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

FINDINGS AND RECOMMENDATIONS OF THE HEARING EXAMINER

March 4, 2014

Mark Lawrence
Hearing Examiner

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FINDINGS AND RECOMMENDATIONS OF THE HEARING EXAMINER

I. APPEARANCES

On behalf of the Applicant Delmarva Power & Light Company:

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TODD A. COOMES, ESQ., Richards, Layton & Finger

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Assistant General Counsel

On behalf of the Delaware Public Service Commission:

JAMES McC. GEDDES, ESQ., Rate Counsel
JULIE M. DONOGHUE, ESQ., Deputy Attorney General
Delaware Department of Justice

On behalf of the Division of the Public Advocate:

David L. Bonar, Public Advocate

REGINA A. IORII, ESQ., Deputy Attorney General
Delaware Department of Justice

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

MICHAEL J. QUINAN, ESQ.
Christian & Barton, LLP

On behalf of Intervenor, Delaware Department of Natural Resources & Environmental Control ("DNREC")

RALPH DURSTEIN, ESQ., Deputy Attorney General
Delaware Department of Justice

On behalf of Intervenor, The Caesar Rodney Institute

David Stevenson, Director,
Center for Energy Competitiveness

II. BACKGROUND

1. On March 22, 2013 Delmarva Power & Light Company ("Delmarva" or the "Company") filed with the Delaware Public Service Commission (the "Commission") an Application to increase its annual operating revenues rates by $42,044,000, or 7.38% in total revenues (the "Application").[1] (Exh. 1, p.3.) If Delmarva's rate request was granted in its entirety by the Commission, a typical residential customer using 1,000 kWh per month would experience an average monthly increase of $7.63 (from $141.23 to $148.86), or about a 5.4% increase in the customer's total monthly bill. (*Id.* at p.12.) Delmarva's Application also seeks Commission approval of various tariff modifications.[2]

2. The Company cites several reasons for requesting a rate increase, the most significant being the need to invest a total of approximately $397 million in its electric distribution system over the next five (5) years to serve Delmarva's customers. (Exh. 2-Boyle-

[1] Exhibits from the evidentiary hearing will be cited herein as "Exh. __ -(witness name, if any), pg.#." Schedules from the Company's Application or pre-filed testimony will be cited as "Exh.__-Witness name, if any; Sch. __." References to the pages of the Evidentiary Hearing transcript will be cited as "Tr.-__ (page #)."

References to the parties' post-hearing briefs are cited herein as follows: Delmarva's Initial and Reply Briefs: "DPL OB" and "DPL RB." Staff's Opening Brief: "Staff OB." DPA's Opening Brief: "DPA OB." DEUG's Opening Brief: "DEUG OB."

[2] The Company's proposed tariff modifications are: (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) tariff changes proposed for clarification and editorial reasons. (*See* Exh. 1, Application, pp. 6-7 & Appendix A.)

p.5.) In this docket, the Company is seeking to place $39,876,047 in rate base for actual plant closings through September, 2013, plus an additional $18,355,421 of forecasted plant closings through December 31, 2013. (Exh. 20-Ziminsky-Schs. (JCZ-R)-6,7.) According to the Company, this investment is needed to maintain and enhance system reliability, for infrastructure replacement, and to improve the Company's response to major storms. (*Id.* at p.3.)

3. According to Delmarva, the Company is required to make these investments in infrastructure at a time when it has low customer growth, following a significant time period during which it did not earn its authorized Return on Equity ("ROE"). (*Id.*) The Company is seeking an overall Rate of Return of 7.53%, including a 10.25% ROE, based upon an adjusted rate base of $745,604,175. (Exh. 20-Ziminsky, Sch. (JCZ-R)-1, pp.2-3; Exh. 3-Hevert, p.2.)

4. The Company's March 22, 2013 Application is based on twelve (12) months of actual data ending December 31, 2012. (Exh. 5-Ziminsky, p.4.) The Company used this actual data for establishing its test year for cost allocation purposes. (*Id.*) In developing the Company's overall revenue requirement, the Company used this same period as its test period. (*Id.*) The Company also proposes ratemaking adjustments, including adjustments related to infrastructure improvements, beyond the test period. (*Id.* & pp. 27-28.)

5. With its Application, Delmarva submitted direct testimony from Frederick J. Boyle, Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc. ("PHI"); Robert B. Hevert, Managing Partner, Sussex Economic Advisors, LLC; Michael W. Maxwell, Vice

President, PHI's Asset Management; Jay C. Ziminsky, Manager, Revenue Requirements, PHI's Regulatory Affairs Department; Kathleen A. White, Assistant Controller, PHI and its utility operating companies including Delmarva; Elliott P. Tanos, PHI's Manager of Cost Allocation; and Marlene C. Santacecilia, a Regulatory Lead in PHI's Rate Economics Department.

6. In Order No. 8337 dated March 22, 2013, pursuant to 26 *Del. C.* §§306(a)(1) and 502 and 29 *Del. C.* ch. 101, the Commission initiated this docket, suspended the proposed full rate increase pending the completion of evidentiary hearings into the justness and reasonableness of the proposed rates and tariffs; and designated me as the Hearing Examiner to conduct such hearings and report to the Commission my proposed findings and recommendations. The Commission also granted Delmarva's request to implement interim rates amounting to an annual increase of $2,500,000 in operating revenues, effective June 1, 2013.

7. On March 28, 2013, due to the resignation of the Public advocate, the office of the Attorney General of the State of Delaware ("DAG's Office") filed a Motion to Intervene on behalf of the Public Advocate's Office. By PSC Order No. 8346 (April 11, 2013), the DAG's Office was permitted to intervene. On July 2, 2013, the DAG's Office withdrew its appearance and the new Public Advocate, David L. Bonar, was substituted as a party.

8. Delaware's Department of Natural Resources and Environmental Control ("DNREC"), the Caesar Rodney Institute ("CRI"),

and the Delaware Energy Users Group ("DEUG"), also filed Motions to Intervene, which were each granted without objection from any party.

9. The Commission Staff ("Staff"), the Public Advocate and DEUG conducted extensive written discovery of the Company. Also, Staff and the Public Advocate performed a rate case audit of Delmarva's books and records extending over a period of several weeks.

10. In August 2013, the Commission conducted a public comment session on Delmarva's proposed rate increase in each of Delaware's three (3) counties because Delmarva provides electric distribution service in each county. At each public comment session, Delmarva's representatives summarized the Application and members of the public were afforded an opportunity to comment on the Application.

11. At the New Castle County Public Comment Session, State Representative John Kowalko and two (2) Delmarva customers opposed the ratemaking changes that Delmarva was proposing. (Tr.-30-35.) Two (2) other customers requested that the Commission closely analyze Delmarva's proposed infrastructure investments. (Tr.-35-37.)

12. One (1) member of the public attended the Kent County Public Comment Session and inquired about the Company's Application. (Tr.-56-73.) At the Sussex County Public Comment Session, a representative of the American Association of Retired Persons ("AARP") opposed the proposed increase on behalf of AARP's Delaware members. (TR.-47-50.) Two (2) additional customers also opposed the proposed rate increase. (Tr.-50-53.)

13. "The Commission received more than sixty (60) written comments from the AARP, 20 members of the House of Representatives,

and Delmarva customers.” (DPA OB, p.6.) These comments generally opposed the proposed rate increase. (*Id.* at pp. 6-7.)

14. On August 16, 2013, Staff filed direct testimony with respect to the Company’s Application from Dr. Karl R. Pavlovic, Senior Consultant, Snavely King Majoros & Associates, Inc.; Stephanie L. Vavro, Principal, Silverpoint Consulting, LLC; and David E. Peterson, Senior Consultant, Chesapeake Regulatory Consultants, Inc.

15. The Public Advocate filed direct testimony dated October 16, 2013 from Andrea C. Crane, President, The Columbia Group, Inc.; David C. Parcell, President, Technical Associates, Inc.; and David E. Dismukes, PHD, Consulting Economist, Acadian Consulting Group. On October 16, 2013, DEUG filed direct testimony from Nicholas Phillips, Jr., Managing Principal, Brubaker & Associates, Inc.

16. On September 20, 2013, the Company also filed rebuttal testimony from witnesses Hevert, Maxwell, Ziminsky, Tanos, Boyle and Santacecilia. In its rebuttal testimony, the Company amended its proposed revenue requirement increase as described in the following section of this Report.

17. On September 12, 2013, pursuant to 26 *Del. C.* §306(b), Delmarva requested approval to implement an interim rate increase of $27,655,265, under bond without surety, and subject to refund. Since Delmarva had previously placed $2.5 million of interim rates into effect on June 1, 2013 as permitted by Order No. 8337, Delmarva’s request sought authorization for an additional $25,155,265 of interim rates. By Order No. 8466 (Oct. 8, 2013), the Commission approved Delmarva’s request for a total interim rate increase of $27,655,265

effective October 22, 2013, under bond without surety, and subject to refund with interest upon the conclusion of this docket.

18. On October 17, 2013, Delmarva filed a Motion to Stay further proceedings in this docket pending the resolution of Delmarva's "Forward Looking Rate Plan" which would set electric distribution rates for four (4) years with modification possible under certain circumstances. Delmarva's Forward Looking Rate Plan had been filed with the Commission in a separate docket on October 2, 2013.[3] After hearing Delmarva's Motion on October 22, 2013, by Order No. 8475, the Commission denied Delmarva's Motion to Stay further proceedings in this docket.

19. On November 5, 2013, I conducted a pre-evidentiary hearing teleconference with the participants. At that time, I requested a list of stipulated exhibits and an exchange of witness lists. Also, the parties informed me that no party intended to file a pre-evidentiary hearing motion.

20. On November 13, 2013, I convened duly-noticed evidentiary hearings in Wilmington. I also held hearings on November 14 and 18, 2013. Delmarva, Staff, DEUG and the Public Advocate proffered a total of fifteen (15) witnesses to testify regarding their respective positions. Except for one of Delmarva's witnesses, whose pre-filed testimony the parties stipulated to, all other witnesses who filed pre-filed testimony were cross-examined.

[3] See PSC Docket No. 13-384.

21. Upon the conclusion of the hearings, the evidentiary record remained open due to some pending pleading and evidentiary issues raised by the parties. While the parties were conducting discovery as to these pending issues, on December 16, 2013 and January 7, 2014, I held conference calls with the parties in attempting to finalize the evidentiary record.

22. As of March 3, 2014, the evidentiary record remains open due to a pending issue.[4] The evidentiary record currently consists of ninety nine (99) hearing exhibits and one thousand and thirty one (1,031) pages of hearing transcript.

23. The parties have filed post-hearing briefs in support of their respective positions. I have considered the entire record of this proceeding to date, and herein submit these Findings and Recommendations to the Commission for its consideration.

III. BRIEF SUMMARY OF THE PARTIES' POSITIONS

24. *Delmarva.* The Company selected a historical test year and test period consisting of the twelve (12) months ending December 31, 2012. After making adjustments to rate base and operating expenses, the Company calculated a revenue deficiency of $38,976,366, derived from a rate base of $745,604,175; an overall rate of return of 7.53%; and a Return on Equity ("ROE") of 10.25% on a capital structure

[4] The Company mistakenly included deferred taxes in the Company's post-test year adjustments relating to actual closings and forecasted closings. (DPL OB, p.2.) On February 6, 2014, the Commission agreed with Staff's and the Public Advocate's Procedural Objections that the Company was prevented from claiming these taxes in this rate case. Thus, the Commission orally ordered that the Company could not increase its current, overall revenue requirement by the amount of the taxes-$705,151-to $39,681,517. Since the parties have not agreed upon the content of a written order, the issue is still pending before the Commission.

consisting of 50.78% long-term debt and 49.22% common equity; and pro-forma operating income of $33,298,159. (Exh. 20-Ziminsky, Sch. JCZ-R-1, pp.2-3; Exh. 18-Hevert, p.2, Exh. 3-Hevert, p.32.)

25. *Staff.* Staff did not contest the Company's test period/test year. Staff contended that Delmarva should be allowed a revenue requirement increase of $11,442,413, applied to a rate base of $578,744,304; an overall rate of return of 7.09% and ROE of 9.35% using the Company's proposed capital structure; and pro-forma operating income of $34,318,925. (Exh. 11-Peterson, p.36; Sch. DEP-1, p.1; Exh. 15-Parcell, p.2, Staff OB, pp. 9-10, DPA OB, pp.14-15.)

26. Staff's primary challenges to the Company's rate request are: a) Staff seeks the continued use of an average plant in service balance for the entire test period; b) Staff seeks that the Company's entire post-test period reliability investment claim be removed from this docket, and transferred to the Commission's pending investigation in Reliability Docket No. 13-152; c) Staff seeks that Construction Work In Progress ("CWIP") not be included in rate base; d) Staff seeks that the Company's Cash Working Capital ("CWC") be substantially reduced; and e) Staff seeks a Return on Equity of 9.35%. Staff's proposed adjustments would reduce Delmarva's rate base by $175,962,574, (Staff OB, p.70.)

27. *Public Advocate*. The Public Advocate also did not contest Delmarva's test period/test year. The Public Advocate calculated a revenue deficiency of $7,475,510 on an adjusted rate base of $553,669,028; an overall rate of return of 7.09% and ROE of 9.35% also using the Company's proposed capital structure; and pro-forma

operating income of $34,970,409. (Exh. 13-Crane, pp.4, Schs.-ACC-1,3,16,39; Exh. 15-Parcell, p.2; Staff OB, pp.9-10, DPA OB, pp.14-15.)

28. The Public Advocate's primary challenges to the Company's rate request are: a) it wants the Company's entire post-test period reliability investment claim removed from this docket, not transferred to the Reliability Docket as Staff seeks; b) the Public Advocate seeks that Construction Work In Progress ("CWIP") not be included in rate base; c) it seeks that the Company's pre-paid pension asset should be removed from rate base; and d) like Staff, the Public Advocate, seeks a ROE of 9.35%. The Public Advocate also makes a number of other challenges as to proposed adjustments described later.

29. *DEUG*. DEUG is seeking adjustments only to Delmarva's cost of service study and proposed changes to Delmarva's rate design. (Exh. 16-Phillips.)

IV. APPLICABLE LAW

30. The Commission has jurisdiction over this docket. 26 *Del. C.* §201(a).

31. The Commission applies certain principles in deciding a general rate increase case filed by a public electric utility. According to the United States Supreme Court, a public utility seeking a general rate increase is entitled to an opportunity to earn a fair rate of return on the value of its property dedicated to public service. (Bluefield Water Works and Improvement Co. v. Public Service Comm. of West Virginia, 262 U.S. 679 (1923); Federal Power Comm. v. Hope Natural Gas Co., 320 U.S. 591 (1944)). In determining what

constitutes a fair rate of return, the Commission is guided by the criteria set forth in *Bluefield* where the Court held as follows:

> "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be too high or too low by changes affecting opportunities for investment, the money market and business conditions generally."

(Bluefield Water Works and Improvement Co. v. Public Service Comm. of West Virginia, 262 U.S. 679, 692-93(1923)).

32. In Delaware, a public utility seeking a general rate increase has the Burden of Proof to establish the justness and reasonableness of every element of the rate increase request, pursuant to *26 Del. C.* §307(a). This statute sets forth the "just and reasonable" standard which has to be satisfied by the public utility:

> §307. Burden of Proof
> (a) In any proceeding upon the motion of the Commission, or upon complaint, or upon application of a public utility, involving any proposed or existing rate of any public utility, or any proposed change in rates, the burden of proof to show that the rate involved is just and reasonable is upon the public utility.

33. Thus, according to *26 Del. C.* §307(a), the Burden of Proof does not shift to parties challenging a requested rate increase. The

utility has the burden of establishing the justness and reasonableness of every component of its rate request.

34. In a base rate case, "a Commission must consider and allow the normally accepted operating expenses of a utility corporation 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 *unless found to have been made in bad faith or out of an abuse of discretion."* (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 re-argument,* 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." *(Id.)* (DPA OB, pp. 12-13.)

35. As opposed to following the Delaware Supreme Court's 1986 decision in the *Delmarva* case discussed in the preceding paragraph, Staff argues that the proper standard of review for capital investments is the "used and useful standard" according to the Superior Court's decision in Chesapeake Utilities Corp. v. Delaware Pub. Serv. Comm., 705 A.2d 1059, 1071 (Del. Super. 1997.) For the reasons described below, I find that the "used and useful" standard does not apply to the actual or forecasted plant closings in this

docket because: 1) these expenses are not "extraordinary" according to the Superior court's decision in the *Chesapeake* case; and 2) this Commission's precedent correctly holds otherwise.

36. In *Chesapeake*, the natural gas utility was faced with future expenditures for groundwater remediation for as long as thirty (30) years. (*Id.* at p.1062.) The court addressed federal CERCLA liability which could be imposed upon a utility for long term, future, unknown environmental remediation costs according to the Comprehensive Environmental Response, Compensation and Liability Act ("CERCA").

37. The question in *Chesapeake* was whether an unamortized balance of environmental remediation costs (which the Commission had already determined were recoverable), should be recovered in rate base as utility plant subject to recovery of carrying costs, or whether it should be recoverable through a rider without carrying costs. (*Id.* at p.1061.) The Superior Court upheld the Commission's determination that the carrying costs were not recoverable because the land was no longer "used and useful." (*Id.* at p.1070.)

38. However, according to the *Delmarva* case discussed *supra*, and Commission precedent discussed later herein, capital investment expenditures like those in this case are very different than the costs involved in *Chesapeake* and are not treated as extraordinary expenses. In Docket No. 09-414, the most recently litigated electric rate case, this Commission held as follows as to the permissibility of some post-test period, capital investment adjustments:

> "As demonstrated in our deliberations on the individual issues, we do not accept the DPA's position that a utility using a 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 [Minimum Filing Requirements] 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.” (PSC Order No. 8011, ¶48.)

39. Thus, as will be explained in more detail later herein, the “used and useful” standard from Chesapeake does not apply to the post-test period capital investments in this case. In addition to the *Delmarva* case’s standard i.e the proposed expense adjustments were not made in bad faith or out of an abuse of discretion or constitute waste or inefficiency, Commission precedent has allowed post-test period plant if the plant closings were in service, directly benefitting customers, and were known and measurable.

40. In this Report, if I recommend that the Commission find for a particular party, please assume that I found that the Company either met or did not meet its Burden of Proof regarding a proposed issue or adjustment. Also, due to the overly litigated nature of this Docket, it was impossible for me to address every argument which was raised which is my practice. If an argument was raised and I did not address it, please assume that I rejected it.

V. RETURN ON EQUITY

A. Capital Structure.

41. For purposes of determining the overall rate of return, except as described below, the parties agreed on the Company’s capital structure as of December 31, 2012, as 50.78% long-term debt and 49.22% common equity, with a long-term debt cost rate of 4.91% and a weighted return of 2.49% as “consistent with industry practice and reasonable

and appropriate." (Exh.3-Hevert, p.33; Exh. 15-Parcell, p.3; Exh.11-Peterson, p.5; Staff OB, p.46.)

42. Although the Public Advocate recommended its rate of return based upon the above capital structure, the Public Advocate also argued that, if the Commission permits the Company to recover any of its costs related to its credit facility, the Company's capital structure should be amended to include short-term debt. (Crane, Exh. 13, pp. 30-31.) I discuss the credit facility issue later herein in Section VIII(G).

B. Return on Equity ("ROE") Background.

43. The parties differ as to the Return on Equity ("ROE") which the Commission should award to the Company. The ROE is weighted by the percentage of common equity in the Company's capital structure.

44. Delmarva proposes a ROE in the range of 10.25% to 10.75%, but recommends a ROE of 10.25%. (Exh. 18-Hevert, p.43.) According to Delmarva, "the Company's proposed ROE of 10.25% is a reasonable, if not conservative estimate of its Cost of Equity." (*Id.* at pp.2,26.) Public Advocate Witness Parcell proposes a ROE in the range of 9.20%% to 9.50%, but recommends an overall ROE of 9.35%. (Exh. 15-Parcell, p.35.) As a result of the settlement in its most recent rate case, Delmarva's current ROE is 9.75%. (PSC Order No. 8265 (Dec. 18, 2012), ¶1.)

45. Delmarva argues that a Return on Equity of 10.25% is necessary "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." (Exh. 17-Boyle,p.2.)

"In part, the terms upon which the Company obtains capital is dependent upon the Company's rating by various rating agencies." (DPL OB, p.32.) Favorable credit ratings allow the Company to "obtain long-term financing at lower rates and negotiate better terms and conditions from its vendors, all of which provide a direct benefit to the customer." (Exh. 17-Boyle,p.8.)

46. "Delmarva plans to make infrastructure investments of approximately $400 million over the next five years to address infrastructure replacement and to enhance and maintain the reliability of the Company's system to better serve and meet the expectations of Delmarva's customers." (*Id.* at p.2.)

47. According to Delmarva, these needed infrastructure investments are following a period during which Delmarva earned substantially below its authorized ROE, as described in the following table:

Year	**Earned ROE**	**Authorized ROE**	**Rev Deficiency (Excess) Millions**
2008	9.26%	10.00%	$2.6
2009	5.11%	10.00%	$17.0
2010	8.23%	10.00%	$7.2
2011	4.78%	10.00%	$25.1
2012	5.59%	9.75%	$23.8

(Exh. 20-Ziminsky, p.3.)

48. In addition to regulatory lag, the Company maintains that "[t]he low earned ROEs reflect the attrition resulting from the imbalance of Delmarva's revenues (driven by customer counts and sales), expenses (driven by Operation and Maintenance (O&M expenses), and rate base (driven by plant in service)." (*Id.*)

49. “During the past five (5) years, Delmarva’s … customer count has remaied fairly flat, while sales and [monthly weather-adjusted] usage per customer have declined.” (*Id.* at pp. 3-6.) Meanwhile, during this period, the Company’s annual Operation & Maintenance (“O & M”) expenses have increased an average of 7.6%, or an annual average increase of $6.252 million. (*Id.* at pp. 6-7.)

50. During the last five (5) years, the Company’s rate base has increased at the average rate of 10.1%, or an annual average increase of $48.0 million. (*Id.* at p.7.) As reflected in the following table, during this time period, Delmarva’s net plant in service has increased at the average annual increase of $39.2 million or 7.1%. (*Id.* at p.8.) This case involves a 2012 test period/test year, including 2013 infrastructure investments.

Year	Plant in Service Average ($Mil)	Plant in Service Increase	Plant in Service Increase %
2008	$511.9	$35.7	7.5%
2009	$542.3	$30.4	5.9%
2010	$582.2	$39.9	7.3%
2011	$633.5	$51.3	8.8%
2012	$672.2	$38.7	6.1%

(*Id.* at p.8.)

51. The Company asserts that the overall 9.35% ROE proposed by Public Advocate Witness Parcell is “too low to be a reasonable estimate.” (Exh. 18-Hevert, pp. 3-4,12.) Staff did not proffer its own analysis as to the ROE the Commission should award to the Company. Instead, in developing its overall revenue requirement, Staff relied upon the ROE recommendation of Public Advocate Witness Parcell. (Exh. 11-Peterson, p.5, Staff OB, p.25.)

