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 AND MISCELLANEOUS TARIFF CHANGES (FILED March 22, 2013)	))))))	PSC DOCKET NO. 13-115

POST-HEARING OPENING BRIEF OF DELMARVA POWER & LIGHT COMPANY

Todd L. Goodman
Pamela J. Scott
Delmarva Power & Light Company
500 North Wakefield Drive
Mail Stop 92 DC 42
Newark, DE 19702
T: (302) 429-3786
E: todd.goodman@pepcoholdings.com

Todd A. Coomes
Richards, Layton & Finger, P.A.
One Rodney Square
920 North King Street
Wilmington, Delaware 19801
T: (302) 651-7500
E: coomes@rlf.com

December 30, 2013

Table of Contents

Table of Contents

Page(s)

Table of Contents

Page(s)

Table of Contents

Page(s)

Table of Contents

Page(s)

TABLE OF AUTHORITIES

Cases/Orders **Page(s)**

STATUTES & RULES

OTHER AUTHORITIES

ADMINISTRATIVE MATERIALS

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 AND MISCELLANEOUS TARIFF CHANGES (FILED March 22, 2013)	))))))	PSC DOCKET NO. 13-115

POST-HEARING OPENING BRIEF OF
DELMARVA POWER & LIGHT COMPANY

Delmarva Power and Light Company (Delmarva or the Company) submits this Post-Hearing Opening Brief in accordance with the procedural schedule agreed to by the parties and set by the Hearing Examiner on November 25, 2013.[1]

SUMMARY OF ARGUMENT

Delmarva has requested in this proceeding a rate that will be reflective of the services provided by the Company during the rate effective period. The Company requests a rate base, cost of service and rate design that generally adheres to past ratemaking treatments approved by the Commission. In the limited cases where the Company does not follow recent ratemaking treatment, it specifically identifies those instances and provides the basis for why its proposed treatment is appropriate. Delmarva also presents an analysis and evaluation of the current market conditions from which a reasonable return on equity can be determined. This analysis is not only founded upon objective return one equity (ROE) estimation models, but is also consistent with market conditions in which interest rates are rising. Based upon the testimony

[1] To the extent that the Company has not addressed any particular issue or position of any of the parties to this proceeding in this brief, it does not constitute agreement or disagreement with that position.

and evidence presented in this proceeding, Delmarva's proposed revenue requirement of $39.681 million[2] and requested overall rate of return of 7.53% are well supported and should be adopted by the Commission.

There can be no debate that Delmarva has been investing in its infrastructure to both maintain and enhance reliability for its customers. As the record reflects, reliability is the primary concern of Delmarva's customers, and Delmarva's investment is showing real and measurable results for its customers. On this point, however, there has been much debate during the course of this proceeding regarding the level of Delmarva's investments and expenses, especially with respect to its reliability infrastructure investments. Yet, the record is clear that Delmarva exercised professional judgment in all of its decisions related to infrastructure investments. The Company's reliability infrastructure investments in 2012 and 2013 are well supported, its adjustments reflect sound ratemaking treatment reflective of Delaware law and there is no evidence, much less has there been any assertion, that Delmarva's investment expenses are not in the best interests of its customers.

Delmarva does not seek a rate increase for its reliability infrastructure investments alone. Delmarva seeks a rate increase because it is not now earning, and has not recently earned, its authorized return on equity notwithstanding its rate increase following PSC Docket No. 11-528. In fact, even after annualizing such rate increase, Delmarva only earned a 5.59% return on equity during the 2012 test period, significantly below the currently authorized ROE of 9.75%.[3]

---

[2] On November 11, 2013, Delmarva identified an error in its schedules by which deferred taxes were mistakenly included in the adjustments for Company Adjustment Nos. 26(a) and (b). *See* Exh. 25: Letter from Richards, Layton & Finger dated November 12, 2013 and Attachments. Elimination of the error has the effect of increasing the Company's overall proposed revenue requirement by $705,151 to a total of $39,681,517. *See id.* Delmarva sent corrected schedules and a letter to the parties explaining the error and adjustment on November 12, 2013. *See id.* At the Evidentiary Hearing, the parties agreed to a procedure to give Staff and DPA time to review and evaluate the issue, including taking discovery as needed. *See* Tr. at 558:12-560:9. The parties are engaged in discovery on the deferred tax issue, and Delmarva reserves all rights with respect to this issue.

[3] Exh. 20: Ziminsky Rebuttal at 3, Table 1.

Continuing to not earn its authorized ROE may place Delmarva at a competitive disadvantage to obtain the lowest cost when it comes to raising necessary capital on reasonable terms to continue to make important investments in the electric distribution system. Ultimately, the ability of the Company to access the capital markets on reasonable terms impacts the rates that are paid by customers.

Given that the Company's books reflect its under earning position, perhaps it is not surprising that neither the Staff of the Public Service Commission ("Staff") nor the Delaware Division of the Public Advocate ("DPA") disagree that Delmarva's rates should be increased. Instead, they disagree as to the overall amount of the increase, which is largely driven by (1) disagreements as to individual revenue components and adjustments and (2) the assessment of the market conditions that drive the determination of Delmarva's ROE.

There is one fundamental difference in the parties' overall recommendations: the parties' differing approach to recognizing known and measurable changes to test period costs. Post-test period adjustments are not new ground for opposition in Delaware ratemaking proceedings and, contrary to established Delaware law and Commission precedent, DPA argues that all post-test period adjustments should be prohibited. While Staff does not seek to arbitrarily exclude *all* post-test period adjustments, it does oppose several known and measurable post-test period adjustments on the general ratemaking principle that they relate to costs incurred after the conclusion of the test period.

The positions of both DPA and Staff are clearly at odds with Delaware law, which recognizes that rate fixing is prospective and requires the consideration of available, accurate information. Following Delaware law, the Commission has repeatedly rejected arguments such as those advanced by Staff and DPA witnesses in this case that post-test period adjustments should not be considered, and has allowed out-of-period adjustments when it is reasonably certain that the expense will be incurred or the item will be placed in service during the rate effective period and where the amounts associated therewith are sufficiently ascertainable.

As demonstrated in this Opening Brief, the record shows that Delmarva's request is reasonable and should be accepted by the Commission.

PROCEDURAL HISTORY

On March 22, 2013, Delmarva initiated this rate case by filing an application ("Application") with the Commission seeking approval of: (1) an increase in Delmarva's electric base rates; and (2) certain tariff changes.[4] The Company sought an increase in annual operating revenues of $42,044,000, or 7.38% in total revenues. Delmarva also requested interim rates amounting to an annual increase of $2.5 million in operating revenues. In support of its Application, Delmarva filed direct testimony from the following witnesses: Frederick J. Boyle, Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc. ("PHI"); Robert B. Hevert, Managing Partner at Sussex Economic Advisors; Michael W. Maxwell, Vice President, Asset Management; Jay C. Ziminsky, Manager, Revenue Requirements: Marlene C. Santacecilia, Regulatory Affairs Lead; Elliott P. Tanos, Manager, Cost Allocation; and Kathleen A. White, Assistant Controller.

On April 9, 2013, the Commission issued Order No. 8337, opening Docket No. 13-115 to consider Delmarva's Application. The Commission suspended Delmarva's proposed rates and revised tariff sheets subject to Delaware law or further order of the Commission. The Commission granted the Company's request to implement interim rates, effective June 1, 2013;

[4] The Company's requested tariff changes relate to: (a) adding LED lighting options to its Outdoor Lighting (OL) tariff, (b) adding a new rider related to recovering relocation costs for projects sponsored by the Delaware Department of Transportation or other State agencies, and (c) minor tariff changes proposed for clarification and editorial reasons. *See* Exh. 1: Application at 6-7 and Appendix A.

designated Hearing Examiner Mark Lawrence for the proceeding; set a deadline for filing petitions to intervene; and established public notice requirements. Public notice of the Application was published in The News Journal and The Delaware State News and affidavits of publication were identified as Ex. 9 at the evidentiary hearing.

On April 11, 2013, Hearing Examiner Lawrence granted the Petition for Leave to Intervene filed by the Caesar Rodney Institute in Order No. 8345, and the Petition of the Attorney General of the State of Delaware for Leave to Intervene in Order No. 8346.[5]

On April 16, 2013, Staff filed a motion requesting the Commission to open an investigation to examine Delmarva's proposed expenditures for reliability improvements over the course of several years.[6] Delmarva filed a response to the Staff motion, opposing the creation of a separate docket from this proceeding to investigate its future reliability expenditures and contending that the reliability investments could be investigated in this proceeding. Staff's motion was heard before the Commission on April 23, 2013, and subsequently an agreement was reached by Delmarva, Staff and DPA for a proposed order opening a docket to review Delmarva's planned distribution infrastructure and reliability investments over a future period, which is PSC Docket No. 13-152. That separate docket was opened by order of the Commission on May 7, 2013 for "the purpose of investigating Delmarva's proposed distribution infrastructure and reliability investments going forward for a period of up to five years" and considering whether the Docket No. 50 reliability standards should be revised.[7]

On May 7, 2013, Hearing Examiner Lawrence granted the Petition for Leave to Intervene

[5] The Delaware Attorney General's motion was based, *inter alia*, on the vacancy of the Public Advocate's office. This office was filled during the course of this proceeding by David L. Bonar, and his appearance was entered in substitution of the Attorney General of the State of Delaware.
[6] *In the Matter of the Investigation Into Delmarva Power & Light Company's Planned Distribution Infrastructure Investments Over the Next Five Years* (Opened April 16, 2013) Docket No. 13-152, Order No. 8363 p. 2 (May 7, 2013).
[7] *Id.* at 4; *see also* Tr. at 197:24-198:1-2.

filed by the Department of Natural Resources and Environmental Control ("DNREC") in Order No. 8376.

The Hearing Examiner approved a procedural schedule effective June 25, 2013. The schedule provided for two rounds of discovery (initial and follow-up) by other parties on the Application, followed by the filing the other parties' testimony and rebuttal testimony by the Company, with discovery allowed as to each. The Evidentiary Hearing was set for November 13, 14 and 18, 2013.

On July 2, 2013, Hearing Examiner Lawrence granted the Petition for Leave to Intervene Out of Time filed by the Delaware Energy Users' Group ("DEUG") in Order No. 8411.

On August 16, 2013, Staff, DPA and DEUG filed direct testimony with respect to the Company's Application. Staff submitted testimony from: David E. Peterson, Senior Consultant with Chesapeake Regulatory Consultants, Inc.; Stephanie L. Vavro, Principal with Silverpoint Consulting LLC ("Silverpoint"); and Karl L. Pavlovic, Senior Consultant with Snavely King Majoros & Associates, Inc. DPA submitted testimony from: Andrea C. Crane, President of The Columbia Group, Inc.; David E. Dismukes, Consulting Economist with the Acadian Consulting Group; and David C. Parcell, President and Senior Economist of Technical Associates, Inc. DEUG submitted the testimony of Nicholas Phillips, Jr., Managing Principal of Brubaker & Associates, Inc.

On September 12, 2013, Delmarva filed an application with proposed tariff sheets seeking to implement under bond a cumulative interim rate increase of $27,655,265, as permitted by 26 *Del. C.* § 306(b).[8] The Commission found that Delmarva had the statutory right, after the expiration of seven months from filing the Application, to place into effect the interim rate

[8] *In the Matter of the Application of Delmarva* Power *& Light Company for an Increase in Electric Base Rates and Miscellaneous Tariff Changes* (Filed March 22, 2013) Docket No. 13-115, Order No. 8466 p. 2 (October 8, 2013).

increase, subject to refund with interest.[9] Delmarva placed the interim rate increase into effect on October 22, 2013.[10]

On September 20, 2013, Delmarva filed Rebuttal Testimony from certain of its witnesses in response to the direct testimony filed by the other parties. In its rebuttal filing, Delmarva lowered the proposed revenue requirement increase to $38.976 million, which as a result of a correction, was updated to $39.681 million as described in footnote 2 *supra*.

Evidentiary hearings were held on November 13, 14 and 18, 2013.

---

[9] *Id.* at p. 3.

[10] On October 2, 2013, Delmarva filed with the Commission a policy filing entitled "Proposed Forward Looking Rate Plan of Delmarva Power & Light Company," requesting that the Commission examine the plan which would set electric distribution rates for four years. *See In the Matter of the Policy Filing Made by Delmarva Power & Light Company Entitled Proposed Forward Looking Rate Plan* (Filed October 2, 2013) Docket No. 13-384, Order No. 8467 p. 1 (October 22, 2013). The Commission opened a docket (PSC Docket No. 13-384) to review the details contained in the forward looking rate plan ("FLRP"). *See id.* at p. 2. Subsequently, Delmarva filed a motion to stay further proceedings in this docket pending resolution of the FLRP, which motion DPA opposed. *See* Docket No. 13-115, Order No. 8475 p. 2 (October 22, 2013). After a hearing before the Commission on October, 22, 2013, Delmarva's motion to stay this docket was denied and the FLRP is being evaluated in the separate docket.

ARGUMENT

I. DELMARVA IS ENTITLED TO RECOVERY OF ITS CAPITAL INVESTMENTS, INCLUDING THOSE INVESTMENTS MADE FOR THE PURPOSE OF ENHANCING AND MAINTAINING RELIABILITY FOR ITS CUSTOMERS.

Delaware law requires a public utility to "furnish safe[,] adequate and proper service and keep and maintain its property and equipment in such condition as to enable it to do so."[11] In order for Delmarva to continue to fulfil this requirement, it must incur expenses in the form of ongoing operation and maintenance expenses and capital investments in its distribution infrastructure that are needed to provide its customers with appropriate service. In the context of a base rate case, "a Commission must consider and allow the normally accepted operating expenses of a utility corporation *unless found to have been made in bad faith or out of an abuse of discretion*."[12]

In September 2006, the Commission adopted the "Electric Service Reliability and Quality Standards" ("Docket 50").[13] Docket 50 contains broad provisions concerning achieving, maintaining, measuring and reporting on reliability and service quality issues. With respect to statistical reliability indices that must be achieved, Docket 50 focuses on one performance requirement – SAIDI. SAIDI, which stands for "System Average Interruption Duration Index," measures the average system-wide number of minutes of service interruption per year experienced by Delmarva customers.[14] Docket 50 requires Delmarva to maintain, at a minimum,

---

[11] 26 *Del. C.* § 209 (a)(2).

[12] *Delmarva Power & Light Co. v. Public Serv. Comm'n*, 508 A.2d 849, 859 (Del. 1986) (quoting *Application of Diamond State Tel. Co.*, 103 A.2d 304, 319 (Del. Super. Ct. 1954), *aff'd in part and reversed in part on other grounds*, 107 A.2d 786 (Del. Super. Ct. 1954), *on reargument*, 113 A.2d 437 (Del. Supr. 1955) (emphasis in original)). In citing to *Application of Diamond State Tel. Co.*, the Delaware Supreme Court recognized no interpretative difference between "abuse of discretion" and other Public Service Commission standard or review cases using the terms "waste" or "inefficiency". *See id.*

[13] 26 *Del. Admin. Code.* 3007 *et. seq.* These regulatory standards arose out of a proceeding known as Commission "Regulatory Docket 50" and as such, have been traditionally referred to simply as "Docket 50."

[14] *See id.* at 3007 § 2.0.

a SAIDI that does not exceed 295 minutes.[15]

For purposes of this proceeding and the arguments made by Staff (and to a lesser extent, the Public Advocate), the relevant provisions of Docket 50 are as follows:

1. "Compliance with this regulation is a minimum standard,"[16]

2. "Compliance does not create a presumption of safe, adequate and proper service,"[17]

3. "Each EDC[18] needs to exercise their professional judgment based on their systems and service territories"[19] and

4. "EDCs are required to explore the use of proven state of the art technology, to provide cost effective electric service reliability improvements."[20]

These four pertinent Docket 50 provisions make it clear that achieving a SAIDI of 295 minutes is the absolute "minimum" level of reliability that Delmarva must provide.[21] Docket 50 also makes it clear that merely achieving a SAIDI of 295 minutes is not good enough. Achieving a SAIDI of 295 minutes by itself "does not create a presumption" that Delmarva has met the requirement of providing "safe, adequate and proper service."[22] As such, Delmarva's engineers and managers must exercise their "professional judgment based on their systems and service territories" to determine what level of reliability the Company should seek to provide to its customers.[23] Finally, Docket 50 makes it clear that Delmarva may not remain static in providing

---

[15] *See id.* at 3007 § 4.3.1.2.
[16] *Id.* at 3007 §1.3.
[17] *Id.*
[18] "EDC" stands for "Electric Distribution Company." *Id.* at 3007 § 1.1.
[19] *Id.* at 3007 § 1.3.
[20] *Id.* at 3007 § 1.8.
[21] *Id.* at 3007 §1.3.
[22] *Id.* (citing 26 *Del. C.* § 209 (a) (2)).
[23] *See id.* Docket 50's clear mandate that Delmarva must exercise its professional judgment to determine the appropriate level of system reliability is consistent with established Delaware law and Commission precedent holding that the Commission's duty to regulate utilities does not entail reviewing the day to day operations and decisions made by utility company management. *See Delmarva Power & Light Co.*, 508 A.2d at 859 *("[A] public utility commission shall not dictate business practices to be followed by a utility.*"(quotation omitted and emphasis added)). The Commission must allow the utility to recover the normally accepted operating expenses in the form of reliability capital investments "*unless found to have been made in bad faith or out of an abuse of discretion.*" *Id.*

service reliability to its customers. Docket 50 mandates that Delmarva must remain vigilant in its efforts to use "state of the art technology" to provide actual "service reliability improvements" to its Delaware customers.[24]

Delmarva's reliability investments have been criticized by Staff without any basis in fact, regulation or law. Staff Witness Vavro of Silverpoint provided prefiled testimony in this case. Although Staff Witness Vavro alleged (1) that the level of Delmarva's reliability capital investment was not "necessary" to comply with Delaware's Docket 50 reliability requirements and (2) that there was no "clear mandate" to improve reliability performance, at no point did Staff Witness Vavro recommend any reduction in recovery by Delmarva for any of its reliability capital investments.[25]

Delmarva exercised professional judgment in making the two key determinations related to reliability investments: (1) Delmarva exercised professional judgment in determining that reliability investments needed to be increased both to prevent a degradation of reliability and to provide an appropriate level of enhanced reliability for its customers, and (2) Delmarva exercised professional judgment in the reliability project initiatives it chose in order to maintain and enhance reliability for its customers. The evidence in this docket establishes that Delmarva's reliability investments are appropriate and in full compliance with Delaware law, Delaware regulations and Commission precedent. As such, Delmarva's reliability capital investments are fully recoverable in this docket.

(*emphasis in original*). Delmarva is expected to use its judgment, based upon its engineering, system planning and customer service experience, to make day-to-day decisions on how to appropriately plan and invest in its infrastructure in order to provide the appropriate levels of system reliability to its customers.

[24] *See* 26 *Del. Admin. Code* 3007 § 1.8.

[25] *See* Exh. 12: Vavro Direct generally (*no denial of recovery recommended*); and Tr. at 828:8 -15, 828:23-829:11, and 840:10-22. In fact, there was no testimony offered in this case in which a witness from any party recommended denial of recovery for test year capital investments related to reliability. Although DPA Witness Dismukes recommended denial of recovery of certain reliability investments, those recommendations related only to the post-test year adjustments addressed in Company Adjustment 26. DPA Witness Dismukes' testimony with respect to post-test year adjustments is addressed later in this brief.

A. Delmarva Exercised Professional Judgment In Making Its Determination That Reliability Investments are Necessary In Order To Both Maintain and Enhance Reliability For Its Customers.

The evidence in this docket establishes that Delmarva appropriately exercised its professional judgment (based upon Delmarva's system, its service territory, and the expectations of customers) to develop a reliability capital investment plan that provides its customers with the level of reliability they need. Company Witness Maxwell provided testimony on behalf of Delmarva regarding the Company's construction program for capital investments designed to provide Delmarva's customers with safe and reliable service. Company Witness Maxwell is an electrical engineer with over 26 years of experience in the utility industry.[26] He is responsible for the planning required to allow for the reliable design and operation of all distribution, transmission and substation facilities, as well as the engineering and design of the distribution and transmission facilities constructed by Delmarva and all PHI utilities.[27]

Company Witness Maxwell explained that Delmarva has an obligation to provide its customers with safe and reliable service.[28] He further explained that Delmarva has exercised its professional judgment to conclude that merely meeting the minimum SAIDI reliability standard contained in Docket 50 of 295 minutes would neither satisfy Delmarva's obligations to its customers nor meet their needs and expectations:

> the minimum performance contained in Docket 50 is <u>not</u> intended to serve as the "goal" or the "standard" for reliability or even a level of reliability that will be considered "adequate" or "proper." As the Docket 50 rules specifically state: "*Compliance with this regulation is a minimum standard. Compliance does not create a presumption of safe, adequate and proper service.*" Moreover, the Docket 50 rules further specifically state that "*[e]ach EDC needs to exercise their professional judgment based on their systems and*

[26] Exh. 4: Maxwell Direct at 1:15-2:2.
[27] *Id.* at 1:6-8.
[28] Exh. 19: Maxwell Rebuttal at 3:19.

> *service territories.*" Delmarva Power has exercised its professional judgment to conclude that merely meeting the minimum SAIDI performance standard set forth in Docket 50 would not be adequate or satisfactory to meet the needs and expectations of Delmarva's customers.[29]

Accordingly, Delmarva plans its system to perform better than the minimum Docket 50 reliability standard of SAIDI 295. As the evidence in this proceeding establishes, there were five principal factors that drove Delmarva's decision that reliability infrastructure investment needed to be increased to meet Delmarva's duties to its customers under Docket 50. These five principal factors are addressed below.

1. <u>Enhanced Reliability Is Expected and Needed By Customers Due To Growing Dependence Upon Reliable Electricity By An increasingly Digital/Electronic Society And Economy.</u>

An important factor in Delmarva's decision to seek to maintain and enhance the level of reliability it provides to its customers is the growing importance of electric grid reliability in today's society. As Company Witness Maxwell explained:

> A reliable electric grid is essential to meeting the rapidly-evolving needs of an increasingly digital society. The digital/electronic nature of business, government, communication systems, healthcare and emergency services has developed to the point where the level of reliability that may have been acceptable less than a decade ago is no longer suited to meet customer needs and expectations. It is reasonable to expect that our customers will continue to become more reliant upon electronics and communications and as a result, reliability of the electrical grid will continue to be more important to customers. In today's society, when the power is out, computers do not work, communications systems fail, orders do not get taken, stores close, wages are lost, and production shuts down.[30]

The increased need for reliability by today's society in general is an important factor in Delmarva's decision to increase its investments in reliability infrastructure for the purpose of

[29] *Id.* at 4:5-14 (*emphasis original*).
[30] *Id.* at 4:15- 5:2.

maintaining and enhancing reliability.

2. <u>The Increase In The Frequency And Severity Of Storms Has Posed New System Reliability Challenges To Utilities.</u>

Another significant factor in Delmarva's reliability investment decisions is the increase in the frequency and severity of storms. While it is clear that individuals, the economy, communication networks and the ability to provide governmental and emergency services have all become increasingly reliant upon a reliable electric distribution grid, the increase in the frequency and severity of storms has posed new challenges to utilities. As Company Witness Maxwell explained:

> At the same time that outages in general have become more problematic to customers and the economy, the region has experienced storms of increasing strength and frequency. As the U.S. Department of Energy has reported, eight of the largest ten hurricanes have occurred over the past decade. In the last few years alone, Hurricane Isabel, Hurricane Sandy and the 2012 Derecho have made it clear that the region is facing more frequent and powerful storms that have the potential to impair essential components of the energy infrastructure and cause enormous economic losses. As storms increase in frequency and intensity, the ability to withstand storms and to restore electricity quickly when disruptions occur will become even more important. While it is true that the 2012 Derecho and Hurricane Sandy largely spared Delaware, the same was not true for neighboring states. Maryland and New Jersey were battered by the Derecho and New Jersey and New York were devastated by Sandy. For Delmarva Power to wait until Delaware is directly impacted the way our neighboring states did before we act to modernize the electric system and make it more resilient would be irresponsible.[31]

In August 2013, five months after Delmarva filed this rate case, the President's Council of Economic Advisors and the U.S. Department of Energy issued a report from the Executive

[31] *Id.* at 5:3-16. With respect to the following statement within the quote from Company Witness Maxwell's Direct Testimony: "*As the U.S. Department of Energy has reported, eight of the largest ten hurricanes have occurred over the past decade,*" *see* Hoffman, Patricia (*Assistant Secretary of the U.S. Department of Energy's Office of Electricity Delivery and Energy Reliability*), <u>Keeping the Lights on for Americans: Modernizing the Nation's Electric Grid</u>, Huffington Post, June 2, 2013. (A copy of this article is attached to this brief as Opening Brief Att. 1).

