BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF DELMARVA POWER & LIGHT COMPANY FOR APPROVAL OF A CHANGE IN ELECTRIC DISTRIBUTION RATES AND MISCELLANEOUS TARIFF CHANGES (FILED MARCH 22, 2013)	))))))	PSC DOCKET NO. 13-115

FINDINGS, OPINION AND ORDER NO. 8589
DATED AUGUST 5, 2014

BEFORE COMMISSIONERS: J. DALLAS WINSLOW, Chair
JOANN T. CONAWAY, Commissioner
JAYMES B. LESTER, Commissioner
JEFFREY J. CLARK, Commissioner

APPEARANCES:

FOR THE APPLICANT, DELMARVA POWER & LIGHT COMPANY ("Delmarva" or the "Company"):

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FOR THE DELAWARE PUBLIC SERVICE COMMISSION STAFF ("Staff"):

JAMES McC. GEDDES, ESQUIRE
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JULIE M. DONOGHUE, ESQUIRE
Deputy Attorney General

FOR THE DIVISION OF THE PUBLIC ADVOCATE (the "Public Advocate" or the "DPA"):

DAVID L. BONAR, Public Advocate

REGINA A. IORII, ESQUIRE

Deputy Attorney General

FOR THE COMMISSION:

KATHLEEN P. MAKOWSKI, ESQUIRE
Deputy Attorney General

FOR INTERVENOR DELAWARE ENERGY USERS' GROUP ("DEUG"):

MICHAEL J. QUINAN, ESQUIRE
Christian & Barton, LLP

FOR INTERVENOR DELAWARE DEPARTMENT OF NATURAL RESOURCES AND ENVIRONMENTAL ("DNREC"):

RALPH DURSTEIN, ESQ., Deputy Attorney General
Deputy Attorney General

FOR INTERVENOR THE CAESAR RODNEY INSTITUTE ("CRI"):

DAVID STEVENSON, DIRECTOR,
Center for Energy Competitiveness

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY

This matter comes before this Commission on an application (the "Application") filed by Delmarva on March 22, 2013, to increase its electric rates by $39 million.[1] In September 2009, Delmarva submitted a request to increase its revenue requirement by $27.6 million; in Order No. 8011, issued on August 9, 2011, we approved a $16.371 million increase. Four months later, in December 2011, Delmarva requested a $31.8 million increase in its revenue requirement. In Order No. 8265, issued on December 18, 2012, we approved a settlement of that case for $22 million, or about 70% of its requested increase. This Application was filed only three months later.

The Company's Application was based on a test year consisting of twelve months of actual data ending December 31, 2012. The Company used this same period as its test period and proposed numerous adjustments to the actual expenses and costs that would, in its words, make the expense levels more reflective of the period during which rates would be in effect. Many of the proposed adjustments reached beyond the end of the test period. As we will discuss further in this Order, we have allowed some of these adjustments, but have rejected others.

In this proceeding, based on our through review of the Company's Application and the record developed on this matter, we

[1] The Company's original request for rate relief in this Application was $ 42 million, subsequently revised to $39 million in its rebuttal testimony.

find that a revenue requirement increase of $15.096 million, an authorized return on equity of 9.70%, and an overall rate of return of 7.26% are appropriate. When applied to an allowed rate base of $619,566,495, this will produce annual operating income of $44,980,528. We believe that these additional revenues will be sufficient to permit the Company to provide safe and adequate service to its customers at just and reasonable rates.

II. PROCEDURAL HISTORY

1. On March 22, 2013, Delmarva 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"). The Company's rate request sought to increase a typical residential customer average monthly bill, using 1,000 kWh per month, by $7.63 (from $141.23 to $148.86), or about a 5.4% increase.[2]

2. Delmarva's Application also sought Commission approval of various tariff modifications: (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. In support of its Application, Delmarva submitted the direct testimony of Frederick J. Boyle, Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc.

[2] Removing the supply portion of customers' bills, the request represented a 23.8% increase over existing distribution revenues.

("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.

3. The Company cited several reasons for its requested rate increase, the most significant being investments Delmarva made in its distribution system to both maintain and enhance reliability due to aging infrastructure and the increase in both the frequency and intensity of severe weather events. In this docket, the Company is seeking to place $39,876,047 in rate base representing actual plant closings through September 2013, plus an additional $18,355,421 of forecasted plant closings through December 31, 2013. The Company asserted that these investments were needed to maintain and enhance system reliability, to replace aging infrastructure, and to improve its response to major storms.

4. In Order No. 8337 dated April 9, 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 Mark Lawrence as Hearing Examiner to

conduct such hearings and report to the Commission proposed findings and recommendations. The Commission also granted Delmarva's request to implement a $2.5 million interim rate increase effective June 1, 2013, as permitted by 26 *Del. C.* § 306(c).

5. On April 11, 2013 the Hearing Examiner granted the office of the Attorney General of the State of Delaware's ("DAG's Office") Motion to Intervene on behalf of the then-vacant Public Advocate's position.[3] On July 2, 2013, the DAG's Office withdrew its appearance, and the new Public Advocate, David L. Bonar, was substituted as a party.

6. The DNREC, CRI, and DEUG also filed Motions to Intervene, which were granted without objection from any party.

7. Staff, the DPA and DEUG conducted extensive written discovery of the Company's Application. Also, Staff and the DPA performed a rate case audit of Delmarva's books and records extending over a period of several weeks.

8. In August 2013, the Hearing Examiner conducted public comment sessions on Delmarva's proposed rate increase in each of Delaware's three counties. 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.

9. At the New Castle County Public Comment Session, State Representative John Kowalko and two Delmarva customers opposed

[3] The Public Advocate resigned on March 28, 2013.

the ratemaking changes that Delmarva was proposing. Two other customers requested that the Commission closely analyze Delmarva's proposed infrastructure investments. (Tr. at 30-37).[4]

10. One member of the public attended the Kent County Public Comment Session and inquired about the Application. 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. Two additional customers also opposed the proposed rate increase. (Tr. at 47-73).

11. The Commission received more than sixty written comments from the AARP and Delmarva customers, as well as from 20 members of the House of Representatives. These comments generally opposed the proposed rate increase.

12. On August 16, 2013, Staff filed direct testimony addressing 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.

13. The DPA also filed direct testimony dated August 16, 2013 from Andrea C. Crane, President of The Columbia Group, Inc.; David C. Parcell, President of Technical Associates, Inc.; and David E. Dismukes, PHD, Consulting Economist with the Acadian Consulting Group. On August 16, 2013, DEUG filed direct

[4] Transcript citations will be referred to as Tr. at ___.

testimony from Nicholas Phillips, Jr., the Managing Principal of Brubaker & Associates, Inc.

14. 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, 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.

15. On September 20, 2013, in response to Staff, the DPA and DEUG testimonies, the Company filed rebuttal testimony from witnesses Hevert, Maxwell, Ziminsky, Tanos, Boyle and Santacecilia. In its rebuttal, the Company reduced its proposed revenue requirement increase to $38,976,366 million, related primarily to a reduction in post-test period plant additions and lower Other Post Employment Benefits ("OPEB") expense.

16. On October 17, 2013, Delmarva filed a Motion (the "Motion") to Stay further proceedings in this docket pending analysis and consideration of its "Forward Looking Rate Plan" (filed on October 2, 2013),[5] which proposed to set electric distribution rates for four years with some modifications

[5] *See* PSC Docket No. 13-384.

possible under certain circumstances and establish more stringent reliability performance requirements with new metrics for measuring Delmarva's reliability performance. The DPA opposed Delmarva's Motion, while Staff took no position. After a hearing on October 22, 2013, the Commission denied the Motion and ordered this matter to proceed as scheduled. (Order No. 8475 dated October 22, 2014).

17. The Hearing Examiner conducted the scheduled evidentiary hearings on November 13, 14, and 18, 2013. Staff, DEUG and the DPA proffered a total of 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 during the evidentiary hearings.

18. The evidentiary record consists of 99 hearing exhibits and 1,541 pages of transcript. Upon the conclusion of the hearings, the evidentiary record remained open due to certain issues raised by the parties.[6] The record was subsequently closed.

[6] The Company mistakenly included deferred taxes in the Company's post-test year adjustments relating to actual closings and forecasted closings, but did not discover the error and make the parties aware of it until November 12, 2013 -- one day before the start of the evidentiary hearings. Delmarva sought to correct the errors and submitted new schedules, to which both Staff and the DPA objected. On January 14, 2014, after consideration of Staff and the DPA's procedural objections to the admissibility of additional evidence on the deferred tax issue and the Company's response to those objections, the Hearing Examiner denied the objections and ordered supplemental testimony and a hearing on the deferred tax issue. Staff and the DPA filed a motion for an interlocutory appeal of the Hearing Examiner's recommended decision. On February 6, 2014, after consideration of the Hearing Examiner's order and the objections to it and hearing oral argument, we granted the motion for an interlocutory appeal and agreed with Staff's and the DPA's Procedural Objections. Our decision was memorialized in Order No. 8537 (April 15, 2014).

19. After the completion of the evidentiary hearings, the parties filed post-hearing briefs in support of their respective positions. On March 5, 2014, the Hearing Examiner issued his Findings and Recommendations (the "Report"). The Company, Staff, the DPA and DEUG each filed exceptions to the Report on March 17, 2014.

20. On April 1 and 2, 2014, the Commission met to hear oral argument from the parties and to deliberate on the issues involved in this case. We issued a "minute" order at the conclusion of our deliberations memorializing the effect of the decision.[7] This is the Findings, Order and Opinion of the Commission reflecting our deliberations and decisions on the issues raised in this docket. All evidence presented in this case, as well as the public's comments, has been thoroughly reviewed and carefully considered by the Commission in reaching our decision in this matter.

III. DISCUSSION, FINDINGS AND OPINION

A. Overview of the Participants' Revenue Requirement Positions

21. *Delmarva.* The Company selected an historical test year and test period consisting of the 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%; a Return on Equity ("ROE") of 10.25% on

[7] *See* Order No. 8549 (April 2, 2014) approving new electric rates effective with service on May 1, 2014.

a capital structure consisting of 50.78% long-term debt and 49.22% common equity; and pro-forma operating income of $33,298,159. (Exh. 20 (Ziminsky-R), Sch. JCZ-R-1, at 2-3; Exh. 18 (Hevert-R) at 2; Exh. 3 (Hevert) at 32).[8]

22. *Staff.* Staff did not contest the Company's selection of the proposed 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) at 36; DEP-1 Sch. 1, pg.1 of 3; Exh. 15 (Parcell) at 2, Staff AB at 9-10).

23. Staff's primary challenges to the Company's rate request were: (a) the Company's use of a year-end, rather than an average, test period plant in service balance; (b) Delmarva's inclusion of the 2013 post-test period reliability investment in rate base in this case, which Staff claims violates the matching principle and should not be allowed; (c) alternatively, the adjustment for post-test period reliability investments should be reviewed in the Commission's pending investigation in Docket No. 13-152; (c) Delmarva's inclusion of Construction Work In Progress ("CWIP") in rate base; (d) the amount of the Company's Cash

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[8] References to the exhibits from the evidentiary hearing will be cited herein as "Exh. __ (Witness Name) at ___" for direct testimony; Exh.__ (Witness Name –R) at ___" for rebuttal testimony; Exh. __" for non-testimonial exhibits. Schedules from the Company's Application or pre-filed testimony will be cited as "Exh.__(Witness name), if any; Sch. __." Post-Hearing briefing will be cited as Delmarva's Opening and Reply Briefs: "DPL OB" and "DPL RB." Staff's Answering Brief: "Staff AB." DPA's Answering Brief: "DPA AB." DEUG's Answering Brief: "DEUG AB." Exceptions will be referenced by party name as cited for the post-hearing briefing with the extension EB, e.g., "DPL EB." Finally, references to the Hearing Examiner's Report will be referred to as "HER at___."

Working Capital ("CWC") claim; and (e) the Company's proposed ROE. Staff's proposed adjustments would reduce Delmarva's rate base by $175,962,574. (Staff AB at 70).

24. *DPA*. DPA also did not contest Delmarva's proposed test period/test year. DPA 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) at 4, Sch. ACC-1, 3, 16, 39; Exh. 15 (Parcell) at 2; DPA AB at 14-15).

25. The DPA's primary challenges to the Company's rate request were: (a) Delmarva's inclusion of the 2013 post-test period reliability investment in rate base in this case, which the Public Advocate claims violates the matching principle and should not be allowed; (b) Delmarva's inclusion of CWIP in rate base; (c) the Company's inclusion of a pre-paid pension asset and OPEB liability in rate base; and (d) the Company's proposed ROE.

26. *DEUG*. DEUG sought adjustments only to Delmarva's class cost of service study ("CCOSS") and proposed rate design. (Exh. 16 (Phillips). Specifically, DEUG argued that the costs associated with certain accounts (Accounts 364-367) should be classified and allocated based on both demands and customer counts. (Exh. 16 (Phillips) at 9-10; DEUG AB at 1-2). DEUG also argued for a revised CCOSS using a minimum distribution system ("MDS") concept which recognizes that a utility incurs minimum costs to extend its primary and secondary distribution system and

to connect additonal customers, both of which is regardless of demand or energy requirements. (*Id.* at 11). The cost of the MDS can be considered as customer-related because it depends primarily on the number of customers. (*Id.*) DEUG argues that because Delmarva's proposed CCOSS fails to allocate and classify certain costs as customer-related, the proposed rates for the General Service Primary ("GSP") customer class are inflated and would produce revenues substantially higher than the cost of service to such class. (DEUG AB at 2). DEUG also argued that the rate increase for the General Service Transmission ("GST") customer class should be limited to no more than one-half of the system average percentage increase to reflect the power factor benefit to the system associated with this class. (Exh. 16 (Phillips) at 21; DEUG AB at 3).

B. <u>Uncontested Issues</u>

27. The following issues were not contested in this docket:

- Rate Change from Docket No. 11-528
  (Company Adjustment #1)
- Weather Normalization
  (Company Adjustment #2)
- Bill Frequency
  (Company Adjustment #3)
- Injuries & Damages Expense Normalization
  (Company Adjustment #6)
- Uncollectible Expense Normalization
  (Company Adjustment #7)
- Remove Employee Association Expense

(Company Adjustment #9)

- Removal of Executive Incentive Compensation (Company Adjustment #11)
- Removal of Certain Executive Compensation (Company Adjustment #12)
- Storm Restoration Expense Normalization (Company Adjustment #13)
- Pro-forma Advanced Metering Infrastructure ("AMI") Operations & Maintenance ("O&M") Expenses (Company Adjustment #17)
- Pro-forma AMI O&M Savings (Company Adjustment #18)
- Pro-forma AMI Depreciation and Amortization Expense (Company Adjustment #19)
- Normalize Other Taxes (Company Adjustment #25)
- Amortization of Actual Refinancing Costs (Company Adjustment #27)
- Remove Qualified Fuel Cell Provider Project Costs (Company Adjustment #28)
- Remove Post-1980 Investment Tax Credit Amortization (Company Adjustment #30)
- Removal of Renewable Portfolio Standards Labor Charges (Company Adjustment #32)
- Interest Synchronization (Company Adjustment #33)
- Pro-forma Other Post-Employment Employee Benefits ("OPEB") Expense (Company Adjustment #35)
- Adjustment of Wilmington Franchise Tax[9]

[9] Staff recommended that the Wilmington Franchise tax be removed from the Conversion Factor for customers not residing in Wilmington, Delaware. The Company did not oppose Staff's position and stated it would make the appropriate changes if directed by the Commission to do so. We address this issue below. *See infra* at ¶209, p. 84.

- Income Tax Factor and Revenue Multiplier
- Removal of Pre-Paid Insurance from rate base

28. Discussion and Decision. We acknowledge and accept, for purposes of this docket only, the Hearing Examiner's recommendation that we approve these adjustments. We agree with the Hearing Examiner[10] that Staff's and the DPA's acceptance of these adjustments, and our approval of them in this docket, are based upon the particular facts and circumstances of this proceeding and shall not be precedential nor preclude any party from disputing them in a future proceeding. (Unanimous).

C. Test Year and Test Period

29. As noted, Delmarva used an historic test year and test period consisting of the twelve months ended December 31, 2012. No party contested Delmarva's selection of the test year or test period, although the DPA commented that using only historic information, and then selectively adjusting it, is inconsistent with our Minimum Filing Requirements ("MFRs")[11] that allow up to nine months of forecasted data to be used in a utility's application for new rates. (DPA AB at 40-41).[12]

D. Rate Base Issues

1. Average Rate Base vs. Year-End Rate Base

30. In its direct testimony and schedules, Delmarva used a year-end rate base for the test period. (Exh. 5 (Ziminsky) at 33). The Company suggested that year-end rate base "better

[10] HER at 76.
[11] 26 *Del. Admin. C.* §1002
[12] Delmarva also used an historic test year and test period in Docket Nos. 09-414 and 11-528.

reflects the assets which will be serving customers during the rate effective period for which rates in this proceeding are being established." (*Id.; see also* Exh. 20 (Ziminsky-R) at 85 ("use of year-end rate base better reflects the increasing net investment in rate base that would be representative of the rate effective period."). It further noted that its affiliate Atlantic City Electric uses a year-end rate base to determine its revenue requirements. (*Id.*)

31. Staff's witness observed that this Commission has generally used an average rate base, as opposed to a year-end rate base, in determining rates for the utilities it regulates. (Exh. 11 (Peterson) at 7-8). According to Mr. 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 9-11). The year-end rate base only calculates the rate base at year-end, which in this case was December 31, 2012. (*Id.*). Furthermore, unlike an average rate base, a year-end rate base does not give due consideration to when plant is placed into service. (*Id.* at 10.) Mr. Peterson testified that rate base should be matched with revenues that are earned and expenses that are incurred throughout the entire test period; otherwise the income-producing capacity of the mostly recently installed plant is understated, and that understatement creates a larger revenue deficiency. Mr. Peterson testified that using an average rate

base prevents ratepayers from paying annualized returns on plant that was only in service for a short period of time during the test period. (*Id.*).