C. Company Witness Robert B. Hevert.

52. The Company's ROE witness was Robert B. Hevert, the Managing Partner of Sussex Economic Advisors. Mr. Hevert is an economic and financial consultant with approximately twenty five (25) years of experience with regulated entities. (Exh. 3-Hevert, Attach. A.)

53. Delmarva is a transmission and distribution company and a wholly-owned subsidiary of Pepco Holdings, Inc. ("PHI") and its stock is not publically traded.[5] (*Id.* at pp. 5-6,8.) Delmarva provides electric service to approximately 303,000 customers in Delaware. (*Id.* at p.6.) Delmarva also provides natural gas supply and distribution service to approximately 125,000 Delaware customers. (*Id.*)

D. Hevert's Proxy Group.

54. From Value Line's classified electric utilities group, after utilizing some screening criteria described below, Mr. Hevert determined that twelve (12), dividend-paying, vertically integrated, electric companies would serve as a comparable proxy group for determining the proper ROE. (*Id.* at pp. 5-8.)

55. Mr. Hevert's proxy group screening criteria also included, for example, the following: 1) all companies have been covered by at least two utility industry equity analysts; 2) all companies have investment grade, senior unsecured bond and/or corporate credit ratings from Standard & Poor's ("S&P");[6] 3) Mr. Hevert "excluded

[5] For a complete description of PHI's and Delmarva's corporate structure, please see Exhibit 15-Parcell, pp. 14-15.)

[6] "Delmarva's current long-term issuer credit rating is BBB+ (outlook: Stable) by S&P, Baa2 (outlook: Stable) from Moody's Investors Service, and BBB+ (outlook: Stable) by Fitch." (Exh. 3-Hevert, pp. 6-7.)

companies whose regulated operating income over the three (3) most recently reported fiscal years represented less than 60% of combined income;" 4) "excluded companies whose regulated electric operating income over the three (3) most recently reported fiscal years represented less than 90% of total regulated operating income." (*Id.* at p.7.)

56. Mr. Hevert's proxy group and approved 2012 ROEs are listed below:

Company	Ticker	2012 Approved ROE
American Electric Power Company, Inc.	AEP	9.7%
Cleco Corporation	CNL	11.2%
Empire District Electric Company	EDE	7.9%
Great Plains Energy Inc.	GXP	6.2%
Hawaiian Electric Industries, Inc.	HE	10.4%
IDACORP, Inc.	IDA	11.4%
Otter Tail Corporation	OTTR	6.9%
Pinnacle West Capital Corporation	PNW	9.8%
PNM Resources, Inc.	PNM	6.6%
Portland General Electric Company	POR	8.3%
Southern Company	SO	12.9%
Westar Energy, Inc.[7]	WR	9.5%

(Exh. 15-Parcell; Sch. DCP-10; Exhs. 50, 51, 52.)

54. Using this proxy group, Mr. Hevert applies four (4) ROE models: a) the Constant Growth and Multi-Stage Discounted Cash Flow Models ("DCF") and b) the Capital Asset Pricing Model ("CAPM"); while also presenting c) the Bond Yield Plus Risk Premium ("Risk Premium") Model. (Exh. 3-Hevert, pp.10-30; Exh. 18-Hevert, pp.20-22.) Mr. Hevert

[7] Company witness Hevert stated that he excluded Delmarva's parent company, Pepco Holdings, Inc. ("PHI"), from his proxy group "to avoid circular logic…" (Exh.3-Hevert, p.7.)

proposes a ROE in the range of 10.25% to 10.75%, but recommends a ROE of 10.25%. (Exh. 18-Hevert, p.43.)

55. Although it considers other models, in the past the Commission has preferred using the Discounted Cash Flow (DCF) method in determining a utility's ROE. (PSC Order No. 8011, ¶284.) As will be explained, however, Company witness Hevert argues that current market conditions, particularly increasing interest rates, require the Commission to apply more than one model in determining the Company's ROE. (Exh. 18-Hevert, p.10.)

E. Hevert's Constant Growth DCF Anaylsis.

56. "The DCF approach is based on the theory that a stock's current price represents the present value of all expected cash flows, [including the dividend yield and expected long-term annual growth rate]." (Exh. 3-Hevert, pp. 10-11.) The model assumes a single growth estimate in perpetuity. (*Id.* at p.12.) According to Mr. Hevert, "dividend growth can only be sustained by earnings growth." (Exh. 18-Hevert, p.17.)

57. "In all, the DCF method takes into account several factors important in the determination of a fair rate of return: 1) preferences of investors; 2) equity financing; 3) risk; and 4) inflation." (James C. Bonbright *et al., Principles of Public Utility Rates* (2nd ed. 1988), p.319.)

58. "Company witness Hevert's Constant Growth DCF analyses are based on the 30-day, 90-day, and 180-day average stock prices for the period ending [July 31, 2013], annualized dividends per share as of [July 31, 2013], and the average of [the maximum/minimum for each

proxy company] as reported by Value Line, First Call and Zack's EPS projections." (Exh. 18-Hevert, p.8; Exh. 15-Parcell, p.37; Exh.3-Hevert, p.13.)

59. Mr. Hevert selected these three (3) averaging periods so that his results were not skewed by a highly unusual trading day event, and because the averaging periods were "reasonably representative of expected capital market conditions over the long term." (Exh. 3-Hevert, p.12.)

60. The results of Mr. Hevert's Constant Growth DCF analysis in his Rebuttal testimony are as follows:

Constant Growth Discounted Cash Flow Model
30-Day Average Stock Price

	Low ROE	Mean[8] ROE	High ROE
Proxy Group Mean	8.25%	9.18%	10.15%
Proxy Group Median	8.28%	9.05%	10.15%

Constant Growth Discounted Cash Flow Model
90-Day Average Stock Price

	Low ROE	Mean ROE	High ROE
Proxy Group Mean	8.21%	9.15%	10.11%

Constant Growth Discounted Cash Flow Model
180-Day Average Stock Price

	Low ROE	Mean ROE	High ROE
Proxy Group Mean	8.37%	9.30%	10.27%

[8] The "mean" is determined by adding the numbers on a list and dividing by the number of numbers on the list. (Merriam-Webster Dictionary.com.)

61. The results of Company Witness Hevert’s Constant Growth DCF analysis in his Rebuttal testimony reflect that his projected ROE for his proxy group utilities exceeeds Delmarva’s claimed ROE of 10.25% only in his 180 day high earnings growth scenario. (Exh. 18-Hevert, Sch.(RBH)-1.) His low and medium growth scenarios are nearer to 9.35%, than 10.25%. In his direct testimony, however, the results of Mr. Hevert’s medium and high growth earnings scenarios exceed 10.25%. (Exh. 3-Hevert, Sch. (RBH)-1.)

62. Although the recent increase in interest rates has caused an increased ROE under Mr. Hevert’s CAPM and Risk premium models, according to Mr. Hevert “decreases in the Constant Growth DCF results have not followed this trend as both the average dividend yield and projected growth rate for my proxy group have fallen since the filing of my Direct Testimony. As such, the Constant Growth DCF results are difficult to reconcile with current market conditions, in particular the significant increase in interest rates, and should be viewed with caution. It is precisely for precisely this type of circumstance that it is important to apply more than one analytical approach in estimating the Cost of Equity….” (Exh. 18-Hevert, pp.9-10.)

F. Hevert’s Multi-Stage DCF Analysis.

63. Mr. Hevert also included a Multi-Stage DCF model in his rebuttal testimony. Exh. 18-Hevert; pp. 16-22.) Like the Constant Growth DCF model, the Multi-Stage DCF model “defines the Cost of Equity as the discount rate that sets the current price equal to the discounted value of future cash flows.” (*Id.* at p.6.) “…[T]he model sets the subject company’s stock price equal to the present value of

future cash flows received over three stages: a) in the first two stages, cash flows are defined as projected dividends; and b) 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." (*Id.* at p.20.) This price, called the "terminal price," "is defined by the present value of the remaining cash flows in perpetuity."[9] (*Id.* at pp. 20-12.)

64. Company witness Hevert describes the advantages of the Multi-Stage model as follows:

> "The primary benefits relate to the flexibility provided by the model's structure. Since it provides the ability to specify near, intermediate and long-term growth rates, for example, the model avoids the sometimes-limiting assumption that the subject company will grow at the same, constant rate in perpetuity.
>
> In addition, by calculating the dividend as the product of earnings and the payout ratio, the model enables analysts to include assumptions regarding the timing and extent of changes in the payout ratio to reflect, for example, increases or decreases in expected capital spending, or a transition from current payout levels to long-term expected levels. In that regard, because the model relies on multiple sources of earnings growth projections, it is not limited to a single source, such as Value Line, for all inputs, and mitigates the potential bias associated with relying on a single source of growth estimates.
>
> The model also enables the analyst to assess the reasonableness of the inputs and results by reference to certain market-based metrics. For

[9] Witness Hevert used the Gordon Model to calculate the terminal price which is expressed as D/(r-g), where D is the expected dividend, divided by the difference between the Cost of Equity (i.e the discount rate)-r, and the long-term expected growth(g). (Exh. 18-Hevert, p.20.)

example, the stock price estimate can be divided by the expected Earnings Per Share in the final year to calculate an average P/E ratio. Similarly, the terminal P/E ratio can be divided by the terminal growth rate to develop a Price to Earnings Growth (PEG) ratio. To the extent that either the projected P/E or PEG ratios are inconsistent with historical or expected levels, it may indicate incorrect or inconsistent assumptions within the balance of the model." (*Id.* at pp.21-22; emphasis supplied.)

65. The results of Company Witness Hevert's Multi-Stage DCF analysis are as follows:

Multi-Stage Growth Discounted Cash Flow Model
Mr. Hevert's Proxy Group
30-Day Average Stock Price

Min	9.49%
Mean	10.00%
Max	10.55%

Multi-Stage Growth Discounted Cash Flow Model
Mr. Hevert's Proxy Group
90-Day Average Stock Price

Min	9.48%
Mean	9.97%
Max	10.51%

Multi-Stage Growth Discounted Cash Flow Model
Mr. Hevert's Proxy Group
180-Day Average Stock Price

Min	9.70%
Mean	10.15%
Max	10.68%

(Exh. 18-Hevert, Sch. (RBH-R-7, pp. 1-3.)

66. Witness Hevert’s Multi-Stage DCF analysis reflects that his projected ROE for his proxy group utilities exceeds Delmarva’s claimed ROE of 10.25% only in his entire high earnings growth scenario, but not in his low or medium growth scenarios. (Exh. 18-Hevert, Sch.(RBH)-1.) In the medium earnings growth scenario, however, Mr. Hevert’s calcuations are much closer to Delmarva’s claimed 10.25% ROE than the Public Advocate’s claimed 9.35% ROE. Even in Mr. Hevert’s low earnings growth scenario, Mr. Hevert’s calculations all exceed Mr. Parcell’s recommended 9.35% ROE.

67. Finally, Company witness Hevert considered Delmarva’s comparatively small size and the effect of flotation costs, and the current state of the capital markets, including “recent significant increases in Treasury bond yields, utility bond yields and the relative under-performance of utility stocks.” (Exh. 18-Hevert; p.43.) However, Mr. Hevert did not make any explicit adjustments to his calculated ROE for these factors. (*Id*. at pp. 15-16,43.)

G. Public Advocate Witness David C. Parcell.

68. David C. Parcell is the President and Senior Economist of Technical Associates, Inc. (Exh. 15-Parcell, p.1.) Mr. Parcells is an economic and financial consultant with approximately forty (40) years of experience with regulated entities. (*Id*. at Attach. 1.)

69. Public Advocate Witness Parcell proposes a ROE in the range of 9.20%% to 9.50%, but recommends an overall ROE of 9.35%. (Exh. 15-Parcell, p.35.) Mr. Parcell’s recommedation is based upon the mid-point of the results of his DCF and Comparable Earnings models. Although Mr. Parcell also performed a Capital Asset Pricing Model

(“CAPM”) analysis, since Mr. Parcell did not use his CAPM results as support for his recommended ROE, this Report will not address his CAPM analysis in detail. (*Id.* at pp. 2-3.)

H. Witness Parcell’s Proxy Group.

70. Mr. Parcell performed two (2) separate Constant Growth DCF analyses using two (2) different proxy groups: 1) after utilizing screening criteria described below, Mr. Parcell determined that twelve (12), dividend-paying, publicly-traded, electric utility companies would serve as his proxy group for determining the ROE which the Commission should award to the Company; and 2) Mr. Parcell also analyzed Mr. Hevert’s proxy group. (Exh.15-Parcell; pp.19-20.)

71. Mr. Parcell’s proxy group screening criteria also included, for example, the following: 1) market capitalization of $1 billion to $10 billion; 2) electric revenues of 50% or greater; 3) common equity ratio of 40% or greater; 4) a Standard & Poor’s (“S&P”) stock ranking of A or B; and 5) a S&P or Moody’s Bond Rating of A. (*Id.*)

72. Mr. Parcell’s proxy group and approved 2012 ROEs are presented below:

Company	Ticker	2012 Approved ROE
Allete, Inc.	ALE	8.7%
Alliant Energy Corp.	LNT	11.0%
Avista Corp.	AVA	6.4%
Black Hills Corp.	BBOX	7.1%
IDACORP, Inc.	IDA	9.9%
MGE Energy, Inc.	MGEE	11.4%
Northwestern Energy	NWE	9.3%
Pepco Holdings, Inc.	POM	9.31%
Portland General Electric Company	POR	8.3%
TECO Energy, Inc.	TE	10.8%

Westar Energy, Inc.	WR	9.5%
Wisconsin Energy Corp.[10]	WEC	13.3%

(Exh. 15-Parcell,Sch. DCP-6, 10; Exhs. 50, 51, 52; TR.-462.)

I. Parcell's Constant Growth DCF Analysis.

73. **Witness Parcell's Proxy Group.** As opposed to Company witness Hevert who relies exclusively upon projected future earnings, Mr. Parcell's Constant Growth DCF analysis also relies upon considerable historical data.[11] "Public Advocate Witness Parcel considers five measures of growth: (1) historical, five-year average earnings retention growth rates from Value Line for 2008-2012; (2) five-year average historical growth in Earnings Per Share (EPS), Dividends Per Share (DPS) and Book Value Per Share (BVPS) from Value Line; (3) projected earnings retention growth for 2013, 2014 and 2016-2018 from Value Line; (4) projected EPS, DPS and BVPS growth rates from Value Line for years 2010-2012 to 2016-2018; and (5) five-year projections of EPS growth as reported by First Call." (Exh.18-Hevert, p.16; Exh. 15-Parcell, p.23.)

74. In his direct testimony, Mr. Parcell's reasoning for his Constant Growth DCF analysis as described above, is as follows:

> "It is apparent that recent economic and financial circumstances have been different from any that have prevailed since at least the 1930s. The late 2008-early 2009 deterioration in stock

[10] Only IDACORP, Inc., Portland General Electric Company, and Westar Energy, Inc., are included in both Mr. Hevert's and Mr. Parcell's proxy groups.

[11] Witness Parcell used a DCF model which "recognizes that the return expected or required by investors is comprised of two factors: the dividend yield (current income) and expected growth in dividends (future income)." (Exh. 15-Parcell, p.20.) The model is expressed as K=D/P + g, with K being the cost of capital, D is the current dividend rate, divided by P, the current price, plus g, the constant rate of expected growth. (*Id.*)

prices, the decline in U.S. Treasury bond yields, and an increase in corporate bond yields were evidenced in the then-evident "flight to safety [which ended in 2009]." On the other side of this "flight to safety" is the negative perception of the recent declines in capital costs and returns, which significantly reduced the value of most retirement accounts, investment portfolios and other assets.

One significant aspect of this has been a decline in investor expectations of returns. Finally, as noted above, utility interest rates are currently at levels below those prevailing prior to the financial crisis of late 2008 to early 2009 and are near the lowest level in the past 35 years."

(Exh.15-Parcell, p.14; emphasis supplied; Tr.-473.)

75. Mr. Parcell's Constant Growth DCF calculations using his criteria described earlier, compared with Mr. Hevert's proxy group using Mr. Parcell's criteria, is as follows:

	Mean[12]	Median[13]	Mean Low[14]	Mean High[15]	Median Low[16]	Median High[17]
Parcell Proxy Group	8.1%	7.9%	7.0%	9.4%	6.7%	9.0%
Hevert Proxy Group	8.2%	8.0%	6.8%	9.0%	6.4%	9.1%

(Exh. 15-Parcell; pp. 23-24.)

76. Mr. Parcell's "Update" of Mr. Hevert's Constant Growth DCF analysis of Hevert's proxy group, using Mr. Parcell's criteria and sources, is presented below:

[12] The "mean" is determined by adding the numbers on a list and dividing by the number of numbers on the list. (Merriam-Webster Dictionary.com.)
[13] The "median" is the middle value in a list ordered from smallest to largest. (Merriam-Webster Dictionary.com.)
[14] Using only the lowest growth rate.
[15] Using only the highest growth rate.
[16] Using only the lowest growth rate.
[17] Using only the lowest growth rate.

	Dividend Yield (1)	Expected Dividend Yield (2)	Zacks EPS Growth (3)	Zacks DCF (4)	Expected Dividend Yield (5)	First Call EPS Growth (6)	First Call DCF (7)	Expected Dividend Yield (8)	Value Line EPS Growth (9)	Value Line DCF (10)	Average DCF (11)	Expected Dividend Yield (12)	Highest EPS Growth (13)	Highest DCF (14)	Highest DCF Excl Extreme Values (15)
American Electric Power Co															
Cisco Corp															
Empire District Electric															
Great Plains Energy															
Hawaiian Electric Industries															
IDACORP															
Otter Tail Corp															
Pinnacle West Capital															
PNM Resources, Inc.															
Portland General Electric															
Southern Company															
Westar Energy															
Average	3.85%	3.95%	5.25%	9.20%	3.95%	5.03%	8.98%	3.98%	6.63%	10.61%	9.59%	3.99%	7.36%	11.35%	9.51%
Median	3.96%	4.06%	4.83%	9.19%	4.07%	5.03%	9.29%	4.09%	5.00%	9.01%	9.08%	4.10%	5.73%	9.84%	9.45%

(Exh. 15-Parcell, Sch. DCP-14.)

77. Staff’s Brief argues as follows for a 9.35% ROE: “Delmarva owns no generation, is solely a distribution company, has no competition, and serves a heavily residential customer base, which is stable and unlikely to relocate. Thus the economic risk to Delmarva is low. … [The DPA’s and] Staff’s suggested return of 9.35% on equity will enable the Company to attract necessary capital and meet its statutory requirement of providing safe and reliable service to its customers despite the currently low interest rate environment.”[18] (Staff OB, p.45.)

J. Hearing Examiner’s Constant Growth & Multi-Stage DCF Analysis.

78. Based upon the evidentiary record, I find that Company Witness Hevert’s Constant Growth and Multi-Stage Discounted Cash Flow

[18] Staff and the DPA also argue that the Commission should follow the Maryland Commission’s disagreement with Mr. Hevert’s proposed ROE in a recent case involving Pepco Holdings, Inc. (Staff OB, 41-46; DPA OB 122,127.) Aside from the fact that the Maryland Commission virtually agreed with Mr. Hevert’s proposed ROE in a recent rate case involving Delmarva Power Maryland, because neither Staff or the Public Advocate attempted to establish any evidentiary “nexus” between the awarded ROE in the Pepco Maryland rate case involving a different entity (with different revenues and expenses)and this Delaware rate case, I find the argument unpersuasive. (TR.-462-464.)

(DCF) Models to be the more credible ROE analysis. First, Staff did not present a ROE witness, although it relied upon Public Advocate Parcell's testimony. Although Public Advocate Witness Parcell presented his Constant Growth DCF analysis, he did not offer a Multi-Stage DCF analysis.

79. In this post-recession economy of increasing interest rates, I find that Company witness Hevert's overall position more persuasive. According to Mr. Hevert, "analysts' earning projections are the relevant measure of growth as, over the long term, dividend growth can only be sustained by earnings growth." (DPL OB, p.44.) Although I am sensitive to increasing rates for ratepayers during these challenging economic times, I find that Public Advocate Witness Parcell's approach is overly conservative. This is because it excessively relies upon data from the 2008 recession through and including 2012, the historical average earnings retention growth rates, and average historical growth in earnings per share, dividends, and book value.[19] (Exh. 18-Hevert, p.17.) As argued by Delmarva in its Opening Brief, there is no compelling reason for "[t]he use of … projected DPS, BVPS, and Sustainable growth rates …." (DPL OB, p.44.)

80. According to Mr. Hevert, "recently authorized returns for electric utilities in other jurisdictions provide a practical benchmark for assessing reasonableness of cost of equity recommendations in this case." (DPL OB, p.40.) Much of Mr. Parcell's

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[19] According to Brigham and Houston, two (2) prominent experts in this field, "[g]rowth in dividends occurs primarily as a result in earnings per share. Earnings growth, in turn, results from a number of factors, including 1) inflation; 2) the amount of earnings the company retains and invests; and 3) the rate of return the company earns on its equity (ROE)." (Eugene F. Brigham and Joel F. Houston, *Fundammentals of Financial Management*, p.317 (Concise 4th ed.))

historical criteria regarding dividends and book value for example, was generated during our national financial crisis, the worst of which has since ended.[20]

81. At the evidentiary hearing, both Company witness Hevert and Public Advocate Witness Parcell testified that interest rates have increased since November, 2012. (Tr.-428-29 (Hevert), Tr.-484 (Parcell).) According to Delmarva's Opening Brief, "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; and
> - The average Beta coefficient[21] for Company Witness Hevert's proxy group also increased

[20] Most financial industry analysts rely upon earnings per share analysis more than cash flow, dividends and book value. (*E.g.,* C.A Gleason *et al*., "Valuation Model Use and the Price Target Performance of Sell-Side Equity Analysts," *Contemporary Accounting Research* (March, 2012); Jing Liu *et al*., "Equity Valuation Using Multiples," *Journal of Accounting Research*, Vol. 40, No.1 (March, 2002); Stanley B. Block, "A Study of Financial Analysts: Practice and Theory," *Financial Analysts Journal* (July/August 1999)).

> rapidly after early August 2013, indicating that the proxy group's risk relative to the broad market measurably increased over several weeks. Both current and forward interest rates increased."

(DPL OB, pp.38-39, citations omitted.)

82. According to Delmarva's Witness Hevert, as interest rates increase, the Company's ROE generally should also increase even if not to the same degree. (Tr.-429.) Conversely, if interest rates decrease, then generally the Company's ROE should decrease. (*Id.*) The reason for this correlation between increasing interest rates and increasing ROE is that "increasing interest rates place more risk and [borrowing] costs on a capital-intensive utility like Delmarva." (Hevert, Exh. 18, p.40.) At the evidentiary hearing, Mr. Parcell also acknowledged a relationship between interest rates and a utility's ROE. (Tr.-483.)

