefits would be recognized over his/her working life. But assumptions are rarely 100% accurate, so in some years pension and OPEB costs can be negative based on the fact that prior years' assumptions overstated costs. As an example, if the methodology assumed a 5% return on investment but the actual return was 7%, a negative expense may be booked in a subsequent year. (Ex. 13 at 15).

decision.[45] Assuming the Commission does not accept either argument, then the DPA respectfully suggests that the Commission's decision in Docket No. 05-304 was incorrect.

1. The Prepaid Pension Asset is Not Used and Useful.

The prepaid pension asset is not used and useful in providing service. Indeed, Delmarva admits that it cannot use those funds. (DOB at 91). Under the Employment Retirement and Income Securities Act ("ERISA"), the assets of a qualified retirement plan are required to be maintained in a trust to which Delmarva lacks access:

> Except as provided in subsection (b) of this section, all assets of an employee benefit plan shall be held in trust by one or more trustees. Such trustee or trustees shall be either named in the trust instrument or in the plan instrument described in section 1102(a) of this title or appointed by a person who is a named fiduciary, and upon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan …
>
> *   *   *
>
> Except as provided in paragraph (2), (3), or (4) or subsection (d) of this section, or under sections 1342 and 1344 of this title (relating to termination of insured plans), or under section 420 of Title 26 (as in effect on July 6, 2012), the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.

Id. §§1103(a), 1103(c)(1). In short, the prepaid pension asset is not a used and useful utility asset on which shareholders are entitled to earn a return.

2. Even If the Prepaid Pension Asset Is Used and Useful, Delmarva Has Not Established That Stockholders, Rather Than Ratepayers or Market Gains, Were the Source of the Funds Creating the Asset.

It is clear from the deductions identified in Section 102(3) of the Act that rate base does not include assets not supplied by investors. Other courts have so held in interpreting a rate base

[45] And lest Delmarva object that the DPA's witness did not raise these arguments in her testimony, the DPA notes that they are *legal* arguments and the DPA witness is not a lawyer.

definition similar to Section 102(3). *Arrowhead Public Service Corp. v. Pennsylvania Public Utility Commission*, 600 A.2d 251, 253 (Pa. Cmwlth. 1991) ("a utility is only entitled to earn a return on that property which it funded; not on that property which was contributed to it by others"); *Consumers Counsel v. Public Utilities Commission of Ohio*, 447 N.E.2d 749 (Ohio Supr. 1983); *Northwestern Bell Telephone Co. v. State of Minnesota*, 253 N.W.2d 815, 818 (Minn. Supr. 1977) ("since the point of rate regulation is to provide an adequate but not excessive rate of return to investors, property which is acquired in some manner other than the investment of stockholders' equity is generally not includable in the rate base").

Delmarva argues that its contributions to the pension fund represent a prepayment of pension expense funded by stockholders for which those stockholders are entitled to a return. (DOB at 90). But it has adduced no evidence that shareholders contributed the funds comprising the asset. Without such evidence, "there is no reason to believe that the pension asset is funded by any other source than ratepayers." *Re North Shore Gas Co.*, 2010 WL 537062 (Ill.C.C. Jan. 21, 2010)[46] at 36: "Although the Utilities state that the pension asset was created with shareholder funds, no evidentiary support was provided." (*Id.*). Delmarva admitted that it made no contributions to the pension fund until 2009, when it contributed $135 million (Tr. at 675). Over the past ten years, market returns on the fund have totaled almost $1.245 *billion*. (Ex. 13 at 17 (emphasis added); Tr. at 675; Delmarva 12/20/13 response to DPA on-the-record data request).[47] Simple math shows that Delmarva's fund contributions account for less than 10% of the fund balance and that over 90% of the current fund balance is attributable to market earnings.

[46]http://www.icc.illinois.gov/downloads/public/edocket/259769.pdf

[47]The DPA made an on the record data request asking Delmarva to confirm these percentages. (Tr. at 1022-23). Delmarva finally responded on December 20, 2013 stating (among other things) that the correct balance is $1.245 billion rather than $1.38 billion. Whatever number is correct is irrelevant, however, in light of the fact that there is no dispute about the amount of DPL's 2009 contribution.

Based on almost identical facts, the Hawaii Public Utilities Commission rejected a utility proposal to include a prepaid pension asset in rate base. In *Re Hawaii Electric Co.*, 2007 WL 4477336 (Hawaii PUC Oct. 25, 2007),[48] that commission stated:

> Upon review of the entire record herein, the Commission finds that the $78,791,000 of prepaid pension asset should be excluded form rate base. The commission makes this determination based on the specific facts pertaining to the accounting and ratemaking treatment of HECO's NPPC [net periodic pension costs], consistent with the 2005 test year calculations in this proceeding.
>
> The specific facts in this record do not adequately demonstrate that HECO's shareholders, in fact, provided the funds represented in the prepaid pension asset, such that HECO's shareholders should now be entitled to earn a return on the asset. *Rather, it appears that the majority of the funds constituting the prepaid asset resulted from favorable market conditions during 1999 to 2002, and not from investor contributions.* In particular, from 1999 through 2002, HECO recorded negative pension costs and made no contributions to the pension trust fund. This resulted in the addition of $56,517,000 to the pension asset, as required by SFAS 87, which represents approximately 74% of the estimated pension balance at the end of the 2005 test year. Thus, the favorable market conditions and the SFAS 87 pension accounting requirements resulted in a reduced NPPC, a growing asset, and presumably less expense and greater investor return for HECO's shareholders. Under these circumstances, the commission will not require HECO's ratepayers to pay for a return on such an asset by placing the asset in rate base.

(*Id.* at 14-15).[49] *See also Re Central Telephone Company-Nevada*, 1992 WL 402072 at 45 (Nev. PSC Jan. 7, 1992) (Attachment D) ("The Commission believes it is illogical to conclude that investors should receive a return on a book entry that reduces expense. Investors are entitled to a return only on funds that are actually provided and not on assets that accrue as a result of accounting procedures").

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[48] http://dms.puc.hawaii.gov/dms/OpenDocServlet?RT=&document_id=91+3+ICM4+LSDB15+PC_DocketReport59+26+A1001001A09G15B80207C3613818+A09G15B80207C361381+14+1960

[49] The Hawaii commission noted that its decision was based on the facts of the case, and different circumstances might warrant a different conclusion. But for purposes of this argument the salient point is that the facts are nearly identical to those presented in this case. *Hawaii Electric, supra* at 15.

2. The DPA Respectfully Suggests That the Commission's <u>Decision on the Issue in Docket No. 05-304 Was Incorrect.</u>

Delmarva claims that the prepaid pension asset (and, we assume the OPEB liability) should be included in rate base because ratepayers benefit from their existence. (Ex. 20 at 71). This is because: (1) the existence of a prepaid pension asset means that the cash contributions and return in the pension trust exceed its accumulated benefit obligation; (2) the pension trust's assets are larger than they would otherwise be; (3) which increases the expected return on the asset; (4) which decreases the pension expense; (5) which decreases the cost of service, and thus (6) decreases the amount that ratepayers pay in rates. (*Id.* at 72; DOB at 91). Delmarva takes issue with the DPA's position, claiming that its adjustment is consistent with the Commission's treatment of the issue in Docket 05-304. (Ex. 20 at 72).

The DPA acknowledges that the Commission included the prepaid pension asset in rate base in Docket No. 05-304. It appears, however, that the Hearing Examiner in Docket No. 05-304 and the Commission, which relied on the Hearing Examiner's recommendation, may have misunderstood the issue. (The DPA candidly admits that it is confusing and is not sure that anyone really understood it; maybe Delmarva did, but we're not sure). We have found a discussion of the issue that is illuminative. The discussion is somewhat long, but the DPA includes it in its entirety because of its careful parsing of the utility's arguments, which are identical to the argument Delmarva proffers here.

> CENTEL proposes to include in its calculation of invested capital a prepaid pension asset in the amount of $2,079,022.16 CENTEL witness John P. Meyer testified that CENTEL's pension fund is fully funded and has been since 1985, because of favorable investment experience and reductions in benefit levels. According to Mr. Meyer, ratepayers are receiving a negative pension expense which is used to reduce the cost of service in Texas. The reduction in pension expense and the attendant revenue requirement reduction is supported by investors. Mr. Meyer gave the following example to illustrate his position that a reduced revenue requirement resulted in the need for investor-supplied funds.

First, assume CENTEL incurred and paid allowable operating costs of $10 million (without considering the negative pension expense). The Commission would presumably set rates to permit recovery of $10 million from the ratepayers. The ratepayers would be providing revenues sufficient for CENTEL to pay all of the operating costs and no external cash flow would be necessary. Now consider the effects on revenue requirements and outside financing requirements caused by negative pension expense. Note that when the $1 million negative pension expense is recorded by a non-cash credit to the income statement, the revenue requirement is reduced to $9 million. This $9 million of revenue will be used to pay $9 million of the $10 million of allowable operating costs (excluding pension), and a $1 million shortfall results. External financing is needed to pay the shortfall. Thus, Ms. Blumenthal's suggestion that investors are not the source of the prepaid pension asset recorded on CENTEL's books is incorrect because it fails to take into account the resulting cash shortfall caused by the passing on of the over-funded pension trust assets to Texas ratepayers, in the form of negative pension expense.

OPC witness Ellen Blumenthal disagreed with CENTEL's proposal. According to Ms. Blumenthal, CENTEL has made no contributions to its pension fund and the pension asset on which the Company proposes to earn a return was established with ratepayer funds. Pension expense has been historically recovered through rates on a pay-as-you-go basis. Because investors did not supply any funds for pension costs, and the funds were all provided by ratepayers, Ms Blumenthal recommended that the prepaid pension asset that CENTEL included in rate base be removed.

Further, Ms. Blumenthal recommended that no pension expense be included in rates, because the Company is making no contributions to its pension fund. Ms. Blumenthal testified that by including the prepaid pension asset in rate base, CENTEL, in effect, charges ratepayers again for amounts they have already overpaid.

General Counsel concurred with CENTEL that the correct amount of prepaid pension costs to be included in rate base is $2,079,022. However, General Counsel provided no credible testimony to support its concurrence with CENTEL's proposal.

The prepaid pension asset proposed by CENTEL to be included in rate base caused the examiner great consternation. CENTEL witness Mr. Meyer provided an eloquent discussion to support his proposal that CENTEL earn a return on the prepaid pension asset. However, the examiner finds that the evidence in the record does not support CENTEL's proposal.

If we revisit Mr. Meyer's example, in which CENTEL would incur and pay operating costs of $10 million, Mr. Meyer is correct that the Commission would set rates to permit recovery of the $10 million from ratepayers. The examiner disagrees with Mr. Meyer's next contention, however, that when the $1 million negative pension expense is recorded by a non-cash credit to the income statement, revenue is reduced to $9 million, resulting in a $1 million shortfall. If CENTEL were allowed $10 million in operating costs, the $1 million negative pension expense would have already been deleted from the revenue requirement and there would be no shortfall. The $1 million negative pension expense is simply a non-cash journal entry CENTEL must record on its books.

CENTEL's argument is beguiling at first glance. However, upon further consideration, CENTEL's argument to include a return on the prepaid pension asset is specious. CENTEL argues that the negative pension expense is deducted from the cost of service for the benefit of the ratepayer, and that if CENTEL does not recover the negative pension expense from the ratepayers, then the Company must obtain the cash from another source and pay a return to investors. However, the characterization of the reduction in cost of service as a negative pension expense is a misnomer. The negative pension expense simply means that CENTEL has no revenue requirement for pension expense in its cost of service. There is no cash credit to ratepayers by CENTEL. There is simply a non-cash journal entry made by CENTEL on its books to reduce the amount of the overfunding, much the same way that a financial obligation is amortized over a period of time.

Mr. Meyer admitted at the hearing that the pension asset was funded by ratepayers and that the credit is a non-cash journal entry. However, he subsequently attempted to characterize this non-cash entry as investor-supplied cash that must be included in rate base. The examiner disagrees that CENTEL must go to investors to make up the amount of the negative pension expense. If CENTEL's pension fund does not require additional funding and CENTEL's revenue requirement is reduced as a result, there is no cash for CENTEL's investors to make up. Section 39 of PURA allows CENTEL to earn a reasonable return on invested capital, over and above reasonable and necessary operating expenses. If CENTEL's pension fund is fully funded, then there should be no pension expense included in rates as a reasonable and necessary expense. CENTEL should not earn a return on the credit it must make on its books to reduce the overfunding.

In its brief, CENTEL argues that the excess portion of the pension fund should be treated as an investor-supplied asset because investor monies fund the pension plan in the sense that the funds were earned through authorized rates and are monies that belong to the Company that could either have been used as internal capital or distributed to shareholders. This argument, however, is not credible. CENTEL collected, through its rates, enough money from ratepayers to fund its pension plan. Because CENTEL did not accurately predict that its pension fund would experience favorable investment results and that there would be reductions in benefit levels, the pension fund was subsequently overfunded. If CENTEL had predicted these events in advance, CENTEL's revenue requirement would have

> been reduced, the ratepayers would not have paid in as much, and CENTEL's pension plan would not be overfunded as it presently is. Therefore, CENTEL's argument that the Company or investors would have had use of the additional money in the pension fund is without merit. The examiner is not convinced, and the credible evidence does not show, that it is reasonable for CENTEL's investors to earn a return on the prepaid pension asset because the pension fund is overfunded. The examiner agrees with OPC that to include the prepaid pension asset in rate base would have the effect of charging ratepayers again for amounts they have already paid. Accordingly, the examiner recommends that CENTEL's proposal to include $2,079,022 as a prepaid pension cost be rejected.

Re Central Telephone Company of Texas, 1993 WL 595464 (Tex. PUC Sept. 8, 1993) at 11-12 (emphasis added) (Attachment E). The Texas PUC made the following findings in approving the Hearing Examiner's recommendation:

> 20. CENTEL's argument to include a return on the prepaid pension asset is specious.
>
> 21. Investors are not required to make up the amount of negative pension expense. If CENTEL's pension fund does not require additional funding and CENTEL's revenue requirement is reduced as a result, there is no cash for CENTEL's investors to make up.
>
> 22. If CENTEL's pension fund is fully funded, then there should be no pension expense included in rates as a reasonable and necessary expense. CENTEL should not earn a return on the credit it must make on its books to reduce the overfunding.
>
> 23. The credible evidence does not show that it is reasonable to compensate investors through a return on the prepaid pension asset because the pension fund is overfunded. To include the prepaid pension asset in rate base would have the effect of charging ratepayers again for amounts they have already paid.

Id. at 127-28.

The DPA respectfully submits that the Texas Hearing Examiner got it right.

3. Including the Prepaid Pension Asset and OPEB Cost Adjustments in Rate Base Inappropriately Combines the Accrual and Cash Funding Methodologies.

Last, including pension and OPEB cost adjustments in rate base inappropriately combines the accrual methodology used in the actuarial studies with the cash funding approach. If the

Commission has approved using the actuarial valuation (which uses the accrual methodology) to determine the proper level of pension and OPEB expense to be included in the revenue requirement, then it is inappropriate to include any rate base components that true-up actual versus funded liabilities because the accrual method already takes funding status into account. The fact is that over time, the amounts contributed to DPL's pension and OPEB funds will equal its calculated accrual costs. There may be timing differences due to variations in assumptions from year to year and due to actual versus projected results, but these variations will be trued up in subsequent actuarial studies. (Ex. 13 at 16). Delmarva acknowledged that the DPA proffered this testimony (DOB at 89), but the DPA can find no rebuttal of this testimony in DPL's brief.

In conclusion, the prepaid pension asset and OPEB liability are not used and useful in the provision of utility service and therefore cannot be included in rate base as a matter of law. Assuming the Commission finds otherwise, then the DPA respectfully submits that ratepayers should not be required to pay stockholders a return on money that they have not supplied. Third, the Commission's decision in Docket No. 05-304 appears to have been based on a misunderstanding of the issue and if so, then the Commission should reconsider that decision. Last, including the pension and OPEB in rate base inappropriately combines the actuarial and cash funding methods. Delmarva's request should be rejected.[50]

E. Recovery of Delmarva's Various Deferred Costs Should Be Denied.

1. Introduction

Delmarva requests recovery of various deferred costs, including regulatory asset treatment for Integrated Resource Plan ("IRP") costs, Bluewater Wind Request for Proposal ("RFP") costs, Dynamic Pricing ("DP") costs, Direct Load Control ("DLC") costs, and costs

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[50]The DPA notes that Delmarva includes the actuarially-determined level of pension and OPEB expense in its O&M expenses. The DPA has not challenged those expenses.

relating to a 2010 change in the Medicare tax law that it deferred without seeking or obtaining Commission approval. (Ex. 13 at 18, 27-28).

In evaluating Delmarva's claims for recovery of regulatory assets, DPA witness Crane evaluated three factors. First, she examined whether the Commission had previously approved deferred accounting treatment for the particular cost; if not, the requested recovery is barred by the longstanding prohibition against retroactive ratemaking. Second, she examined the magnitude of the cost to determine whether the costs sought to be recovered are reasonable and appropriate. She noted that allowing a utility to defer costs for potential later recovery does not guarantee recovery of those costs; rather, the deferral is generally conditioned on review of the costs in a future case to determine whether they should be recovered in rates and if so, how much. Regulation is not a cost reimbursement system; utility rates are established based on a test period and remain in effect until the utility seeks a rate change or the regulatory agency initiates a rate review. The reason rates include a return on equity that reflects a premium over a risk-free rate is because shareholders are supposed to assume the risk of managing the utility between rate cases, including the risk of unanticipated costs. Finally, she considered whether the cost was associated with a successful program currently serving customers. If the underlying program giving rise to the costs is not yet substantially complete and providing benefits to customers, then she generally recommends continued deferral until the project is complete and the costs can be examined in relation to the claimed benefits. (*Id.* at 18-20).

2. Deferred IRP Costs

The Commission addressed Delmarva's recovery of IRP costs in Order No. 7003 in Docket No. 06-241. It held as follows:

> 7. That, subject to Commission review and approval, the other initial costs incurred by Delmarva Power & Light Company in developing and submitting its

> IRP under the Act shall be included and recoverable *in its next distribution rate case.* Delmarva Power & Light Company shall also be permitted deferred accounting treatment for this purpose, *in which case the costs shall be amortized as an expense. In all subsequent cases, such costs shall be normalized as an expense in accordance with Commission practice.*
>
> 8. ... Similarly, the Commission reserves decision and judgment on whether the amounts granted deferred accounting treatment under Ordering paragraph 7 related to the initial Integrated Resource Plan, should earn a return, or some other carrying charge, for either the period until the onset of recovery or during any amortized recovery period. Such determinations shall be made during the distribution rate proceeding when Delmarva Power & Light Company seeks to recover the amounts granted deferred accounting treatment under Ordering paragraph 7.

In the Matter of Integrated Resource Planning for the Provision of Standard Offer Supply Service by Delmarva Power & Light Company Under 26 Del. C. §1007(c) & (d): Review and Approval of the Request for Proposals for the Construction of New Generation Resources Under 26 Del. C. §1007(d), Order No. 7003, ¶¶7-8 (Del. PSC August 8, 2006) ("Order No. 7003").[51] Delmarva neither requested reargument of this order nor appealed the order.

In this case, Delmarva seeks to recover a net $57,474 of deferred initial IRP-related costs incurred in August 2009 through amortization over 10 years with rate base treatment of the unamortized balance.[52] It contends that such recovery is mandated by 26 *Del. C.* §1007(c)(1)d, which provides that "[t]he costs that DP&L incurs in developing and submitting its IRPs shall be included and recovered in Delmarva's distribution rates." 26 *Del. C.* §1007(c)(1)d. It claims that the amount is reasonable given that it was "obligated to comply and has incurred carrying costs related to investor-supplied capital." (Ex. 20 at 37). In its brief, it asserts that the DPA's focus on the amount of costs is "inherently subjective," and therefore "inherently arbitrary" because it offers no standard for evaluating the magnitude of adjustments. (DOB at 66).

[51] http://depsc.delaware.gov/orders/7003.pdf

[52] Before being partially offset by deferred taxes, the amount included was $96,847. (Ex. 13 at 20).

Delmarva's request should be denied. First, the section of the Act on which it relies says only that Delmarva's costs shall be included and recovered in distribution rates. It does not say that 100% of those costs are recoverable, nor does it say anything about how those costs should be recovered (normalization or amortization). If Delmarva truly believed that Section 1007(c)(1)d authorizes it to recover 100% of its IRP costs, it should have requested the Commission to reconsider its decision in light of that section or appealed the Commission's decision to the Superior Court. It did neither.

Second, Order No. 7003, issued after the passage of Section 1007(c)(1)d, expressly stated that the initial IRP costs were to be "included and recoverable in [Delmarva's] *next* distribution rate case." (Emphasis added). Delmarva's *next* distribution case after Order No. 7003 was Docket No. 09-414. Nothing in Order No. 8011, issued after the Commission's deliberations in Docket No. 09-414, addresses additional IRP cost deferral. Rather, Order No. 8011 mentions two uncontested IRP adjustments: one for deferred costs for the initial IRP (amortization over 10 years with the unamortized balance included in rate base) and the other for ongoing prospective IRP costs (including a normalized amount of costs in operating expenses). Both of these ratemaking treatments were specifically addressed in Order No. 7003. One cannot assume from the Commission's silence in Order No. 8011 that it was authorizing additional deferrals, but Delmarva asks the Hearing Examine to assume exactly that.

Third, the magnitude of these costs does not justify either regulatory asset treatment or a 10-year recovery period. Contrary to Delmarva's claim, Ms. Crane did identify a standard: materiality. (Ex. 13 at 22). Total distribution revenues at present rates are approximately $176.5 million and earnings are approximately $30 million. (*Id.*). It cannot seriously be argued that denying recovery of this amount would materially impact Delmarva's financial condition.

Finally, Delmarva's argument that investors supplied this capital assumes that all of the dollars associated with this adjustment can be identified as funds received from shareholders as opposed to funds it received from ratepayers. But the dollars cannot be so segregated: they are fungible. One could just as easily argue that all the funds came from ratepayers so shareholders should have received no recovery of any IRP costs – but that would be just as untenable as Delmarva's contrary assumption.

Delmarva did not receive authorization to defer these costs to this case. It did not request reargument of or appeal the Commission decision directing when they should be submitted for recovery. The costs are miniscule in relation to Delmarva's total revenues and earnings and will not have a material impact on its financial condition if they are not recovered. And the assumption that shareholders contributed 100% of the funds spent on the initial IRP is unjustified. Their recovery should be denied.