Office of the President entitled, "***Economic Benefits of Increasing Electric Grid Resilience to Weather Outages***" (the "Presidential Report"). The Presidential Report concluded that power outages caused by severe weather conditions cost the U.S. economy up to $75 Billion per year in lost wages, spoiled inventory, delayed production, inconvenience and damage to the electric grid. The Presidential Report concluded that investment in electric grid modernization will save the economy billions of dollars and reduce the hardships experienced by millions of Americans.[32] In the face of increasingly frequent and violent storms, an increase in reliability infrastructure investment is required in order to simply maintain past levels of reliability performance.

3. Delmarva Must Replace Aging Infrastructure To Avoid Diminished System Reliability and Increased Customer Outages.

In addition to enhanced reliability expectations from its customers and increased challenges from changing weather, Delmarva is facing the issue of aging infrastructure. Among the aging infrastructure issues is the need to replace underground residential distribution cables ("URD cables") that were manufactured in the early 1970s and 1980s.[33] Delmarva, along with the rest of the industry, has been experiencing a high failure rate of these URD cables.[34] Until relatively recently, Delmarva's practice was to repair failed cables or replace only the individual section of failed URD cables after the cable failures had occurred. Having customers experience repeated URD failure-related outages before replacement, however, is highly frustrating to Delmarva's customers.[35] Based upon the increasing failure rate of 1970 – early 1980 vintage URDs, combined with the customer dissatisfaction that arises from running these aged URD cables through numerous failures before replacement, Delmarva adopted a policy whereby an

[32] *Id.* at 5:18-6:6, *citing* Executive Office of the President, Economic Benefits of Increasing Electric Grid Resilience to Weather Outages, August 2013. (A copy of this Report is attached to this brief as Opening Brief Att. 2).
[33] *Id.* at 12:2-4.
[34] *Id.* at 12:4-6.
[35] *Id.* at 12:7-8.

increased effort would be made to identify aged and degraded URD cables and replace them before they fail.[36] In other words, rather than waiting until the aged URD cables fail, causing increasing incidences of repeated outages and customer frustration, Delmarva has focused upon identifying those aged URD cables at the end of their useful lives and replacing them before the customers served by problematic URD cables are forced to suffer through repeated outages.

A subsequent section of this brief (*entitled "Initiative 1 – Load Growth and Load Maintenance Projects"*) addresses an additional aging infrastructure issue related to substation transformers.[37] Yet another significant aging infrastructure issue that Delmarva is addressing is substation switchgear. Switchgear constitutes major substation equipment, the failure of which can affect tens of thousands of individual customers.[38] Delmarva's efforts to prevent outages associated with aging equipment that has a proven failure history (URD cables, aged substation transformers and aged substation switchgear) constitute good engineering practice, good customer service and good professional judgment to fulfill the requirement to provide safe, adequate and proper service.

As Company Witness Maxwell described in his testimony, Delmarva is not alone in its recognition of the importance of replacing aged infrastructure and developing a more reliable electric grid for its customers. In its 2013 ***Report Card for America's Infrastructure***, the American Society of Civil Engineers gave the nation's electric grid a D+, due to its antiquated

---

[36] *Id.* at 12:8-10.

[37] *See* Section I.B.1 below; *see also* Tr. at 706:16-712:15 (Maxwell Redirect). In this portion of Company Witness Maxwell's hearing testimony he addresses Hearing Exhibits 74 and 75, which serve as two examples of how Delmarva extensively tests its facilities to identify aging equipment showing compromised performance. Aged equipment with degraded performance must be replaced to avoid sudden and repeated outages. Exhibit 74 addresses aged feeders and transformers and Exhibit 75 addresses aged transformers, both of which needed to be replaced to avoid load/overload related outages.

[38] *See* Exh. 82 (*"Atlantic City Electric and Delmarva Power Switchgear Replacement Program 2011")* for a thorough report detailing the multi-year need to replace Delmarva's switchgear that has reached its end of useful life or will reach its end of life by the time that the switchgear is scheduled to be replaced.

condition.[39] Another, more comprehensive report issued by the American Society of Civil Engineers in 2011, the "***Failure to Act Report***," concluded as follows:

> If future investment needs are not addressed to upgrade our nation's electric generation, transmission, and distribution systems, the economy will suffer. . . . Ultimately, these costs all lead to the same economic impact: diversion of household income from other uses and a reduction in the competitiveness of U.S. businesses in world economic markets. As costs to households and businesses associated with service interruptions rise, GDP will fall by a total of $496 billion by 2020. The U.S. economy will end up with an average of 529,000 fewer jobs than it would otherwise have by 2020. . . . In addition, personal income in the U.S. will fall by a total of $656 billion from expected levels by 2020.[40]
>
> ***
>
> "These costs incurred by failing to close the investment gap are higher than the investment itself. This means that it is economically inefficient for households and businesses to allow this higher cost scenario to occur.[41]

An increase in reliability infrastructure investment is needed to replace aging deteriorating equipment. Without such investment, reliability performance for Delmarva's customers will degrade.

4. <u>Surveys Of Several Hundred Delmarva Customers Conducted Each Quarter Have Consistently Established That System Reliability And The Rapid Restoration Of Outages Are The Most Important Issues To Delmarva's Customers.</u>

Company Witness Maxwell explained that another important factor in Delmarva's decision to increase its focus upon reliability is the results of Delmarva's research into the

---

[39] Exh. 19: Maxwell Rebuttal at 5:19-21; *see also* American Society of Civil Engineers, <u>2013 Report Card for America's Infrastructure</u>, March 2013 at pp. 60 – 61. (A copy of this Report is attached to this brief as Opening Brief Att. 3).

[40] *See* American Society of Civil Engineers, Economic Development Research Group, Inc. and LaCapra Associates, <u>FAILURE TO ACT – The Economic Impact of Current Investment trends in Electricity Infrastructure</u>, 2011 at p. 10. (A copy of this Report is attached to this brief as Opening Brief Att. 4).

[41] *Id.* at p. 40 (Opening Brief Att 4).

importance of reliable electric service to its customers. Delmarva uses quarterly customer satisfaction surveys performed by Market Strategies International ("MSI") to gauge customer satisfaction and perceptions of the Company's services.[42] These quarterly surveys have consistently found that the most important driver of satisfaction to Delmarva's customers is reliability: "providing reliable electric service" and "restoring outages when they occur."[43] JD Power surveys have documented similar results.[44] In addition, Delmarva's experience from both its Delaware operations and those of its affiliated PHI utilities further establishes that customer satisfaction is maintained by reducing the number of outages that customers experience and, when outages do occur, minimizing the impact by reducing outage duration.[45]

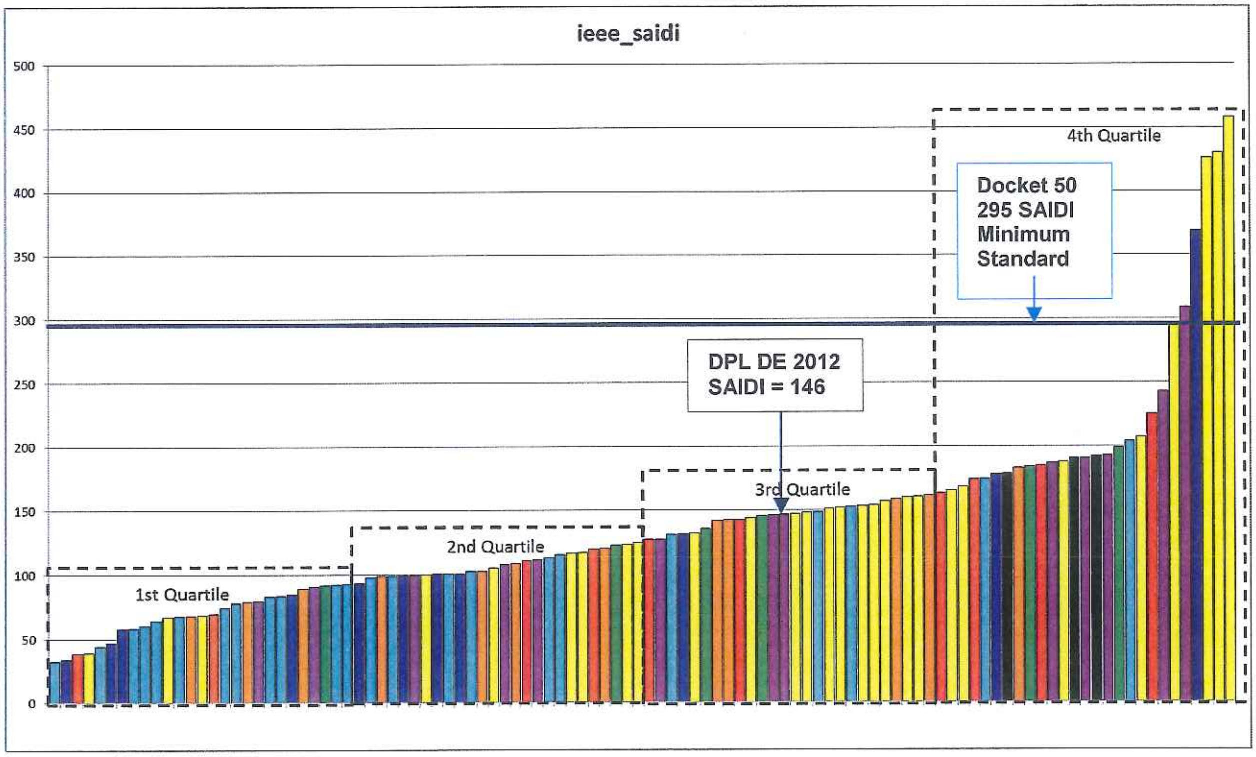
5. **<u>Delmarva's Reliability Performance Compared To the Performance Of Peer Utilities Provides Delmarva With Another Useful Indicator Of The Level Of Reliability It Should Strive To Provide For Its Customers.</u>**

Finally, Company Witness Maxwell testified that yet another factor in determining the appropriate level of reliability to strive for is how Delmarva's actual reliability performance compares with other electric delivery utilities. He explained that Delmarva looks at annual national reliability indices over several years to compare Delmarva's annual performance against the performance of its peers.[46] In his Rebuttal Testimony, Company Witness Maxwell utilized the following chart, which depicts the results of the 2012 Institute of Electrical and Electronics Engineers (IEEE) Annual Reliability Survey, to demonstrate that a utility whose SAIDI performance was actually equal to the Docket 50 performance minimum of 295 minutes would be among the worst performing utilities in the IEEE national study. A utility with an actual

[42] Exh. 19: Maxwell Rebuttal at 6: 9-14 and Schedule (MWM-R)-1; *see also* Tr. at 750:21-751:14 and 753:11-756:15 (Maxwell Redirect); *and* Hearing Exhibit 83.
[43] *Id.*
[44] Exh. 19: Maxwell Rebuttal at 6: 9-14.
[45] *Id.* at 6:15-17.
[46] *Id.* at 7:7-10.

SAIDI performance of 295 minutes places that utility in the bottom of the worst (4th Quartile) performers.[47] Only five utilities out of the 106 participating in the IEEE survey would have failed to meet the Delaware Docket 50 SAIDI 295 minute minimum standard:[48]

Table 1: Delmarva's SAIDI Ranking on 2012 IEEE Annual Reliability Survey



Moreover, it is clear that Delmarva's increased investments in reliability have, in fact, resulted in improved reliability for its customers. Staff Witness Vavro has stated as such and the plain facts establishing the improved performance are indisputable.[49] In 2010 and 2011, before Delmarva's increased investments in reliability began, Delmarva's SAIDI performance was 199 and 192 minutes, respectively.[50] In 2012, after Delmarva began to increase investments in reliability infrastructure, Delmarva's SAIDI performance improved to 146 minutes.[51] As the

---

47 *Id.* at 7:11-8:5.
48 *Id.*
49 Exh. 12: Vavro Direct at 13:4-7; and Exh. 4: Maxwell Direct at 5:16-6:12.
50 Exh. 4: Maxwell Direct at 6:3-12.
51 *Id.*

above IEEE survey chart displays, had Delmarva not increased its reliability investments and, therefore, its SAIDI remained in the 192-199 minute range in 2012, Delmarva's current reliability performance would be among the worst performing utilities in the IEEE national survey - in the middle of the worst (4^{th} Quartile) performers.

A review of the evidence in this docket leads to one conclusion: Delmarva appropriately exercised "professional judgment" in determining that an increase in reliability infrastructure investments was necessary to both maintain and enhance reliability.[52] Based upon its analysis of the five principal factors addressed above, without the increased reliability infrastructure investment, Delmarva could not meet its obligation to provide its customers with "adequate and proper service and keep and maintain its property and equipment in such condition as to enable it to do so."[53]

B. Delmarva Exercised Appropriate Professional Judgment In Selecting The Four Primary Initiatives It Would Pursue To Maintain And Enhance Reliability Performance For Its Customers.

Once Delmarva determined that it was necessary to increase its investments in reliability infrastructure, Delmarva relied upon sound engineering principles, long-standing utility practices and proven state of the art technology in selecting specific infrastructure investments necessary to meet its reliability objectives.[54] Delmarva adopted four primary reliability infrastructure investment initiatives designed to maintain and enhance reliability of the electric system. Those investments have been effective in improving reliability for customers from the SAIDI 192 – 199 minutes range (in 2010 and 2011) to a SAIDI of 146 minutes in 2012. Company Witness Maxwell provided an overview of the four primary reliability infrastructure investment initiatives in Delmarva's capital plan as follows:

---

[52] 26 *Del. Admin. Code.* 3007 §1.3.
[53] 26 *Del. C.* § 209 (a)(2).
[54] Exh. 19: Maxwell Rebuttal at 9:19-10:2.

1. Initiative 1 - Load Growth and Load Maintenance Projects.

Delmarva's Load program is considered reliability work because it is a reliability requirement to identify and address distribution circuit, substation, and substation supply overloads before they result in customer outages.[55] Generally, "load" work takes two forms: (a) investments necessary to address new customer load growth and (b) investments to replace aging poorly performing infrastructure that cannot continue to support existing loads.

(a) New Load Growth - While Delaware as a whole is seeing low overall load growth, there are areas of Delaware that are, in fact, experiencing significant load growth – for example: the Middletown-Odessa-Townsend area in New Castle County below the C&D Canal, the corridor between Dover and Harrington, and the coastal areas in Sussex County are all experiencing enough growth to require action on the part of Delmarva to avoid a degradation in reliability.[56] Delmarva's capital investments to address load growth in these areas are necessary to serve these pockets of growing load.[57]

(b) Replacing Deteriorated Aging Infrastructure to Prevent Load Related Outages - Load-related reliability challenges include not only increasing the capacity of the system to address load growth where it is occurring, but also, continually monitoring and testing existing equipment to prevent load related failures due, not to growing load, but rather, the inability of deteriorated equipment to handle current load. Delmarva's aging infrastructure makes this monitoring and testing especially crucial.

Delmarva practices "reliability centered maintenance" to manage its system. As part of its reliability centered maintenance program, Delmarva engages in "Equipment Condition Assessment" (or "ECA"), which is a process through which Delmarva's reliability engineers

[55] *Id.* at 11:3-6.
[56] *Id.* at 14:5-18.
[57] *Id.*

review the age, performance and condition of equipment through monitoring, testing and field inspections.[58] The ECA identifies equipment that is not performing at a level adequate to meet current or projected future loads.[59] When this monitoring and testing reveals deteriorated equipment conditions that could lead to overloads or other failures, action is taken to prevent customer outages.[60]

During the Evidentiary Hearing, Company Witness Maxwell testified regarding two examples of how the ECA is used to identify aging equipment with deteriorating performance (*in this case, substation transformers*) that, if not replaced, would not be able to continue to handle existing loads and would, therefore, result in large scale outages.[61] He explained that this type of reliability infrastructure work – replacing deteriorated aging infrastructure to avoid outages – is an example of "maintaining" reliability, as opposed to "enhancing" it.[62] He explained that customers on a circuit that is fed by an aging substation transformer showing deteriorated performance may have never experienced an outage and replacing the deteriorated transformer before it fails is done to avoid having those customers experience an outage in the first place.[63]

2. **Initiative 2 - Priority Feeders.**

Delmarva is required by Docket 50 to report individual feeder reliability performance (*feeders are also referred to as "circuits"*), as well as designate a group of the ten poorest-performing "Priority Feeders" for corrective action.[64] Pursuant to this Docket 50 minimum

---

[58] Tr. at 709:23-710-8 (Maxwell Redirect).

[59] *Id.*

[60] *Id.* at 710: 9-712:15.

[61] *Id.* at 706:13-707:18 and 708:18-712:15; *see also* Exh. 74 and 75. At least 26 "Construction Recommendation" memoranda were produced to the parties by Delmarva in this case. Using 2 of the 26 memoranda as examples, Company Witness Maxwell explained how the ECA is utilized to identify aging infrastructure with degraded performance. *See id.* (discussing Hearing Exhibits 74 and 75). He explained that replacement of such degraded aging infrastructure (in this case, substation transformers) is necessary to avoid load-related outages. *See id.* at 711:2-24.

[62] *Id.* at 712:5-15.

[63] *Id.*

[64] *Id.* at 11:7-11; *see also* 26 *Del. Admin. Code* 3007 § 10.3.

requirement, Delmarva must take corrective action with respect to, at a minimum, its ten poorest performing Priority Feeders.[65] Because Delmarva seeks to provide its customers with better reliability than the minimum required by Docket 50, Delmarva developed its "Feeder Improvement Program" to addresses more feeders than just the Docket 50 ten worst performing "Priority Feeders."[66] While the feeders identified for improvement under the Feeder Improvement Program have not reached the level of degraded performance that puts them into the Docket 50 minimum mandatory 10 worst performing Priority Feeder program, Delmarva believes that these feeders are not performing at the level of reliability reasonably expected by customers.[67] As a result, these feeders are identified for reliability work under Delmarva's Feeder Improvement Program.

As Company Witness Maxwell explained in his hearing testimony, the 2012 Annual Docket 50 Performance Report (*Hearing Exhibit 81*) established that Delmarva bettered the minimum SAIDI 295 minute requirement with a system-wide SAIDI of 146 minutes. Despite achieving that system-wide SAIDI performance, however, there were 32 individual feeders/circuits that experienced individual SAIDI performance above 295 minutes for customers on those individual feeders.[68] Although addressing only the ten worst performing feeders would place Delmarva in technical compliance with Docket 50, that decision would disregard the needs of thousands of customers being served by feeders/circuits that, individually, were experiencing SAIDI over 295 minutes.[69] Delmarva exercised its professional judgment to determine that failing to address any feeders above the Docket 50 ten worst performing would not meet the

---

[65] *See* 26 *Del. Admin. Code* 3007 § 10.3; *see also* Tr. at 738:10-15. Delmarva must take corrective action on its ten worst performing Priority Feeders, even if Delmarva is operating in compliance with the SAIDI 295 minute minimum.
[66] Exh. 19: Maxwell Rebuttal at 11:7-12:1; Tr. at 742:13-743:9 (Maxwell Redirect).
[67] *Id.*
[68] Tr. at 737:7-739:6 (Maxwell Redirect) and Exh. 81.
[69] *Id.*

reasonable reliability expectations and needs of customers.[70] Delmarva's Feeder Improvement Program is the appropriate action to address the reasonable reliability expectations and needs of its customers.

3. Initiative 3 - URD Cable Replacement (And Other Aging Infrastructure - Substation Transformers and Switchgear).

Delmarva described the need to address its aging infrastructure in prior sections of this brief. The primary aging infrastructure issue addressed by Delmarva is the need to replace underground residential distribution cables (URD cables) that were manufactured in the early 1970s and 1980s. Another significant aging infrastructure issue that Delmarva addressed in a prior section of this brief is substation switchgear. Additionally, in a preceding section of this brief, entitled "*Initiative 1 – Load Growth and Load Maintenance Projects*," Delmarva described substation transformer investments necessary to address aging infrastructure and avoid load-related reliability problems. Rather than repeat those discussions here, Delmarva notes that its investments to address aging infrastructure are a critical part of Delmarva's reliability work. Failure to address these issues would be a failure of the Company to "exercise professional judgment"[71] in order to "furnish safe[,] adequate and proper service and keep and maintain its property and equipment in such condition as to enable it to do so."[72] Delmarva's efforts to prevent outages associated with aging equipment that is on the verge of failure constitutes good engineering practice, good customer service, and good professional judgment.

4. Initiative 4 - Distribution Automation (DA).

As discussed above, Docket 50 specifically provides that Delmarva is "required to explore the use of proven state of the art technology, to provide cost effective electric service

---

[70] *Id.* at 742:13-743:9; *see also* Exh. 19: Maxwell Rebuttal at 11: 7-12:1.
[71] *See* 26 *Del. Admin. Code.* 3007 *et. seq.*
[72] 26 *Del. C.* § 209 (a)(2).

reliability improvements."[73] Distribution Automation (or "DA") is part of Delmarva's commitment to use proven state of the art technology to provide cost effective electric service reliability improvements through advancements in grid modernization and advanced technologies. Deployment of DA involves the use of advanced distributive control systems, Automated Circuit Reclosers and Automated Circuit Switches to reduce both the number of customers affected by outages and the length of outages for customers who are affected. Automated Circuit Reclosers (or "ACRs") isolate faulted sections of overhead lines by sensing and interrupting fault currents in the section of the feeder exposed to the fault. Computer operated control systems then automatically restore service after the occurrence of a temporary fault. Rather than losing all customers on a feeder to a sustained outage when a fault occurs, DA systems serve to limit the affected customers to only the specific section of feeder affected by the fault. Automated Circuit Reclosers and Switches used as part of a DA restoration scheme isolate a faulted section of a feeder, transfer load between feeders, or separate sections of a feeder to isolate faults. For example, if a feeder serves 1,500 customers, a fault on that feeder would normally result in 1,500 sustained outages. With the use of DA Automated Circuit Switches, however, sustained outages on the feeder would be limited to only the customers served by the specific section of the feeder where the fault exists. Not only will significantly fewer customers be affected by a sustained outage, but because the fault has been isolated by DA Automated Circuit Switches to a specific section of feeder, the fault can be detected and located more quickly and efficiently, meaning that service can be restored more quickly and efficiently to those customers who are affected by the outage.[74]

As Company Witness Maxwell described in his hearing cross examination, Delmarva's

[73] 26 *Del. Admin. Code.* 3007 § 1.8.
[74] Exh. 19: Maxwell Rebuttal at 10:3-11:3.

sister utility - Pepco - proved the effectiveness of Distribution Automation through a two year pilot program.[75] That DA pilot resulted in significant reductions in duration of outages and improvements in various reliability indices for Pepco customers on the feeders/circuits involved in the two year DA pilot.[76] By virtue of the successful DA pilot in the Pepco territory, Delmarva exercised its professional judgment to expand the use of the proven DA technology into other PHI jurisdictions, including Delmarva, Delaware.[77]

C. Staff's Consultant Failed To Offer Any Evidence That Delmarva Failed To Exercise Professional Judgment In Either (1) Determining That Reliability Infrastructure Investment Needed To Be Increased Or (2) Selecting the Specific Reliability Infrastructure Projects To Undertake.