32. The DPA did not object to using year-end rate base, but instead focused on the Company's proposed post-test period adjustments. (DPA AB at 39).

33. In response to Staff's arguments, Delmarva commented that there is a mix of state commission decisions throughout the United States using average versus year-end rate base. (DPL RB at 84). Further, Delmarva suggested that an increasing rate base and low customer growth results in regulatory lag, thus warranting a year-end approach. (*Id.* at 85).

34. Hearing Examiner Recommendation. The Hearing Examiner was persuaded by Staff's arguments and recommended that the Commission continue using an average rate base for the reasons described in Mr. Peterson's testimony. The Hearing Examiner stated that Delmarva had raised no credible arguments to justify changing the Commission's current practice. (HER at 71).

35. Exceptions. The Company excepted to the Hearing Examiner's recommendation. First, it disagreed that there was a general policy regarding the use of average rate base as suggested by Staff's witness. Second, it contended that the MFRs permit use of a year-end rate base. Third, the Company argued that if the Commission were going to use an average rate base to set rates, it should also annualize test period reliability

closings, as it has done in Delmarva's last two litigated cases. (DPL EB at 8-9).

36. Discussion and Decision. We agree with the Hearing Examiner that average rate base should be used to develop rates in this proceeding. Generally, this has been the way we have set rates for this utility in the last several cases, and there has been nothing produced in this record that would make us want to change that general practice. Delmarva is correct that nothing in the MFRs prevents a utility from using year-end rate base, but we are persuaded -- as was the Hearing Examiner -- that average rate base better matches the plant investments with the other components of the rate making calculus.

37. With regard to the Company's contention that we must annualize reliability investments (that is, treat them as if they were made at the beginning of the test period) if an average rate base is used, we find no compelling reason for affording special treatment to one component of rate base to the exclusion of others. Even though the Company suggested that this is the way reliability investments in test period rate base were treated in the past, it does not appear to us that the issue was specifically addressed in any prior cases. Here, however, Staff has argued that treating one component of rate base -- even though it is alleged to be non-revenue producing -- is inconsistent with using an average rate base. We agree and choose not to amend the Hearing Examiner's recommendation on the

use of average rate base to set rates in this matter. (Unanimous).

2. <u>Post -Test Period Reliability Plant Additions</u>

38. In its direct testimony and schedules, Delmarva sought to include what it called "reliability plant investments" that it expected to make during the entire year of 2013. In its rebuttal testimony, it divided this adjustment into two parts: Adjustment 26A and 26B:

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

(Exh. 20 (Ziminsky-R); Sch. JCZ-R 6, p. 1 & 7, p.1).

39. <u>Adjustment 26A</u>. Delmarva argues that Adjustment 26A, which consists of actual plant closings eight months after the test period and retirements for that same period, is similar to the nine-month plant closings adjustment which we approved in Docket No. 09-414 over Staff's and the DPA's objections. (DPL OB at 61). Also, without objection, we allowed Delmarva to include four months of such plant closings in rate base in Docket No. 05-304. (*Id.*). The Company argues that, although the plant additions are outside the test period, they are in service, directly benefitting customers, and are known and measurable.

(*Id.* at 60-61). Delmarva further suggests that in a base rate case, the Commission must consider and allow the normally-accepted operating expenses of a utility unless they are found to have been made in bad faith, an abuse of discretion, or as a result of waste or inefficiency. (DPL OB at 8, citing *Delmarva Power & Light v. Public Serv. Comm'n*, 508 A. 2d 849, 859 (Del. 1986)). Delmarva further cited previous Commission orders where we approved post-test period adjustments through the filing of rebuttal testimony (PSC Orders Nos. 6930 and 8011) as well as *Application of Delmarva Power & Light Co*., 337 A.2d 517 (Del. Super. 1975).

40. Adjustment 26B. Adjustment 26B involves forecasted plant closings from September to December 2013, adjusted to reflect retirements to plant during this period. (DPL OB at 64). Delmarva argues that the costs of the forecasted plant closings are known and measurable, and are representative of costs in the rate effective period, since it removed a portion of its initial 2013 forecasted plant in its rebuttal testimony. (Exh. 20 (Ziminsky-R) at 56; DPL OB at 64). The Company stated 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 64-65).

41. Regarding its infrastructure investments, Delmarva contends 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" consistent with meeting Regulation Docket 50's reliability requirements.[13] (*Id.* at 9, 11). It identifies five principles that drove its decision to invest in reliability infrastructure improvements: (1) customers need and expect enhanced reliability in the increasingly digital/electronic society and economy; (2) meeting new system reliability challenges caused by an increase in the frequency and severity of storms; (3) replacing aging infrastructure to avoid diminished system reliability and increased customer outages; (4) responding to customer surveys establishing that the most important issue to Delmarva's customers is reliability: "providing reliable electric service" and "restoring outages when they occur;" and (5) ensuring that Delmarva's reliability compares reasonably to other utilities in the region. (*Id.* at 11-19).

42. According to Delmarva as a public utility, Delaware law requires Delmarva, as a regulated public utility, to "furnish safe[,] adequate and proper service and keep and maintain its property and equipment in such condition as to enable it to do so." (*Id.* at 8, citing 26 *Del. C.* §209(a)(2)). Delmarva argues that the Regulation Docket 50 standards are a minimum, that meeting those standards does not create a presumption of safe,

[13] In 2006, in Regulation Docket 50, the Commission adopted the "Electric Service Reliability and Quality Standards." (26 *Del. Admin. C.* §3007 *et seq.*) In Regulation 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).

adequate and proper service; and that each utility provider must exercise its professional judgment based on its systems and service territory and explore the use of proven state of the art technology to provide cost effective electric service reliability improvements. (*Id.* at 9-10).

43. Finally, Delmarva argues that, based upon its analysis of the five principles identified above, it was necessary to increase its investments in reliability infrastructure to be able to continue to meet the needs and expectations of its customers. Delmarva adopted four primary reliability initiatives designed to both maintain and enhance the reliability of the electric system: (a) load growth and load maintenance projects; (b) priority feeders; (c) URD Cable Replacement (and other aging infrastructure); and (d) Distribution Automation. (DPL RB at 15).

44. The DPA and Staff claim that the Commission should exclude both the actual post-test period plant investment and the forecasted post-test period plant investment. Staff also suggests that all of the 2013 reliability investments be made part of the Commission's reliability investigation (Docket No. 13-152) for further evaluation before including them in rate base.

45. The DPA argued that Delmarva is making these capital investments "to avoid the fate that befell its affiliate Pepco in Maryland," referring to Pepco's service problems. (DPA AB at 16). The DPA maintained that Pepco's Maryland experience does

not require this Commission to include this plant in rate base in this case, noting that Delmarva's performance in Delaware has far surpassed the Regulation Docket 50 reliability standards. (*Id.*). Furthermore, the DPA observed that Delmarva has committed to filing annual rate cases, and so these investments will necessarily be included in rate base in the Company's next case. The DPA contends that this is an important factual difference from the preceding Delmarva electric cases. (*Id.* at 17).

46. The DPA found Delmarva's proffered justifications for including the post-test period plant additions in rate base in this case unpersuasive. First, the DPA observed that customers expect and currently pay for reliable service now, and their growing dependence on reliable electricity in an increasingly digital/electronic society and economy has not changed customers overall expectations regarding utility service. (*Id.* at 27). Second, in response to Delmarva's contention that the increase in the frequency and severity of storms poses new system reliability challenges to utilities, the DPA pointed out that the Company provided no evidence as to how the increase in plant investment will improve Delaware customers' reliability experience in Delaware. (*Id.* at 28). Third, although Delmarva claimed it must replace aging infrastructure to avoid diminished system performance and increased customer outages, it did not tie the national statistics or the reports it cited to its system's needs. (*Id.* at 30-33). Fourth, Delmarva's statements that customer surveys have "consistently established" that system

reliability and restoring service rapidly after outages are the most important issues to them was divorced from any questions related to cost, and the survey results had not materially changed since 2000 with respect to the question of reliability and how customers grade Delmarva's service. (*Id.* at 33-34).

47. The DPA also took issue with Delmarva's claims that comparisons with other utilities' performance were important in deciding whether post-test period plant investments should be included in rate base, and with the Company's reliance on its own professional judgment for justifying the post-test period plant investments. (*Id.* at 35-39).

48. Staff argued that Delmarva's proposed plant investments were made to comply with "the PHI corporate directive to build its asset base as a means to grow its earnings and maintain its dividend payout to its stockholders." (Staff AB at 53-54). Staff maintained that the Company seeks to "grow into its dividend." (*Id.* at 54). Staff suggested that this corporate philosophy was unnecessary -- at least as applied in Delaware. (*Id.* at 55). According to Staff, there was no perceived need to accelerate the level of investments into rate base where there was no target that the Company is trying to meet. Furthermore, the absence of any framework or guidelines within which to judge the usefulness of these investments made a review of them difficult. (*Id.*).

49. Staff also claimed that the Company had incorrectly identified the standard for including the post-test period plant

investment in rate base as "abuse of discretion, bad faith or waste" rather than the statutory "used and useful" standard. (*Id*. at 11-12).

50. Staff and the DPA also opposed Adjustment 26B for regulatory and accounting reasons. Both maintained that Adjustment 26B violated the test period matching principle, and created a mismatch between the post-test period plant investment and the test period revenues and expenses. (Exh. 11 (Peterson) at 11; Exh. 13 (Crane) at 6). Both acknowledged that the Commission had previously included post-test period plant investments in Delmarva's rate base, but they contended that the circumstances of this docket warranted a different result. First, they observed that Delmarva has easily met Regulation Docket No. 50's SAIDI standards "by a wide margin for years." (DPA AB at 3; Staff AB at 13-17). Second, Regulation Docket No. 50 was "the only applicable standard dealing with reliability issues." (Staff AB at 15; *see* DPA AB at 26). Third, Delmarva neither established nor quantified "how its investment of millions upon millions of Delaware ratepayers' dollars will make service to them any more reliable than it already is." (DPA AB at 3; *see* Staff AB at 15). Unlike Maryland, nothing had occurred in Delaware that warranted increasing the historical levels of reliability plant investments. (DPA AB at 26; Staff AB at 53). Delmarva had performed no cost-benefit analyses to establish the cost-effectiveness of these plant investments. (DPA AB at 33-34; Staff AB at 17). Finally, they contended that Delmarva's

reliance upon its broad "professional judgment" did not allow Delmarva to spend whatever it wanted in the absence of "an appropriate regulatory target." (Staff AB at 16; *see* DPA AB at 36-39).

51. Hearing Examiner Recommendation. The Hearing Examiner recommended that the Commission include the actual Company's plant closings from January through August 2013 in rate base (Adjustment 26A), but that the Commission reject including the forecasted plant closings from September through December 2013 (Adjustment 26B). (HER at 71).

52. He concluded that Adjustment 26A was consistent with prior Commission decisions and was persuaded that, although they were outside the test period, the Adjustment 26A plant closings were in service, directly benefitting customers, and were known and measurable. (HER at 71-72). He further found that the appropriate standard for determining whether the post-test period plant investments were properly included in rate base was the "waste, bad faith, or abuse of discretion" standard. (*Id.* at 15-17).

53. The Hearing Examiner found that 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 72). Further, he determined that the Company properly exercised its professional judgment by installing the capital investments described in Adjustment 26A in providing "safe, adequate and

proper service." (*Id.* at 73). However, he found that Commission precedent did not support including forecasted plant closing, Adjustment 26B, in rate base because those capital investments were not in service at the time the record closed in this proceeding. (*Id.* at 72).

54. The Hearing Examiner expressed concerns about whether Delmarva's future capital investment plans were cost-effective. (*Id.* at 73). However, he rejected Staff's and the DPA's arguments regarding the lack of evidence for cost-effectiveness because, to date, "this Commission has not required a cost-effectiveness study" from Delmarva prior to approving its capital investments. (*Id.* at 73-4).

55. Exceptions. Staff and the DPA excepted to both of the Hearing Examiner's recommendations on this issue; Delmarva objected to the recommendation to exclude the Adjustment 26B plant investment.

56. Staff contended that neither Adjustments 26A nor 26B should be allowed in rate base. First, Staff argued that the Hearing Examiner had incorrectly determined that the "waste, bad faith or abuse of discretion" standard governed whether investments were properly included in rate base. (Staff EB at 5-8). Second, the Company had not shown any need for the investment. (*Id.* at 29). Staff noted that the Company's reliability metrics showed that it was far exceeding the Regulation Docket 50 standards. Third, Staff argued that these post-test period reliability investments should be reviewed in

the investigation docket opened by the Commission, rather than as a post-test period adjustment in this case. (*Id.* at 27-28). Fourth, Staff noted that there was no adjustment for lower operating expenses resulting from the installation of new plant, nor was there an appropriate reduction to existing rate base for accumulated depreciation. Finally, Staff argued that the Company had not complied with the settlement in Docket No. 11-528 which required it to work with Staff to establish metrics for the recovery of future reliability investments. (*Id.* at 29-32).

57. The DPA also argued that the entire adjustment should be rejected. It also argued that the Hearing Examiner had applied the incorrect standard for determining whether the plant investments were properly included in rate base. (DPA EB at 27-28). It further noted that customers have always expected reliable service and Delmarva had produced no evidence that its 2013 level of projected investment will improve or enhance reliability in Delaware. Third, Delmarva did not quantify the benefits to ratepayers of the post-test period investment; instead, it compared its performance to other utilities, which the DPA contended was not particularly useful for determining whether the post-test period plant should be included in rate base in this case. (*Id.* at 41-42). Fourth, the DPA argued that including the post-test period plant investment in rate base violated the longstanding regulatory principle of matching investments, expenses and revenues for the same period, and noted that Delmarva could have avoided this imbalance by using a

partially-projected test period as permitted by the Commission's MFRs. Fourth, the DPA contended that earlier Commission decisions were irrelevant in this case because the Commission had not considered arguments that the investments had not been justified on the basis of need or benefits to ratepayers. Finally, the DPA asserted that the circumstances of this case were different from the prior cases in which the Commission approved post-test period plant in rate base; specifically, the Company was on record as saying that it would file annual rate cases in the near future and therefore the plant would be included in the Company's test period rate base in its next filed case. (*Id.* at 28-29).

58. Delmarva excepted to the Hearing Examiner's recommendation to exclude the Adjustment 26B plant investment from rate base. (DPL EB at 10-11). The Company asked the Commission to extend its precedent to include in rates reliability capital investments that will be completed, in service and providing used and useful service to customers during the rate effective period. (*Id.* at 51-52). According to the Company, the Commission has permitted the inclusion of reasonably known and measurable post-test year adjustments in the revenue requirement so that rates in effect during the rate effective period accurately reflect the cost of providing service during that same period. (*Id.*). The Adjustment 26B reliability plant investments were forecasted to be completed and serving customers by December 2013 – well within the rate effective period.

Because the plant additions as represented in Adjustment 26B would be in service and benefitting customers during the rate effective period, excluding them from rate base would result in rates that did not reflect the cost of providing service during the rate effective period. (*Id.*).

59. With respect to Staff's argument that Delmarva did not comply with its Docket No. 11-528 settlement obligations related to establishing new reliability metrics, the Company agreed with the Hearing Examiner's rejection of this argument. (DPL EB at 38-39). It referenced certain efforts made towards meeting its settlement obligations including numerous meetings with the DPA and various members of Staff, as well as the extensive work that went into the Docket No. 13-384 filing (Forward Looking Rate Plan). (*Id.* at 41-2). Delmarva also agreed with the Hearing Examiner's rejection of Staff's and DPA's contentions that both Adjustments 26A and 26B should be rejected because Delmarva *might* file a rate case in 2014. (*Id.* at 46-48). Delmarva argued that excluding the Adjustment 26 investments in rates would violate both established Commission precedent rejecting strict test period construction and Delaware law, including the Commission's own MFRs (26 *Del. Admin C.* 1002, Part A § 1.3.1). Finally, the Company agreed with the Hearing Examiner's rejection of Staff's suggestion that the post-test year adjustments should be addressed in the reliability investigation docket (Docket No. 13-152) because prior Commission decisions and the MFRs firmly established a utility's ability to recover post-test year

adjustments in rate cases. (*Id.* at 48). Delmarva argued that Staff's attempt to use an "investigation" filed after the rate case to prevent a utility from recovering for investments in a rate case violated the Administrative Procedures Act. (*Id.* at 49-51).

60. Discussion and Decision. The issue of including post-test period reliability additions in rate base has consumed, along with the cost of capital issues, a great deal of this record. It is an important issue. We have given it detailed consideration in light of the unique circumstances of this case.

61. In Docket No. 05-304, we approved post-test plant additions occurring up to 4 months after the close of the test period.[14] In Docket No. 09-414, we approved post-test period plant additions occurring up to 9 months after the close of the test period.[15] In this case, Delmarva asks us to approve post-test period plant closings occurring up to 12 months after the end of the test period. Both Staff and the DPA have contested all of Delmarva's post test period adjustments (i.e., both 26A and 26B), raising arguments that we have considered before but also raising some new arguments that we have not previously considered

62. In recent rate proceedings we have recognized that under appropriate circumstances an historic average test period may, if properly supported, be adjusted for reliability investments where it is likely those investments will not

[14] See PSC Order No. 6930 (June 6, 2006) in Docket No. 05-304.
[15] See PSC Order No. 8011 (August 9, 2011) in Docket No. 09-414.

generate additional utility revenue.[16] But both Staff and the DPA point to the Company's admitted intent to file annual rate proceedings as a material change from the facts underlying our prior decision where post-test period plant additions were contested for the first time.[17] In addition, the total amount of these investments -- approximately 10% of the requested rate base -- appears to distinguish the Company's request from its request in the last two litigated proceedings.