3. Deferred RFP Costs

Order No. 7003 also addressed recovery of RFP-related costs. It provided that:

> 6. That, subject to Commission review and approval, *Delmarva Power & Light Company shall be permitted to recover its incurred costs associated with the RFP process* and the expense of the consultant retained by the Coordinating State Agencies for the RFP process and the evaluation of bids resulting from that process *in Standard Offer Service rates in PSC Docket No. 04-391.* Delmarva Power & Light Company shall be permitted deferred accounting treatment for this purpose.
>
> 8. That the Commission reserves any judgment and decision on whether carrying charges, and at what level, may be recovered on the amounts now granted deferred accounting treatment under Ordering paragraph 6. If Delmarva Power & Light Company seeks to recover such carrying charges, it shall file an application for such carrying costs *when it seeks to recover through revisions to its Standard Offer Service prices the amounts granted deferred accounting treatment under Ordering paragraph 6. …*

(Order No. 7003, ¶¶6, 8) (emphasis added). As noted previously, Delmarva neither sought reargument of nor appealed this order.

Delmarva now seeks recovery of a net $28,764 of RFP-related costs through amortization over 10 years and rate base treatment of the unamortized balance.[53] It says that these costs, which began in August 2009, were not "fully known and measurable" at the time of its last base rate filing. (Ex. 20 at 39). It relies on Order Nos. 7003 and Order No. 8011 in seeking their recovery in this proceeding and in the proposed manner. It also contends that Section 1007(c)(1)d of the Act requires their recovery in distribution rates. (*Id.* at 38-41).

Delmarva's request should be denied for the same reasons as its request for recovery of the IRP costs. First, Section 1007(c)(1)d provides Delmarva with no assistance here, as it is limited to costs of developing and submitting *IRP*s, not RFPs. 26 *Del. C.* §1007(c)(1)d. Delmarva tries to make these costs part of the IRP costs by claiming that the Bluewater RFP was part of the initial IRP, and indeed subsection (d) of Section 1007 identifies the RFP as part of the initial IRP process, but that subsection *also* specifically addresses the RFP process, and there is no provision in that subsection similar to section 1007(c)(1)d.

Second, Order No. 7003 specifically instructed Delmarva to recover these costs through Standard Offer Service ("SOS") rates – *supply rates – not distribution rates.* This makes sense, because the RFP addressed deregulated supply. Again, Delmarva neither requested reargument of Order No. 7003, nor did it appeal the order. Delmarva procures SOS supply and resets SOS rates annually. If it has not included these costs in SOS rates, it has no one to blame but itself.

Third, even if Delmarva could recover the RFP costs through distribution rates, neither Order No. 7003 nor Order No. 8011 authorized continued deferral of RFP costs.

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[53]Before being partially offset by deferred taxes, the amount included was $48,469. (Ex. 13 at 22).

Finally, the amount at issue here is even more miniscule in comparison to Delmarva's revenues and earnings than the IRP costs. Again, it cannot seriously be argued that denial of recovery of this amount would have a material impact on DPL's financial condition.

Delmarva did not receive approval to defer these costs to this case. It did not request reargument of or appeal the decision directing when they should be submitted for recovery. The costs are miniscule in relation to its total revenues and earnings and will not materially impact its financial condition if they are not recovered. Their recovery should be denied.

4. Deferred DP Costs

In Order No. 8105 in Docket No. 09-311, the Commission approved a settlement that authorized Delmarva to offer DP to customers, first on a limited basis to the 6,904 AMI Field Acceptance Test ("FAT") customers and then more broadly to its entire SOS customer base. (Ex. 5 at 17). It also authorized the creation of a regulatory asset for DP program-related costs. *See Delmarva Power,* Order No. 7420. In this case, Delmarva originally sought recovery of a net $3,843,284 of DP-related costs through amortization over 15 years and rate base treatment of the unamortized balance.[54]

In its rebuttal testimony, however, it separated its proposal into two parts. Part 1 seeks recovery of the actual DP regulatory asset balance of $5,049,437 as of August 31, 2013. DPL witness Ziminsky testified that these costs relate to customer education, outbound DP event calls, overflow customer call handling relating to DP events, amortization of DP-related systems and returns associated with the foregoing costs. (Ex. 20 at 42). He testified that customers had the opportunity to benefit from these costs because Delmarva called a DP event on July 17, 2013, after the program was available to all residential SOS customers, and Delmarva paid approximately $775,000 in bill credits. He further noted that Delmarva called a second event on

[54]Before being partially offset by deferred taxes, the amount included was $6,699,487. (Ex. 13 at 23).

September 11, 2013 for which participating customers would receive bill credits. (*Id.* at 42-43). Part 2 of the DP proposal seeks recovery of $821,155 of forecasted DP costs, which Delmarva claims will be incurred before the end of this case. It continues to propose a 15-year amortization period and to include the unamortized balance of the regulatory asset in rate base. (*Id.* at 43).

As of December 31, 2012, the regulatory asset balance was $413,576. In January 2013 Delmarva reclassified costs from the AMI regulatory asset to the DP regulatory asset, which increased the DP regulatory asset balance at December 31, 2012 to $2,456,025. DPA witness Crane testified that since the DP program began during the test year with the FAT customers, it was reasonable to permit some cost recovery in rates, and so recommended including the regulatory asset balance as of December 31, 2012 - $2,456,025 – in rates.[55] She recommended continued deferral of the DP-related costs through December 31, 2013 until DP implementation was complete and there was more data for evaluating the program. (Ex. 13 at 24).

Delmarva's proposals should be rejected. The order approving creation of the regulatory asset for AMI, which is the basis for regulatory asset treatment of the DP costs, specifically states that the Commission "may wish to consider an appropriately valued regulatory asset for [AMI] investment *consistent with the matching principle giving consideration to both costs and savings…* ." *Delmarva Power,* Order No. 7420 at Ordering ¶(3) (emphasis added).

Parties should be able to contest both the amount and reasonableness of actual costs incurred and savings realized rather than costs Delmarva thinks it will incur. Moreover, there does not seem to be any recognition of savings realized in 2013 from the DP program. Delmarva is not prejudiced by continuing to accrue DP program costs in a regulatory asset. Regardless of what DPL has paid in 2013 to DP participants, the test period that Delmarva chose for this case

[55]Delmarva incorrectly asserts that Ms. Crane did not reflect this reclassification of costs from the AMI regulatory asset to the DP regulatory asset. (DOB at 69). As discussed above, it is wrong. (Ex. 13 at 24).

is the 12 calendar months ending December 31, 2012. Allowing recovery of the 2013 DP costs in this case, whether actual or projected, is inconsistent with Order No. 7420's direction that recovery of the regulatory asset be considered consistent with the matching principle giving regard to both costs and savings. Thus, the DPA respectfully submits that Delmarva's proposal to include DP costs incurred in 2013 in the revenue requirement should be rejected.[56]

5. Deferred DLC Costs

In Order Nos. 7420 (Docket No. 07-28) and 8253 (Docket No. 11-330), the Commission authorized Delmarva to implement a DLC program and to create a regulatory asset for the costs incurred in connection with its implementation. In this case, Delmarva seeks recovery of a net $5,706,782 of DLC-related costs, to be amortized over 15 years with rate base treatment for the unamortized balance.[57] DPL witness Ziminsky testified that Delmarva began implementing the program in late 2012 and that implementation would continue through 2016. (Ex. 20 at 49). However, Delmarva did not actually begin implementing the program until April 2013. (Ex. 13 at 26-27, citing Delmarva's response to PSC-RR-44). DPA witness Crane therefore recommended excluding DLC program costs from rate recovery in this case because implementation had not begun until after the test period ended and the program was still young. She noted that Delmarva could continue to defer the program costs for review in a future proceeding, after the program had been functioning for some time and sufficient data existed to determine whether and/or how much of the costs should be recovered in rates. (*Id.* at 27).

In rebuttal, similar to its proposal for the DP regulatory asset costs, Delmarva divided the DLC regulatory asset costs into two parts: Part 1 seeks recovery of the actual DP regulatory asset

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[56]The DPA does not contest Delmarva's proposed normalized level of DP expense. (Ex. 13 at 46).

[57]Before being partially offset by deferred taxes, the amount included was $9,616,281. (Ex. 13 at 26).

balance of $5,049,437 as of August 31, 2013, while Part 2 seeks to recover projected regulatory asset costs from September through December 2013. (Ex. 20 at 49). Delmarva asserts that 7,490 customers are already receiving benefits from the DLC program and that it expects an additional 12,110 customers to have devices installed by the end of 2013; thus, all actual and projected 2013 costs should be recovered in the rates set in this proceeding. (*Id.* at 51-52).

This proposal, too, should be rejected. Indeed, rejection is even more appropriate here, where *none* of the costs that Delmarva seeks to recover were incurred in the test period that it selected. Delmarva admits that it did not begin implementing the DLC program until April 2013. Again, parties should be able to contest both the amount and reasonableness of actual costs incurred and savings realized rather than costs Delmarva thinks it will incur. And again, there appears to be no recognition of savings realized in 2013 from the DLC program.

Delmarva suffers no prejudice by continuing to accrue DLC program costs in a regulatory asset. Regardless of how many DLC participants DPL had in 2013, the test period that it chose is the 12 calendar months ending December 31, 2012. Allowing recovery of the 2013 DLC costs in this case is inconsistent with Order No. 7420's direction that recovery of the regulatory asset be considered consistent with the matching principle giving regard to both costs and savings. Thus, the DPA respectfully submits that Delmarva's proposal to include DLC costs incurred in 2013 in the revenue requirement should be rejected.[58]

6. Deferred Medicare Tax Subsidy Costs

Delmarva included in its revenue requirement a one-time charge of $110,507 from 2010 relating to a change in the law regarding Medicare Part D. It seeks to amortize this amount over three years and to include the unamortized balance in rate base. Delmarva deferred this amount

[58]For the same reasons, the DPA rejected Delmarva'inclusion of a normalized level of DLC program expense in its operating expenses for rate recovery. (Ex. 13 at 46-47). We will not address this issue again in our discussion of operating expenses since the rationale for rejecting Delmarva's proposal is the same as set forth here.

on its books, although it neither applied to the Commission for authorization to defer the costs nor received Commission approval for their deferral. (Ex. 5 at 30; Tr. at 603-04). It justifies including this out-of-period expense on the grounds that: the change in the law was outside its control; it used the accrual method of accounting for this expense; its approach is symmetrical since it reduced its rate base as a result of the additional deferred tax credits; customers have received the benefit of a lower rate base in each base rate case since 2004; and the DPA did not contest the benefit of the subsidy when that benefit accrued to ratepayers, but is now contesting the adjustment when it does not benefit ratepayers. (Ex. 20 at 57-58).

The adjustment should be rejected. First, including this out-of-period expense in rates resulting from this proceeding constitutes retroactive ratemaking. The Delaware Supreme Court held thirty years ago that a utility may not recover previously-incurred expenses in prospective rates. *Public Service Commission v. Diamond State Telephone Co.*, 468 A.2d 1285, 1296-1300 (Del. Supr. 1983). It specifically cited the "pervasive and fundamental rule underlying the utility rate-making process [] that 'rates are exclusively prospective in application and that future rates may not be designed to recoup past losses' in the absence of express legislative authority." (*Id.* at 1298) (citations omitted). Delmarva cites no legislative authority allowing it to recover the cost it incurred in 2010 (because there is none). And it admits that it neither sought nor received Commission approval in 2010 to defer the expense. (Tr. at 603-04).[59] The prohibition against retroactive ratemaking resolves all of Delmarva's arguments supporting the inclusion of the 2010 expense in rates resulting from this case; however, we will address all of Delmarva's arguments.

Second, under Ms. Crane's evaluation criteria, the magnitude of these costs is small. She notes that shareholders should expect that from time to time they will be required to absorb

[59]Not surprisingly, Delmarva cites no authority for its contention that its request is not retroactive ratemaking because it is not trying "to correct or reset a previously-approved rate and then apply that change to customers of the past period." (DOB at 71).

unanticipated most increases resulting from changes in laws or other reasons; that is why they earn a return on equity. (Ex. 13 at 28).

As for DPL's argument that the DPA did not contest the benefit of the subsidy to ratepayers: the DPA's statutory duty is to represent the interests of all regulated public utility consumers. 29 *Del. C.* §8716(e)(2). Not the utility – the *consumers.* So why *would* the DPA challenge a benefit to consumers? And why is Delmarva so surprised that the DPA challenges an adjustment that does *not* benefit consumers?

Allowing Delmarva to recover this expense at all constitutes retroactive ratemaking. Its inability to recover it will not have a material effect on its financial position. Its attempt to include it in the revenue requirement in this case should be rejected.

F. Delmarva's Adjustment to Include Credit Facility Costs in Rate Base and Operating Expenses Should Be Rejected.

Delmarva increased its rate base by $520,111 and operating expenses by $337,108 relating to PHI's short-term credit facility. The rate base adjustment represents amortization of Delmarva's portion of the start-up costs associated with the facility (and includes a return on the unamortized balance of the costs), and the operating expense represents its portion of the facility's annual recurring costs. (Ex. 13 at 29). Delmarva states that the credit facility serves the day-to-day cash needs of PHI's companies and is a temporary funding source for new construction. Aalthough the costs are recorded as interest expense for financial reporting purposes, they are not reflected in the cost of capital for ratemaking purposes and therefore would not be recovered otherwise. (Ex. 5 at 30; Ex. 3 at 7). Delmarva further contends that the existence of the credit facility is a key consideration in rating agencies' assessments of its long-term credit rating; it provides assurance that Delmarva will pay its obligations when the capital markets are in turmoil. Furthermore, Delmarva contends that the credit facility allows it to obtain a higher credit rating, which allows it to obtain lower-cost long-term financing on better terms and conditions. Finally, the credit facility provides flexibility to Delmarva's long-term financing program because it can use the facility to bridge the gap between the due date of maturing debt and the issuance of new debt when the market is more accessible or terms are more favorable. According to Delmarva, the credit facility would be required regardless of whether if issued short-term debt; thus, it would not be appropriate to condition the recovery of its costs on including short-term debt in the capital structure. (Ex. 3 at 8-9; DOB at 32-33 and73-74).

The DPA acknowledges that the Commission approved including the credit facilities costs in Order No. 8011; however, it believes that the Commission reached the wrong decision in that case. Unless short-term debt is included in Delmarva's capital structure, the cost of credit facility should be excluded from its revenue requirement. DPA witness Crane testified that although the credit facility is a source of low-cost short-term debt for Delmarva, ratepayers do not get any rate benefit of that low-cost debt because there is no short-term debt in Delmarva's capital structure. (Ex. 13 at 29). She notes that Delmarva's short-term debt cost as of December 31, 2012 was 0.38%, but its proposed capital structure contains only long-term debt at a cost of 4.91% and equity at a requested 10.25% COE. (Ex. 13 at 30, citing Delmarva's response to PSC-COC-9). Furthermore, ratepayers are paying for Delmarva's day-to-day "working capital" needs in the CWC allowance, materials and supplies, and prepaid insurance, all of which are included in rate base and on which Delmarva earns a return. (*Id.* at 30).

Delmarva's explanations for why the credit facility is beneficial may be true. The DPA will assume that they are for purpose of this argument. If so, there are many benefits – none of which are passed through to ratepayers. It is unjust and inequitable to require ratepayers to fund the costs of the credit facility (in addition to the CWC allowance, materials and supplies allowance and prepaid insurance allowance that they are *also* funding) but deny them the benefit of that much lower cost (by some 350 basis points) debt in the capital structure. The DPA is not suggesting that Delmarva cannot recover those costs under any circumstances. All we are saying is that *if* the Commission allows their recovery, it should be conditioned on giving the ratepayers who are paying those costs in rates the *benefit* of those costs by including short-term debt in Delmarva's capital structure. (Ex. 30 at 30-31). At a time when ratepayers are being asked to pay more and more in rates, they should at least be given the benefit of the costs for which they are being charged when such benefit exists, as it does here.[60]

If the Commission does not want to include short-term debt in Delmarva's capital structure, another ratemaking treatment would provide Delmarva with recovery of the credit facility costs and match the costs to ratepayers with the benefit of using short-term debt. As Staff witness Peterson testified, Delmarva first assigns short-term debt to CWIP. This assignment is recognized in the AFUDC rate, which Delmarva then capitalizes to its construction accounts. (Ex. 11 at 34). Recognizing the credit facility costs as an increase in the effective cost of short-term debt in the AFUDC rate will appropriately compensate Delmarva for those costs. (*Id.;* Ex. 13 at 31). Delmarva claims that this is inappropriate because the credit facility costs are not associated with the amount of borrowing and are incurred even if it does not borrow on the facility. (Ex. 3 at 7; DOB at 73). But Delmarva does not like the most appropriate treatment, which is to include short-term debt in the capital structure (which would afford recovery of these costs). The DPA would accept this treatment as an alternative to ratepayers receiving *no* benefit -

[60] The DPA cannot help but compare Delmarva's position on these costs to the deferred Medicare tax subsidy costs. There, Delmarva painted itself as benevolent for passing through the cost savings from the subsidy to the ratepayers from 2004 until the law changed in 2010. (Ex. 20 at 58). Why doesn't Delmarva want to give the ratepayers the benefit of the *credit facility's* lower cost?

which is not the case under DPL's treatment and the treatment that this Commission approved in Delmarva's last litigated rate case.

Like Delmarva's treatment of the prepaid pension asset, this ratemaking treatment is another "heads I win, tails you lose" proposal. It is unfair to ratepayers. As the Commission has acknowledged in the context of incentive compensation plans, it must consider the effect of such plans on ratepayers in the context of the then-existing economic circumstances which it recognized would change. That acknowledgement should apply here as well. The Commission can give ratepayers the benefit of the credit facility by including short-term debt in the capital structure and allowing Delmarva to recover the costs associated with the credit facility. *That* is a win-win. The DPA respectfully requests the Commission to reconsider its position on this issue.

IV. OPERATING INCOME ISSUES

A. Delmarva's Salary and Wage Adjustments Should Be Rejected.

Although Delmarva chose a test period of the 12 calendar months ending December 31, 2012, it based its salary and wage claim on projected payroll costs on the period from January 1, 2012 through November 2014. The adjustment, which increases its revenue requirement by $1,782,036, includes the following:

- Annualization of the IBEW Local 1238 2% test period increase;
- IBEW Local 1238 estimated 2% increase effective February 2013;
- IBEW Local 1238 estimated 2% increase effective February 2014;
- Annualization of the IBEW Local 1307 2% test period increase;
- IBEW Local 1307 estimated 2% increase effective June 2013;
- IBEW Local 1307 estimated 2% increase effective June 2013;
- Annualization of 3% non-union test period increase;

- Estimated 3 % non-union increase effective March 2013; and
- Estimated 3% non-union increase effective March 2014.

(Ex. 5 at 13; Ex. 13 at 32). In rebuttal, it reduced the adjustment to $1,173,236 to reflect the actual terms of the contracts reached with Locals 1238 and 1307 (Ex. 20 at 21-22 and Sch. (JCZ-R)-2),[61] but it continues to include projected increases going out almost two years beyond the end of the test period. It justifies this overreaching by pointing to the Commission's decisions in Docket Nos. 94-22, 03-127, 05-304 and 09-414, where the Commission permitted it to include salary and wage increases well beyond the end of the test period. (Ex. 5 at 12; Ex. 20 at 23-24). Calling the DPA's proposed ratemaking treatment "arbitrary," it also claims that such increases are reasonably known and measurable based on the contractual requirements for the union employees and based on its history of granting raises. (Ex. 20 at 24-25; DOB at 82).

The DPA acknowledges that the Commission has allowed Delmarva to include wage and salary increases far outside the test period in its revenue requirement in previous cases. (DOB at 81). The DPA also acknowledges that Commission regulations permit modifications to test period data occasioned by reasonably known and measurable changes in current or future rate base items, expenses or revenues. 26 *Del. Admin. Code* §1002.1.3.1. But the circumstances under which that approval was given are much different than the circumstances presented here. As we discussed with respect to Delmarva's post-test period rate base additions, the time between rate cases provided some justification for including post-test-period wage adjustments in the revenue requirement because there was no guarantee that Delmarva would file another rate case within a short period of time. In this case, however, we *have* that guarantee: Delmarva has been clear about its intent to file annual rate cases. If Delmarva intends to file another rate case

[61]According to Schedule (JCZ-R)-2, page 2, the annual contractual increases for the two locals beginning in 2013 are 2.25% rather than 2%. (Ex. 20 at Sch. (JCZ-R)-2 p. 2).

in 2014, past history suggests that the 2013 calendar year will be the test period. Under these circumstances, the Commission need not include these post-test-period adjustments in the revenue requirement in this case because they will be included in the test period in the next case.

Delmarva could have used a partially projected test period consisting of as many as nine months of projections, which would have permitted it to include reasonably known and measurable changes, which would have encompassed the 2013 wage increases. *See* 26 *Del. Admin. Code* §1002.1.2.2. But it didn't. Using a test period consisting of actual results for a 12-month period and then including projected increases extending two years past that period renders the Commission's regulation defining permissible test periods a nullity. And, as we noted previously, Delmarva made no adjustment to recognize increased revenues.

The salary and wage adjustment distorts the regulatory triad of synchronizing rate base, expenses and revenues. Delmarva alone chose the test period. It should be held to the test period it chose. The DPA's recommendation is hardly "arbitrary:" it is based on the fundamental ratemaking principle of matching test period expenses, rate base and revenues. And it is not arbitrary when the circumstances have changed since the Commission's last decision. The DPA respectfully requests that Delmarva's wage and salary adjustment be denied, and that only annualization of the wage and salary increases that occurred during the test period be approved.[62]

B. Delmarva's Adjustment to Include 100% of Non-Executive Incentive Compensation Expense Should Be Rejected.

DPL included in its revenue requirement $1,993,802 of non-executive incentive compensation, most of which relates to its Annual Incentive Plan ("AIP").[63] Under the 2012 AIP,

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[62]The DPA notes that if its recommendation is adopted, an adjustment to eliminate certain payroll taxes from the revenue requirement is also necessary. That adjustment appears at Ex. 13 at 37-38 and Sch. ACC-19.

[63]Delmarva removed executive incentive compensation program costs from its revenue requirement in this case. (Ex. 5 at 8, 15; Ex. 13 at 34).

no payments are made unless earnings reach certain targeted levels. (Ex. 13 at 33; Ex. 70).[64] If the earnings thresholds are satisfied, then a combination of business unit and individual goals must be met before any awards are made. Award percentages rise as pay scales rise, so higher-paid employees are eligible for proportionately greater awards. (Ex. 13 at 34).

The DPA acknowledges that in Docket No. 05-304, the Commission included in rates the amounts associated with the achievement of safety, reliability and customer service goals in rates, but excluded the amounts related to the achievement of financial goals.[65] Notwithstanding that, the DPA respectfully requests the Commission to reconsider its position on such costs and to exclude them from the revenue requirement altogether.

