DELMARVA POWER & LIGHT COMPANY
REBUTTAL TESTIMONY OF J. MACK WATHEN
BEFORE THE DELAWARE PUBLIC SERVICE COMMISSION
CONCERNING AN INCREASE IN GAS BASE RATES
DOCKET NO. 10-237

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1. Q: <u>Please state your name and position, and business address.</u>

A: My name is J. Mack Wathen. I am Vice President, Regulatory Affairs for Pepco Holdings, Inc., (PHI) located at P.O. Box 9239, Newark, DE 19714. I am testifying on behalf of Delmarva Power & Light Company (Delmarva or the Company). My educational background and personal qualifications were provided in my Direct Testimony filed in this proceeding.

2. Q: <u>Did you previously submit Direct Testimony in this case?</u>

A: Yes.

3. Q: <u>What is the purpose of your Rebuttal Testimony?</u>

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

4. Q: <u>Please identify the Company's rebuttal witnesses.</u>

A: Company Witness Frank J. Hanley rebuts the recommendations of the witnesses for the Commission Staff and DPA on rate of return and cost of capital issues.

Company Witness W. Michael VonSteuben will provide a complete listing of all uncontested adjustments. He will also provide rebuttal to certain contested adjustments and proposals made by DPA Witness Crane and Staff Witness Smith.

In addition, Company Witness VonSteuben is responsible for quantifying the revenue requirements of the Company's rebuttal.

Company Witness Ernest L. Jenkins, Sr. will rebut DPA Witness Crane's and Staff Witness Smith's testimony on compensation, executive compensation and employee benefits issues.

Company Witness Timothy J. White will rebut DPA Witness Crane on her cash working capital proposal.

Company Witness Joseph F. Janocha will rebut portions of the testimony of witnesses for DPA and Staff on rate design issues.

Company Witness Jay C. Ziminsky will rebut portions of the testimony of witnesses for DPA and Staff on certain ratemaking proposals.

5. Q: <u>DPA recommends reducing the Company's overall revenue requirement by a decrease of $4.7 Million and Staff similarly recommends a decrease of approximately $679,000 in base distribution revenue. Please comment on the financial impact of these proposals on the Company and its ability to raise capital on reasonable terms</u>.

A: As I stated on pages 5 and 6 of my Direct Testimony, the Company invested approximately $70 million in its Delaware gas distribution system over the past three years in order to continue to provide safe and reliable service to its customers. However, at current rates, Delmarva's return on equity (ROE) of 5.74% is falling significantly short of the 10.25% ROE currently approved by the Commission. At this low rate of return, the Company is at a competitive disadvantage when it comes to raising the necessary capital, which ultimately is to the detriment of our customers. The Company's rates for distribution service must reflect the current costs of providing service. It is critically important for Delmarva to have the opportunity to earn a fair return on its capital in order to be able to raise additional capital on reasonable terms.

DPA's recommended $4.7 Million decrease, if adopted, would have an extremely negative effect on the Company's operations and its customers and would further lower Delmarva's current cash flow. Staff's overall revenue requirement proposal to decrease revenues by $679,000 would have a similarly detrimental impact.

If adopted, these proposals would be viewed extremely negatively by both the financial community and the rating agencies, and could cost the Company's customers more in the long run in higher capital costs. In fact, in the Company's 4th quarter 2009 earnings conference call, an analyst referring to Company's Delaware Electric rate proceeding noted that: "Delaware was a little aggressive...with respect to the decrease in ROE...." He further inquired: "How does one think about the purpose of going in if the ROE is so much lower? How should [the financial community and rating agencies] think about that in terms of regulatory process?" The ROE recommendations of the Staff and DPA in this proceeding are even lower than their recommendations in the Company's Electric rate proceeding. This quote clearly reflects the concern on the part of the financial community to these unreasonably low rate of return recommendations.

6. Q: <u>What significant recommendations of the Staff and DPA would have the most detrimental impacts on the Company and its customers?</u>

A: The most significant recommendations in terms of detrimental impact are: the unreasonably low rate of return recommendations of DPA Witness Crane and Staff Witness Rothschild; and the positions of the DPA and Staff to not accept reasonably known and measurable adjustments past the end of the test period, contrary to the standard practice of this Commission. Company Witness VonSteuben provides detail of the Commission practices that DPA and Staff have deviated from.