Staff Witness Vavro testified as Staff's reliability consultant. She described the purpose of her testimony as follows:

> "We were asked to consider whether the level of [reliability] spending was reasonable, and whether the [reliability] investments were necessary to comply with the service quality standards included in Regulation Docket no. 50, *i.e.,* a maximum SAIDI of 295 minutes."[78]

At the evidentiary hearings, Staff Witness Vavro clarified, that the purpose of her testimony was to "look at the reliability project[s] and comment on whether the REP spending is necessary to comply with Docket 50 requirements."[79] Staff Witness Vavro's testimony, however, provides no evidence that Delmarva failed to exercise professional judgment in determining that reliability needed to be improved and that additional investments in reliability infrastructure were needed to both maintain and enhance reliability for customers. Staff Witness

---

[75] Tr. at 767:1-7 (Maxwell Re-Cross) and Exh. 78; *see also* Tr. at 765:16-769:10 (discussion concerning the manner in which Distribution Automation (DA), using Automatic Circuit Reclosers (ASRs), was first proven effective through a two year pilot program with Pepco, then rolled out in to other jurisdictions, such as Delmarva Delaware).
[76] *Id.* at 767:8-15.
[77] *Id.*
[78] Exh. 12: Vavro Direct at 11:4-10; *see also* Tr. at 840:23-841: 9 (Vavro Re-direct).
[79] Tr. at 827:*20*-24 (Vavro Cross).

Vavro did not recommend any reduction in recovery by Delmarva for any of its reliability capital investments.[80] Moreover, Staff Witness Vavro did not challenge any of the reliability infrastructure investment initiatives made by Delmarva.[81]

1. Staff and its Consultant Offered No Evidence That Delmarva Failed To Exercise Professional Judgment In Reaching Its Determination That Reliability Should to Be Improved.

Staff Witness Vavro offered the following conclusions in her testimony with regard to Delmarva's decision to make increased reliability investments for the purpose of enhancing and maintaining reliability: (1) "from a policy perspective, there was no clear mandate to necessitate spending for reliability enhancement programs in Delaware....,"[82] (2) "we saw no engineering necessity for the REP reliability-related capital projects to maintain SAIDI at its status quo level,"[83] and (3) "Given the Company has no new performance standards to meet, there is little context or framework within which the parties in this proceeding can consider these [increased reliability] investments."[84]

Upon reviewing merely those three conclusions, it would appear that Staff Witness Vavro is opining that unless and until the Commission establishes a new Docket 50 minimum SAIDI requirement stricter than 295 minutes, Delmarva should not seek to improve reliability performance above SAIDI 295 minutes. In another part of her Direct Testimony, however, Staff Witness Vavro clarifies that under Docket 50, a SAIDI of 295 minutes is not the goal that Delmarva should seek to achieve:

---

[80] *See* Exh. 12: Vavro Direct generally (*no denial of recovery recommended*); and Tr. at 828:8 -15, 828:23-829:11, and 840:10-22.

[81] Exh. 12: Vavro Direct at 13: 4-7 ("To be clear, we are not challenging the Company's selection of projects in its REP, or questioning whether those projects might have a positive effect.")

[82] *Id.; see also id.* at 13:9-10 ("Our concern in this proceeding is that spending for such [reliability] improvement comes without a clear mandate....")

[83] *Id.* at 12:22-23.

[84] *Id.* at 14:19 -21.

> Under the current [Docket 50] standards, a SAIDI of 295 is the absolute maximum value above which point penalties may be imposed. No one actually expects the Company to operate at that level. The [Docket 50] standards recognize that each utility must exercise its professional judgment in satisfying the standard based on its system and service territory.[85]

As such, it appears that Staff Witness Vavro's conclusion is that without an adjustment of the current Docket 50 SAIDI 295 minute minimum performance requirement, it was not necessary for Delmarva to seek to enhance reliability for its customers from the SAIDI 200 minutes range where it remained from 2007 – 2011, to an improved SAIDI of 146 minutes in 2012.[86] Both the clear language of Docket 50 and the evidence of record establish that Staff Witness Vavro's conclusion is without merit.

Docket 50 clearly provides: (1) that a SAIDI of 295 minutes is the absolute "minimum" level of reliability that Delmarva must provide,[87] (2) that achieving a SAIDI of 295 minutes "does not create a presumption" that Delmarva has met the requirement of providing "safe, adequate and proper service,"[88] and (3) that Delmarva's engineers and managers must exercise their "professional judgment based on their systems and service territories" to determine what level of reliability the Company should seek to provide to its customers.[89] As set forth above, Delmarva's decision that its reliability investments needed to be increased for the purpose of enhancing and maintaining reliability was based upon five principal factors:

(1) The increasing need for reliable service to meet the needs of an increasingly digital society and economy;

(2) The increase in the frequency and severity of storms;

---

[85] *Id.* at 14: 4-9; *see also* Tr. at 826:12-22 (Vavro Cross).
[86] *See id.* at *12*:11-12 (*chart showing Delmarva's SAIDI performance from 2007 – 2011 as 197, 213, 190, 199 and 192, respectively with SAIDI performance in 2012 improving to 146 after the increased reliability infrastructure investments began*); *see also* Exh. 19: Maxwell Rebuttal at 5:16- 6:12.
[87] 26 *Del. Admin. Code.* 3007 §1.3.
[88] *Id.*
[89] *Id.*

(3) The need to replace aging and degrading infrastructure, including URD cables, substation transformers and switchgear;

(4) The quarterly surveys from MSI and JD Power & Associates that have consistently found that the most important driver of satisfaction to Delmarva's customers is "providing reliable electric service" and "restoring outages when they occur."

(5) How Delmarva's reliability performance compares with respect to other electric delivery utilities in the United States – namely, the annual IEEE national survey revealing that had Delmarva not increased its reliability investments to improve its SAIDI performance from the 192-199 minute range, where it was from 1998 – 2011, Delmarva's current reliability performance would be among the worst performing utilities in the IEEE national survey.

Based upon an analysis of these factors, Delmarva's reliability engineers exercised their professional judgment to conclude that an increase in reliability infrastructure investment was necessary both: (1) to "furnish safe[,] adequate and proper service and keep and maintain its property and equipment in such condition as to enable it to do so," as required by Delaware statute[90] and (2) to comply with Docket 50's clear mandate requiring Delmarva to "exercise their professional judgment based on [Delmarva's] system[] and service territor[y]" to determine the level of reliability necessary to meet the reasonable expectations of its customers.[91]

The evidence of record in this docket is clear that the following conclusions of Silverpoint are without merit:

(1) "from a policy perspective, there was no clear mandate to necessitate spending for reliability enhancement programs in Delaware….,"[92]

<u>Silverpoint is incorrect</u> – This conclusion of Silverpoint is incorrect for at least two reasons. <u>First</u>: Docket 50 <u>does</u> contain a "clear mandate" - that Delmarva must "exercise [its]

[90] 26 *Del. C.* § 209 (a)(2).
[91] 26 *Del. Admin. Code.* 3007 § 1.3.
[92] Exh. 12: Vavro Direct at 8:13- 14; *see also id.* at 13: 9-10 ("Our concern in this proceeding is that spending for such [reliability] improvement comes without a clear mandate….")

professional judgment" to determine the appropriate level of reliability to provide its customers.[93] Delmarva did, in fact, exercise professional judgment in determining that an increase in reliability infrastructure investment was necessary. Second: Docket 50 contains a second "clear mandate" in that utilities are specifically "*required* to explore the use of proven state of the art technology, to provide cost effective electric service *reliability improvements*."[94] With respect to that clear Docket 50 mandate, Delmarva is utilizing Distribution Automation (or "DA") to provide "cost effective reliability improvements." As previously addressed herein, DA is a "state of the art technology" that has been proven through both the successful two year Pepco pilot project and the successful adoption of DA by leading utilities nationwide.

(1) "we saw no engineering necessity for the REP reliability-related capital projects to maintain SAIDI at its status quo level,"[95]

Silverpoint is incorrect - Delmarva appropriately exercised its professional judgment to determine that there was a "necessity" for the increased investment in reliability-related capital projects. As discussed above, Delmarva's Load and Aging Infrastructure programs are "necessary" to avoid significant degradation to its 1998 – 2011 "status quo" SAIDI performance in the 200 minute range. Without those increased load and aging infrastructure investments, Delmarva would not be able to (a) prevent a significant decline in reliability or (b) "maintain its property and equipment in such condition as to enable it to do so."[96] Delmarva's Priority Feeder and Distribution Automation initiatives are "necessary" to provide Delmarva's customers with the enhanced reliability performance (SAIDI 146 minutes range) that they reasonably expect and need.

---

[93] 26 *Del. Admin. Code.* 3007 § 1.3.
[94] *Id.* § 1.8 (*emphasis added*).
[95] Exh. 12: Vavro Direct at 12:22-23.
[96] 26 *Del. C.* § 209 (a)(2).

(2) "Given the Company has no new performance standards to meet, there is little context or framework within which the parties in this proceeding can consider these [reliability] investments."[97]

Silverpoint is incorrect - If Delmarva were to wait for the Commission to enact "new performance standards to meet" before taking action to provide its customers with the level of reliability needed, Delmarva would be in clear violation of the Docket 50 mandate for Delmarva to exercise its "professional judgment" to determine the appropriate level of reliability to provide to its customers and the appropriate level of infrastructure investment necessary to achieve that performance.[98]

2. Staff and its Consultant Offered No Evidence That The Reliability Infrastructure Investment Initiatives Selected By Delmarva Were Anything Other Than Appropriate.

As addressed above, Staff Witness Vavro testified that her role was limited to the issue of "whether the REP spending is necessary to comply with Docket 50 requirements."[99] Staff Witness Vavro made it clear that Delmarva's reliability performance has improved noticeably due to Delmarva's increased reliability infrastructure investments and that Silverpoint is not challenging the reliability infrastructure projects selected by Delmarva:

> "there has been a noticeable improvement in SAIDI performance since the REP reliability-related initiatives began. To be clear, we are not challenging the Company's selection of projects in its REP, or questioning whether those projects might have a positive effect."[100]

Simply stated, there was no evidence offered in this docket for the purpose of challenging whether the four reliability infrastructure investment initiatives chosen by Delmarva are appropriate for the purpose of maintaining and enhancing reliability. The facts are

---

[97] Exh. 12: Vavro Direct at 14:19-21.
[98] 26 *Del. Admin. Code.* 3007 § 1.3.
[99] Tr. at 827:20-*24* (Vavro Cross) and 840:23-841:9 (Vavro Re-direct); *see also* Exh. 12: Vavro Direct at 11:4-10.
[100] Exh. 12: Vavro Direct at 13: 4-7.

uncontroverted that the reliability infrastructure investments chosen by Delmarva have resulted in marked reliability performance enhancement for Delmarva's customers.[101]

With respect to whether Delmarva is entitled to recovery of its reliability infrastructure investments, the evidence is clear that Delmarva met its Docket 50 responsibility to exercise its professional judgment by:

a. Determining that, due to aging infrastructure and the increasing severity and frequency of storms, increased reliability infrastructure investments are needed to prevent reliability from degrading (i.e., to maintain reliability),

b. Determining that, due to the increasing reliance upon reliable electric service by a digital society and economy, Delmarva's customers have developed a need for enhanced reliability that is appropriately met by increased reliability infrastructure investments and utilization of proven state of the art technology, and

c. Selecting reliability infrastructure investments, including the use of proven state of the art technology, to provide cost effective electric service reliability improvements that have served to both maintain and meaningfully enhance the reliability performance being provided to Delmarva's customers.

Delmarva appropriately exercised its judgment, based upon its engineering, system planning and customer service experience, to appropriately plan and invest in its infrastructure in order to provide the appropriate levels of system reliability to its customers. Accordingly, pursuant to both Docket 50 and established Delaware law concerning the right of utilities to recover their operating expenses, Delmarva is entitled to full recovery of its reliability infrastructure investments.[102]

---

[101] *Id.; see also* Exh. 4: Maxwell Direct at 5:16-6:12.

[102] *See Delmarva Power & Light Co.*, 508 A.2d at 859. (The Commission must allow the utility to recover its

II. RATE OF RETURN

A. The Company's Overall Rate of Return, As Approved by the Commission, Is Important to Accessing Capital on Reasonable Terms.

The Company's requested overall rate of return based on its capital structure on December 31, 2012, is 7.53 percent, based on the following elements:[103]

REQUESTED OVERALL RATE OF RETURN

Type of Capital	December 31, 2012 Capital Structure Ratios	Cost Rate	Weighted Cost Rate
Long-Term Debt	50.78%	4.91%	2.49%
Common Equity	49.22%	10.25%	5.04%`
TOTAL	100.00%		**7.53%**

Authorizing an overall rate of return of 7.53% is important for the Company so that it may have access to capital on reasonable terms.[104] In part, the terms upon which the Company obtains capital is dependent upon the Company's rating by various rating agencies. These rating agencies monitor each State's regulatory environment, evaluating the Company's regulatory treatment, regulatory lag, ability to recover its costs and ability to be able to achieve an authorized return on its assets.[105]

B. The Proposed Capital Structure and Cost of Debt Reflect the Company's Structure and Embedded Cost and Should be Accepted for the Purposes of this Proceeding.

The Company proposed to use its December 31, 2012 capital structure of 50.78% long-term debt and 49.22% common equity for purposes of setting the allowed overall return. The

---

normally accepted operating expenses "*unless found to have been made in bad faith or out of an abuse of discretion.*") (*emphasis in original*); *see also, Application of Wilmington Suburban Water Corp.*, 203 A.2d 817, 829 (Del. Super. Ct. 1964), *aff'd in part by*, 211 A.2d 602 (Del. 1965).

[103] Exh. 2: Boyle Direct at 6:18-19 and Schedule (FJB)-1.

[104] Tr. at 167:16-22 (Boyle Cross).

[105] *Id.* at 168:6-17 and 169:11-15.

Company's embedded cost of long-term debt is 4.91 percent. No party proposed the use of any alternative capital structure or opposed the Company's cost of long-term debt, and DPA Witness Parcell used the proposed capital structure and long-term debt cost in his cost of capital analyses.[106] Accordingly, the Commission should find the Company's proposed capital structure reasonable and accept it for purposes of this proceeding.

While the DPA recommended its overall cost of capital based on the capital structure proposed by the Company,[107] DPA Witness Crane also argued that the Commission should amend the Company's capital structure to include short-term debt in the event it permits the Company to recover any of its costs relating to its credit facility.[108] This assertion was also made by DPA Witness Crane in PSC Docket No. 09-414 and rejected by the Commission.[109] The assertion is again inappropriate in this proceeding and should be rejected.

The credit facility costs included by Delmarva in its determination of revenue requirement in this proceeding are similar to those credit facility operating expenses included in PSC Docket 09-414, and the Company's overall capital structure is substantially the same. Customers receive the benefit of the Company's use of short-term debt for temporary financing of plant and fluctuations in its working capital requirements[110] The credit facility also supports the Company's commercial paper program, which allows the Company to issue short-term debt at a cost lower than borrowing on the facility, and provides liquidity to the Company that is a key consideration in rating agencies' assessment of the Company's long-term credit rating.[111] As explained by Company Witness Boyle, if the Company were to eliminate the credit facility, the

---

[106] Exh. 15: Parcell Direct at 3:4-5.
[107] Exh. 13: Crane Direct at 5:9-12.
[108] *Id.* at 30:20-31:1.
[109] *In the Matter of the Application of Delmarva Power & Light Company for an Increase in Electric Base Rates and Miscellaneous Tariff Changes* (Filed September 18, 2009) Docket No. 09-414, Order No. 8011 at ¶ 214 (August 9, 2011).
[110] Exh. 17: Boyle Rebuttal at 7:21-22.
[111] *Id.* at 7:3-13.

long-term credit rating of the Company would change, possibly even to below investment grade.[112] These ratings are a benefit to the customer as the higher credit rating should enable the Company to obtain long-term debt at lower rates.[113]

Delmarva ultimately relies on the combination of this long-term debt and equity to permanently finance its long-lived distribution assets, and linking recovery of the credit facility costs to the inclusion of short-term debt in its capital structure is inappropriate.[114]

C. Delmarva's Proposed ROE of 10.25% is Supported by the ROE Modeling in this Proceeding and Reflective of Market Conditions.

1. <u>The Company's Proposed ROE Is Consistent with Market Conditions.</u>

This Commission has observed before that determining the appropriate ROE "has always been one of the most difficult issues [it considers] in a rate case."[115] Yet, proper determination of the ROE is important in every rate case to ensure both that the regulated utility maintains the financial integrity necessary to attract needed capital and that customers receive service at just and reasonable rates. This rate proceeding is no different, and Delmarva and DPA have each presented expert analysts that opine upon the appropriate ROE for the Company, each utilizing different ROE estimation models or inputs. While there are numerous methodology and input differences between Company Witness Hevert and DPA Witness Parcell as discussed below, perhaps the most significant distinction between their two analyses is how such analysis: (1) correlates with the current market conditions and recent changes, and (2) is sensitive to the realities of the market.

As summarized below, Company Witness Hevert's analyses and recommendations

---

[112] Tr. at 221:7-19 (Boyle Cross).
[113] Exh 17: Boyle Rebuttal at 7:14-17.
[114] *Id.* at 9:4-11.
[115] PSC Order No. 8011 at ¶ 283 (citing *In the Matter of the Application of Delmarva Power & Light Company for Approval of a Change in Electric Distribution Base Rates and Miscellaneous Tariff Changes* (Filed September 1, 2005) Docket No. 05-304, Order No. 6930 at ¶ 269 (June 6, 2006).

correlate with the current market conditions. There seems to be little debate that market conditions have improved and interest rates have increased since Delmarva's last two rate proceedings, from which ROE's of 10% (Commission decided, order issued August 9, 2011) and 9.75% (settled and approved by Commission order on December 18, 2012) were awarded.[116] Both analysts agreed at the evidentiary hearing that interest rates are up since November 2012.[117] DPA Witness Parcell recognized that the "flight to safety" referenced in his direct testimony is no longer a major factor in the market.[118] Furthermore, both analysts recognized that there is a correlation between interest rates and ROE, and that when interest rates rise, so does ROE.[119] Yet, while Company Witness Hevert recommended that a ROE range from 10.25% to 10.75% would be reasonable, DPA Witness Parcell recommended that the ROE be set at 9.35%. DPA Witness Parcell's ROE is .4% (that is, 40 basis points) lower than Delmarva's currently allowed ROE and .65% (65 basis points) less than the last Commission-decided ROE, notwithstanding the overall improvement in the economy and increasing interest rates. Such an ROE does not correlate with the current market conditions and is inappropriate for maintaining Delmarva's financial integrity and allowing it to compete for capital with other sources of investment.

A key measure of a company's financial integrity is the credit ratings it receives from rating agencies. Delmarva's current long-term issuer credit ratings are BBB+, Baa2, and BBB+ from S&P, Moody's, and Fitch Ratings, respectively.[120] Company Witness Boyle pointed out that the regulatory environment, as reflected in reasonable, consistent and predictable ratemaking

---

[116] *See id.* ¶ 287 *and In the Matter of the Application of Delmarva Power & Light Company for an Increase in Electric Base Rates and Miscellaneous Tariff Changes* (Filed December 2, 2011) Docket No. 11-528, Order No. 8265 at ¶ 1 (December 18, 2012).
[117] Tr. at 428:21-429:20 (Hevert Cross) and 484:12-22 (Parcell Cross).
[118] *Id.* at 473:5-18 (Parcell Cross)
[119] *Id.* at 429:3-14 (Hevert Cross) and 484:3-11 (Parcell Cross).
[120] Exh. 3: Hevert Direct at 6:20-7:1.

policies, is a very important factor to credit rating agencies.[121] In fact, in July 2013 Fitch Ratings downgraded Pepco, a sister company of Delmarva from BBB+ to BBB, due to the state regulatory environment and the outcomes from Pepco's rate cases.[122] The Company's recommended ROE of 10.25 percent is consistent with market conditions, would signal a consistent and reasonable regulatory environment, and will enable Delmarva to maintain a sound financial profile and appropriate credit ratings. The ROE recommendation of DPA Witness Parcell is outside the range of reasonableness, inconsistent with the Commission's past practice and would harm the Company and its customers if adopted.

2. Company Witness Hevert's Modeling and Analysis of Market Conditions Support the ROE Proposed by the Company.

The Company's proposed ROE is 10.25%. In his direct testimony, Company Witness Hevert presented his analyses and recommendation regarding the Company's ROE, utilizing three modeling methods: (1) the Constant Growth Discounted Cash Flow (DCF) model, (2) the Capital Asset Pricing Model (CAPM), and (3) the Bond Yield Plus Risk Premium approach. In response to DPA Witness Parcell's testimony regarding ROE, Company Witness Hevert provided rebuttal testimony in which he updated these three models through July 31, 2013, and also presented a Multi-stage form of the DCF model. Each of these is discussed in more detail below, and Company Witness Hevert's models produced the following ranges:[123]

Method	Low	High
Constant Growth DCF	8.28%	10.35%
Multi-Stage DCF	9.48%	10.68%
Capital Asset Pricing Model	8.69%	10.81%
Bond Yield Plus Risk Premium	10.29%	10.90%

[121] Exh. 17: Boyle Rebuttal at 4:9-23.
[122] *Id.* at 4:23-5:2.
[123] Exh. 18: Hevert Rebuttal at Schedules (RBH-R)-1, (RBH-R)-4, (RBH-R)-5 and (RBH-R)-7. The ranges provided do not include the 15 basis point flotation cost adjustment calculated on Schedule (RBH)-7 to Hevert Direct.

Company Witness Hevert found, based upon the updated results, that his analyses supported an ROE between 10.25% and 10.75% for the Company, with the Company's proposed ROE at the low end of that range.[124] While Company Witness Hevert estimated the ROE using market data and the models to quantify the range of investor expectations of required equity returns, his key consideration in determining the ROE range was to ensure that the overall analysis reasonably reflects investors' view of the financial markets in general and the Company (in the context of the proxy companies) specifically.[125]

Company Witness Hevert's analyses relying upon multiple models and taking into consideration market realities is consistent with this Commission's recent approach to setting ROE. In Delmarva's 2005 base rate case, the Commission stated its continued reliance on the discounted cash flow (DCF) method in determining a utility's ROE, but also held that consideration of other methods was appropriate:

> Over the years we have repeatedly expressed our belief that the DCF equity cost model should be the model on which we primarily rely in establishing a utility's cost of equity. We continue to believe that the DCF equity cost model is an appropriate method for calculating a utility's cost of equity and should be the primary method for calculating the appropriate cost of equity in this jurisdiction. However, we have not said that we should rely solely on the DCF equity cost model and, in fact, over the years we have indeed examined the results of other equity cost models and taken them into account in deciding the cost of equity. In reaching our determination as to the appropriate cost of equity for Delmarva, we give effect to the results of other equity cost models as well.[126]

In Delmarva's last decided rate case, the Commission reiterated its continued reliance on the DCF model.[127] While the Commission then looked at the DCF-derived and other model-derived estimate ranges and found that the record supported a large range of ROEs (from 8.53%

---

[124] *Id.* at 2:7-12.
[125] Exh. 3: Hevert Direct at 10:4-12.
[126] PSC Order No. 6930 at ¶ 269.
[127] PSC Order No. 8011 at ¶ 284.

to 11.4%), it ultimately found convincing analyses and testimony that used companies similar to Delmarva and recommended a ROE that would support Delmarva's current ratings.[128] The Commission was also sensitive to "the realities of the market," taking into account the perception of the approved ROE in the market as well as the need for Delmarva to compete with other utilities for capital.[129]

Company Witness Hevert's recommendation, and the analytical results on which it is based, considers a variety of factors including the specific risks faced by Delmarva and existing and expected capital market conditions. That is especially important when market conditions have changed significantly over an abbreviated period, as occurred between the filing of the Application and the Company's rebuttal testimony. Significantly, between February 2013 and September 2013:

- Both current and forward interest rates increased.
- The Treasury yield curve shifted upward, with longer-term maturities experiencing the greater increases.
- On a spot basis, the 30-year Treasury yield rose by 52 basis points from February 15, 2013 through August 30, 2013. (Since November 2012, the 30-year Treasury yield increased by nearly 100 basis points.)
- On a forward-looking basis, the expected 27-year Treasury yield three years hence (that is, the "forward" 27-year Treasury yield) increased by 54 basis points from February through August 2013 (Since November 2012, forward long-term yields increased by nearly 100 basis points.)
- As interest rates increased, Company Witness Hevert's proxy group companies' stock value significantly decreased.
- The average Beta coefficient for Company Witness Hevert's proxy group also increased rapidly after early August 2013, indicating that the proxy group's risk relative to the broad market measurably increased over several weeks.[130]

---

[128] *Id.* ¶¶ *285*-286.
[129] *Id.* ¶ *287.*
[130] Exh. 18: Hevert Rebuttal at 4:13-8:2.