Delmarva also asks the Commission to reconsider its position on these costs and include all such expense in rates. It claims that: the program is "critical" for attracting and retaining competent talent; it strives to align employee behavior with company business objectives such as customer satisfaction, employee productivity, employee safety and operational efficiency; it made a business decision to place a portion of employees' compensation at risk to motivate them to achieve their "best performance;" such plans are standard in the industry; and the incentive compensation plan benefits customers by (for example) controlling spending and encouraging employees to think of ways to save money. (Ex. 2 at 10-11; Ex. 20 at 69; DOB at 95).

Delmarva did not identify any new facts or reasons for the Commission to include 100% of non-executive incentive compensation expense in the revenue requirement. (Tr. at 657-59). DPL witness Ziminsky candidly conceded that employees receive nothing even if they meet all

[64]The 2013 AIP structure changed slightly to provide that awards are funded from an Enterprise Incentive Pool; however, an earnings trigger must be satisfied before any incentive payments are made. (Ex. 13 at 34).

[65]In Docket No. 09-414, the Commission excluded all non-executive incentive compensation expense from the revenue requirement because Delmarva had not quantified the amount of expense related to achieving safety, reliability and/or customer service goals. *Delmarva Power*, Order No. 8011 at ¶¶195-196).

of the safety, customer service, reliability, and "balanced scorecard" goals *unless* the earnings thresholds are achieved. (*Id.* at 660-61). He also testified that employees would work safely without an incentive compensation plan. (*Id.* at 659-60). Similarly, Mr. Boyle testified that Delmarva's employees would perform their duties in a way that protected customers' interests without an incentive compensation plan. (*Id.* at 205). In this regard, the DPA agrees with DPL: it does not doubt that Delmarva's employees live up to the high standards expected of them regardless of whether there is an incentive plan.

The DPA observes that Delmarva did not always have a non-executive incentive compensation plan. In response to an in-hearing data request, Mr. Ziminsky stated that Delmarva did not implement a non-executive incentive plan until 1999. (*Id.* at 1020). Delmarva has been providing utility service since before 1999, so it seems apparent that employees performed their duties ably and dependably before the incentive plan was implemented. Thus, it cannot be said that these costs are normally incurred in the provision of utility service.

Furthermore, even if incentive plans are standard in the industry, that does not mean that ratepayers should be wholly responsible for paying for them: in other jurisdictions, shareholders are either wholly or partially responsible for the costs of such plans. *See Narragansett Electric Co. v. Rhode Island Public Utilities Commission*, 35 A.3d 925, 937-38 (R.I. Supr. 2012); *Commonwealth Edison Co. v. Illinois Commerce Commission,* 924 N.E.2d 1065, 1077-79 (Ill. App. 2009), *appeal denied*, 938 N.E.2d 519 (Ill. 2010); *Re Public Service Company of Oklahoma,* 2007 WL 6081138 (Okl. C.C. Oct. 7, 2009) at 145;[66] *Pennsylvania Public Utilities Commission v. UGI Utilities, Inc.*, 1994 WL 843040 (Pa. PUC Sept. 23, 1994) at 5-6 (Attachment F).

[66] http://imaging.occeweb.com/AP/Orders/0035DC7E.pdf

Delmarva claims that the DPA's arguments that the plan's financial goals only benefit shareholders are "unsupported." (DOB at 96). But it is Delmarva's claim of ratepayer benefits that is unsupported. What really are the benefits to ratepayers of employees meeting the safety, customer service, reliability and other non-financial goals, and how does meeting them benefit ratepayers? Savings that accrue between rate cases benefit shareholders, because rates are not adjusted in between cases to reflect such savings. The incentive plans basically requires ratepayers to pay higher compensation costs as a consequence of high corporate earnings. (Ex. 13 at 35). This does not benefit ratepayers. The benefit to stockholders, however, is easily identified: reduced costs equal greater profits and potentially higher dividends.

It is true that Delmarva could pay higher salaries in lieu of an incentive plan. But that does not mean that higher salaries would be deemed reasonable. Furthermore, there is no evidence that its employees are *underpaid*; Delmarva has given employees raises every year save one in the last ten years (Ex. 20 at 24-25). It also gears its compensation packages to be at the midpoint of peer group comparisons (which, notably, also include non-regulated companies). (Tr. at 203). By definition, the midpoint means that at least 49% of the peer group companies' employees earn less than their Delmarva equivalents. Nor has Delmarva provided any evidence that it would have difficulty attracting qualified employees in the absence of an incentive plan: Mr. Boyle was unable to identify any employee who had selected a position with Delmarva *because of* the incentive plan. (Tr. at 203). And in this economy, qualified people are unlikely to be quibbling about whether a potential employer has an incentive compensation package.

In Docket No. 05-304, the Commission acknowledged that this is a difficult issue. It expressed belief that such plans benefit ratepayers by extending the time between rate cases. *Delmarva Power*, Order No. 6930 at ¶96. But that rationale no longer holds true in light of

Delmarva's record of filing rate cases and its stated intent to file annual rate cases. The Commission also observed that it could not examine the issue in a vacuum, but had to consider the effect of such plans on ratepayers in the context of the then-existing economic circumstances which it recognized would change. (*Id.*). The economic circumstances have changed: Delaware is slowly recovering from the worst financial crisis since the Great Depression. If anything, the circumstances are more dire now than in 2006, when deregulation was going to result in a nearly 60% increase in electric supply rates but the economy was better than it is today.

Stockholders clearly benefit financially from the existence of incentive programs triggered by financial goals. The benefits to ratepayers, however, are ephemeral at best. The DPA respectfully requests the Commission to find that the costs of the non-executive compensation program should be borne by the primary (if not the sole) beneficiaries: the stockholders.

C. Delmarva's Proposed Relocation Expense Level Should Be Rejected.

Delmarva includes is test period expense of $130,447 of relocation expenses in its revenue requirement. (Ex. 13 at 38). Relocation expenses for the three prior years were $20,482 in 2009, $37,450 in 2010 and $31,749 in 2011. (*Id.*, citing Delmarva's response to AG-RR-20). It is obvious that the 2012 expense level is significantly higher; indeed, it is almost three times greater than the next highest expense level (2010), and over four times more than the 2011 expense level. It is equally obvious that the test period expense level is an aberration.

Delmarva claims that its relocation expense is "well-supported in the record" and that it is following "precedent" from Docket Nos. 09-414 and 05-304 by using the test period expense level; it is a normal expense incurred in the ordinary course of business; and there is no support for normalization because expenses can be higher or lower in any given year. (DOB at 97; Ex. 20

at 74). One searches DPL's brief in vain for any support, however. The only support Delmarva provides is Mr. Ziminsky's identification of the 2012 expense level.[67] Noticeably absent from its discussion is any acknowledgement of the magnitude of the difference from the preceding three years, or even from the immediately preceding year.

The Commission has long recognized that normalization is proper when test period expense is out of line with a utility's past experience and is not expected to be representative of the future. *Delmarva Power,* Order No. 8011 at ¶132; *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*, PSC Docket No. 91-20, Order No. 3389, (Del. PSC Mar. 31, 1992) at ¶141 (Attachment G). In Docket No. 91-20, Delmarva claimed a test period level of tree trimming expense that was significantly higher than the expense in preceding years. The DPA challenged the expense level. The Hearing Examiner found that DPL had not justified the significant increase over such a short time period and recommended normalization. The Commission agreed. (*Id.* at ¶¶74, 138, 142).

Delmarva argues that the DPA "merely … select[ed] … data from a pre-test year period instead of relying upon the actual test year period for ratemaking," and that this is "improper." (DOB at 97). But the Commission has applied a normalization adjustment that did not include the test year expense level in a previous case involving this same utility. In Docket No. 09-414, the Commission considered a similar situation involving Delmarva's pension expense, and concluded that the abnormally high test period expense level should be excluded from the normalization adjustment because including it would "result in overrecovery of the pension expense." *Delmarva Power,* Order No. 8011 at ¶132. If the Commission followed such a

[67]And as noted previously, its mere assertion that its adjustment is well-supported is insufficient. *See Utah Department of Business Regulation*, 612 P.2d at 1245-46.

normalization procedure here – excluding the 2012 test period level and averaging the prior three years – the expense level to be included in rates would be $29,909, which is less than the DPA's recommendation.

Delmarva bears the burden of proving that the amount of relocation expense it seeks to include in rates is reasonable. It presented no evidence that the $130,447 it seeks to include in rates in this case is likely to occur in the future, and its 2012 expense level is clearly out of line with past experience. DPA's proposal – which permits DPL to include the *highest* pre-test period of relocation expense – is reasonable and should be accepted.

D. The DPA's Recommendation to Exclude SERP Expenses from Delmarva's Revenue Requirement Should Be Accepted.

Delmarva includes $1,101,782 of Supplemental Executive Retirement Plan ("SERP") benefits expense in its revenue requirement. SERP benefits are known as "top hat" or "excess benefit" plans; in most circumstances, the difference is that a top hat plan can have multiple broad purposes, but the sole purpose of an excess benefit plan is to avoid the limitations imposed by Internal Revenue Code §415. *Garratt v. Knowles*, 245 F.3d 941, 946 n.4 (7th Cir. 2001). The SERP provides benefits to key executives that are *in addition to* the normal retirement programs DPL provides. As described in PHI's 2012 Proxy Statement:

> The PHI 2011 Supplemental Executive Retirement Plan, or the 2011 SERP, provides retirement benefits to participating executives in addition to the benefits a participant is entitled to receive under the Pepco Holdings Retirement Plan to supplement benefits which participants forego due to certain limitations on benefit calculations imposed by the [Internal Revenue] Code. If the benefit payment that otherwise would have been available under the applicable benefit formula of the Pepco Holdings Retirement Plan is reduced due to a contribution or benefit limit imposed by law, the participant in the Pepco Holdings Retirement Plan is entitled to a compensating payment. In addition, a participant in the Pepco Holdings Retirement Plan is entitled to either or both of the following enhancements to the calculation of the participant's retirement benefit:

- the inclusion of compensation deferred under the Company's executive deferred compensation plans; and

- to the extent not permitted by the Pepco Holdings Retirement Plan, the inclusion of annual cash incentive compensation received by the participant.

(Ex. 13 at 39-40, quoting PHI 2012 Proxy Statement at 44; *see* Ex. 67).

Delmarva argues that including SERP benefits in its revenue requirement is consistent with Commission precedent and Delaware law. (DOB at 91). The DPA acknowledges that the Commission rejected its argument to exclude these expenses from the revenue requirement in Docket No. 09-414. But times have changed. As the Commissioners know, the economy is sluggish; customer comments indicate that many of them are struggling to pay their energy bills. Contrast this to the lavish compensation that PHI's senior executives get even before the SERP benefits are considered:

- In 2012, Joseph Rigby, PHI's Chief Executive Officer, received more than $11 million of total compensation, including $985,000 in base salary, $4.7 million in stock options, $1.19 million in non-equity incentive compensation, and more than $200,000 of "other" compensation. (Ex. 67 at 50; Tr. at 662-63).

- In 2012, Anthony J. Kamerick, PHI's former Chief Financial Officer, received more than $2.6 million of total compensation, including $513,000 in base salary, over $650,000 in stock awards, and over $370,000 of non-equity incentive compensation. (Ex. 67 at 50; Tr. at 664).

- In 2012, Kirk Emge, PHI's former General Counsel, received more than $1.9 million in total compensation, including $400,000 in base salary, almost $300,000 in non-equity incentive compensation, more than $400,000 in stock awards, and more than $70,000 of "other" compensation. (Ex. 67 at 50; Tr. at 665-66).

- In 2012, Frederick Boyle, PHI's current Chief Financial Officer, received almost $1.3 million in total compensation, consisting of almost $321,000 of base salary, more than $233,000 of non-equity incentive compensation, over $500,000 in stock options, and $144,402 of "other" compensation. (Ex. 67 at 50; Tr. at 663-64).

- In 2012, David Velasquez, received total compensation of more than $2.9 million, including $503,000 base salary, almost $316,000 of non-equity incentive compensation, over $640,000 of stock awards, and a $100,000 bonus. (Ex. 67 at 50; Tr. at 664-65).

- In 2012, Kevin Fitzgerald, the new General Counsel, received over $1.5 million of total compensation, including $159,000 of base salary, more than $115,000 of non-equity incentive compensation, and over $1.27 million of stock awards. (Ex. 67 at 50; Tr. at 665).

These executives also receive one or more additional "perquisites and personal benefits" that Delmarva did not include in its requested revenue requirement, such as: a car allowance; company-paid parking; tax preparation; financial planning services; an annual executive physical; payment of certain club dues; personal use of company-leased entertainment venues and company-purchased tickets to sporting and cultural events not otherwise used for business purposes; and reimbursement for spousal travel. (Ex. 67 at 45). Plus, they also receive the *normal* retirement benefits that other Delmarva employees receive, for which ratepayers are already paying, and which the DPA did not challenge in this case.

Other commissions have rejected arguments identical to those that Delmarva makes here: that the SERP helps it to attract and retain qualified employees, that it is a common practice, that it is within the utility's business judgment, that it benefits ratepayers. *See Re Yankee Gas Services Company*, 2011 WL 2816882 (Conn. DPUC June 29, 2011)[68] at 71-73; *Re UNS Gas, Inc.*, 2010 WL 1634233 (Ariz. C.C. Apr. 4, 2010)[69] at 32-34; *Public Service Company of Oklahoma, supra* at 114-15; *Re Consumers Energy Company*, 2005 WL 3617546 (Mich. PSC Dec. 22, 2005)[70] at 34. The Connecticut DPUC stressed that ratepayers should not be funding

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[68] http://www.dpuc.state.ct.us/FINALDEC.NSF/2b40c6ef76b67c438525644800692943/e90fe40d54d3f7cf852578bf00627433/$FILE/101202-062911.doc

[69] http://images.edocket.azcc.gov/docketpdf/0000111281.pdf

[70] http://www.dleg.state.mi.us/mpsc/orders/electric/2005/u-14347_12-22-2005.pdf

benefits over and above those deductible under the Internal Revenue Code, especially during difficult economic times. *Yankee Gas, supra* at 72.

It cannot be disputed that these executives are already well compensated. They are the 1%; most of Delmarva's ratepayers are the 99%. In a time when ratepayers face ever-increasing utility costs, requiring them to finance additional benefits for executives who are already quite handsomely compensated is unfair and unreasonable. The DPA suggests that this is not the signal this Commission should be sending to ratepayers. If Delmarva wants to provide additional retirement benefits to already-highly compensated executives, shareholders should fund them. The DPA respectfully requests the Commission to reconsider its position.

E. <u>Delmarva's Medical Benefit Expense Level Should Be Rejected.</u>

Delmarva is self-insured for its medical benefits costs, so its actual medical costs vary based on the specific amount of services required each year. (Ex. 13 at 41). For ratemaking purposes, however, it based its proposed medical expense level on forecasts by Lake Consulting, Inc., its benefit plans consultant, for the first quarter of 2013. (Ex. 5 at 14 and Sch. (JCZ)-9.1). Lake analyzes benefit trends each quarter in the "mid-Atlantic region." (*Id.* at Sch. (JCZ)-9.1). The study projects increases in HMO costs ranging from 7.9%-12% (average 9.4%); increases in PPO costs ranging from 7.7%-12% (average 9.6%); increases in dental costs ranging from 5%-7.8% (average 6%); and an average 6% increase in vision costs (Lake does not specifically track vision cost expense but notes that vision cost trends generally follow dental cost trends). (*Id.*). Delmarva proposes an 8% increase for medical expense and 5% increases for both dental and vision expense. (*Id.* at 14-15).

The DPA acknowledges that the Commission accepted Delmarva's use of Lake's projections to establish the appropriate amount of medical benefits cost included in its revenue requirement in Docket No. 09-414. However, it believes that the Commission should reconsider that decision for several reasons.

First, although administrative proceedings are less formal than court proceedings, and hearsay is frequently admitted, there are limits. Administrative rulings cannot rest solely upon hearsay evidence. *See Crooks v. Draper Canning Co.,* Del. Supr., 633 A.2d 369 (table), 1993 WL 370851 (Sept. 7, 1993) (Attachment H); *Morris v. Gillis Gilkerson, Inc.*, Del. Super., 1997 WL 819110, Lee, J. (Nov. 25, 1997) at *3 (Attachment I); *Lavelle v. Kent County Personnel Administration Board*, Del. Super., 1997 WL 719134, Ridgely, J. (Sept. 12, 1997) at *8 (Attachment J). The Lake report is an out of court statement offered to establish the truth of Delmarva's claim for an increase in medical benefits cost. *Del. R. Evid.* 801(c), 803. No one from Lake testified at the evidentiary hearing. Therefore, it is hearsay. And the only "evidence" Delmarva adduced in support of its claim was this hearsay evidence report. As a matter of law, then, the Commission may not rely on it to approve the adjustment.

Nor can the Lake report come in as hearsay on which an expert relies in forming an opinion. *Del. R. Evid.* 703. Delmarva's witness on this issue, Mr. Ziminsky, is an accountant. Based on the work experience described in his testimony, he has always been employed in finance and accounting. (Ex. 5 at 1-2). Nothing in his work experience suggests that he has any experience or expertise in the area of medical benefits. Thus, he cannot be considered to be an expert in the area of medical benefits. His reliance on the Lake study is entitled to no more weight than if anyone off the street were relying on it.

Assuming that the Commission rejects the foregoing objections, the Lake study provides absolutely *no* data specific to Delmarva or even to PHI. Rather, it is based on "trends" in medical premiums by several major insurance companies. (Ex. 13 at 41; Ex. 5 at Sch. (JCZ)-

9.1). The use of "trends" does not rise to the level of a reasonably known and measurable change. (Ex. 13 at 41). The DPA has attached a PricewaterhouseCoopers report on 2013 medical cost "trends." (Attachment K).[71] This report is no more worthy of reliance than the Lake study; neither of them is specific to either Delmarva or Delaware.

Delmarva clearly has evidence of what its own experience has been: in rebuttal, it identified the annual changes in its medical benefits costs from 2008 through 2012. (Ex. 20 at 31). That evidence shows that the four-year average increases for medical, dental and vision benefits were 4.58%, 2.33% and 9.72% respectively, and the five-year averages were 6.61%, 1.95% and 13.17% respectively. (*Id.*). As can be seen, its actual averages increases for medical and dental benefit costs are below the average percentage increases DPL proposes in this case (although vision is not).

Furthermore, the Lake study is based on a crabbed definition of the "mid-Atlantic" region: it only looked at Virginia, Maryland and the District of Columbia. There is no information in the study about the trends in medical costs in *Delaware*, which is where Delmarva is located and which is a mid-Atlantic state. Nor is there any information about Pennsylvania or New Jersey, which are also "mid-Atlantic" states.

Fifth, this is essentially an inflation adjustment, which this Commission has a long history of rejecting. *See Delmarva Power,* Docket No. 91-20, Order No. 3369 at ¶¶139, 142.

The Lake study is hearsay and cannot form the sole basis of the Commission's decision. However, there is no other evidence to support Delmarva's adjustment. Its accounting witness sponsoring the adjustment is not an expert in the field of medical benefits. Even if the Lake study could serve as the basis for a Commission decision, it is no more worthy of reliance than any

[71] The DPA is not submitting the PricewaterhouseCoopers study for the truth of the contents. We attach it simply to show that there are different opinions on "trends" in medical costs.

other study documenting purported medical cost trends: it is not specific to Delmarva or even to Delaware. Delmarva has not established that its proffered cost increases are reasonably known and measurable. The DPA respectfully submits that the study, and the adjustment based on it, should be rejected.

F. Delmarva's Adjustments to IRP Operating Expense Should Be Rejected.

Delmarva proposes two operating expense adjustments associated with its IRP. First, it proposes a normalized amount of IRP costs to be included in the revenue requirement going forward, as the Commission instructed in Docket No. 06-241. The IRP cycle is every two years; Delmarva estimated $1,745,000 of IRP costs over those two years and then included one year of costs ($872,500) in its revenue requirement. Second, in connection with its rate base adjustment to reflect the amortization of the deferred IRP costs over ten years, it made a corresponding adjustment to operating expense. (Ex. 5 at 16).

The DPA objects to both adjustments. Addressing the second adjustment first, DPA witness Crane eliminates the amortization expense associated with the incremental deferred IRP costs for the same reasons that she eliminates the amortization of such costs from rate base. In the interest of brevity, the DPA will not repeat those arguments here, but refers the Hearing Examiner to its arguments in the rate base section of this brief. *See supra* at 62-65.

Delmarva's normalization adjustment results in a significant increase in prospective IRP costs compared to the test period. Its actual IRP cost experience is much lower than its estimate:

Year	IRP Costs
YTD 2013	$14,526
2012	$302,062
2011	$46,909
2010	$927,875
2009(after Regulation Docket No. 60 Approval	$213,440
2009 Full Year	$367,373

(Ex. 13 at 43, citing Delmarva's response to PSC-RR-33).

Delmarva contends that despite it and IRP working group members being watchful for "unnecessary expenditures," and despite its success in reducing IRP compliance costs up to this point, "there is little reason to believe that these costs will continue to decline" because updated analyses will be required and Delmarva will need "the analytical flexibility to address new important issues as they arise in order for the IRP to remain useful and relevant." (Ex. 20 at 35).[72] It further notes that the IRP may need to be presented to the Commission for ratification if the parties cannot reach agreement, which would result in additional expense. (*Id.*). But it offers an alternative: to include in the revenue requirement for this case the average amount spent on the IRPs over the past years and establish a deferral (i.e., a regulatory asset) for any costs above that amount for amortization and recovery in a subsequent case. (*Id.* at 35-36).

Delmarva's estimated IRP expense level should be rejected because it is not reasonably known and measurable. Delmarva submits no reliable and quantifiable data to support its estimate . More than 50% of its estimate is for "consultants, outside legal counsel, and 'special studies.'" (Ex. 13 at 43). These types of expenses can vary greatly from estimates, especially where the parameters of the project are not well defined. And we note that the IRP expenses Delmarva has already incurred in connection with the two IRPs it has filed in 2010 and 2012 would have included these types of expenses.

Furthermore, there *is* reason to expect that IRP costs will decline. A bill was submitted to the General Assembly in the most recent legislative session that would, among other things,

[72] Whether IRPs are useful or relevant in a deregulated supply industry is open to debate, but unfortunately it is not a debate that the Commission can resolve. The DPA notes only that he does not believe that IRPs are either useful or relevant where the supply function has been deregulated, and that the continued existence of the IRP requirement serves only to increase the costs that Delmarva ratepayers must bear.

increase the period between IRP filings from two to three years. *See* Senate Bill No. 264.[73] And as Delmarva notes, the working group participants are trying to prevent unnecessary expense.