83. Witness Hevert's Multi-Stage DCF analysis reflects that his projected ROE for his proxy group utilities exceeds Delmarva's claimed ROE of 10.25% only in his entire high earnings growth scenario, but not in his low or medium growth scenarios. (Exh. 18-Hevert, Sch.(RBH)-1.) In the medium earnings growth scenario, however, Mr. Hevert's calcuations are much closer to Delmarva's claimed 10.25% ROE than the Public Advocate's claimed 9.35% ROE. Even in Mr. Hevert's low earnings growth scenario, Mr. Hevert's calculations all exceed Mr. Parcell's recommended 9.35% ROE.

84. I find Mr. Hevert's Multi-Stage DCF analysis as persuasive as his Constant Growth DCF analysis in this docket because Multi-Stage

[21] The Beta coefficient of an investment measures its systemic risk or relationship between its return and the returns of the financial market as a whole. (DPL OB, pp.38-39.)

DCF analysis does not assume that earnings and dividends will grow indefinately at the same rate.[22] (Exh. 18-Hevert, p.18.) Also, the Multi-Stage DCF analysis model relies upon multiple earnings growth projections and longer—term financial market metrics. (*Id.*) Both features are particularly important due to the future uncertainty regarding "recent significant increases in Treasury bond yields, utility bond yields and the relative under-performance of utility stocks." (Exh. 18-Hevert; p.43.)

85. As to Mr. Hevert's Constant Growth DCF analysis reflected in his Rebuttal testimony, Mr. Hevert's projected ROE for his proxy group utilities exceeds Delmarva's claimed ROE of 10.25% only in his high earnings growth scenario, but not in his low or medium growth scenarios. (Exh. 18-Hevert, Sch.(RBH)-1.) In his direct testimony, however, the results of Mr. Hevert's medium and high growth earnings scenarios exceeded 10.25%. (Exh. 3-Hevert, Sch. (RBH)-1.)

86. According to Mr. Hevert's rebuttal testimony, "decreases in the Constant Growth DCF results [have occurred] as both the average dividend yield and projected growth rate for my proxy group have fallen since the filing of my Direct Testimony. As such, the Constant Growth DCF results are difficult to reconcile with current market conditions, in particular the significant increase in interest rates, and should be viewed with caution. It is precisely for precisely this type of circumstance that it is important to apply more than one

[22] For this reason, some state public utility commissions, for example Oregon, prefer the Multi-Stage DCF analysis. (PUC Order No. 12-437 dated Nov. 16, 2012.)

analytical approach in estimating the Cost of Equity…." (Exh. 18-Hevert, pp. 9-10.)

87. Public Advocate Witness Parcell also disagreed with Company Witness Hevert for including Otter Tail Power and PNM Resources in Hevert's proxy group due to what Mr. Parcell characterized as "unsustainable" growth rates. (Exh. 15-Parcell,pp. 40-41.) However, as an adjustment, Mr. Hevert removed Otter Tail Power from his Direct and Rebuttal calculations because it was "more than two standard deviations from the unadjusted growth rate…." (Exh. 18-Hevert, pp. 18-19.)

88. Additionally, Mr. Hevert "did not give weight to results well below any reasonable estimate of the Company's ROE in comparison to historical ROE results [finding such results highly improbable]." (DPL OB, p.40.) Delmarva's Opening Brief argues that "ROE estimates that are lower than any that have been observed even over the past two years should [not] be considered in determining the Company's ROE." (*Id.*)

89. As Delmarva's Opening Brief maintains, Public Advocate Witness Parcell "did not consider the improbability of growth rates that may be too low or unsustainable." (DPL OB, p.45.) Specifically, Mr. Parcell "included nine growth rates that suggest zero, or negative real growth." (*Id.*) Also, "using Mr. Hevert's lower limit of sustainable growth of 3.10%, [t]hirty-two of Public Advocate Witness Parcell's growth rate estimates (16 relating to his proxy group and 16 relating to Mr. Hevert's proxy group) are equal to or less than that threshold." (*Id.*)

90. Also, Mr. Hevert testified that “Value Line is the only service noted in DPA Witness Parcell’s Direct Testimony that provides DPS, or BVPS growth projections. While services such as Zacks and First Call survey multiple analysts to arrive at their consensus growth estimates, Value Line projections reflect the view of a single analyst.” (*Id.* at p.17.)

91. Finally, Mr. Parcell also disagreed with Mr. Hevert’s selection of the highest growth rate to form his three (3) forecasted scenarios. (Exh. 15-Parcell, pp. 38-41.) However, Mr. Hevert offered both mean and median results to be analyzed by the Commission. (Exh. 18, Hevert, pp. 18-19.) For the reasons described above, I find Company Witness Hevert’s DCF analysis more persuasive than Public Advocate Witness Parcells’ DCF testimony.

K. Hevert’s Capital Asset Pricing Model (“CAPM”) Analysis.

92. “The CAPM analysis is a [forward looking] risk premium approach that estimates ROE as a function of risk-free return plus a risk premium (to compensate investors for non-diversifiable risk).” (DPL OB, p.42; Exh. 3-Hevert, p.15.) The CAPM is defined by four (4) forward-looking estimated components.[23] (Exh. 3-Hevert, p.15.)

93. Although his CAPM findings form part of his ROE recommendation, Company witness Hevert echoed Witness Parcell’s concern that the Federal Reserve has recently maintained U.S. Treasury yields at historically low levels. (Exh. 18-Hevert, pp.20-21; Exh. 15,Parcell, p.34.) According to Mr. Hevert, the Federal Reserve’s

[23] The CAPM formula is k = rf +B (rm-rf), with k being the required market ROE for a security, rf the risk-free rate of return, B the Beta coefficient of that security (the non-diversifiable risk), rm the required return on the market as a whole, and rf again the risk-free rate of return. (Exh. 3-Hevert, p.15.)

policy “rather substantially” decreases CAPM estimates. (Exh. 18-Hevert, pp.20-21.)

94. Although not virtually discounting his CAPM results like Witness Parcell did, according to Mr. Hevert, primarily because low interest rates will not continue indefinately, “CAPM results do not reflect the appropriate range of ROE estimates.” (*Id.* at p.21; Exh. 15-Parcell, p.33.) Witness Hevert’s position is that, if the inverse relationship between this model and interest rates is considered by a simple linear regresssion analysis and a semi-log regression analysis, except for his lowest results, his CAPM results provide a reasonable ROE estimate. (Exh. 3-Hevert,p.20.)

95. For his CAPM analysis, Mr. Hevert employs two (2) different estimates of the long-term risk free rate. (Exh. 3-Hevert,p.17.) Those estimates are: 1) the current 30-day average yield on 30-year Treasury bonds (i.e 3.12%); and 2) the near-term projected 30-year Treasury yield (i.e 3.25%). (*Id.*) According to Witness Hevert, “equity ownership represents a perpetual claim on the subject company’s cash flows.” (*Id.* at p.23.) “Since the 30-year treasury bond is the longest duration risk-free security [and since utility assets represent long-term assets] it is, in my view, the appropriate security for [to match the perpetual equity claim in my analysis].” (*Id.* at pp. 23-24; Exh. 18-Hevert, p.17.)

96. Witness Hevert utilized three (3) Market Risk Premium values: a) Sharpe Ratio MRP (6.03%); b) *Ex ante* (or future) Bloomberg MRP (9.88%); and *Ex ante* Capital IQ MRP (9.81%). (Exh. 3-Hevert, Sch. (RBH)-4.) Mr. Hevert’s analysis included the average reported Beta

coefficients from Bloomberg, which uses a two (2) year period, and Value Line, which uses a five (5) year period, for each of his proxy group companies. (*Id.* at pp.19-20.)

97. Mr. Hevert developed two (2) forward-looking estimates of the Market Risk Premium: 1) the market required return (ROE based upon Constant Growth DCF), less the current 30-year Treasury bond yield;[24] and 2) "the Sharpe, which is the ratio of the long-term average Risk Premium for the S&P 500 Index, to the risk of that index."[25] (Exh.3-Hevert, pp.17-18.)

98. The results of Mr. Hevert's Capital Asset Pricing Model after averaging the current 30 year Treasury and the near-term projected 30 year Treasury, were as follows: a) using the Proxy Group Bloomberg Beta Coefficient, Sharp 8.98%, Bloomberg 10.52%, and Value Line 10.03%; and b) using the Proxy Group Value Line Average Beta Coefficient, Sharp 9.15%, Bloomberg 10.73%, and Value Line 10.23%. (Exh.18-Hevert, Sch. (RBH-R)-4, p.1.)

[24] See pages 17-18 of Mr. Hevert's direct testimony for a more complete explanation. (Exh.3.)

[25] See pages 18-19 of Mr. Hevert's direct testimony for a more complete explanation. (Exh.3.)

99. In his Rebuttal testimony, Mr. Hevert's CAPM results are as follows:

Capital Asset Pricing Model Results
Sharpe Ratio, Bloomberg, and Value Line Derived Market Risk Premium

	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]
			Ex-Ante Market Risk Premium			CAPM Results		
	Risk – Free Rate	Average Beta Coefficient	Sharpe Ratio Derived	Bloomberg Market DCF Derived	Value Line Market DCF Derived	Sharpe Ratio Derived	Bloomberg Market DCF Derived	Value Line Market DCF Derived
PROXY GROUP BLOOMBERG BETA COEFFICIENT								
Current 30-Year Treasury (30-day average) [9]	3.59%	0.707	7.53%	9.70%	9.01%	8.91%	10.45%	9.96%
Near-Term Projected 30-Year Treasury [10]	3.73%	0.707	7.53%	9.70%	9.01%	9.06%	10.60%	10.10%
Mean						8.98%	10.52%	10.03%
			Ex-Ante Market Risk Premium			CAPM Results		
	Risk – Free Rate	Average Beta Coefficient	Sharpe Ratio Derived	Bloomberg Market DCF Derived	Value Line Market DCF Derived	Sharpe Ratio Derived	Bloomberg Market DCF Derived	Value Line Market DCF Derived
PROXY GROUP VALUE LINE AVERAGE BETA COEFFICIENT								
Current 30-Year Treasury (30-day average) [9]	3.59%	0.729	7.53%	9.70%	9.01%	9.07%	10.66%	10.15%
Near-Term Projected 30-Year Treasury [10]	3.73%	0.729	7.53%	9.70%	9.01%	9.22%	10.81%	10.30%
Mean						9.15%	10.73%	10.23%

Notes:
[1] See *Notes [9] and [10]*
[2] Source: Schedule (RBH-R)-3
[3] Source: Schedule (RBH-R)-2
[4] Source: Schedule (RBH-R)-2
[5] Source: Schedule (RBH-R)-2
[6] Equals Col. [1] + (Col. [2] x Col. [3])
[7] Equals Col. [1] + (Col. [2] x Col. [4])
[8] Equals Col. [1] + (Col. [2] x Col. [5])
[9] Source: Bloomberg Professional
[10] Source: Blue Chip Financial Forecasts, Vol. 32, No. 7, July 1, 2013, at 2

(Exh. 18-Hevert, Sch. (RBH-R)-4.)

100. Witness Hevert's CAPM analysis reflects that his projected ROE for his Proxy Groups Bloomberg Beta Coefficient and Value Line Average Beta Coefficient exceed Delmarva's claimed ROE of 10.25% only in his Bloomberg Market DCF derived scenario, but not in his Sharp Ratio Derived and Value Line Market DCF Derived scenarios. (Exh. 18-Hevert, Sch.(RBH-R)-4.)

101. In his Value Line Market DCF Derived scenario, however, Mr. Hevert's calcuations are much closer to Delmarva's claimed 10.25% ROE than the Public Advocate's claimed 9.35% ROE. (*Id.*) Also, according to Witness Hevert, "taking into consideration the inverse

relationship between the MRP and interest rates (via both a simple linear regression analysis and a semi-log regression analysis) … produces CAPM estimates of 10.52% to 11.05% based on [Mr. Parcell's] proxy group." (Exh. 18-Hevert, p.31.)

L. Parcell's Response to Hevert's CAPM Analysis.

102. Mr. Parcells' results of his CAPM Model did not form any of the basis of his ROE opinion. Regardless, the Public Advocate argues that, "according to Mr. Parcells, his CAPM results should be considered as one factor in determining Delmarva's ROE." (DPA OB, p.129.) The Public Advocate further argues that "Mr. Parcells testified that they indicate that capital costs remain at historically low levels and that Delmarva's [Cost of Equity] is less than in previous years." (*Id.*)

103. Both Mr. Parcells and Staff's Brief criticize Mr. Hevert's selection of his risk premium because, according to Mr. Parcells, risk premiums have averaged less than 6% since 1929. (Exh. 15-Parcells, pp. 41-42; Staff OB, pp. 29-30.)

104. Also, both Staff's and the Public Advocate's Briefs criticize Mr. Hevert's discounting of his low ROE scenario-the Sharpe ratio-derived CAPM results-because the results are low when compared to results over the last thirty (30) plus years. (Staff OB, p.39; DPA OB, p.129.)

M. Hearing Examiner's CAPM Analysis.

105. Witness Hevert's CAPM analysis reflects that his projected ROE for his Proxy Groups Bloomberg Beta Coefficient and Value Line Average Beta Coefficient exceed Delmarva's claimed ROE of 10.25% only

in his Bloomberg Market DCF derived scenario, but not in his Sharp Ratio Derived and Value Line Market DCF Derived scenarios. (Exh. 18-Hevert, Sch.(RBH-R)-4.)

106. In his Value Line Market DCF Derived scenario, however, Mr. Hevert's calcuations are much closer to Delmarva's claimed 10.25% ROE than the Public Advocate's claimed 9.35% ROE. (*Id.*) Also, according to Witness Hevert, "taking into consideration the inverse relationship between the MRP and interest rates (via both a simple linear regression analysis and a semi-log regression analysis) … produces CAPM estimates of 10.52% to 11.05% based on [Mr. Parcell's] proxy group." (Exh. 18-Hevert, p.31.)

107. Since Mr. Parcells' results of his CAPM Model did not form any of the basis of his ROE opinion, and despite Staff's and the DPA's criticism of Mr. Hevert's testimony, I find that Mr. Hevert's CAPM testimony is more persuasive than Mr. Parcell's CAPM testimony.

N. Hevert's Bond Yield Plus Risk Premium ("Bond Yield Plus") Analysis.

108. This regression analysis "estimates the Cost of Equity as the sum of an Equity Risk Premium (i.e the incremental return that an equity investment provides over a risk-free rate) and a bond yield." (Exh. 3-Hevert, pp. 21-22.) This approach "is based on the financial tenet that equity investors' returns are subject to more risk than returns to bondholders." (DPL OB, pp.42-43.) "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." (*Id.* at p.43.)

109. Mr. Hevert defined his Equity Risk Premium as the 1,392 authorized ROEs for electric utilities between Jan. 1, 1980 and Feb. 15, 2013 (the dependent variable), compared with the average 30-year Treasury yield (the independent variable), factoring in the average period of 201 days between case filing and final Commission order. (Exh. 3-Hevert, pp. 21-23.)) Using regression coefficients to factor in the negative relationship between the 30-year Treasury yield and the Equity Risk Premium, Mr. Hevert concluded that this model's ROE is between 10.29% and 10.90%. (*Id.* at p.23; Exh.18-Hevert, Sch. (RBH-R)-5.)

110. In his Rebuttal testimony, Mr. Hevert's Bond Yield Plus results are as follows:

Bond Yield Plus Risk Premium

	[1] Constant	[2] Slope	[3] 30-Year Treasury Yield	[4] Risk Premium	[5] Return on Equity
Current	-3.08%	-2.94%	3.59%	6.70%	10.29%
Near Term Projected	-3.08%	-2.94%	3.73%	6.58%	10.32%
Long-Term Projected	-3.08%	-2.94%	5.40%	5.50%	10.90%

111. Witness Hevert's Bond Yield Plus analysis reflects that his projected ROE for all three scenarios: a) Current; b) Near Term Projected; and c) Long-term projected, all exceed Delmarva's claimed 10.25% ROE. (Exh.18-Hevert, Sch.(RBH-R)-5.) Without making an adjustment, Witness Hevert states that the Commission should consider Delmarva's smaller size compared to the proxy group and the effect of

flotation costs in determining where “the Company’s ROE falls within the range of results.” (Exh. 3-Hevert pp. 25-26.)

O. Witness Parcell’s Response to Hevert’s Bond Yield Plus Analysis.

112. Mr. Parcells’ sole criticism in his direct testimony of Mr. Hevert’s Bond Yield Plus analysis was as follows: “the average authorized ROE for electric utilities has not been set as high as 10.23% since 2010 and has not been as high as 10.76% since 2003.” (Exh. 15-Parcells, p.42) “This indicates that Mr. Hevert’s risk premium results, which are claimed to be based on regulatory decisions, are excessive relative to these decisions.” (*Id.*)

P. Parcell’s Comparable Earnings Analysis.

113. According to Public Advocate Witness Parcell, his Comparable Earnings analysis “is designed to measure the returns expected to be earned on the original cost book value of similar risk enterprises.” (Exh. 15-Parcell-p.29.) Witness Parcell analyzes the ROEs between 1992 and 2012 earned for the two (2) subject proxy groups and the unregulated S&P 500 groups between 1992 and 2012. (*Id.* at pp. 29-32.) Then, Mr. Parcell compares these ROEs with the corresponding Market-to-Book ratio (“M/B”). (*Id.*) “The M/B ratio is the market price i.e stock price per share, divided by the total common equity (or the book equity) per share.” (DPL OB, p.46.)

114. For the proxy groups, Witness Parcell reasons that historical returns of 8.30% to 12.00% have been adequate to produce M/B ratios of 120.00% to 170.00%. (Exh. 15-Parcell-p.31.) The results are as follows: (Exh. 15-Parcell-p.31.)

115. For the S&P 500 groups, Witness Parcell reasons that historical returns of 12.40% to 14.70% have been adequate to produce M/B ratios of 204.00% to 346.00%. (*Id.* at p.32.) Finally, using financial metrics, Mr. Parcell finds that the risk level of the regulated utility sector is less than the risk level of the S&P 500 groups. (*Id.* at p.32 & Exh. DCP-12.)

116. Witness Parcell concludes that the ROE "for the proxy utilities is no more than 9.00% to 10.00%." (Exh. 15-Parcell-p.32.) "An earned return of 9.00% to 10.00% should thus result in a M/B [ratio] well above 100%." (*Id.* at pp.32-33.) "… [T]he fact that M/B ratios substantially exceed 100% indicates that historic and prospective ROEs of over 10% reflect earnings levles that are well above the actual COE for those regulated [proxy] companies." (*Id.* at p.33.) Mr. Parcell then designates the mid-point of this 9.00-10.00% range i.e 9.50% as Delmarva's ROE for his Comparable Earnings model. (*Id.*)

Q. Hevert's Response to Parcell's Comparable Earnings Analysis.

117. Delmarva argues that Mr. Parcell's Comparable Earnings analysis is unpersuasive because "[a]t the evidentiary hearing, DPA Witness Parcell recogized that he does not use a specific M/B ratio in his analysis, and that there is no formula for his analysis. In other words, it is subjective and inappropriate for reliance in this proceeding." (DPL OB, p.47 (*citing* Tr.-477.))

118. Moreover, Delmarva argues that Witness Parcell underestimates the required ROE by focusing on only one variable, the ROE, in Mr. Parcell's analysis of the Market Value Per Share in the

Market-to-Book ratio. (DPL OB, pp.46-47.) According to Delmarva, “the 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.” (*Id.* at p.46; Exh. 18-Hevert, pp.32-33.)

R. Hearing Examiner’s ROE Recommendation.

119. I describe in the graph below Delmarva’s and the Public Advocate’s/Staff’s final positions as to the following ROE models: Discounted Cash Flow (“DCF”), Capital Asset Pricing Model (“CAPM”), Bond Yield Plus Risk Premium (BYPRP”), and Comparable Earnings. (“CE”)

120. Staff did not proffer its own analysis as to the ROE the Commission should award to the Company. Instead, in developing its overall revenue requirement, Staff relied upon the ROE recommendation of Public Advocate Witness Parcell. (Exh. 11-Peterson, p.5; Staff OB, p.25.)

PARTY	DCF	CAPM	BYPRP	CE	FINAL POSITION
DELMARVA	10.25%-10.75% Constant Growth& Multi-Stage DCF	Proxy Group Bloomberg Beta Coefficient- Sharp-8.98% Bloomberg-10.52% Value Line-10.03% Proxy Group Value Line Average Beta Coefficient- Sharp-9.15% Bloomberg-10.73% Value Line-	Current-10.29% Near Term Projected-10.32% Long Term Projected-10.90%	n/a	10.25%

		10.23%			
PUBLIC ADVOCATE/ STAFF	9.20% Constant Growth DCF	n/a*fn[26]	n/a	9.50%	9.35%

121. Without repeating my earlier analysis of these ROE models, based on the evidentiary record presented to me, I recommend that the Commission award a 10.25% ROE to the Company. Currently, the Company's awarded ROE is 9.75%. I was presented with only two (2) options: the Company argued that it was entitled to a 10.25% ROE and the Public Advocate/Staff argued that the Company was entitled to a 9.35% ROE.

122. The Company presented four (4) models: the Constant Growth DCF, the Multi-Stage DCF, the Capital Asset Pricing Model ("CAPM"), and the Bond Yield Plus Risk Premium ("BYPRP") model. The Public Advocate/Staff presented two (2) models: the Constant Growth DCF and the Comparable Earnings models. Again, I recommend that the Commission award a 10.25% ROE to the Company.

VI. CAPITAL INVESTMENTS.

123. Regarding Delmarva's capital investments, including its reliability investments, I will now describe a) the post-test year capital investment amounts Delmarva is claiming in this docket; b) Commission precedent as to awarding post-test year, capital investments ; c) Delmarva's Objectives and Initiatives and Docket 50; d) Delmarva's legal arguments for payment); e) Public Advocate's and Staff's Argument Against Awarding the Company its Capital Investments; and f) my Recommendations, which all follow Commission precedent.

[26] As previously stated, Public Advocate Witness Parcell did not use his CAPM results to form any basis for his recommended ROE.

A. The Capital Investments Delmarva is claiming in this Docket.

124. Delmarva is claiming two (2) post-test period adjustments which Staff and the Public Advocate have objected to, for different reasons explained later. The two (2) proposed adjustments are as follows:

ADJUSTMENT	AMOUNT OF INCREASE TO RATE BASE	AMOUNT OF DECREASE TO TEST PERIOD EARNINGS	OBJECTED TO BY STAFF & DPA
Adjustment 26A- *Actual* Plant Closings From January-August, 2013	$39,876,047	$549,901	Yes
Adjustment 26B- *Forecasted* Plant Closings From September-December, 2013	$18,355,521	$247,373	Yes

(DPL OB, pp. 59,64.)