7. Q: Please comment on the importance of Commission adherence to reasonable, consistent and predictable ratemaking practices.

A: It is widely accepted that the rate-setting process must be forward looking. This is because the primary purpose of setting utility rates is to provide the utility the opportunity to recover its cost of providing service, including the opportunity to earn its authorized rate of return. If Commissions do not recognize in rates, rate-related (not volume-related) expense increases, and non-revenue producing rate base additions that occur during the rate effective period, the utility will not be allowed that opportunity. In fact, to not recognize these added costs would virtually guarantee that the utility will fall short of its authorized rate of return. This is why it is common regulatory commission practice to either adjust the historical test period for known and measureable increases of this nature, or to grant the utility use of a fully forecasted test period. Consistent with this principle, and in order to make the test period more reflective of the period when the new rates will be in effect, since at least the 1980's, the Commission has consistently allowed adjustments outside of the test period for known and measurable changes.

Moreover, as I stated in my Direct Testimony on pages 11 and 12, the regulatory environment is a very important factor to credit rating agencies in assessing the credit quality of investor-owned utilities. In fact, Standard & Poor's (S&P) has indicated that the regulatory climate is perhaps the most important factor it analyzes when evaluating investor-owned utilities. Included in S&P's evaluation of the regulatory environment for utilities is the consistency and predictability of rate treatment and decisions. If the Commission were to depart from its long-established ratemaking practice of allowing known and measurable adjustments outside of the test period, it would send an alarming signal to the credit rating community of a deterioration in the regulatory climate and, therefore, a heightened uncertainty in the recovery of Delmarva's appropriately incurred expenses and investments.

It is also important to understand that we rely upon consistency of rate making treatment in our planning for, and operation of, Delmarva. I am not suggesting that ratemaking practices should be unreasonably inflexible and unable to meet the changing needs of customers, the environment, the utility and the State's energy goals. Decoupling is an example where rate design practices are changing to meet the needs of customers, the environment, the utility and the State's energy goals. The numerous changes in established ratemaking treatment advocated by Staff and DPA, however, are not supported by any changing needs in the regulatory or energy environments, nor will they allow the Company an opportunity to earn the authorized rate of return. Company Witness VonSteuben addresses the specific instances of inconsistency in more detail in his rebuttal testimony.

8. Q: <u>Please comment on the Staff's and DPA's recommended ROE.</u>

A: The ROE's recommended in this proceeding by Staff and DPA are as follows: Staff 8.25% and DPA 7.17% assuming implementation of decoupling. Staff's recommendation is below <u>any</u> authorized electric company ROE reported by Regulatory Research Associates (RRA) across the country since 1990, which is as far back as RRA makes information available. DPA's recommendation is far lower than Staff's recommendation. Both of these recommendations are outside the range of reasonableness and could harm Delmarva and its customers if adopted. Company Witness Hanley discusses in detail the flaws in the calculations of these two recommendations in his rebuttal testimony.

9. Q: <u>Please comment on the Staff's recommended cost rate of long-term debt for Delmarva.</u>

A: Staff Witness Rothschild has made downward adjustments to the Company's proposed cost of debt in this proceeding based on the advice he received from Liberty Consulting Group based on their conclusions that the timing of a bond issuance was influenced by the Company's unregulated activities. This adjustment, if adopted, would penalize Delmarva based on 20/20 hindsight. It is doubtful that Mr. Rothschild would still be recommending such an adjustment if interest rates were considerably higher today. The fact is that Delmarva cannot, and should not, engage in the practice of playing an interest rate guessing game or, in this case, a high stakes gamble that the economy will improve in time for our needs, when timing its financing. Neither we nor Mr. Rothschild can predict the future with any degree of certainty.

The bond offering completed in the fall of 2008 was needed at that time in the judgment of Delmarva's management team to protect the Company's liquidity during a time of a liquidity crisis and possible economic and banking industry meltdown.

10. Q: Does this conclude your Rebuttal Testimony?

A: Yes, it does.