Delmarva's proffered alternative is not a viable solution. Despite its acknowledgement that the Commission has not adopted a dollar for dollar reimbursement ratemaking system (Tr. at 642), that is exactly what this alternative is. The Commission order specifically instructed all parties that going forward a *normalized* level of IRP expense would be included in rates. Moreover, it is woefully one-sided: Delmarva does not offer to return to ratepayers any amount less than the normalized amount included in rates should it spend less than that amount.

The DPA is well aware that Delmarva is statutorily required to submit an IRP every two years. Given the lack of support for Delmarva's estimate, the fact that it exceeds actual IRP expenses incurred for all but one year since 2009, and that the time between IRP filings may be increased, the DPA submits that the normalized amount of IRP expense to be included in rates should be based on the three-year average of Delmarva's actual expenses from 2010 through 2012, or $425,615. (Ex. 13 at 43-44 and Sch. ACC-23). This includes two of the three highest amounts that Delmarva has spent on IRPs since 2009.

G. Delmarva's Operating Expense Adjustments Corresponding to Its Rate Base Adjustments for RFP Costs, DLC Costs, Medicare Tax Subsidy Expense and Credit Facility Expense Should Be Rejected.

These adjustments correlate to Delmarva's rate base adjustments for: (1) the Bluewater Wind RFP; (2) the DLC deferred costs; (3) the deferred Medicare tax subsidy costs; and (4) the credit facility. The same reasons that support rejecting these adjustments on the rate base side also support excluding the corresponding adjustments to operating expense. (Ex. 13 at 44-47, 49). The DPA will not repeat those reasons here, but respectfully refers the Hearing Examiner to its discussion of these issues in the rate base section of this brief. *See supra* at 65-72.

[73] http://www.legis.delaware.gov/LIS/lis146.nsf/vwLegislation/SB+264/$file/legis.html?open

H. Delmarva's Claimed Level of Regulatory Expense Should Be Rejected.

Delmarva proposes to include in its revenue requirement $53,316 of non-rate case-related regulatory costs (based on a three-year average of actual costs) and $632,000 of estimated costs for this rate case. The latter costs include $92,600 for its cost of capital witness. It claims that its proposed ratemaking treatment is consistent with previous dockets. (DOB at 78).

First: Delmarva cannot rely on purported ratemaking treatment in prior cases in which the Commission never addressed the issue. No precedent can be assumed from Commission silence.

Second, Delmarva's claimed rate case expense is excessive. In its last three rate cases, two of which were litigated to a Commission decision, Delmarva incurred rate case expense of $634,050 (Docket No. 11-528), $245,241 (Docket No. 09-414), and $400,000 (Docket No. 05-304). (Ex 13 at 48). Obviously, Delmarva is going to incur expenses in litigating rate cases, whether they settle or not. But that does not mean that its estimate should be taken at face value or that the individual components that comprise the overall claim should be accepted.

Delmarva asserts that the DPA's proposed normalized expense level has "no relationship to the expected level of costs in this proceeding, as each rate proceeding may encompass different issues that may be of varying complexity." (DOB at 79). The same could be said for Delmarva's non-rate case regulatory expenses, but it nevertheless included an average of its *actual* for that part of its claim. Furthermore, there are fewer "complex" issues in this case than there were in Docket No. 09-414. That docket included proposals for ring fencing, revenue decoupling and amortization of Delmarva's 2008 pension loss, none of which are issues in this case. And the issues are in this case are no more complex than the ones in prior rate cases. Delmarva clearly has a history of rate cases and now knows the actual amounts incurred in prosecuting them. Why then does it proffer an *estimate* of rate case expense for this case?

Delmarva claims that the DPA has not offered any "credible" evidence that its expenses for this proceeding were made in bad faith, were wasteful or were inefficient. (DOB at 79). First, as discussed previously, it is not the DPA's burden of proof; and second, even if it was the DPA's burden, it has offered such evidence. At the evidentiary hearing, Delmarva confirmed that it had retained Dr. Roger Morin as its cost of capital witness in Docket No. 09-414. Dr. Morin is a well-known cost of capital expert who testifies regularly on behalf of public utilities. Dr. Morin is a well-known cost of capital witness. Delmarva paid Dr. Morin $65,000 for his services. (Tr. at 646-47). Is Mr. Hevert $30,000 better than Dr. Morin? Similarly, Delmarva's witness accepted subject to check that the DPA's cost of capital witness was being paid $21,600. (*Id.*). Is Mr. Hevert more than four times as good as Mr. Parcell? The DPA means no disrespect to Mr. Hevert: he charges what the market will bear. But is it reasonable to saddle ratepayers with the cost of a witness that is four times as high as the cost of the witness retained for the ratepayers?

Moreover, PHI retained the same witness for all four of its rate cases in its jurisdictions (and paid him $92,600 for each of those cases). (Tr. at 643). He also testified for all the PHI utility companies in their prior rate cases. (Ex. 3 at Attachment A). The $92,600 fee is even more striking when his familiarity with PHI and its utility companies is taken into account, and is particularly egregious to the DPA when one considers that the COE (which generally comprises the lion's share of cost of capital testimony) is an issue of interest only to stockholders.

Finally, Delmarva seeks to amortize the rate case expenses over three years. (DOB at 79). That is, it seeks dollar for dollar recovery of its *estimated* rate case expenses. It proffers no changed circumstances nor any new argument that would support the Commission's abandonment of its longstanding practice of including a normalized amount of rate case expense in the revenue requirement. Moreover, DPL witness Ziminsky admitted that he did not propose amortization in his testimony. (Tr. at 641).

The DPA does not take issue with the fact that Delmarva is required to support its requested cost of capital in a rate case with an expert witness. That does not mean, however, that ratepayers must pay for the most expensive witness. It is clear that respected cost of capital witnesses can be found that come at a reasonable price. Nor does the DPA dispute that Delmarva incurs costs in prosecuting a rate case. But that too does not mean that its projected expenses must be accepted without inquiry. The DPA respectfully submits that the Commission should accept its three-year normalized regulatory expense level of $426,432.

I. Delmarva's Proposed Level of Corporate Governance Expense Should Be Rejected.

PHI's Service Company billed Delmarva $21.08 million in the test period for corporate governance costs.[74] Delmarva's portion of such costs has increased over the past few years as a result of PHI's 2010 sale of Conectiv Energy (which resulted in fewer companies over which to spread the costs) and more importantly, as a result of a change in the methodology by which PHI allocates such costs across its companies. This methodological change resulted in a significant decline in the percentage of costs borne by PHI and a correspondingly significant increase in the percentage of costs allocated to PHI's operating subsidiaries. Prior to the change in methodology, PHI was responsible for approximately 5% of corporate governance costs. In 2011, however, the percentage of these costs allocated to PHI decreased to 0.23%, and in the test period PHI shouldered only 0.06% of such costs. (Ex. 13 at 50).

[74]Corporate governance costs include what are called "External Affairs" expenses. These costs generally relate to interactions with legislators and/or community organizations and are intended to promote the utility's political agenda or corporate image. (Ex. 13 at 51).

DPA witness Crane testified that although it appeared that Delmarva had removed costs clearly identified with lobbying from the revenue requirement, she had identified several categories of External Affairs costs billed to it that appeared to relate to "soft" lobbying activities, such as public relations, corporate citizen social responsibility, strategic communications, PAC committee, and corporate contributions, for which she contended that ratepayers should not be responsible. (*Id.*). Delmarva's discovery responses did not indicate whether the corporate contributions identified as External Affairs had been booked below the line; thus, she could not determine whether these costs had been excluded from the revenue requirement. She stated that if Delmarva was able to establish that it had already excluded External Affairs costs that she had recommended be disallowed, she would revise her recommendation accordingly. (*Id.* at 52).

In rebuttal, Delmarva demonstrated to the DPA's satisfaction that it had not included corporate citizen social responsibility, PAC committee and corporate contribution charges in its revenue requirement. (Ex. 20 at 77). Thus, at the evidentiary hearing, the DPA revised its disallowance to exclude these amounts. (Tr. at 545-46; see Ex. 99 (revised Crane schedules).

The discussion does not end there, however; there are still expenses relating to public relations and strategic communications that Delmarva did not identify as having been removed from the revenue requirement, but for which it provided no support. In rebuttal, Delmarva asserts that it "takes seriously the central role it plays in the region's economic development and the importance of ensuring that all benefit from that growth." It claims that it is "dedicated to meeting the needs of [its] customers and shareholders" and "giving back to the communities" it serves and "protecting the environment." To this end, it supports "a wide variety of cultural, civic, educational, environmental, health safety, and business initiatives that are dedicated to improving the quality of life for all citizens." (Ex. 20 at 76). It claims that these expenses "relate to both the manner in which both PHI and Delmarva are directed and controlled as well as social responsibility expenses which directly benefit customers," and that they are "normal and ordinary business expenses" that were included in the revenue requirement based on the Commission decisions in Docket Nos. 05-304 and 09-414. (*Id.* at 77). It concludes that its request to include these expenses in its revenue requirement is "well-supported" and should be approved. (DOB at 97).

That is all well and good, but Delmarva has not borne its burden of proof for including these expenses in the revenue requirement. First, the Commission did not address these types of expenses in either Docket Nos. 05-304 or 09-414. In Docket No. 05-304, Staff challenged advertising expenses. Delmarva presented examples of the advertisements that it claimed were included in its revenue requirement case, and the Hearing Examiner found that the costs were appropriately inclued based on what Delmarva had supplied. The Commission adopted the Hearing Examiner's recommendation. *Delmarva Power,* Order No. 6930, *supra* at ¶¶99-102. The issue was not raised in Docket No. 09-414 and the Commission did not address it. *See Delmarva* Power, Order No. 8011. Here, Delmarva has not identified the challenged expenses here as advertising expenses; indeed, it has barely identified them at all, and it provided no evidence other than unsupported testimony regarding what the costs were for. (Tr. at 671-72).

Delmarva's remaining arguments fare no better. The mere assertions that the expenses are normal and ordinary and that they relate to the manner in which PHI and Delmarva are directed and controlled do not establish that they *are* normal and ordinary or that they do relate to the entities' direction and control. As Ms. Crane testified and as Mr. Ziminsky admitted, Delmarva produced no evidence that they were. (Tr. at 671-72).

The contentions that Delmarva takes its role in the community seriously, is dedicated to meeting customer and shareholder needs, and gives back to the community (regardless of whether one agrees with those statements or not) simply prove the DPA's point that these expenses go toward promoting Delmarva's public image as a good corporate citizen. From that description they sound identical to the corporate citizenship social responsibility expenses that it *did* exclude from the revenue requirement. Likewise, its assertion that the expenses relate to "social responsibility expenses that directly benefit customers" (Ex. 20 at 77) sounds exactly like the corporate citizenship social responsibility expense that it *says* it excluded from the revenue requirement. (*Id.*). On redirect examination at the evidentiary hearing, Mr. Ziminsky testified that the expenses included the cost of a Delmarva employee going to schools to talk to children about electric safety and the costs of customer education for the DP and DLC programs. (Tr. at 670-71, 682). Upon recross-examination on that issue, he admitted that the DP- and DLC-related education costs were included in the regulatory assets created for those programs. (*Id.* at 696). And Delmarva stated in its filing that "[n]o contributions for educational or other charitable purposes are included as part of the Cost of Service." (Ex. 1 at MFR Sch. 3-F). So how can we be sure that these costs do not include some DP and DLC educational costs?

Delmarva could have produced tangible examples of what the costs were incurred for. DPL witness Ziminsky admitted that on cross-examination that there was nothing in the MFRs or in the case that described what these expenses really are. (Tr. at 671-72). In light of DPL's failure to satisfy its burden of proof, they should be excluded from the revenue requirement.

J. Delmarva's Meals and Entertainment Expense Claim Should Be Rejected.

Delmarva includes in its revenue requirement almost $300,000 of expenses for meals and entertainment that were not deductible on its income tax return. DPA witness Crane testified that the Internal Revenue Service ("IRS") has determined that such expenses are not appropriate deductions for federal tax purposes, and opined that if they were not deemed by the IRS to be for reasonable business purposes, the Commission should reach the same conclusion with respect to including them in Delmarva's cost of service. (Ex. 13 at 52).

Delmarva contends that its request to include these expenses in its revenue requirement is "well-supported." (DOB at 98). It claims that the expenses were incurred during the normal course of business, which includes "providing meals to union employees, business meals, meals related to required overtime, and meals provided for training." (Ex. 20 at 78). It asserts that the DPA's reliance on the IRS criterion is "arbitrary" and "blurs the line between the taxing authority governance of the IRS and its regulations compared to the Commission's oversight of public utilities in the State of Delaware." (*Id.*; DOB at 98-99). Finally, it asserts that including these expenses in the revenue requirement is consistent with Commission precedent from Docket Nos. 05-304 and 09-414. (Ex. 20. at 78-79).

This issue was not litigated in either Docket Nos. 05-304 or 09-414 and the Commission rendered no decision on it. The Commission created no precedent on this issue in those cases.

Second: recall that this expense represents items that were not deductible for tax purposes. The Internal Revenue Code contains exceptions to the 50% limitation on deductibility for "de minimis fringe" benefits provided by employers that are not included in the employee's gross income: such fringe benefits include occasional group meals served at the office and meals provided to employees to enable them to work overtime. 26 *U.S.C.* §§132(e), 274(n); Treas. Reg. §1.132-6(d). Therefore, meals provided to employees during required overtime, training and the like were more likely than not 100% deductible. The fact that *these* expenses were *not* deductible (a fact that Delmarva does not dispute) suggests that they did not fall within the exception to the

50% limitation. Since Delmarva did not provide any further information about the nature of the expenses, the DPA was forced to find some other source of information about them, which turned up in PHI's 2012 Proxy Statement, where PHI admitted incurring costs for various sporting and entertainment events. (Ex. 13 at 53).

Delmarva's characterization of the DPA's reference to the IRS criterion as "arbitrary" and "blurring the line" between taxing governance and Commission oversight of public utilities comes with more than a little ill grace. Delmarva is asking the Commission to do exactly that with respect to its belatedly-raised ADIT issue. And the DPA's reference to the 50% limitation can hardly be called "arbitrary;" something is "arbitrary" when it is "capricious, unreasonable or unsupported."[75] Our lawmakers decided upon that limitation, and while it could be argued that their decision was arbitrary, the DPA's reliance upon the legal standard they created is not.

Ratepayers should not be paying for any Delmarva or PHI employee to attend entertainment or sporting events, and Delmarva has produced no evidence other than its unsupported statement that the costs are for business-related purposes. While the amount at issue in this adjustment may be small compared to the overall $38 million revenue requirement increase, the principle it reflects goes far beyond its amount. Allowing Delmarva to include this expense in rates is essentially telling ratepayers that it is acceptable for them (but not shareholders) to pay for things having nothing to do with safe and adequate utility service. That is not an appropriate message to send to ratepayers, especially in this economy.

K. Delmarva's Proposed Membership Fee and Dues Expense Level Should Be Rejected.

Delmarva includes $315,474 of membership fees and dues in its revenue requirement. (*See* Ex. 1 MFR Sch. No. 3-G for the organizations to which PHI and/or Delmarva pays such

[75] http://dictionary.reference.com/browse/arbitrary?s=t

fees and dues). Many of these organizations – particularly the Chambers of Commerce – engage in lobbying activities, and most also engage in "soft" lobbying activities such as public affairs, media relations and other advocacy initiatives, which are not necessary for the provision of safe and reliable utility service. DPA witness Crane recommended disallowing 20% of the claimed membership dues and fees since ratepayers should not be paying for these types of contributions and since Delmarva was unable to quantify a precise amount despite being asked three times. (*Id.* at 54). She selected this percentage in recognition that the specific level of hard and soft lobbying activity varies from organization to organization, and based on her review of the identified organizations and recommendations in other utility proceedings. (*Id.* at 54-55).

$147,774 (almost half the challenged amount) went to the Edison Electric Institute ("EEI"). (Ex. 1 at MFR Sch. No. 3-G). The EEI is an industry trade association that represents "all investor-owned utilities" and whose mission is "to ensure members' success by advocating public policy, expanding market opportunities, and providing strategic business information." Its "vision" is to "make a significant and positive contribution to the long-term success of the electric power industry." Its "vital mission" (as opposed to its mere "mission" above) is to provide electricity to "foster economic progress and improve the quality of life." (Ex. 20 at 80).

That description (which makes EEI sound like a charitable institution) comes directly from the EEI website.[76] What is not obvious from that description is the extent to which EEI engages in lobbying. Delmarva says that it removed the portion of the dues that is attributable to EEI's lobbying activities from the revenue requirement, but it did not quantify that amount despite repeated requests for it during discovery. (Ex. 13 at 55).[77]

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[76]http://www.eei.org/about/mission/Pages/default.aspx

[77]Delmarva did not quantify how much it removed from the revenue requirement that was supposedly attributable to lobbying by any of these organizations. All it said in its filing was that "[n]o Federal and State legislative costs

Delmarva's revenue requirement also includes membership dues and fees for organizations such as 16 obviously identifiable Chambers of Commerce ($28,797),[78] the Art League of Ocean City, Inc., the Girl Scouts, the Committee of 100, the Delaware Alliance for Nonprofit Advancement ("DANA") ($20,000), and the Delaware Public Policy Institute ("DPPI") ($45,000), just to name the ones specifically identified in testimony. (Ex. 1 at MFR Sch. No. 3-G; Ex. 13 at 53; Ex. 20 at 80-81). Delmarva describes DANA as "a leader of the nonprofit sector whose mission is to strengthen, enhance and advance non-profits and the sector in Delaware through advocacy, training, capacity building and research." (Ex. 20 at 80). It asserts that its status as an alliance partner in DANA benefits ratepayers because DANA is "recognized for providing skills leadership, convening leadership and voice leadership for the nonprofit sector," and thus ratepayers' quality of life improves when nonprofits "deliver[] on their mission efficiently and effectively." (*Id.* at 80-81). Similarly, Delmarva describes DPPI as a "non-profit, non-partisan, non-governmental public policy research organization" that identifies "emerging issues that drive Delaware's future agenda" and whose mission is to conduct research and encourage the study and discussion of issues affecting the citizens of Delaware." (*Id.* at 81). Its membership in DPPI is said to benefit ratepayers because DPPI has conducted various studies

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expended by Delmarva Power are included as part of the Cost of Service." (Ex. 1 at MFR Sch. No. 3-F) (emphasis added). The DPA thought that statement was a bit vague, so it issued discovery on the issue. In AG-RR-53, it asked Delmarva to quantify any portion of dues or membership fees that were directed toward lobbying by the respective entities. The response was that "'[p]ortions of dues or membership fees identified as lobbying activities by the organization are not included in this filing.'" In AG-RR-54, the DPA asked Delmarva to identify all lobbying costs incurred in the test year and to identify the amount of any such costs included in its claim. Delmarva again failed to quantify the amounts and stated merely that it had not included lobbying costs in the filing. (Ex. 13 at 55 and Appendix C). Finding these responses less than illuminating, the DPA tried a third time. In AG-RR-158, it DPA referred to Delmarva's response to AG-RR-53 and asked it to provide the total amount of dues expense, the total amount of PHI's dues expense, and the amount of that dues expense allocated or charged to Delmarva for each organization whose dues were adjusted to remove lobbying costs. The DPA also asked Delmarva to quantify the percentage and dollar amount of lobbying costs adjusted out of its claim. Again, Delmarva stated that it books lobbying costs below the line and failed to identify either the organizations that engaged in lobbying or the amount of dues/fees recorded below the line. (*Id.* and Appendix C).

[78]There may be more, but it appears that some of the organizations' names were truncated on the schedule. (Ex. 1 at MFR Sch. No. 3-G).

addressing issues such as health care, economic development, land use, water/wastewater, effective government and education, and used many task forces comprised of representatives from government, business, civic organizations, environmental organizations, educators, and private citizens. (*Id.*).

The DPA respects the work that Delaware nonprofits do to improve Delawareans' lives. But Delmarva's argument that membership in these organizations benefits its ratepayers is a non sequitur. That DANA provides various types of leadership does not establish any benefit to Delmarva ratepayers. That DPPI conducts studies on various issues and convened task forces dos not establish any benefit to Delmarva ratepayers. Delmarva does not explain how any of these organizations' activities contribute anything to assist Delmarva in conducting its business. These are conclusory statements without any evidentiary support.

Delmarva does not address the DPA's exception to the Chamber of Commerce contributions (of which the lion's share - $22,750 - went to the Delaware State Chamber of Commerce). Those organizations frequently engage in lobbying activities. So do the Delaware Business Roundtable ($2,500), the Delaware Contractors' Association ($1,440), and the Committee of 100 ($1,200). But Delmarva has provided no evidence of any amounts that were "removed." *See supra* n.77.

Some of the entries on MFR Sch. No. 3-G are Maryland organizations: the Chambers of Commerce for Berlin, Queen Anne's County, the Crisfield area, Dorchester County, Harford County, Northeast, Ocean City, Pokomoke City, Salisbury and Talbot County. While the total amount is not substantial ($4,437), the DPA wonders why Delaware ratepayers should pay for dues for Maryland organizations. The schedule also includes non-Delaware non-chamber of commerce organizations: Business Queen Anne's, Elkton Alliance, Greater Salisbury

Committee, Leadership Maryland, MD/DC Utilities Association, Ocean City Development Corp., Ocean City Hotel-Motel, and The Greater Perryville (the name of this organization apparently was truncated). Again, the amount is small, but why are Delaware ratepayers paying for anything related to Maryland organizations?

Delmarva once again relies on the Commission's decisions in Docket Nos. 05-304 and 09-414 as precedent for including these expenses in the revenue requirement. Once again, however, that reliance is misplaced: in neither case was the issue contested, so in neither case did the Commission make a decision on the issue.

Ratepayers can lobby their legislators on their own. They do not need to pay Delmarva to do it. Delmarva's Company's request to include these expenses in the revenue requirement is not "well-supported." (DOB at 99). The DPA's adjustment is conservative in light of the fact that it was stonewalled in trying to obtain the information it requested. It should be adopted.

V. <u>COST OF CAPITAL</u>

A. **<u>Introduction.</u>**

Both DPL witness Hevert and DPA witness Parcell agree that the guidelines for determining a public utility's COE are set forth in the United States Supreme Court's decisions in *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1942). (Ex. 3 at 4; Ex. 15 at 5-6). Both also agree that since Delmarva is not a publicly-traded company, its COE must be determined through analysis of comparable publicly-traded utilities (called a proxy group). (Ex. 3 at 5; Ex. 15 at 19). Both used a constant growth discounted cash flow ("DCF") methodology and a Capital Asset Pricing Method ("CAPM") methodology to estimate Delmarva's COE. (Ex. 3 at 3, 10-14 and Sch. RBH-1). And both believe that general economic conditions are important in determining the appropriate COE for a utility. (Ex. 3 at 27-30; Ex. 15 at 8-14). The similarities, however, end there.