While the data underlying Company Witness Hevert's analyses reflect the 30-, 90-, and 180-day period ended July 31, 2013, the consistent and concurrent increases in current and forward Treasury yields, together with the proxy companies' significant under-performance and increased risk relative to the overall market are important considerations in arriving at ROE recommendations and should be taken into consideration by the Commission in this proceeding.[131]

As explained during the evidentiary hearing, Company Witness Hevert's ROE recommendation is based on, and supported by, market conditions.[132] Significantly, both analysts recognized a general correlation between interest rates and ROE to move directionally together.[133] While the degree they move together may change, and there is no lockstep movement, generally speaking as interest rates rise, ROE will rise as well, and as interest rates decrease, ROE will fall.[134] DPA Witness Parcel recognized at the evidentiary hearing that interest rates have risen since November 2012 and since the filing of the Application in March 2013.[135] Yet, DPA Witness Parcell recommended an ROE less that that agreed to in the Company's last settled electric rate case and less than that awarded by the Commission in the 09-414 docket.

a. <u>**DCF Method and Multi-stage DCF.**</u>

The DCF approach is based on the theory that a stock's current price represents the present value of all expected future cash flows.[136] The Constant Growth DCF model requires the analyst to identify: (1) the expected dividend yield, and (2) the expected long-term annual

---

[131] *See id.* at 8:5-9.
[132] Tr. at 425:6-14 *and* 438:8-439:3 (Hevert Cross)
[133] *Id.* at 429:3-14 (Hevert Cross) and 484:3-11 (Parcell Cross).
[134] *See id.*
[135] *See id.* at 484:12-22 (Parcell Cross).
[136] Exh. 3: Hevert Direct at 10:20-21.

growth rate.[137] For dividend yield, Company Witness Hevert used his proxy companies' current annualized dividend, and average closing stock prices over the 30-, 90- and 180-trading day periods.[138] Three averaging periods were used to calculate the average stock price to ensure that the DCF model's results were not skewed by any anomalous event.[139]

In the Constant Growth DCF Model, the model assumes a single growth estimate in perpetuity.[140] Company Witness Hevert explained that since dividend growth can only be sustained by earnings growth, the model should incorporate a variety of measures of long-term earnings growth.[141] In his DCF modeling, Company Witness Hevert calculated his results by using the maximum/minimum EPS growth rates as reported for each proxy group company, making adjustment for a growth rate more than two standard deviations from the unadjusted group mean.[142] Company Witness Hevert explained that, in considering his DCF results in developing his ROE range and recommendation, he did not give weight to results well below any reasonable estimate of the Company's ROE in comparison to historical ROE authorized results.[143] He found such results to be "highly improbable," similar with his recognition at the evidentiary hearing that "recently authorized returns for electric utilities in other jurisdictions provide a practical benchmark for assessing reasonableness of cost of equity recommendations in this case."[144] In considering his DCF results, Company Witness Hevert also did not adopt the highest DCF results as his high end for his ROE range.

The fact that Moody's has placed most regulated utilities in the US on review for a potential ratings upgrade does not mean that low modeling results now are more meaningful. All

[137] *Id.* at 11:6-8.
[138] *Id.* at 11:22-12:2.
[139] *Id.* at 12:3-5.
[140] *Id.* at 12:20-21.
[141] *Id.* at 13:1-3.
[142] *Id.* at 13:15-14:5.
[143] *Id.* at 14:11-18.
[144] *Id.* at 14:16; Tr. *at* 433:12-18.

of the companies included in Company Witness Hevert's proxy group, and in DPA Witness Parcell's proxy group, are part of that review.[145] Because the market data included in the analyses used to estimate the ROE reflect expected risk, Delmarva's risk has not decreased relative to its peers as a result of Moody's announced review. There is no reason, therefore, to believe that ROE estimates that are lower than any that have been observed even over the past two years should be considered in determining the Company's ROE.

In the context of the Constant Growth DCF model, Company Witness Hevert identified that his expectation would be that under current and expected market conditions he would expect increased growth rates and dividend yields, and therefore, an increase in ROE.[146] Contrary to his intuition and observable, prevailing market conditions, however, Company Witness Hevert found that Constant Growth DCF results have not followed this trend.[147] Based on the updated analytical results contained in his Rebuttal Testimony, and the counterintuitive trends produced by the Constant Growth DCF model, Company Witness Hevert recommended that greater consideration should be given to analytical approaches that are consistent with observable, prevailing capital market conditions.[148]

In response to DPA Witness Parcell's concern about the sustainability of certain analyst growth rates, Company Witness Hevert performed a Multi-Stage form of the DCF model in order to limit the effect of short-term growth rates on the DCF model.[149] Company Witness Hevert's Multi-Stage model focuses on cash flow growth rates over three distinct stages. As with the Constant Growth form of the DCF model, the Multi-Stage form defines the Cost of Equity as the discount rate that sets the current price equal to the discounted value of future cash

---

145 *See* Exh. 26; Parcell Direct Exhibit DCP-7 and Hevert Rebuttal Schedule (RBH-R)-1.
146 Exh. 18: Hevert Rebuttal at 10:9-12.
147 *Id.* at 10:12-15.
148 *Id.* at 10:15-11:4.
149 *Id.* at 20:8-11.

flows.[150] Unlike the Constant Growth form, however, the Multi-Stage model is solved in an iterative fashion.[151] In the first two stages, "cash flows" are defined as projected dividends.[152] In the third stage, "cash flows" equal both dividends and the expected price at which the stock is sold at the end of the period (i.e., the "terminal price").[153] Company Witness Hevert calculated the terminal price based on the Gordon model, which defines the price as the expected dividend divided by the difference between the Cost of Equity (i.e., the discount rate) and the long-term expected growth rate.[154] In essence, the terminal price is defined by the present value of the remaining "cash flows" in perpetuity.[155] In each of the three stages, the dividend is the product of the projected Earnings Per Share, and the expected dividend payout ratio.[156]

b. <u>CAPM and Risk Premium Methods.</u>

Company Witness Hevert also applied CAPM and Risk Premium analyses in estimating the Company's ROE.

The CAPM analysis is a risk premium approach that estimates ROE as a function of risk-free return plus a risk premium (to compensate investors for non-diversifiable risk).[157] It is comprised of four components, each of which theoretically must be forward looking.[158] In his direct testimony, Company Witness Hevert explained that the results of his CAPM did not fully reflect the appropriate range of ROE estimates given the continued Federal Reserve policy of maintaining low long-term interest rates, which will not continue indefinitely.[159]

The Bond Yield Plus Risk Premium approach is based on the financial tenet that equity

---

[150] *Id.* at 20:11-13.
[151] *Id.* at 20:14-15.
[152] *Id.* at 20:17-18.
[153] *Id.* at 20:18-20
[154] *Id.* at 20:20-23
[155] *Id.* at 20:23-21:1.
[156] *Id.* at 21:1-3.
[157] Exh. 3: Hevert Direct at 15:6-8.
[158] *Id.* at 15:9-10.
[159] *Id.* at 20:7-21:6.

investors' returns are subject to more risk than returns to bondholders.[160] Thus, equity holders require a premium over returns available to debt holders, and risk premium approaches estimate ROE as the sum of the bond yield plus an equity risk premium.[161] Company Witness Hevert defined the equity risk premium in his analysis as the difference between authorized ROEs and the then-prevailing level of long-term Treasury yield, and gathered data from historical electric utility rate proceedings between 1980 to 2013, factoring in any lag in reaching a proceeding's final decision.[162] Company Witness Hevert's Risk Premium analysis was developed to reflect the fact that interest rates and authorized ROEs were high during one period, for example the 1980's, and low during another, for example the post-Lehman bankruptcy period.[163]

In updating his CAPM and Risk Premium methods, Company Witness Hevert found that the increase in long-term interest rates indicated an increase in the ROE under both models.[164] He found that that relationship made sense, both intuitively and methodologically, and such results reinforced his recommendation of the Company's ROE.[165]

3. <u>DPA Witness Parcell's Analyses is based upon Subjective Factors and Results in a Recommended ROE Too Low to be a Reasonable Estimate of the Company's ROE.</u>

DPA Witness Parcell estimates the Company's ROE based on: (1) the Constant Growth DCF model; (2) the CAPM; and (3) the Comparable Earnings Model (CEM).[166] DPA Witness Parcell excludes his CAPM results, which range from 6.90% to 7.00%, and defines his ROE range of 9.20% to 9.50% by reference to the mid-point of his respective DCF and CEM

---

160 *Id.* at 21:9-11
161 *Id.* at 21:11-13.
162 *Id.* at 21:18-22:5.
163 *Id.* at 22:16-23:14.
164 Exh. 18: Hevert Rebuttal at 9:16-18 and 40:18-21.
165 *Id.*
166 *See* Exh. 15: Parcell Direct at 20-33,

results.[167] DPA Witness Parcell's 9.35% recommendation, then, is the midpoint of his 9.20% to 9.50% range.

DPA Witness Parcell's analyses and recommendation are biased downward as a result of several analytical deficiencies, including the use of inappropriate growth rates in his Constant Growth DCF analyses, estimates of the Market Risk Premium that are so low as to produce CAPM results that have little relevance in estimating the Company's ROE, and a level of subjectivity in the Comparable Earnings Method that enables a range of results that are disconnected from, and inconsistent with, other data provided in his testimony. Beyond those analytical issues, DPA Witness Parcell's recommendation does not reasonably reflect the continuing and significant changes in capital markets that together point to an increase, rather than a decrease, in the Company's ROE.

a. <u>Modeling Deficiencies In DPA Witness Parcell's Analyses.</u>

(1) DCF Growth Rates.

DPA Witness Parcell relies on five measures of growth, which include both historical and projected growth in DPS, BVPS, and EPS, as well as historical and projected measures of Sustainable Growth. The use of historical data, projected DPS, BVPS, and Sustainable Growth rates is inappropriate.[168] Analysts' earnings projections are the relevant measure of growth as, over the long term, dividend growth can only be sustained by earnings growth.[169] The use of earnings growth estimates is also supported by the fundamental assumptions underlying the Constant Growth DCF model, which state that earnings, dividends and stock prices all grow at the same rate, and that the payout, Market-to-Book, and Price/Earnings (P/E) ratios all remain

---

[167] *Id.* at 33:9-19.
[168] *See* Exh. 18: Hevert Rebuttal at 16:19-18:3
[169] *Id.* at 16:19-17:7.

constant, in perpetuity.[170] Under those assumptions, the Constant Growth DCF model produces the same result whether the stock is held in perpetuity or sold after an assumed holding period.[171]

While DPA Witness Parcell commented on growth rates that he considered too high to be sustainable, he did not consider the improbability of growth rates that may be too low be sustainable.[172] For example, DPA Witness Parcell's Exhibit DP-2, Page 1 of 6 notes that over the "Current Cycle", the Consumer Price Index has been (on average) 2.10 percent. Nonetheless, nine of the growth rates presented on Exhibit DCP-7, Page 4 of 4 (i.e., DPA Witness Parcell's summary of "DCF Cost Rates") are 2.10 percent, or lower. That is, in developing his DCF analyses, DPA Witness Parcell included nine growth rates that suggest zero, or negative real growth.[173] As identified by Company Witness Hevert, if one assumes that investors would require at least 1.00 percent real growth to take on the risk of equity ownership, the lower limit of "sustainable" growth would be approximately 3.10 percent.[174] Thirty-two of DPA Witness Parcell's growth rate estimates (16 relating to his proxy group and 16 relating to Company Witness Hevert's proxy group) are equal to or less than that threshold.[175] Thus, his analysis uses rates that are so low as to be unsustainable in the long-run.

(2) Application of the CAPM.

DPA Witness Parcell did not use his CAPM results to set his recommended range or ROE.[176]

[170] *Id.* at 17:7-11.
[171] *Id.* at 17:11-13.
[172] *Id.* at 19:7-10.
[173] *Id.* at 19:14-16.
[174] *Id.* at 19:16-20.
[175] *Id.*
[176] *See* Exh. 15: Parcell Direct at 33:9-19.

(3) DPA Witness Parcell's CEM Analysis Relies Substantially on His Subjective Assessment.

The M/B ratio equals the market value (or stock price) per share, divided by the total common equity (or the book equity) per share.[177] Book value per share is an accounting construct, which reflects historical costs.[178] In contrast, market value per share (i.e., the stock price) is forward-looking, and is a function of many variables, including (but not limited to) expected earnings and cash flow growth, expected payout ratios, measures of "earnings quality", the regulatory climate, the equity ratio, expected capital expenditures, and the expected return on book equity.[179] Thus, the M/B ratio is a function of numerous variables in addition to the historical or expected ROE.[180]

DPA Witness Parcell's CEM analysis examines realized ROE for several groups of companies (the respective proxy groups, and the S&P 500 companies) and evaluates investor acceptance of those returns by reference to the resulting M/B ratio. DPA Witness Parcell reasons that his results indicate historical returns of 8.30% to 12.00% have been adequate to produce M/B ratios of 120.00% to 170.00%.[181] His review of S&P 500 companies, which DPA Witness Parcell considers to be representative of the competitive sector of the economy, indicate average earned returns from 12.40% to 14.70%, with M/B ratios ranging from 204.00% to 341.00%.[182] Lastly, DPA Witness Parcell compares the risk levels of the utility industry with those of the competitive sector, by considering such metrics as the Value Line Safety Rank, Value Line Beta Coefficient, Value Line Financial Strength, and S&P Stock Rank.[183]

---

[177] Exh. 18: Hevert Rebuttal at 32:13-14.
[178] *Id.* at 32:14-15.
[179] *Id.* at 32:15-33:1.
[180] Tr. at 477:20-478:16 (Parcell Cross).
[181] Exh. 15: Parcell Direct at 31:13-14.
[182] *See id.* at 32:2-4.
[183] *See id.* at 32:7-14.

Based on his CEM analysis, DPA Witness Parcell concludes that the ROE "for the proxy utilities is no more than 9.0% to 10.0%."[184] DPA Witness Parcell further concludes that "an earned return of 9.0% to 10.0% should thus result in a M/B well above 100%," and that "the fact that M/B ratios substantially exceed 100% indicates that historic and prospective ROEs of over 10.0% reflect earnings levels that are well above the actual COE for those regulated companies."[185] At the evidentiary hearing, DPA Witness Parcell recognized that he does not use a specific M/B ratio in his analysis, and that there is no formula for his analysis.[186] In other words, it is subjective and inappropriate for reliance in this proceeding. For example, DPA Witness Parcell suggests that Market-to-Book ratios of 130.00% and greater indicate excessive earnings levels, but provides no evidence to support that position.

Further, there are a number of variables beyond the earned ROE that affect the M/B ratio. Because the data presented by DPA Witness Parcell focuses on only one, they produce empirical results that are highly inconsistent with market realities and under-estimate Delmarva's ROE.

DPA Witness Parcell's CEM analysis, and the conclusions that he derives from that analysis, rely substantially on his subjective assessment as to the relationship between Market-to-Book Value (M/B) ratios and the earned ROE.[187] Equally important, DPA Witness Parcell's analyses and conclusions are heavily dependent on his sense of what may (or may not) be an appropriate Market-to-Book ratio for a company such as Delmarva. Given the highly subjective nature of that approach, there are a range of plausible results, including that a M/B ratio of approximately 150.00% would be associated with the ROE of 10.25% as proposed by

[184] *Id.* at 32:16-17.
[185] *Id.* at 32:20-33:4.
[186] Tr. at 477:6-19.
[187] *See* Exh. 18: Hevert Rebuttal at 34:18-3.

Delmarva.[188]

b. The DPA's Recommended ROE is Not Reflective of Capital Market Conditions.

In his direct testing, DPA Witness Parcell refers to comparatively low levels of inflation (as measured by the Consumer Price Index) which, he asserts, are "reflective of lower capital costs," and historically low Treasury and utility bond yields; DPA Witness Parcell, attributes those comparatively low rates to a "flight to safety."[189] DPA Witness Parcell further notes that the "flight to safety" led to a "negative perception" of the recent market which resulted in the reduced valuation of "retirement accounts, investment portfolios, and other assets."[190] DPA Witness Parcell suggests that this has caused "a decline in investor expectations of returns, including stock returns."[191] Yet, Parcell recognized at the evidentiary hearing that the "flight to safety" is no longer applicable:

> Q: And in your discussion on Page 14 [of Parcel Direct Testimony], you reference the flight to safety in the late 2008 early 2009 time period. Do you believe the flight to safety condition that existed then is no longer a major factor in the market.
>
> A. The answer is yes. The flight to safety in late 2008 and early 2009 is when even utility bond rates for three or four months were pushing about ten percent. Investors were buying nothing except treasury bonds. That flight to safety gradually dissipated over the remainder of 2009. So, in that context, it's not a factor now.[192]

With respect to recent market performance, as noted above the broad market increased by nearly five percentage points over the four months from May through September 6, 2013. During the same period, utility stocks (as measured by both respective proxy groups)

[188] *See id.* at 39:3:12.
[189] Exh. 15: Parcell Direct at 13:5-6 and 14:1-4.
[190] *Id.* at 14:4-7.
[191] *Id.* at 14:7-8.
[192] Tr. at 473:5-18 (Parcell Cross).

significantly under-performed the broad market. That is, financial assets that reflect the broad market have increased in value; utility stocks have not enjoyed the same performance. Whether the utility sector's under-performance is due to the rapid increase in interest rates, or the rotation by investors out of utility stocks into other sectors (or both), it is important to consider recent market data and the implications of that data in arriving at ROE recommendations.[193]

DPA Witness Parcell's recommended range gives equal weight to all four estimates resulting from his DCF and CEM models assuming, for example, that an ROE of 9.00% is equally as plausible as an ROE of 10.00%. An authorized ROE of 9.00%, however, would be below 99.86% of the 1,410 ROE authorizations observed since 1980.[194] Those estimates are also inconsistent with recent market conditions.

4. **<u>ROE Conclusion</u>**

The updated results presented in Company Witness Hevert's rebuttal testimony support an ROE between 10.25% and 10.75%, with the Company's proposed 10.25% ROE at the low end of that range. Company Witness Hevert adjusted the high end of his recommended range from 11.00% to 10.75% to reflect certain changes in the results of his updated analyses relative to those presented in his Direct Testimony, but did not change his position that the Company's proposed ROE of 10.25% is reasonable. Furthermore, Company Witness Hevert explained that the recent changes in current and expected market conditions would suggest an increase, not a decrease, in the ROE and that that is what certain of his model results indicate. He recognized also that The Consistent Growth DCF model results had decreased since March 2013 and, that while those lower results are inconsistent with observable measures of increased capital costs, he

---

[193] *See* Exh. 18: Hevert Rebuttal at 41:4-10.
[194] *Id.* at 13:5-6.

believed that it was reasonable to reflect the lower results in his recommendation. Accordingly, while Company Witness Hevert lowered the high end of his recommended range, his opinion remained that the Company's proposed ROE of 10.25% is a reasonable, if not conservative estimate of its ROE, and this ROE should be adopted by the Commission.

III. RATE BASE AND REVENUE REQUIREMENT ADJUSTMENTS

A. UNCONTESTED ADJUSTMENTS

The Company presented several adjustments that either were accepted or not contested by the parties to this proceeding. The Company requests that the Hearing Examiner recognize the adjustments discussed below in Sections III. A. 1-13 in his report and approve the Company's ratemaking treatment with respect to such adjustments. These uncontested adjustments are well supported by the evidence presented by the Company, and follow Commission precedent or well-accepted ratemaking treatment. By providing such explicit recognition, the Hearing Examiner would allow the Company and the parties in future proceedings to appropriately reflect accepted Commission ratemaking practices. The adjustments, as summarized in greater detail below, are:

- Rate Change from Docket No. 11-528 (Company Adjustment No. 1);
- Weather Normalization (Company Adjustment No. 2);
- Bill Frequency (Company Adjustment No. 3);
- Injuries & Damages Expense Normalization (Company Adjustment No. 6);
- Uncollectible Expense Normalization (Company Adjustment No. 7);
- Remove Employee Association Expense (Company Adjustment No. 9);
- Removal of Executive Incentive Compensation (Company Adjustment No. 11);
- Removal of Certain Executive Compensation (Company Adjustment No. 12);

- Storm Restoration Expense Normalization (Company Adjustment No. 13);
- Proform Advanced Metering Infrastructure (AMI) O&M Expenses (Company Adjustment No. 17);
- Proform AMI O&M Savings (Company Adjustment No. 18);
- Proform AMI Depreciation & Amortization Expense (Company Adjustment No. 19);
- Normalize Other Taxes (Company Adjustment No. 25);
- Amortization of Actual Refinancing Costs (Company Adjustment No. 27);
- Remove Qualified Fuel Cell Provider Project Costs (Company Adjustment No. 28);
- Remove Post 1980 Investment Tax Credit (ITC) Amortization (Company Adjustment No. 30) and
- Removal of Renewable Portfolio Standards (RPS) Labor Charges (Company Adjustment No. 32).

1. Rate Change from Docket No. 11-528 (Company Adjustment No. 1).

The Company proposed an adjustment to include the revenue effect of the final rates in Docket No. 11-528 although their January 1, 2013 effective date was outside of the test period.[195] This adjustment was detailed in Company Witness Ziminsky's Direst Testimony, at Schedule (JCZ)-1, and resulted in a $5,643,025 increase to test year earnings. The Company's proposal to include the rate changes from Docket No. 11-528 is reasonable, uncontested and should be approved.

[195] Exh. 6: Santacecilia Direct at 9:8-10.

2. Weather Normalization (Company Adjustment No. 2).

The Company proposed a weather normalization adjustment consistent with the treatment used in previous dockets.[196] This adjustment was detailed in Company Witness Santacecilia's Direst Testimony, at Schedule (MCS)-3, and resulted in a $163,716 increase to test year earnings. The Company's proposal to adjust for weather normalization is reasonable, uncontested, consistent with Commission precedent and should be approved.

3. Bill Frequency (Company Adjustment No. 3).

The Company proposed a bill frequency adjustment by which "as billed" revenues were equal to unbundled delivery revenues.[197] This adjustment was detailed in Company Witness Santacecilia's Direct Testimony, at Schedule (MCS)-3, and resulted in a $1,227,683 increase to test year earnings. The Company's proposal to adjust for bill frequency is reasonable and uncontested and should be approved.

4. Injuries & Damages Expense Normalization (Company Adjustment No. 6).

The Company proposed an adjustment to normalize injuries and damage expenses using a three year period consistent with the treatment adopted in Docket Nos. 03-127, 05-304 and 09-414.[198] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-5, and resulted in a $52,979 increase to test year earnings. The Company's proposal to normalize Injuries and Damages Expense is reasonable, uncontested, consistent with Commission precedent and should be approved.

5. Uncollectible Expense Normalization (Company Adjustment No. 7).

The Company proposed an adjustment to normalize its test period level of uncollectible expense using a three year average of this expense consistent with the treatment included in

---

196 *Id.* at 8:12-16.
197 *Id.* at 7:7-8:1.
198 Exh. 5: Ziminsky Direct at 12:5-7.

Docket Nos. 03-127, 05-304, 09-414 and 11-528.[199] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-6, and resulted in a $93,186 increase to test period earnings. The Company's proposal to normalize uncollectible expenses is reasonable, uncontested, consistent with Commission precedent and should be approved.

6. Remove Employee Association Expense (Company Adjustment No. 9).

Consistent with past treatment, including the treatment in Docket No. 09-414, the Company removed for ratemaking purposes the amounts charged to expense for support of the Employees' Association.[200] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-8, and resulted in a $53,123 increase to test year earnings. The Company's proposal to remove its Employees' Association expenses is reasonable, uncontested, consistent with Commission precedent and should be approved.