B. Commission Precedent As To Post-Test Year Capital Investment Adjustments.

125. In the two (2) most recently litigated rate cases addressing post-test year, capital investments, the Commission ordered as follows:

Docket No.	Adjustment Description	OBJECTED TO BY STAFF & DPA?	Commission Order
05-304	4 Months of *Actual* Plant Closings	No. Uncontested	Awarded to Company
09-414	9 Months of *Actual* Plant Closings	DPA-Yes Staff-No as to first 4 months ;Yes as to remaining 5 months	Awarded to Company

(DPL OB, pp.19,59,61,64; PSC Order No. 8011, §§53-60.)

C. Delmarva's Argument for Payment. Adjustment 26A.

126. Delmarva argues that its post-test year Adjustment 26A, which involves actual plant closings eight (8) months after the test

year, is similar to the nine (9) month plant closings adjustment approved by the Commission in Docket No. 09-414 over Staff's and the Public Advocate's objections in that docket. (DPL OB, p.61.) Also, the Commission allowed recovery for four (4) months of such plant closings in Docket No. 05-304. (*Id.*) The Company argues that, although outside the test period, the plant closings for which the Company seeks recovery in this case are in service, directly benefitting customers, and are known and measurable. (*Id.* at pp.60-61.)

127. In Docket No. 09-414, the Commission opined about the permissibility of some post-test period capital investment adjustments as follows:

> "As demonstrated in our deliberations on the individual issues, we do not accept the DPA's position that a utility using a 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 [Minimum Filing Requirements] 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." (PSC Order No. 8011, ¶48.)

128. Post-test period adjustments are permitted by the Commission's regulations as follows:

> "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." (26 *Del Admin Code* 1002, Part A §1.3.1)

129. Finally, Delmarva's Brief provides that, in a base rate case, the Commission must consider and allow the normally accepted

operating expenses of a utility corporation unless found to have been found to have been made in bad faith, an abuse of discretion, waste or inefficiency. (DPL OB, p.8, *quoting* Delmarva Power & Light v. Public Serv. Comm'n, 508 A. 2d 849,859 (Del. 1986) (additional citations omitted)); Staff OB, pp.12-13.)

130. Adjustment 26B. Unlike Adjustment 26A which involves actual plant closings, Adjustment 26B involves forecasted plant closings from September to December, 2013, adjusted to reflect any retirements to plant during this period. (DPL OB, p.64.) Delmarva argues that the costs of the forecasted plant closings are known and measurable, but obviously does not argue that the plant is in service. (*Id.*) The Company does argue that "[t]here is no concern regarding intergenerational inequity because the plant being placed into service will enhance reliability for the same customers who will pay the rates established in this case." (*Id*. at pp. 64-65.)

131. Delmarva's Objectives & Initiatives. Regarding its infrastructure investments, Delmarva argues that it "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." (DPL OB, p.11.)

132. According to Delaware law, as a public utility, Delmarva is required 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." (26 *Del. C.* §209(a)(2). Delmarva's Opening Brief refers to

this as “the requirement to provide safe, adequate and proper service.” (DPL OB, p.9)

133. In 2006, in Docket 50, the Commission adopted the “Electric Service Reliability and Quality Standards.” (26 *Del. Admin. Code* 3007 et. seq.) In Docket 50, the Commission required Delmarva to achieve a minimum SAIDI (System Average Interruption Duration Index) Requirement of 295 minutes. (*Id*. at 3007, §1.3.)

134. This SAIDI Requirement means that Delmarva customers may not experience an average loss of service of more than 295 minutes per year. (*Id*.) Thus, because an average is involved, some customers may experience a loss of service of more than 295 minutes per year. (*Id*.; TR-737-41.) The lower the SAIDI number in a particular year, the better Delmarva is doing regarding this standard. (*Id.*)

135. Delmarva argues that Delmarva properly exercised its professional judgment in providing “safe, adequate and proper service,” and in meeting Docket 50’s requirements. Delmarva argues as follows:

> “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;”
> 2. “Compliance does not create a presumption of safe, adequate and proper service;”
> 3. “Each EDC [Electronic Distribution Company] needs to exercise their professional judgment based on their systems and service territories;” and

4. “EDCs are required to explore the use of proven state of the art technology, to provide cost effective electric service reliability improvements.”

(DPL OB, p.9; citations omitted)

136. <u>Delmarva’s Five (5) Objectives</u>. Delmarva maintains that it has the following five (5) “Objectives” in exercising its professional judgment to make infrastructure improvements:

a. Enhanced Reliability Is Expected and Needed By Customers Due To Growing Dependence Upon Reliable Electricity By An Increasingly Digital/Electronic Society And Economy.

b. The Increase In The Frequency And Severity Of Storms Has Posed New System Reliability Challenges To Utilities.

c. Delmarva Must Replace Aging infrastructure To Avoid Diminished System Reliability and Increased Customer Outages.

d. 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.

e. 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.

(DPL OB, pp.11-19.)

137. <u>Customers Expect And Need Greater Reliability In An Increasingly Digital & Electronic Society.</u> Company Witness Michael Maxwell testified on behalf of the Company as to the Company’s infrastructure investment plan. His position is Vice President of Asset Management for Pepco Holdings, Inc. (TR.-302-03.) He is an electrical engineer with over twenty five (25) years of electrical

experience. (*Id.*) Regarding Delmarva Delaware, his responsibilities include the equipment design and engineering of all of its distribution assets, including all environmental and large projects. (*Id.*, Tr.-721.)

138. Mr. Maxwell testified as follows:

> "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."

(Exh.19-Maxwell,p.4.)

139. <u>Increase in the Frequency and Severity of Storms.</u> Another Delmarva Objective is to address the increase in the frequency and severity of storms. Company Witness Maxwell testified:

> "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 [Mid-Atlantic] 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."

(Id. at p.5.)

140. Aging Infrastructure. Delmarva's Third Objective is addressing the issue of aging infrastructure. According to the Company, "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." (DPL OB, p.15.)

141. According to the Company, its primary aging infrastructure issue is the industry-wide need to replace aging underground residential cables (URD cables) manufactured in the 1970s or early 1980s due to a high failure rate. (DPL OB, pp.14, 23; Exh. 84.) The Company has a tracking program and is attempting to replace these URD cables before service interruption. (*Id.* at pp.14-15; Exh. 84.) Through its Equipment Condition Assessment Program, in advance, the Company determines which substation transformers are near the end of

their service life, are not in good condition, or could soon experience over load due to for example “PNB,” Perspective New Business. (*Id.* at p.23; TR.-709-10.)

142. Delmarva also has a Switchgear Replacement Program which monitors service interruptions since much of this equipment was installed in the 1970s and is approaching the end of its useful life. (Exh. 82.) At some point, equipment which needs constant maintenance has to be replaced to avoid service interruptions. (TR.-716.) The Company’s “Design Authority” examines which new technology should replace the current equipment. (Tr.-723.)

143. <u>The Importance of Reliable Electric Service to its Customers</u>. As Company witness Maxwell testified at the evidentiary hearing, for many years, Delmarva has used quarterly customer satisfaction surveys of between 300 and 450 customers performed by Market Strategies International ("MSI") to measure customer satisfaction. (TR. 750-56; Exh. 83.) According to Delmarva, these surveys have consistently found that the most important “driver” of satisfaction to Delmarva's customers is reliability i.e. providing reliable electric service and restoring outages when they occur. (*Id.*) Mr. Maxwell also testified that “Delmarva's experience from … its Delaware operations … 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.” (Exh. 19-Maxwell, p.6.)

144. <u>Comparing Delmarva to Other Utilities</u>. Finally, as to Delmarva’s Objective No. 5, Company Witness Maxwell testified that

another factor in determining the appropriate level of reliability is comparing Delmarva's actual reliability performance with other electric distribution utilities. (*Id.* at p.7.) According to Mr. Maxwell, the results of the 2012 Institute of Electrical and Electronics Engineers ("IEEE") Annual Reliability Survey reflect 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 nation, and only 5 of 106 utilities would not have met the Docket 50 standard. (*Id.* at pp.7-8.)

145. Finally, Delmarva argues that, based upon its analysis of the five (5) Objections 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, as required by Delaware law. (DPL RB, pp. 12-13.)

146. <u>Delmarva's Five (5) Initiatives</u>. Additionally, Delmarva has five (5) "Initiatives" regarding its infrastructure investments:

a. Comply with Docket 50;

b. Load Growth and Load Maintenance Projects;

c. Priority Feeders;

d. URD Cable Replacement and other Aging Infrastructure – Substation Transformers and Switchgear; and

e. Distribution Automation.

147. Delmarva's Opening Brief describes some of the following achievements regarding its Initiatives:

a. <u>Comply with Docket 50</u> –

As Company Witness Maxwell testified to, the 2012 Annual Docket 50 Performance Report established that Delmarva bettered the minimum SAIDI 295 minute requirement with a system-wide SAIDI of 146 minutes. (DPL OB,p.22; Exh. 81.) In contrast, in 2010 and 2011, Delmarva's SAIDI performance was 199 and 192 minutes, *respectively*. (Exh. 4-Maxwell, p.6.)

b. Load Growth and Load Maintenance Projects –

“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 degradation in reliability.” (DPL OB, p.22.) 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 review the age, performance and condition of equipment through monitoring, testing and field inspections. The ECA identifies equipment that is not performing at a level adequate to meet current or projected future loads. When this monitoring and testing reveals deteriorated equipment conditions that could lead to overloads or other failures, action is taken to prevent customer outages.” (DPL OB, pp. 20-21)

c. Priority Feeders.

Repairing not only the 32 individual feeders exceeding Docket 50’s 295 minute SAIDI requirement, but also others not meeting the “reasonable reliability expectations and needs of customers.” (DPL OB, pp.20-21.)

d. URD Cable Replacement (and other Aging Infrastructure).

As discussed earlier, “[a]mong the aging infrastructure issues is the need to replace underground residential distribution cables (“URD cables”) that were manufactured in the early 1970s and 1980s. Delmarva, along with

> the rest of the industry, has been experiencing a high failure rate of these URD cables. Based upon the increasing failure rate, Delmarva adopted a policy whereby an increased effort would be made to identify aged and degraded URD cables and replace them before they fail." (DPL OB, pp. 14-15; emphasis deleted.) Additionally, many aging transformers and switchgear have been replaced. (*Id.*)

e. Distribution Automation.

> "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 Re-closers and Automated Circuit Switches to reduce both the number of customers affected by outages and the length of outages for customers who are affected." (DPL OB, p.24.)

D. Public Advocate's and Staff's Argument Against Awarding the Company its Capital Investments. Introduction.

148. The Public Advocate and Staff argue that the Commission should not in this Docket award the Company its claimed capital investment expenses for its actual plants closings (Adjustment 26A) nor its forecasted plant closings (Adjustment 26B). While the Public Advocate seeks outright denial, Staff seeks that the actual and forecasted plant closings be transferred to the Commission's Reliability Docket for evaluation.

149. The Public Advocate argues that Delmarva made these capital investments "to avoid the fate that befell its affiliate major Pepco in Maryland," referring to Pepco's service problems. (DPA OB,p.16) For reasons described later, the Public Advocate maintains that

Pepco’s Maryland experience does not require this Commission to award Delmarva Delaware these expenses.

150. Staff argues that Delmarva made these plant investments to comply with “the PHI corporate directive to build its asset base as a means to grow its earnings and maintain its earnings and maintain its dividend payout to its stockholders.” (Staff OB, p.54.) Staff maintains that the Company seeks to “grow into its dividend.” (*Id*. at p.3.) Both Staff and the Public Advocate also argue that, in determining whether to award Delmarva its infrastructure investments, the Commission should take into consideration that Delmarva intends to file rate cases more often than usual. Since the Public Advocate’s and Staff’s arguments are intertwined, I will discuss them together in this Section, while noting where they differ.

151. Argument Against Payment. Staff Witness David Peterson and Public Advocate Witness Andrea Crane oppose Adjustment 26. Staff Witness Peterson maintains that Adjustment 26 violates the test period matching principle, and will create a mismatch between plant investment and the revenues and expenses from the plant investment. (Exh. 11 – Peterson, p.11.) Similarly, Public Advocate Witness Crane recommends that all post-test 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. (Exh. 13, Crane, p.6.)

152. Although the Commission previously awarded Delmarva post-test period plant investment which is in service, the Public Advocate and Staff argue that this docket is much different, and a different result is warranted. Their major substantive reasons are as follows:

A. Delmarva has easily met Docket 50's SAIDI standards "by a wide margin for years." (DPA OB, p.3; *See* Staff OB, pp.13-17.)

B. Docket 50 is "the only applicable standard dealing with reliability issues." (Staff OB, p.15; *See* DPA OB, p.26.)

C. Delmarva did not establish "how its investment of millions upon millions of Delaware ratepayers' dollars will make service to them any more reliable than it already is." (DPA OB, p.3; *See* Staff OB, p.15.)

D. Unlike Maryland, nothing has occurred in Delaware which warranted these plant investments. (DPA OB, p.26; Staff OB, p.17.)

E. Delmarva did not establish the cost-effectiveness of these plant investments i.e. cost vs. benefits. (DPA OB pp. 33-34; Staff OB, p.17.)

F. Delmarva's reliance upon its broad "professional judgment" masks that Delmarva does not have "an appropriate regulatory target" allowing whatever spending Delmarva wants. (Staff OB, p.16; *See* DPA OB, pp.36-39.)

I will now discuss Staff's and the Public Advocate's reasons for denying payment in the order presented above.

153. <u>"Delmarva has easily met Docket 50's SAIDA standards by a wide margin for years." "Docket 50 is the only applicable standard dealing with reliability issues."</u> Docket 50 provides as follows:

> 1.3 Compliance with this regulation is a minimum standard. Compliance does not create a presumption of safe, adequate and proper service. Each EDC [Electric Distribution Company] needs to

> exercise their professional judgment based on their systems and service territories. Nothing in this regulation relieves any utility from the requirement to furnish safe, adequate and proper service and to keep and maintain its property and equipment in such condition as to enable it to do so. (26 *Del. C*. § 209.)
>
> 1.8 EDC's are required to explore the use of proven state of the art technology, to provide cost effective service reliability improvements.

154. The Public Advocate argues that, since it is undisputed that the Company satisfied the 295 SAIDI requirement of Docket 50 prior to the claimed infrastructure investments, the Company should not be compensated for the plant investments since it has not demonstrated the need for the plant investments. (DPA OB, p.3.)

155. Similarly, Staff argues that since the Company satisfied Docket 50's SAIDA requirement, the Commission should not award the Company the plant expenses in this docket opened in March, 2013. However, Staff argues that these expenses should be evaluated in the Commission's Reliability Docket, Docket No. 13-152 opened in May, 2013. (Staff OB, pp.19-21.)

156. Staff's Opening Brief argues as follows: "Ms. Vavro concluded that: (1) Silverpoint saw no engineering necessity for the reliability enhanced capital projects to maintain SAIDI at current levels; and (2) that by seeking rate base treatment for these capital investments now the Company is essentially "putting the cart before the horse" given that the Company has no new performance standards to meet nor is there any framework or context within which to consider these additional investments. Thus, [Ms. Vavro] concluded that the dramatic increase in reliability spending must be part of a broader

corporate strategy, and certainly was not driven by the existing reliability standards found in Regulation Docket No. 50." (Staff OB, p.19.)

157. <u>"Delmarva did not establish how its investment of millions upon millions of Delaware ratepayers' dollars will make service to them any more reliable than it already is." "Unlike Maryland, nothing has occurred in Delaware which warranted these plant investments. Delmarva did not establish the cost-effectiveness of these plant investments i.e. cost vs. benefits."</u> The Public Advocate's Brief describes Pepco's major service problems in Maryland and resulting in $1 million fine. (Staff OB, pp.21-26.) Arguing that Pepco's Maryland experience caused Delmarva's plant investment in this case, the Public Advocate argues as follows:

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

> full year thereafter." (Staff OB, p.26; citations omitted.)

158. As to Delmarva not establishing the cost-effectiveness of its proposed capital investments, the Public Advocate referred to testimony from Dr. David Dismukes, PH.D, a consulting Energy Economist from Louisiana State University:

> Delmarva spent hours examining Mr. Maxwell on "redirect" about how PHI evaluates its projects for necessity and cost-effectiveness and introduced during that redirect numerous documents purporting to show PHI's policies on various activities and how PHI actually does assess the costs and benefits of projects. Dr. Dismukes already knew all of this, however he had already reviewed the documents that Delmarva introduced on redirect: he testified that DPL stated that "it employs a variety of other methods to ensure that investments are developed in an 'economic' manner such as: competitive bidding of materials and use of standard engineering design and work practices to ensure that the work is accomplished such that it meets all applicable standards." But, he testified, these are not cost-benefit analyses. Nothing that Delmarva introduced into evidence at the hearing addressed any of the specific reliability projects contained in Adjustment 26. If such evidence existed, wouldn't it be fair to assume that Delmarva would have addressed it in its rebuttal, or at the very least during its extended redirect examination of Mr. Maxwell? This belies Delmarva's contention that traditional economic cost-benefit analyses cannot be done because the costs and benefits of its reliability plans do not lend themselves to such analysis." (DPA OB, pp.29-30, citations omitted.)

159. Finally, after the Derecho storm, the recent trend in Maryland is to require cost-benefit analyses from electric utilities:

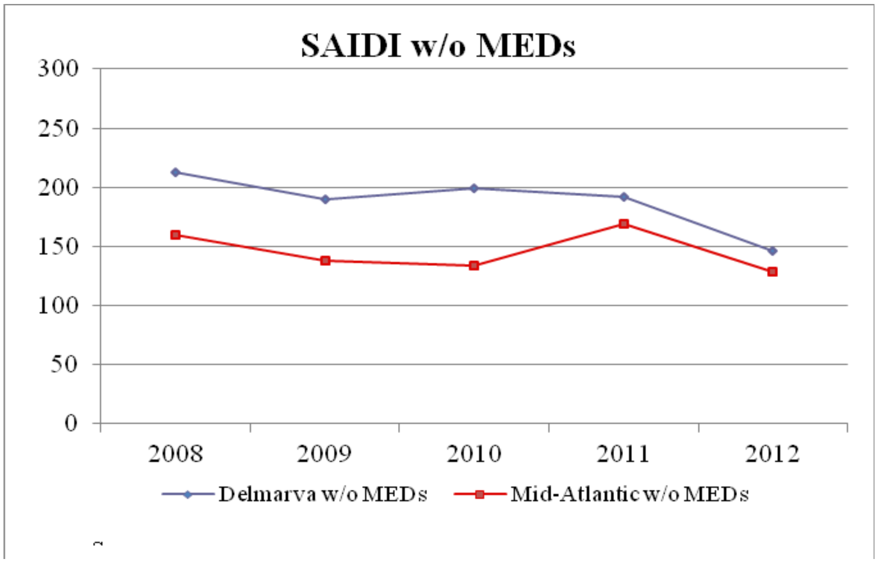
> "Moreover, we know that cost-benefit analyses *can* be done; in fact, Delmarva's affiliate Pepco recently filed a cost effectiveness analysis of its proposed selective underground proposals in Maryland and the District of Columbia, in which it used the results of a 2008 Department of

Energy meta-study to evaluate the reductions in outage costs for residential customers as a benefit associated with its selective undergrounding proposal and then compared those benefits to the undergrounding program costs. Furthermore, the Maryland PSC has explicitly directed electric utilities subject to its jurisdiction to include a cost-benefit analysis for every reliability improvement proposed in their short-term five-year plans, so Delmarva is going to have to perform cost-benefit analyses for the projects in its Maryland REP." (DPA OB, p.29; citations omitted.)

160. Staff's argument is much more cynical as to Delmarva's motive for its capital investments: corporate greed. (Staff OB, p.2.) Staff's Brief argues as follows:

"This rate case is not prompted by the Company's actual needs as much as by its greed. This case is about the shareholders – not the ratepayers. The Company is on a spending spree, spending millions of dollars on capital projects that are not required by any applicable Delaware law or regulation…. [T]hese projects are necessary to increase revenues and to sustain existing dividends, not to meet any reliability requirements in Delaware. Although the Company wraps its request in a purported need to sustain reliability – to meet its own theoretical regulatory paradigm – unwrapped it is nothing more than a naked demand for additional revenues surrounded by a patina of a purported need that does not exist – at least not in Delaware." (DPA OB, p.2.)

161. <u>"Delmarva's reliance upon its broad professional judgment masks that Delmarva does have an appropriate regulatory target allowing whatever spending Delmarva wants."</u> Staff argues that the following graph shows how Delmarva compares to other unspecified electric utilities operating in the Mid-Atlantic region:



(Exh. 86.)

162. According to Staff's Brief:

> "Clearly, Delmarva's performance on a system basis is comparable with other utilities in the region. As pointed out above [in the graph], there is no basis on which to opine as to why the level of spending that was appropriate in 2008 through 2010, when Delmarva's SAIDI was in the 200 range must be substantially augmented and why it must happen now.
>
> In fact, Delmarva's own planning documents indicate that it did not think it would achieve a SAIDI of 142 until 2016 – three years after the close of this record. But it did achieve a 146 SAIDI in 2012. Obviously, the Company's "professional judgment" under forecasted the impact on its system reliability from investing an additional by $30 million dollars a year. But that begs the question of why is the Company spending so much so quickly. And it can't be because of more frequent storms as the Company suggests. The SAIDI standard being discussed excludes major events such as Hurricane Sandy and the wind event on June 29, 2012, referred to as Derecho. Nor are those events being addressed in the Reliability Enhancement Plan initiated in Delaware in 2011. There is no real initiative aimed at reducing outage time for individual customers in those situations. As Mr. Maxwell was forced to admit, the Customer Average Interruption Duration Index ("CAIDI"), which measures the length of time an individual

> customer suffers an outage, has not changed measurably since 2002; it remains around two (2) hours.[27] Thus, one's opinion about the severity of recent storms, and how Delaware has not suffered the way other Mid-Atlantic states have, is not casually related to the question of what is an appropriate SAIDI level in Delaware."
>
> (Staff OB, pp.18-19.)

163. The Public Advocate argues that the $39 million Automated Distribution System ("AMI") was supposed to improve reliability. (DPA OB, pp.19-20.) The Commission approved AMI in 2008. (*Id.*) "Delmarva's claim that its investments have resulted in improved reliability (even assuming it is true) does not establish that the projected post-test period investments will improve reliability. And in any event, that claim is nothing more than an assumption. AMI for electric customers went into effect on a system-wide basis in 2011. Since AMI was supposed to help improve reliability and postpone or obviate the need for reliability spending, it is just as likely that AMI implementation had something to do with its SAIDI improvement between 2011 and 2012. And a 50/50 likelihood that Delmarva is wrong does not satisfy its burden of proof." (DPA OB, p.35.)