Delmarva contends that the terms upon which it obtains capital is dependent on its ratings by various rating agencies, and those agencies monitor each state's regulatory environment, including the utility's regulatory treatment, regulatory lag, the utility's ability to recover its costs and the utility's ability to achieve its authorized return. (DOB at 32). It argues that the Commission should authorize an increase in its authorized COE from 9.75% to 10.25%, based on the results of Mr. Hevert's COE studies producing COEs ranging from 8.21% to 10.91%; his consideration of the risks associated with Delmarva's comparatively small size vis-à-vis the proxy group companies and flotation costs associated with equity issuances; and the relationship between current historically low Treasury bond yields and the COE. (Ex. 3 at 3, 10-23, 27-30 and Schs. (RBH-R)-1, (RBH-R)-4, (RBH-R)-5 and (RBH-R)-6). Delmarva's proposed COE and its proposed cost of long-term debt produce an overall 7.53% cost of capital. (Ex. 2 at 6 and Sch. (FJB)-1). The DPA's overall cost of capital recommendation is 7.09%, based on Delmarva's proposed cost of long-term debt and Mr. Parcell's recommended 9.35% COE. (Ex. 15 at 2).

As we will show, Delmarva's proposed COE is unreasonably high under current market conditions and should be rejected. The 9.35% COE recommended by DPA witness Parcell is more in line with current market conditions and warrants acceptance.

1. <u>Delmarva's Position.</u>

DPL witness Hevert selected a proxy group of 12 publicly-traded utility companies using the following selection criteria: the company (1) consistently pays quarterly cash dividends; (2) is covered by at least two utility industry equity analysts; (3) has investment grade senior unsecured bond and/or corporate credit ratings from Standard & Poors; (4) regulated utility operating income over the three most recently reported fiscal years represents at least 60% of combined income; (5) regulated electric operating income over the three most recently reported fiscal years represents at least 90% of total regulated operating income; and (6) must not be known to be a party to a merger or other significant transaction. (Ex. 3 at 7). Thirteen companies satisfied those criteria, but he eliminated Edison International based on facts unique to it. (*Id.* at 8-9). The utilities comprising his final proxy group were American Electric Power Co., Inc.; Cleco Corp.; Empire District Electric Co.; Great Plains Energy, Inc.; Hawaiian Electric Industries, Inc.; IDACORP, Inc.; Otter Tail Corp.; Pinnacle West Capital Corp; PNM Resources, Inc.; Portland General Electric Co.; Southern Co.; and Westar Energy, Inc. (*Id.* at 9). He then applied constant growth DCF, CAPM, bond yield plus risk premium, and multi-stage DCF models to these proxy companies.

a. Constant Growth DCF Model

The DCF model is based on the theory that a stock's price equals the discounted present value of all expected future cash flows. (Ex. 3 at 10; Ex. 15 at 20). In its constant growth form, the DCF expresses the COE as the sum of the expected dividend yield and the long-term growth rate. (Ex. 3 at 10). The constant growth DCF model assumes a constant average annual growth rate for earnings and dividends; a stable dividend payout ratio; a constant price to earnings multiple; and a discount rate that exceeds the expected growth rate. Under these assumptions, dividends, earnings, book value and the stock price all grow at the same constant rate. (*Id.* at 11).

DPL witness Hevert calculated the dividend yield component of his constant growth DCF model based on the proxy companies' current annualized dividend and average closing stock prices over the 30-, 90- and 180-trading day periods as of February 15, 2013 (direct testimony) and the average closing stock prices over the same length trading periods as of July 31, 2013 (rebuttal testimony). (*Id.* at 11-12 and Sch. RBH-1; Ex. 18 at Sch. (RBH-R)-1). He testified that three averaging periods avoid anomalous events that might affect stock prices on any given day and are reasonably representative of long-term capital market conditions. (*Id.* at 12). He adjusted the dividend yield by applying one-half of the long-term growth rate to the current dividend yield to account for the fact that utilities increase their quarterly dividends at different times during the year. (*Id.*).

Mr. Hevert testified that it is important to select appropriate measures of long-term earnings growth in applying the constant growth DCF model since dividend growth can only be sustained by earnings growth. (*Id.* at 12-13). He used Zacks and First Call consensus long-term earnings growth projections and Value Line long-term earnings growth projections. He calculated mean high and low DCF results for the proxy companies: the mean high result used the maximum growth rate reported by any of his sources for the particular company, and the mean low result used the minimum growth rate reported by any of those sources. (*Id.* at 13). He removed the Value Line growth rate for Otter Tail Corp. because it was more than two standard deviations from the unadjusted group mean. (*Id.* at 14).

Mr. Hevert's updated constant growth DCF results are as follows:

	Mean Low	**Mean**	**Mean High**
30-Day Average	8.25%	9.18%	10.15%
60-Day Average	8.21%	9.15%	10.11%
90-Day Average	8.37%	9.30%	10.27%

(Ex. 18 at Sch. (RBH-R)-1). The same figures from his direct testimony are as follows:

	Mean Low	**Mean**	**Mean High**
30-Day Average	9.00%	10.21%	11.63%
60-Day Average	9.09%	10.30%	11.71%
90-Day Average	9.08%	10.29%	11.71%

In his direct testimony, Mr. Hevert stated that he gave no weight to the mean low DCF results because he claimed they were "well below any reasonable estimate" of Delmarva's COE. He cited the Regulatory Research Associates ("RRA") report showing that in only one of the 1,392 rate cases since 1980 with reported authorized COEs was the authorized return 9% or lower. (Ex. 3 at 14; *see also* Ex. 28).

b. <u>CAPM Model.</u>

Mr. Hevert next calculated the proxy companies' COEs using the CAPM model. The CAPM model is a risk premium approach that derives a COE as a function of a risk-free return plus a risk premium to compensate investors for company risks that cannot be eliminated through diversification ("systematic" risk). The model has four inputs, each of which must be estimated: the company's required market return; the security's beta coefficient; the risk-free rate of return; and the required return on the market as a whole. (Ex. 3 at 15). The CAPM theory posits that investors are only concerned with systematic (non-diversifiable) risk, since unsystematic risk can be eliminated by diversification. Beta represents systematic risk. A higher beta indicates greater volatility; a company with a 1.00 beta is as risky as the overall market and so provides no diversification benefit. (*Id.* at 16).

Before discussing his CAPM model studies, Mr. Hevert testified that he had concerns about the CAPM model based on current market conditions. He noted that the risk-free rate in the model is generally represented by the yield on long-term Treasury securities, and that in times of financial market turmoil, investors tend to allocate their capital to low-risk investments such as Treasury bonds, which bids down the yield on those investments. He further noted that since the Lehman Brothers bankruptcy in 2008, the Federal Reserve's focus was on maintaining low long-term interest rates. Thus, even if investors invested in riskier assets, the Federal

Reserve's policy could have the effect of maintaining low yields on Treasury securities. (*Id.*). Moreover, capital markets continue to change: over the 90 trading days ending February 15, 2013, the 30-year Treasury yield ranged from 2.72% to 3.23%. Finally, he observed that the risk premium tends to move in the opposite direction from interest rates. All of these factors could lead to "relatively volatile" CAPM results. (*Id.* at 17).

Mr. Hevert calculated the CAPM-derived COE using two risk-free rate measures: the current 30-day average yield on 30-year Treasury bonds (3.12%) and the near-term projected yield on the same investment (3.25%). He also developed two estimates of the market risk premium ("MRP") input. The first estimate used the market-required return minus the 30-year Treasury bond yield. He estimated the market-required return by calculating the average COE based on the constant growth DCF model using Bloomberg and Capital IQ data. He derived the average DCF result for both by calculating the average expected dividend yield and combining it with the average projected earnings growth rate. He then subtracted the current 30-year Treasury yield from this amount to reach the market DCF-derived MRP. (*Id.* at 17-18 and Sch. (RBH-2). His second estimate of the MRP input was based on the principle that investors require higher returns for higher risk. It relied on the Sharpe ratio, which is the ratio of the long-term average risk premium for the S&P 500 Index to the risk of that index. (*Id.* at 18). He used the 30-day average of the Chicago Board Options Exchange's ("CBOE") three-month volatility index and the average of futures settlement prices on the CBOE's one-month volatility index for the July-September 2013 period, which he claimed are "market-based, observable measures of investors' expectations regarding future market volatility." (*Id.* at 19). For the beta input into his CAPM model, Mr. Hevert used the average reported beta coefficient from Bloomberg and Value Line. (*Id.* at 19-20).

Mr. Hevert's updated CAPM results are shown below. The first two rows of results were calculated using the Bloomberg beta, and the last two rows of results were calculated using the Value Line beta.

	Sharpe Ratio-Derived Market Risk Premium	**Bloomberg-Derived Market Risk Premium**	**Capital IQ-Derived Market Risk Premium**
3.12% Current 30-Year Treasury	8.91%	10.45%	9.96%
3.25% Near-Term Projected Treasury	9.06%	10.60%	10.10%
3.12% Current 30-Year Treasury	9.07%	10.66%	10.15%
3.25% Near-Term Projected Treasury	9.22%	10.81%	10.30%

(Ex. 18 at (RBH-R)-4). The results for the same calculations in Mr. Hevert's direct testimony are shown below. As before, the first two rows of results were calculated using the Bloomberg beta, and the last two rows of results were calculated using the Value Line beta.

	Sharpe Ratio-Derived Market Risk Premium	**Bloomberg-Derived Market Risk Premium**	**Capital IQ-Derived Market Risk Premium**
3.12% Current 30-Year Treasury	7.43%	10.19%	10.14%
3.25% Near-Term Projected Treasury	7.57%	10.32%	10.37%
3.12% Current 30-Year Treasury	7.44%	10.20%	10.15%
3.25% Near-Term Projected Treasury	7.57%	10.33%	10.28%

(Ex. 3 at 20).

In his direct testimony, Mr. Hevert stated that his CAPM results did not reflect a reasonable range of COE estimates because they were approximately 100 basis points below the lowest COE authorized in at least 30 years and *a fortiori* were unreasonable. As to the remaining results, he noted that the Federal Reserve's intervention in the capital markets had maintained interest rates at historically low levels, and since the CAPM uses Treasury yields as an input, the effect is a significant decrease in CAPM-derived COE estimates at this time. (*Id.* at 20-21). However, he took a different tack in his rebuttal testimony. There, he testified that only the results of the Sharpe ratio-derived CAPM should be disregarded, and that the relevant range of CAPM COE results was 9.96%-10.81%. (Ex. 18 at 41-42).

c. **Bond Yield Plus Risk Premium Model.**

According to Mr. Hevert, this model is based on the principle that since equity owners bear the residual risks of ownership, their returns are subject to greater risk than returns to bondholders; thus, they require a premium over debt returns. The equity risk premium ("ERP") is the difference between the historical COE and 30-year Treasury yields. Mr. Hevert believed it was reasonable to use actual authorized returns for electric utilities as the historical COE since he was using the approach to calculate the ERP for electric utilities. (Ex. 3 at 21). He used the RRA research for this input. He also calculated the average period between the filing of a case and the date of the final order (or what he called the "lag period"). For the long-term bond yield input, he calculated the average 30-year Treasury yield over the average lag period (approximately 201 days). (*Id.* at 21-22). He claimed that this analysis could also be used to address the stability of the ERP because the data covered a number of economic cycles and was "particularly relevant" in light of the current historically low Treasury yields. (*Id.* at 22).

Mr. Hevert used a regression analysis in which the ERP was the dependent variable and the long-term yield was the independent variable to determine the relationship between interest rates and the ERP. He noted that the RRA report included periods of "very high" and "quite low" interest rates and authorized returns. He accounted for that variability by using the semi-log regression, which expresses the ERP as a function of the natural log of the 30-year Treasury yield. (*Id.* at 22-23). His results indicated a statistically significant negative relationship between the long-term yield and the ERP over time; therefore, he concluded that simply applying the 4.39% long-term ERP would "significantly understate" the COE and produce results "well below any reasonable estimate." (*Id.* at 23). Using the regression coefficients in his analysis, he determined that the implied COE ranged from 10.23% to 10.76%. (*Id.* and Sch. (RBH)-5).

d. Multi-Stage DCF Model.

In his rebuttal testimony, Mr. Hevert performed a multi-stage DCF study, which focuses on cash flow growth rates over the near term, intermediate term and long term. (Ex. 18 at 20-21). In the first two stages, cash flows equal projected dividends; in the last stage, cash flows equal both dividends and the expected sale price of the stock at the end of the period (the "terminal price"). (*Id.* at 20). The terminal price is defined by the present value of the remaining cash flows in perpetuity. In each stage, the dividend is the product of the projected earnings per share ("EPS") and the expected dividend payout ratio. (*Id.* at 20-21). Mr. Hevert claimed that the primary benefit of the multi-stage DCF model is its flexibility; it avoids the limiting assumption in the constant growth DCF model that the company will grow at the same constant rate forever because it is able to specify near-, intermediate- and long-term growth rates. Since it calculates the dividend as the product of EPS and the payout ratio, analysts can include assumptions regarding the timing and extent of changes in the payout ratio. It is not limited to a single source for its inputs and so mitigates the potential bias of relying on a single source for EPS growth estimates. Finally, it enables the analyst to assess the reasonableness of the inputs and results by reference to market-based metrics. (*Id.* at 21). Applying his multi-stage DCF model, Mr. Hevert derived COEs for his proxy companies ranging from 9.48% to 10.66%:

	Mean Low	Mean	Mean High
30-Day Average	9.49%	10.00%	10.55%
60-Day Average	9.48%	9.97%	10.51%
90-Day Average	9.70%	10.15%	10.66%

(*Id.* at 22 and Sch. (RBH-R)-7).

e. Consideration of Business Risks: Small Size and Flotation Costs.

According to Mr. Hevert, finance and academia have long accepted that the COE for small companies is subject to a "small size effect." (*Id.* at 24, citing Annin and Levis). He acknowledged that the empirical evidence of the small size effect was often based on non-utility industries, but stated that utility analysts such as Ibbotson Associates had noted that obstacles such as a smaller customer base, limited financial resources, and lack of diversity across customers, energy sources and geography implied a higher investor return. (*Id.*). He testified that Delmarva was somewhat smaller than the average for the proxy companies in terms of customers and annual revenues. Since Delmarva is not publicly traded, it was necessary to calculate a stand-alone market capitalization for it. He calculated a $0.50 billion implied market capitalization for Delmarva, compared to the proxy group's median $2.58 billion market capitalization. (*Id.* at 24-25 and Sch. (RBH)-6). Delmarva's implied market capitalization fell in the ninth decile of Morningstar's market capitalization deciles, which corresponded to a 2.79% size premium and suggested that a premium as high as 178 basis points could be expected for Delmarva relative to the proxy group. Instead of applying a specific adjustment to Delmarva's COE, however, he considered its small size in determining where its COE fell within the range of results derived from his studies. (*Id.* at 25-26).

Next, Mr. Hevert considered flotation costs. He testified that these costs are associated with the sale of new issuances of common stock and are part of capital costs. They are reflected on the balance sheet as "paid-in capital" rather than as current expenses on the income statement. They are incurred over time, so although the great majority of such costs are incurred prior to the test year, they remain part of the cost structure during the test year and beyond. (*Id.* at 26). Mr. Hevert determined a 15-basis point adjustment for Delmarva by modifying his DCF calculation to provide a dividend yield to reimburse investors for those costs. He claimed that the adjustment recognizes the cost of issuing equity incurred by PHI and the proxy companies in their most recent two issuances. (*Id.* at 26 and Sch. (RBH)-7). Again, however, he did not make a specific adjustment to Delmarva's COE, but considered the effects of the flotation costs in determining where its COE fell within the range of results derived from his studies. (*Id.* at 26-27).

2. **<u>The DPA's Position.</u>**

DPA witness Parcell selected a proxy group of 11 publicly-traded utility companies using the following selection criteria: (1) market capitalization between $1 billion -$10 billion; (2) 50% or more of revenues form electric operations; (3) common equity ratio of 40% or greater; (4) Value Line safety ranking of 1, 2 or 3; (5) S&P stock ranking of A or B; (6) S&P or Moody's bond ratings of A; (7) currently paying dividends; and (8) is not currently involved in a major merger. He compiled a proxy group consisting of the following utilities: Allete; Alliant Energy; Avista Corp.; Black Hills Corp.; IDACORP; MGE Energy; Northwestern Energy; Portland General Electric; TECO Energy; Westar Energy; and Wisconsin Energy. (Ex. 15 at 19-20 and Sch. DCP-6). He also conducted his COE studies on Mr. Hevert's proxy companies. (*Id.* at 20).

a. **<u>DCF Model.</u>**

Like Mr. Hevert, Mr. Parcell performed a constant growth DCF model study on his comparison companies. He too adjusted the dividend yield to reflect the fact that companies pay dividends at different times of the year. (*Id.* at 21-22).

Mr. Parcell testified that the DCF's dividend growth rate component is usually the "most crucial and controversial" input. He noted that the objective for this component is to reflect the growth that investors expect that is embodied in the price and yield of a company's stock. Individual investors have different expectations, as shown by the fact that every decision to sell stock at $X is matched by another decision to buy that stock at $X. (*Id.* at 22). Investors also consider alternative indicators in deriving their expectations as reflected by the fact that there are several indicators for estimating investors' growth expectations. Thus, he testified, analysts should use more than one growth indicator to determine the dividend growth input. (*Id.* at 22-23). Mr. Parcell considered five indicators, which he called "appropriate and representative" for estimating investor expectations: (1) Value Line five-year average (2008-12) earnings retention ("fundamental growth"); (2) Value Line five-year average of historic growth in EPS, dividends per share ("DPS"), and book value per share ("BVPS"); (3) Value Line projected earnings retention growth for 2013. 2014 and 2016-18; (4) Value Line 2010-12 to 2016-18 EPS, DPS and BVPS projections; and (5) First Call five-year EPS growth projections. (*Id.* at 23).

Mr. Parcell's DCF-derived results for his proxy group ranged from a low of 7.0% to a high of 10.4%, and for Mr. Hevert's proxy group ranged from a low of 6.9% to a high of 9.9%. (*Id.* at Sch. DCP-7 p.4). His mean and median results for the two groups are shown below. The mean and median low are the results from using only the lowest growth rate, while the mean and median high are the results from using only the highest growth rate.

	Mean	*Median*	*Mean Low*	*Mean High*	*Median Low*	*Median High*
Proxy Group	8.1%	7.9%	7.0%	9.4%	6.7%	9.0%
Hevert Group	8.2%	8.0%	6.8%	9.0%	6.4%	9.1%

(*Id.* at 24 and Sch. DCP-7 p. 4).

Mr. Parcell testified that in determining the appropriate COE for Delmarva he gave less weight to the low and average values derived from his DCF studies. Hence, he concluded that the appropriate COE from Delmarva ranged from 9.0%-9.4%. (*Id.* at 24-25).

b. Comparable Earnings Model.

The comparable earnings ("CE") model comes from the "corresponding risk" standard of the *Bluefield* and *Hope* cases and is based on the economic concept of opportunity cost – the prospective return available to investors from alternative investments of similar risk. (*Id.* at 28-29). It is designed to measure the returns expected to be earned on the original cost book value of enterprises of similar risk; as such, it provides a direct measure of a fair return since it translates into practice the competitive principle upon which regulation rests. (*Id.* at 29). It normally examines the experienced and/or projected returns on book common equity; this follows from the use of rate base regulation for public utilities. In turn, this cost of capital is the fair rate of return applied to the book value of rate base to establish the revenue requirement. (*Id.*).

The CE model requires the analyst to examine a relatively long period to determine earnings trends over at least a full business cycle to avoid undue influence from unusual or abnormal conditions that may occur in a shorter period. Mr. Parcell examined actual earned returns for the two groups of proxy companies and for unregulated companies for the 1992-2012 period,[79] and evaluated investor acceptance of those returns as evidenced by the resulting market to book ("MTB") ratios. He testified that the MTB ratios allowed assessment of the degree to which a given return level equates to the cost of capital. He stated that it is generally recognized that MTB ratios greater than 1.0 (100%) for utilities reflect a situation in which a company is able to attract new equity capital without dilution (above book value). One objective of a fair

[79]Mr. Parcell testified that this time period encompassed three business cycles: 2009-12 (the current cycle), 2002-08 (the next most recent business cycle), and 1992-2001 (the previous business cycle). (*Id.* at 30).

COE is maintaining stock prices at or above book value, but there is no regulatory obligation to set rates that will maintain an MTB ratio significantly above one. (*Id.* at 30).

Mr. Parcell's CE analysis produced the following results for the utility proxy companies:

	Parcell Proxy Group	*Hevert Proxy Group*
Historic Earned ROE		
Mean	9.1%-11.8%	8.4%-11.5%
Median	9.2%-12.0%	8.3%-11.8%
Historic MTB		
Mean	128%-170%	122%-155%
Median	120%-161%	118%-162%
Prospective ROE		
Mean	9.3%-10.0%	9.2%-9.8%
Median	8.8%-9.5%	9.0%-9.8%

(*Id.* at 31 and Schs. DCP-10 and DCP-11). His results indicated that utility earned ROEs from 8.3% to 12% had produced MTBs of 120%-170%, and that projected ROEs from 8.8% to 10% related to MTBs of 134% and greater. The results for the S&P 500 over the same period showed that average ROEs from 12.4% to 14.7% produced MTBs ranging from 204% to 341%. (*Id.* at 31-32 and Sch. DCP-12). He testified that these results indicated the level of realized and expected returns in the regulated and competitive sectors, but to apply these returns to the proxy companies it was necessary to compare their risk levels. After comparing several risk indicators for the S&P 500 group and the utility groups, he concluded that the S&P 500 group was riskier than the utility groups. (*Id.* at 32 and Sch. DCP-12).

Mr. Parcell concluded from his CE analysis that the COE for the proxy utilities ranged between 9.0%-10.0%. (*Id.* at 32-33). He noted that the fact that MTB ratios substantially exceed 100% indicated that historic and prospective ROEs greater than 10% reflect earnings "well above" the actual COE for the regulated utilities, and that a company whose stock sells above book value can attract capital in a way that enhances existing stockholders' book value, thus creating a favorable environment for financial integrity. (*Id.* at 33).

c. **CAPM Model.**

Mr. Parcell used the average 20-year Treasury bond yield over the May-July 2013 period (3.04%) as his risk-free rate (*id.* at 26) and the most recent Value Line betas. As noted previously, beta measures the relative volatility of a particular stock relative to the overall market. Companies whose betas are less than 1.0 are considered less risky than the market, and companies whose betas exceed 1.0 are considered riskier than the market. Mr. Parcell noted that utility stocks have traditionally been less than 1.0. (*Id.* at 26-27).