63. We are concerned, at least with regard to Adjustment 26B, that the record developed in this proceeding is devoid of any tangible evidence related to cause and effect -- a causal link between the improvements Delmarva illustrated and the investments it is actually making. We know that Delmarva has increased its level of investment in what it captions "reliability" investments over the last several years and that on a system basis the length of outages has declined as reflected in the lower SAIDI numbers. However, the relationship between the two facts -- increased investment and lower SAIDI numbers -- is unclear and not fully developed in this record.

64. We believe our investigation in Docket No. 13-152 will help us better understand how the Company's planned level of investment will result in more reliable service for its customers. We do not anticipate, however, that it will determine the appropriate ratemaking treatment for Adjustments 26A and 26B. Rather, we believe it will provide a forum to establish the

[16] *See* footnote 14 and 15, *supra*.
[17] *See* footnote 15, *supra*.

proper policy guidelines for reviewing these types of investments in the future, and provide a better framework on which to evaluate them after all the parties have acquired and studied the same information upon which Delmarva is making its investment decisions.

65. We approve Adjustment 26A. The Commission's MFRs indicate that post-test year adjustments up until the filing of rebuttal testimony may be considered, and we have in the past approved similar post-test year reliability investments by the Company.[18] We find, contrary to the Hearing Examiner's conclusion, that the initial inquiry for determining whether these additional investments should be included in rate base is the "used and useful" one set forth in 26 *Del. C.* §102(3).[19] That section defines rate base as including, among other things, "[t]he original cost of all *used and useful utility plant* … ." (Emphasis added). The record supports a finding that the post-test period investments in Adjustment 26A are being used and are useful as they are providing service to existing customers. The levels of those investments are also known and measurable. (3-1, Commission Clark voting no).

66. We cannot reach a similar conclusion with regard to the forecasted plant (Adjustment 26B). We note that the Company reduced its rate request by approximately $3 million, primarily because its forecast of plant closures in its direct testimony

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[18] *See* PSC Order Nos. 6930 and 8011.
[19] *See* 26 *Del. C.* §102(3).

and schedules was overly optimistic and had to be adjusted downward by $8 million in its rebuttal testimony and schedules filed six months later. In light of the objections of both Staff and the DPA that the plant reflected in Adjustment 26B was neither in service (used) nor useful (of actual benefit to existing customers), we agree with the Hearing Examiner's conclusion that it should not be included in the Company's rate base at this time. (Unanimous).

3. Construction Work in Progress ("CWIP")

67. Delmarva seeks to include $70,154,772 of CWIP in rate base, with a corresponding $965,309 Allowance for Funds Used During Construction ("AFUDC") offset to earnings. (Exh. 5 (Ziminsky) at 31-33; Exh. 13 (Crane) at 10; Exh. 11 (Peterson) at 14). 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) at 9).

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

69. In this docket, Delmarva sought a change from the Commission's most recent decision regarding CWIP and requested that its year-end CWIP balance for distribution projects be included in rate base. "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." (DPL OB at 76). According to Delmarva, "the risk that these new distribution projects will not result in new units of property approaches zero." (*Id.* at 77). "Such projects are known and measureable and will reasonably be in service during the effective period of rates developed in this proceeding." (*Id.*). The Company asserts that CWIP is allowed to be included as an "other element of property" of rate base under the Commission's MFRs. (DPL RB at 33).

70. Additionally, the Company argues that it follows the Federal Energy Regulatory Commission's ("FERC") guidelines for accruing AFUDC. Therefore, many of the distribution projects do not exceed the minimum threshold for accruing AFUDC and those that do only accrue for a few months. (*Id.* at 76; Tr. at 507, 625-626). 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 those assets provide. (DPL OB at 77).

71. If the Commission rejected Delmarva's request to include CWIP in rate base, it proposed an alternative: It would record a carrying cost on all CWIP and treat the difference between the actual accrued AFUDC and the full calculated carrying cost as a regulatory asset. This regulatory asset would be treated in Delmarva's next base rate case as if it were actually accrued AFUDC, would be amortized over an assigned life and would

be included in rate base as if it had been capitalized. (Exh. 5 (Ziminsky) at 32-33; Ex. 20 (Ziminsky-R) at 63). Calculation of the full AFUDC would begin on the effective date of the new rates from this case. In the next base rate case, the balance of the regulatory asset would be determined from the effective date of the rates from this case through the end of the test period in the next base rate case and would be amortized using the average book life. The next regulatory asset would begin to accrue at the end of the test period in Delmarva's next base rate case. (Ex. 5 (Ziminsky) at 33; Ex. 20 (Ziminsky-R) at 64).[20]

72. Both Staff and the DPA argue that the Commission should continue to exclude CWIP from rate base because it is not used and useful in providing service to customers during the test period and violates the established regulatory principle of matching assets with the customers they are serving. (Exh. 11 (Peterson) at 13-14; Exh. 13 (Crane) at 8-10). They argue that 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)). (DPA AB at 47; Staff AB at 59). CWIP is construction work in progress, and so by definition, CWIP is not used and useful. (Exh. 13 (Crane at 9).

73. Finally, the DPA argues that in Delmarva's two most-recently litigated electric rate cases (Docket Nos. 05-304 and 09-414), a major reason why this Commission refused to include

[20] The Company did not raise this in its briefs.

CWIP in rate base was because the amount of AFUDC as a percentage of CWIP was less than 2% and therefore would have a considerable adverse effect on the revenue requirement. (*See* e.g., PSC Order No. 8011, ¶¶67-68.) According to the DPA, in this docket the AFUDC earnings offset is only 1.37%. (Exh. 13 (Crane) at 10-11).

74. Hearing Examiner's Recommendation. The Hearing Examiner accepted Staff's and the DPA's arguments on this issue and recommended rejecting the Company's adjustment to include CWIP in rate base with a corresponding AFUDC offset. (HER at 80). He noted that this Commission had excluded CWIP from rate base in Delmarva's two most-recently litigated electric rate cases under virtually identical circumstances. Additionally, he noted that Delmarva bore the burden of proof on this issue but had raised no compelling new argument to justify the Commission's abandonment of its prior policy regarding including CWIP in rate base. (*Id.* at 80). He also noted that if Delmarva believed its current accrual of AFUDC was insufficient to compensate shareholders during construction, it could change its AFUDC accrual policies. He noted that both Company Witness Ziminsky and Staff Witness Peterson testified that FERC's guidelines were optional, not compulsory. (HER at 80).

75. Finally the Hearing Examiner recommended rejecting Delmarva's alternative proposal to create a regulatory asset for the full amount of AFUDC. He agreed with the DPA that CWIP and

AFUDC were classic, ongoing costs of running a utility and were inappropriate for regulatory asset treatment.[21] (HER at 80-81).

76. Exceptions. The Company excepted to the Hearing Examiner's recommendation on this issue. First, it contended that the Commission had discretion to include CWIP in rate base pursuant to 26 *Del. C.* §102(3)(g) as an additional element of property that is necessary for effective utility operations, but is not actually used and useful. According to the Company, these projects are "known and reasonable" and were either used and useful during the test period or would be used and useful during the rate effective period. (DPL EB at 54).

77. Discussion and Decision. We adopt the Hearing Examiner's recommendation with respect to the exclusion of CWIP (and corresponding AFUDC adjustment to earnings). Our decision is consistent with our prior decisions on this issue, and as the Hearing Examiner noted, Delmarva has cited no new facts or arguments to support a change in our previous decisions to exclude CWIP from rate base. We believe that CWIP by definition does not meet the used and useful standard necessary to be considered a rate base investment. Accordingly, we find that CWIP should not be part of Delmarva's rate base upon which rates will be set in this proceeding. (Unanimous).

4. Cash Working Capital ("CWC")

[21] *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 15-16.

78. CWC is the amount of cash a utility needs to cover cash outflows between the time it receives revenue from its customers and the time it must pay its expenses. It is an element of rate base. (Exh. 13 (Crane at 11). The Company performed a lead-lag study and determined that a CWC adjustment of $10,887,807 should be included in rate base. (Exh. 5 (Ziminsky) Sch. (JCZ)-1, p.1.) The Company used expense lags for payroll, Operating & Maintenance and affiliated transactions. (DPA AB at 48). The major contested CWC issue relates to the inclusion in the lead-lag study of Delmarva's contractual payment obligations to its affiliated Service Company and how often it actually makes those payments and records them on its books.

79. The Company calculated 14.43 days of expense lead for its payments to its affiliated Service Company, reflecting twice-monthly payments to the Service Company as recorded on Delmarva's books and records. However, Delmarva's agreement with the Service Company only requires payment to be made once a month. (Exh. 11 (Peterson) at 17-18). Delmarva witness Ziminsky testified that approximately 70% of the Company's net Operating & Maintenance ("O&M") lag consists of payments to the Service Company. (Tr. at 616.) According to the Company, the Commission should approve its 14.43 days of expense lead included in its study because it records and makes bi-monthly payments to its Service Company, and the lead-lag study used by Delmarva in its Application was based on its books. (Exh. 20 (Ziminsky-R) at 60). The Company asserts that to use the settlement frequency as

proposed by Staff and DPA would be improper and would require the study to be repeated in order to take into account other information. (DPL OB at 75).

80. Staff and the DPA argue that, by the terms of Delmarva's agreement with its Service Company, Service Company invoices are only required to be paid once a month, not twice. (Exh. 11 (Peterson at 17; DPA AB at 51-52). They argue that the terms of Delmarva's contract with the Service Company should govern its CWC calculation, contending that Delmarva's voluntary choice to make twice-monthly payments, rather than once as required by the service contract, artificially inflates the CWC requirement and the corresponding rate base adjustment. (Staff AB at 61; DPA AB at 52).

81. In its brief, the DPA cited decisions from Pennsylvania, Connecticut, Arizona and California rejecting similar arguments from utilities and holding that a utility's internal arrangement with an unregulated affiliate regarding payment that differs from the contractual payment obligation should not dictate the utility's CWC requirement. (DPA AB at 50-51).

82. Staff and the DPA, however, differ as to the correct expense lead time, and that difference materially affected the Company's CWC requirement. Staff calculated an expense lead time of 35.2 days. According to Staff Witness Peterson, assuming the 15.2 day average service period is 15.2 days (i.e., 365 days/12/2), one must 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 at 18). Depending on which day of the week the first business day falls during the month, the 15th billing day will range between 19 and 21 calendar days. (*Id.*). Using its expense lead time of 35.2 days, Staff increased the overall weighted average lead days for all O&M expenses from 17.33 days to 31.70 days. *(Id.* at 18.) Staff concluded that Delmarva's CWC request should be reduced by $4,200,129. (*Id.*).

83. DPA Witness Crane also used an average service period of 15.2 days; however, instead of business days, she employed a combined billing and payment lag of 15 days and calculated an expense lead time of 30.21 days. (Exh. 13 (Crane at 13). She concluded that Delmarva's CWC request should be reduced by $1,889,057. (*Id.* and Sch. ACC-6).

84. <u>Hearing Examiner's Recommendation</u>. The Hearing Examiner found that the Company had not carried its burden of proof on this issue. He was persuaded that a utility's internal arrangement with an unregulated affiliate regarding payment that differs from the contractual payment obligation should not dictate the utility's CWC requirement. (HER at 83). Thus, he rejected the Company's claimed $10,887,807 CWC requirement. However, he did not make a recommendation as to whether the Commission should accept Staff's or the DPA's proposed reduction to CWC, which used different days (business vs. calendar) to calculate the adjustment. (*Id.* at 83-84).

85. Exceptions. The Company excepted to the Hearing Examiner's recommendation. It noted that there was no dispute as to whether a CWC allowance should be allowed in rate base, only a dispute as to how much to include. (DPL EB at 54). Delmarva maintains that its lead-lag study reflects transactions on its books and records, insisting that if the actual Intercompany Money Pool Balance settlement frequency was applied, a new lead-lag study would be required. Finally, the Company suggested that since Staff and the DPA did not perform a lead-lag study with their proposed expense leads, importing only one off-the-book frequency into the lead/lag study is arbitrary. (*Id.* at 55).

86. Discussion and Decision. We adopt the Hearing Examiner's recommendation on this issue. We agree with the DPA and Staff that ratepayers should not be burdened by payment schedules between affiliated companies that are not contractually required. Since a majority of Delmarva's distribution O&M expenses are Service Company-related, the assignment of expense lead days has a significant effect on the CWC requirement. (Exh. 11 (Peterson) at 18-19). We believe that the lead-lag study should reflect this fact, and it is not incumbent upon those parties challenging the Company's adjustment to redo the entire lead-lag study.

87. With regard to the amount of the adjustment, we believe that Staff's position is correct and supported by the record presented here. It reflects the actual payment terms under which Delmarva is contractually obligated to pay the

affiliated Service Company. Ratepayers should receive the benefit of the longer contractually-mandated lead between the payment of such expenses to the Service Company. (Unanimous).

5. <u>Prepaid Pension and OPEB Liability</u>

88. In its original filing, Delmarva included three prepaid assets in its proposed rate base: $61,581,370 of pension costs; ($8,176,221) of accrued OPEB liability; and $41,431 of insurance. (Exh. 13 (Crane) at 14). The Company acknowledged that it had double-counted the pre-paid insurance claim by including it both in rate base and in its CWC requirement. Thus, it removed the prepaid insurance balance from rate base in its rebuttal testimony. (*Id.* at 17-18; Exh. 20 (Ziminsky-R) at 65). The other two prepaid assets -- pension costs and accrued OPEB liability balances -- remain issues in the case, which the DPA seeks to exclude from Delmarva's rate base.

89. By way of background, since the adoption of Financial Accounting Standards Board Statement Nos. 87 and 106 ("SFAS 87" and "SFAS 106"), and pursuant to Commission policy, pension and OPEB expense have been determined on an actuarial basis using the accrual method of accounting. The accrual method seeks to recover pension and OPEB benefit costs over the working lives of the employees who receive such benefits based on assumptions regarding salary levels, earnings on fund balances, mortality rates and other factors. A separate calculation determines funding requirements. The actuarial valuation may be positive or

negative in any given year. (Exh. 13 (Crane) at 14-15).[22] A prepaid pension asset occurs when the accumulated contributions and growth in the pension plan exceed the accumulated expenses associated with the pension obligations. An OPEB liability occurs when the accumulated costs of the OPEB obligations are greater than the associated contributions and growth of the plan assets. (Exh. 20 (Ziminsky-R) at 71).

90. The DPA observed that 26 *Del. C.* §102(3) defines rate base as "[t]he original cost of all used and useful utility plant and intangible assets …" less related accumulated depreciation and amortization; customer advances and contributions in aid of construction ("CIAC"); and accumulated deferred and unamortized income tax liabilities and investment credits, accumulated depreciation of customer advances and CIAC. Rate base does not include any asset that is not "*used and useful*" and does not include any plant and/or intangible assets supplied by any entity other than utility investors. (DPA AB at 54).

91. The DPA argued that the Company's prepaid pension asset and OPEB liability were not used and useful in the provision of utility service because the Company is legally prohibited from accessing these funds. Furthermore, even if the funds were available for the Company's use, Delmarva could not satisfy its burden of establishing that shareholders, rather than

[22] If the assumptions underlying the actuarial methodology were always accurate, there would be positive pension and OPEB expense each year, and an employee's benefits would be recognized over his or her working life. However, assumptions are never 100% accurate, so in some years' pension and OPEB costs can be negative based on the fact that prior years' assumptions overstated costs. For example, if the methodology assumed a 5% return on investment but the actual return was 7%, a negative expense may be booked in a subsequent year. (Exh. 13 (Crane) at 15).

ratepayers or the market, contributed the funds that comprised them. The DPA asserted that the Commission did not consider either of these arguments in previous dockets, and both support a reversal of its prior decision. In the alternative, the DPA suggested that the Commission's decision in Docket No. 05-304 was incorrect. (*Id.* at 53-57). The DPA cited decisions from Hawaii, Illinois, Nevada and Texas holding that the pension asset and OPEB liability were not used nor useful in the provision of utility service and that the utility bore the burden of proving that shareholders, rather than ratepayers or the market, invested the monies comprising the funds. (*Id.* at 55-61). Finally, the DPA argued that including pension and OPEB cost adjustments in rate base inappropriately combined the accrual methodology used in the actuarial studies with the cash funding approach. (*Id.* at 61-62).

92. The Company contended that the inclusion of its prepaid pension asset and OPEB liability in its rate base reduces pension expense (through contributions and earnings), which in turn, reduces pension expense below what it would otherwise be. The Company cited this Commission's Order No. 6930 in Delmarva Docket No. 05-304 that "the Company has no access to this asset to use it for other operating expenses; it is precluded by federal law from using any of the money it has collected for pensions for any other purposes." (Exh. 20 (Ziminsky-R) at 72). Furthermore, the prepaid pension asset and OPEB liability create

a CWC requirement that cannot otherwise be accessed by the Company. (*Id.* at 73).

93. In its Reply Brief, Delmarva identified that this Commission recognized in PSC Docket No. 05-304 that a pre-paid pension asset is appropriately included in rate base. The Company stated that a pre-paid pension asset is useful to customers, as it results in rates lower than they would otherwise be calculated. It also argued that the Texas case upon which the DPA relied had since been rejected by the Texas Commission.

94. Hearing Examiner Recommendation. The Hearing Examiner summarized the evidence presented on the issue in this case as 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 at 30).

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

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

d. In PSC Order No. 6930 in 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. Nor did Order No. 8011 in Docket No. 09-414 address this issue. (See ¶42.) (HER at 85-86).