7. Storm Restoration Expense Normalization (Company Adjustment No. 13).

The Company proposed an adjustment to normalize its storm expense using a three year average of this expense consistent with the treatment approved in Docket No. 09-414.[201] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-12, and resulted in a $457,675 increase to test period earnings. The Company's proposal to normalize storm restoration expenses is reasonable, uncontested, consistent with Commission precedent and should be approved.

8. Proform Advanced Metering Infrastructure (AMI) O&M Expenses; Proform AMI O&M Savings and Proform AMI Depreciation & Amortization Expense (Company Adjustment Nos. 17. 18 and 19).

The Company proposed a series of related adjustments with respect to its AMI Program expenses. For Adjustment No. 17, the Company proposed an adjustment to have AMI-related

---

[199] *Id.* at 12:13-15.
[200] *Id.* at 13:22-23.
[201] *Id.* at 15:19-21.

expenses included in the cost of service used to develop its rate base consistent with the AMI Regulatory Asset Phase-In Recovery plan agreed to in Docket No. 11-528.[202] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-16, and resulted in a $1,303,207 decrease to test period earnings. If this proposed adjustment is approved, these expenses would no longer be deferred as they were during the test period and would be expensed during the rate effective period.

Subject to certain exceptions, the Company proposed Adjustment No. 18 to reflect in base rates the amount of O&M savings from AMI, relating to meter reading expense, remote turn-on/turn-off functionality, customer care and other services.[203] For the exception relating to remote turn-on/turn-off related to involuntary service terminations, the Company proposed that such savings, when realized, be credited to a regulatory asset.[204] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-17, and resulted in an $811,752 increase to test period earnings. If this proposed adjustment is approved, these expenses would no longer be deferred as they were during the test period and would be expensed during the rate effective period.

The Company proposed Adjustment No. 19 to charge incremental AMI depreciation and amortization expenses relating to meters and AMI system-related assets to expense in its cost of service and thus stop the need to defer these assets to a regulatory asset.[205] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-18, and resulted in a $1,662,531 decrease to test period operating income. If this proposed adjustment is approved, these expenses would no longer be deferred as they were during the test period and

---

[202] *Id.* at 19:21-20:1.
[203] *Id.* at 20:10-20.
[204] *Id.* at 21:11-14.
[205] *Id.* at 22:20-23:8.

would be expensed during the rate effective period. Such treatment avoids additional carrying costs being incurred by the Company for the regulatory asset, which benefits customers, and reflects sound ratemaking treatment for rates to be reflective of the services being provided in the rate effective period.

The Company's proposed AMI-related adjustments are reasonable and uncontested and should be approved collectively.

9. Normalize Other Taxes (Company Adjustment No. 25).

The Company proposed an adjustment to remove from its cost of service a non-recurring tax credit arising from the reversal of an accrual related to 2009 Delaware franchise taxes.[206] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-24, and resulted in an $112,545 decrease to test period earnings. The Company's proposal is reasonable and uncontested and should be approved.

10. Amortization of Actual Refinancing Costs (Company Adjustment No. 27).

The Company proposed an adjustment decreasing the test period earnings by $370,828 and increasing the test period rate base by $2,976,401 to reflect the earnings and rate base treatment of refinancings that were allocated to the electric business.[207] This treatment is consistent with the treatment of refinancing costs in prior Commission decisions, going back to Docket No. 86-24. This adjustment was detailed in Company Witness Ziminsky's Direct Testimony and Schedule (JCZ)-26. The Company's proposal is reasonable and uncontested and should be approved. The Company's proposal to amortize its refinancing costs is reasonable, uncontested, consistent with Commission precedent and should be approved.

[206] *Id.* at 27:6-8.
[207] *Id.* at 28:16-22.

11. Remove Qualified Fuel Cell Provider Project Costs (Company Adjustment No. 28).

The Company proposed an adjustment to remove Qualified Fuel Cell Provider-related costs that are currently included as expense in test period cost of service as those costs are to be recovered through the Fuel Cell Provider tariff, not base rates.[208] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-27, and resulted in an $84,783 increase to test period earnings. The Company's proposal to remove Qualified Fuel Cell Provider project costs is reasonable and uncontested and should be approved.

12. Remove Post 1980 Vintage ITC Amortization (Company Adjustment No. 30).

The Company proposed an adjustment to remove post-1980 vintage Investment Tax Credit (ITC) amortizations consistent with the treatment included in previous dockets, including Docket No. 09-414, and the requirements of the Economic Recovery Tax Act of 1981.[209] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-29, and resulted in a $255,733 decrease to test period earnings. The Company's proposal to remove post-1980 ITC amortizations is reasonable, uncontested, consistent with Commission precedent and should be approved.

13. Removal of Renewable Portfolio Standards (RPS) Labor Charges (Company Adjustment No. 32).

The Company proposed an adjustment to remove expenses related to the RPS process that are to be recovered through the Qualified Fuel Cell Provider tariff.[210] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony, at Schedule (JCZ)-31, and resulted in a $41,136 increase to test period earnings. The Company's proposal to remove RPS labor

[208] *Id.* at 28:24-29:2.
[209] *Id.* at 29:16-19.
[210] *Id.* at 30:15-17.

expenses is reasonable and uncontested and should be approved.

B. CONTESTED RATE BASE ADJUSTMENTS

The Delaware Superior Court ruled in 1975 that:

> Rate fixing is prospective: the rates should be just and reasonable in the foreseeable future as well as the present. Use of a test year for particular study is accepted practice. The test year, which is past experience, is evaluated as a basis for predicting the future. While the Commission has discretion in setting the test year, this does not mean that it may arbitrarily refuse to consider later available accurate information. Later information is especially important as a check on the continuing validity of the test year, experience in a period of rapid change like the present. Ignoring later information increases the likelihood of frequent costly and unsettling rate proceedings.[211]

Based on this reasoning, the Commission has repeatedly rejected arguments such as those advanced by Staff and DPA witnesses in this case that post-test period adjustments should not be considered. For example, in Docket No. 91-20, decided in 1992, the hearing examiner acknowledged that:

> this Commission has frequently allowed out-of-period adjustments under certain circumstances when the adjustments are known and measurable and when the changes are of such magnitude that the test period will no longer be representative of the utility's operations. The Commission's Minimum Filing Requirements also confirm that a utility may adjust test period data to reflect known and measurable changes to future rate base items.[212]

Agreeing with the hearing examiner and adopting his recommendation and supporting reasons for allowing a post-test period adjustment, the Commission explained that adopting the argument that all post-test period adjustments should be disallowed would also violate Delaware law, stating: "under Delaware Law, we may not arbitrarily refuse to consider accurate post-test

---

[211] *Application of Delmarva Power & Light Co.*, 337 A.2d 517, 518 (Del. Super. Ct. 1975)(internal citations excluded).

[212] *In re Delmarva Power & Light Co.*, 1992 WL 465021, Docket No. 91-20, Order No. 3389 at ¶ 50 (March 31, 1992).

period information in setting a utility's rates."[213]

The Commission reaffirmed its ruling on post-test year adjustments in Order No. 4104, where it held that:

> This Commission has permitted expenses that will be incurred outside of the test period, or items that will be placed in service outside of the test period, to be included in operating expenses or rate base for the purpose of establishing rates when it is reasonably certain that the expense will be incurred or the item will be placed in service during the rate effective period and where the amounts associated therewith are sufficiently ascertainable. Thus, for example, we have approved post-test period adjustments for such items as wage increases that are contractually scheduled to become effective during the rate effective period, and we have approved the inclusion in rate base of equipment that will be placed into service shortly after the close of the test period.[214]

Most recently, in the Company's last litigated electric rate proceeding brought before the Commission in Docket No. 09-414, the Commission spoke directly to the issue in response to DPA's advancement of an overarching theme of strict adherence to the test period. Rejecting DPA's position, the Commission stated:

> As demonstrated in our deliberations on the individual issues, we do not accept the DPA's position that a utility using an historic test period can never make any adjustment to the components of the test period to recognize events occurring after the close of the test period. Our MFRs expressly authorize utilities to propose, and our practice has been for many years to consider, post-test period adjustments to recognize known and measurable changes in rate base, expenses and revenues.[215]

Notwithstanding Delaware law and its consistent application by this Commission, Staff and DPA have raised in this proceeding a number of challenges to post-test period adjustments proposed

---

[213] *Id.* at ¶ 52 (citing *Delmarva Power & Light Co.*, 337 A.2d at 517).
[214] *In the Matter of the Application of the Delaware Division of Chesapeake Utilities Corporation for a General Increase in Natural Gas Rates and Charges Throughout Delaware and for Approval of Other Tariff Changes* (Filed April 4, 1995) Docket No. 95-73, Order No. 4104 at VII(B)(2) (December 19, 1995).
[215] PSC Order No. 8011 at ¶ 48.

by the Company for rate base and expenses based on the strict adherence to test period principle. Following Delaware law, and as further discussed below, these challenges should be rejected by the Commission.

1. <u>The Company's Proposed Adjustment for Reliability Plant Closings for January 2013 through August 2013 (Company Adjustment No. 26a) is Consistent with Commission Precedent and Delaware Law.</u>

The Company proposed an adjustment to include in rate base its post-test period reliability project closings through August 2013 consistent with the treatment approved in Docket No. 09-414.[216] This adjustment reflects the actual reliability plant closings added to Plant in Service through September 2013, adjusted to reflect any retirements to plant associated with this period, and properly synchronizes the value that customers will realize during the rate effective period to the amount included in rates.[217] This adjustment was detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ-R)-6, and resulted in a \$549,901 decrease to test period earnings and an increase to test period rate base of \$39,876,047.

Staff Witness Peterson and DPA Witness Crane oppose Adjustment 26 on general ratemaking grounds. Staff Witness Peterson asserts that the adjustment constitutes a violation of the test period matching principle, and will create a mismatch between plant investment and the revenues and expenses that flow from such investment.[218] Similarly, DPA Witness Crane recommended that all post-test year plant additions be eliminated from the Company's proposed rate base as they result in a mismatch of the "regulatory triad" used to set rates.[219] Neither Staff Witness Peterson nor DPA Witness Crane relied upon the opinions or recommendations of Staff

---

[216] Exh. 5: Ziminsky Rebuttal at 52:14-21 and 53:3-5. Adjustment 26 was initially proposed as a single adjustment in the Application for January 2013 - December 2013 using forecasted reliability plant closings. The adjustment was divided into two parts by the Company when it filed its Rebuttal testimony with Adjustment 26a reflecting actual project closings through September 2013 and Adjustment 26b reflecting forecasted plant closings through December 2013.
[217] *Id.* at 53:3-7
[218] Exh. 11: Peterson Direct at 11:22-25; Tr. at 504:18-22 (Peterson Cross).
[219] Exh. 13: Crane Direct at 6:13-18.

Witness Vavro or DPA Witness Dismukes in opposing Adjustment No. 26.

DPA Witness Dismukes also opposed Adjustment No. 26, and recommended its rejection.[220] His objection was two-fold: (1) based on general ratemaking grounds that that adjustment was uncertain, and not currently "used and useful" or entirely "known and measurable," and (2) based on his assertion that the post-test period reliability investments "are not supported by any cost-benefit or value of service studies which should be a pre-requisite for a forward-looking investment adjustment of this nature."[221]

The Staff and DPA Witnesses' opposition to Adjustment No. 26a on general ratemaking grounds is misplaced and unsupported, and this adjustment should be approved consistent with the past decisions of the Commission and in order to make the test period more reflective of the period during which the rates approved in this case will be in effect.

First, post-test period adjustments are allowed by the Commission's regulations, which state in pertinent part:

> Modifications in test period data occasioned by reasonably known and measurable changes in current or future rate base items, expenses (i.e., labor costs, tax expenses, insurance, etc.) or revenues may be offered in evidence by the utility at any time prior to its filing of rebuttal evidence.[222]

The costs associated with the reliability projects for Adjustment No. 26a are clearly known and measurable, as reflected in Schedule (JCZ-R)-6. To this point, in her Direct Testimony, DPA Witness Crane recognized that the Commission has allowed post-test year adjustments that are reasonably known and measurable but not those that are "merely speculative," and asserted as to Adjustment No. 26 that "plant additions through December 31, 2013 are not known and

---

[220] Exh. 14: Dismukes Direct at 2:22-23.
[221] *Id.* at 2:23-3:4.
[222] 26 *Del. Admin. Code* 1002, Part A § 1.3.1.

measurable."[223] At the evidentiary hearing, DPA Witness Crane agreed that the actual plant closing results for Adjustment No. 26a were known.[224]

Second, Adjustment No. 26a is similar to prior reliability adjustments that were approved by the Commission in Docket Nos. 05-304 and 09-414, and including the reliability projects in rate base is consistent with Delaware law and the Commission's precedent. In Docket No. 05-304, "both Staff and DPA accepted [plant closing] adjustments to rate base to include plant closings up to four months beyond the end of the test period."[225] Thus, in the 05-304 proceeding, the post-test period reliability plant adjustment was uncontested.[226] In Docket No. 09-414, the Commission approved the Company's nine month post-test period reliability plant adjustment notwithstanding the opposition of Staff and DPA.[227] As cited above, in approving the adjustment, the Commission rejected a strict test period construction as advanced by DPA, and agreed with the Company that the costs were known and measurable and that the adjustment was "necessary to make the test period more reflective of the period during which the rates approved in this case will be in effect."[228] The Commission also found in Docket No. 09-414 that the plant additions were necessary for the reliable operation of the distribution system and not being made to serve future customers.[229]

Similar to the adjustments approved in Docket Nos. 05-304 and 09-414, the Company's post-test period reliability plant adjustment reflects the annualization of reliability plant added to Plant in Service for a nine month period beyond the test period. Further, as described above, the reliability projects are necessary for the reliable operation of the Company's distribution system

---

[223] Exh. 13: Crane Direct at 8:5-7.
[224] Tr. at 547:21-548:7 (Crane Cross).
[225] *See* PSC Order No. 6930 at ¶ 39.
[226] *Id.* at ¶ 32.
[227] *See* Order No. 8011 at ¶ 60.
[228] *Id.*
[229] *Id.*

and were not undertaken to serve future customers. Thus, there are no expected revenues associated with the projects as Company Witness Ziminsky described during the hearing.[230] Nor has the Company identified any known and measurable expense reductions from the Adjustment No. 26 reliability projects as described by Company Witness Ziminsky.[231] Neither Staff Witness Peterson nor DPA Witness Crane identified any revenues or expenses associated with Adjustment No. 26 in their respective testimonies. Accordingly, Adjustment No. 26a will make the test period more reflective of the effective rate period based upon the information known.

Staff and DPA object to Adjustment No. 26 on the basis that it violates the test period matching principle and results in a mismatch of the "regulatory triad." These general assertions should be rejected since, as discussed above, the Commission's regulations allow for such an adjustment; the Commission expressly rejected a strict test-period construction in Docket No. 09-414 and these types of adjustments are necessary to make rates reflective of the effective period. Moreover, Delaware law is clear that the Commission is to fix rates prospectively and consider "later available accurate information." Accordingly, the general ratemaking criticisms of Staff Witness Peterson and DPA Witness Crane of this adjustment should be given no weight.

Furthermore, DPA Witness Crane's criticisms that the adjustment does not take into consideration other rate base components that would offset the revenue requirement associated with the adjustment is unsupported. First, this criticism is simply a more specific restatement of her general post-test period ratemaking adjustment criticism as the logical conclusion is that all rate base components would have to be restated through the adjustment period to satisfy this criticism, meaning the adjustment period would in effect be the test period. Second, the Company considered revenue and expense off-sets that may be associated with Adjustment No.

---

[230] Tr. at 569:2-9 (Ziminsky Cross) and 684:18-685:11 (Ziminsky Re-direct).
[231] *Id.*

26 and determined that none were known and measurable.[232]

Lastly, the assertion by DPA Witness Dismukes that Adjustment No. 26 should be rejected because it is not supported by any cost-benefit or value of service study is unsupported by Delaware law and the Commission's regulations, arbitrary, and should not be given any weight. As recognized by DPA Witness Dismukes at the evidentiary hearing, the Commission's regulations do not require a cost effectiveness study or analysis to be conducted for reliability investments.[233] While DPA Witness Dismukes testified that, as a "general practice matter" and for governance of utilities broadly, the Commission would look at the cost effectiveness of resources as they are added into rates,[234] neither his Direct Testimony nor testimony at the Evidentiary Hearing offers any opinion that the Company's reliability investments were wasteful, inefficient or made in bad faith. As described above, the Company's reliability investments were made in its sound business judgment and are well supported in the record, and the absence of a formal cost-benefit or value of service study as envisioned by DPA Witness Dismukes is not sufficient to reject Adjustment No. 26.

Furthermore, DPA Witness Dismukes recommendation in this respect is arbitrary. While he seeks to reject the post-test period reliability investments associated with Adjustment No. 26, he does not make a similar recommendation as to the Company's 2012 reliability investments. Thus, the application of his proposed requirement that reliability investments be supported by such studies is arbitrarily applied and should be rejected.

The reliability plant additions that are the subject of Adjustment No. 26a are known and measurable additions that are in service and used and useful. They were necessary for the reliability of the Company's distribution system and better reflect the effective rate period.

---

[232] *Id.*
[233] Tr. at 515:8-11 (Dismukes Cross).
[234] *Id.* at 515:12-18.

Consistent with Delaware law and the Commission's precedent, the Company should be permitted to include in rate base the cost of these reliability projects.

2. <u>The Company's Proposed Adjustment for Reliability Plant Closings for September 2013 through December 2013 (Company Adjustment No. 26b) is Consistent with Commission Precedent and Delaware Law.</u>

The Company proposed an adjustment to include in rate base its post-test period reliability project closings from September 2013 to December 2013 consistent with the treatment approved in Docket No. 09-414.[235] This adjustment reflects the forecasted reliability plant closings added to Plant in Service for the three months following the Company's rebuttal testimony, adjusted to reflect any retirements to plant associated with this period, and properly synchronizes the value that customers will realize during the rate effective period to the amount included in rates. This adjustment was detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ-R)-7, and resulted in a $247,373 decrease to test period earnings and an increase to test period rate base of $18,355,521.

For the same reasons as stated above for Adjustment No. 26a, the Commission should also permit the similar adjustment for reliability projects placed into service between September and December 2013. The costs are reasonably known and measurable.[236] Notably, the Company updated its forecasted reliability plant closings in its rebuttal testimony. As identified in Schedule (JCZ-R)-7, the Company's updated forecasted reliability closings for the four month period were $20.570 million, reflecting the removal of approximately $10 million dollars from its initial 2013 forecasted total.[237] Further, there is no concern regarding intergenerational inequity because the plant being placed into service will enhance reliability for the same

[235] Exh. 5: Ziminsky Rebuttal at 55:17-19 and 56:8-12.
[236] *Id.* at 56:5.
[237] The Company's initial 2013 forecasted total was $74.957M, and its actual closings through August 2013 were $44.694M.

customers who will pay the rates established in this case.

The only difference between Adjustment No. 26b and Adjustment No. 26a is that Adjustment No. 26b extends an additional four months beyond the end of the test period using forecasted costs. These costs are representative of the Company's costs during the rate effective period and their inclusion will make the rate approved in this case more reflective of such effective period. As identified before, the Commission's regulations and rulings allow for post-test period adjustments up until the filing of rebuttal testimony. Since that time requirement is satisfied here, and it is otherwise equitable to include these costs in rates, the Commission should approve the proposed adjustment.

3. The Company is Entitled to Recovery of its Integrated Resource Plan Deferred Costs and RFP Deferred Costs (Company Adjustment Nos. 15 & 16) Consistent with Commission Precedent and Delaware Law.

The Company proposed to amortize the initial IRP costs and RFP (also known as Bluewater Wind RFP) process costs incurred beginning in August 2009, consistent with the treatment given in Docket No. 09-414 for these costs that were incurred by or before July 2009.[238] The treatment of the initial IRP costs and RFP costs was uncontested in Docket No. 09-414.[239] The costs are proposed to be amortized over a multi-year period with unamortized balance included in rate base.[240] These adjustments were detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ)-14 and (JCZ)-15, and resulted in a cumulative $9,078 decrease to test period earnings and an increase to test period rate base of $86,238.

DPA Witness Crane opposed these adjustments on the basis that the magnitude of the costs are "small," and "the fact that the Company was not authorized to continue deferring" its

[238] Exh. 5: Ziminsky Direct at 16:10-13, 16:1 and 17:1-7.
[239] *See* PSC Order No. 8011 at ¶ 32.
[240] Exh. 5: Ziminsky Direct at 16:19-20 and 17:7-8

IRP-related costs.[241] Staff Witness Peterson did not contest these adjustments.

First, DPA Witness Crane's opposition to any adjustment, including Adjustment Nos. 15 and 16, based on its magnitude is an inherently subjective determination and, correspondingly, inherently arbitrary. Notwithstanding her discussion of the general principles she utilizes in analyzing deferred costs, DPA Witness Crane offers no standard, either within the industry or as applied by herself, as to evaluation of the magnitude of an adjustment.[242] Therefore, this basis for opposition to an adjustment should be given no weight.

Second, given the statutory requirement for Delmarva to recover its IRP costs and the prior precedent in Docket No. 09-414 with respect to these types of costs, Adjustment Nos. 15 and 16 should be approved. EURCSA sets forth that: "The costs that DP&L incurs in developing and submitting its IRPs ***shall*** be included and recovered in DP&L's distribution rates."[243] The initial IRP and RFP costs incurred by Delmarva were not included in its distribution rates, and thus in Docket No. 09-414 the parties agreed to an uncontested adjustment for such costs incurred through July 2009. Indeed, while the Company initially requested a three year amortization period for these costs, on rebuttal it agreed to a recommendation to amortize costs over a multi-year period with the unamortized balance of the costs included in rate base.

Furthermore, Order No. 7003, as cited to by DPA Witness Crane does not require the rejection of these adjustments. As outlined by DPA Witness Crane, Order No. 7003 provides that the initial costs incurred by Delmarva "in developing and submitting its IRP under the Act shall be included and recoverable in its next distribution rate case," and that in subsequent cases "such costs shall be normalized as an expense in accordance with Commission practice."[244]

[241] Exh. 13: Crane Direct at 22:5-7.
[242] *See id.* at 19-20.
[243] 26 *Del. C.* § 1007(c)(1)(d)(emphasis added).
[244] *See In the Matter of Integrated Resource Planning for the Provision of Standard Offer Supply Service by*

While it may have been anticipated that the Company would recover all of its initial IRP costs within one distribution rate case, nothing in Order No. 7003 precludes recovery of such initial costs in two cases. Such a reading would be contrary to the language of 26 *Del. C.* § 1007(c)(1)(d) which expressly provides that all IRP costs will be recovered by Delmarva through distribution rates, which cannot happen if this adjustment is rejected.

For these reasons, the Commission should approve the proposed adjustments.

4. The Company is Entitled to Recovery of its Dynamic Pricing Regulatory Asset (Adjustment Nos. 20a and b) Consistent with Commission Precedent and Delaware Law.

The Company proposed to amortize and begin recovering the costs related to its dynamic pricing program which were deferred to a regulatory asset based on Order No. 7420.[245] This program enables the Company's customers to take greater control of their electricity usage by providing a simple automated method by which customers can reduce consumption during certain peak periods and receive bill credits for doing so.[246] Dynamic pricing was offered to test participants in the summer of 2012 and rolled-out to all of the Company's Standard Offer Service residential customers in the summer of 2013.[247] The Company spilt this adjustment into two parts so that the first adjustment (No. 20a) relates to the actual regulatory asset costs incurred through August 2013, and the second adjustment (No. 20b) relates to forecasted regulatory asset costs from September 2013 through October 2013.[248] The Company proposes a 15-year amortization period with the unamortized balance receiving rate base treatment, and deferral of costs into the regulatory asset will stop if the Company's adjustments related to this

---

Delmarva Power & Light Company Under 26 Del. C. § 1007(c): Review and Approval of the Request for Proposals for the Construction of New Generation Resources Under 26 Del. C. § 1007(d) (Opened July 25, 2006): PSC Docket No. 06-241, Order No. 7003 at 5-6 ¶ 7 (August 8, 2006).

[245] Exh. 5: Ziminsky Direct at 23:16-21.

[246] *Id.* at 23:12-14.

[247] Exh. 20: Ziminsky Rebuttal at 41:17-20.