164. The Public Advocate also disputes Delmarva's reliability work itself: "Delmarva acknowledged in its opening brief that 32 individual feeders' SAIDIs exceed the Regulation Docket No. 50 standard of 295 minutes. Mr. Maxwell testified that Delmarva may or may not fix all 32 of these poorly performing feeders in 2013. And although some of the feeders with high SAIDIs have been identified as candidates for corrective action in the immediate future, *most have*

[27] The Company's recent CAIDI results are: Year 2010-136 minutes, Year 2011-136 minutes and Year 2012-129 minutes. (Exh. 81, p.3.)

not. Delmarva's assertion that it exercised its "professional judgment to determine that failing to address any feeders above the Docket 50 worst performing would not meet the reasonable reliability expectations and needs of customers" is belied by its own documents." (DPA OB, p.38; citations omitted)

165. The Public Advocate further disputes Delmarva's reliability claims: "Next, Delmarva identifies its URD cable replacement, substation transformers and switchgear policies. But all it does is identify these general items: it does not indicate what the problems with these items in Delaware are, and does not identify which of the projected projects in it Adjustment 26 will remedy the unidentified problems." (*Id.*; citations omitted.)

166. According to the Public Advocate, "Delmarva offers Distribution Automation ("DA") as part of its commitment pursuant to Regulation Docket 50's directive to effect reliability improvements. Most of its discussion centers on what exactly DA is and what it does. But Delmarva also points out that it has been required to do this since September 2006, when Commission adopted the electric service reliability and quality standards. Delmarva also identified DA as an important benefit associated with AMI in Docket No. 07-28." (*Id.*; citations omitted.)

167. The Public Advocate also argues that Delmarva could have used a partially forecasted test period which would have produced three (3) months of actual data i.e. January to March, 2013. (DPA OB, p.40.) If so, Delmarva would have been required to project nine (9) months of expenses. (*Id*. at p.41.)

168. Finally, the Public Advocate argues that the proposed capital investments are not known and measurable because Delmarva's projected expenses are not reliable. (*Id*. at pp.41-42.)

> "Even after Delmarva split Adjustment 26 into two parts to reflect actual costs through August 31, 2013 and projected costs from September through December 2013, Dr. Dismukes testified without contradiction that the actual costs through August 31, 2013 were 20% *less* than what Delmarva had projected. He also testified without contradiction that: (1) Adjustment 26 contains almost $10 million for 14 reliability projects that Delmarva had budgeted for previous years but which included in the 2013 projections and (2) there have been large variances in Delmarva's capital budgets: in 2007, it went over budget on reliability investments by 25%; in 2009, it was over budget by 12.1%; and in 2012 it was over budget by 6.7%. There have also been large variances within individual projects: the Millsboro District Priority Circuit project, which is part of Adjustment 26, was over budget by 182.5% in 2011 and was under budget by 46.8% in 2012, and the 2012 Christiana District Distribution Automation project was budgeted at $1.5 million but cost $3.4 million – a variance of 131%. Delmarva projected closing 95 projects to plant from January – March 2013, but only closed 55 of those projects during that time frame. And the amount Delmarva closed to plant from January – March 2013 was $9.4 million compared to the forecast of $21 million." (*Id*. at pp.41-42; citations omitted.)

169. <u>Average Rate Base vs. Year-End Rate Base</u>. Before I give my recommendations as to the Company's proposed capital investment adjustments, I need to address how rate base is calculated. The Commission currently uses average rate base, as opposed to year-end rate base as proposed by the Company. (Exh. 11-Peterson, p.7.) Average rate base is sometimes referred to as "the thirteen-point average." (*Id.*) If the Commission remains with the average rate base

method, then the Company's rate base is reduced by $41 million rather as proposed in the Application. (Staff OB, pp.47-48.)

170. According to Staff Witness Peterson, the average rate base or 13–point average reflects traditional ratemaking because rate base, particularly plant investment, is measured throughout the entire period (i.e. the test year beginning balance and the twelve month-end balances). *(Id*. at pp. 9-11.) The year-end rate base only calculates the rate base at year-end, in this case 2012. (*Id.*)

171. According to Staff Witness Peterson, the problem with the year-end rate base is that, unlike the average rate base method, the year-end method does not give due consideration to when, for example, plant is placed into service. (*Id.* at p.10.) Under the average method, for example, if plant is placed into service in January, it would receive more favorable treatment under the average method than plant placed into service in December. The year-end method would not make any distinction. (*Id.*)

172. According to Staff Witness Peterson, the year method "understates the income producing capability of the Company's present rates and overstates Delmarva's present deficiency." (*Id.*) "Delmarva's rate payers end up paying higher rates to compensate the Company for its cost of service." *(Id.)*

173. Delmarva argues that year-end rate base "better reflects the assets which will be serving customers during the rate effective period…." (Exh. 5-Ziminsky, p.33.) Also, Atlantic City Electric, Delmarva's affiliate, uses the year-end average method. (*Id*.) In its Reply Brief, Delmarva argues that increasing rate base and low growth

resulting in regulatory lag warrants a year-end approach. (DPL RB, p. 37.) Finally, Delmarva argues that the Commission's Minimum Filing Requirements permit Delmarva's suggested approach. (*Id.*)

174. I agree with Staff that the Commission should continue using the average rate base method for the reasons described above in Staff Witness Peterson's testimony, which I found very persuasive. Delmarva has not raised any credible argument to change the Commission's current practice. Thus, I recommend that the Commission not approve the Company's request to change from using the average rate base method to the year-end rate base method.

E. Hearing Examiner's Capital Investments Recommendations.

175. I recommend that the Commission award the Company its plant closings from January, 2013 through and including August, 2013, by approving Adjustment No. 26A. I also recommend that the Commission not award the Company its *forecasted* plant closings from September, 2013 through and including December, 2013, by not approving Adjustment No. 26B.

176. I agree with Delmarva that its post-test period Adjustment 26A, involving actual plant closings eight (8) months after the test year, warrants Commission approval, based upon the nine (9) month plant closings adjustment approved by the Commission in Docket No. 09-414 over Staff's and the Public Advocate's objections in that docket. (DPL OB, p.61.) Also, the Commission allowed recovery for four (4) months of such plant closings in Docket No. 05-304. (*Id.*) The Company persuasively argues that, although outside the test period, the plant closings for which the Company seeks recovery in this case are in

service, directly benefitting customers, and are known and measurable. (*Id.* at pp.60-61.) Thus, I recommend that the Commission approve Adjustment 26A.

177. Unlike Adjustment 26A which involves actual plant closings, however, Adjustment 26B involves forecasted plant closings from September to December, 2013, adjusted to reflect any retirements to plant during this period. (DPL OB, p.64.) Delmarva argues that the costs of the forecasted plant closings are known and measurable, but obviously does not argue that the plant is in service. (*Id.*) The Company does argue that "[t]here is no concern regarding intergenerational inequity because the plant being placed into service will enhance reliability for the same customers who will pay the rates established in this case." (*Id*. at pp. 64-65.)

178. In Docket Nos. 09-414 and 05-304, the Commission allowed post-test period plant if, like Adjustment 26A, the plant closings were in service, directly benefitting customers, and were known and measurable. (*Id.* at pp.60-61.) However, Commission precedent does not permit recovery regarding forecasted plant closings because they are not in service. Accordingly, I recommend that the Commission not award the Company its forecasted closings from September, 2013 through and including December, 2013, by not approving Adjustment No. 26B.[28]

179. Based upon the evidence and legal argument described above, I also find as follows: a) Docket 50's SAIDI requirement of 295 is

[28] I also find that the expenses related to Adjustment 26A, and all other expenses described in this Report for which I have found that the Company met its Burden of Proof, were not incurred in bad faith, waste, inefficiency, or out of an abuse of discretion. (Delmarva Power & Light Co. v. Public Serv. Comm'n*,* 508 A.2d 849, 859 (Del. 1986))

only one (1) minimum reliability standard which the Company must comply with, and that the Company complied with its SAIDI requirement through the end of the test period, December 31, 2012; b) under Delaware law, the Company has a broader duty than Docket 50's SAIDI requirement, specifically to provide "safe, adequate and proper service" according to 25 *Del. C.* §209(a)(2); c) as permitted by the express language of Docket 50, which permits an electric company to exercise its professional judgment, the Company properly reasonably exercised its professional judgment in providing "safe, adequate and proper service," by installing the capital investments described in Adjustment 26A, and by addressing service and reliability needs relating to, for example, URD cables, switchgear, substation transformers, equipment assessment, priority feeders, and Distribution Automation.

180. Staff and the Public Advocate oppose both adjustments for the reasons described earlier herein. However, Staff argues that both Adjustment 26A and 26B should be transferred to the Commission's pending "Reliability Docket" to be evaluated, while the Public Advocate argues that both adjustments should be denied by the Commission in this docket.

181. Due to the Public Advocate's and Staff's evidence and Briefs, particularly Dr. Dismukes' testimony, I too have concerns about whether Delmarva's future capital investment plans are cost-effective. However, as to Adjustment 26A, I did not find Staff's and the Public Advocate's argument that evidence regarding cost-effectiveness was lacking persuasive because, to date, this Commission

has never required a cost-effectiveness study from Delmarva for its capital investments.

182. As reflected in the following table, during 2008 through 2012, Delmarva's net plant in service has increased at the average annual increase of $39.2 million or 7.1%. (Exh. 20-Ziminsky, p.8.)

Year	**Plant in Service Average ($Mil)**	**Plant in Service Increase**	**Plant in Service Increase %**
2008	$511.9	$35.7	7.5%
2009	$542.3	$30.4	5.9%
2010	$582.2	$39.9	7.3%
2011	$633.5	$51.3	8.8%
2012	$672.2	$38.7	6.1%
2013		*$39.9* (closings, Jan.-Aug.2013, if approved)	

(*Id.*; DPL OB, 59,64.))

183. "Delmarva plans to make infrastructure investments of approximately $400 million over the next five years to address infrastructure replacement and to enhance and maintain the reliability of the Company's system to better serve and meet the expectations of Delmarva's customers." (Exh. 17-Boyle,p.2.)

184. With low growth and declining customer usage, Delmarva's proposed infrastructure investments, which would greatly outpace its spending in 2008-2013 described above, are possibly unsustainable for Delmarva's residential customers. On average, the proposed spending could reach $80 million per year through 2017. Also, as argued by Staff, these infrastructure improvements may be benefitting large business customers much more than residential customers, yet these large business customers may not be shouldering enough of the

financial burden.[29] I believe that cost-benefit studies are often helpful not only as to this issue, but also the issues of SAIDI and CAIDI compliance as to all forecasted major infrastructure improvements.

185. In the Company's defense, there is no evidence in this case that Delmarva has had major service issues in Delaware, although Delaware was largely spared by the major storms which severely damaged our neighboring states, New Jersey and Maryland. Also, regulators who deal with a prior, historical test year have the comforting benefit of hindsight, while an electric utility like Delmarva must plan future, reliable infrastructure to properly serve its increasingly service restoration and digitally demanding customers in accordance with Delaware law.

186. Finally, I also recommend that Delmarva's forecasted plant closings (Adjustment 26B) be reviewed in the Reliability Docket as argued by Staff. (Staff OB, p.52.) My recommendation is consistent with PSC Order No. 8363 (May 7, 2013) in the Reliability Docket because, based upon the evidentiary record, the forecasted plant closings are not in service.

187. Of course, the Reliability Docket does not prevent Delmarva from filing a future rate case, including claiming the forecasted

[29] There is no record evidence that this is now the case in Delaware, but it is something to guard against in the future. For an excellent discussion of this issue, see Sullivan *et al.*, "How To Estimate the Value of Service Reliability Improvements."

closings in Adjustment 26B and future infrastructure investments, while the Reliability Docket is simultanelously being processed.[30]

VII. UNCONTESTED REVENUE REQUIREMENT ADJUSTMENTS

189. The Company presented some adjustments that either were accepted or not contested by the parties to this proceeding. I recommend that the Commission approve these adjustments discussed below. Except where I note some issues below, these adjustments are well supported by the evidence presented by the parties and are discussed at length in the Briefs. Staff's and the Public Advocate's agreement to these adjustments in this docket does not mean that in future cases these adjustments cannot be disputed by Staff or the Public Advocate. (Staff OB, p.21; DPA OB, p.11.)

190. The uncontested adjustments are as follows:

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

- Weather Normalization
  (Company Adjustment #2)

- Bill Frequency
  (Company Adjustment #3)

- Injuries & Damages Expense Normalization
  (Company Adjustment #6)

- Uncollectible Expense Normalization
  (Company Adjustment #7)

- Remove Employee Association Expense
  (Company Adjustment #9)

- Storm Restoration Expense Normalization
  (Company Adjustment #13)

[30] My recommended approach complies with Delaware's Administrative Procedures Act ("the APA"), and avoids the concerns about the relationship between the Reliability Docket and a future rate case, raised by Delmarva in its Reply Brief. (DPL RB, pp.5-8.)

- Pro-form Advanced Metering Infrastructure (“AMI”) Operations & Maintenance (“O&M”) Expenses (Company Adjustment #17) (*But see* Staff OB, pp.84-85.)

- Pro-form AMI O&M Savings (Company Adjustment #18)

- Pro-form AMI Depreciation and Amortization Expense (Company Adjustment #19)

- Normalize Other Taxes (Company Adjustment #25)

- Amortization of Actual Refinancing Costs (Company Adjustment #27-Staff OB, p.23.)

- Remove Qualified Fuel Cell Provider Project Costs (Company Adjustment #28)

- Remove Post-1980 Investment Tax Credit Amortization (Company Adjustment #30)

- Removal of Renewable Portfolio Standards Labor Charges (Company Adjustment #32);

- Interest Synchronization; (Company Adjustment #33) (agreed “in concept” per Company, Exh. 20-Ziminsky, p.12; Staff discusses in its OB, p.86;

- Pro-forma Other Post-Employment Employee Benefits (“OPEB”) Expense (Company Adjustment #35); Exh. 20-Ziminsky, pp. 13-14 (not briefed by either Staff or Public Advocate, presumably uncontested);

- Wilmington Franchise Tax-Staff states that Company agreed to terms proposed by Staff if Commission orders same (Staff OB, pp.85-86; Exh.60.)

- Income Tax Factor and Revenue Multiplier;

- Removal of Pre-Paid Insurance from rate base (Staff OB, p.23, *citing* Exh.20-Ziminsky, p.65.); and

- Depending on Commission’s rulings, Operating Expense Adjustments Corresponding to its Rate Base Adjustments for RFP costs, DLC costs, Medicare Tax Subsidy expense and Credit Facility Expense. (DPA OB, p.91.)

VIII. CONTESTED ADJUSTMENTS

A. Construction Work In Progress ("CWIP").

191. Delmarva seeks to include $70,154,772 of CWIP in rate base and a corresponding $965,309 Allowance for Funds Used During Construction ("AFUDC") offset to earnings. (Exh. 5-Ziminsky, pp. 31-33; Exh. 13-Crane, p.10; Exh. 11-Peterson, p.14.). If permitted by the Commission, Delmarva's inclusion of CWIP in rate base increases its revenue requirement by approximately $7.71 million and represents over 18% of the Company's requested revenue requirement. (Exh. 13-Crane, p.9.). Staff and the Public Advocate object to including CWIP in rate base. (Exh.13-Crane, p.11; Exh.11-Peterson, pp. 13-14.)

192. Although the Commission has discretion to include or exclude CWIP from rate base, the Commission has excluded CWIP from rate base in Delmarva's last two (2) litigated electric rate cases, Docket Nos. 05-304 and 09-414. (Staff OB, p.59.)

193. In this docket, Delmarva argues that the Commission should reconsider its prior decisions excluding CWIP from rate base. According to the Company, CWIP is used and useful, is serving customers, and should be treated as plant in service for rate base purposes. (Exh. 5-Ziminsky, p.32.). "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." (DPA OB, p.76.) According to Delmarva, "the risk that these new distribution projects will not result in new units

of property approaches zero." (*Id.* at p.77.) Such projects are known and measureable and will reasonably be in service during the effective period of rates developed in this proceeding." (*Id.*)

194. Additionally, the Company argues that it follows the Federal Energy Regulatory Commission's ("FERC") optional guidelines for accruing AFUDC, and according to those guidelines, many of its CWIP projects are eligible to accrue AFUDC and others are close to eligible. (*Id.* at p.76; TR.-507,627.) According to Delmarva, if the Commission does not include CWIP in rate base, it will not be fairly compensated for these carrying costs while Delmarva's customers will benefit from the service the assets provide. (*Id.* at p.77.)

195. Both Staff and the Public Advocate argue that the Commission should continue to not allow CWIP in rate base because the CWIP is not used and useful in providing service to customers during the test period. (Exh. 11-Peterson, pp 13-14; Exh. 13-Crane, pp.9-10.) Under Delaware law, only plant that is used and useful in providing service to ratepayers during the test period may be included in rate base. (26 *Del. C.* §102(3).) CWIP is construction work in progress, and so by definition, CWIP is not used and useful. (Exh. 13-Crane, p.9.) Both Staff and the Public Advocate argue that including this plant in rate base violates the established regulatory principle of matching assets with the customers they are serving. (Exh. 11-Peterson, pp 13-14; Exh. 13-Crane, pp.8-9.)

196. Finally, the Public Advocate argues that, in the two (2) most recently litigated Delmarva electric rate cases (Docket Nos. 05-304 and 09-414), a major reason why the Commission refused to place

CWIP in rate base was because the amount of AFUDC as a percentage of CWIP was less than 2% and would have a considerable adverse effect on the revenue requirement. (PSC Order No. 8011, ¶¶67-68.) In this docket, it is 1.37%. (Exh. 13-Crane, pp.10-11).

197. Hearing Examiner’s Recommendation on Construction Work in Progress (“CWIP”). I agree with the arguments and evidence presented by the Staff and Public Advocate as described above. The Commission has excluded CWIP from rate base in the two (2) most recently litigated electric rate cases under virtually identical circumstances. Additionally, Delmarva has not raised any compelling new argument and Delmarva bears the burden of proof. Thus, I recommend that the Commission remove CWIP from rate base as proposed by the Company, and also reverse the earnings adjustment for AFUDC.

198. If Delmarva believes that its current accrual of AFUDC is insufficient to compensate shareholders during construction, then Delmarva can change its AFUDC accrual policies. Both Company Witness Ziminsky and Staff Witness Peterson testified that FERC’s guidelines are optional, not compulsory. (Tr-507,627.)

199. I also do not agree with Delmarva’s alternative proposal to create a regulatory asset for the full amount of AFUDC. As argued by the Public Advocate, “regulatory asset treatment is reserved for large, non-recurring expenses that have the potential to impair a utility’s financial well-being and do not contribute to rate base.” (In the Matter of the Application of Delmarva Power & Light Company for an Increase In Its Retail Rates for the Distribution of Electric Energy, Case No. 9192, Order No. 83085 (MD. PSC Dec. 30, 2009) at pp.

15-16.) CWIP and AFUDC are classic, ongoing costs of running a utility and should not qualify for regulatory asset treatment." (DPA OB, pp.47-48.)

B. Cash Working Capital ("CWC").

200. According to its lead-lag analysis, the Company included $10,887,807 in rate base. (Sch.5-Ziminsky, Sch. (JCZ)-1, p.1.) "CWC is the amount of cash a utility needs to cover cash outflows between the time it received revenue from customers and the time it must pay expenses." (Exh. 13-Crane, p.11.)

201. In this case, the Company used expense lags for payroll, Operating & Maintenance and affiliated transactions. (DPA OB, p.48.) A major issue relates to Delmarva's payments to its affiliated Service Company.

202. The Company calculated 14.43 days of expense lead to Delmarva's payments to its affiliated Service Company. (DPL OB, p.75.) "Delmarva's payments to the Service Company are made around the 15th business day in the month following the billing month." *(Id.)*

203. According to Delmarva, "the lead/lag study used in this proceeding is representative of [twice monthly payment] transactions [to its Service Company] as reflected on Delmarva's books and records…." (*Id.*; DPA OB, pp.48-49.) As Delmarva witness Ziminsky testified, approximately 70% of the Company's net Operating & Maintenance ("O&M") lag consists of payments to the Service Company. (TR.-616.) According to the Company, the Commission should approve its 14.43 days of expense lead because it made twice monthly payments to its Service Company and CWC recognizes when cash is actually

expended for goods and services i.e. the cash basis of accounting. (Exh. 20-Ziminsky, p.60.)

204. Staff and the Public Advocate argue that, by the terms of Delmarva's agreement with its Service Company, the Service Company is required to bill only once per month and Delmarva is required to pay only once a month. (Exh. 11-Peterson, p.17; DPA OB, pp.51-52.) Staff and the Public Advocate argue that Delmarva chose to make twice monthly payments at its own peril. (Staff OB, p.61; DPA OB, p.52.) Staff maintains that the Company intentionally inflated its CWC. (Staff OB, p.61.)

205. In its Brief, the Public Advocate relies on precedent from Pennsylvania, Connecticut, Arizona and California which principally hold that: a) the ratepayers' rate base should not be burdened with an extra expense if a utility's agreement does not require it; and b) a utility's arrangement with an affiliate about payment is an arrangement between those two (2) companies which should not affect rate base. (DPA OB, pp.50-51.)

206. Staff and the Public Advocate differ as to the correct expense lead time, a difference which materially affects the amount of CWC which each argues the Company is entitled to recover. Staff argues that a correct expense lead time is 35.2 days, as opposed to the Company's proposed 14.43 days. According to Staff Witness Peterson, assuming the 15.2 day average service period is 15.2 days (i.e. 365 days/12/2), you need to add 20 extra days to account for the fact that Delmarva's affiliated transactions are generally settled on the 15th *business* day of the month. (Exh 11, Peterson, p.18.) "Depending on

what day of the week that the first business day falls during the month, the 15th billing day will range between 19 and 21 calendar days." (*Id.*)

207. Using its expense lead time of is 35.2 days, Staff increases the overall weighted average lead days for all O&M expenses from 17.33 days to 31.70 days. *(Id*. at p.18.) Staff concludes that Delmarva's CWC request should be reduced by $4,200,129. (*Id*.)

208. Public Advocate Witness Crane also uses an average service period of 15.2 days. (Exh. 13-Crane, p.13.) However, instead of business days, Ms. Crane uses "a combined billing and payment lag of 15 days" and calculates an expense lead time of 30.21 days. (*Id.*) Public Advocate Witness Crane concludes that Delmarva's CWC request should be reduced by $1,889,057. (*Id*. & Sch. ACC-6.)

209. <u>Hearing Examiner's Recommendation as to CWC</u>. I agree that the Company has not carried its Burden of Proof as to this issue because, as argued by the Public Advocate: 1) the ratepayers' rate base should not be burdened with an extra expense if a utility's agreement does not require it; and 2) a utility's arrangement with an affiliate about payment is an arrangement between those two (2) companies which should not affect rate base. Thus, I recommend that the Commission reject the Company's claimed $10,887,807 of Cash Working Capital ("CWC") and a corresponding $965,309 Allowance for Funds Used during Construction ("AFUDC") offset to earnings.