Mr. Parcell estimated the MRP input using two measures. First, he compared the actual returns on equity of the S&P 500 from 1978-2012 with the actual annual Treasury bond yields for the same period. His MRP from this analysis was 6.60%. (*Id.* at 27 and Sch. DCP-8). Next, he considered the total returns (dividends/interest plus capital gains or losses) for the S&P 500 group and for long-term government bonds as reported in Morningstar, using both arithmetic and geometric means. The MRPs using this alternative were 5.7% with the arithmetic mean and 4.1% with the geometric mean. (*Id.* at 27-28). Mr. Parcell testified that calculating the MRP using both arithmetic and geometric means was appropriate because investors have access both types of means; therefore, both types are presumably reflected in investment decisions. He concluded that the expected MRP was approximately 5.47% (the average of his three MRP calculations).

Mr. Parcell's CAPM results for his proxy group ranged from 6.3% to 7.7%, with a mean of 7.0% and a median of 6.9%. The results for the Hevert proxy group ranged from 6.0% to 8.2%, with a mean of 7.0% and a median of 6.9%. (*Id.* at 28 and Sch. DCP-9). He identified two reasons for the lower CAPM results. First, risk premiums were currently lower than in prior years, reflecting a decline in investor expectations of equity returns and risk premiums. Second, the interest rate on Treasury bonds has been lower in recent years, partially as a result of the

Federal Reserve's stimulus actions, which also affects investors' return expectations negatively. He noted that while investors may have initially believed that the decline in Treasury yields was temporary, that has not been the case: interest rates have remained at historically low levels despite the recent increases. Consequently, he testified that "it cannot be maintained that low interest rates (and low CAPM results) are temporary and do not reflect investor expectations." (*Id.* at 34). At the very least, those results indicate that capital costs remain at historically low levels and that Delmarva's COE is less than in previous years, and therefore his CAPM results should be considered as one factor in determining Delmarva's COE. (*Id.*).

d. <u>Overall Cost of Capital.</u>

Using Delmarva's proposed capital structure and cost of long-term debt, Mr. Parcell recommended an overall cost of capital of 7.02% to 7.17%. He testified that this recommendation will result in pre-tax coverage and a debt ratio within the benchmark range for an A-rated utility. (*Id.* at 35).

B. <u>Delmarva's Requested COE Is Excessive and Should Be Rejected.</u>

Delmarva's recommended COE is excessive and should be rejected. Despite a recent increase in Treasury bond yields, even Delmarva's witness admits that those yields remain historically low. (Ex. 3 at 27). As the DPA will demonstrate, each of Delmarva's witness' COE models, and nearly all of his inputs into those models, are biased upward to produce an unreasonably high COE.

1. <u>Delmarva's Witness Inconsistency Renders His Testimony Suspect.</u>

Delmarva identifies the "most significant" difference between its witness' and the DPA's witness' positions as how their analyses correlate with current market conditions and are sensitive to market realities. (DOB at 34). In this case, Delmarva's cost of capital witness says that the recent increases in interest rates should be associated with an increase in the COE, even if not to the same degree. (Ex. 3 at 14; Ex. 18 at 3-12; Tr. at 428-29). As Delmarva notes, Mr. Parcell agrees with that. (DOB at 35). He also agrees with its corollary: that decreases in interest rates should also be associated with a decrease in the COE, even if not to the same degree. Mr. Hevert pays lip service to that corollary (Tr. at 429), but it does not appear that he applies that tenet in practice. How do we know this? We need only review his testimony in Delmarva's prior rate case, Docket No. 11-528. In *that* case, at a time when interest rates truly were at historic lows (Tr. at 425-26), he recommended an even *higher* COE than he recommends here (10.75%). *See* Docket No. 11-528, Hevert Direct Testimony at 3, 72; Hevert Rebuttal Testimony at 5. When asked about his Docket No. 11-528 recommendation during cross-examination in this case, responded that his recommended COE in that case was high because the market was unstable and investors were very risk-averse. (Tr. at 427).[80]

The DPA knows that utility cost of capital witnesses are retained and paid to advocate high COEs, just as regulatory staff and public advocate cost of capital witnesses are retained and paid to advocate low COEs. That is simply a fact: utilities are unlikely to retain someone who recommends a low COE, and regulatory staff and public advocates are unlikely to retain someone who recommends a high COE. Witnesses become associated with working for one side or the other, and anyone working in the public utility industry or in utility regulation knows which witnesses generally work for what client.[81] But the witnesses should at least have the courage of their convictions. If COEs move up with increases in interest rates, they should also

[80] As will be seen *infra* at 122-23, at least one commission considering a similar recommendation from Mr. Hevert at around the same time did not accept that explanation.

[81] This is exemplified by the cost of capital witnesses in this case: Mr. Hevert's Attachment A shows that he has testified exclusively for utilities since leaving Bay State Gas Company (Ex. 3 at Attachment A), and Mr. Parcell's Attachment 1 shows that he has testified exclusively for regulatory agencies and consumer interests. (Ex. 15 at Attachment 1 p. 2).

move down with decreases in interest rates, and that should be reflected in a witness' COE recommendation. A witness unwilling to admit the latter when advocating the former is at the very least guilty of inconsistency, and that inconsistency should color the consideration of the rest of his testimony. The DPA respectfully requests that the Hearing Examiner keep this in mind in evaluating the cost of capital witnesses' testimony.

2. Other Commissions Have Rejected Mr. Hevert's Recommendations As Too High For Various Reasons.

Mr. Hevert used only RPS projections for his dividend growth input. Other commissions have recognized that focusing only on projected EPS growth rates produces too high a growth rate. In *In the Matter of the Application of Potomac Electric Power Company for Authority to Increase Existing Retail Rates for Electric Distribution Service*, FC 1087, Order No. 16930 at 60 (DC PSC Sept. 27, 2012),[82] the DC PSC rejected Pepco's DCF-derived COE as "inflated," noting that "projected EPS growth rates are overstated and should not be exclusively relied upon." The DC PSC gave greater weight to Pepco's "low mean" DCF results (which used the lowest EPS growth rates) and to the growth rates proposed by other witnesses, including the OPC's witness, who calculated his growth rates in the same manner as Mr. Parcell. (*Id.* at 59). Pepco's witness in that case was Mr. Hevert.

Other judgments that the analyst makes can also skew the DCF results upward or downward. One such judgment is the selection of proxy companies. The Maryland PSC has twice rejected Pepco and Delmarva COE studies on the ground that the proxy group included utilitites with greatly disparate growth rates both on the high and low ends and which had significant generation risk. *In the Matter of the Application of Delmarva Power & Light Company for Authority to Increase Its Rates and Charges for Electric Distribution Service*, Case

[82]http://www.dcpsc.org/pdf_files/commorders/orderpdf/orderno_16930_FC1087.pdf

No. 9285, Order No. 85029 at 77(Md. PSC July 20, 2012);[83] *Pepco*, Order No. 85028 at 107. The DC PSC also rejected Pepco's DCF estimate due to the inclusion of vertically-integrated companies in the proxy group. *Pepco*, FC 1087 at 60. Pepco's and Delmarva's witness in those cases was Mr. Hevert.

Mr. Hevert acknowledged on cross-examination that generation companies tend to be riskier than transmission-and-distribution only companies such as Delmarva. (Tr. at 440). He also stated that his proxy companies had coal-fired and nuclear generation facilities, and while he was not ready to concede that these types of generation made these companies riskier, he agreed that the Environmental Protection Agency is considering regulations to require owners of coal-fired generating units to either reduce the amount of coal they burn or to retrofit the units. (*Id.* at 442-44). He also agreed that his proxy companies could derive as much as 40% of their operating income from unregulated operations, which are viewed as riskier than utility operations. (*Id.* at 446). The DPA admits that Mr. Parcell's proxy group suffers from some of the same flaws as Mr. Hevert's proxy group; it simply is not possible to find enough pure transmission-and-distribution companies to serve as proxies for Delmarva. But what this means for the COE is that Delmarva has less risk and therefore would not command as high a COE as companies with generation – a fact that Mr. Parcell recognizes but Mr. Hevert seems not to.

The Nevada Public Utilities Commission rejected Nevada Power Company's suggestion that its COE was rising because of increased volatility in capital markets. *Application of Nevada Power Company d/b/a NV Energy for Authority to Increase Its Annual Revenue Requirement for General Rates Charged to All Classes of Electric Customers and for Relief Properly Related*

[83] http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\CaseNum\9200-9299\9285\90.pdf)

Thereto, Docket No. 11-0606 *et al.*, Order Dated Dec. 23, 2011 at 25.[84] It found that the weak economy reduced expected returns[85] and thus the opportunity cost of investing in utilities. It further found that the low bond yields made utility stocks more attractive since they are "significantly less risk than investment within the relatively volatile broad equity market." *Id.* Nevada Power's witness in that case was Mr. Hevert.

And the Illinois Commerce Commission found that "[a]mong the many problems" with Ameren's bond yield plus risk premium methodology were its reliance on authorized utility ROEs throughout the United States and its "heavy reliance on historical data and the difficulty in determining an appropriate historical period to rely upon." *Ameren Illinois Company, d/b/a Ameren Illinois Proposed General Increase in Natural Gas Rates*, Docket No. 11-0282, Order (Ill. C.C. Jan. 10, 2012) at 125.[86] Ameren Illinois' witness in that case was Mr. Hevert.

In both Pepco's and Delmarva's 2009 Maryland cases, the Maryland PSC began its discussion of its decision on the appropriate cost of equity in both cases with this statement: "We find, as an initial matter, that Delmarva's recommended 10.75% cost of equity is excessive and unjustified." *Delmarva Power,* Order No. 85029 at 77 (Md. PSC July 20, 2012); *Pepco*, Order No. 85028 at 107 (which added the adjective "totally" before "unjustified"). More recently, in its decision in Pepco's most recent rate case, that same commission found Mr. Hevert's proposed 10.25% COE to be "anomalously high in relation to other recommendations." *In the Matter of the Application of Potomac Electric Power Company for an Increase In Its Retail Rates for the Distribution of Electric Energy*, Case No. 9311, Order No. 85724 at 106 (Md. PSC July 12,

[84]http://pucweb1.state.nv.us/PDF/AxImages/DOCKETS_2010_THRU_PRESENT/2011-6/13762.pdf

[85]This is a finding that seems to be confirmed by the expected long-term returns on Delmarva's pension plan assets that were used to calculate the net periodic benefit cost over the last several years, which was 8.25% for the 2007-2009 period; 8.0% for 2010; and 7.25% for 2011 and 2012. (Exs. 30-31).

[86]http://www.icc.illinois.gov/downloads/public/edocket/310038.pdf

2013).[87] Moreover, as pointed out at the evidentiary hearing, Mr. Hevert's recommendations have ranged from 26 to 205 basis points over the ROEs the commissions ultimately approved. (Tr. at 457-58).

The DPA doubts that there is a cost of capital witness anywhere in the country whose recommendations have been adopted without reservation. But the DPA respectfully believes that the findings of our sister commissions – especially those that also regulate other PHI companies and have considered this same witness and his testimony – are worthy of reliance. Mr. Hevert's inputs into his COE models invariably bias his study results upward. They should be given no weight in determining the appropriate COE for Delmarva.

3. Thirty-Year Old Authorized Returns on Equity Have No Bearing on What Delmarva's COE Should Be Now.

Despite Mr. Hevert's claim on cross-examination that his purpose for using the RRA authorized returns was to generally examine the relationship between authorized returns and interest rates (Tr. at 437), he actually uses them time and again in an attempt to demonstrate the unreasonableness of DPA witness Parcell's recommended COE compared to other authorized COEs (and convince the Commission to award Delmarva a high return). His prefiled testimony belies his oral testimony:

> Q: Did you give any weight to the Mean Low DCF results in developing your ROE range and recommendation?
>
> A: No, the mean low results are well below any reasonable estimate of the Company's Cost of Equity. *Of the 1,392 rate cases since 1980 that disclosed the awarded ROE, for example, only one included an ROE of 9.00% or lower. On that basis alone, the mean low results are highly improbable.* As such, I did not give these estimates any weight in arriving at my ROE range and recommendation.

(Ex. 3 at 14 and n.11) (emphasis added).

[87] http://webapp.psc.state.md.us/Intranet/Casenum/NewIndex3_VOpenFile.cfm?ServerFilePath=C:\Casenum\9300-9399\9311\\164.pdf

> Q: Did you give your Sharpe Ratio-based CAPM results significant weight in arriving at your ROE range and recommendation?
>
> A: No, I did not. The CAPM results based on the Sharpe ratio derived MRP range from 8.91% to 9.22%. *As discussed above, results below more than 99.50% of authorized ROEs since 1980* (and well below the Company's previously authorized ROE) should be given little to no weight in the context of developing a recommended ROE.

(Ex. 18 at 41) (emphasis added). Furthermore, he discounts certain results of his DCF and CAPM studies because they are "highly improbable" based on his analysis of RRA's disclosure of the authorized COEs in 1,392 rate cases since 1980. (Ex. 3 at 14; Ex. 18 at 41). It is clear that Mr. Hevert *did* use the RRA results for more than simply examining the relationship between authorized returns and interest rates.

There are problems with relying on the RRA results. One is that the report contains no discussion of the circumstances under which the reported returns were authorized. Mr. Hevert admitted that case-specific circumstances should be considered, and that a return that is reasonable at one time based on one set of facts can become either too high or too low (Tr. at 432, 453-54). And what we *do* know about the circumstances in which many of the returns identified in the RRA report were authorized shows that they have no relevance to the current docket. The RRA report contains authorized COEs from the 1980 and 1990s, which Mr. Hevert agrees was a time of "quite high" returns that are unlikely to occur during the rate effective period in this case. (Tr. at 435-38). Many of the reported returns are for vertically-integrated companies; Mr. Hevert agrees that generation companies are generally riskier than transmission-and-distribution-only companies. (Tr. at 440). Finally, many of the returns on the report are old: Mr. Hevert agrees that returns from the 1980s and from the early 2000s are not "recent" (Tr. at 436, 447), so it is fair to assume that he would not consider returns from the 1990s to be "recent" either.

A second problem is that looking at other authorized returns is circular; Mr. Hevert agreed that if regulators only looked at what other regulators were awarding, "after a while the number would never go anywhere." (*Id.* at 432). But that is exactly what Delmarva exhorts the Commission to do: look at other authorized returns and award Delmarva something similar.

4. <u>Delmarva Is In No Danger of Being Downgraded.</u>

Delmarva conjures up the spectre of rating agency downgrades if the Commission does not authorize its recommended 10.25% COE, pointing to Fitch's July 2013 downgrade of its affiliate Pepco due to the state regulatory environment and the outcome of its rate cases. (DOB at 35-36). Delmarva says authorizing a 10.25% COE will "signal a consistent and reasonable regulatory environment" and enable it to "maintain a sound financial profile and appropriate credit ratings." (*Id.* at 36).

This is a constant refrain in Delmarva rate cases, and the Commission should pay it no heed. First, Pepco's situation is not comparable to Delmarva's. As discussed at length *supra*, the Maryland PSC and District of Columbia PSC have taken Pepco to task for longstanding reliability problems that simply do not exist in Delaware. Moreover, as Mr. Boyle admitted on cross-examination, Delmarva has not been downgraded at any time by the rating agencies in the last five years. (Tr. at 169).

Second, on November 8, 2013, Moody's issued a report identifying a number of utilities that it is considering for an upgrade. (Ex. 26). That report includes Delmarva as well as its affiliates Atlantic City Electric - and Pepco. In its report, Moody's stated:

> We believe that many US regulatory jurisdictions have become more credit supportive of utilities over time and that our assessment of the regulatory environment that has been incorporated into ratings may now be overly conservative.

> The US utility sector's low number of defaults, high recovery levels, and generally strong financial metrics from a global perspective provide additional corroboration for our view that ratings should generally be higher.
>
> We expect that most upgrades will be limited to one notch, and that the reviews of the affected companies will be completed within approximately 90 days. Although we anticipate that most of the utilities placed under review will be upgraded, there may be selected instances where ratings will not be upgraded following the completion of our review.

(*Id.* at 1). Moody's noted that certain companies or utility holding companies were not on review for upgrade due to specific circumstances such as being engaged in substantial generation construction or other large capital projects, having a current "Negative Outlook" or being "under potential downward rating pressure," characterized by material concentration or event risk, facing market or regulatory risks specific to their particular jurisdiction, or being part of a corporate family with significant non-utility operations. (*Id.*) Pepco made Moody's list for potential upgrade despite the allegedly non-supporting regulatory environments it faces in Maryland and the District of Columbia and despite Fitch having already downgraded it.

While the DPA acknowledges that Moody's may not upgrade Delmarva, this report suggests that Moody's does not consider Delmarva to be in danger of a *downgrade.* In this same vein, Moody's also identified as candidates for upgrading numerous utilities whose most recent authorized ROEs are less than 10% (Ex. 28; Tr. at 179-88), which certainly suggests that Moody's does not consider ROEs below 10% to be a kiss of death.

Third, this Commission should not be bullied into authorizing a COE that is above market due to the unsupported conjectures of what the rating agencies might or might not do. The Supreme Court has specifically cautioned regulators against doing so. *Permian Basin,* 390 U.S. at 791. This Commission, too, has acknowledged that under *Permian Basin* it is required to assess both the broad public interest and the utility's interest. *Delmarva Power*, Order No. 8011 at ¶282.

The DPA acknowledges that this Commission believes it is important for the utility to be financially healthy (and agrees that it is important). The Maryland PSC recognizes the importance of a financially healthy utility too, but it has dismissed arguments similar to those Delmarva puts forth here regarding what rating agencies might do to or for it:

> Pepco implores us to increase rates in order to strengthen its earnings and send "constructive signals" to the investment community. Pepco argues that if we grant the large rate increase it has requested, if we allow pre-payments and surcharges for infrastructure investments and if we increase the return to shareholders, then customers and the public will benefit from the *possibility* that its credit rating might improve, that lenders *might* treat Pepco more favorably, and that Wall Street *might* view Maryland as a more favorable regulatory climate. To us, that is a lousy bargain. The only certain outcomes from that approach are new burdens on Pepco's customers. We know *for certain* that if we adopted Pepco's requests, customers would pay more. We know *for certain* that customers would assume financial risks that the Company always has borne. And we know *for certain* that Pepco and its parent company would reap higher earnings, which it would be free to use as it saw fit, and which it would not be compelled to reinvest in the business. As Pepco's witness conceded, there is *no* certainty that the public would see any return on that investment.

Pepco, Order No. 85028 at 3-4 (emphasis in original). (And remember: at around the same time one rating agency downgraded Pepco, another rating agency has identified it for a potential upgrade). (Ex. 26). Delmarva has investment-grade bond ratings. (Ex. 15 at Sch. DCP-3. p.1). Mr. Boyle testified that PHI has issued debt since the Commission's decision in Docket No. 09-414. (Tr. at 169). And Delmarva agreed (subject to check) that despite its allegedly reduced earnings, it: paid dividends in each year from 2008 through 2012; paid all of its creditors in each of those years; paid executive and non-executive incentive compensation to its employees in each of those years; gave non-union employees raises in each of those years except 2009; and gave raises to union employees in each of those years except 2010. (*Id.* at 635-37).

Notwithstanding its lack of revenues, it still had money for raises and incentive compensation and bonuses and dividends. It can be assumed that the rating agencies know all of the doom and gloom Delmarva claims about its earnings and revenues and return on equity. Despite all that, Moody's is still considering upgrading Delmarva. (Ex. 26).

The DPA respectfully submits that the Maryland PSC is correct. We can be certain that a rate increase will result in customers paying more and that Delmarva will have more money to use as it sees fit. But there is no guarantee that the rating agencies or Wall Street or lenders will look more favorably on Delmarva even if the Commission gives it everything it requests.

5. Delmarva's Claimed Deficiencies In the DPA's COE Studies Should Be Rejected.

This Commission generally has not examined the individual inputs into cost of capital witnesses' models, or even the witnesses' application of those models. However, in the event the Commission does delve into the witnesses' cost studies more deeply than it has in the past, the DPA will address Delmarva's claimed deficiencies in its COE studies.

Delmarva claims that: (1) Mr. Parcell's reliance on historical growth measures as well as projected growth measures bias his DCF study results downward; and (2) his DCF included growth rates that are too low to be sustainable in the long run. (DOB at 44-45). Cost of capital witnesses always argue about whether only analysts' projected growth rates should be used as the appropriate growth rate input. But as discussed previously, the DC PSC rejected using only projected EPS growth rates in the DCF model because they were "overstated." *Pepco*, FC 1087 at 60. Moreover, Mr. Hevert agreed that a company cannot grow indefinitely at a faster rate than the market in which it sells its product (Tr. at 454). Since 2010, the highest quarterly real GDP growth was 4.1% in the fourth quarter of 2011. For the first two quarters of 2013, real GDP growth was 1.8% and 1.7%, respectively. The overall annual real GDP since 2010 has been

2.4% in 2010, 1.8% in 2011 and 2.2% in 2012. (Ex. 15 at Sch. DCP-2, pp. 1-2). Only two of the 35 projected EPS growth rates Mr. Hevert used in his direct and rebuttal DCF studies are less than 3%, and . (Ex. 3 at Sch. (RBH)-1, pp. 1-3; Ex. 18 at Sch. (RBH-R)-1, pp. 1-3).

Next, Delmarva calls the "fact" that Mr. Parcell did not use his CAPM results to set his recommended COE range a deficiency. (DOB at 45). Delmarva is wrong: Mr. Parcell specifically stated that his CAPM results should be considered *as one factor* in determining Delmarva's COE. (Ex. 15 at 34). While he did not include those results in calculating the average from his studies, he testified that they indicate that capital costs remain at historically low levels and that Delmarva's COE is less than in previous years. (*Id.*). Furthermore, we note that Mr. Hevert discounted the results of his CAPM studies in his direct testimony and did not use the results of his Sharpe ratio-derived CAPM model in determining that his 10.25% recommended COE was reasonable in his rebuttal testimony. (Ex. 3 at 20-21; Ex. 18 at 41). Even if Mr. Parcell had not used his CAPM results to inform his recommended COE (which is not the case), if it is a deficiency, then Mr. Hevert's direct testimony suffers the same fate.