[248] *Id.* at 42:2-5

program are accepted.[249] These adjustments were detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ-R)-4, and resulted in a cumulative $232,260 decrease to test period earnings and an increase to test period rate base of $3,367,773.

DPA Witness Crane recommended that the Company's rate base adjustment for dynamic pricing deferred costs be limited to actual costs through the end of the test year, and that additional costs deferred through 2013 be evaluated once implementation of the program is complete.[250] This recommendation does not recognize certain test year costs that were reclassified to the regulatory asset in January 2013. DPA Witness Crane also recommended that the Company continue to defer dynamic pricing program costs until the effective date of new rates from this proceeding, and any deferral would end then with a normalized level of program costs included in the prospective rate.[251]

Staff Witness Peterson recommended that Delmarva continue to defer all costs associated with the dynamic pricing program until its next base rate proceeding following full deployment of the program.[252]

In Docket No. 09-414, the Company proposed to amortize incremental AMI-related expenses incurred outside of the test period and before the meters were fully deployed and in-service, and Staff, DPA and the Company ultimately agreed to an amortization plan which was approved by the Commission.[253] In approving the amortization plan, the Commission recognized that there was no disagreement as to the amount of the regulatory asset recorded by Delmarva or that the costs related to meters or other assets that were not used and useful.[254]

In this proceeding, the amounts set forth in Adjustment Nos. 20a and 20b reflect the

---

[249] *Id.* at 42:5-8 and 43:1-4.
[250] Exh. 13: Crane Direct at 25:7-11.
[251] *Id.* at 25:11-17.
[252] Exh. 11: Peterson Direct at 32:5-7.
[253] *See* PSC Order No. 8011 at ¶¶ 208-211.
[254] *Id.* at ¶ 211.

actual and forecasted costs placed into the dynamic pricing regulatory asset during the respective time periods and are consistent with the Commission's regulations.[255] Moreover, the costs reflected in the asset are for a used and useful program. The dynamic pricing program has now been rolled out to all of the Company's residential customers, and those customers that have taken advantage of the program have already received both energy savings and bill credit benefits. Similarly, customers that take advantage of the program will receive benefits during the rate effective period and beyond.

The recommendation of DPA Witness Crane is also improper because it does not reflect the significant reclassification in January 2013 of certain costs from the Company's AMI regulatory asset to the dynamic pricing regulatory asset. As recognized by DPA Witness Crane, this reclassification was done in conjunction with a review by Staff.[256] The reclassified costs include costs incurred by the Company prior to 2013, and should be included in the Company's rate determination.

Therefore, the Company should begin recovery of its costs related to the dynamic pricing program and these adjustments should be approved.

5. The Company is Entitled to Recovery of its Direct Load Control Regulatory Asset (Adjustment Nos. 23a and b) Consistent with Commission Precedent and Delaware Law .

The Company proposed to amortize and begin recovering the costs related to its residential air conditioning cycling program which were deferred to a regulatory asset based on Order No. 8253.[257] The Direct Load Control program involves the installation at participating customers' residences of a Direct Load Control switch and thermostat.[258] Implementation of the

[255] 26 *Del. Admin. Code* 1002, Part A § 1.3.1.
[256] Exh. 13: Crane Direct at 24:10-13.
[257] Exh. 5: Ziminsky Direct at 25:14-20.
[258] *Id.* at 25:6-8.

program started in late 2012 and will continue through 2016.[259] As of August 31, 2013, there had been 7,490 unit installations of the projected 51,600, and another 12,110 were forecasted to be installed by the end of 2013.[260] The Company spilt this adjustment into two parts so that the first adjustment (No. 23a) relates to the actual regulatory asset costs incurred through August 2013, and the second adjustment (No. 23b) relates to forecasted regulatory asset costs from September 2013 through December 2013.[261] The Company proposes a 15-year amortization period with the unamortized balance receiving rate base treatment.[262] These adjustments were detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ-R)-5, and resulted in a cumulative $391,496 decrease to test period earnings and an increase to test period rate base of $5,676,693.

DPA Witness Crane recommended that all deferred Direct Load Control program costs be excluded from rate base and that the Company should continue to defer such costs.[263] She stated that "the parties should review these costs, either in the Company's next base rate case or in some other proceeding, to determine how much, if any, of these costs should be recovered from ratepayers and whether the Company should recover carrying costs on any deferral approved for recovery."[264] Staff Witness Peterson similarly recommended that Delmarva continue to defer all costs associated with the Direct Load Control program.[265]

For the reasons set forth above with respect to Adjustment Nos. 20a and b, the Commission should approve these adjustments. While the full program has not been implemented, customers have already had the Direct Load Control devices installed at their

[259] *Id.* at 25:5-6
[260] Exh. 20: Ziminsky Rebuttal at 49:22 and 50:14-18.
[261] *Id.* at 49:12-16
[262] *Id.* at 50:1-3.
[263] Exh. 13: Crane Direct at 27:6-8.
[264] *Id.* at 27:8-11.
[265] Exh. 11: Peterson Direct at 32:5-7.

residence and are receiving benefits. The proposed adjustments achieve the matching purpose of allowing recovery of actual incurred costs to accompany benefits received by customers, making the rates from this proceeding reflective of the effective rate period. Furthermore, the recommendation of DPA Witness Crane that the Company's Direct Load Control program costs continue to be deferred is contrary to her recommendation with respect to Adjustment No. 20 that actual test year costs be included. Continuing to defer costs is not beneficial to customers, and creates regulatory uncertainty for a program that the Commission approved. Accordingly, the Company proposes that it be permitted to recover the costs of this program.

6. The Company's Proposed Adjustment to Recover Amortized Medicare Subsidy Deferred Costs (Adjustment No. 29) is Not Retroactive Ratemaking and Should be Approved by the Commission.

The Company proposed an adjustment to recover taxes related to a change in law regarding Medicare Part D in March 2010.[266] The change of law resulted in a deferred tax charge to the Company's Federal income tax expense, and the charge to tax expense was deferred in the financial records of the Company.[267] This adjustment was detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ)-28, and resulted in a $21,860 decrease to test period earnings and an increase to test period rate base of $54,560.

DPA Witness Crane opposed this adjustment because Delmarva did not request or receive the Commission's authorization to defer these costs when the liability for the charge became known and permitting recovery would constitute retroactive ratemaking.[268] Staff Witness Peterson did not contest this adjustment.

This adjustment stems from a change in law that was outside of the Company's control and for which it incurred a one-time charge. The Company is not attempting to, and has not

[266] Exh. 5: Ziminsky Direct at 29:6-8.
[267] *Id.* at 29:8-12.
[268] Exh. 13: Crane Direct at 28:5-9.

proposed, to correct or revise its previously approved rate and then apply that change to customers of the past period. If that was what the Company was attempting to do, it would constitute retroactive ratemaking. Delmarva did not do that, however. To account for the charge, the Company used the accrual method of accounting as it does for other cost of service items.[269] Accordingly, the Commission should approve this adjustment.

7. **The Company's Proposed Adjustment to Recover Credit Facility Costs (Company Adjustment No. 31) is Consistent with Commission Precedent and Delaware Law.**

The Company proposed an adjustment to recover its costs related to the PHI credit facility, consistent with the ratemaking treatment approved in Docket No. 09-414.[270] In August 2011, PHI renewed the credit facility for a five year term, and there are annual period costs associated with setting up and maintaining the credit facility, which are not tied to the amount of borrowings made using the facility.[271] The costs for the credit facility are not reflected in the cost of capital for ratemaking purposes and would not otherwise be recovered without this adjustment.[272] This adjustment was detailed in Company Witness Ziminsky's Direct Testimony and Company Witness Boyle's Rebuttal Testimony, at Schedule (JCZ)-30, and resulted in a $200,057 decrease to test period earnings and an increase to test period rate base of $520,111.

DPA Witness Crane recommended that credit facility costs be eliminated from the Company's revenue requirement, and asserts that if the Commission permits recovery of such cost then the Company's capital structure should be amended to reflect the inclusion of short-term debt.[273]

Staff Witness Peterson asserts that the proper treatment of the Company's credit facility

[269] Exh. 20: Ziminsky Rebuttal at 57:21-22.
[270] Exh. 5: Ziminsky Direct at 30:4-5.
[271] Exh. 17: Boyle Rebuttal at 7:3-5 and Exh. 5; Ziminsky Direct at 30:7-10
[272] Exh. 5: Ziminsky Direct at 30:7-10
[273] Exh. 13: Crane Direct at 29:8-9, 30:20-21 and 31:1

costs is to recognize them as an increase in the effective cost of short-term debt in the calculation of the Company's AFUDC rate.[274] He recommends that the credit facility adjustment be reversed.[275]

The credit facility allows the Company to borrow in the commercial paper market and is a primary source of short-term liquidity for the Company. It is not a substitute for short-term debt or the Company's cash working capital and is not encompassed within either of them. As explained by Company Witness Boyle, Delmarva uses short-term debt to temporarily fund its construction program and fluctuations in its working capital requirements.[276] The credit facility is required by underwriters to support the Company's commercial paper program, which allows the Company to issue short-term debt at a cost lower than borrowing on that facility.[277] Moreover, the credit facility provides vital liquidity for Delmarva that is a key consideration in rating agencies' assessment of the Company's long-term credit rating.[278] As noted earlier, if the Company were to eliminate the credit facility, the long-term credit rating of the Company would change, possibly even below investment grade.[279]

Staff Witness Peterson is incorrect in his assertion that credit facility costs should be included in the calculation of the Company's AFUDC rate. AFUDC capitalizes incremental financing costs incurred to fund capital construction projects.[280] The Company's credit facility costs are not incremental costs, but rather period costs that are incurred even if no funds are borrowed.[281] Accordingly, the costs should be recovered through cost of service, not the Company's AFUDC rate.

---

[274] Exh. 11: Peterson Direct at 34:5-7.
[275] *Id.* at 34:9-11.
[276] Exh. 17: Boyle Rebuttal at 7:21-22.
[277] *Id.* at 8:3-6.
[278] *Id.* at 8:7-9.
[279] Tr. at 221:7-19 (Boyle Cross).
[280] Exh. 17: Boyle Rebuttal at 7:10-11.
[281] *Id.* at 7:11-13.

It is also inappropriate to have the recovery of the Company's credit facility costs contingent upon including short-term debt as suggested by DPA Witness Crane. The Company relies on a combination of long-term debt and equity to permanently finance its distribution assets, and would be required to maintain a credit facility regardless of whether it issued short-term debt.[282] Consequently, DPA Witness Crane's proposed adjustment seeking to remove the costs of the credit facility is inappropriate and should be denied.

Similar objections to the ones raised in this proceeding were raised against the Company's adjustment relating to its credit facility costs in Docket No. 09-414 and the Commission approved the inclusion of such costs in the cost of service.[283] The Company's proposal to include credit facility costs is consistent with Commission precedent and should be approved.

8. <u>The Company's Proposed Adjustment for Cash Working Capital (Adjustment No. 34) is Supported by its Lead/Lag Study and Should be Approved by the Commission.</u>

The Company proposed an adjustment to recover the change in cash working capital associated with certain adjustments.[284] Without this adjustment, the Company's cash working capital in rate base would only reflect the amount related to the per books balances.[285] This adjustment was detailed in Company Witness Ziminsky's Rebuttal Testimony, at Schedule (JCZ-R)-10, and resulted in a $69,472 decrease to test period rate base.

Staff Witness Peterson recognized that cash working capital allowance should be included in rate base to compensate investors for investor-supplied funds, and that a lead/lag study was the proper methodology to determine such amount.[286] He disagreed, however, with

[282] *Id.* at 9:4-8.
[283] *See* PSC Order No. 8011 at ¶¶ 69-75.
[284] Exh. 5: Ziminsky Direct at 31:1-2.
[285] Exh. 20: Ziminsky Rebuttal at 58:11-12.
[286] Exh. 11: Peterson Direct at 16:8-10.

expense lead days the Company assigned to O&M expenses, and specifically the lead days assigned to Service Company billings.[287] Staff Witness Peterson asserts that "contrary to how payments to the Service Company are reflected in the Company's lead-lag analysis (i.e., paid twice each month for current month billings), Delmarva's payments to the Service Company are made around the 15th business day in the month following the billing month."[288] Rather than the 14.43-day expense lead time assigned to Service Company billings by the Company, Staff Witness Peterson calculates a 35.2 day expense lead.[289]

DPA Witness Crane similarly recommended an adjustment to the time used by the Company in its lead/lag study for payments to affiliated companies, including the Service Company.[290] DPA Witness Crane calculated a revised expense lag associated with affiliated transactions of 30.21 days.

The recommendations of Staff Witness Peterson and DPA Witness Crane to revise the affiliated transactions expense lead/lag are incorrect. As recognized by Company Witness Ziminsky, if Delmarva prepared a lead/lag study on PHI specific transactions, then these recommendations may have some merit.[291] However, the lead/lag study used in this proceeding is representative of transactions as reflected on Delmarva's books and records, and thus the 14.43 day lag for Affiliate's Transactions was based on the timing of these types of expenses being recorded on Delmarva's books.[292] To apply the Intercompany Money Pool Balance settlement frequency as used by Staff Witness Peterson and DPA Witness Crane would be improper, and would require for the entire lead/lag study to be repeated to take into account other information. Neither Staff Witness Peterson nor DPA Witness Crane performed such analysis, and importing

[287] *Id.* at 17:2-4.
[288] *Id.* at 17:25-25 and 18:1-2.
[289] *Id.* at 18:12-23.
[290] Exh. 13: Crane Direct at 12:17-18.
[291] Exh. 20: Ziminsky Rebuttal at 60:1-2.
[292] *Id.* at 60:2-5.

only one identified off-the-book frequency into the performed lead/lag study is arbitrary. Accordingly, their recommendations with respect to the Company's lead/lag study should not be adopted by the Commission.

9. **<u>Staff and DPA's Objections to the Company's Adjustment for Construction Work in Progress (CWIP) are Without Merit, and the Commission Should Approve the Inclusion of CWIP in Rate Base in this Proceeding.</u>**

The Company's distribution projects are made up of thousands of work requests, the majority of which are characterized as having short construction durations and, on a per unit basis, a low cost when compared to major plant additions such as a substation.[293] Furthermore, the Company follows FERC guidelines for accruing AFUDC, and therefore many of the distribution projects do not exceed the minimum threshold for accruing AFUDC and those that do only accrue for a few months.[294] Accordingly, the Company included CWIP in its rate base in the Application and requests that the Commission exercise its discretion to allow CWIP in this proceeding. Such treatment is proper in this docket on the ground that the Company's CWIP balance, as of December 31, 2012, was the cost for distribution projects, which were either: (i) in service at the time, only not closed to the Company's books, or (ii) would be in service very soon.[295]

Staff Witness Peterson opposes the inclusion of CWIP, stating his primary objection as "that the construction projects in question were not used and useful during the test period."[296] Notably, he makes the same assertion for Adjustment 26. Staff Witness Peterson also asserts that Delmarva is "appropriately compensated for construction period financing costs when it capitalizes AFUDC," and suggests that the Company "change its AFUDC capitalization policies

[293] Exh. 5: Ziminsky Direct at 31:19-23.
[294] *Id.* at 31:23 and 32:1-4; Tr. at 625:19-626:11 (Ziminsky Cross).
[295] *Id.* at 32:8-11.
[296] Exh. 11: Peterson Direct at 13:12-18.

so that it actually capitalizes AFUDC on all projects."[297]

DPA Witness Crane opposes the inclusion of CWIP on several grounds, stating that it is not an appropriate rate base element.[298] DPA Witness Crane suggests that the Company should accrue AFUDC on projects until they are completed and put into service, and that the Company "is compensated in this manner."[299]

These arguments of Staff and DPA with respect to CWIP place form over substance, and lead to customer rates that are not reflective of service provided during the rate period. As the record makes clear, the Company's CWIP, for which no AFUDC is collected, is comprised of short-term projects that close to plant on a daily, weekly or monthly duration. Further, as the record reflects, "[t]he risk that these new distribution projects will not result in new units of property approaches zero."[300] Such projects are known and measurable and will reasonably be in service during the effective period of rates developed during this proceeding. Rates should reflect the cost of assets used to provide service to customers during the effective period.

The assertion that the Company is compensated by AFUDC for its CWIP costs is incorrect. So long as the Company does not accrue AFUDC on these assets, by definition it is not compensated for their carrying costs.[301] Because there is no principled basis for customers to receive service from assets that are used and useful without paying for them, the Company's request to include CWIP in rate base should be approved.

[297] *Id.* at 14:11-12, 15:26 and 16:1.
[298] Exh. 13: Crane Direct at 9:11-15.
[299] *Id.* at 9:19-21.
[300] Exh. 20: Ziminsky Rebuttal at 63:6-7.
[301] *See* FERC Uniform System of Accounts, 18 C.F.R. Part 101, Electric Plant Instructions, Sec. 3(A)(17).

C. CONTESTED EXPENSE ADJUSTMENTS

1. <u>The Company's Proposed Adjustment for Regulatory Expenses (Company Adjustment No. 5) is Supported by the Record and Should be Approved by the Commission.</u>

Consistent with treatment approved in previous dockets, including 05-304, the Company proposed to adjust its regulatory commission expenses in the test period.[302] First, the Company normalized the test period level of expense using a three-year average.[303] Second, the Company adjusted the test period level of expense to reflect the estimated cost of this proceeding, including the cost of Staff, amortized over a three-year period.[304] This adjustment was detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ)-4, and resulted in an $85,345 decrease to test period earnings.

Neither DPA nor Staff contested the Company's proposal to normalize regulatory Commission expenses. Staff Witness Peterson asserted, however, that the Company's estimate of the costs associated with this proceeding does not represent a known cost, and recommended that a normalized rate case expense over the Company's last three rate proceedings be used.[305] DPA Witness Crane asserted that the Company's estimate of the costs associated with this proceeding were "excessive," and similarly recommended that the Commission use an average cost of the Company's last three rate proceedings.[306]

"[T]he Commission is required to allow a utility normally accepted operating expenses in the absence of a finding of waste, inefficiency or bad faith."[307] It is undisputed that expenses incurred in the process of a rate case are "normally accepted operating expenses." The

[302] Exh. 5: Ziminsky Direct at 11:21-22.
[303] *Id.* at 11:22-23.
[304] *Id.* at 12:1-2.
[305] Exh. 11: Peterson Direct at 28:23-24 and 29:12-15.
[306] Exh. 13: Crane Direct at 48:8-13.
[307] *Delmarva Power & Light Co.*, 508 A.2d at 859; *see also Application of Wilmington Suburban Water Corp.*, 203 A.2d at 836.

Company's prior practice has been to estimate its costs associated with a rate proceeding as the basis for its regulatory expense adjustment in the given proceeding and revise the estimate as appropriate based upon Staff or DPA issues. The Company followed this practice in this proceeding, yet both experts for Staff and DPA have arrived at the same recommendation that an average cost of the Company's last three rate proceedings should be used. Such a policy switch is misguided and unwarranted.

The averages proposed by Staff and DPA have 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. Staff Witness Peterson himself recognized "how variable and unpredictable rate case expenses can be."[308] Taking an average of three cases is arbitrary and unsupported, and the appropriate level of rate case expenses that should be allowed to be recovered is that which the Company expects to incur in the present case, subject to examination by the other parties.

Because neither Staff nor DPA alleged or offered any credible evidence that the Company's expenses for this proceeding were made in bad faith, were wasteful, or were inefficient, the Commission should permit the Company to recover the estimated costs in its rate case expense adjustment. Further, the Commission should approve including the unamortized balance of regulatory commission expense in rate base as these are required and necessary costs for the Company for which the Company has advanced money in its normal course of business.[309]

For these reasons, the Company should be permitted to recover the costs of this rate case through a three-year amortization period.

---

308 Exh. 11: Peterson Direct at 29:10.
309 Exh. 20: Ziminsky Rebuttal at 19:11-22.

2. The Company's Proposed Wage and FICA Adjustment (Company Adjustment No. 8) Is Consistent with Commission Precedent and Delaware Law.

Consistent with the Commission's treatment of Wage and FICA expense in Docket Nos. 94-22, 03-127, 05-304 and 09-414, the Company proposed an adjustment to its test period wage and FICA levels of expense for known price changes required to be made to be reflective of the rate effective period.[310] The wage increases were applied to the Company's test period salaries and wages to be reflective of a rate effective period between November 2013 and October 2014, and included actual known wage increases effective in 2012, 2013 and 2014 and an estimated wage increase in March 2014.[311] The recovery of such costs would ensure that the rates set by this Commission reflect "as closely as is practical, the conditions that will exist during the first year the new rates are in effect." The wage increases included by the Company "are all reasonably known and measurable as they are contractually obligated or reasonably predicted based on history." This adjustment was detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ-R)-2, and resulted in a $1,173,236 decrease to test period earnings.

Staff Witness Peterson updated the Company's adjustment to reflect known payroll rate changes at the time of the filing of his testimony versus earlier estimates, and eliminated "speculative payroll rate changes" that were included in the Company's adjustment, including the estimated March 2014 wage increase.[312]

DPA Witness Crane recommended that only test year salary and wage increases be included in the Company's revenue requirement, and that these increases be annualized to reflect

---

[310] Exh. 5: Ziminsky Direct at 12:20-22.
[311] Exh. 20: Ziminsky Rebuttal at 21:1-23.
[312] Exh. 11: Peterson Direct at 24:11-13.

the Company's costs for a full year.[313] She asserted that most of the salary and wage increases in the adjustment reached "too far beyond" the end of the test year.[314]

Both Staff and DPA have offered recommendations that are contrary to Delaware law and plainly inconsistent with this Commission's past decisions, including its most recent decision with respect to the Wage and FICA adjustment proposed by the Company in Docket No. 09-414. They have done so without recommending any policy reason for a change or evidence in support of their positions, and their recommendations should carry no weight. The Delaware Superior Court has explicitly held that the Commission may not arbitrarily refuse to consider accurate post-test period information in setting utility rates.[315] Yet, by proposing a bright-line rule (DPA Witness Crane) or simply opposing an adjustment as "speculative" because of its timing (Staff Witness Peterson), that is exactly what Staff and DPA have asked the Hearing Examiner and Commission to do.

In Docket No. 05-304, the Company proposed eight separate out-of-period wage adjustments, the last of which was for a wage increase over two years after the end of the historic test period used by the Company. The hearing examiner recommended the inclusion of all of the Company's proposed wage adjustments, agreeing that the adjustments were "reasonably known and measurable," noting that five of the increases were encompassed in existing contracts and one had already taken effect.[316] Adopting the hearing examiner's finding and recommendation, the Commission recognized that these adjustments reach outside the test period, but nevertheless included such costs because "several of the adjustments relate to contractually-required wage and

[313] Exh. 13: Crane Direct at 32:19-21 and 33:1.
[314] *Id.* at 33:3-6.
[315] *See Delmarva Power & Light Co.*, 337 A.2d at 518.
[316] PSC Order No. 6930 at ¶ 110.

salary increases that the Company is not free to ignore and which are known and measurable."[317]

In Docket No. 09-414, the Commission again spoke as to adjustments for wage increases outside of the time period and whether they are known and measurable. The Commission, once again, allowed for post-test period wage and salary increases to be reflected in cost of service, stating:

> 106. **Discussion.** We are sympathetic to the position that several of the increases take place far outside the selected test period. However, this seems to be one of those adjustments that the *Delmarva Power* decision would require us to consider in determining the cost of service. The wage increases at issue here are reasonably known and measurable, and their inclusion in the cost of service is more representative of the period during which rates set here will be in effect. The June 2009 wage increase took effect shortly after the close of the test period, and the March 1, 2010 increase took effect during the course of this case. And while we are not considering the fact that Delmarva reached new collective bargaining agreements with its unions since it is not part of the record, we do observe that in prior cases union contracts have included annual wage increases. *See Delmarva Power*, Docket No. 05-304. Thus, we reject the Hearing Examiner's recommendation, and approve Delmarva's request to include all of these wage increases in its cost of service. (Unanimous).[318]

Following these previous decisions, the Commission should reject the arbitrary recommendations offered by Staff Witness Peterson and DPA Witness Crane and approve the Company's post-test period known and measurable wage and FICA increases.