210. However, I am not able to make a recommendation as to whether the Commission should accept Staff's proposed $4,200,129 reduction to CWC or the Public Advocate's proposed $1,889,057

reduction, a difference of $2,311,072. This issue is not addressed to my satisfaction in the evidentiary record, the evidentiary hearing transcript, or any of the parties' briefs. (*See* Staff OB, p.61 fn 226; DPA OB, p.49.) Some options are: a) the issue can be presented differently to the Commission based upon the current evidentiary record; b) the evidentiary record could be supplemented by agreement of the parties; or c) a supplemental evidentiary hearing could be held.

C. Pre-Paid Pension Asset.

211. The Public Advocate's Brief argues that the Commission should reverse its prior decisions allowing pre-paid pension assets and OPEB liability to be included in rate base. On February 3, 2014, Staff filed an untimely brief joinder, citing no new case law, agreeing with the Public Advocate's position.

212. In its Reply Brief, Delmarva directly contradicts the Texas case law primarily relied upon by the Public Advocate, but simply ignores the Hawaii case which generally supports the Public Advocate's position as described herein. (*In the matter of* Hawaiian Electric Company, Inc., 2007 WL 4477336, HA. PUC, Oct. 2007.) Unlike the parties did in Docket No. 09-414, none of the parties addressed how our neighboring states are currently ruling as to this issue with other utilities, including but not limited to, Delmarva's related companies. (PSC Order No. 8011, ¶137.) After reviewing the limited case law provided to me, I am not confident that all relevant, nationwide case law has been provided to me.

213. Just as importantly, if I agreed with the Public Advocate's position, it seems that an evidentiary hearing would have to be conducted as to the exact nature of the funds contained in the Company's pension fund. In *Hawaiian Electric Company* case, the Hawaii PUC held that, to include the entire pension fund in rate base, the entire amount had to be contributed by the utility's investors and be used and useful. (*Id.*) The Consumer Advocate in that case sought to exclude the pre-paid pension from rate base, successfully arguing that the ratepayers paid the funds, not the utility's investors. (*Id*.) All parties in that case agreed, however, that if funds are excluded from rate base, then a corresponding adjustment to the Accumulated Deferred Income Tax Reserve ("ADIT reserve") needed to be made. (*Id.*)

214. In this case, the current evidence or briefing as to plan contributions is a follows:

a. In the 2012 test period, "absent pension plan returns, the overall pension expense level would have increased by $4.682 million or 42%." (DPL RB, p.30.)

b. "Delmarva admitted that it made no contributions to the pension fund until 2009, when it contributed $135 million." (DPA OB, p.55.)

c. Over the past ten (10) years, market returns on the funds have totaled almost $1.245 billion. (*Id.* at fn.47.)

d. In PSC Order No. 6930 from Docket No. 05-304, the Hearing Examiner found that "the Company's books contain a pre-paid pension asset of $16,614,053," the source of which was not specified. (See ¶49.) Likewise, Order No. 8011 from Docket No. 09-414 does not answer this issue. (See ¶42.)

215. Hearing Examiner's Recommendation as to Pre-Paid Pension Asset. The Public Advocate unpersuasively argues that "[s]imple math shows that Delmarva's fund contributions account for less than 10% of the account balance and that over 90% of the current account balance is attributable to market earnings." (*Id*.) But, even assuming arguendo that the Public Advocate's legal position is correct, and I am not sure that it is, how much, if any, of accumulated earnings from Delmarva's $135 million contribution in 2009 and/or its 2005 contribution, if any, should be credited to rate base? Also, what ADIT reserve adjustment, if any, must be made? I have not been provided with evidence fully answering these factual questions.

216. In conclusion, for the reasons stated above, although the Public Advocate's claim may eventually prove to be valid, I find that the pre-paid pension asset should remain in rate base as the case law and pension plan evidence presented to me do not warrant changing established Commission precedent that this adjustment should be included in rate base.

D. Deferred Integrated Resource Planning ("IRP") Costs.

217. The Company proposes a base rate adjustment to recover a net of $57,474 of deferred initial IRP-related costs incurred beginning in August 2009. (Exh.5-Ziminsky, pp. 16-17.) The Company proposes to amortize these costs over ten (10) years, with rate base treatment of the unamortized balance. *(Id*.)

218. Delmarva argues that its proposal "is consistent with the treatment given in Docket No. 09-414 for these costs that were incurred by or before July 2009." (DPL OB, p.65.) The treatment of the initial IRP costs was uncontested in Docket No. 09-414. (*Id*.) Delmarva maintains that the Delaware legislature has "required it to comply and has incurred carrying costs related to investor-supplied capital." (Exh. 5-Ziminsky, p.37.)

219. The Delaware Electric Utility Retail Customer Supply Act of 2006 ("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." (26 *Del. C.* §1007 (c)(1)(d); emphasis supplied.) "The initial IRP 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 (3) 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." (DPL OB, p.66.)

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

> 7. That, subject to Commission review and approval, the other initial costs incurred by Delmarva Power & Light Company in developing and submitting its IRP under the Act shall be included and recoverable in its next distribution rate case. Delmarva Power & Light Company shall also be permitted deferred accounting treatment for this purpose, in which case the costs shall be amortized as an expense. In all

subsequent cases, such costs shall be normalized as an expense in accordance with Commission practice.

8. Similarly, the Commission reserves decision and judgment on whether the amounts granted deferred accounting treatment under Ordering paragraph 7 related to the initial Integrated Resource Plan, should earn a return, or some other carrying charge, for either the period until the onset of recovery or during any amortized recovery period. Such determinations shall be made during the distribution rate proceeding when Delmarva Power & Light Company seeks to recover the amounts granted deferred accounting treatment under Ordering paragraph 7.

(PSC Order No. 7003 dated August 8, 2006, ¶¶7-8.)

221. The Public Advocate, joined in by Staff in its Brief, argues as follows:

> "Delmarva's request should be denied. First, the section of the Act on which it relies says only that Delmarva's costs shall be included and recovered in distribution rates. It does not say that 100% of those costs are recoverable, nor does it say anything about how those costs should be recovered (normalization or amortization). If Delmarva truly believed that Section 1007(c)(1)d authorizes it to recover 100% of its IRP costs, it should have requested the Commission to reconsider its decision in light of that section or appealed the Commission's decision to the Superior Court. It did neither.
>
> Second, Order No. 7003, issued after the passage of Section 1007(c)(1)d, expressly stated that the initial IRP costs were to be "included and recoverable in [Delmarva's] *next* distribution rate case." Delmarva's *next* distribution case after Order No. 7003 was Docket No. 09-414. Nothing in Order No. 8011, issued after the Commission's deliberations in Docket No. 09-414, addresses additional IRP cost deferral. Rather, Order No. 8011 mentions two uncontested IRP adjustments: one for deferred costs for the initial IRP (amortization over 10 years with the unamortized balance included in rate base) and

> the other for ongoing prospective IRP costs (including a normalized amount of costs in operating expenses). Both of these ratemaking treatments were specifically addressed in Order No. 7003. One cannot assume from the Commission's silence in Order No. 8011 that it was authorizing additional deferrals, but Delmarva asks the Hearing Examine to assume exactly that." (PA OB, p.64; Staff OB, p.66.)

222. Hearing Examiner's IRP Costs Recommendation. Delaware law requires that the Company be compensated as follows: "The costs that DP&L incurs in developing and submitting its IRPs *shall* be included and recovered in DP&L's distribution rates." (26 *Del. C.* §1007 (c)(1)(d); emphasis supplied.)

223. I find that this statute permits the Company the ratemaking treatment it seeks with this adjustment. When construing a statute, a court or an administrative agency must adhere to traditional canons of statutory construction. The United States Supreme Court has held that "courts must presume that a legislature says in a statute what it means and means in a statute what it says there." (Connecticut Nat'l Bank v. Germain, 112 S. Ct. 1146, 1149 (1992); Miller v. Spicer, 602 A.2d 65, 67 (Del. 1991).) This bedrock canon of statutory construction supports the Company's position, not the Public Advocate's position. I find that the statute allows Delmarva to recover its costs, including amortization.

E. IRP Operating Expense.

224. The Company proposes an operating expense adjustment related to its statutorily-required IRP. Delmarva proposes a normalized amount of IRP costs to be included in the revenue requirement going forward, as the Commission ordered in Docket No. 06-

241. Since the IRP cycle is every two (2) years, Delmarva estimated $1,745,000 of IRP costs over those two (2) years and then included one (1) year of costs ($872,500) in its revenue requirement. (DPA, OB, p.69.)

225. Staff and the Public Advocate object to the proposed adjustment, each arguing that Delmarva’s normalization adjustment results in a significant increase in prospective IRP costs compared to the test period. According to Staff Witness Peterson, an allowance of $700,000 in rates is necessary to reflect the recurring IRP costs, while acknowledging the uncertain costs in the next IRP. Accordingly, Mr. Peterson proposed to normalize Delmarva's actual IRP expenses over the last seven (7) years using the Company's actual average annual expense. (Exh. 11-Peterson, p.30.)

226. The cost uncertainty for the next IRP relates to updated analyses which Delmarva will be required to perform for “the analytical flexibility to address new important issues as they arise in order for the IRP to remain useful and relevant.” (Exh. 20-Ziminsky, p.35.) If the parties cannot reach an agreement, the IRP would need to be presented to the Commission for ratification at a contested hearing, which would result in additional expenses. (*Id.*) According to the Company, however, the working group participants are trying to prevent unnecessary expenses. (DPL OB, p.86.)

227. Public Advocate Witness Crane also testified that the Company’s IRP costs could vary significantly, recommending that the recurring IRP costs be normalized based on actual past experience over a three-year period (2010-2012), which amounts to $425,615. (Exh.13-

Crane, pp. 43-44.) “This includes two of the three highest amounts that Delmarva has spent on IRPs since 2009.” (DPA OB, p.91.) The Public Advocate maintains that the Company’s proposal “exceeds actual IRP expenses incurred for all but one year since 2009.” (*Id.*)

228. The Company’s yearly IRP costs from 2006-2013 were as follows:

Year	**IRP Costs**
YTD 2013	$14,526
2012	$302,062
2011	$46,909
2010	$927,875
2009	$367,373
2008	$1,700,598
2007	$736,456
2006	$822,837

(Exh. 11-Peterson, Sch. DEP-1, Sch. 3, p.6; Exh. 13-Crane, p.43, *citing* Delmarva’s response to PSC-RR-33.)

229. Hearing Examiner’s Recommendation as to IRP Operating Expense. Delmarva’s estimated IRP expense level should be rejected because it is not reasonably known and measurable. Delmarva submits no reliable and quantifiable data to support its estimate. More than 50% of its estimate is for consultants, outside legal counsel, and special studies. These types of expenses can vary greatly from estimates, especially where the parameters of the project are not well defined. The IRP expenses Delmarva has already incurred in connection with the two IRPs it has filed in 2010 and 2012 would have included these types of expenses.” (DPA, OB, p.90.)

230. I agree with Public Advocate Witness Crane that the normalized amount of IRP expense to be included in rates should be

based on the three-year average of Delmarva’s actual expenses from 2010 through 2012, or $425,615. This includes two (2) of the three (3) highest amounts that Delmarva has spent on IRPs since 2009.

F. Deferred RFP Costs.

231. The Company is seeking to recover $28,764 of RFP-related net costs through amortization over ten (10) years and rate base treatment of the unamortized balance. (Exh. 13-Crane, p.22.) According to Delmarva, these costs relate to the Bluewater Wind RFP process required to be filed with the initial IRP by EURCSA. (Exh. 20-Ziminsky, p.39.)

232. “The initial IRP 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.” (DPL OB, p.65.) The costs began in August 2009, and were not “fully known and measurable” at the time of its last base rate filing. (Exh. 20-Ziminsky, p.39.)

233. The Public Advocate disputed this adjustment, joined in by Staff in Brief. (Staff OB, p.66.) However, the Public Advocate does not dispute that these costs relate to the RFP process required to be filed with the initial IRP by EURCSA as argued by the Company. As will be explained, the Public Advocate argues that the Company did not follow Commission Orders to seek these funds in Standard Offer Service rates, not distribution rates.

234. Section 26 *Del. C.* §1007 (c)(1)(d) of EURCSA provides as follows: "The costs that DP&L incurs in developing and submitting

its IRPs shall be included and recovered in DP&L's distribution rates."

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

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

(Order No. 7003, ¶¶6,8; emphasis supplied)

236. Delmarva maintains that Section 1007(c)(1)d of the Act and Order No. 7003 permit recovery in the proposed manner in distribution rates. (DPL OB, p.66.) As to Order No. 7003, Delmarva argues that "[w]hile it may have been anticipated that the Company would recover all of its IRP costs within one distribution rate case, nothing in Order No. 7003 precludes recovery of such initial costs in two cases." (*Id.* at p.67.)

237. The Public Advocate first argues that Delmarva's request should be denied because "Section 1007(c)(1)d provides Delmarva with no assistance here, as it is limited to costs of developing and submitting *IRP*s, not RFPs." Second, Order No. 7003 specifically instructed Delmarva to recover these costs through Standard Offer Service ("SOS") rates – *supply rates – not distribution rates.* This makes sense, because the RFP addressed deregulated supply. Third, even if Delmarva could recover the RFP costs through distribution rates, neither Order No. 7003 nor Order No. 8011 authorized continued deferral of RFP costs." (DPA OB, pp. 66-67.)

238. <u>Hearing Examiner's IRP Costs Recommendation</u>. Delaware law requires that the Company be compensated as follows: "The costs that DP&L incurs in developing and submitting its IRPs *shall* be included and recovered in DP&L's distribution rates." (26 *Del. C.* §1007 (c)(1)(d); emphasis supplied.)

239. This statute permits the Company the ratemaking treatment it seeks with this adjustment. When construing a statute, a court or an administrative agency must adhere to traditional canons of statutory construction. The United States Supreme Court has held that "courts must presume that a legislature says in a statute what it means and means in a statute what it says there." (Connecticut Nat'l Bank v. Germain, 112 S. Ct. 1146,1149 (1992); Miller v. Spicer, 602 A.2d 65,67 (Del. 1991.)) This bedrock canon of statutory construction supports the Company's position, not the Public Advocate's position. I find that the statute allows Delmarva to recover its costs, including amortization.

G. Credit Facility Costs.

240. The Company proposes an adjustment to recover its costs related to the PHI credit facility. The credit facility allows Delmarva to borrow in the commercial paper market and is a primary source of short-term liquidity. (Exh. 17, Boyle, p.8.) In August 2011, PHI renewed the credit facility for a five (5) year term, and there are annual period costs associated with starting up and maintaining the credit facility, which do not include the facility’s borrowings. (*Id*. at p.72.) This adjustment results in a $200,057 decrease in period earnings and an increase to test period rate base of $520,111. (Exh. 20-Ziminsky, Sch. (JCZ-R-1, p.2.)

241. According to Delmarva, “short-term debt is used to temporarily fund its construction program and fluctuations in its working capital requirements. When the level of short-term debt is such that the Company can efficiently issue long-term debt, long-term debt is issued and the short-term debt is paid down.” (*Id*. at pp. 7-8.) The Company argues that, if the credit facility was eliminated, the long-term credit rating of The Company would change, possibly even below investment grade. (DPL 0B, p.73.)

242. In Docket No. 09-414, in Order No. 8011, the Commission unanimously held as follows, overruling the Public Advocate’s (not Staff’s) objection:

> Discussion: We conclude that the credit facility costs should be included in the cost of services. We accept Delmarva’s testimony that the credit facility is not a substitute for short-term debt or CWC, and is not encompassed within either item. We note that the DPA does not disagree that the capital structure contains no short-term

> debt; hence it is obvious that the facility's costs are not included in the capital structure. We are further persuaded that the CWC lead-lag study only recovers the return on the time lag between the payment of interest and the receipt of customer payments. Thus, we approve the inclusion of the credit facility costs in the cost of service, including the unamortized balance in rate base. (Unanimous).

243. The Public Advocate, joined by Staff in brief, basically argues that the same arguments it did in Docket No. 09-414. Public Advocate Witness Crane recommends that credit facility costs be eliminated from the Company's revenue requirement, but if the Commission permits recovery of such costs, then the Company's capital structure should be amended to reflect the inclusion of short-term debt. (Exh. 13-Crane, pp. 29-31.)

244. Staff Witness Peterson argues that the Company's credit facility costs should be an increase in the effective cost of short-term debt in the calculation of the Company's AFUDC rate. Staff Witness Peterson recommends that the Commission's credit facility adjustment be reversed.[31] (Exh. 11-Peterson, p. 34.)

245. The Company disagrees with Staff, arguing as follows:

> "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. The Company's credit facility costs are not incremental costs, but rather period costs that are incurred even if no funds are borrowed. Accordingly, the costs should be recovered through cost of service, not the Company's AFUDC rate." (DPL OB, p.73.)

[31] Staff also briefly argues that Delmarva "attempts to collect expenses incurred prior to the test period without a specific Commission Order allowing such deferral is retroactive ratemaking and cannot be allowed." (Staff OB, p. 69.) Since no further argument is made or precedent cited, I will not address this argument any further.

246. Hearing Examiner's Recommendation. In Docket No. 09-414, the Commission unanimously held that the Company's credit facility costs should be included in rate base. After hearing the same arguments presented in this docket, I also view this expense as critically important to Delmarva's operation, and also *very* beneficial to ratepayers. This expense allows the Company to not only fund its construction and working capital, but it also is the first step for the Company in seeking long-term debt issuance which benefits ratepayers. Therefore, I recommend that the Commission again approve this expense.

H. Dynamic Pricing Program Regulatory Asset ("DP").

247. According to Delmarva Witness Ziminsky, these actual and forecasted costs are for customer education, outbound DP event calls, overflow customer call handling relating to DP events, authorization of DP-related systems, and returns associated with the foregoing costs. (Exh. 20–Ziminsky, p.20.) He testified that customers had the opportunity to benefit from these costs because Delmarva called a DP event on July 17, 2013, after the program was available to all residential SOS customers, and Delmarva paid approximately $775,000 in bill credits. (*Id*.) Witness Ziminsky also testified that Delmarva called a second event on September 11, 2013 for which participating customers would receive bill credits. (*Id*. at pp.42-43.)

248. In arguing that the Commission should award this proposed adjustment to the Company, Delmarva maintains as follows:

> "In this proceeding, the amounts set forth in Adjustment Nos. 20a and 20b reflect the actual and forecasted costs placed into the dynamic

> pricing regulatory asset during the respective time periods and are consistent with the Commission's regulations. Moreover, the costs reflected in the asset are for the 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 during the rate effective period and beyond." (DPL OB, pp. 68-69.)

249. Public Advocate Witness Crane recommended that the Company's rate base adjustment for dynamic pricing deferred costs be limited to its actual costs of $2,453,025 through the end of the test year, December 31, 2012. (Exh. 13-Crane, p.24.) Moreover, Ms. Crane stated that additional costs deferred through 2013 should be evaluated once implementation of the program is complete. (*Id*. at p.25.) Ms. Crane's recommendation did not recognize certain test year costs which were reclassified to the regulatory asset in January, 2013. (DPL OB, p.68.) Finally, Ms. 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. (*Id*.)

250. 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. (Exh.11–Peterson, p. 21.) According to Mr. Peterson, "because full deployment of DP did not occur during the test period, the related benefits and savings to be achieved during the program are not reflected in the Company's test period results. (*Id*. at pp.31-32.)

251. Arguing for full deployment of DP before reimbursing the Company, Staff Witness Peterson testified as follows:

> "Moreover, full deployment of the program will not be completed until well after the end of the test period in this case. The difference in timing between recognition of program related costs and expected benefits to be achieved through the program creates a test period mismatch, which should be avoided. Rather, I recommend that Delmarva continue to defer all incremental costs associated with the Dynamic Pricing program until the Company's next base rate proceeding following full deployment of the program. Deferral of these costs, as previously provided for by the Commission, provides a strong measure of assurance of eventual recovery of such costs provided they are deemed necessary, and reasonably incurred." (*Id*. at p.32.)

252. Hearing Examiner's Recommendation. I recommend that the Commission follow Public Advocate Witness Crane's position and award the Company $2,456,025, its actual costs through the end of the test period, December 31, 2012. This approach is consistent with the PSC Order No. 7420, which states that the Commission "may wish to consider an appropriately valued regulatory asset for [AMI] investment consistent with the matching principle giving consideration to both costs and savings." (See ¶3.)

253. The Public Advocate's Brief further explains why I agree with Witness Crane's recommendation:

> "Parties should be able to contest both the amount and reasonableness of actual costs incurred and savings realized rather than costs Delmarva thinks it will incur. Moreover, there does not seem to be any recognition of savings realized in 2013 from the DP program. Delmarva is not prejudiced by continuing to accrue DP program costs in a regulatory asset. Regardless of what DPL has paid in 2013 to DP participants, the test period that Delmarva chose for this case is the 12 calendar months ending December 31, 2012.

> Allowing recovery of the 2013 DP costs in this case, whether actual or projected, is inconsistent with Order No. 7420's direction that recovery of the regulatory asset be considered consistent with the matching principle giving regard to both costs and savings. Thus, the DPA respectfully submits that Delmarva's proposal to include DP costs incurred in 2013 in the revenue requirement should be rejected." (DPA OB, pp.68-69.)

I. Direct Load Control Program Regulatory Asset("DLC").

254. The Company proposes 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 Nos. 7420 and 8253. (DPA OB, p.69.) The Direct Load Control program involves installing at participating customers' residences a Direct Load Control Switch and thermostat. (DPL OB, p.70.) Delmarva seeks recovery of a net $5,706,782 of DLC-related costs, to be amortized over fifteen (15) years with rate base treatment for the unamortized balance. (Exh. 13-Crane, p.26.) If approved, this expense would result in a cumulative $391,496 decrease to test period earnings. (DPL OB, p.70.)

255. PSC Order No. 7420 approving creation of the regulatory asset for AMI, which is the basis for regulatory asset treatment of the DLC costs, specifically states that the Commission "may wish to consider an appropriately valued regulatory asset for [AMI] investment consistent with the matching principle giving consideration to both costs and savings…." (PSC Order No. 7420, ¶(3.)

256. Delmarva began implementing the DLC program in April, 2013 and will continue through 2016. (Exh. 13-Crane, pp. 26-27 *citing* Delmarva's response to PSC-RR-44). According to Company Witness

Ziminsky, 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. (Exh. 20-Ziminsky, p.49.)

257. The Company split its proposed DLC adjustment into two (2) parts: 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. (Exh. 20-Ziminsky, p.49.)

258. The Company argues that “[w]hile the full [DCL] program has not been implemented, customers have already had the Direct Load Control devices installed at their 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.” (DPL OB, pp.70-71.) According to the Company, “[c]ontinuing to defer costs is not beneficial to customers, and creates regulatory uncertainty for a program that the Commission approved.” (DPL OB, p.71.)

259. Public Advocate Witness Crane recommended that all actual and deferred DLC costs be excluded from rate base because no costs were incurred during the test period. (Exh. 13-Crane, pp. 26-27, DPA OB, p.70.) Staff Witness Peterson recommended the same thing. (Exh. 11-Peterson, p. 33.)