Delmarva contends that Mr. Parcell's CE study relied substantially on his subjective assessment. (DOB at 46-47). But all models require subjective assessments. For example, the constant growth DCF model requires the analyst's subjective assessment of the appropriate growth appropriate. The CAPM model requires the analyst's subjective assessment of the appropriate risk-free rate and the appropriate MRP. So it is not surprising that the CE model also required Mr. Parcell to apply his judgment with respect to the relationship between MTB ratios and earned ROEs. Delmarva obviously disagrees with Mr. Parcell's testimony that such a relationship exists and what his determination of the appropriate MTB ratio is for a company like

Delmarva, but that is a different issue than criticizing a study simply because it requires the analyst to apply his subjective judgment.

Delmarva asserts that the DPA's COE recommendation does not reflect current capital market conditions. (*Id.* at 48-49). It claims that he admitted that the "flight to safety" that he discussed in his testimony no longer applies, and concludes from that that there is no basis for Mt. Parcell's statement that investors expect lower returns. Next, it claims that although "the broad market increased by nearly five percentage points" over the May 2013-September 6, 2013 time frame, utility stocks "significantly underperformed the broad market" during this period, and regardless of what the reason for that underperformance is, it must be considered in deriving the appropriate COE. Finally, it complains that Mr. Parcell assumes that a 9% COE is as likely as a 10% COE because he gave equal weight to all of his DCF and CE study results. (*Id.*).

Mr. Parcell did testify that the flight to safety was no longer a factor in the capital markets. But that was not the sole basis for his conclusion that investors expect lower returns. Indeed, one of the most significant factors for his conclusion is that despite the recent increase in bond yields, capital costs are still at historic lows:

> On the other side of this "flight to safety" is the negative perception of the recent declines in capital costs and returns, which significantly reduced the value of most retirement accounts, investment portfolios and other assets. One significant aspect of this has been a decline in investor expectations of returns. Finally, as noted above, utility interest rates are currently at levels below those prevailing prior to the financial crisis of late 2008 to early 2009 and are near the lowest level in the past 35 years.

(Ex. 15 at 13-14).

There is no record support for Delmarva's assertion that utility stocks "significantly underperformed the broad market" during the May 2013-September 6, 2013 period. Delmarva cited nothing in the record to support this statement; the only record citation that appear in the paragraph discussing this says nothing about utility stocks underperforming the broad market. There are times when utility stocks outperform the broad market, but Delmarva says nothing about that; apparently that street only goes one way. Finally, the average MTB ratio for the companies in both Mr. Hevert's and Mr. Parcell's proxy groups has increased each year in the 2009-2012 period, showing that utilities are performing quite well. (Ex. 15 at Sch. DCP-10, p.2).

	2009	2010	2011	2012
Parcell Proxy Group	106%	126%	136%	146%
Hevert Proxy Group	102%	118%	128%	139%

Finally, Mr. Parcell's equal weighting of the results of both studies actually results in a higher COE recommendation: had he placed greater weight on the DCF results, his recommended COE would have been substantially lower. He would have been justified in doing so, since – as Delmarva acknowledges – this Commission relies primarily on the DCF to set a utility's COE, but he applied his judgment in giving less weight to the low and average results that his model produced. (Ex. 15 at 24-25).

The alleged deficiencies that Delmarva identifies in Mr. Parcell's studies are nonexistent. Its arguments should be rejected.

6. <u>To the Extent Delmarva's Recommended COE Contains an Allowance for Flotation Costs, the Commission Should Expressly Reject It.</u>

Mr. Hevert considered flotation costs in reaching his final recommendation. The Commission has rejected flotation cost adjustments time and again. *Delmarva Power*, Order No. 8011 at ¶288; *Delmarva Power*, Order No. 6930 at ¶275; *Delmarva Power*, Order No. 3389 at ¶231. Delmarva has proffered no new facts or arguments supporting a change in this policy.

7. To the Extent Delmarva's Recommended COE Contains an Adjustment for Its Alleged Small Size, It Should Be Rejected.

Mr. Hevert testified that he considered Delmarva's small size in determining the appropriate COE for Delmarva. He acknowledges that the studies upon which he relies for this effect did not specifically examine utilities but claims that utility analysts have noted that there are risks associated with small market capitalization. (Ex. 3 at 24).

Delmarva's request should be denied. First, neither of the articles that Mr. Hevert cited in his direct testimony is specific to utilities. Second, the Annin article discusses such an adjustment in the context of including it in the CAPM model. Mr. Hevert did not do that here; rather, he calculated an adjustment outside of the CAPM model. The Annin article also says that the adjustment is over and above any increase already provided to smaller companies as a result of their high betas; however, utilities are less risky than the market as a whole (see Ex. 3 at Sch. (RBH)-3 for the proxy company betas), and transmission-and-distribution utilities are less risky than companies which still own generation, as most of the proxy companies do.

Third, Professor Annie Wong performed a study that *did* specifically examine whether the small size effect existed in the public utility industry. *See* A. Wong, *"Utility Stocks and the Size Effect: Am Empirical Analysis,"* 1993 Journal of the Midwest Finance Association, pp. 95-101 (Attachment L). Dr. Wong specifically referenced previous studies, noting that the samples in those studies were dominated by industrial firms and no one had examined the size effect in public utilities. *Id.* at 95. Her objective was to "provide a test of the size effect in public utilities." *Id.* at 96. She selected a sample of 152 public utilities and, for each of the 152 utilities, selected one slightly larger and one slightly smaller industrial firm, so that there were 304 industrial firms in her non-utility sample. *Id.* She concluded:

> The objective of this study is to examine if the size effect exists in the utility industry. After controlling for equity values, there is some weak evidence that firm size is a missing factor from the CAPM for the industrial but not for the utility stocks. This implies that although the size phenomenon has been strongly documented for the industrials, the findings suggest that there is no need to adjust for the firm size in utility rate regulations.

Id. at 98.

For all of the foregoing reasons, Delmarva's suggestion that the Commission should take its small size into account in determining the appropriate COE should be rejected.

* * *

Quite simply, Delmarva's proposed COE is overstated. It relies on a inflated growth rate input for the DCF; on CAPM studies whose MRP input greatly exceeds the long-term experience of the differential between common stocks and government bonds; and on a bond yield plus risk premium model that uses average authorized returns that have not been seen since 2003, in addition to having been rejected by at least one commission. The DPA's recommended COE is more in line with market conditions as they exist and are expected to exist for the foreseeable future. The DPA therefore respectfully requests the Commission to reject Delmarva's proposed COE, and to approve the DPA's recommended COE.

VI. CLASS COST OF SERVICE STUDY ("CCOSS")

A. The DPA's Modifications to Delmarva's CCOSS Should Be Accepted.

1. Introduction – Discussion of CCOSS

A CCOSS is a method to reconcile utility costs and revenues across different customer classes. (Ex. 14 at 23). Its goal is to determine the cost of providing service to a particular customer class and the revenue contribution that each class makes to cover those costs. The CCOSS results can be used as a tool to develop each customer class' revenue responsibility and rates. (*Id.* at 23-24; Ex. 10 at 9).

A CCOSS typically has three steps: functionalization, categorization and allocation. In the functionalization step, costs are defined based on their nature; where, as here, the utility is a distribution-only utility, most costs are functionalized as distribution-related. In the categorization step, the distribution costs are separated into a particular type of cost, such as demand-, energy- or customer-related. Demand-related costs are those associated with meeting maximum electricity demand (for example, substations and transformers are designed at least partially to meet maximum demand requirements). The most common demand allocation factors are related to system coincident peaks ("CP") and non-coincident customer class peaks ("NCP"). Energy costs are those that tend to vary with the amount of electricity sold and can be thought of as volumetric. Customer-related costs are associated with connecting customers to the system, metering, and other customer support functions. In the last step, the demand-, energy- and customer-related costs are allocated to a respective customer class. (Ex. 14. at 24-25; *see also* Ex. 10 at 11).

This is not a simple process. Some costs can be clearly identified and directly assigned to a function/category, but others are more ambiguous and difficult to assign. The primary CCOSS challenge is treating "joint and common" costs. Because of their shared or integrated nature, such costs can be difficult to assign to a particular function or category. As a result, unique allocation factors are used in a CCOSS to classify such costs, and the process of developing these factors is often subject to differing interpretations and emphases. (Ex. 14 at 24).

A utility's historic book costs are the core of a CCOSS; thus, rates are based on historic average costs. Although economic theory suggests that the most efficient form of pricing in perfectly competitive markets should be based on marginal costs, distribution utilities do not operate in perfectly competitive markets (they are natural monopolies); therefore, it is not possible for distribution utilities to reach the ideal pricing formula outlined in economic theory. There are two reasons for this. First, the nature of natural monopolies makes pricing difficult in the presence of declining average costs, a problem further complicated by the presence of the joint and common costs, as explained earlier. Second, the costs used in a CCOSS are historic and static, not dynamic and forward-looking, which undermines many experts' cost causation and pricing claims. In the end, a CCOSS reveals no one single correct answer, so regulators must exercise their judgment regarding the nature of these costs and their implications in setting fair, just and reasonable rates. (*Id.* at 25-26).

Often, the main challenge in evaluating CCOSS results is determining whether costs will be recovered strictly by each customer class' peak load contributions or whether off-peak usage will also be considered. Methodologies that are heavily biased to peak considerations can tend to favor larger customer classes and off-peak customers, and prejudice relatively lower load factor customers such as residential and small commercial customers. Such methodologies also fail to fully capture the commodity the utility sells (electricity), and how the value of that electricity varies by the amount purchased by the different customer classes. (*Id.* at 26-27).

Delmarva uses three separate allocators to distribute demand-related costs - Primary Demand (DEMPRI), Secondary Demand (DEMSEC) and Line Transformer Demand (DEMTRNSF). (*Id.* at 27). It derived these allocators from two separate measurements of electric demand – a Class Maximum Diversified Demand (Class MDD) and a sum of customer maximum non-coincident demands (Customer NCP). The Class MDD is a traditional measure of non-coincident customer class peaks (NCP) measured as the maximum hourly system demand attributable to each rate class for a given year (in the case, calendar year 2011). (*Id.* at 27). The Customer NCP is an aggregation of each customer's individual maximum hourly system demand within a rate class. Since not all customers possess the metering equipment to directly measure individual demands, Customer NCP calculations rely heavily on estimates from a sample of load research meters dispersed throughout the service territory. (*Id.* at 28).

The DEMPRI factor is simply the ratio of each individual customer class MDDs. Delmarva used it to allocate Structures & Improvements (Account 361); Station Equipment (Account 362), and the primary voltage system assets in Account 364 (Poles, Towers & Fixtures), Account 365 (Overhead Conductors), Account 366 (Underground Conduit) and Account 367 (Underground Conductors & Devices). (*Id.* at 27-28).

DEMSEC was derived based on 50% Class MDD and 50% Customer NCP excluding LGS-S, GS-P and GS-T customers; and DEMTRNSF was derived using 50% Class MDD and 50% Customer NCP but excluding Class MDD for LGS-S customers and completely excluding GS-P and GS-T customers. (Ex. 14 at 27). Delmarva used the DEMTRNSF factor to allocate Account 368 (Line Transformers), and used the DEMSEC factor to allocate overhead and underground services and the secondary voltage system assets attached to Accounts 364-367. (*Id.* at 29).

Pursuant to the settlement agreement in Docket No. 09-414, Delmarva conducted a workshop to address deficiencies that Staff had identified in its CCOSS in that case. (*Id.* at 29-30). It made five changes to its CCOSS practices as a result of that workshop: (1) use Delaware-specific load survey data to estimate residential non-coincident peak demands; (2) use weather-normalized sales and revenue data; (3) use an updated analysis of system losses; (4) allocate Account 369 (Service Lines) on the basis of a derived allocator; and (5) disaggregate traffic signal customers from the general street lighting class. (*Id.* at 30).

DPA witness Dr. Dismukes testified that Delmarva had complied with the Settlement Agreement in Docket No. 09-414, but identified several remaining deficiencies in its CCOSS methodology. First, the load data Delmarva used in the CCOSS was based on calendar year 2011 usage, even though the financial data it used is associated with a 2012 test year. (*Id.* at 32-33). Second, Delmarva had not verified the validity of its load research sampled since an April 2008 analysis that used September 2007 billing data. Dr. Dismukes noted that Delmarva had stated that it had no written policy for updating load research samplings, but rather "'relie[d] on the quality of current sample load data statistics to dictate sample maintenance needs.'" (*Id.* at 33, quoting Delmarva's response to AG-COS-25).

Dr. Dismukes also disagreed with two of the allocation factors used in the CCOSS: (1) a labor allocator for general and common plant accounts; and (2) a 50/50 weighting of number of customers and energy sales allocator for Accounts 907 through 913. (*Id.* at 33). Dr. Dismukes prepared an alternative CCOSS using his recommended allocation factors of total distribution plant for general and common plant accounts and a customer-based allocation factor for Accounts 907-913. (*Id.* at 33, 35-37 and Schs. DED-9 and DED-11).

DEUG witness Phillips takes issue with the classification and allocation of Accounts 364-367 as entirely demand-related and contends that they should be classified and allocated based on both demands and customer counts using a minimum distribution size or zero intercept methodology. (Ex. 16 at 9-10; Tr. at 990). He claims that allocating these accounts solely on the basis of demand is inconsistent with cost causation and generally accepted costing methodology, and that using no customer component is wrong and produces erroneous results. (Ex. 16 at 10, 20). According to Mr. Phillips, the distribution system's primary purpose is to deliver power from the transmission grid to the customer in various geographical locations and at different voltage levels, and certain investments must be made just to connect a customer to the system. Moreover, many equipment manufacturers only have minimum sized equipment available, and safety concerns and construction practices often require minimum sized equipment; thus, demand is irrelevant in these circumstances. Rather, he states that "[t]hese investments are properly considered to be customer-related." (Ex. 16 at 10). This is the "minimum distribution system" cost of service concept, which Mr. Phillips says "has been accepted for decades as a valid consideration by numerous state public utility commissions" and has "also been presented in the Cost Allocation Manual that the National Association of Regulatory Utility Commissioners ("NARUC") publishes. (*Id.* at 10-11) ("Manual"). Essentially, the MDS methodology assigns all costs of a hypothetical minimum distribution system to customers. (*Id.* at 11). He claims that the Manual supports allocating part of Accounts 364-367 on the basis of customer count, and that regulatory authorities in 13 states have classified a portion of these accounts (ranging from 30%-50%) as customer-related. (*Id.* at 14-17). He claims that Delmarva supported a customer component for allocating these costs in Docket No. 92-85, and that it agreed to provide zero intercept and minimum distribution system studies in its "last" Maryland electric rate case, Case No. 9249, as part of the settlement of that case. (*Id.* at 16).

Mr. Phillips prepared a CCOSS that classified a portion of the Account 364-367 costs on a customer basis, using his calculated average customer component. (*Id.* at 18 and Schs. NP-3 and NP-4). He claimed to have adjusted the customer allocation factor associated with the secondary system for both his MDS and zero intercept studies in order to address certain criticisms of those methodologies. (*Id.* at 19). He averaged the results of the two studies "to account for the subjective estimates used in the individual studies" (the subjective assessment of the minimum size system in the MDS study and the estimated data used in the zero intercept study). (*Id.*). The result of his reclassification of some of the Account 364-367 costs was an increase in costs allocated to the residential customer class and a decrease in costs allocated to the GS-S and GS-P classes. (*Id.* and Sch. NP-4).

Staff witness Pavlovic testified that the relationship between cost allocation, rate design and revenue requirement recovery was "deceptively simple:"

> If a utility's costs of providing service are not accurately allocated to its rate classes and rate class costs are not accurately reflected in the rate classes' tariff billing charges, then the utility will either over or under recover its costs of service or revenue requirement. The less accurately the costs are reflected in the rate classes' tariff billing charges the greater the utility's under or over recovery of its costs will be.

(Ex. 10 at 6). He identified two primary drivers of distribution costs: the number of customers the system serves and those customers' demands on the system, and framed the issue as whether Delmarva's proposed cost allocations and tariff rates accurately reflected Delaware customers' distribution customer and demand costs. (*Id.* at 6-7). He concluded that Delmarva's CCOSS was "suspect" and did not reflect as accurately as possible each class' cost-causative impact on the system because: (1) it failed to develop separate allocators for underground and overhead facilities; (2) used demand allocators that did not accurately reflect class diversity at the load center level; and (3) employed four composite allocators that used an arbitrary 50/50 weighting of demand allocators. (*Id.* at 5, 12).

Dr. Pavlovic testified that Adjustment 26 would "substantially and/or disproportionately" impact the CCOSS results; however, since Staff had recommended rejecting the adjustment entirely, he did not examine it further. (*Id.* at 11-12).

As to his first criticism, Dr. Pavlovic testified that Delmarva had properly functionalized its overhead and underground facilities separately, but then used the same demand allocator for both, which effectively reversed the separate functionalization. (*Id.* at 12). According to Dr.

Pavlovic, underground and overhead facilities have different cost characteristics and residential and commercial customers typically use them in different proportions. Commercial customers generally make greater use of underground facilities, which are substantially more expensive than overhead facilities; thus, using the same allocator for both generally overallocates costs to the residential class and underallocates costs to the commercial class. Since Delmarva uses class rates of return to distribute its revenue requirement, if a class rate of return is understated, the revenue requirement distribution will overstate that class' cost contribution, and that class' rates will recover more than its share of the costs. (*Id.* at 12-13).

Next, Dr. Pavlovic testified that the diversity on each functional type of facilities and voltage level is a function of how a utility actually plans and deploys its facilities and the actual distribution of customers served by those facilities. Diversity generally declines from a maximum on transmission facilities to zero at the individual customer's service. In practice, the actual amount of diversity on a facility will range between zero measured by maximum customer demand and the maximum measured by coincident peak demand. However, the demand allocators that Delmarva used arbitrarily assumed no load diversity, which Dr. Pavlovic opined was "extremely unlikely." (*Id.* at 13-14). He noted that an allocator that does not accurately measure diversity on the facilities will result in underallocation to some classes and overallocation to others, but it was not possible to tell which classes would be favored or disfavored without actually determining the class diversity on Delmarva's facilities. (*Id.* at 14).

Last, Dr. Pavlovic testified that Delmarva's composite allocation factors (MEN SEC, DEMTRNSF, CSERV and CSALES) involved arbitrary assumptions about cost causality on the system. He stated that using composite allocators is appropriate to allocate costs that are a function of two cost drivers having equal impact on the costs being allocated, but that is rarely the case; thus, to assume so introduces more inaccuracy. (*Id.* at 14). He noted that Delmarva is currently using the information in its Geospatial Information System to more accurately identify and separate its primary and secondary voltage facilities for CCOSS purposes, and that the GIS information combined with the individual customer-specific demand that Delmarva collects from the AMI meters can be used to develop "extremely accurate" demand allocators. (*Id.* at 15-16). Dr. Pavlovic recommended that the Commission order Delmarva to develop accurate demand allocators to be used in the CCOSS for its next rate case. (*Id.* at 16).

There are very few disagreements among the parties, especially considering that the CCOSS is replete with exercises of judgment and application of assumptions. However, the DPA does have disagreements with each of the CCOSS witnesses, which we discuss below.

2. DEUG's Proposal to Allocate Accounts 364-367 On Both a Demand and a Customer Basis Is Unwarranted and Should Be Rejected.

Mr. Phillips' proposal to assign a customer component to the Account 364-367 costs should be rejected because the minimum distribution system and zero intercept methodologies that he uses are meritless. In his seminal work on public utility regulation, Professor Bonbright criticized those methodologies:

> The really controversial aspect of customer-cost imputation arises because of the cost analyst's frequent practice of including, not just those costs that can be definitely earmarked as incurred for the benefit of specific customers, but also a substantial fraction of the annual maintenance and capital costs of the secondary (low-voltage) distribution system – a fraction equal to the estimated annual costs of a hypothetical system of minimum capacity. This minimum capacity is sometimes determined by the smallest sizes of conductors deemed adequate to maintain voltage while keeping them from falling of their own weight. In any case, the annual costs of this phantom, minimum-sized distribution system are treated as customer costs and are deducted from the annual costs of the existing system, only the balance being included among those demand-related costs… . Their inclusion among the customer costs is defended on the ground that, since they vary directly with the area of the distribution system (or else with the lengths of the distribution lines, depending on the type of distribution system), they therefore vary with the number of customers. Alternatively, they are calculated

> by the "zero-intercept" method whereby regression equations are run relating cost to various sizes of equipment and eventually solving for the cost of a zero-sized system.
>
> *What this last-named cost imputation overlooks, of course, is the very weak correlation between the area (or the mileage) of a distribution system and the number of customers served by this system. For it makes no allowance for the density factor (customers per linear mile or per square mile). Our casual empiricism is supported by a more systematic regression analysis in (Lessels, 1980) where no statistical association was found between distribution costs and number of customers. Thus, if the company's entire service area stays fixed, an increase in number of customers does not necessarily betoken any increase whatsoever in the costs of a minimum-sized distribution system.*

J. Bonbright, A. Danielsen and D. Kamerschen. *Principles of Public Utility Rates*, at 491 (2d ed. 1988) (emphasis added) (excerpt admitted as Ex. 93).

Mr. Phillips attempts to dismiss Professor Bonbright's criticism, saying that this treatise has something in it for everyone. (Tr. at 993). However, it apparently does *not* have anything in it that supports his proposed CCOSS methodologies.

Next, it is irrelevant that Delmarva supported a customer component in Docket No. 92-85. That case was more than 20 years ago, and as Company witness Tanos testified, minimum size installations have changed over the past 20-30 years. Standardization, economies of scale, reliability, load density and safety have all contributed to a more economic and reliable delivery system with installed facilities that have increased in size but have achieved lower costs. (Ex. 22 at 14). Moreover, in Docket No. 05-304, the last time that the Commission actually addressed this CCOSS issue, Delmarva had abandoned the MDS methodology because of its weaknesses. *Delmarva Power,* Order No. 6930 at ¶292. The Hearing Examiner in that case thoroughly discussed the MDS methodology advocated by DEUG's witness in that case and recommended its rejection, and the Commission agreed. *Id.* at ¶¶291,294, 297-298.

Third, Delmarva did not propose a MDS or zero intercept methodology in its last Maryland case. The case that Mr. Phillips references – Case No. 9240 – was not Delmarva's "last" (as in most recent) case in Maryland. As Mr. Phillips admitted on cross-examination, Delmarva has filed two rate cases since then. And in its decision in Case No. 9285, the Maryland PSC found that "[b]ased upon the record in this proceeding, … the Company's COSS fairly and reasonably distributes costs among its customer classes." *Delmarva Power*, Order No. 85029 at 83.[88] Furthermore, to the extent anyone in Maryland wants a CCOSS prepared using the MDS methodology, it is the Maryland PSC Staff, which apparently wants it for comparison purposes. (*Id.* at 84; Ex. 96). In its most recent distribution rate case, Delmarva provided the requested study but specifically pointed out that it was not supporting its use and observed that it would shift almost $38 million in revenue requirement from demand-related to customer-related costs, resulting in nearly doubling the proposed residential customer charge. Delmarva further stated that there were data limitations with conducting minimum distribution system studies, and its consultant's attempt to adjust the study to ameliorate certain problems did not assuage its concerns because those adjustments also applied broad-based assumptions. (Ex. 97 at 4-5).