3. <u>The Company's Proposed Adjustment for an Increase in Employee Benefit Expenses (Company Adjustment No. 10) Is Consistent with Commission Precedent and Delaware Law.</u>

Consistent with the Commission's treatment of employee benefit expenses in Docket No. 09-414, the Company proposed an adjustment to recognize increases in employee medical,

[317] *Id.* at ¶ 112.
[318] PSC Order No. 8011 at ¶ 106.

vision and dental expenses expected in the rate effective period.[319] The expenses were forecasted by the Company's expert benefits consultant, analyzing benefit cost trends in the Mid-Atlantic region.[320] This adjustment was detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ)-9 and (JCZ-R)-3(most recent study), and resulted in a $318,199 decrease to test period earnings.

Staff Witness Peterson asserted that the Company's proposed adjustments are not based on known cost changes as knowing only the general trend in healthcare costs does not provide enough information to qualify the adjustments as known changes.[321] He asserts that the adjustments are "speculative."[322]

DPA Witness Crane recommended that the Commission reject the medical benefit adjustment because it is not based "on data that is specific to DPL's medical benefits program or to DPL's employees."[323] She too asserts that "[t]he use of general cost trends does not rise to the level of a known and measurable change."[324]

Despite these objections, the Commission should permit the proposed adjustment since the costs are reasonably known and measurable. In order for the Company to determine the level of cost increase which must be factored in to provide benefits, the Company consults with its benefits expert, which performs a quarterly survey of six major healthcare benefit providers in the Mid-Atlantic region, and asks for the trends that those providers are using to project cost claim changes for the upcoming year.[325] The Company uses its business judgment, as well as industry data provided by its expert, to estimate the increase in benefit costs over the rate

[319] Exh. 5: Ziminsky Direct at 14: 5-7.
[320] *Id.* at 14:8-9.
[321] Exh. 11: Peterson Direct at 27:25-28 and 28:1-5.
[322] *Id.* at 28:6.
[323] Exh. 13: Crane Direct at 41:21 and 42:1-2.
[324] *Id.* at 41:15-16.
[325] Exh. 20: Ziminsky Rebuttal at 29:16-20.

effective period.[326] Thus, the Company's proposed increases are reasonably known and measurable, supported by industry data, and are the best representative of the increased costs the Company will likely incur over the rate effective period.[327] In addition, the Company has chosen to incorporate increases below the surveyed average in its Company forecasts and revenue requirement.[328]

In Docket No. 09-414, Delmarva included a similar adjustment that was based on a study prepared by the same benefits expert, Lake Consulting. In that case, the Commission adhered to its practice of adjusting test period cost levels to reflect future out of period changes. In Docket No. 09-414, the Commission held:

> The proposed increase for medical, dental and vision expense is reasonably known and measurable and more accurately reflects the costs that Delmarva will incur in the future to provide these benefits. We are bound by Delaware law requiring that rates be just and reasonable not only at the time we are setting them, but for some period thereafter (within reason, of course). Thus, we approve the adjustment to increase medical, dental and vision expense. (Unanimous)[329].

As the Delaware Superior Court held in *In re Delmarva Power & Light Co.*:

> [r]ate fixing is prospective: the rates should be just and reasonable in the foreseeable future as well as the present. Use of a test year for particular study is accepted practice. . . . While the Commission has discretion in setting the test year, this does not mean that it may arbitrarily refuse to consider later available accurate information. . . .Later information is especially important as a check on the continuing validity of the test year, experience in a period of rapid change like the present.[330]

The Commission should follow its prior precedent and not give weight to the unsupported recommendations of consultants for DPA and Staff, which do not acknowledge

---

[326] *Id.* at 30:15-18.
[327] *Id.* at 30:18-20.
[328] *Id.* at 30:20-22
[329] PSC Order No. 8011 at ¶ 113.
[330] *See In re Delmarva Power & Light Co.*, 337 A.2d at 518.

established precedent. The Company's calculated increase in employee benefit expenses is known and measurable and, therefore, should be approved.

4. **<u>The Company's Proposed Adjustment for IRP Recurring Costs (Company Adjustment No. 14) is Supported by the Record and Should be Approved by the Commission.</u>**

Consistent with the uncontested treatment of recurring IRP costs in Docket No. 09-414, the Company proposed an adjustment to normalize such costs in this proceeding.[331] Under EURCSA and implementing regulations, the IRP process is done on a two-year cycle and the Company is required to submit an IRP to the Commission bi-annually.[332] The costs within the cycle are not ratably incurred each year, and the Company proposed an annualized amount based upon its projected bi-annual expenses.[333] The proposed annualized amount is less than those amounts requested by the Company in its last two proceedings.[334] This adjustment was detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ)-13, and resulted in a $342,371 decrease to test period earnings.

Staff Witness Peterson stated that an allowance in rates is necessary to reflect the recurring IRP costs, but asserted that the Company's estimate to prepare the IRP is speculative as are even the tasks that will be undertaken in the next IRP.[335] Accordingly, he did not agree with the proposed adjustment and instead proposed to normalize Delmarva's actual IRP expenses over the last seven years using the Company's actual average annual expense.[336]

DPA Witness Crane also asserted that the Company's projected IRP expenses were

---

[331] Exh. 5: Ziminsky Direct at 16:3-4.
[332] *See* 26 *Del. C.* § 1007(c)(1).
[333] Exh. 5: Ziminsky Direct at 16:4-5 and Footnote 1 of Schedule (JCZ)-13; Exh. 20; and Ziminsky Rebuttal at 34:6-8.
[334] Exh. 20: Ziminsky Rebuttal at 34:10-12.
[335] Exh. 11: Peterson Direct at 30:19-22
[336] *Id.* at 30:23-31:2.

speculative and that the costs could vary greatly.[337] She too recommended that the recurring IRP costs be normalized based on actual past experience over a three-year period (2010-2012).[338]

Similar to the averages proposed by Staff Witness Peterson and DPA Witness Crane with respect to Adjustment No. 5, the three-year average proposed by Staff and DPA has little relationship to the expected level of recurring IRP costs going forward, as each IRP cycle may encompass different issues that may be of varying complexity. Each of the witnesses recognized this potential variability, yet did not proffer any analysis of future recurring IRP costs. As stated by the Company, while the informal IRP Working Group has been very helpful in keeping the IRP focused on relevant issues and meeting the IRP requirements in less expansive ways, including by reaching settlement agreements in the IRP proceedings, there is little reason to believe that the IRP costs will continue to decline.[339] Increased costs may be required for older analyses to be updated to more current conditions or analyses of new issues so that the IRP remains relevant and useful.[340] Moreover, Staff and DPA witnesses appeared to recognize the IRP is a two-year cycle, but recommended three-year averages. Taking an average of three years for a two-year cycle is arbitrary and unsupported.

Because neither Staff nor DPA alleged or offered any credible evidence that the Company's proposed recurring IRP expenses were made in bad faith, were wasteful, or were inefficient, the Commission should permit the Company to recover the estimated costs in this adjustment. The Company does recognize that there is an alternative to its proposal by which a normalized amount of costs based on past years IRP costs is included in the revenue requirement and a deferral for costs above that average amount is established and is agreeable to such an

[337] Exh. 13: Crane Direct at 43:5-10.
[338] *Id.* at 43:11-12 and 44:2-4.
[339] Exh. 20: Ziminsky Rebuttal at 34:14-22 and 35:1-7.
[340] *Id.* at 35:7-10.

alternative as set forth in its rebuttal testimony.[341]

5. **<u>The Company's Proposed Adjustments to Recover Dynamic Pricing O&M and Amortization Expenses (Adjustment Nos. 21 & 22) are Supported by the Record and Should be Approved by the Commission.</u>**

With the full roll-out of the Dynamic Pricing program in summer 2013, the Company proposed to have its recurring annual Dynamic Pricing-related expenses included in the cost of service as Adjustment No. 21.[342] The Company also proposed to include its incremental Dynamic Pricing amortization expense, which includes the amortization of the dynamic pricing portion of software as well as the dynamic pricing interfaces with the customer information system, as Adjustment No. 22.[343] Otherwise, these costs would be deferred into a regulatory asset and not recovered until some later date.[344] These adjustments were detailed in Company Witness Ziminsky's Direct and Rebuttal Testimony, at Schedule (JCZ)-20 and (JCZ)-21, and resulted in a cumulative $1,178,520 decrease to test period earnings.

Staff Witness Peterson recommended that Delmarva continue to defer all costs associated with the dynamic pricing program until its next base rate proceeding following full deployment of the program.[345] DPA Witness Crane did not contest these adjustments.[346]

The dynamic pricing program has now been rolled out to all of the Company's residential customers, and those customers that have taken advantage of the program have already received bill credit benefits. Similarly, customers that take advantage of the program will receive benefits during the rate effective period and beyond. Therefore, the Company should begin recovery of its costs related to the dynamic pricing program as its normal course of business and these

---

[341] *Id.* at 35:17-36:2.
[342] Exh. 5: Ziminsky Direct at 24:15-18.
[343] *Id.* at 25:4-10.
[344] *Id.* at 24:18-19.
[345] Exh. 11: Peterson Direct at 32:5-7.
[346] Exh. 13: Crane Direct at 46:5-12.

adjustments should be approved.

6. The Company's Proposed Adjustment to Pro Forma OPEB Expense (Company Adjustment No. 35) is Supported by the Record and Should be Approved by the Commission.

In filing its rebuttal testimony, the Company proposed an additional adjustment for the test period level of OPEB expense to reflect an amendment to PHI's retiree medical plans that will be effective January 1, 2014.[347] This adjustment was detailed in Company Witness Ziminsky's Rebuttal Testimony, at Schedule (JCZ-R)-9, and resulted in a $944,306 decrease to test period earnings.

The Company proposed the adjustment of OPEB expenses to more closely reflect the expenses that are expected to be made over the rate effective period. Because the OPEB expenses are sufficiently known and measurable, the adjustment should be permitted, and the costs included in rate base.

7. The Company's Prepaid Pension Asset and OPEB Liability Should be Included in Rate Base Consistent with the Commission's Precedent.

The Company's books and records reflect a Prepaid Pension Asset and an OPEB Liability on the balance sheet.[348] A prepaid pension asset occurs when accumulated contributions and growth in the pension plan exceed the accumulated expenses associated with the pension obligations.[349] In contrast, an OPEB liability reflects the accumulated costs associated with OPEB obligations exceeding the associated contributions and growth of those plan assets.[350] Consistent with the treatment of pension assets and OPEB liabilities in Docket Nos. 05-304 and 09-414, the Company included its prepaid pension asset and OPEB liability in

---

[347] Exh. 20: Ziminsky Rebuttal at 60:20-61:2
[348] *Id.* at 71:10-11.
[349] *Id.* at 71:11-13.
[350] *Id.* at 71:13-15.

RLF1 9713238v.2

its rate base.[351] Staff Witness Peterson did not contest the inclusion of these items in the Company's rate base.

DPA Witness Crane disagrees with the Company's treatment of the prepaid pension asset and recommends that it be excluded from rate base.[352] She contends that as the Company no longer has a negative pension expense included in its revenue requirement, the basis for the inclusion of the pension asset in rate base from the Commission's decision in Docket No. 05-304 is no longer valid.[353] She also asserts that "a review of the derivation of the Company's pension asset shows that the asset is largely unrelated to the amount of contributions made by DPL to the pension fund."[354] DPA Witness Crane also recommended excluding the Company's accrued OPEB liability from rate base on the basis that it is inappropriate if the Commission is using actuarial values in the revenue requirement.[355] She stated generally that, in her opinion, "including rate base adjustments relating to pension and OPEB costs inappropriately combines the accrual methodology used in the actuarial studies, and which this Commission has adopted for ratemaking purposes, with the cash funding approach used by some other regulatory commissions."[356]

In Docket No. 05-304, the Commission authorized the inclusion of a prepaid pension asset in the Company's rate base, concluding.[357]

> However, we believe that the pre-paid pension asset is appropriately included in rate base because it is caused by negative pension expense, which reduces base rates, resulting in rates that are lower than they otherwise might be, and at the same time creates a cash working capital requirement. We also recognize that

[351] *Id.* at 70:3-4.
[352] Exh. 13: Crane Direct at 16:3-6.
[353] *Id.*
[354] *Id.* at 17:4-5.
[355] *Id.* at 16:7-11.
[356] *Id.* at 16:15-19.
[357] PSC Order No. 6930 at ¶ 58.

> the Company has no access to this asset to use for other operating expenses; it is precluded by federal law from using any of the money it has collected for pensions for any other purpose. Thus, for these reasons and the reasons set forth in the Hearing Examiner's findings and recommendations, we adopt the Hearing Examiner's findings and recommendations. (Unanimous)

While the Commission did not define "negative pension expense" in its order, it incorporated the hearing examiner's explanation that "a negative pension expense is created when the pension fund asset exceeds pension fund liabilities, both of which are actuarially determined on the basis of past and present investment returns and future obligations and expected investment returns."[358] The hearing examiner further explained:

> Customers pay reduced rates due to the negative pension expense, but there is no reduced cost to Delmarva except in a booked account that the Company is legally prohibited from accessing. Thus, the decrease in the Company's cash flow increases its need to access capital markets to cover its expenses.[359]

The hearing examiner concluded the Company's proposed rate base adjustment "properly permits the return necessary to reflect these funds supplied by investors."[360]

Similar to the facts presented to the hearing examiner and the Commission in Docket No. 05-304, the Company's books again reflect a prepaid pension asset, funded with investor supplied capital, which is benefitting customers from its existence.[361] As set forth by Company Witness Ziminsky:

> The existence of a Prepaid Pension Asset on the Company's balance sheet indicates that the Company's cash contributions and return in the pension trust exceed the accumulated benefit obligation. This being the case, the pension trust's assets are higher than they otherwise would be, which increases the expected return on assets. The increase in the expected return on assets because of the existence of a Prepaid Pension Asset decreases the Company's

[358] *Id* at ¶ 53.
[359] *Id* at ¶ 54.
[360] *Id.*
[361] Exh. 20: Ziminsky Rebuttal at 71:17-19.

> pension expense, all things being equal. The decrease in the Company's pension expense due to the existence of the Prepaid Pension Asset decreases the Company's cost of service.[362]

Thus, as in Docket No. 05-304, the reduced pension expense "results in base rates lower than they otherwise would be, and concurrently creates a cash working capital requirement. This cash working capital requirement cannot be accessed by DPL because it is legally impermissible to do so."[363]

DPA Witness Crane appears to put great emphasis on the fact that the Company is making contributions to the pension plan at this time, and thus does not have a "negative pension expense" on its revenue requirement. This argument is misplaced. First, as that term is used by the hearing examiner in Docket No. 05-304 and referenced in Order No. 6930, the Company does have a "negative pension expense" as its pension fund asset exceeds its pension fund liabilities. Moreover, the reasons the Commission approved the adjustment in Docket No. 05-304 are present at this time notwithstanding the Company's contributions. The Company's pension expense in cost of service has been reduced by the return on its prepaid pension asset, which the Company has properly funded and has no opportunity to access the funds. This creates a cash working capital requirement for the Company. For these reasons, the Company's prepaid pension asset, as well as OPEB liability, should be included in its rate base

8. <u>The Company Is Entitled to Recover the Cost of its Supplemental Executive Retirement Plan Consistent with the Commission's Precedent and Delaware Law.</u>

The Company included Supplemental Executive Retirement Plan (SERP) expenses in the Company's revenue requirement. As identified by DPA Witness Crane, "these costs relate to supplemental retirement benefits for key executives that are in addition to the normal retirement

---

[362] *Id.* at 72:7-14.
[363] *Id.* at 73:9-11.

programs provided by the Company."[364] As explained by Company Witness Ziminsky:

> It is common practice among companies that offer qualified defined benefit pension plans, such as PHI, to provide executives with a benefit that allows them to compensate for IRS limits which cap the amount of salary that the Company may use in calculating benefits. Because of this cap, executives do not receive equitable pension contributions, relatively speaking, when compared to the typical company employee. The goal behind providing a SERP is to provide executives a way to receive a pension that is similar to the typical employee. The Company's SERP, which is a non-qualified plan, accomplishes this by providing DPL's executives with a benefit that makes up for the contribution differences caused by the IRS salary cap.[365]

Although DPA has agreed in previous proceedings with SERP adjustments, DPA Witness Crane objects to SERP costs being included in utility rates now and recommends that the Company's claim for SERP costs be disallowed.[366] She asserts that the Company's officers "are already well compensated," and that if the Company wants to provide SERP benefits to its officers, then shareholders should fund the excess benefits.[367] Staff Witness Peterson did not contest the inclusion of SERP costs.

The Commission has previously approved the inclusion of SERP expenses in the Company's cost of service, recognizing that the benefits are necessary to attract and retain executive talent and that they are true retirement benefits, which are not tied to the achievement of financial goals.[368] These facts have not changed in this proceeding. SERP benefits are still a common benefit offered to attract and retain executives in the utility industry and thus a reasonable cost to include in test period cost of service.[369] As described by Company Witness Boyle at the evidentiary hearing, SERP benefits are part of "recruiting executives, becomes part

[364] Exh. 13: Crane Direct at 39:11-12.
[365] Exh. 20: Ziminsky Rebuttal at 75:2-10.
[366] Exh. 13: Crane Direct at 40:12-21.
[367] *Id.* at 40:13-20.
[368] PSC Order No. 8011 at ¶ 184.
[369] Exh. 20: Ziminsky Rebuttal at 75:12-13.

of the overall compensation package that is looked at and is part of the overall development of compensation."[370]

DPA Witness Crane asserts general arguments against the SERP expenses based upon the amount of compensation already received by the officers of the Company. She did not offer any specific reasons as to why the cost of SERP should not be included in the Company's expenses, however. She simply drew an arbitrary line excluding those costs, with no claim that the costs are somehow unreasonable, inappropriate, or are wasteful, inefficient or made in bad faith.

The SERP is necessary to allow the Company to promote the long-term retention of executive talent and therefore, should be included in cost of service. The Commission should, consistent with its prior decisions, permit the Company to recover the expenses of its SERP program.

9. <u>The Company Is Entitled to Recover its Cost of Non-Executive Incentive Compensation Consistent with Delaware Law and the Commission Should Approve the Inclusion of the Company's AIP Costs in this Proceeding.</u>

The Company proposed the inclusion of the test period level of non-executive incentive compensation in the Company's cost of service.[371] The Company's annual incentive plans (AIP) are part of employees' total compensation package, and the program helps to focus employees' attention and efforts on achieving the Company's goals, many of which are explicitly related to safety and customers.[372] While the application of the Company's AIP may differ from area to area, or among levels, they have the same framework, including: an employee measure, such as safety; a customer satisfaction component; a reliability measure; and financial components, such as O&M expense control, managing capital expenditures and achieving net income targets,

[370] Tr. at 283:19-22 (Boyle Cross).
[371] Exh. 5: Ziminsky Direct at 34:3-4.
[372] *Id.* at 35:1-6.

which, if achieved, lower the revenue requirements to customers.[373] Company Witness Ziminsky quantified the component allocation of the total non-executive incentive expense included in the test period as follows: $1,196,280 for customer satisfaction, $797,520 for reliability, $199,380 for safety, $99,690 for Affirmative Action and $99,690 for regulatory and compliance.[374]

The Commission disallowed non-executive incentive compensation that was not related to safety in Docket No. 05-304 because it determined that the compensation had "primarily financial triggers," and was not triggered on safety, customer service, or other benefits for ratepayers.[375] This treatment in Docket No. 05-304 was a departure from Commission precedent, which had allowed incentive compensation in the past. In doing so, the Commission concluded that, in balancing the interests of Delmarva and its customers, "only the amount of those payments that Delmarva demonstrated were attributable to the achievement of safety, reliability and customer service goals should be included in its cost of service."[376] In Docket No. 09-414, this Commission again considered whether to allow the Company's non-executive compensation as part of the Company's cost of service, and denied the Company's proposal for lack of evidence as to the amount of compensation attributable to the achievement of safety, reliability and customer service goals.[377]

Both Staff Witness Peterson and DPA Witness Crane removed the Company's non-executive incentive compensation from the Company's cost of service.[378] Both witnesses took exception to the fact that the Company's AIP does not award incentive compensation unless certain financial goals are attained, asserting that this objective benefits shareholders not

---

[373] *Id.* at 35:9-15.
[374] *Id.* at 36:3-6.
[375] PSC Order No. 6930 at ¶ 98.
[376] PSC Order No. 8011 at ¶ 194.
[377] *See id.* at ¶¶ 194, 196.
[378] Exh. 13: Crane Direct at 37:12-14; Exh. 11: Peterson Direct at 27:4-6.

customers.

The Company disagrees with the Staff and DPA recommendations and asks the Commission to reconsider its position on the Company's AIP in this proceeding and allow all non-executive incentive compensation into base rates here. Company Witness Boyle explained in his Rebuttal Testimony and at the evidentiary hearing the importance of non-executive compensation in attracting and keeping skilled employees in the Company, and creating incentives to attain levels of performance benefit customers.[379] He described that, consistent with peer practices, a portion of a Company employee's compensation is "at risk" and earned by achieving performance goals to the benefit of both customers and Delmarva.[380] Company Witness Boyle explained that Delmarva needs to provide compensation plans that are competitive with other choices that skilled employees have, and that he was not aware of a single company in the industry that doesn't offer annual incentive plans.[381] He indicated that the overall compensation package is very important to any individual who is considering joining a company.[382]

Company Witness Boyle also explained that including financial targets in the AIP is not designed to simply increase profits, but also lowers the costs that will be in the Company's cost of service (by both operating expenses and the Company's financial metrics).[383] He explained that Delmarva uses its incentive plan to drive certain performance that it views as focal areas, such as reliability and safety.[384] Company Witness Ziminsky further explained that the financial triggers also serve to "ensure that the incentives, one, can be paid out of earnings and don't

[379] Exh. 17: Boyle Rebuttal at 10:5-7; Tr. at 201:19-24 and 2021-6 (Boyle Cross).
[380] *Id.* at 10:10-23.
[381] Tr. at 201:21-24 and 202:1-6 (Boyle Cross).
[382] *Id.* at 203:3-7.
[383] Exh. 17: Boyle Rebuttal at 11:2-9.
[384] Tr. at 205:21-24, 205:16-23 (Boyle Cross).

jeopardize the Company."[385]

The assertions made by Staff Witness Peterson and DPA Witness Crane that financial goals only benefit shareholders is unsupported.[386] The Company's AIP is carefully designed to make the Company more economically efficient, safe and reliable.[387] The financial metrics included in the Company's AIP related to O&M and capital spending, and these metrics incentivize employees to control spending and seek opportunities to save money in order to meet their budgets.[388] If spending is controlled, customers benefit through lower expenses reflected in the cost of service, and ultimately through lower rates.[389]

The evidence in this proceeding establishes that incentive compensation programs, such as the non-executive program for which Delmarva seeks recovery, are routinely utilized in the utility industry to obtain the best performance from employees. Delmarva's non-executive incentive program is carefully designed to make the Company more economically efficient, safe and reliable, all of which benefits customers. Under Delaware law, the expenses of programs like Delmarva's are recoverable in rates "unless found to have been made in bad faith or out of an abuse of discretion."[390] For these reasons, and as described by Company Witnesses Boyle and Ziminsky, the Commission should approve the inclusion of the Company's non-executive incentive compensation in the Company's cost of service. Furthermore, if the Commission should decide to exclude financial-related portions of the compensation, it should approve the inclusion of non-financial compensation expenses.

---

[385] Tr. at 693:3-8 (Ziminsky Re-direct).
[386] Tr. at 213:12-19 (Boyle Cross).
[387] Exh. 17: Boyle Rebuttal at 11:21-22.
[388] *Id.* at 11:12-15.
[389] *Id.* at 11:15-20.
[390] *Delmarva Power & Light Co.*, 508 A.2d at 859.