260. The Public Advocate’s Brief argues as follows:

> “This proposal, too, should be rejected … because *none* of the costs that Delmarva seeks to recover

> were incurred in the test period that it selected. Delmarva admits that it did not begin implementing the DLC program until April 2013. Again, parties should be able to contest both the amount and reasonableness of actual costs incurred and savings realized rather than costs Delmarva thinks it will incur. And again, there appears to be no recognition of savings realized in 2013 from the DLC program. Delmarva suffers no prejudice by continuing to accrue DLC program costs in a regulatory asset. Regardless of how many DLC participants DPL had in 2013, the test period that it chose is the 12 calendar months ending December 31, 2012. Allowing recovery of the 2013 DLC costs in this case is inconsistent with Order No. 7420's direction that recovery of the regulatory asset be considered consistent with the matching principle giving regard to both costs and savings. Thus, the DPA respectfully submits that Delmarva's proposal to include DLC costs incurred in 2013 in the revenue requirements should be rejected. (DPA OB, p.70.)

261. Hearing Examiner's Recommendation. For the reasons stated above, I agree with Public Advocate Witness Crane and Staff Witness Peterson that this request should be denied.

262. Although Delmarva argues that Ms. Crane's position as to Direct Load Control is inconsistent with her Dynamic Pricing position, I find that Ms. Crane's positions are consistent. (DPL OB, p.71.) Regarding Dynamic Pricing, Ms. Crane recommended recovery for all actual costs incurred through the end of the test period, December 31, 2012, approximately $2.46 million. Regarding DLC, no actual costs were incurred during the test period and the program is much less developed than the Dynamic Pricing Program; hence Ms. Crane's recommendation that no Direct Load Control costs are recoverable in rate base.

J. Medicare Subsidy Deferred Costs.

263. The Company proposed Adjustment No. 29 to recover taxes related to a change in law regarding Medicare Part D which became effective in March, 2010. (DPL OB, p.71.) The change of law resulted in a one-time charge to Delmarva which caused 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 but no Commission deferral was sought. (*Id*.) This proposed adjustment would result in a $21,860 decrease to test period earnings and an increase to test period rate base of $54,560. (*Id*.) Delmarva seeks to amortize this amount over three (3) years and to include the unamortized balance in rate base. (DPL OB, p.70.)

264. Delmarva primarily argues that it should be permitted to recover this 2010 expense because the Medicare law change which made a subsidy not tax deductible "was outside of the Company's control," and the Company deferred the expense on its books using accrual accounting. (Exh. 20-Ziminsky, p.57.)

265. The Public Advocate argues against awarding The Company this claim, joined in by Staff in its Brief. (Staff, p.64.) According to the Public Advocate:

> "The adjustment should be rejected. First, including this out-of-period expense in rates resulting from this proceeding constitutes retroactive ratemaking. The Delaware Supreme Court held thirty years ago that a utility may not recover previously-incurred expenses in prospective rates. Public Service Commission v. Diamond State Telephone Co.,468 A.2d 1285, 1296-1300 (Del. Supr. 1983). It specifically cited the "pervasive and fundamental rule underlying the utility rate-making process that "rates are exclusively prospective in application and that

> future rates may not be designed to recoup past losses in the absence of express legislative authority." Delmarva cites no legislative authority allowing it to recover the cost it incurred in 2010 (because there is none). And it admits that it neither sought nor received Commission approval in 2010 to defer the expense. The prohibition against retroactive ratemaking resolves all of Delmarva's arguments supporting the inclusion of the 2010 expense in rates resulting from this case…." (DPA OB, p.71; citations omitted.)

266. Hearing Examiner's Recommendation. For the reasons stated above, I agree with the Public Advocate and Staff that this proposed adjustment must be denied because it would constitute retroactive ratemaking. Additionally, this proposed adjustment violates the matching principle.

K. Wage and FICA Adjustment.

267. The Company proposes an adjustment of $1,782,036 to its test period wage and FICA levels of expense. This adjustment would result in a $1,173,236 decrease to test period earnings. (DPL OB, p.80.) The subject payroll costs involve the period of January 1, 2012 through October, 2014. (*Id.*) Specifically, this proposed adjustment involves the following:

- Annualization of the International Brotherhood of Electrical Workers ("IBEW") Local 1238-2% test period increase;
- IBEW Local 1238, estimated 2% increase effective February 2013;
- IBEW Local 1238, estimated 2% increase effective February 2014;
- Annualization of the IBEW Local 1307-2% test period increase;

- IBEW Local 1307, estimated 2% increase effective June 2013;
- IBEW Local 1307, estimated 2% increase effective June 2014;
- Annualization of 3% non-union test period increase;
- Estimated 3% non-union increase effective March 2013; and
- Estimated 3% non-union increase effective March 2014.

(Exh. 5-Ziminsky, pp.12-13, Exh. 13-Crane, p.32.)

268. In support, the Company argues that:

> "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. … 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." (DPL OB, p.80.)

269. Staff Witness Peterson updated the Company's adjustment to reflect known payroll rate changes at the time of filing of Staff's testimony versus earlier estimates, and eliminated the estimated March, 2014 wage increase because "there is no commitment for Delmarva to increase non-union salaries by 3% in 2014." (Exh. 11-Peterson, pp.23-24.)

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

the Company’s costs for a full year. (Exh. 13-Crane, pp. 32-33.) According to Ms. Crane, most of the salary and wage increases in the adjustment “reached too far beyond the end of the test year.” (*Id*. at p. 33.)

271. Hearing Examiner’s Recommendation. For the reasons stated above, I agree with the Company that, consistent with Commission precedent, the Commission should award to the Company this known adjustment involving wages and FICA. Commission regulations permit modifications to test period data occasioned by reasonably known and measurable changes in current or future or future rate base items, expenses or revenues. (26 *Del. Admin. Code* §1002.1.3.1.)

L. Delmarva’s Regulatory Expenses.

272. Delmarva proposes to include in its revenue requirement $53,316 of non-rate case-related regulatory costs (based on a three-year average of actual costs) and $632,000 of estimated costs for this rate case. (DPA OB, p.92.) If approved, this adjustment would result in an $85,345 decrease to test period earnings. (DPL OB, p. 78) Neither DPA nor Staff contested the Company’s proposal to normalize non-rate case-related regulatory costs.

273. Since the costs associated with this rate case were not yet known, Staff Witness Peterson and Public Advocate witness Crane recommended that a normalized rate case expense over the Company’s last three rate proceedings be used. (Exh. 11-Peterson, pp. 28-29; Exh. 13-Crane, pp. 47-49.) Both Staff Witness Peterson and Public Advocate Witness Crane produced the following chart in their respective August 16,2013 testimonies:

Case No.	*Rate Case Expense*
Docket No. 11-528	$634,054
Docket No. 09-414	$245,241
Docket No. 05-304	$400,000
Average	*$426,432*

(*Id.*)

274. Staff and the Public Advocate each propose now that this adjustment should remain $426,432. (*Id.*) The Company's $632,000 estimate is close to the cost of its most recent rate case-which settled. The Commission has never directly addressed this issue, although in Docket 05-304 the Commission apparently allowed the Company's to estimate this expense based upon the issues in a particular rate case. (DPL OB, pp.78-79; DPA OB, p.92.)

275. Hearing Examiner's Recommendation. I agree with The Company because its regulatory expenses were $634,054 in Docket No. 11-528, the most recent rate case, which resulted in a settlement. This is a contested rate case.

276. Staff's and the Public Advocate's estimate was issued in August, 2013. The parties have had protracted litigation since that time. When compared to a rate case which settles, Delmarva has incurred additional attorneys fees, expert consulting fees, and travel costs and fees for three (3) days of evidentiary hearings (as opposed to one day if a case settles), as well as attorney's fees for preparing Opening and Reply Briefs. The Company should be awarded its requested rate making treatment.

M. Non-Executive Incentive Compensation.

277. The Company proposes an adjustment which would include the test period level of $1,993,802 of non-executive incentive compensation in the Company's cost of service. (Exh. 5-Ziminsky, p.34.) According to Delmarva, "the Company's annual incentive plans (AIP) are part of employees' total compensation package, and the program helps to focus and motivate employees' attention and efforts on achieving the Company's goals, many of which are explicitly related to safety and customers." (DPL OB, p.94.) The AIP Plan is available to all PHI management employees who do not participate in any other incentive plan. (Exh. 13-Crane, p.33.)

278. According to the AIP Plan, no payments are made unless earnings reach certain targeted levels. (*Id*. at p.33; Exh. 70.) If the earnings thresholds are satisfied, then a combination of business unit and individual goals must be met before any awards are made. Award percentages rise as pay scales rise, so higher-paid employees are eligible for proportionately greater awards. (Exh. 13-Crane, p.34.)

279. Company Witness Ziminsky testified that the total non-executive incentive expense included in the test period is allocated 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. (Exh. 5-Ziminsky, p.35.)

280. In Docket No. 05-304, the Commission included in rates the amounts associated with the achievement of safety, reliability and customer service goals. (PSC Order No. 6930, ¶¶97-98.) In Docket No.

09-414, the Commission denied the Company’s non-executive compensation as part of the Company’s cost of service due to the lack of evidence as to the amount of compensation attributable to the achievement of safety, reliability and customer service goals. (PSC Order No. 8011,¶196.)

281. Staff Witness Peterson and Public Advocate Witness Crane removed the Company’s non-executive compensation from the Company’s cost of service. (Exh. 13-Crane, p.37; Exh. 11-Peterson, pp.25-27.) Both witnesses testified that the Company’s AIP does not award any incentive compensation unless certain financial goals are attained, asserting that this objective benefits shareholders, not customers. (*Id*.)

282. Company Witness Ziminsky testified that employees receive nothing even if they meet all of the safety, customer service, reliability, and “balanced scorecard” goals unless the earnings thresholds are achieved. (Tr.-660-61). He also testified that employees would work safely without an incentive compensation plan. (Tr.-659-60). Company Witness Boyle testified that Delmarva’s employees properly perform their duties and protected customers’ interests without an incentive compensation plan. (Tr.-205).

283. Based upon Company Witness Boyle’s testimony, the Company principally argues that the AIP:

a. helps attract and retain skilled employees;

b. creates incentives to perform at a higher level which benefits customers;

c. all utilities known to Delmarva which are similar to Delmarva provide similar plans;

d. if met, the financial targets help reduce the cost of service by reducing operating expenses; and

e. the Company uses the AIP to encourage employee reliability and safety performance.
(DPL OB, p.95; DPL RB, p.35.)

284. Hearing Examiner's Recommendation. I recommend that the Commission, consistent with its prior decisions in Docket Nos. 05-304 and 09-414, remove the Company's Non-Executive Incentive Compensation Plan from cost of service. This precedent holds that all costs related to the achievement of financial goals will be excluded.

285. Delmarva has structured this plan such that the achievement of its corporate financial goals overrides its goals of improving safety, reliability and customer satisfaction. As argued by Staff and the Public Advocate, if the Company's financial goals are not met, regardless of how successful an employee helps improve any safety, reliability or customer satisfaction goal, the employee will receive nothing.

286. Obviously, this plan could have been easily structured to satisfy Commission precedent to be included in cost of service. The Company chose a different route, however, presumably to satisfy its shareholders, stock analysts, and the rating agencies, which is perfectly acceptable. However, based on Commission precedent, the Plan as currently structured should not be included in cost of service. This is because, since the employees receive nothing if Delmarva's financial goals are not met, Delmarva has not met its burden of satisfying the Commission's threshold requirement of proving the amount of non-executive compensation that is attributable to the achievement of safety, reliability or customer service goals.

N. Relocation Expenses.

287. The Company included $130,447 of relocation expenses incurred during the test year, 2012. Public Advocate 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 (3) years. (Exh. 13-Crane, pp. 38-39.) Relocation expenses for the three (3) prior years were $20,482 in 2009, $37,450 in 2010 and $31,749 in 2011. (*Id.*, citing Delmarva's response to AG-RR-20).

288. The Company disagrees with Ms. Crane, stating:

> "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. That is improper and not supported by the Commission's regulation or precedent." (DPL OB, p.97.)

289. The Public Advocate' Brief argues that the Commission has ordered normalization when a test year expense greatly exceeds past experience, and there is no evidence that such a large expense may incur in the future:

> "In Docket No. 91-20, [by PSC Order No. 3389], Delmarva claimed a test period level of tree trimming expense that was significantly higher than the expense in preceding years. The DPA challenged the expense level. The Hearing Examiner found that DPL had not justified the significant increase over such a short time period and recommended normalization. The Commission agreed. (*Id.* at ¶¶74,138,142). Delmarva argues that the DPA "merely…select[ed]… data from a pre-test year period instead of relying upon the actual test year period for

> ratemaking," and that this is "improper." (DPL OB,p.97). But the Commission has applied a normalization adjustment that did not include the test year expense level in a previous case involving this same utility. In docket No. 09-414, the Commission considered a similar situation involving Delmarva's pension expense, and concluded that the abnormally high test period expense level should be excluded from the normalization adjustment because including it would "result in over-recovery of the pension expense." (*Delmarva Power*, Order No. 8011 at ¶132.)
>
> If the Commission followed such a normalization procedure here – excluding the 2012 test period level and averaging the prior three (3) years – the expense level to be included in rates would be $29,909, which is less than the DPA's recommendation [that the Commission award the highest cost form the previous three (3) years i.e. $37,450 from 2010]." (DPA OB, pp. 82-83.)

290. Hearing Examiner's Recommendation. I agree with the Public Advocate. Like Docket No. 91-20 which involved a significant increase in tree trimming expense, Delmarva did not present any evidence as to why its 2012 test period relocation expenses were 4 to 5 times the amounts in each year: 2009, 2010 and 2011. Additionally, Delmarva did not present any evidence that its high 2012 expense level was likely to continue in the future. Thus, the Company did not meet its Burden of Proof.

O. Corporate Governance Expenses.

291. Due to the paucity of evidence presented to me regarding this proposed adjustment, I have re-produced below Delmarva's *entire* argument in its Opening Brief regarding this proposed adjustment:

> "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.

> 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. 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 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.[32]

> 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. For example, as described by Company Witness Ziminsky at the evidentiary hearing, the corporate communication group handles all customer education issues, including saving energy and electrical safety. 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." (DPL OB, pp.97-98; footnotes and authorities omitted.)

292. The Public Advocate argues against awarding the Company its claimed Corporate Governance Expenses. The Public Advocate primarily argues that the Company, which has the Burden of Proof, "has provided no support for the expenses relating to public relations and strategic communications that Delmarva did not identify as having been removed from the revenue requirement." (DPA OB, p.95.)

[32] The final amount claimed by the Company after Ms. Crane's deductions was not briefed by the parties.

293. Also, Ms. Crane found that there was no direct benefit to ratepayers. According to Ms. Crane:

> "I am recommending that these costs be disallowed. Just as ratepayers should not be required to pay direct lobbying costs, they should not be required to pay for "soft" lobbying either. Unless a cost is directly related to the provision of utility service and provides a benefit to ratepayers, it should not be included in regulated rates. The costs that I recommend be disallowed are the types of costs that promote shareholder and corporate interests. If the Company wants to incur these costs, they should be borne by the Company's shareholders and not its ratepayers." (Exh. 13-Crane, p.51.)

294. Hearing Examiner's Recommendation. For the reasons stated above, I agree with the Public Advocate that the Company has not met its Burden of Proof regarding this issue, of which there is not any Commission precedent. Frankly, based on the record, I do not know what this money was spent on, except unknown amounts were spent on "customer education issues, including saving energy and electrical safety." The Company chose not to document and segregate these expenses, and considering the shadow of soft-lobbying costs, I recommend not awarding the Company its Corporate Governance Expenses.

P. Membership Fees and Dues Expenses.

294. The Company has included $315,474 of membership fees and dues, net of reported lobbying expenses, in its test period cost of service. Exh. 20-Ziminsky, p.79; DPA OB, p.99.) Public Advocate Witness Crane recommended that 20% of the Company's membership fees and dues be disallowed because such costs constitute lobbying activities or "engage in other activities which should not be charged to ratepayers, such as public affairs, media relations or

other advocacy initiatives." (Exh. 13-Crane, pp. 53-54.) According to Witness Crane, her recommendation "is based on her review of the organizations and on her recommendations in other utility rate proceedings. (*Id.* at pp. 54-55.)

295. Hearing Examiner's Recommendation: First, the Company maintains that it excluded all lobbying costs from its $147,774 expense for Edison Electric Institute ("EEI"), which I accept. (DPL OB, p.100.) EEI's website states that it is a national and international trade organization of investor-owned utilities, which advocates public policy, expands market opportunities and provides strategic business information." (DPA OB, p.100; quoting website.) I recommend that this expense be allowed because it is vital to the Company's operation which borders or is very close to a number of Mid-Atlantic states.

296. Second, I agree with Ms. Crane's recommendation that 20% i.e. $63,094 should be deducted from the total $315,474 in claimed fees and dues because the remaining groups, although clearly worthwhile, are not necessary for providing safe and reliable electric service. Specifically, the following groups should not be reimbursed: a) various Maryland and Delaware Chambers of Commerce-$28,797, with $22,750 being spent with Delaware Chambers; b) the Art League of Ocean City, Inc. (MD), the Girl Scouts, the Committee of 100, the Delaware Alliance for Nonprofit Advancement ("DANA") ($20,000); and c) the Delaware Public Policy Institute ("DPPI") ($45,000). (DPA OB, pp.101-02.)

297. Ms. Crane recommended that the Company's membership fees and dues in the above organizations be disallowed because such costs constitute lobbying activities or “engage in other activities which should not be charged to ratepayers, such as public affairs, media relations or other advocacy initiatives.” (Exh. 13-Crane, pp. 53-54.) These expenses total $93,797, well within Ms. Crane’s recommended disallowance of $60,094. In conclusion, the Company should be awarded the rate treatment after disallowing $60,094.

Q. Supplemental Executive Retirement Plan (“SERP”).

298. The Company included $1,101,782 of Supplemental Executive Retirement Plan (SERP) expenses in the Company’s revenue requirement. (DPA OB, p.83.) “These costs relate to supplemental retirement benefits for key executives that are in addition to the normal retirement programs provided by the Company.” (Exh. 13-Crane, p.39.) According to 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.” (Exh. 20-Ziminsky, p. 75.)

299. In Docket No. 09-414, the Commission included SERP expenses in the Company’s cost of service. (PSC Order No. 8011,¶184.) Although

the Hearing Examiner recommended otherwise, the Commission held that "[w]e are persuaded by Delmarva's argument that these benefits are necessary to attract and retain executive talent." (*Id.*) The Commission also noted that these were "true retirement benefits" and "not tied to the achievement of financial goals." (*Id.*)

300. The Public Advocate, joined by Staff in Brief, 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, not ratepayers." (Exh. 13-Crane, p.40; Staff OB, p.81.) "The Public Advocate removed the SERP benefits from the Company's cost of service on the ground that ratepayers should not be burdened with funding these additional benefits, especially in light of the compensation that senior executives are already receiving, ranging from $1.5 million dollars for the new General Counsel to $11.3 million dollars for Mr. Rigby, PHI's CEO." (Staff OB, pp.81-82.)

301. <u>Hearing Examiner's Recommendation</u>. Based on the Commission's relatively recent decision in Docket No. 09-414 and the reasons stated above, and no new compelling arguments being raised, I recommend that the Commission award the Company its SERP costs.

R. Expenses for Employee Benefits.

302. Delmarva proposes an 8% increase for medical expense and 5% increases for dental and vision expenses. (DPA OB, p.86.) If approved, this adjustment would result in a $318,999 decrease to test period earnings. (DPL OB, p.83.)

303. Delmarva is self-insured for its medical benefits costs. The Company's actual medical costs vary based on the amount of services required each year. (Exh. 13-Crane, p.41.) In order for the Company to determine the level of cost increase which must be factored in to provide employee benefits, the Company consults with its benefits expert, Lake Consulting, Inc., which performs a quarterly survey of six (6) major healthcare benefit providers in the Mid-Atlantic region, and asks for the actuarial trends that those providers are using to project cost claim changes for the upcoming year. (Exh. 20-Ziminsky, p.29.)

304. The subject survey by Lake Consulting, Inc. is based upon data from first quarter, 2013. (Exh. 5-Ziminsky, p. 14 and Sch. (JCZ)-9.1). Lake Consulting analyzes benefit trends each quarter in the "Mid-Atlantic region." (*Id*. at Sch. (JCZ)-9.1.) "Lake's study projects increases in HMO costs ranging from 7.9%-12% (average 9.4%); increases in PPO costs ranging from 7.7%-12% (average 9.6%); increases in dental costs ranging from 5%-7.8% (average 6%); and an average 6% increase in vision costs (Lake does not specifically track vision cost expense but notes that vision cost trends generally follow dental cost trends.) (*Id*.) Delmarva proposes an 8% increase for medical expense, and 5% increases for both dental and vision expense. (*Id*. at 14-15.)" (DPA's OB, p.86.)

305. The annual changes over the last five (5) years in total Company benefit costs are as follows:

	Medical	Dental	Vision
2012	13.82%	4.07%	24.15%

2011*	-3.55%	3.83%	-4.07%
2010	2.38%	4.07%	9.26%
2009	8.87%	-4.10%	17.19%
2008	1.37%	3.76%	2.08%
5 Yr. Avg.	4.58%	2.33%	9.72%
*4 Yr. Avg.**	*6.61%*	*1.95%*	*13.17%*

*According to Delmarva, "[t]he declines in 2011 changes were driven by reduced headcounts resulting from the Organizational Review Process that reviewed and realigned resources after the 2010 divestiture of Connectiv Energy. In that regard, a 4-year average (excluding 2011 results is also shown). The benefit increases (8% - medical, 5% dental, 5% - vision) generally fall within or near the ranges set by the 5-year and 4-year adjusted averages." (Exh. 58.)

306. In Docket 09-414, the Commission approved a similar adjustment based upon a Lake Consulting Report, unanimously holding that:

> "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) (PSC Order 8011, ¶113.)

307. Staff's and the Public Advocate's arguments for rejecting this adjustment save one,[33] are the same Staff arguments the Commission rejected in Docket 09-414, when the Commission stated as follows:

[33] In this case, the Public Advocate argues the Lake Report is hearsay but I find that it is admissible. First, the Public Advocate's hearsay objection was never made at the

Staff rejects this adjustment on several grounds. First, it notes that Lake did not provide its work to Delmarva until May 2009, after the test period had ended, and the proposed adjustment is outside the test period. Second, the estimates are not "reasonably known and measurable." Third, it does not appear that Delmarva considered the impact of the modifications to its benefit plans or what its own insurer(s) have advised it regarding such expenses. Fourth, there is no evidence that any of companies surveyed provide coverage to Delaware employees, or that the expense trend in the geographic area surveyed is representative of the expense trend in Delaware. In this regard, Staff dismisses the Maryland PSC's acceptance of this adjustment in Delmarva's most recent case there, noting that the surveyed companies were located in the Virginia-Maryland-District of Columbia area, where its Maryland employees work, and that geographic area is well known to be more expensive than Delaware. Last, Staff argues that its prior acceptance of this adjustment is irrelevant because it is not bound by a position it took in a different case involving different facts and circumstances. (PSC Order No. 8011, §§108,109; citations omitted.)