95. The Hearing Examiner was not persuaded that simple math demonstrated that Delmarva's fund contributions accounted for less than 10% of the account balance and that over 90% of the current account balance was attributable to market earnings. (HER at 86). He also was unable to determine how much, if any, of the accumulated earnings from Delmarva's $135 million contribution in 2009 and/or its 2005 contribution should be attributable to rate base and what ADIT reserve adjustment, if any, should be made.

96. Although noting that the DPA may ultimately prevail on its contention that the funds comprising the prepaid pension asset and OPEB liability were not supplied by investors, the Hearing Examiner found that the pre-paid pension asset should remain in rate base as the case law and pension plan evidence presented in this proceeding did not warrant changing established Commission precedent. (*Id.*).

97. Exceptions. Both DPA and Staff excepted to the Hearing Examiner's recommendation. Staff joined with the DPA's general objection to the Hearing Examiner's conclusion that he was not persuaded that Delmarva's contributions were less than 10% or if the DPA was correct, what portion -- if any -- should be credited to rate base. According to Staff, the issue was simple: If the record does not establish that shareholders

supplied the actual funds, then those funds should not be included in rate base.[23]

98. The DPA's exceptions addressed both the prepaid pension asset and the accrued OPEB liability. The DPA first contended that the Hearing Examiner had improperly placed the burden of proof on it to establish that the prepaid pension asset and OPEB liability should be excluded from rate base, rather than placing the burden on the Company to establish that they were properly included in rate base. The DPA argued that once it raised the issue, Delmarva was required to come forward with evidence that stockholders funded the prepaid expenses, and Delmarva had not done so. (DPA EB at 49-50). Second, the DPA reiterated its contentions that the prepaid pension asset and OPEB liability were not used and useful in providing electric service; even if they were, Delmarva did not establish its burden of proof that investors had actually provided the source of the funds in the accounts; and that including the pension asset and the OPEB liability improperly combined accrual methodology used in actuarial studies with the cash funding approach. (*Id.* at 50-53, 57). The DPA also contended that neither of the subsequent Texas commission cases that the Company cited explained the basis for the Commission's decision. (*Id.* at 56-57).

99. <u>Discussion and Decision.</u> We agree with the Hearing Examiner that this issue is not as fully developed on this record as we would like. It is a complicated issue, and we appreciate

[23] The Company objected to Staff's joinder with the DPA on this issue. In light of our decision on this issue, we need not address the Company's objection.

that the parties have tried to enlighten us on the nuances of the arguments that underlie their various positions. But we note that we have allowed this adjustment in at least one of the prior Delmarva cases when it was objected to, and although we could remand this back to the Hearing Examiner to develop the record further, as one Commissioner suggested, we have decided not to do that and to include these two items in rate base. (Unanimous).

6. Credit Facility

100. Delmarva increased its rate base by $520,111 and increased operating expenses by $337,108 relating to a short-term credit facility that PHI operates. The rate base portion represents amortization of Delmarva's portion of the start-up costs associated with the facility (and includes a return on the unamortized balance of the costs), and the operating expense represents its portion of the facility's annual recurring costs. (Ex. 13 (Crane) at 29). In August 2011, PHI renewed the credit facility for a five-year term, and there are annual period costs associated with starting up and maintaining the credit facility, which are not tied to the amount of borrowings made using the facility. The Company stated that this adjustment was consistent with the Commission's precedent and Delaware law.

101. According to Delmarva, the credit facility allows the Company to borrow in the commercial paper market and is a primary source of short-term liquidity for the Company. (DPL OB at 73). It is not a substitute for short-term debt or the Company's cash working capital, and is required by underwriters to support the

Company's commercial paper program. (*Id.*) "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." (Exh. 17 (Boyle-R) at 7-8). The Company argues that if the credit facility was eliminated, its long-term credit rating would change, possibly even below investment grade. (DPL OB at 73).

102. The DPA recommended eliminating the credit facility costs from the Company's revenue requirement; however, 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 so that ratepayers would receive the benefit of the Company's lower capital costs. (Exh. 13 (Crane) at 29-31).

103. Staff also argued that the Company's credit facility costs should be reflected in the cost of capital for ratemaking purposes. Since it is being recorded on the Company's books as an interest expense, it is serving the day-to-day needs of the utility, and the benefits should flow to the ratepayers in the form of lower capital costs. Alternatively, Staff suggested that these costs could be recovered as an increase in the effective cost of short-term debt included in the calculation of Delmarva's AFUDC rate. (Exh. 11 (Peterson) at 34).

104. The Company disagreed with Staff's alternative proposal, arguing that 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. Thus, the costs should be recovered through cost of service, not the Company's AFUDC rate. (DPL OB at 73).

105. Hearing Examiner's Recommendation. The Examiner observed that in the last Delmarva case, this Commission unanimously held that the Company's credit facility costs should be included in rate base. He found that Staff and the DPA had made the same arguments that they had presented before and had proffered nothing new that would warrant a different decision. He also viewed this expense as important to Delmarva's operations and beneficial to ratepayers. This expense, according to the Hearing Examiner, allowed Delmarva not only to fund its construction and working capital, but it also is the first step for the Company in seeking long-term debt issuance that benefits ratepayers. Therefore, he recommended that the Commission again approve this expense. (HER at 97).

106. Exceptions. Both Staff and the DPA excepted to the Hearing Examiner's recommendation. Both pointed out that they were not suggesting that the Commission completely exclude these costs from the revenue requirement; they were simply suggesting that the benefits from that financing vehicle be shared with its ratepayers, either through lower short-term debt costs reflected in the Company's capital costs or recovered in the AFUDC rate

associated with CWIP.[24] (DPA EB at 60-61; Staff EB at 68-70). As Staff pointed out, Delmarva first assigns short-term debt to CWIP under the Uniform System of Accounts. Since CWIP is capitalized to the Company's construction accounts, the Company would be compensated for its credit facility costs in its AFUDC rate. In this way, the costs to ratepayers would better match the benefits resulting from the use of short-term debt, since Delmarva does not recognize the credit facility as a source of capital in its proposed capital structure. (Staff EB at 38).

107. The DPA maintained that the most appropriate way to address what it called a "heads I win, tails you lose" situation was to include short-term debt in the Company's capital structure. (DPA EB at 61). The DPA argued that it was unjust to require ratepayers to fund the credit facility in addition to the CWC requirement, but deny them the benefit of lower debt costs. (*Id.*). In lieu of including short-term debt in the capital structure, the DPA supported Staff's alternative proposal of including such costs in the ADUDC rate rather than having ratepayers receiving no benefit at all. (*Id.*).

108. Discussion and Decision. We adopt Staff's alternative position that the credit facility should be accounted for in the Company's revenue requirement as an increase in the effective cost of short-term debt in the calculation of the AFUDC rate used to support CWIP. We are sensitive to the fact that our decision

[24] Staff also noted that it did not address, nor apparently did the Hearing Examiner, the credit facility issue in the prior case (Docket No. 09-414) that the Examiner referenced in his resolution of the issue here. (Tr. at 1271).

here is different than the one we made in Docket No. 09-414. Although the DPA objected to the inclusion of the credit facility costs in rate base in that case, the DPA did not proffer the alternative treatment that Staff suggested here, and the Hearing Examiner in that case did not address this issue.

109. Here, Staff presented two alternative ways to allow the Company to recover these costs that would also allow ratepayers to receive the benefit of the lower operating costs that result from the use of this financing tool. We believe that the proper decision is to include them in the AFUDC rate rather than as a component of rate base. In this way the ratepayers will benefit from the lower costs associated with this financing vehicle used to reduce short-term borrowing costs, and the Company will recover the costs associated with securing short-term debt financing by increasing the rate which Delmarva uses to capitalize its construction accounts. (Unanimous).

7. <u>IRP and RFP Deferrals</u>

110. The Company proposes a base rate adjustment to recover a net of $57,474 of deferred initial Integrated Resource Plan ("IRP")-related costs incurred beginning in August 2009 and $29,764 of costs related to the Bluewater Wind Request for Proposals ("RFP") process that was included in the initial IRP filing. (Exh. 5 (Ziminsky) at 16-17). Delmarva proposes to amortize these costs over ten years, with rate base treatment of the unamortized balance. (*Id*. a6 16-17, 39). It maintains that 26 *Del. C.* §1007(c)(1)(d) required it to conduct the Bluewater

Wind RFP and to prepare the initial IRP and that it has incurred carrying costs related to investor-supplied capital to comply with the statutory mandates. (*Id.* at 37). Furthermore, it argued that these adjustments are "consistent with the treatment given in Docket No. 09-414 for these costs that were incurred by or before July 2009." (DPL OB at 65).[25]

111. The DPA, joined by Staff in its Brief, argues that Delmarva's adjustments should be rejected. First, the DPA argued that Section 1007(c)(1)(d) says only that Delmarva's IRP 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. (DPA AB at 66).

112. Second, the DPA contended that Commission Order No. 7003, issued after the passage of Section 1007(c)(1)d, expressly states that the initial IRP costs were to be "included and recoverable in [Delmarva's] *next* distribution rate case," which was Docket No. 09-414. The DPA argued that nothing in Order No. 8011, issued after the Commission's deliberations in Docket No. 09-414, addressed 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

[25] The treatment of the initial IRP and RFP costs was uncontested in Docket No. 09-414.

treatments were specifically addressed in Order No. 7003, and the Company did not appeal that order. The DPA suggested that it could not be assumed from the Commission's silence in Order No. 8011 that it was authorizing additional deferrals, but Delmarva was asking the Hearing Examine to make that assumption. (*Id.* at 64; *see* Staff AB at 66).

113. Finally, the DPA pointed out that ordering paragraph 6 of Order No. 7003 specifically addressed the RFP costs, stating that they shall be recovered in Standard Offer Service ("SOS") rates, not distribution rates, since they involved supply cost issues. Since the SOS costs are reset annually, the Company has had sufficient opportunity to recover those costs in the SOS rates. (DPA OB at 65-66).

114. Hearing Examiner's Recommendation. The Hearing Examiner found that 26 *Del. C.* §1007(c)(1)(d) permitted the Company's proposed ratemaking treatment and that tenets of statutory construction supported the Company's position, not the DPA's. He found that Section 1007(c)(1)(d) allowed the Company to recover its costs, including amortization. (HER at 89 and 94).

115. Exceptions. Staff excepted to the Hearing Examiner's recommended treatment of the IRP costs. It argued that absent a specific Commission order allowing a deferral of costs, no utility should be able to *sua sponte* seek recovery of costs that precede the test period upon which the utility is seeking rate relief. (Staff EB at 37). Staff further argued that,

notwithstanding Section 1007(c)(1)(d), a utility's actions or inactions could waive whatever rights it may initially have had to collect such costs.

116. Staff contended that the Commission gave the Company specific instructions in Order No. 7003 as to how to collect these initial IRP/RFP costs and that those procedures should be followed. (*Id.*).

117. Discussion and Decision. We initially addressed Delmarva's recovery of its initial IRP costs in Order No. 7003 in Docket No. 06-241. There we held:

> 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, ¶¶7-8 (August 8, 2006)).

118. We agree with Staff that allowing a utility to defer a cost for collection in future rates should be the exception, not the rule, and should only occur when there exists a specific Commission order allowing such a deferral.

119. Here we find no order that specifically directs Delmarva to defer these costs to *this* case. As pointed out, the initial IRP costs incurred through July 2009 were included as part of the rates set in Docket No. 09-414. Our Order in Docket No. 06-241 indicated that "[i]n all subsequent cases, such costs shall be normalized as an expense in accordance with Commission practice."[26] No further direction on the issue of the deferral of these costs has been given by this Commission. We rely on our prior decision for purposes of this case and find that the Company's deferral of these costs for recovery in this case should be rejected. (Unanimous).

[26] *See* PSC Order No 7003, *supra*.

8. Medicare Subsidy Deferred Costs.

120. The Company proposed to recover $110,507 related to a change in law regarding Medicare Part D, which became effective in March 2010. (DPL OB at 71). The change of law caused a one-time deferred tax charge to the Company's federal income tax expense. The Company deferred this charge to tax expense in its financial records, but it never sought Commission approval of the deferral. (*Id*.). The Company's adjustment decreases test period earning by $21,860 and increases test period rate base by $54,560. (*Id*.). Delmarva seeks to amortize this amount over three years and to include the unamortized balance in rate base. (*Id*. at 70). It argued that it should be permitted to recover this 2010 expense because the change in the Medicare law "was outside of the Company's control" and it deferred the expense on its books using accrual accounting. (Exh. 20 (Ziminsky-R) at 57). According to the Company, the adjustment does not constitute retroactive ratemaking since it does not seek to revise a previously approved rate. (*Id*. at 72).

121. The DPA opposed the Company's proposal, and was supported by Staff in its Brief. According to the DPA, including this out-of-period expense in rates constituted retroactive ratemaking. Citing a seminal Delaware Supreme Court case holding that a utility may not recover previously-incurred expenses in prospective rates, the DPA suggested that such rates may not be designed to recoup past losses in the absence of express

legislative authority.[27] (DPA AB at 73). The DPA noted that Delmarva cited no legislative authority allowing it to recover the costs it incurred in 2010, irrespective of the cause, and the Company neither sought nor received Commission approval to defer this expense. (*Id.*) Finally, the DPA argued that the costs were small and immaterial and that shareholders are granted a return on equity to account for the fact that the utility may incur unanticipated costs. (*Id.*).

122. Hearing Examiner's Recommendation. The Hearing Examiner agreed with the DPA and Staff that this proposed adjustment should be denied because allowing recovery of the previously-incurred and deferred costs constituted retroactive ratemaking. He noted that there was no statutory authority authorizing the Company to collect this out-of-period expense. Furthermore, he found that the proposed adjustment violated the matching principle of establishing a fair and balanced relationship between levels of investment, revenues and expenses. (HER at 103-04).

123. Exceptions. The Company excepted to the Hearing Examiner's recommendation on the grounds that the adjustment stemmed from a change in the law, not a proposed change in a prior rate, and thus was distinguishable since it was accruing for a cost that had not previously been collected. (DPL EB at 62-63).

[27] *Public Service Commission v. Diamond State Telephone Co*., 468 A.2d 1285, 1298 (Del. 1983).

124. Discussion and Decision. We adopt the Hearing Examiner's recommendation that Delmarva's proposed adjustment constitutes retroactive ratemaking. We note that there is no legislative authority authorizing Delmarva to collect these out-of-period costs, and Delmarva admits that it did not seek or receive our approval to defer the costs on its books for subsequent rate recovery. (Unanimous).

E. Operating & Maintenance Expenses/Operating Income

1. Wage and FICA Expense

125. The Company proposed an adjustment of $1,782,036 to its test period wage and FICA expense levels, decreasing test period earnings by $1,173,236. (DPL OB at 80). The adjustment includes the following actual and projected salary and wage increases for the period of January 1, 2012 through October 2014:

- 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 at 12-13; Exh. 13 (Crane) at 32).

126. The Company argued that the Commission has allowed such adjustments to its test period wage and FICA levels of expense for known price changes to be reflective of the rate effective period. The recovery of such costs, according to the Company, would ensure that the rates set by this Commission reflect, as closely as practical, the conditions that will exist during the period the new rates are in effect. (Exh. 20 (Ziminsky-R) at 26).

127. Staff 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 non-union wage increase because "there is no commitment for Delmarva to increase non-union salaries by 3% in 2014." (Exh. 11 (Peterson) at 23-24).

128. The DPA recommended that only annualized test period salary and wage increases be included in the Company's revenue requirement. (Exh. 13 (Crane) at 32-33). The DPA contended that the Company's post-test period salary and wage increases "reached too far beyond the end of the test year." (*Id.* at 33).

129. <u>Hearing Examiner's Recommendation</u>. The Hearing Examiner recommended approval of the Company's adjustment. He cited prior Commission decisions approving similar wage and FICA

adjustments and relied on the MFRs permitting modifications to test period data occasioned by reasonably known and measurable changes in current or future or future rate base items, expenses or revenues. (HER at 104-6, citing 26 *Del. Admin. C.* §1002.1.3.1.).

130. Exceptions. Staff and the DPA excepted to the Hearing Examiner's recommendation. Both pointed out that the historic time period between rate cases provided some justification for including post-test period wage adjustments in the revenue requirement in prior decisions, and both noted that the Company has been clear about its intent to file annual rate cases on a going-forward basis. In light of this change in circumstances, they contended that the Commission should not accept these post-test period adjustments since they would be reflected in the next rate case. (DPA EB at 63; Staff EB at 40-41).

131. Discussion and Decision. In reviewing this proposed adjustment, it is clear that the majority of these contract adjustments are estimates, not real numbers that are actually known and measurable. Although we have approved similar wage and FICA adjustments in the past, it is clear that, based on the Company's own statements in this case, the rate effective period is in all likelihood going to be shorter. Moreover, these post-test period expense adjustments have no post-test period revenue offset. We do not believe that the relationship between historical revenue, investment and expenses should be adjusted solely for estimates of future expenses. In addition, there is

no reasonable expectation that all of these wage and salary increases will be approved. Given the Company's representations that it will be filing annual rate cases, we do not believe it is appropriate to include the post-test period wage and FICA adjustment in this case. We accept the DPA's position that only the annualized test period expense level should be included in the revenue requirement. (Unanimous).

2. <u>Non-Executive Incentive Compensation</u>

132. The Company proposed to include $1,993,802 of non-executive incentive compensation expense in its test period revenue requirement ($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) at 34-35). 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 at 93). The Company claims that the incentive program is "critical" for attracting and retaining competent talent; that the program is intended to align employee behavior with company business objectives that include customer satisfaction, employee productivity, employee safety and operational efficiency; that it made a business decision to place a portion of employees' compensation at risk to motivate them to achieve their "best performance;" that such plans are standard in

the industry; and that the incentive compensation plan benefits customers by, for example, controlling spending. (Ex. 2 (Boyle) at 10-11; Ex. 20 (Ziminsky-R) at 69; DPL OB at 95).