Here, neither Staff nor the DPA seeks any change in Delmarva's CCOSS methodology; they only suggest changing certain inputs. The only party suggesting a methodology change is DEUG, and even its witness admits that its proposal would shift a substantial amount of cost to

[88]To be fair, we note that the Maryland PSC also observed that Delmarva was supposed to have prepared and submitted a zero intercept and a NDS CCOSS for the purpose of providing Staff the opportunity to compare those results with the CCOSS in the instant case, and directed Delmarva to complete the work necessary to provide those studies to Staff "as soon as reasonably practicable." *Delmarva Power,* Order No. 85029 at 84. Once Staff had received the studies, Staff was to inform the Commission "whether, and if so, why, such COSSs should be prepared for Delmarva's next rate case." By letter dated February 14, 2013, Maryland PSC Staff informed the Commission that in its next base rate case Delmarva should file an appropriately updated minimum system study, but that Staff was no longer recommending submission of a zero-intercept CCOSS because "the majority of the results are not statistically reliable." (Ex. 96).

the customer component and hence to residential ratepayers. (Ex. 16 at 19). The DPA respectfully submits that DEUG's proposed CCOSS methodologies be rejected.

3. The DPA's Proposed Changes to the CCOSS Should Be Accepted.

a. Delmarva Should Be Instructed to Use More Recent Load Data in Its CCOSS And to Verify the Validity of Its Load Research Samples.

Delmarva takes issue with Dr. Dismukes' observation that it used calendar year 2011 load data in its CCOSS, stating that it "followed historical filing practices" and "used the most recent data available at the time" it prepared the CCOSS. (Ex. 22 at 8). Mr. Tanos states that since the test period was the calendar year ended December 2012, the most recent set of demand measures were based on 2011. (*Id.*). Delmarva also claims that it performs regular monthly checks of the sample statistical reliability as part of its monthly load profiling process for the Delmarva Zone final load settlements. Mr. Tanos testified that Delmarva checks the validity of the sample by comparing the sample monthly mean energy with that of its class population and "others such as the relative precision of the sample noncoincident demand and energy values during the peak months" show how well the samples will perform in determining the customer maximum demands used in the CCOSS. (*Id.* at 8-9). He presented tables showing that the non-demand metered class noncoincident demands exceeded the statistical reliability design standards during the peak months of the last several years. And finally, he presented what he called a set of sample validation tests like those originally performed for the sample design that confirmed that the residential profile class samples were valid in the 2011 study year. (*Id.* at 9 and Sch. (EPT-R)-1).

There are two points to be made here. First, Delmarva seems to suggest that logistically it was unable to provide a CCOSS that included allocations contemporaneous to the test year that it chose. It did not file its request with the Commission for a general rate increase until March

2013, nearly three months after the conclusion of 2012. (Tr. at 900). It is implausible that Delmarva could not have obtained the 2012 data to perform its CCOSS prior to its filing in March. Furthermore, even if this was the case, Delmarva has complete discretion regarding the timing of any filing before the Commission. It could (and should) have delayed its filing until it could provide the Commission and parties with a complete application that included a CCOSS with appropriate allocations corresponding to its chosen test year. Last, even if Delmarva could not delay its filing for whatever reason, nothing in the Commission's rules or regulations governing rate case procedure prevented it from updating its CCOSS to include 2012 data as it became available. (Tr. at 901). Instead of any of these options, Delmarva chooses to rely on a CCOSS that it knows could be flawed in a potentially material way, rather than simply correcting for the flaw. Delmarva's explanation is insufficient. The Commission should reject it and should direct Delmarva to base rates resulting from this case on an updated CCOSS that correctly utilizes 2012 load information.

Second, as to Delmarva's process of verifying the validity of its load research samples: when asked in discovery to provide copies of all statistical software code and results associated with *all* statistical tests it performed to verify the accuracy of its load research sample, Delmarva provided only a single set of code and results associated with a April 15, 2008 analysis reviewing September 2007 billing data. (Ex. 90). The DPA took that response at face value: why would it have reason not to do so? It turns out that the DPA should not have relied on Delmarva's response, because in its rebuttal testimony Delmarva contradicted that response: it stated that it performs tests of sample validity on a monthly basis, and that those tests confirmed the validity of its samples for the 2011 load study year. (Ex. 8 at 8-9 and Sch. (EPT-R)-1). The record, however, contains no confirmation of the validity of Delmarva's load research samples. Thus, in conjunction with directing Delmarva to update its CCOSS to utilize 2012 load information, the Commission should also direct Delmarva to provide proof of the validity of its load research samples in estimating individual customer demands for 2012.

Further, the Commission should direct Delmarva to review its discovery response procedures. It is clear that Delmarva's response to AG-COS-19 omitted pertinent information relevant to the question asked. (Ex. 90). Delmarva's deficient response misled parties, either purposefully or through simple neglect, and caused a potentially unnecessary dispute to arise. Unnecessary and needless disputes such as this imposes additional rate case costs on ratepayers, and should be avoided in future proceedings.

b. General & Common Plant Should Be Allocated Using a Total Distribution Plant Allocator.

According to DPL witness Tanos, the labor allocation factor reflects the weighting of the functionalized O&M expense accounts, which themselves reflect the weighting of functionalized plant categories. (Ex. 22 at 10). DPA witness Dismukes recommends a total plant allocator. Delmarva's labor allocator requires more derivation than Dr. Dismukes' total plant allocator. While Dr. Dismukes acknowledges that the Manual recognizes using a labor allocator to allocate General & Common ("G&C") plant accounts, he contends that using a total distribution plant allocator is more straightforward and less complex than the labor allocator. (Ex. 14 at 34- 35).

Delmarva claims that it uses the more complex labor allocator not only to allocate G&C plant, but also to allocate certain Administrative & General expense accounts that are labor-oriented or labor-based, such as infrastructure used in housing staff and meeting personnel needs such as computers, communication equipment, and software used to run the system. (Ex. 22 at 10). It also claims that PHI uses this allocator for all of its affiliates except Pepco, which continues to use a plant–based allocator (as Dr. Dismukes recommends) "[d]ue to historical filing practices." (*Id.* at n.1). It says that FERC uses the labor ratio approach, and that in 2006 an EEI survey showed that almost 70% of the 25 reporting electric companies use labor to allocate G&C plant. (*Id.* at 10-11).

The DPA is perplexed at the "we've always done it that way" and "everyone else does it that way" approach, especially when that approach is more complex than an equally valid approach. The CCOSS it already rife with complexity: why add more needlessly? The total distribution plant allocator is more appropriate to allocate G&C plant because G&C plant supports Delmarva's overall role of providing distribution service and because it is more straightforward. (Ex. 14 at 34). Delmarva seems to recognize that G&C plant supports its distribution service: it admits that these costs are the costs of "meeting personnel resource needs. Including computers, communication equipment, and software that are used by personnel *to run the system*." (Ex. 22 at 10) (emphasis added). And it does not contest Dr. Dismukes' characterization of the total distribution plant allocator as more straightforward.

In Case No. 9285, the Maryland PSC directed Delmarva to either use a total distribution plant allocator for G&C costs or to explain in detail why the labor allocator is appropriate for Delmarva. *Delmarva Power,* Order No. 85029 at 84-85. That FERC and other utilities use that same allocator does not explain why it is appropriate for Delmarva; it is simply an "everybody else does it that way" response. The DPA respectfully requests the Hearing Examiner to require Delmarva to use a total distribution plant allocator.

c. Accounts 907-913 Should Be Allocated Using a Customer-Based Allocation Factor.

Delmarva allocates Accounts 907-910 (Customer Service & Information) and Accounts 911-917 (Sales Expenses) using allocators weighted 50% on total number of customers and 50% on total energy sales. (Ex. 8 at Sch. EPT-1). Dr. Dismukes testified that these are costs associated with (1) encouraging safe and efficient use of the utilities' services; (2) responding to customer inquiries; and (3) advertising utility services to influence customers. (Ex. 14 at 35-36). Although acknowledging that the Manual is not prescriptive, he observed that it offers "rather definitive guidelines" for allocating these costs:

> The usual approach in functionalizing customer accounts, customer service and the expense of information and sales is to assign these expenses directly to the distribution function and classify them as customer-related.
>
> * * *
>
> Where these accounts have been assigned to the distribution function, care must be taken in developing the proper allocators. Even with detailed records, cost directly assigned to the various customer classes may be very cumbersome and time consuming. Therefore, an allocation factor based upon the number of customers or the number of meters may be appropriate if weighting factors are applied to reflect differences in the cost of reading residential, commercial and industrial meters.

(Ex. 14 at 36; Ex. 91 at 102-03).

Delmarva disagrees with Dr. Dismukes' recommendation. First, Mr. Tanos argues that it would assign "the vast majority" of such costs to the residential class based on total class population. (Ex. 22 at 11). Second, he contends that these accounts include services that benefit all customers receiving electric service, and are focused on programs that encourage safety, efficiency and conservation. Third, he notes that Delmarva maintains personnel that service all customers. Fourth, Mr. Tanos disagrees with Dr. Dismukes' reference to the Manual: he says that the manual describes the goal of the programs for Accounts 906-910, and explains that the manual says that Account 913 expenses, which include the costs of exhibits, displays, and advertising designed to promote utility service, suggests use of a more general allocator rather than number of customers. (*Id.* at 11-12). (Interestingly, Delmarva offers no rebuttal to Dr. Dismukes' recommendation insofar as it applies to Accounts 914-917). Thus, Delmarva concludes that its 50/50 weighting of number of customers and energy usage fairly represents all customers in allocating these expenses. (*Id.* at 11).

The DPA submits that Dr. Dismukes' proposed modifications more closely comport with cost-causation and should be accepted. It recognizes that Dr. Dismukes' recommendations allocate more of these costs to the residential class,[89] but the nature of the costs is customer-related, not usage-related. Although the Manual is not prescriptive, it does serve as a guideline for allocating these costs, and it classifies them as customer-related. Accounts 901-905 "are generally classified as customer-related," with the exception of Account 904 (Uncollectible Accounts), which may be directly assigned to particular customer classes. (Ex. 91 at 103). The Manual further states that Accounts 906-910 (Customer Service and Informational Expenses) "include the costs of encouraging safe and efficient use of the utility's service," and except for conservation and load management costs which should be separately analyzed, they are classified as customer-related. (*Id.*). The Manual specifically emphasizes the costs of responding to customer inquiries and preparing billing inserts, activities that intuitively are most closely linked to number of customers than levels of utility sales. (*Id.*). For Accounts 911-917 (Sales Expenses), the Manual suggests a more general allocation scheme since the costs do not vary with the number of customers. It notes, however, that they could be classified as customer-related because the goal in incurring these costs is to influence customers. (*Id.* at 103-04). Thus, the Manual recommends either direct assignment to each customer class if data are available, or allocation based upon each class' revenue responsibility (*id.* at 104) – neither of which approaches Delmarva used. (Ex. 8 at Sch. EPT-1; Tr. at 913-14).

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[89] 88% compared to 61%, or roughly $600,000. See, Sch. EPT-1 at 9, 15.

Delmarva claims to be concerned with accurately assigning costs to the customer classes that cause their incurrence. If so, then it should not object to Dr. Dismukes' recommendation with respect to these expenses. The DPA's modifications should be accepted.

d. **Staff's Proposal Regarding the Allocator for Overhead and Underground Facilities Should Be Rejected In This Case.**

The DPA submits that Staff's contention that commercial customers make greater use of more expensive underground facilities and so should bear more of the cost of those facilities is unsupported and should be rejected in this case. The DPA sympathizes with Dr. Pavlovic's inability to obtain information from Delmarva on this issue (although its affiliate Pepco had such information that Dr. Pavlovic was able to use in Case No. 1087 before the DC PSC) (Tr. at 971, 973-74, 976), and the DPA would support using a different allocator if there were evidence to support it. But Dr. Pavlovic admitted that it was simply his belief. (*Id.* at 971). Given the lack of evidence, it should be rejected in this case. The DPA makes this argument reluctantly, and hopes that in Delmarva's next base rate case the information to enable Staff or the DPA to make such a determination will be available. If the information is available for Pepco, the DPA sees no reason why it cannot be available for Delmarva as well.

VII. RATE DESIGN

A. Introduction.

The goal of designing rates is to strike a balance between policy goals and just, fair and reasonable rates. (Ex. 14 at 38). There are several generally-accepted principles used to design rates, including: (1) rates should be just, fair, reasonable and not unduly discriminatory (codified in the Act at 26 *Del. C.* §311); (2) protecting customers from rate shock; (3) maintaining rate continuity; (4) rates should be informed by, but not based solely on, cost allocation; and (5) rates should be understandable to customers. (*Id.* at 37-38). The weight assigned to any of these principles in designing rates can change depending on the circumstances and the importance of certain policy goals – for example, in Docket No. 05-304 the Commission, adopting the Hearing Examiner's recommendation, emphasized gradualism because it believed customers were going to experience substantial rate shock as a result of the expiration of price caps imposed on supply rates after deregulation becoming effective at the same time as new distribution rates from that proceeding. *Delmarva Power,* Order No. 6930 at ¶289, ¶298.[90] Thus, in that case the Commission approved the Hearing Examiner's recommendation to adopt Staff's proposed two-step revenue distribution, which: (1) determined specific class revenue goals for the classes targeted to receive rate increases to move them closer to their required class returns; and (2) decreased rates based on scaling back Delmarva's claimed cost-based class revenue requirements for those classes proportionately. (*Id.* at ¶277-278, ¶289, 298). Customer charges were set at a level halfway between the customer's current customer charge and Delmarva's proposed customer charge to move the customer charges toward cost of service while limiting the intraclass rate impacts that would have resulted from its proposed rate design. For classes with demand charges, the residual revenue requirement was assigned to the demand charges in such a way that no class' demand charge would be increased. Any remaining revenue requirement was assigned to the energy charge. (*Id.*).

In this case, Delmarva believes that rates that accurately reflect underlying costs provide greater fairness; thus, its goal is to design rates that reflect cost causation as closely as possible. (Ex. 6 at 2-3). It uses class relative rates of return[91] to evaluate the degree to which its rate

[90] The Commission did not specifically address rate design in Delmarva's two prior rate cases, Docket Nos. 11-528 and 09-414; it approved stipulations in both in which the settling parties agreed to a distribution of the approved revenue increase across all customer classes except GS-T on an equal percentage basis. *Delmarva Power*, Order No. 8265 at 30; *Delmarva Power*, Order No. 7897 at Ex. A, pp. 4-5.

[91] A relative rate of return (which Delmarva calls the "unitized rate of return," or "UROR") is the ratio of a given class' estimated rate of return to the overall system rate of return. They are a special type of index number

design accurately reflects underlying costs, but it also considered customer impacts in determining how much revenue to allocate to a particular class and how far to move the classes toward cost causation. (*Id.* at 3-4). It proposes a two-step process for distributing the revenue across the customer classes: (1) move each class rate of return toward or within a "reasonable band" (0.90-1.10) of the overall system rate of return; and (2) allocate the remaining revenue increase to all classes equally based on their current distribution revenue as a percentage of the total distribution revenue. (*Id.* at 4; Ex. 14 at 41, citing Delmarva's response to AG-RD-25). Under its proposed rate design, no service classification will receive a rate increase of more than 1.5 times the overall percentage increase. (Ex. 6 at 4). The remaining portion of the class' revenue requirement will be recovered through the energy charge; however, for classes that also have a demand charge, Delmarva will recover the entire remaining revenue requirement through the demand charge. (Ex. 6 at Sch. (MCS)-1).

Currently, the typical residential bill for delivery service (not including supply) is \$39.01; under Delmarva's proposed revenue distribution it will increase to \$46.64 – a. \$7.63 difference increase representing almost 20%. (Tr. at 864-65). This large proposed increase is driven by an even larger proposed increase in the customer charge: the current residential customer charge is \$9.35 per month, but under Delmarva's proposal it will increase to \$13.98 per month – a \$4.63 difference representing almost 50%. (*Id.* at 865). Delmarva's proposed monthly residential customer charge is higher than the customer charges of 16 other utilities (73%) in this general

measuring a specific class' return relative to Delmarva's overall rate of return. If Delmarva's overall rate of return is 1.0, then a class whose relative rate of return is greater than 1.0 is earning at a percentage greater than Delmarva's overall rate of return, and a class whose relative rate of return is less than 1.0 is earning at a percentage less than Delmarva's overall rate of return. Dr. Dismukes explained by way of example that if the residential class is estimated to be earning 11% from the CCOSS and Delmarva is requesting a 10% overall rate of return, then the residential class is said to have a relative rate of return of 1.10 (11% ÷ 10%). (Ex. 14 at 41-42).

geographic area of the Atlantic region,[92] and higher than those utilities' average residential customer charge.[93] (Ex. 14 at Sch. DED-16). And although its proposed $12.54 small commercial customer charge is lower than the average small commercial monthly customer charge for the regional utilities, 55% of those utilities have lower actual customer charges than Delmarva proposes. (*Id.* at 45 and Sch. DED-16).

DPA witness Dismukes recommended a revenue distribution similar to the two-step methodology to which the parties in Docket No. 11-528 agreed. In the first step, he limits the increase to any underearning class to 1.15 times the system average increase. In the second step, he distributes any remaining revenue deficiency across all other classes in proportion to their test year revenues. (Ex. 14 at 43 and Sch. DED-13). He testified that this approach is consistent with the overall allocation of the rate increase to underearning classes, but is tempered by allocating a share of the proposed increase to the overearning classes. (*Id.* at 43). Costs not recovered through the customer charge will be recovered through the energy charge; however, for classes having both a demand change and a delivery service rate, he maintains the existing relationship between those rates and thus allocates the increase equally between the two. (Id. at 47-48 and Sch. DED-15).

B. Delmarva's Proposed Rate Design Is Unjust and Unreasonable For Residential Customers And Should Be Rejected.

The Public Utilities Act under which this Commission derives its authority specifically provides that "[n]o public utility shall make, impose or exact any unjust or unreasonable … individual or joint rate for any product of service supplied or rendered by it within the State … ."

[92]As defined by the U.S. Census Bureau, the Atlantic region includes New York, Pennsylvania, New Jersey, Maryland, Delaware, the District of Columbia, West Virginia, North Carolina, South Carolina, Virginia, Georgia and Florida. (Ex. 14 at Sch. DED-16).

[93]The average includes high monthly customer charges for six New York utilities (over $15/month) and very low customer charges for four New Jersey utilities (less than $4/month). (Ex. 14 at Sch. DED-16).

26 *Del. C.* §303(a). The DPA submits that Delmarva's proposed rate design is unjust and unreasonable to residential ratepayers, and should be rejected in favor of the DPA's proposed rate design, which incorporates the principle of gradualism to ease the effect of this (and the previous) rate increase on residential ratepayers.

The DPA agrees with Delmarva that on a strict cost basis, neither the current nor the proposed residential or small commercial customer charges recover all the costs assigned to those classes. (Ex. 14 at 46 and Sch. DED-17). But that is not the be-all and end-all in designing rates; costs can be instructive for establishing a baseline for rate-setting, but they need not (and perhaps should not) be the sole basis for rates in order for rates to be set optimally. That is, fixed charges need not strictly equal fixed costs, and variable rates need not strictly equal variable costs). (Ex. 14 at 45). Unfortunately, as Dr. Dismukes testified, "the 'fixed charge-equals-fixed-cost' dogma gets repeated so often that it can often drown out meaningful discussions about other equally important considerations in setting rates in imperfect markets." (*Id.* at 45-46).

Delmarva's rate design seeks to move all customer classes closer to the relative rate of return – in other words, to eliminate subsidization. In a vacuum, the DPA would agree with Delmarva. But we are not in a vacuum. The real world effect of Delmarva's proposed revenue distribution is that the average residential customer will experience a 21% rate increase and the average residential space heating customer will experience a 35% increase, thus making residential customers responsible for *almost 65%* of its revenue requirement. (Ex. 14 at 43, citing Ex. 6 at Sch. (MCS)-1). Delmarva did not challenge Dr. Dismukes on this point; it merely responded that its proposal "better serves the ultimate goal of designing a rate that appropriately reflects customer costs." (Ex. 21 at 4). And its only argument in its brief is that its rate design is consistent with its submissions in prior dockets and is "reasonable and practical." (DOB at 110).

If there was ever a time to apply the principle of gradualism, it is now. The economy is sluggish at best. Delaware ratepayers are struggling to make ends meet. Those who are Delmarva ratepayers have experienced rate increases totaling more than $66 million since January 2011, representing an increase of 38% in revenues in just three years. (Tr. at 256). In Docket No. 09-414, the Commission granted Delmarva a $16.7 million revenue increase that raised the average residential customer's bill by $3.69 per month (Order No. 7897 dated Jan. 18, 2011), and in Docket No. 11-528 it granted Delmarva a $22 million revenue increase that raised the average residential customer's bill by $4.49 per month (Order No. 8267), and it has placed a $27.7 million interim rate increase into effect in this case that has raised the average residential customer's bill by $5.36 per month. (Order No. 8566). In addition, approximately 120,000 of Delmarva's electric customers are also natural gas customers, and in Docket No. 12-546 the Commission granted Delmarva a $6.8 million revenue increase that raised the average residential customer's bill by $5.34 per month. (Order No. 8465). Thus, while Delmarva's electric business has received over $66 million in revenue increases in three years, ratepayers have experienced an almost $14 per month increase in that same time; if they are also Delmarva natural gas customers, they have experienced an almost $20 per month increase in that same time.

The Commission has recognized that it cannot consider the effect of certain operating expense adjustments in a vacuum but must consider that effect in light of the current economic circumstances, which change from time to time. *Delmarva Power*, Order No. 6930 at ¶96. The DPA submits that the Commission's observation holds true for rate design as well. The DPA submits that trying to move all classes to cost in one fell swoop in this case is unjust and unreasonable because so doing requires residential ratepayers to shoulder 65% of the requested revenue requirement. Delmarva's proposed rate design should be rejected in favor of the DPA's proposed rate design, which also moves the classes closer to their actual cost of service but does so in a more gradual manner in light of the economic circumstances in which Delmarva's ratepayers find themselves.

CONCLUSION

Based on the foregoing arguments and authorities, the DPA respectfully requests the Hearing Examiner to recommend that the Commission approve its proposed adjustments and reject the Delmarva adjustments that it has challenged.

Respectfully submitted,

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