308. Hearing Examiner's Recommendation. Based upon the Commission's relatively recent decision in 09-414, and no new compelling arguments being raised, I recommend that the Company be awarded this proposed adjustment. As the Company argued in its Brief:

> 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. In addition, the Company has chosen to incorporate increases below the surveyed average in its Company forecasts and revenue requirement. (DPL OB, p.84.)

Evidentiary Hearing so I find that it was waived. Second, the Lake Report is an attachment to Mr. Ziminsky's testimony. I find that the document is admissible pursuant to Commission Rule 25(a) which allows the Hearing Examiner to rely upon hearsay evidence when supported by other evidence. That is the case here since Mr. Ziminsky's testimony was admitted into evidence without objection by any party, including the Public Advocate.

S. Meals and Entertainment Expenses.

309. The Company included $298,182 of business expenses, which includes providing meals to union employees, business meals, meals related to overtime and meals provided for training. (Exh. 20-Ziminsky, p.78; DPL OB, p.98.) Without citing any specific authority, the Company argues that Commission precedent in Docket Nos. 05-304 and 09-414 authorizes this expense. (Exh. 20-Ziminsky, pp. 78-79.) Without citing any specific authority, the Public Advocate argues it does not. (DPA OB, p. 98.) Based on my review of those dockets, the Commission did not directly address this issue in either docket.

310. The Company argues that these expenses are "operating expenses" and cites the *Delmarva* case which held that operating expenses are recoverable in the absence of an abuse of discretion, bad faith, inefficiency or waste. (*Delmarva*, 508 A.2d. 849,859 (Del. 1986.)

311. Public Advocate Witness Crane opined that meal and entertainment expenses which are not deductible for federal tax purposes are deemed by the IRS not "to be reasonable business expenses," and recommends that the Commission adopt the use of the IRS 50% criteria as a reasonable balance between shareholders and customers. (Exh. 13-Crane, pp.52-53.)

312. The Public Advocate's Brief argues that the Company's broad description of these claimed expenses does not change the fact that the expenses are for various sporting and entertainment events according to Delmarva's 2012 Proxy Statement. (*Id.* at p.53; DPA OB, p.99.) Moreover, the Public Advocate argues that "meals provided to

employees during required overtime, training and the like were more likely than not 100% deductible [due to Treasury regulations].” (*Id.*)

313. Hearing Examiner’s Recommendation. Due to the lack of evidence produced by the Company as to the exact nature of these expenses, I recommend that the Commission not award these expenses to the Company. Delmarva’s 2012 Proxy Statement states that some of these expenses were for sporting and entertainment events. Also, I accept the Public Advocate’s argument that employee meals during overtime and training are seemingly not part of the taxable expenses being claimed now. I find that the Company has not met its Burden of Proof regarding these expenses.

IX. COST OF SERVICE AND RATE DESIGN.

A. Cost of Service.

314. Company’s Position. According to the Company, its Class Cost of Service Study (CCOSS) 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.” (DPL OB, p.100)

315. Delmarva maintains that “[t]he cost allocation approaches in the Company’s CCOSS are consistent with the methods used in the filings in Docket Nos. 05-403, 09-414, and 11-528, that served as the foundation or starting point for the approved rate design in those cases.”(DPL RB, p.38.) According to Delmarva, it is also consistent with the NARUC Manual, Delmarva’s Delaware experience, and the electric industry. (*Id.* at pp. 38,41.)

316. “In this proceeding, the CCOSS also incorporates the results of the initiatives stemming from the CCOSS workshop held in compliance with PSC Order No. 8011 in Docket No. 09-414, for consideration by the Commission.”(DPL RB, p.38.)

317. The Company and the Public Advocate testified that the following initiatives have been agreed upon by the parties: a) the use of Delaware specific load survey data to estimate residential non-coincident peak demand; b) use of weather normalized sales and revenue; c) the development of a revised Account 369-Service line allocator; and d) the disaggregation of the traffic signal service from the general street lighting service. (DPL RB, pp.42-43; Tr.-918-19; Exh. 14-Dismukes, p.32; DPA OB. p.136.)

318. I will now discuss some issues in the Company’s CCOSS focusing on issues raised by Staff, the Public Advocate and DEUG. As will be discussed later herein, Staff and the Public Advocate seek that the Company’s CCOSS be rejected, and changes to Delmarva’s CCOSS. (Staff OB, pp.95-96; DPA OB, pp.133-150.) DEUG seeks a change to Delmarva’s CCOSS regarding certain distribution plant accounts. (Exh. 16-Phillips, pp.9-10.)

319. Delmarva’s Allocation Factors. Delmarva describes the allocation factors in its CCOSS as follows, arguing that they allocate almost 80% of the applicable distribution plant costs based on a highly diversified demand allocator, and produce reasonable class results:

> “…Delmarva’s distribution plant investment (including substations and primary lines) are allocated using the class maximum diversified demands, reflecting the diversified demands

> served by these facilities. The secondary plant cost allocators recognize that equipment, such as line transformers, may serve multiple customers so that the diversity of load will impact the sizing of the transformer. Other transformers serve a single customer so no load diversity is considered in sizing that equipment. Company Witness Tanos pointed out that the very large secondary customer generally will have their own transformer at their facility and are generally not adjacent to other large customers. Smaller customers have much smaller loads and are often more clustered, which provides for the aggregation of several customers for sizing and installing transformers.
>
> To reasonably reflect these conditions in developing the allocation of line transformer costs, the CCOSS first [segregated] the larger secondary customers and allocated line transformer costs to this class based solely on the customer maximum non-diversified demands. Next, the remaining line transformer costs were allocated to all other secondary customers using the 50/50 weighting of class diversified demands and customer maximum non-diversified demands. The 50/50 weighted demand approach recognizes the aggregation described above and is a reasonable and manageable approach to achieve a further allocation of these costs. Using only one of the demand approaches (either class demands or customer maximum) would under allocate (class demands) or materially over allocate (customer maximum) costs to smaller customers, such as residential." (DPL RB, pp.39-40; Tr.-945.)

320. <u>Delmarva's Underground and Above Ground Facilities</u>. Delmarva Witness Tanos testified as to the use of 50/50 weighting of class diversified demands and customer non-coincident demands, as it relates to underground and above ground facilities. (Exh. 22-Tanos, pp.4-6.) In addition to arguing that Staff Witness Pavlovic has not provided any evidence that Delmarva's approach is incorrect, Witness Tanos provided some Delaware evidence as to why the 50/50 weighting between residential and commercial customers, the latter of which

Witness Pavlovic argues uses substantially more costly underground facilities, is reasonable.(*Id*.)

321. Accoring to Company Witness Tanos, "…[f]or the past forty-three years, Delaware law has required that regulated electric distribution companies provide underground facilities for all new extensions of electric services for new residential subdivisions of greater than five (5) lots and for multi-family buildings. Every new residential subdivision in Delaware is installed with underground facilities, and new homes are predominately planned subdivisions." (DPA RB, pp.41-42.)

322. Allocators. As to General and Common Plant, Delmarva uses a labor allocator to allocate certain labor-related O & M expense accounts, which reflect the weighting of functionalized plant categories. (*Id*. at p.10.) These expenses include labor-related expenses such as infrastructure used in housing staff, and meeting personnel needs such as computers, communication equipment, and software used to run the system, (*Id*.)

323. According to Delmarva, "the Company's Labor Allocator is similar in function to the use of operating labor ratios in the NARUC Manuel." (DPL RB, p.45.) Also, all of Delmarva's affiliates (except PEPCO) use a labor indicator. (Exh. 22-Tanos, pg. 10, fn.l.) Finally, Delmarva argues that FERC and 70% of reporting electric companies use a labor indicator. (*Id*. at p.10.)

324. Delmarva allocates its Customer Service and Information Accounts and Sales Expenses Accounts using allocators weighted 50% on total number of customers and 50% on total energy sales. (Exh. 8-

Tanos, Sch. EPT-1.) These costs are associated with a) encouraging safe and efficient use of the utilities' services; b) responding to customer inquiries; and c) advertising utility services to customers. (Exh. 14-Dismukes, pp.35-36.)

325. Although the Company classifies these accounts as customer-related, Company Witness Tanos testified the use of the number of customers alone to allocate the costs of these accounts would assign the vast majority of the costs to the residential class based on total class population. (Exh. 22-Tanos, p.11, DPL OB, pp.148-49; DPL RB, p.46.) According to Witness Tanos, the NARUC Manual describes the goals of the programs, such as conservation programs that include saving electricity on an annual basis, and for Sales Expenses, and that the NARUC Manual suggests the use of a more general allocation scheme, rather than number of customers. The Company prepared an equally weighted composite allocation based on the number of customers and their corresponding sales usage. (*Id.* at pp.11-12.)

326. Load Data & AMI. For its CCOSS, Delmarva used 2011 load data, which the Company maintains was the most recent available data for this rate case filed on March 22, 2013. (DPL OB, pp.104-05; Exh. 8-Tanos, pp.8-9; Sch. 1.) Delmarva argues that it followed the same procedure in Docket Nos. 09-414 and 11-528. (DPA RB, p.44.)

327. Delmarva is currently using AMI data for residential and small commercial class services, which data became available on August 29, 2013. (Exh. 22-Tanos, p.6.) Delmarva's Brief states that, after it accumulates one (1) year of AMI data, Delmarva will use it to

determine CCOSS class maximum diversified loads and customer hourly demands (Exh. 22-Tanos, p.6; Tr.-938-39.)

328. Criticism of Company's CCOSS. Load data & AMI. Staff and the Public Advocate argue that Delmarva's CCOSS should be rejected because Delmarva's 2011 load data is inaccurate data for this rate case, which involves a 2012 test period and test year. (Staff OB, p.90, DPA OB, pp.145-46.) Both argue that Delmarva's 50/50 allocation is less accurate than AMI data which Staff argues should be used now. The Public Advocate does not specifically argue whether it is seeking that the Company perform a new CCOSS with 2012 and/or 2013 data or use the current seven (7) months of AMI data if it is able to do so. (*Id.*) The Public Advocate also argues that Delmarva's practice of monthly sampling checks to verify its load research sample was not accurate enough to determine the 2011 load. (DPA OB, p. 145.)

329. 50/50 Allocation. In arguing for using AMI data, Staff (but not The Public Advocate) maintains that, without class studies, the Company's 50/50 allocation is inaccurate and violates *26 Del. C.* 303(a)'s requirement that rates not be "unjust, unreasonable, unduly preferential or unjust discriminatory."

330. According to Staff: "Staff's Witness Pavlovic pointed out that some of Delmarva's transformers serve single customers and others serve multiple customers; however, Delmarva arbitrarily uses a simple average, 50/50 split, of its Customer NCP demand measure[34] and Class

[34] Delmarva defines Customer NCP as "the sum of the individual maximum demands of the customers within a class on a customer-by-customer basis over the analysis period." (See attachment to Exh. 10 (Pavlovic), PSC-COC-29, at ¶1.)

MDD demand measure[35] to allocate transformer cost responsibility. According to Mr. Pavlovic, "it is extremely unlikely that exactly 50% of Delmarva's transformers serve single customers and 50% serve multiple customers. Hence, it is extremely unlikely that an arbitrary 50/50 weighting of the two demand measures will accurately reflect the actual class cost responsibility for transformers. If a utility's costs of providing service are not accurately allocated to its rate class and rate class costs are not accurately reflected in the rate classes' tariff billing charges, then the utility will either over- or under-recover its costs of service or revenue requirement." (Staff OB, pp. 92,90.)

331. According to Staff, Delmarva's 50/50 allocation of the Class MDD and Customer NCP, and defining the Customer NCP as a non-diversified demand measure reflecting zero diversity, are fatal flaws in the Company's CCOSS. (Staff OB, pp.89-90.)

332. <u>Underground and Above Ground Facilities</u>. Staff (but not the Public Advocate who disagrees) argues that the Company's use of a single allocator for underground and above ground facilities has caused inaccurate costs to the residential and commercial classes: "In fact, [Company Witness] Mr. Tanos acknowledged that underground distribution facilities cost more in general than overhead distribution facilities. Because commercial customers generally make greater use of underground facilities, and because underground facilities are generally more expensive, Delmarva's use of a single

[35] Delmarva defines Class MDD as "the maximum hourly demand found for the customer class over the analysis period where the simultaneous demands of the class of customers is taken as a whole." (See attachment to Exh. 10 (Pavlovic), PSC-COS-30 at¶1.)

allocator that does not reflect the differences in customer classes' use or overhead and underground facilities represents a source of inaccuracy in the CCOSS and likely results in over-allocation to underground costs to the residential class." (Staff OB, p. 88.)

333. AMI & GIS. Staff Witness Pavlovic recommends that the AMI data and Geospatial Information System (GIS) information be used to develop CCOSS demand allocators to be submitted in Delmarva's next rate case. (Exh. 10-Pavlovic, pp.15-16.) The Company rejects this proposal due to the lack of interface of numerous Company databases that are not linked, the large cost, and the inability of the Company's accounting department to perform Mr. Pavlovic's recommendation. (DPL OB, p.42.)

334. Customer Information & Sales Expenses. Public Advocate Witness Dismukes argues that the Company's proposed CCOSS is generally reasonable but Customer Information and Sales Expenses should be classified as customer-related, and then allocated based only on the number of customers. (Exh. 14-Dismukes, p.36.) This approach would simplify and make the Company's CCOSS more accurate. (*Id*. at pp.36-38.)

335. Total Distribution Plant. Public Advocate Witness Dismukes also proposes to use a total Distribution Plant Allocator to allocate general and common plant accounts. (*Id*. at p.36.) According to Professor Dismukes, this approach is simply preferred by him, but it would simplify and make Delmarva's CCOSS more accurate than Delmarva's labor allocator. (*Id*. at pp.36-38; Tr.-528.) The total cost of

Professor Dismukes' recommendations to the residential class would be approximately $600,000. (DPA OB, p.149 fn 1.)

336. DEUG. DEUG Witness Phillips agrees that the Delmarva CCOSS should be accepted, but argues that certain distribution plant accounts currently classified as demand-related should be re-classified as customer related. (Exh. 16-Phillips, pp.9-10.) Further, he supports the use of the Minimum Distribution System (MDS) analysis to determine this customer cost component. (*Id*. at p.10.)

337. According to DEUG:

> "Certain distribution investments that must be made to connect a customer to the system are unrelated to that customer's demand level or energy usage and should properly be considered as customer-related. Mr. Phillip's analysis shows that Delmarva's CCOSS fails to reflect a reasonable customer component in the classification and allocation of certain distribution plant costs, resulting in proposed rates for the General Service Primary ("GSP") customer class, in particular, that are inflated and that would produce revenues substantially above the cost of service. For this reason, Mr. Phillips has prepared and submitted a revised CCOSS that takes into account actual cost causation and that should be used to allocate any distribution revenue increase in this case, as well as in the design of distribution rates." (DEUG OB, p.2.)

338. Hearing Examiner's Recommendation. For the reasons described above and herein, I recommend that the Company's CCOSS be adopted "as is", along with the four (4) changes agreed upon at the Commission-ordered Workshop. My recommendation is primarily based on the fact that the Company's approach in this Docket was approved by the Commission in Docket Nos. 05-304, 09-414, and 11-528. Delmarva's load data approach in this case, was approved by settlement basically

on an across the board class basis in the two (2) most recent dockets. Moreover, reliable AMI data is now becoming available.

339. This Report is dated March 4, 2014. Some AMI data became available on August 29, 2013. Thus, there is currently six (6) months of reliable CCOSS data available to the Company. The Company maintains that it needs twelve (12) months of AMI data to properly accumulate it for CCOSS purposes.

340. The AMI program cost approximately $39 million. (DPA OB, pp. 19-20.) As opposed to costly and time consuming, relatively minor modifications of the CCOSS which has been approved in the three (3) most recent dockets, the Commission should now be focusing on what, how and when AMI data will be incorporated into the CCOSS.

341. For example, in the next rate case, AMI data will answer Staff's and the Public Advocate's concerns as to use of the 2011 load data in this case. AMI data will presumably answer Staff Witness Pavlovic's questions about the Company's demand allocation methods, and the apportionment of underground and above-ground costs.

342. I am concerned about Delmarva's next electric rate case. If many CCOSS issues raised in this case will be answered by AMI, that information must be included in its next CCOSS. The Company's Brief states 1) that it is already using residential and small commercial AMI data for load purposes; 2) the Company needs one (1) year of AMI load data to "determine the CCOSS class maximum diversified loads and a full year of customer hourly demands…." (DPL RB, p.41.) Company Witness Tanos' testimony at the evidentiary hearing was less

optimistic, stating that the one year time period was the Company's "expectation." (Tr.-938-939.)

343. Based on the $39 million AMI investment, the Company's ratepayers, Staff and the Public Advocate have their own expectations about AMI. (DPA OB, p.20.) One expectation is accurate CCOSS data for setting rates. Even Delmarva's "Blueprint for the Future" states that AMI will help Delmarva "make improvements to customer reliability, outage management, *and billing accuracy and timeliness*." (DPA OB, Attach. A, p.3.)

344. I recommend that the Commission order that, in its next rate case, Delmarva must include all available AMI data in its CCOSS, including but not limited to, the CCOSS class maximum diversified loads and customer hourly demands, peak and non-peak data, residential, commercial and industrial and all other class use, and above and below ground use. This data must be current as of one (1) month prior to the filing date of Delmarva's next rate case.

345. As to DEUG's claims, I agree with the Company's position that they should not be adopted:

> "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. Further, he supports the use of Minimum Distribution System (MDS) analysis to determine this customer cost component. The Commission previously considered use of the MDS in Docket No. 05-304, and rejected it. There has been no evidence presented of changed conditions in this proceeding such that would now cause the Commission to reconsider use of the MDS, and for the many reasons detailed in Witness Tanos' Rebuttal Testimony, DEUG's proposal should be rejected." (DPL OB, p.47.)

B. Rate Design

346. The Public Advocate argues that Delmarva's rate design is flawed because gradualism warrants that residential ratepayers pay less than 100% of the rate approved in this case. According to the Public Advocate: "Delaware ratepayers are struggling to make ends meet. Those who are Delmarva ratepayers have experienced rate increases totaling more than $66 million since January 2011, representing an increase of 38% in revenues in just three years. (DPA OB, pp. 154-55; Tr.-256.)

347. According to the Public Advocate, "[i]n Docket No. 09-414, the Commission granted Delmarva a $16.7 million revenue increase that raised the average residential customer's bill by $3.69 per month, and in Docket No. 11-528 it granted Delmarva a $22 million revenue increase that raised the average residential customer's bill by $4.49 per month, and it has placed a $27.7 million interim rate increase into effect in this case that has raised the average residential customer's bill by $5.36 per month." (DPA OB, p.155; citations omitted.)

348. <u>Hearing Examiner's Recommendations</u>. Unlike past situations involving Delmarva and other Delaware utilities, based on the rate increases described above which, including the interim rates in this case, total $13.48 per month for the average residential user since January 2011 (including charges for legislative enactments), I recommend that the Commission not employ gradualism in this case.

349. DEUG argues that the Company's rate design is flawed because: "[t]he revenue allocation issue raised by DEUG relates to the

rate Delmarva proposes to charge to the General Service Transmission ("GST") class of customers. Delmarva's rate design for the GST class fails to take into account the fact that those customers were offered a credit for power factor improvement that reduces costs and benefits the entire system. By failing to take that credit into account, Delmarva has significantly inflated the revenue burden imposed on the GST class. To correct for this, Mr. Phillips proposes that the percentage increase in GST rates granted by the Commission in this proceeding should be no more than one-half the system average percentage increase." (DEUG OB, p.3.)

350. I do not agree with the DEUG because there is no record evidence of reduced costs due to the power factor credit.

X. SUMMARY OF RECOMMENDATIONS.

351. In summary, and for the reasons discussed above, I recommend to the Commission the following:

A. That the Commission accept the Company's capital structure agreed upon by the parties;

B. That the Commission accept the Company's recommended Return on Equity of 10.25%;

C. That the Commission award the Company its plant closings from January, 2013 through and including August, 2013, by approving Adjustment No. 26A;

D. That the Commission not award the Company its forecasted plant closings from September, 2013 through and including December, 2013, by not approving Adjustment No. 26B and that this Adjustment be examined in the Commission's Reliability Docket as described in this Report;

E. I recommend that the Commission not approve the Company's request to change from using the average rate base method to the year-end rate base method;

F. That the Commission approve the adjustments agreed upon by the parties;

G. That the Commission remove Construction Work In Progress (“CWIP”) from rate base and also reverse the earnings adjustment for AFUDC;

H. That the Commission reject the Company’s claimed $10,887,807 of Cash working Capital (“CWC”) and a corresponding $965,309 Allowance for Funds Used during Construction (“AFUDC”) offset to earnings, and select either Staff’s or the Public Advocate’s claimed amounts if established to the Commission’s satisfaction;

I. That the Commission award the Company’s proposed ratemaking treatment of its pre-paid pension asset, by continuing to assign it to rate base;

J. That the Company should be awarded its deferred IRP costs with the rate treatment it seeks;

K. That the Company should be awarded its IRP operating expenses, but at the level recommended by the Public Advocate;

L. That the Company should be awarded its RFP costs with the rate treatment it seeks;

M. That the Company should be awarded its Credit Facility costs with the rate treatment it seeks;

N. That the Company should be awarded the Dynamic Pricing Program Regulatory Asset rate treatment recommended by the Public Advocate;

O. That the Company should be awarded the Direct Load Control rate treatment recommended by the Public Advocate and Staff;

P. That the Company should not be awarded the Medicare Subsidy Deferred Costs rate treatment it seeks;

Q. That the Company should be awarded the Wage and FICA rate treatment it seeks;

R. That the Company should be awarded the Regulatory Expenses rate treatment it seeks;

S. That the Company should not be awarded the Non-Executive Incentive Compensation rate treatment it seeks;

T. That the Company should not be awarded the Relocation Expenses rate treatment it seeks;

U. That the Company should not be awarded the Corporate Governance Expenses rate treatment it seeks;

V. That the Company should be awarded the Membership Fees and Dues rate treatment I have recommended which is primarily based upon that recommended by the Public Advocate;

W. That the Company should be awarded the Supplemental Executive Retirement Plan ("SERP") rate treatment it seeks;

X. That the Company should be awarded the Expenses for Employee Benefits rate treatment it seeks;

Y. That the Company should not be awarded the Meals and Entertainment rate treatment it seeks;

Z. That the Company's proposed Cost of Service be approved, along with the four (4) changes agreed upon at the Commission-ordered Workshop; and

AA. That the Company's Rate Design be approved.

Respectfully submitted,

Mark Lawrence

Mark Lawrence
Hearing Examiner

Dated: March 4, 2014