133. Under the terms of the AIP, no payments are made unless earnings reach a minimum level. If earnings reach the minimum level (or trigger), then employees are entitled to AIP compensation if the Company's goals related to customer satisfaction, employee productivity, employee safety and operational efficiency are achieved. However, if the earnings trigger is not achieved, employees receive no incentive payments regardless of their performance. As explained by the Company, the earning s trigger serves to ensure that there are sufficient earnings available to pay the incentives, thus avoiding a situation where the Company cannot afford to pay the incentives. (DPL OB at 95-96). If the earning threshold is 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 at 34).

134. Staff and the DPA removed the Company's non-executive compensation from the Company's cost of service. (Exh. 13 (Crane) at 37; Exh. 11 (Peterson) at 25-27). Both argued that the AIP primarily benefits shareholders because no matter how well employees may perform, no incentive compensation is paid unless the earnings threshold is attained. (Exh. 13 (Crane) at 37; Exh. 11 (Peterson) at 25-27).) The DPA further argued that

Delmarva did not always have an incentive plan, and Delmarva has been providing utility service since before 1999; thus, these costs are not normally incurred in the provision of utility service. (DPA AB at 81). Finally, the DPA contended that other jurisdictions have held that shareholders should be either partially or wholly responsible for the costs of such plans. (*Id.* at 81-82).

135. Further, as the DPA pointed out, employees receive nothing even if they meet all of the safety, customer service, reliability, and "balanced scorecard" goals unless the earnings threshold is achieved; that employees would work safely without an incentive compensation plan; and that employees would properly perform their duties and protect customers' interests without an incentive compensation plan. (Tr. at 659-61).

136. Hearing Examiner's Recommendation. The Hearing Examiner recommended that the Commission, consistent with its prior decisions in Docket Nos. 05-304 and 09-414, remove the costs associated with the Company's Non-Executive Incentive Compensation Plan from cost of service. He found that Delmarva had structured the AIP such that the achievement of its corporate financial goals overrode the improving safety, reliability and customer satisfaction goals. He noted that if the Company's financial goals were not met, an employee would receive nothing regardless of how successful the employee was in meeting the safety, reliability or customer satisfaction goals. He observed that Delmarva could have structured its plan to satisfy

Commission precedent for inclusion in its cost of service, but it chose a different route, presumably to satisfy its shareholders, stock analysts, and the rating agencies. Although the Hearing Examiner opined that such a structure was "perfectly acceptable," he concluded that the costs of the plan should be excluded from the revenue requirement in this case because Delmarva had 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. (HER 110-11).

137. Exceptions. The Company excepted to the Hearing Examiner's recommendation, arguing that his analysis of Commission precedent was mistaken, imprecise and inconsistent with Delaware law. (DPL EB at 65). It insisted that the earnings threshold did not override the other performance goals, but rather were only a means to ensure that the incentives can be paid. (*Id.* at 65-66). The Company further disagreed with the Hearing Examiner's conclusion that it had not identified the AIP amounts attributable to the achievement of reliability, safety and customer service goals, stating that it had specifically identified those amounts in the record and that it was appropriate for Delmarva to be provided recovery of those costs at a minimum. (*Id.* at 69). Delmarva also argued that the manner in which it determines employee compensation involves the day-to-day operations of the utility; that the cost of paying employees for their work is a normally accepted operating expense of

utility companies; and that recovery of the expenses must be approved unless found to have been made in bad faith or out of an abuse of discretion. (*Id.* at 69-70). Nowhere in the record was bad faith or abuse of discretion alleged, nor was such a finding made by the Hearing Examiner. (*Id.* at 70).

138. Discussion and Decision. As we have determined before in other cases, we are not convinced that this plan can be analyzed without the earnings trigger that is contained within it. We understand why those triggers are there -- presumably to ensure that the Company can afford to pay the benefits under the plan. That makes it a plan that implicitly is dependent on earnings; otherwise, the benefits would be paid regardless of any impact on earnings. But that is not the case here, and it has not been the case since we first addressed this issue in detail in Docket No. 05-304 in 2006.

139. We also are not convinced that these costs are necessary for the operation of the Company in providing utility service to its customers. Rather, we believe this to be an extraordinary expense that is tied to an earnings trigger that protects shareholders' interests, even with regard to that portion of the plan that is tied to safety, reliability and customer service. Accordingly, we deny the inclusion of the costs of this plan in customers' rates. (Unanimous).

3. **Relocation Expenses**

140. The Company included $130,447 of relocation expenses incurred during the test period. The DPA asserted that, based upon a review of past such expenses, the test period relocation expenses were abnormally high and did not represent a normal, ongoing level of expense. The DPA recommended that the Commission utilize a "normalized" cost of $37,450, reflecting the highest cost incurred in the previous three years. (Exh. 13 (Crane) at 38-39).[28]

141. The Company argued that the Commission should reject the DPA's recommendation. It characterized the DPA's recommendation as not a normalization of an expense over a chosen time period, but as merely "the selection of data from a pre-test year period instead of relying upon the actual test year period for ratemaking." (DPL OB at 97).

142. The DPA argued that the Commission has ordered normalization when a test year expense greatly exceeds past experience and where there is no evidence that the test period expense levels can be expected in the future. The Public Advocate cited our decision in Docket No. 91-20 with respect to tree trimming, noting that the Company had claimed a significantly higher test period expense level than it had incurred in preceding years. In that case, we agreed with the Hearing Examiner that Delmarva had not justified the significant

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[28] Relocation expenses for the three prior years were $20,482 in 2009, $37,450 in 2010 and $31,749 in 2011. (*Id*., citing Delmarva's response to AG-RR-20).

increase over such a short time period, and included a normalized level of expense in the revenue requirement.[29]

143. The DPA also pointed out that this Commission considered a similar situation in Docket No. 09-414 involving Delmarva's pension expense and excluded the abnormally high test period expense level from the normalization adjustment because including it would "result in over-recovery of the pension expense."[30] The DPA noted that if the Commission followed such a normalization procedure here -- excluding the 2012 test period level and averaging the prior three years -- the expense level to be included in rates would be $29,909, which was less than the DPA's recommendation. (DPA AB at 82-83).

144. Hearing Examiner's Recommendation. The Hearing Examiner agreed with the DPA. He found that Delmarva had not met its burden of proof. The Company presented no evidence as to why its 2012 test period relocation expenses were 4 to 5 times higher than the amounts incurred in 2009, 2010 and 2011, and it did not present any evidence that its high 2012 expense level was likely to continue in the future. (HER at 112).

145. Exceptions. The Company excepted to the Hearing Examiner's recommendation. It referenced evidence provided by Company Witness Ziminsky's in his rebuttal testimony that the expenses were "normal expenses incurred in the ordinary course of business" and there was no normalized cost for the expenses. (Exh. 20 (Ziminsky-R) at 74). Further, Delmarva pointed out the

[29] *Delmarva Power*, Docket No. 91-20, Order No. 3389 at ¶¶74,138,142 (March 31, 1992).
[30] *Delmarva Power*, Docket No. 09-414, Order No. 8011 at ¶132 (August 9, 2011).

lack of any discussion regarding this issue during the evidentiary hearings, nor was there any assertion that the expenses were incurred in bad faith or out of an abuse of discretion. Finally, according to the Company, the DPA did not take into account the actual test period relocation expense in its proposed adjustment. (DPL EB at 71).

146. Discussion and Decision. We agree with the Hearing Examiner's conclusion that the Company did not meet its burden of proof on this issue. There is no meaningful explanation as to why the 2012 experience for relocation costs were so high. In accordance with prior Commission practice, we believe that normalizing expenses that vary significantly from year to year is appropriate where there is no evidence that they will likely occur at such a high level again and adopt the DPA's recommendation establishing $37,450 as the appropriate amount to be included in the Company's revenue requirement. (Unanimous).

4. Employee Health Care Benefits

147. 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) at 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. ("Lake"), which performs a quarterly survey of six 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-R) at 29).

148. The Lake survey, which Delmarva relied on to establish its projected rate increases, is based upon data from the first quarter of 2013. (Exh. 5 (Ziminsky) at 14 and 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."[31] (*Id.*) Delmarva proposes an 8% increase for medical expense, and 5% increases for both dental and vision expense. (*Id.* at 14-15).

149. The annual changes over the last five years in total Company benefit costs are:

	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%[32]

[31] Lake does not specifically track vision cost expenses but notes that vision cost trends generally follow dental cost trends.

[32] According to Delmarva, "[t]he declines in 2011 charges were driven by reduced headcounts resulting from the Organizational Review Process that reviewed and realigned resources after the 2010 divestiture of Conectiv 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).

150. Staff and the DPA argued that the adjustment is an estimate that is not "reasonably known and measurable" and should not form the basis for increasing operating expenses. They further argued that the record evidence of Delmarva's actual health benefits experience over the last five years demonstrated that it had generally experienced smaller percentage increases than it was requesting here. They contended that there was no evidence that any of the companies surveyed provide coverage to Delaware employees, or that the expense trend in the geographic area surveyed was representative of the expense trend in Delaware. (Staff AB at 77-78; DPA AB at 86-89). The DPA also argued that: (1) the Lake study was hearsay and under Delaware law, an agency decision cannot rest solely on hearsay; and (2) even if the Lake study could be considered hearsay on which an expert relies in forming an opinion, the Company's sponsoring witness was not an expert in the medical benefits field; and (3) the Company's adjustment was simply an inflation adjustment. (DPA AB at 89-91).

151. <u>Hearing Examiner's Recommendation</u>. The Hearing Examiner relied on this Commission's decision in Docket No. 09-414 in recommending approval of the Company's adjustment. He rejected the DPA's arguments concerning the hearsay nature of the Lake study, stating that the DPA waived the argument by not raising the issue at the hearing, and further finding that the report was an attachment to a witness' testimony to which no one objected and admissible pursuant to Commission Rule 25(a). (HER

at 120, n.33). He further found that no party had presented any different arguments than those made in Docket No. 09-414. He agreed with the Company that the proposed increases were reasonably known and measurable, supported by industry data, and were the best representation of the increased costs the Company would likely incur over the rate effective period. He further noted that the Company had chosen to incorporate increases below the surveyed average in its revenue requirement. (*Id.* at 120-21).

152. Exceptions. Both Staff and the DPA excepted to the recommendation of the Hearing Examiner on this issue. Staff reiterated that the Lake study had no data specifically related to Delmarva, but was merely based on trends experienced by several major insurance companies in Virginia, Maryland and the District of Columbia. Without tying the general trends to the actual experience in Delaware, Staff argued that there was no basis to claim that the adjustment for these future expenses were known and measurable. (Staff EB at 44-45).

153. The DPA contended that there were two new arguments raised in this case that had not been presented in Docket No. 09-414. First, the record in this case contained evidence of Delmarva's actual experience from 2008 through 2012 demonstrating that its actual experience did not support its proposed adjustment. Second, the DPA contended that this was essentially an inflation adjustment, and the Commission had rejected inflation adjustments in prior cases. (DPA EB at 76-77). The

DPA repeated its hearsay arguments, and further argued that the adjustment was unsupported by any Delaware-specific evidence. (*Id.* at 77).

154. Discussion and Decision. We reject the Hearing Examiner's recommendation on this issue. We acknowledge that we accepted this adjustment in Docket No. 09-414, but we have reconsidered that decision, as we are permitted to do. We agree with the DPA that this is essentially an inflation adjustment based on trends not in Delaware, but in Maryland, Virginia and the District of Columbia. Moreover, as the Company admits, it is a projection of costs that have not been paid yet. Unlike a contractually-mandated increase, it is not a known and measurable change. We further note that the adjustment appears to be at odds with the Company's actual experience over the last several years. Accordingly, based on the evidence presented in this case, we do not believe that these projections of future costs should be used to adjust operating expenses beyond the levels incurred during the test period. (3-1, Chair Winslow voting no). [33]

[33] The DPA argued that the Lake is hearsay that could not be the sole basis for a decision, but the Hearing Examiner found that it was admissible. (HER at 120). As noted, the DPA raised these procedural objections again in its exceptions; however, in light of our decision here we find it unnecessary to address the Hearing Examiner's conclusion on the admissibility of the Lake report.

5. **Supplemental Employee Retirement Benefits**

155. The Company included $1,101,782 of Supplemental Executive Retirement Plan ("SERP") expenses in its revenue requirement. (DPA AB at 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) at 39). According to the Company, it is common practice among companies such as PHI that offer qualified defined benefit pension plans to provide executives with a benefit that allows them to be compensated for Internal Revenue Service ("IRS") limits which cap the amount of salary that the Company may use in calculating benefits. The Company suggests that because of this cap, executives do not receive an equitable pension contribution, relatively speaking, when compared to the typical company employee. The goal behind providing a SERP benefit 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 Delmarva's executives with a benefit that makes up for the contribution differences caused by the IRS salary cap. (Exh. 20 (Ziminsky-R) at 75). The Company asserted that providing retirement benefits plans to its employees is a normally accepted operating expense to which it is entitled to recovery unless found to have been made in bad faith or as a result of waste or inefficiency. (DPL RB at 32, citing *Delmarva Power & Light v. Public Serv. Comm'n*, 508 A. 2d 849, 859 (Del. 1986)).

156. The DPA, joined by Staff in its brief, acknowledged that the Commission had included SERP benefits in the Company's revenue requirement in Docket No. 09-414, but requested the Commission to reconsider that position. (DPA AB at 86-87). The DPA argued that the Company's officers are already well compensated and that if the Company wants to provide SERP benefits to its officers, shareholders should fund them. (Exh. 13 (Crane) at 40; Staff AB at 81). The DPA introduced evidence of the compensation that PHI's senior executives received in 2012, ranging from $1.5 million for the new General Counsel to $11.3 million for Mr. Rigby, PHI's retiring CEO. (Staff AB at 81-82).[34]

157. <u>Hearing Examiner's Recommendation</u>. The Hearing Examiner relied on the Commission's "relatively recent" decision in Docket No. 09-414 and the reasons Delmarva gave to recommend that the Commission include the Company's SERP costs in the revenue requirement. In Docket No. 09-414, the Commission included SERP expenses in the Company's cost of service.[35] In that case, the Commission was persuaded by Delmarva's argument that these benefits are necessary to attract and retain executive talent. The Hearing Examiner also noted that the Commission had found that the SERP benefits were "true retirement benefits" and "not tied to the achievement of financial goals." He found no

[34] The record reflects that these executives' compensation consists of salary, non-equity incentive compensation, stock options, bonuses, and what the PHI proxy statement calls "other" compensation. (Exh. 67 at 50; Tr. at 662-66).
[35] PSC Order No. 8011, ¶184.

"new compelling arguments" to recommend excluding the SERP expense from the revenue requirement. (HER at 116-17).

158. Exceptions. Staff and the DPA both excepted to the Hearing Examiner's recommendation. Staff's major complaint was that the SERP plan was simply a way to circumvent the IRS salary caps and was unnecessary for ratepayers to fund given the multi-million dollar salaries of PHI's senior executives. Staff suggested that the argument in support of this adjustment was no more compelling than the one made for incentive compensation benefits, which the Hearing Examiner excluded from the Company's operating expenses. (Staff EB at 42).

159. The DPA argued that Delaware law permits the Commission to change its position on an issue. (DPA EB at 72). The DPA noted that the SERP benefits are on top of the compensation and other "perks" that members of senior management receive such as a car allowance, free parking, payment of club dues, free tickets to events, reimbursement for spousal travel, etc. (DPA EB at 73-74). The DPA also contended that other Commissions have rejected arguments that these types of benefits are necessary to attract and retain certain high level employees or that they directly assist ratepayers. (*Id.* at 74). The DPA argued that in light of the sluggish economy and the comments of some customers that they are having a difficult time paying their energy bills, ratepayers should not be burdened with funding extra benefits for top management. (*Id.*).

160. Discussion and Decision. We reject the Hearing Examiner's recommendation. We acknowledge that we included SERP expense in the Company's revenue requirement in Docket No, 09-414, but, as the DPA points out, we may reconsider our decisions in prior cases. Similar to our decision on non-executive incentive compensation, we believe that this is also an extraordinary expense that is not necessary to provide utility service to Delmarva's customers. These are, after all, additional benefits (although of a different type than the AIP incentive compensation) that are awarded over and above salaries, defined pension benefits, and the other benefits identified by the DPA as only being granted to the most senior executives. Other Delmarva employees do not get to participate in the SERP.

161. Having already decided that the AIP costs are an extraordinary expense, we find that the SERP expense is sufficiently similar and conclude that it is not necessary to the provision of utility service. Accordingly, and based on the record before us, we find that this expense should be excluded from the revenue requirement. (Unanimous).[36]

[36] The original motion made to approve the Hearing Examiner's recommendation did not receive a majority of the four Commissioners (2-2; Commissioners Conaway and Lester voting no). Staff argued that in light of the Commission's split vote on the SERP issue, there was no final decision of the Commission on the SERP issue and that, as such, Delmarva would be denied the right to an appeal on the issue. The Company disagreed with Staff's argument. A motion to reconsider the issue was made over the Company's objection, with all the Commissioners voting to reject the Hearing Examiner's recommendation. The Chairman indicated he was supporting the motion so that there would be a final appealable decision on this issue.

6. <u>Recurring IRP Expenses</u>

162. By statute, Delmarva is required to file an IRP every other year.[37] The Company proposed to include in its revenue requirement a normalized amount of $872,500 of IRP costs, as the Commission ordered in Docket No. 06-241. Since the IRP cycle is every two years, Delmarva estimated $1,745,000 of IRP costs over those two years and then included one year of costs in its revenue requirement. (DPA AB at 69).