10. The Company's Relocation Expenses are Well-Supported in the Record and Should be Approved by the Commission.

Consistent with its treatment of relocation expenses in previous rate proceedings, the Company included such expenses as incurred during the test year.[391] DPA Witness Crane asserted that the test year relocation expenses did not represent a normal, on-going level of expense based upon her review of past such expenses and recommended that the Commission utilize a "normalized" cost, reflecting the highest cost from the previous three years.[392]

DPA Witness Crane's recommendation with respect to relocation expenses should not be adopted by the Commission. The recommendation is not for a normalization of an expense over a chosen time period, but is merely the selection of data from a pre-test year period instead of relying upon the actual test year period for ratemaking. This is improper and not supported by the Commission's regulations or precedent.

11. The Company's Corporate Governance Expenses are Well-Supported in the Record and Should be Approved by the Commission.

The Company included certain corporate governance expenses as incurred during the test year. The Company's corporate governance expenses relate to both the manner in which PHI and Delmarva are directed and controlled as well as social responsibility expenses which directly benefit customers.[393] DPA Witness Crane recommended that costs associated with certain External Affairs activities be disallowed unless the Company demonstrated that such costs have a direct benefit to customers or were removed elsewhere.[394]

In making her adjustment, DPA Witness Crane removes the 2012 expenses associated with Public Relations, Corporate Citizenship Social Responsibility, Strategic Communications, PAC Committee, and Corporate Contributions. The categories noted as Corporate Citizen Social

---

[391] Exh. 20: Ziminsky Rebuttal at 74:6-7.
[392] Exh. 13: Crane Direct at 38:11-18 and 39:1-7.
[393] Exh. 20: Ziminsky Rebuttal at 77:18-20.
[394] Exh. 13: Crane Direct at 52:3-5.

Responsibility, PAC Committee, and Corporate Contributions are all below the line expenses. In other words, these expenses are not charged to customers. DPA Witness Crane agreed at the evidentiary hearing that expense removed to reflect these categories should be restored.[395]

Expenses for Public Relations and Strategic Communications are normal and ordinary business expenses which directly benefit customers and should be included in the Company's cost of service.[396] For example, as described by Company Witness Ziminsky at the evidentiary hearing, the corporate communications group handles all customer education issues, including saving energy and electrical safety.[397] These expenses are clearly incurred to the benefit of customers. There has been no argument that these expenses were incurred in bad faith or out of an abuse of discretion and no such argument could be legitimately made. As such, under Delaware law, these expenses are recoverable in rates.[398]

12. <u>The Company's Proposed Meals and Entertainment Expenses are Well-Supported in the Record and Should be Approved by the Commission.</u>

The Company included expenses incurred during the normal course of business, which includes providing meals to union employees, business meals, meals related to overtime and meals provided for training.[399] DPA Witness Crane assumed that meal and entertainment expenses that are not deductions for federal tax purposes are deemed by the IRS not "to be reasonable business expenses," and recommend that the Commission adopt the use of the IRS 50% criteria as a reasonable balance between shareholders and customers.[400]

With her arbitrary reliance on an IRS regulation, DPA Witness Crane blurs the line between the taxing authority governance of the IRS and its regulations compared to the

---

[395] Tr. at 545:16-546:5 (Crane Direct); *see also* Exh. 99.
[396] Exh. 20: Ziminsky Rebuttal at 77:20-22.
[397] Tr. at 670:8-671:7 (Ziminsky Cross) and 681:18-682:11 (Ziminsky Re-direct)
[398] *See Delmarva Power & Light Co.*, 508 A.2d at 859.
[399] Exh. 20: Ziminsky Rebuttal at 78:18-19.
[400] Exh. 13: Crane Direct at 52:13-20 and 53:10-11.

Commission's oversight of public utilities in the State of Delaware. The inclusion of these expenses in cost of service follows Delaware law and past ratemaking treatment,[401] and the proposed adjustment should be rejected. Operating expenses such as meals to union employees, business meals, meals related to overtime and meals provided for training, are normal operating expenses for which the company is entitled to recovery.[402]

13. <u>The Company's Membership Dues Expenses are Well-Supported in the Record and Should be Approved by the Commission.</u>

Consistent with its treatment of membership due expenses in previous rate proceedings, the Company included its dues, net of reported lobbying expenses, in its test period cost of service.[403] DPA Witness Crane recommended that 20% of the Company's membership dues identified in MFR Exhibit G-3 be disallowed on the basis that such costs constitute lobbying activities or should not otherwise be charged to cost of service.[404] This recommendation was made by DPA Witness Crane on her review of the organizations and on her recommendations in other utility rate proceedings.[405]

The recommendation to remove 20% of the Company's membership dues based on DPA Witness Crane's review of the Company's organization list and her past recommendations in other proceedings is arbitrary and unsupported. There is no analysis provided of how 20% of the dues are inappropriate. Furthermore, DPA Witness Crane is incorrect in her assertion that these costs constitute lobbying efforts as the Company has only included in cost of service the costs that do not constitute lobbying. The inclusion of these expenses in cost of service follows the Company's treatment of membership dues in previous rate proceedings.[406] For these reasons, the

[401] Exh. 20: Ziminsky Rebuttal at 78:23-79:2.
[402] *See Delmarva Power & Light Co.*, 508 A.2d at 859.
[403] Exh. 20: Ziminsky Rebuttal at 79:18-19.
[404] Exh. 13: Crane Direct at 54:17-19.
[405] *Id.* at 54:21 and 55:1.
[406] Exh. 20: Ziminsky Rebuttal at 79:18-20.

Commission should permit these normally accepted operating expenses.[407]

IV. RATE DESIGN/COST OF SERVICE ISSUES

A. CLASS COST OF SERVICE STUDY

The Company's Class Cost of Service Study (CCOSS) in this proceeding allocates or assigns the costs of Delmarva's distribution system to the respective customer classes on the basis of cost causation, the results of which are just and reasonable.[408] Appropriately allocated costs then provide a basis to derive class rate of return results and class revenue targets that serve as an important guide in designing the rates charged to each customer class. This methodology is consistent with the cost of service model filed in PSC Docket No. 11-528, which formed the basis for the rate design in that case.[409]

1. <u>CCOSS Workshop Initiatives</u>

The CCOSS developed for this docket includes certain initiatives undertaken as a result of the CCOSS workshop conducted after the conclusion of Docket No. 09-414 in accordance with the provisions of PSC Order No. 8011.[410] Those initiatives are: (1) use of Delaware specific load survey data to estimate residential non-coincident peak demands; (2) use of weather normalized sales and revenues; (3) updated analysis of system losses (rather than relying upon an analysis performed in 1996); (4) revised service line analysis; and (5) differentiation of the traffic signal service from the street lighting service.[411]

2. <u>Staff and Intervener CCOSS Issues</u>

a. <u>Staff Witness Pavlovic</u>

Staff Witness Pavlovic raised the following three objections to Delmarva's CCOSS: (1)

[407] *See Delmarva Power & Light Co.*, 508 A.2d at 859.
[408] Exh. 8: Tanos Direct at 4:4-5.
[409] Exh. 8: Tanos Direct at 4:3-10 and 7:13-14; Tr. at 915:14-24.
[410] *See* PSC Order No. 8011 at ¶¶ 314-316.
[411] Exh. 8: Tanos Direct at 7:20-8:21.

he criticized the CCOSS demand allocators, asserting that they assume zero diversity; (2) he objected to the use of equal weighting of demand measures for allocation of certain distribution plant and the 50/50 weighting used for other allocators; and (3) he faulted the Company for failing to properly allocate primary and secondary underground and overhead facilities to the classes.[412]

In response to Staff Witness Pavlovic's objections, Company Witness Tanos established that the demand allocators used in the CCOSS reflect a high level of diversity.[413] In particular, the costs of the primary distribution facilities are allocated based on the demands of each customer class that reflect the diversity of the entire customer class,[414] such as the residential classes consisting of 268,602 customers.[415] The class diversified demands are also applied as part of the 50/50 weighted demand measures used to assign the costs of secondary system poles, lines and transformers.[416] The combination of the primary system costs allocated using the class diversified demands, together with the secondary plant costs (apportioned as part of the blended demand allocators), represents approximately eighty percent (80%) of the total applicable distribution plant costs, which reflect the customer class diversified demands.[417]

Moreover, the Company considers load diversity when constructing and operating distribution facilities, such as substations. Load diversity is also considered when sizing equipment to serve smaller groups of customers such as line transformers. In this context, load diversity is reflected in the relationship between the individual customer demands and the peak demand of the group of customers served by the equipment.[418]

---

412 Exh. 10: Pavlovic Direct at 12:5-12 and 13:19-20.
413 Exh. 22: Tanos Rebuttal at 2:8-5:13.
414 Exh. 8: Tanos Direct at 9:21-22; Exh. 22 Tanos Rebuttal at 2:19-3-7; and Tr. at 941: 8-19 (Tanos Cross).
415 Exh. 8: Tanos Direct at 19:1-2 and Schedule (EPT)-1, at 19-1: line 2.
416 Exh. 8: Tanos Direct at 9:22-10:1; and Tr. at 941:20-942:2 (Tanos Cross).
417 Exh. 8: Tanos Direct: Schedule (EPT) -1, at 2-1: lines 1-23.
418 Exh. 22: Tanos Rebuttal at 3:4-4:23.

The Company has not conducted load diversity studies for each customer class for each functional plant category,[419] however, the Company has been conducting detailed analyses, on a class basis, of the individual customer demands and class peak demands which are relevant for diversity considerations and consistent with industry practice.[420] On cross examination, Staff Witness Pavlovic confirmed that he had not conducted any independent analysis of the Delaware distribution system and he did not develop or recommend any alternative weighting parameters.[421]

Based upon the Company's experience with the Delaware distribution system and the ongoing detailed analysis of demands by customer class and the load diversity embodied in each demand allocator, including the 50/50 weighted allocators, the Company's cost allocation approach is reasonable and practical and achieves a fair allocation of the cost to serve the respective customer classes.[422]

With respect to allocation of underground and overhead facilities, Staff Witness Pavlovic's contention was not based upon any study or analysis of Delmarva Delaware's distribution system and, therefore, cannot be supported.[423] In Delaware, since July 7, 1970, all new extensions of electric service necessary to furnish permanent service to new residential buildings in a subdivision having 5 or more building lots or to new multi-occupancy buildings are required to be placed underground; therefore, for the last forty-three years it has been the Company's standard operating procedure to install underground electric facilities in residential subdivisions of greater than five (5) lots.[424] Recent construction data was presented that

[419] Tr. at 941:8-942:2 (Tanos Cross).
[420] Exh. 8: Tanos Direct at 9:19-10:4; Exh. 22: Tanos Rebuttal 2:8-5:5; and Tr. at 948:7-949:18 (Tanos Cross).
[421] Tr. at 965:18-966:15 and 973:15-974:23 (Pavlovic Cross).
[422] Exh. 22: Tanos Rebuttal at 7:1-23.
[423] Tr. at 965:4-17 (Pavlovic Cross).
[424] 26 *Del. C.* § 901(c); Exh. 22: Tanos Rebuttal at 5:21-6:4.

highlights the trend of residential compared to commercial construction levels.[425]

Staff Witness Pavlovic recommends that the Advanced Metering Infrastructure (AMI) data and the Geospatial Information System (GIS) be used to develop CCOSS demand allocators to be submitted in Delmarva's next rate case.[426] Such an initiative would require the interface of numerous major Company databases that are not linked; this initiative would be highly complex and expensive for cost of service purposes.[427] In addition, the challenge to geographically assigned costs is problematic because of the characteristics of the Delaware distribution system, where feeders may contain significant portions of both overhead and underground construction.[428] The Company's asset accounting system is not currently maintained at the level of detail needed for this request, and the classification of customers itself under this proposal would introduce additional complexities for cost assignment.

The Company is developing the process to use the AMI meter data to determine the demand measures for the CCOSS, and has already started to use the AMI meter data from the residential and small commercial class services in its Load Settlement process. After a year of load data is collected, the Company should be able to determine the CCOSS class maximum diversified loads.[429] The Company is also developing a process to reliably identify the maximum hourly demand for all service points for the Delaware retail classes.[430] However, that data is not yet available, and it would be inappropriate to rely on it or to conclude that the current CCOSS is not reasonable because that data is not yet available.

b. <u>DPA Witness Dismukes</u>

DPA Witness Dismukes recommends that the Commission adopt Delmarva's proposed

---

[425] *Id.*
[426] Exh. 10: Pavlovic Direct at 15:17-16:4.
[427] Exh. 22: Tanos Rebuttal at 6:22-7:15.
[428] Tr. at 928:5-9 (Tanos Cross).
[429] Exh. 22: Tanos Rebuttal at 6:8-16.
[430] *Id.* at 6:16-18.

COSS, subject to the following modifications: (1) use of distribution plant to assign general and common plant accounts; and (2) use of number of customers to allocate Customer Service and Information Expense (FERC Accounts 907-910) and Sales Expense (Account 913)[431]. He also states that the load data used by the Company in its CCOSS is stale, and asserts that the Company has not verified the validity of the load research samples since the sample was designed (in 2008).[432]

The Company followed its routine ratemaking process, and used the most recent load data available, in preparing the CCOSS. Company Witness Tanos detailed the processes and steps required to complete the load analysis for cost of service purposes and explained that once these steps are performed the class demand measures are then available for the CCOSS.[433] Since the cost of service year ended December 2012, the most recent set of annual demand measures were based on 2011 data.[434] The Company has followed a rigorous process to determine the demand measures, including the load research analysis and the research samples used to develop the demands.[435]

Following the development and testing of the original load research samples in 2008, the Company performed regular monthly checks of the sample statistical reliability as part of the monthly load profiling process for the Delmarva Zone final load settlements. Evidence was presented showing the non-demand metered class non-coincident demands exceeded the statistical reliability design standards during the peak months of the last several years. Moreover, a set of sample validation tests similar to those originally performed for the sample design were performed and presented to demonstrate that the residential profile class samples

[431] Exh. 14: Dismukes Direct at 33:11-15 and 34-35.
[432] *Id.* at 32:21-22 and 33:1-7.
[433] Exh. 22: Tanos Rebuttal at 8:5-15.
[434] *Id.* at 8:15-16.
[435] *Id.* at 8:20-23.

were valid in the 2011 load study year.[436] From the results presented it can be concluded that the sample data used for the customer maximum demands for the Residential Classes were valid and statistically reliable.[437]

DPA Witness Dismukes acknowledges that the Company's LABOR allocator is similar in function to the use of operating labor ratios discussed in the NARUC Manual.[438] He argues, however, that distribution plant should be used to allocate general and common plant.

The underlying principle guiding the development of Delmarva's CCOSS is cost causation. The LABOR allocator is applied to General and Common plant as well as to certain Administrative and General expense accounts that are labor-oriented or labor-based. This would include infrastructure that is used in housing staff and meeting personnel resource needs, including computers, communication equipment, and software that are used by personnel to run the system. Additionally, the Company applies the LABOR allocator in the development of the CCOSS for Delmarva Delaware Gas, Delmarva Maryland and the Atlantic City Electric Company. The labor ratio approach is also recognized as an acceptable allocation method by the FERC and the utility industry.[439] On cross examination, DPA Witness Dismukes admitted that the distribution plant approach he used is his preferred methodology, and that certainly other methods are acceptable.[440]

Finally, DPA Witness Dismukes argues that Customer Information and Sales Expenses (FERC Accounts 907-913) should be assigned based only on the number of customers. Company Witness Tanos established, however, that the use of the number of customers alone to allocate the costs of the referenced accounts would assign the vast majority of the costs to

---

[436] *Id.* at 9:1-10.

[437] *Id.* at 9:10-13 and Tr. at 904:8-905:6 (Tanos Cross).

[438] *See* National Association of Regulatory Commissioners, Electric Utility Cost Allocation Manual (1992); Exh. 14: Dismukes Direct at 34:17-21; and Tr. at 538:20-539:6 (Dismukes Cross).

[439] Exh. 22: Tanos Rebuttal at 10:19-11:4.

[440] *Id.* at 11:17-12:2; Tr. at 538:20-539:23 (Dismukes Cross).

essentially one class, Residential, based on total class population.[441] Concerning FERC Accounts 906-910, the NARUC Manual describes the goal of the programs, such as conservation programs that include saving electricity on an annual basis, and for Sales Expenses (Account 913) the NARUC Manual suggests the use of a more general allocation scheme, rather than number of customers.[442] The O & M expense accounts include services that benefit all customers who received electric service and are focused on programs designed to encourage safety, efficiency and conservation. The Company maintains personnel that service all customers and a representative approach is to prepare an equally weighted composite allocation based on the number of customers and their corresponding sales usage. In this manner, all customers are fairly represented in the final allocation process for these expenses.[443]

c. **DEUG Witness Phillips**

DEUG Witness Phillips agrees that the Delmarva CCOSS comports with generally accepted costs of service methods, but argues that certain distribution plant accounts currently classified as demand-related should be re-classified as customer related.[444] Further, he supports the use of the Minimum Distribution System (MDS) analysis to determine this customer cost component.[445] The Commission previously considered use of the MDS in Docket No. 05-304, and dismissed it.[446] In Docket No. 11-528, and more recently in proceedings before the Maryland Public Service Commission, Delmarva has consistently argued against the use of the MDS approach for determining the customer-related costs.[447] In the current proceeding, DEUG Witness Phillips' opinion was not based upon an independent analysis involving the Delaware

---

[441] *Id.* at 11:5-10.
[442] Tr. at 913:7-9 (Tanos Cross).
[443] Exh. 22: Tanos Rebuttal at 11:5-10.
[444] Exh. 16: Phillips Direct at 9:11-12 and 10:1-5.
[445] Exh. 16: Phillips Direct at 10:10-23.
[446] *See* PSC Docket Order No. 6930 at ¶¶ 297-298.
[447] Tr. at 988:5-17 (Phillips Cross).

system; rather, he relied upon data from an MDS analysis in Maryland and then averaged the results of the Maryland minimum size and zero intercept studies to reach his conclusion[448]. Simply averaging two hypothetical results from another utility to create a portion of certain distribution accounts as customer-related is extremely misleading and does not remotely reflect cost causation, but is more end-result driven. DEUG's proposal using an MDS-based CCOSS would result in allocation of investment based upon a hypothetical minimum system to connect customers using no load. In addition, the MDS-CCOSS approach can disproportionately impact residential class customers, in this case shifting approximately $37 million in plant asset costs to the residential classes, including about $28 million transferred from the General Service Primary customer class.[449]

The Company's proposal to classify distribution poles, lines and line transformers as demand-related and to classify services and meters as customer-related is consistent with the methods used in previous studies before the Commission and provides a reasonable classification of the customer and demand-related cost components. The Company's approach is well recognized in the industry and should be continued.

3. **<u>Conclusion.</u>**

The Delmarva CCOSS filed in this Docket is consistent with the Company's submissions in prior dockets which was the starting point for the approved rate design in those cases. The CCOSS provides a reasonable and practical approach to achieve a fair allocation of costs to the respective customer classes.

In this case, there has not been any evidence presented of changed conditions, therefore, the Company's CCOSS should be used as an important guide in the rate design process.

---

[448] Exh. 16: Phillips Direct at Exhibit. NP-4, line 1, columns 2 and 11; and Exh 8: Tanos Schedule (EPT) -1, page 1, line 1 columns 2 and 4.
[449] Exh. 22: Tanos Rebuttal at 12:23-13:5 and 16:4-10.

B. RATE DESIGN

1. Introduction

Company Witness Santacecilia provided the rate design supporting the Company's proposed increase in distribution service. Company Witness Santacecilia testified that the proposed rate design incorporates the results from the CCOSS performed by Company Witness Tanos. In addition, Company Witness Santacecilia's recommended rate design considered the unitized rate of return (UROR) for each customer rate class in the allocation of overall revenue requirements among customer classes.[450]

Company Witness Santacecilia uses a two-step revenue allocation process in order to move overearning classes into a deadband established around the system rate of return and then fairly apportions the increase to every rate class. The proposed rate design attempts to move revenue collection into the customer and demand charges, when available, so that rate class structures are reflective of the cost causation identified in the CCOSS,[451] consistent with Commission precedent.[452]

Company Witness Santacecilia further supports the Weather Normalization Adjustment using the rolling thirty year normal weather calculation.[453] The thirty year weather normalization period has been utilized by Delmarva in every base rate case since Docket 94, and the thirty year time horizon continues to be the period recommended by the National Oceanic and Atmospheric Administration (NOAA). She also introduced and supported the Utility Facility Relocation Charge Rider (Rider UFRC), a mechanism for Delmarva to recover unreimbursed costs associated with relocation of the Company's delivery facilities as needed to accommodate

[450] Exh. 6: Santacecilia Direct at 3:14-4:2.
[451] *Id.* at 4:3-13.
[452] *See* PSC Docket Order No. 6930 at ¶298.
[453] Exh. 6: Santacecilia Direct at 8:12-9:8.

projects of the Delaware Department of Transportation and other state agencies.[454] This docket represents the first opportunity for the Company to add the Rider to its tariff since the rules defining the UFRC were promulgated. Finally, Company Witness Santacecilia supported tariff changes pertaining to the addition of LED light offerings within the Outdoor Lighting Tariff.[455]

2. Staff and Intervener Rate Design Issues

a. Staff Witness Pavlovic

Staff Witness Pavlovic recommends that the Commission accept Delmarva's proposed revenue allocation and rate structure.[456]

b. DPA Witness Dismukes

DPA Witness Dismukes accepts the Company's rate design with a slight modification to the revenue allocation.[457] His proposal respects the Company's rate design goal of moving every rate class to a rate of return equal to the system return but in a much more gradual manner; however, his proposed modification, to not allow any overearning class to receive a decrease in the first step, will maintain a greater portion of the subsidization those rate classes currently provide to other under-earning rate classes than the Company's proposal.[458]

c. DEUG Witness Phillips

DEUG Witness Phillips proposes a modification to the revenue allocation filed by the Company. DEUG Witness Phillips' suggestion to reverse the power factor credit of the GS-T class for purposes of rate design causes the rate of return for the GS-T class to be above the system average. He therefore takes issue with the rate increase proposed for the General Service Transmission class as being above the system average level of increase, and claims that such

[454] *Id.* at 9:12-23.
[455] *Id.* at 10: 3-9.
[456] Exh. 10: Pavlovic Direct at 23:1.
[457] Exh. 14: Dismukes Direct at 4:6-14.
[458] Exh. 21: Santacecilia Rebuttal at 3:14-19.

increase should be limited to no more than one half of the system average percentage increase to reflect the power factor benefit to the system associated with this class[459]. DEUG Witness Phillips' proposal is in conflict with past practice in terms of treatment of the power factor credit within rate design, sets an arbitrary limit for the GS-T class, would result in shifting the revenue requirement from the LGS, GS-P and GS-T to the remaining rate classes and is not supported[460].

3. Conclusion.

The rate design proposed by Delmarva is consistent with the Company's submissions in prior dockets and is a reasonable and practical approach; therefore, the Company's rate design should be approved.

[459] Exh. 16: Phillips Direct at 21:10-14.
[460] Exh. 21: Santacecilia Rebuttal at 5:1-4.

increase should be limited to no more than one half of the system average percentage increase to reflect the power factor benefit to the system associated with this class[459]. DEUG Witness Phillips' proposal is in conflict with past practice in terms of treatment of the power factor credit within rate design, sets an arbitrary limit for the GS-T class, would result in shifting the revenue requirement from the LGS, GS-P and GS-T to the remaining rate classes and is not supported[460].

3. Conclusion.

The rate design proposed by Delmarva is consistent with the Company's submissions in prior dockets and is a reasonable and practical approach; therefore, the Company's rate design should be approved.

CONCLUSION

For the reasons stated above, the Commission should accept Delmarva's requested increase in rates as reflective of costs to be incurred during the rate effective period.

Respectfully submitted,

Todd L. Goodman / TAC (#4694)

Todd L. Goodman
Pamela J. Scott
Delmarva Power & Light Company
500 North Wakefield Drive
Mail Stop 92 DC 42
Newark, DE 19702
T: (302) 429-3786
E: todd.goodman@pepcoholdings.com

Todd A. Coomes
Richards, Layton & Finger, P.A.
One Rodney Square
920 North King Street
Wilmington, Delaware 19801
T: (302) 651-7500
E: coomes@rlf.com

December 30, 2013

[459] Exh. 16: Phillips Direct at 21:10-14.
[460] Exh. 21: Santacecilia Rebuttal at 5:1-4.