163. The Company's yearly IRP costs from 2006-2013 were:

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) at 43, *citing* Delmarva's response to PSC-RR-33.)

164. Staff and the DPA objected to the amount of the proposed adjustment, each arguing that it results in a significant increase in prospective IRP costs compared to the test period. According to Staff, an allowance of approximately $700,000 in rates is sufficient to recover the actual recurring IRP costs, while acknowledging the uncertain costs in the next IRP. Accordingly, Staff proposed to normalize Delmarva's actual IRP expenses over the last seven years using the Company's actual average annual expense. (Exh. 11 (Peterson at 30).

[37] *See generally* 26 *Del. C.* §1007.

165. The DPA recommended that the recurring IRP costs be normalized based on the Company's actual experience over a three-year period 2010-2012, which amounts to $425,615. (Exh.13 (Crane) at 43-44). The DPA pointed out that this recommendation includes two of the three highest expense levels that Delmarva had spent on IRPs since 2009, and further argued that the Company's proposal exceeds actual IRP expenses incurred for all but one year since 2009. (DPA AB at 91).

166. Hearing Examiner's Recommendation. The Hearing Examiner recommended that Delmarva's estimated IRP expense level be rejected because it was not reasonably known and measurable. According to the Hearing Examiner, Delmarva submitted no reliable and quantifiable data to support its estimate. He noted that more than 50% of its estimate was for consultants, outside legal counsel, and special studies, and he agreed with the DPA that these types of expenses can vary greatly from estimates, especially where the parameters of the project are not well defined. Furthermore, he observed that the IRP expenses Delmarva had incurred in connection with its 2010 and 2012 IRPs would have included these types of expenses. (HER at 91). He recommended that the Commission include the DPA's normalized amount of $425,615 in the Company's revenue requirement, noting that the DPA's normalization adjustment included two of the three highest amounts that Delmarva had spent on IRPs since 2009. (*Id.* at 91-92).

167. Exceptions. The Company excepted to the Hearing Examiner's recommendation, contending that its estimate of IRP expenses should be used because it was consistent with prior accepted practices and its testimony reflected that there was little reason to believe that IRP costs will continue to decline. Further, while recognizing the potential variability in IRP costs going forward, Delmarva suggested that neither Staff nor the DPA had proffered any analysis of future recurring IRP costs. (DPL EB at 59).

168. Discussion and Decision. We find that the Hearing Examiner's approach to the resolution of this issue is appropriate. The record indicates that there is a large fluctuation in the annual IRP costs. Thus, it is appropriate to normalize this expense. We believe that the DPA's suggestion to use the last three years, which includes two of the highest in the last six years, is appropriate and supported on this record. (Unanimous).

7. Regulatory Expense

169. Delmarva's regulatory expense claim is based on the total estimated costs for this rate case of $632,600, which includes $315,000 in external legal costs, $92,600 for its cost of capital witness and $225,000 of PSC fees of $225,000 (including court reporter fees). (*See* Exh. 13 (Crane) at 47). Delmarva proposes to normalize the level of expense using a three-year average and to adjust the test period results to reflect the cost of the current filing. (Exh. 5 (Ziminsky) at

11-12). The Company proposed to include the unamortized balance of rate case expense in rate base (Exh. 20 (Ziminsky-R) at 18).[38] If approved, this adjustment would result in an $85,345 decrease to test period earnings. (Exh. 5 (Ziminsky), Sch. (JCZ) -4)). The Company stated that its proposed ratemaking treatment was consistent with previous dockets. (DPL OB at 78).

170. Although the parties agreed on the use of a three-year normalization period, they disagreed on the amount to be recovered. Furthermore, both DPA and Staff objected to including any rate case expense in rate base. (Exh. 11 (Peterson) at 28-29; Exh. 13 (Crane) at 47-49).

171. Staff and the DPA both argued that the Company's estimated rate case expense was excessive. They produced the following chart of the Company's rate case expense incurred in the last several cases:

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*

(Exh. 11 (Peterson) at 28-29; Exh. 13 (Crane) at 48). Both recommended a normalized level of rate case expense of $426,432. (Exh. 11 (Peterson) at 28-29; Exh. 13 (Crane) at 48-49). The DPA

[38] Delmarva also proposed to include in its revenue requirement $53,316 of non-rate case-related regulatory costs (based on a three-year average of actual costs). No party objected to this proposed adjustment or Delmarva's suggested treatment of it.

further argued that the Commission had not addressed the Company's proposed ratemaking treatment in prior dockets and that approval could not be assumed from the Commission's silence. (DPA AB at 95). It pointed out that there had been more contested issues in Docket No. 09-414, yet the rate case costs for that fully-litigated proceeding were substantially lower than the estimated costs of this case. (*Id.* at 95-96). The DPA also took issue with the $92,600 being paid for Delmarva's cost of capital witness, observing that Delmarva had retained a well-respected cost of capital witness in Docket No. 09-414 for $65,000; that the DPA's cost of capital witness only charged $21,500; and that Delmarva's cost of capital witness had also presented testimony for all of the other PHI entities in this round of rate cases as well as a prior round of cases. (*Id.*). The DPA suggested that since the cost of equity is or primary interest only to shareholders, they should bear a portion of the witness' cost. (*Id.* at 96).

172. Hearing Examiner's Recommendation. The Hearing Examiner recommended approval of the Company's estimated rate case expense. He noted that the Company's rate case expense totaled $634,054 in Docket No. 11-528, which was settled. He observed that this case had not settled. Furthermore, he found that the parties had engaged in protracted litigation since August 2013, when Staff and the DPA made their recommendations. As a result, he found that Delmarva had incurred additional attorneys fees, expert consulting fees, and travel costs and fees

for three days of evidentiary hearings and preparing briefs. Accordingly, the Hearing Examiner found that the Company's estimated rate case expense level should be included in the revenue requirement. (HER at 107-08). The Hearing Examiner did not address Delmarva's proposal to collect the unamortized balance of rate case expense in rate base.

173. Exceptions. Both Staff and the DPA excepted to the Hearing Examiner's recommendation. Staff highlighted that the Examiner ignored three relevant facts: (1) the incremental increase over the average of rate case expense over the last three cases was just that -- an estimate; (2) the volatility over the last several cases made normalization of historic information the best predictor of future costs; and (3) the unaddressed issue that the DPA raised about the level of some expenses estimated for the proceeding. (Staff AB at 41).

174. The DPA argued that Delmarva's estimated rate case expenses – especially its cost of capital witness - were excessive. It further argued that it was curious that Delmarva's most recent case (Docket No. 11-528), which settled, cost more than the prior cases (Docket Nos. 09-414 and 05-304) that were litigated. Accordingly, the Company's adjustment of the historic information above the three-year average, based on the last case, was unjustified. (DPA EB at 65-67).

175. Discussion and Decision. We agree with the Hearing Examiner that the rate case expense that the Company incurred for the last base rate case is a better comparison for costs incurred

in this proceeding. In reviewing the record in this proceeding, it is clear that many issues have been joined between the parties and that the post-hearing briefs and exceptions have been extensive. We recognize that rate case expense levels have varied in the last several cases, and we acknowledge Staff's and the DPA's arguments that normalization is appropriate. However, we believe that, for this proceeding, the rate case expenses the Company incurred in its last rate case are more representative of future rate case expenses. (Unanimous).

8. <u>Dynamic Pricing Program ("DP")</u>

176. In Order No. 8105 in Docket No. 09-311, the Commission approved a settlement that authorized Delmarva to offer DP to customers, first on a limited basis, and then more broadly to its entire SOS customer base. (Ex. 20 (Ziminsky-R) at 42). It also authorized the creation of a regulatory asset for DP program-related costs.[39] In this case, Delmarva originally sought recovery of a net $3,843,284 of DP-related costs through amortization over 15 years and rate base treatment of the unamortized balance.[40]

177. 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. (*Id.* at 42). He testified

[39] *See Delmarva Power*, PSC Order No. 7420.
[40] Before being partially offset by deferred taxes, the amount included was $6,699,487. (Ex. 13 (Crane) at 23).

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.*). He also testified that Delmarva called a second event on September 11, 2013 for which participating customers would receive bill credits. (*Id.* at 42-43).

178. In its rebuttal testimony, however, Delmarva separated its proposal into two parts. Part 1 seeks recovery of the actual DP regulatory asset balance of $5,049,437 as of August 31, 2013; Part 2 seeks recovery of $821,155 of additional DP expenses forecasted to be incurred through October 2013. (*Id.*). In urging that the Commission accept its proposed adjustment, Delmarva maintained that the amounts set forth in Adjustment Nos. 20a and 20b reflect the actual and forecasted costs placed into the DP regulatory asset during the respective time periods and are consistent with the Commission's regulations. Delmarva further argued that the costs reflected in the asset are for a program that is currently used and useful. DP has been rolled out to all of the Company's residential customers, and 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 at 68-69).

179. According to the DPA, the regulatory asset balance as of December 31, 2012 was $413,576. (Exh. 13 (Crane) at 24). The DPA noted that in January 2013 Delmarva reclassified certain

costs from the AMI regulatory asset to the DP regulatory asset; as a result of this reclassification, the DP regulatory asset balance at December 31, 2012 was $2,456,025. (*Id.*). Thus, the DPA recommended that the Company's rate base adjustment for DP deferred costs be limited to its actual costs of $2,456,025 through the end of the test period, December 31, 2012. The DPA further recommended that additional costs deferred through 2013 should be evaluated once implementation of the program is complete. (*Id.* at 25). Finally, the DPA recommended that the Company continue to defer DP 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.*).

180. Staff recommended that Delmarva continue to defer all costs associated with the DP program until its next base rate proceeding following full deployment of the program. (Exh.11 (Peterson) at 21). According to Staff, since full deployment of DP did not occur during the test period, the related benefits and savings to be achieved during the program were not reflected in the Company's test period results. (*Id.* at 31-32). Both Staff and the DPA contended that the difference in timing between recognition of program related costs and expected benefits to be achieved through the program created a test period mismatch. (*Id.*; DPA AB at 70).

181. <u>Hearing Examiner's Recommendation</u>. The Hearing Examiner recommended that the Commission approve the DPA's

position and include the Company's actual costs through the end of the test period -- $2,456,025 -- in the revenue requirement. He found that this approach was consistent with Order No. 7420, in which the Commission stated that creation of the AMI regulatory asset should be consistent with the matching principle giving consideration to both costs and savings.[41] He further agreed with the DPA that the parties should be able to contest both the amount and reasonableness of actual costs incurred and savings realized, rather than just the costs Delmarva thinks it will incur; that there did not seem to be any recognition of savings realized in 2013 from the DP program; and that continuing to accrue DP program costs in a regulatory asset did not prejudice Delmarva. He observed that regardless of what Delmarva has paid in 2013 to DP participants, it chose a test period ending December 31, 2012, and therefore allowing recovery of the 2013 DP costs in this case was 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. (HER at 99-100).

182. Exceptions. The Company excepted to the Hearing Examiner's recommendation. Delmarva contended that its proposed adjustments reflected the actual and forecasted costs included in the DP regulatory asset and were consistent with the Commission's regulations. In addition, customers had participated in and would receive benefits from the program during the rate effective

[41] *See* PSC Order No 7420, ¶3.

period; thus, continued deferral of the costs was inappropriate. The Company also identified that the recommendation does not reflect the reclassification of certain costs to the DP regulatory asset, which included costs incurred by the Company prior to 2013, done in conjunction with a review by Staff. (DPL EB at 61-62).

183. Discussion and Decision. We conclude that for purposes of the rates to be set in this case, the Company's revenue requirement should only include the actual DP costs that have been incurred though the end of the test period. The costs and benefits of AMI must be matched. There are additional benefits that will be achieved by the deployment of AMI that are not reflected in the record. This decision will not affect the Company's potential recovery of additional DP costs; its ability to recover those costs is preserved by ordering their continued deferral for consideration in a subsequent rate case, at which time any benefits can also be considered. Accordingly, we agree with the Hearing Examiner and adopt his recommendation on this issue. (Unanimous).

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

184. In PSC Order Nos. 7420 and 8253, this Commission authorized Delmarva to implement a DLC program and to create a regulatory asset for the costs incurred in connection with its implementation.[42] In this case, the Company proposes to amortize

[42] *See* Docket No. 07-28, PSC Order No. 7420 (September 16, 2008); Docket 11-330, PSC Order No. 8253 (December 18, 2012).

and begin recovering the costs related to its DLC program. The DLC program involves installing a direct load control switch and thermostat at participating customers' residences. (DPL OB at 70). Delmarva seeks recovery of a net $5,706,782 of DLC-related costs, to be amortized over fifteen years with rate base treatment for the unamortized balance. (Exh. 13 (Crane) at 26). If approved, this expense would result in a cumulative $391,496 decrease to test period earnings. (DPL OB at 70).

185. Delmarva began implementing the DLC program in April 2013 and the implementation will continue through 2016. (Exh. 13 (Crane) at 26-27, *citing* Delmarva's response to PSC-RR-44). According to Delmarva, as of August 31, 2013, 7,490 of the projected 51,500 installations had been completed, and another 12,110 were forecasted to be installed by the end of 2013. (Exh. 20 (Ziminsky-R) at 49).

186. As it did with its DP-related costs, the Company split its proposed DLC adjustment into two parts in its rebuttal testimony: The first adjustment (No. 23a) related to the actual regulatory asset costs incurred through August 2013, and the second adjustment (No. 23b) related to forecasted regulatory asset costs from September through December 2013. (*Id.*). As it did with the DP-related costs, the Company argued that customers have already had the DLC devices installed at their residence and are receiving benefits. It contended that its 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, and that continuing to defer costs did not benefit customers and created regulatory uncertainty. (DPL OB at 70-71).

187. Noting Delmarva's admission that it did not begin implementing the DLC program until April 2013, the DPA recommended that all DLC costs be excluded from rate base because no costs were incurred during the test period. (Exh. 13 (Crane) at 26-27, DPA AB at 70). The DPA emphasized that 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. It further observed that there appeared to be no recognition of savings realized in 2013 from the DLC program. Staff made a similar recommendation for similar reasons. (Exh. 11 (Peterson) at 33).

188. Delmarva argued that the DPA's position on the DLC-related costs was inconsistent with its position on DP-related costs. It reiterated its contention that ratepayers were participating in the program in 2013 and were already receiving benefits, thus warranting inclusion of the 2013 DLC-related costs in its revenue requirement in this case.

189. <u>Hearing Examiner's Recommendation</u>. The Hearing Examiner recommended adoption of the DPA's and Staff's positions and excluding the 2013 DLC costs from the revenue requirement. He agreed that Delmarva was not prejudiced by continuing to accrue DLC program costs in a regulatory asset. He noted that Order No.

7420 allowing a regulatory asset for such costs also included a proviso that consideration be given to both costs and savings and concluded that allowing recovery of the 2013 DLC costs in this case was inconsistent with that directive since there was no record evidence of savings achieved in 2013 from the DLC program. He rejected Delmarva's argument that the DPA had taken inconsistent positions, noting that the DPA had recommended recovery only of expenses incurred during the test period for both issues. (HER at 102-03).

190. Exceptions. No party excepted to the Hearing Examiner's recommendation on this issue.

191. Discussion and Decision. We adopt the Hearing Examiner's recommendation on this issue for the reasons he gave. The record reflects that none of the DLC-related costs that Delmarva seeks to recover were incurred during the test period. The proposed rates in this case should not reflect the recovery of costs yet to be incurred, especially where there is no record evidence of the savings that may have resulted. Delmarva is not prejudiced by this decision since it can continue to accrue DLC-related costs in the regulatory asset until such time as both costs and benefits can be examined. (Unanimous).

10. Corporate Governance Costs

192. The Company included certain corporate governance expenses incurred during the test year which it claimed relate to both the manner in which PHI and Delmarva are directed and

controlled, as well as social responsibility expenses which directly benefit customers. (Exh. 20 (Ziminsky-R) at 77).

193. The DPA observed that Delmarva's portion of such costs had increased over the past few years as the result of PHI's divestiture of Conectiv in 2010 and a change in methodology by which PHI allocates such costs across its companies. (DPA AB at 94). The DPA recommended that costs associated with certain External Affairs activities be disallowed unless the Company demonstrated that such costs had a direct benefit to customers or had been removed elsewhere. The DPA removed the expenses associated with Public Relations, Corporate Citizenship Social Responsibility, Strategic Communications, PAC Committee, and Corporate Contributions.

194. In its rebuttal testimony, Delmarva stated that the Corporate Citizen Social Responsibility, PAC Committee and Corporate Contribution charges had not been included in its revenue requirement. (Exh. 20 (Ziminsky-R) at 77). Thus, at the evidentiary hearing, the DPA revised its recommended disallowance to exclude these amounts. (Tr. at 545-46; see Exh. 99 (revised Crane schedules); DPA AB at 98). The DPA continued to challenge expenses relating to public relations and strategic communications that Delmarva did not identify as having been removed from the revenue requirement and for which it provided no support. (DPA AB at 98).

195. Delmarva argued that it takes its role in the region's economic development seriously, and it was important that all

benefit from that growth. It stated that it was dedicated to meeting its customers' and shareholders' needs, giving back to the communities it serves and protecting the environment. It did this by supporting "a wide variety of cultural, civic, educational, environmental, health safety, and business initiatives that are dedicated to improving the quality of life for all citizens." (Ex. 20 (Ziminsky-R) at 76). Delmarva further claimed that these expenses "relate[d] to both the manner in which both PHI and Delmarva are directed and controlled as well as social responsibility expenses which directly benefit customers," and that they were "normal and ordinary business expenses" that were included in the revenue requirement based on the Commission decisions in Docket Nos. 05-304 and 09-414. (*Id.* at 77).

196. The DPA argued that Delmarva had not borne its burden of proof for these expenses. It noted that the Commission did not address these types of expenses in either Docket Nos. 05-304 or 09-414, explaining that the allowed expenses in Docket No. 05-304 related to advertising, and that the Commission did not address the issue in Docket No. 09-414. It argued that Delmarva's assertions that the expenses are normal and ordinary and that they relate to the manner in which PHI and Delmarva are directed and controlled do not establish that they *are* normal and ordinary or that they do relate to the entities' direction and control, and Delmarva had admitted that it produced no evidence that they were. (Tr. at 671-72; DPA AB at 99-100). Furthermore,

the DPA contended that Delmarva's argument that it takes its role in the community seriously, is dedicated to meeting customer and shareholder needs, and gives back to the community (regardless of whether one agrees with those statements or not) proved the DPA's point that these expenses were for promoting Delmarva's public image as a good corporate citizen, and from Delmarva's description sounded identical to the corporate citizenship social responsibility expenses that Delmarva had excluded from the revenue requirement. Similarly, the DPA argued that Delmarva's claim that the expenses related to "social responsibility expenses that directly benefit customers" sounded exactly like the corporate citizenship social responsibility expense that it excluded from the revenue requirement. (DPA AB at 100).

197. Finally, the DPA argued that some of the expenses in this category may have been inappropriately categorized. It noted that during the evidentiary hearing, Delmarva's witness testified that the expenses included the cost of a Delmarva employee going to schools to talk to children about electric safety and the costs of customer education for the DP and DLC programs, but upon further questioning, he admitted that the DP- and DLC-related education costs were included in the regulatory assets created for those programs. (*Id.* at 670-71, 682, 696). Since Delmarva stated in its filing that "[n]o contributions for educational or other charitable purposes [we]re included as part of the Cost of Service" (Ex. 1 at MFR Sch. 3-F), the DPA

questioned how the Commission could be sure that the costs in this category did not include some DP and DLC costs. (*Id.*).

198. Hearing Examiner's Recommendation. The Hearing Examiner agreed with the DPA that the Company had not met its burden of proof regarding this issue. He noted that there was no Commission precedent to provide any guidance. He found that based on the record, he could not determine "what this money was spent on, except unknown amounts were spent on 'customer education issues, including saving energy and electrical safety.'" (HER at 114). He found that the Company had chosen not to document and segregate these expenses. Considering "the shadow of soft-lobbying costs," he recommended not awarding the Company this adjustment to test period expenses. (*Id.*).

199. Exceptions. The Company excepted to the Hearing Examiner's recommendation. It suggested that its treatment of corporate expense was consistent with its filings in prior cases, namely Dockets Nos. 05-304 and 09-414, and that the record reflected that these expenses were normal and ordinary business expenses. (DPL EB at 72). It argued that it had not included any below-the-line expenses in its test period cost of service. It cited its testimony at the evidentiary hearing regarding the types of activities included in public relations and strategic communications for which it was seeking recovery. Further, the Company suggested there was no argument by Staff or the DPA that the expenses were incurred in bad faith, or out of an abuse of discretion. (*Id.* at 73).

200. Discussion and Decision. We adopt the Hearing Examiner's recommendation on this issue for the reasons he cited. The record is not clear as to what activities are encompassed in this expense category, and we are unable to make an informed judgment as to whether those expenses benefit ratepayers. We find, as the Hearing Examiner did, that the Company failed to carry its burden of proof on these expenses. (Unanimous).

11. Meals and Entertainment Costs

201. 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-R) at 78; DPL OB at 98). The Company argued that Commission precedent in Docket Nos. 05-304 and 09-414 authorized recovery of this expense. (Exh. 20 (Ziminsky-R) at 78-79). It stated that the expenses were incurred during the normal course of business, which includes "providing meals to union employees, business meals, meals related to required overtime, and meals provided for training." (*Id.* at 78). Furthermore, these expenses are normally-accepted operating expenses that are recoverable in the absence of an abuse of discretion, bad faith, inefficiency or waste.[43]

202. The DPA argued that the IRS has determined that such expenses are not appropriate deductions for federal tax purposes, and opined that if they are not deemed by the IRS to be for reasonable business purposes, the Commission should reach the

[43] *Delmarva*, 508 A.2d. 849, 859 (Del. 1986).

same conclusion with respect to including them in Delmarva's cost of service. (Ex. 13 (Crane) at 52). It contended that the Commission had not previously addressed this issue, and Delmarva's suggestion that the Commission had addressed it in a prior case was incorrect. It reiterated that this expense represented items that were not deductible for tax purposes, and noted that the Internal Revenue Code contained exceptions to the 50% limitation on deductibility for "de minimus fringe" benefits such as occasional group meals served at the office and meals provided to employees to enable them to work overtime. 26 *U.S.C.* §§132(e), 274(n); Treas. Reg. §1.132-6(d). The DPA suggested that meals provided to employees during required overtime, training and the like were more likely than not 100% deductible, and given that these expenses were not deductible indicated that they did not satisfy the IRC exception. Since Delmarva did not provide any further information about the nature of the expenses, the DPA examined PHI's 2012 Proxy Statement, wherein PHI stated that it had incurred costs for various sporting and entertainment events. (Ex. 13 (Crane) at 53).

203. Hearing Examiner's Recommendation. The Hearing Examiner found a "lack of evidence" produced by the Company as to the exact nature of these expenses. He noted that PHI's 2012 Proxy Statement stated that some of these expenses were for sporting and entertainment events. He also accepted the DPA's argument that employee meals during overtime and training are seemingly not part of the taxable expenses being claimed. Thus,

he found that the Company had not met its burden of proof regarding these expenses. (HER at 122).

204. Exceptions. The Company excepted to the Hearing Examiner's recommendation. It argued that the DPA's reliance on the IRS limitation was arbitrary and blurred the line between the taxing authority of the IRS and the oversight of public utilities by this Commission. Significantly, the purpose of the IRS limitation relied upon by the DPA was to increase revenues, rather than to not recognize meals and entertainment expense as reasonable business expenses. Thus, it concluded that the DPA's argument "rejects Congress' logic for the limitation and uses the limitation for false reasons." (DPL EB at 77). Second, the Company contended the record reflected that the expenses were incurred in the normal course of business and asserted there was no discussion of this issue during the evidentiary hearings. Finally, it claimed that its treatment of these expenses was consistent with the Commission's past treatment of them. (*Id.*).

205. Discussion and Decision. We agree with the Hearing Examiner that the Company did not meet its burden of proof with respect to these expenses. Accordingly, we agree with the DPA's adjustment removing $298,182 of meals and entertainment expenses. (Unanimous).

12. Membership Fees and Dues Expenses

206. The Company included $315,474 of membership fees and dues, net of reported lobbying expenses, in its test period cost of service. (Exh. 20 (Ziminsky-R) at 79; DPA AB at 99). In

discovery, the DPA asked Delmarva three separate times to quantify the amount of dues attributable to lobbying expenses that the Company had removed from the revenue requirement, but never received a response. (Exh. 13 (Crane) at 54-55 and Ex. C). Thus, the DPA recommended that 20% of this expense be disallowed because such costs constitute lobbying activities or "engage[ing] in other activities which should not be charged to ratepayers, such as public affairs, media relations or other advocacy initiatives." (*Id.* at 53-54). The organizations to which Delmarva paid dues included the Edison Electric Institute ("EEI"), various state and local chambers of commerce (including some in Maryland), the Delaware Business Roundtable, the Delaware Contractors' Association, the Committee of 100, and various nonprofits. (DPA AB at 103-04, 106). The DPA's recommendation was based on its witness' review of the organizations, on recommendations in other utility rate proceedings, and in recognition of the fact that the specific level of hard and soft lobbying activity varies from organization to organization. (Exh. 13 (Crane) at 54-55). The DPA argued that Delmarva had not established how its membership in these organizations provided any benefit to Delaware ratepayers, and that Delmarva's assertion that it did so was devoid of support. (DPA AB at 106).

207. Delmarva responded to the DPA's assertions by identifying that "[f]ollowing the Company's accounting guidelines, any lobbying expenses reported by these organizations are recorded 'below the line'" and that the Commission has

allowed these expenses in prior cases. (Exh. 20 (Ziminsky-R) at 79). It contended that its participation in these organizations provides numerous benefits to its customers, including: focusing on issues important to the provision of electricity (EEI); improving quality of life for Delawareans when non-profits deliver on their missions efficiently and effectively (Delaware Alliance for Nonprofit Advancement); and conducting studies addressing issues such as health care, economic development, land use, water/wastewater, effective government and education through task forces comprised of representatives from government, business, civic organizations, environmental organizations, educators, and private citizens. (Delaware Public Policy Institute). (*Id.*).

208. Hearing Examiner's Recommendation. The Hearing Examiner accepted the Company's EEI dues, noting that 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. He stated that this is "vital to the Company's operation, which borders or is very close to a number of Mid-Atlantic states." (HER at 115). However, he agreed with Ms. Crane's recommendation that 20% ($63,094) should be deducted from the total $315,474 in claimed fees and dues because membership in the remaining groups, "although clearly worthwhile," were not necessary for providing safe and reliable

electric service.[44] (*Id.* at 115-16). He noted that the aggregate amount attributable to the groups the DPA had identified was almost $94,000, well in excess of the DPA's recommended disallowance of $60,094. (*Id.* at 115-16).

209. Exceptions. The Company excepted to the Hearing Examiner's recommendation. It argued that the DPA's 20% reduction was "arbitrary and unsupported." (DPL EB at 74). It again argued that its treatment of these expenses was consistent with its practice in prior cases and "the Commission's acceptance of such expenses," and that membership in these non-profit organizations improves the quality of life for all Delawareans. (*Id.*). Lastly, Delmarva identified that there was no argument that the expenses were incurred in bad faith or out of an abuse of discretion, and that these expenses are well accepted expenses of operating a regulated utility. (*Id.*).

210. Discussion and Decision. We adopt the Hearing Examiner's recommendation. Although the 20% reduction that the DPA witness made may seem somewhat arbitrary on its face, we have no evidence as to what percentage of these expenses relate to activities that are not directly related to providing electric service. We note that the record shows that the DPA asked the Company to quantify the amount of dues attributable to lobbying that were removed from this expense and no quantification was

[44] 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). (HER at 115-116).

provided. We know organizations such as Chamber of Commerce, the Committee of 100 etc., engage in lobbying activities. In the absence of a specific number, we will rely on the DPA witness, whose opinion is based on a review of other electric utilities in other proceedings, her review of the organizations, and recognition of the fact that the specific level of hard and soft lobbying activity varies from organization to organization. (Unanimous).

13. <u>Wilmington Franchise Tax</u>

211. The Company includes in its conversion factor a 0.106% allowance for the Wilmington franchise tax. Thus, the Company collects this tax from all of its customers irrespective of where they live. But the municipal services funded by this franchise tax are not available to the people who do not reside in the City of Wilmington. Staff argued that only Delmarva electric customers who actually receive the municipal services should be assessed the tax. (Exh. 11 (Peterson) at 35).

212. The Company did not take a position on this issue, but did agree to make an adjustment if the Commission so ordered. (Tr. at 618-19).

213. <u>Discussion and Decision</u>. We agree with Staff that customers who do not reside in the City of Wilmington should not be assessed the Wilmington franchise tax. Thus, we will order the Company to change its customer assessments to reflect the removal of the component related to the Wilmington franchise tax (0.106%) from the rates of customers not living in the City of

Wilmington and who are not receiving the municipal services that the tax is meant to fund. (Unanimous). This assessment change must be applied within a reasonable time period. We direct Staff to work with the Company on this issue and to report to the Commission once the new assessment has been applied.

14. Interest Synchronization

214. There was no opposition to the request that the interest expense associated with the debt portion of the overall return requirement reflect the rate base approved in this proceeding. Because the amount of the overall return requirement is lower than the Company's filed position, the actual interest expense will be lower and income taxes will be higher as the result of a smaller adjustment. (Unanimous).

F. Cost of Capital and Return on Equity ("ROE")

1. Capital Structure

215. For purposes of determining the overall rate of return, except as described below, the parties agreed on the Company's actual 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%. (Exh. 2 (Boyle), Sch. (FJB)-1; Exh. 3 (Hevert) at 33; Exh. 15 (Parcell) at 3; Exh.11 (Peterson) at 5).

2. ROE

216. As a result of the settlement in Delmarva's most recent rate case, Docket No 11-528, its current ROE is 9.75%.[45] Initially, Delmarva's cost of capital witness Mr. Hevert found that his studies supported an ROE between 10.25% and 11.00%. Although in his view 10.50% was reasonable and appropriate, the Company proposed a 10.25% ROE, which was at the low end of his suggested range. (Exh. 3 (Hevert) at 2). According to Mr. Hevert, the Company's recommendation of 10.25% is reasonable, if not a conservative estimate of its ROE. (*Id.* at 2).

217. Public Advocate Witness Parcell's ROE studies supported an ROE in the range of 9.20% to 9.50%; thus, he recommended a 9.35% ROE. (Exh. 15 (Parcell) at 35). Staff did not sponser a witness, but instead relied on Mr. Parcell for its recommended equity return for Delmarva. (Exh. 11 (Peterson) at 5).

218. Both Messrs. Hevert and Parcell agreed on several general issues in determining the appropriate ROE for Delmarva: (1) The guidelines for determining a public utility's ROE are found in the Supreme Court's rulings in *Bluefield* and *Hope*[46] (Exh. 3 (Hevert) at 4; Exh. 15 (Parcell) at 5-6); (2) since Delmarva is not a publicly-traded company, its ROE must be determined through analysis of comparable publicly-traded utilities (called a proxy group) (Exh. 3 (Hevert) at 5; Exh. 15 (Parcell) at 19); (3) use of a constant growth discounted cash

[45] Docket No. 11-528, Order No. 8265 (Dec. 18, 2012), ¶1.
[46] *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

flow ("DCF") methodology and a Capital Asset Pricing Method ("CAPM") methodology to estimate Delmarva's ROE; and (4) general economic conditions are important in determining the appropriate COE for a utility. (Exh. 3 (Hevert) at 27-30; Exh. 15 (Parcell) at 8-14).

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

219. Mr. Hevert performed several financial analyses to develop his recommended ROE. As a first step, he selected a proxy group of 12 publicly-traded utility companies using the following selection criteria: the company (1) consistently pays quarterly cash dividends; (2) is covered by at least two utility industry equity analysts; (3) has investment grade senior unsecured bond and/or corporate credit ratings from Standard & Poor; (4) regulated utility operating income over the three most-recently reported fiscal years represents at least 60% of combined income; (5) regulated electric operating income over the three most-recently reported fiscal years represents at least 90% of total regulated operating income; and (6) must not be known to be a party to a merger or other significant transaction. (Exh. 3 (Hevert) at 7). Thirteen companies satisfied those criteria; however, he eliminated Edison International based on some factors unique to it. (*Id.* at 8-9). The utilities comprising his final proxy group were American Electric Power Co., Inc.; Cleco Corp.; Empire District Electric Co.; Great Plains Energy, Inc.; Hawaiian Electric Industries, Inc.; IDACORP, Inc.; Otter Tail Corp.; Pinnacle West Capital Corp; PNM Resources, Inc.; Portland General

Electric Co.; Southern Co.; and Westar Energy, Inc. (*Id.* at 9). He then applied constant growth DCF, CAPM, bond yield plus risk premium, and multi-stage DCF models to these proxy companies.

(1) Constant Growth DCF Model

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

221. Mr. Hevert calculated the dividend yield component of his constant growth DCF model based on the proxy companies' current annualized dividend and average closing stock prices over the 30-, 90- and 180-trading day periods as of February 15, 2013 (direct testimony) and the average closing stock prices over the same length trading periods as of July 31, 2013 (rebuttal testimony). (*Id.* at 11-12 and Sch. RBH-1; Exh. 18 (Hevert-R) at Sch. (RBH-R)-1). He testified that averaging three periods avoids anomalous events that might affect stock prices on any given day and are reasonably representative of long-term capital market conditions. (*Id.* at 12). He adjusted the dividend yield

by applying one-half of the long-term growth rate to the current dividend yield to account for the fact that utilities increase their quarterly dividends at different times during the year. (*Id.*).

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

223. Mr. Hevert's updated constant growth DCF model produced the following results:

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

(Exh. 18 (Hevert-R) at Sch. (RBH-R)-1). The same results from his direct testimony were:

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

(Exh. 3 (Hevert) at Sch. (RBH)-1.

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

(2) <u>Multi-Stage DCF Model</u>

225. In his rebuttal testimony, Mr. Hevert also reported the results of a multi-stage DCF study that focused on cash flow, growth rates over the near term, intermediate term and long term. (Exh. 18 (Hevert-R) at 20-21). In the first two stages, cash flows equal projected dividends; in the last stage, cash flows equal both dividends and the expected sale price of the stock at the end of the period (the "terminal price"). (*Id.* at 20). The terminal price is defined by the present value of the remaining cash flows in perpetuity. In each stage, the dividend is the product of the projected earnings per share ("EPS") and the expected dividend payout ratio. (*Id.* at 20-21). Mr. Hevert testified that the primary benefit of the multi-stage DCF model

is its flexibility; it avoids the limiting assumption in the constant growth DCF model that the company will grow at the same constant rate forever because it is able to specify near-, intermediate- and long-term growth rates. Since it calculates the dividend as the product of EPS and the payout ratio, analysts can include assumptions regarding the timing and extent of changes in the payout ratio. It is not limited to a single source for its inputs and so mitigates the potential bias of relying on a single source for EPS growth estimates. Finally, it enables the analyst to assess the reasonableness of the inputs and results by reference to market-based metrics. (*Id.* at 21). Applying his multi-stage DCF model, Mr. Hevert derived ROEs for his proxy companies ranging from 9.48% to 10.66%, with the following means:

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

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

(3) <u>CAPM Model</u>

226. Mr. Hevert also performed a CAPM analysis. The CAPM, which is similar to a risk premium approach, estimates the cost of equity for a given security by adding a return for non-diversifiable risk to a risk-free rate. The model has four inputs, each of which must be estimated: the company's required

market return; the security's beta coefficient; the risk-free rate of return; and the required return on the market as a whole. (Ex. 3 (Hevert) at 15). The CAPM theory posits that investors are only concerned with systematic (non-diversifiable) risk, since unsystematic risk can be eliminated by diversification. Beta represents systematic risk. A higher beta indicates greater volatility; a company with a 1.00 beta is as risky as the overall market and so provides no diversification benefit. (*Id.* at 16).

227. Mr. Hevert calculated the CAPM-derived ROE using two measures of the risk-free rate input: the current 30-day average yield on 30-year Treasury bonds (3.12%) and the near-term projected yield on the same investment (3.25%). He also developed two estimates of the market risk premium ("MRP") input. The first estimate used the market-required return minus the 30-year Treasury bond yield. He estimated the market-required return by calculating the average ROE based on the constant growth DCF model using Bloomberg and Capital IQ data. He derived the average DCF result for both by calculating the average expected dividend yield and combining it with the average projected earnings growth rate. He then subtracted the current 30-year Treasury yield from this amount to reach the market DCF-derived MRP. (*Id.* at 17-18; Sch. (RBH-2)).

228. Mr. Hevert's second MRP estimate input was based on the principle that investors require higher returns for higher risk. It relied on the Sharpe ratio, which is the ratio of the long-term average risk premium for the S&P 500 Index to the risk

of that index. (*Id.* at 18). He used the 30-day average of the Chicago Board Options Exchange's ("CBOE") three-month volatility index and the average of futures settlement prices on the CBOE's one-month volatility index for the July-September 2013 period, which he stated are "market-based, observable measures of investors' expectations regarding future market volatility." (*Id.* at 19). For the beta input into his CAPM model, Mr. Hevert used the average reported beta coefficient from Bloomberg and Value Line. (*Id.* at 19-20).

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

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

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

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

(Exh. 3 (Hevert) at 20).

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

(4) <u>Bond Yield Plus Risk Premium Model.</u>

231. Finally, Mr. Hevert performed a Bond Yield Plus Risk Premium study. This model is based on the assumption that common equity holders are exposed to more risk than bondholders and therefore require a higher return than bondholders. The equity risk premium ("ERP") is the difference between the historical ROE and 30-year Treasury yields. Mr. Hevert believed it was reasonable to use actual authorized returns for electric utilities as the historical ROE since he was using the approach to calculate the ERP for electric utilities. (Exh. 3 (Hevert) at 21). He used the RRA research for this input. He also calculated the average period between the filing of a case and the date of the final order (or what he called the "lag period"). For the long-term bond yield input, he calculated the average 30-year Treasury yield over the average lag period (approximately 201 days). (*Id.* at 21-22). He testified that this analysis could also be used to address the stability of the ERP because the data covered a number of economic cycles and was "particularly relevant" in light of the current historically low Treasury yields. (*Id.* at 22).

232. Mr. Hevert performed a regression analysis in which the ERP was the dependent variable and the long-term yield was the independent variable to determine the relationship between interest rates and the ERP. He noted that the RRA report included periods of "very high" and "quite low" interest rates and authorized returns and accounted for that variability by using the semi-log regression, which expresses the ERP as a

function of the natural log of the 30-year Treasury yield. (*Id.* at 22-23). His results indicated a statistically significant negative relationship between the long-term yield and the ERP over time; therefore, he concluded that simply applying the 4.39% long-term ERP would "significantly understate" the ROE and produce results "well below any reasonable estimate." (*Id.* at 23). Using the regression coefficients in his analysis, he determined that the implied ROE ranged from 10.23% to 10.76%. (*Id.* and Sch. (RBH)-5).[47]

b. The DPA's Position.

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

[47]Mr. Hevert also discussed issues involving associated business risk with the small size of a particular utility and flotation costs. Since we have historically not made adjustments for these items, we choose not to discuss them further in this decision other than to note that the Company's witness raised them again.

(1) <u>DCF Model</u>

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

235. Mr. Parcell testified that the DCF's dividend growth rate component is usually the model's "most crucial and controversial" input. (*Id.* at 22). He noted that the objective of estimating this component is to reflect the growth that investors expect that is embodied in the price and yield of a company's stock. Since every decision to sell stock at a particular price is matched by another decision to buy that stock at the same price, individual investors have different expectations and consider alternative growth indicators in deriving their expectations. (*Id.*). The fact that there are several indicators for estimating investors' growth expectations indicates that investors do not always use a single growth indicator; therefore, analysts should use more than one growth indicator to determine the dividend growth input. (*Id.* at 22-23). Mr. Parcell considered five such indicators, which he called "appropriate and representative" for estimating investor expectations of dividend growth: (1) Value Line five-year average (2008-12) earnings retention ("fundamental growth"); (2) Value Line five-year average of historic growth in EPS, dividends per share ("DPS"), and book value per share ("BVPS"); (3) Value Line projected earnings retention growth for 2013. 2014 and 2016-

18; (4) Value Line 2010-12 to 2016-18 EPS, DPS and BVPS projections; and (5) First Call five-year EPS growth projections. (*Id.* at 23).

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

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

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

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

(2) <u>Comparable Earnings Model</u>

238. The comparable earnings ("CE") model for estimating the ROE comes from the "corresponding risk" standard of the *Bluefield* and *Hope* cases and is based on the economic concept of opportunity cost -- the prospective return available to investors from alternative investments of similar risk. (*Id.* at 28-29).

It is designed to measure the returns expected to be earned on the original cost book value of enterprises of similar risk; as such, it provides a direct measure of a fair return since it translates into practice the competitive principle upon which regulation rests. (*Id.* at 29). It normally examines the experienced and/or projected returns on book common equity; this follows from the use of rate base regulation for public utilities. In turn this cost of capital is the fair rate of return applied to the book value of rate base to establish the revenue requirement. (*Id.*).

239. The CE model requires the analyst to examine a relatively long period to determine earnings trends over at least a full business cycle and to avoid undue influence from unusual or abnormal conditions that may occur in a shorter period. Mr. Parcell examined actual earned returns for the two groups of proxy companies and for unregulated companies for the 1992-2012 period,[48] and evaluated investor acceptance of those returns as evidenced by the resulting market to book ratios ("MTB ratios"). He testified that this made it possible to assess the degree to which a given return level equates to the cost of capital. He stated that for utilities it is generally recognized that MTB ratios greater than 1.0 (100%) reflect a situation in which a company is able to attract new equity capital without dilution (above book value). One objective of a fair ROE is maintaining stock prices at or above book value, but there is no regulatory

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

obligation to set rates that will maintain an MTB ratio significantly above one. (*Id.* at 30).

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

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

(*Id.* at 31 and Schs. DCP-10 and DCP-11).

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

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

(3) <u>CAPM Model</u>

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

244. Mr. Parcell used two alternatives for estimating the MRP input. First, he compared the actual returns on equity of the S&P 500 from 1978-2012 with the actual annual yields of Treasury bonds for the same period. His MRP from this analysis was 6.60%. (*Id.* at 27, Sch. DCP-8). Next, he considered the total returns (dividends/interest plus capital gains or losses)

for the S&P 500 group and for long-term government bonds as reported in Morningstar, using both arithmetic and geometric means. The MRPs using this alternative were 5.7% with the arithmetic mean and 4.1% with the geometric mean. (*Id.* at 27-28). Mr. Parcell testified that calculating the MRP using both arithmetic and geometric means was appropriate because investors have access both types of means; therefore, both types are presumably reflected in investment decisions. He concluded that the expected MRP was approximately 5.47% (the average of his three market risk premium calculations).

245. Mr. Parcell's CAPM results for his proxy group ranged from 6.3% to 7.7%, with a mean of 7.0% and a median of 6.9%. The results for the Hevert proxy group ranged from 6.0% to 8.2%, with a mean of 7.0% and a median of 6.9%. (*Id.* at 28, Sch. DCP-9). He acknowledged that his CAPM study results studies were low compared to the results of his DCF and CE studies, and identified two reasons for the lower CAPM results. First, risk premiums were currently lower than in prior years, reflecting a decline in investor expectations of equity returns and risk premiums. Second, the interest rate on Treasury bonds has been lower in recent years, partially as a result of the Federal Reserve's stimulus actions, which also affects investors' return expectations negatively. He noted that while investors may have initially believed that the decline in Treasury yields was temporary, that has not been the case: interest rates have remained at historically low levels despite the recent increases.

Consequently, he testified that "it cannot be maintained that low interest rates (and low CAPM results) are temporary and do not reflect investor expectations." (*Id.* at 34). At the very least, those results indicate that capital costs remain at historically low levels and that Delmarva's ROE is less than in previous years. (*Id.*).

246. Hearing Examiner's Recommendations. The Hearing Examiner started his analysis by stating that he was presented with only two options: The Company's proposed 10.25% ROE and the DPA's/Staff's suggested 9.35% ROE. (HER at 48). He commented several times that Staff did not present a ROE witness, although he did note that Staff relied upon the DPA's ROE witness. Noting that Delmarva had presented four models (a constant growth DCF, a multi-stage DCF, a CAPM, and a bond yield plus risk premium model) and the DPA/Staff only presented two models (a constant growth DCF and a CE model),[49] he recommended that the Commission award a 10.25% ROE to the Company.

247. The Hearing Examiner found Mr. Hevert's constant growth and multi-stage DCF models to be the more credible ROE analyses. He also found it important that Mr. Parcell did not offer a multi-stage DCF analysis in addition to his constant growth DCF evaluation. (HER at 32-33).

248. The Hearing Examiner stated that he was sensitive to increasing rates for ratepayers during these challenging economic times, but found that Mr. Parcell's approach "excessively" relied

[49] As will be discussed *infra*, the Hearing Examiner erroneously stated that DPA/Staff witness Parcell had rejected the results of his CAPM study.

upon the historical average earnings retention growth rates and average historical growth in EPS, DPS and BVPS from the 2008 recession through and including 2012. (*Id.* at 33). He concluded that since the worst of the national financial crisis had ended, Mr. Parcell's approach resulted in an "overly conservative" ROE estimate. (*Id.*). He noted that at the evidentiary hearing, both Mr. Hevert and Mr. Parcell testified that interest rates have increased since November 2012. He credited Mr. Hevert's testimony that as interest rates increase, the Company's ROE generally should also increase, even if not to the same degree. Conversely, if interest rates decrease, then generally the Company's ROE should decrease. The Hearing Examiner also pointed out that Mr. Parcell also acknoweldged a relationship between interest rates and a utility's ROE. (HER at 35). The reason for the 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." (Exh. 18 (Hevert-R) at 40).

249. The Hearing Examiner found Mr. Hevert's multi-stage DCF analysis as persuasive as his constant growth DCF analysis in this docket because the multi-stage DCF analysis does not assume that earnings and dividends will grow indefinately at the same rate and relies upon multiple earnings growth projections and longer-term financial market metrics. The Hearing Examiner found both of these features to be 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." (HER at 36, citing Exh. 18 (Hevert-R) at 43).

250. The Hearing Examiner acknowledged that Mr. Hevert's updated constant growth DCF analysis in his rebuttal testimony exceeded his proposed 10.25% ROE in only his high earnings growth scenario, but not in his low or medium growth scenarios. (*Id.* at 36). He accepted Mr. Hevert's explanation that decreases in the constant growth DCF results were difficult to reconcile with current market conditions, particularly the significant increase in interest rates, and should be viewed with caution. (*Id.*). Furthermore, the results of Mr. Hevert's mean and mean high growth earnings scenarios in his direct testimony exceeded 10.25%. (*Id.*). He dismissed the DPA's criticism of Mr. Hevert's use of the highest individual growth rate, noting that Mr. Hevert had also offered both mean and median results to be analyzed by the Commission as well. Thus, he found Mr. Hevert's DCF analysis more persuaive than Mr. Parcells' DCF testimony. (*Id.*).

251. With respect to the witnesses' CAPM results, the Hearing Examiner began by noting that DPA witness Parcell had esentially rejected his CAPM results because they were too low. (*Id.* at 39). He credited Mr. Hevert's opinion that low interest rates will not continue indefinately, and accordingly, traditional CAPM model results do not reflect the appropriate range of ROE estimates. He accepted Mr. Hevert's testimony that if one inverts the relationship between the tradional CAPM model

and interest rates and employs regression anaylsis, one can develop reasonable ROE estimates. (*Id.* at 39). Through this analysis, Mr. Hevert was able to develop CAPM results that exceeded his ROE estimates, which the Hearing Examiner found more persuasive than Mr. Parcell's CAPM testimony, since Mr. Parcell did not rely on his CAPM results. (*Id.* at 43).

252. Although the Hearing Examiner observed that Mr. Hevert had performed a risk premium analysis and Mr. Parcell had performed a comparable earnings study, he did not address them at any length in his recommendations. (HER at 47-48)

253. <u>Exceptions.</u> The DPA and Staff excepted to the Hearing Examiner's findings and recommendations. Both argued that the Hearing Examiner's recommended 10.25% ROE was too high and was not supported by the record. They pointed out that the results of Mr. Hevert's DCF studies were much lower than his recommended ROE of 10.25%. (Staff EB at 21; DPA EB at 18). Both contended the Hearing Examiner's statement that he was constrained to recommend only one or two specific data points was erroneous. Both suggested that the Hearing Examiner appeared to have been swayed by the number of models used rather than the results of those models. (Staff EB at 25; DPA EB at 13). Indeed, with regard to the latter contention, the DPA pointed out that in Docket No. 09-414, the Commission was persuaded by the analysis of a witness who performed fewer analyses than Delmarva's own witness, observing that this Commission has never found an ROE witness less credible based solely on the number of models

employed in reaching an opinion on this issue. (DPA EB at 13). Both pointed out that DPA witness Parcell has submitted testimony to the Commission and appeared before it in numerous cases over the course of many years, unlike Mr. Hevert, who was appearing before the Commission for only the second time. (Staff EB at 15; DPA EB at 12). And both argued that other Commissions before which Mr. Hevert has appeared have rejected his analyses and recommendations; one commission even called his ROE recommendation "excessive and unjustified." (Staff EB at 13; DPA EB at 12).

254. In addition to the foregoing, Staff criticized the Hearing Examiner's recommendation for its reliance on the testimony of one witness to the exclusion of other opinions in recommending the highest ROE for any PHI operating company. Staff argued that case law was well settled that the establishment of a rate of return on common equity within a range of reasonableness is all that is required of a Commission to set just and resonable rates. (Staff EB at 24). Here, Staff noted, that range extended over 90 basis points. (*Id.*). Staff also pointed out if the Commission adopted the Hearing Examiner's recommendation it would be the first Commission to specifically adopt Mr. Hevert's testimony, would grant Delmarva the highest ROE of any of the other PHI operating companies, and would cause Delmarva ratepayers to subsidize Maryland and District of Columbia customers with higher rates. (*Id.* at 25).

255. Staff also took issue with the Hearing Examiner's reliance on the Company's multi-stage DCF that was first presented at the rebuttal stage, at which point Staff and the DPA had no opportunity to analyze it and respond to it. (Staff EB at 13-14).

256. Staff expressed concern that the Hearing Examiner appeared to assume that higher interest rates necessarily translate into a higher ROE for a utility. Staff noted even though both witnesses agreed that interest rates had gone up since Novemeber 2012, shortly before the Commission's decision in Docket No. 11-528, they both had recommended lower ROEs in this proceeding (Hevert lower by 50 basis points; Parcell by 25). (*Id. at 14.)*

257. The DPA also took issue with the Hearing Examiner's opinion that he was limited to only two options in deciding this issue. It noted that this Commisison has specifically rejected such limitations, citing earlier decisions involving Delmarva where we selected an ROE within the range of those that the winesses recommended. (DPA EB at 9-10). The DPA pointed to other Commission decisions rejecting Mr. Hevert's analyses. (*Id*. at 11).

258. In addition to the previously identified contentions, the DPA took issue with the Hearing Examiner's conclusion that Mr. Hevert's DCF studies were more persuasive. It contended the Hearing Examiner's reliance on Mr. Hevert's multi-stage DCF analysis was inappropriate since it was only presented in his

rebuttal testimony, affording the DPA no opportunity to respond. (*Id.* at 12). Moreover, the DPA pointed out, that before Delmarva retained Mr. Hevert, none of its prior ROE witnesses had ever offered a multi-stage DCF as part of their analysis. (*Id.*).

259. The DPA next argued it was unclear from the Hearing Examiner's discussion whether he had given Delmarva's contentions regarding potential downgrading any credence, but if he had, Delmarva was in no danger of being downgraded; in fact, the DPA pointed to a recent Moody's publication identifying several utilities – including Delmarva and even Pepco with all its troubles – for potential *upgrading.* (*Id.* at 13-14).

260. With respect to the Hearing Examiner's discussion of the witnesses' DCF studies, the DPA contended the Hearing Examiner ignored Mr. Hevert's inconsistency in suggesting that the increase in interest rates warranted an increase in the Company's authorized ROE when he had been unwilling to agree that decreases in interest rates warranted decreases in authorized ROEs. (*Id.* at 14-15). Furthermore, the DPA argued the Hearing Examiner had given no consideration to the fact that the companies in both witnesses' proxy groups were riskier than Delmarva (because many of them still have generation plants which are riskier than pure transmission and distribution utilities), which would justify a lower authorized ROE for Delmarva. (*Id.* at 15-16). The DPA further took issue with Mr. Hevert's use of only projected EPS rates as the growth rate input into the DCF (and the Hearing Examiner's acceptance of that since he recommended

Mr. Hevert's proposed ROE; argued that the Hearing Examiner improperly relied on materials that were outside the record (*Id.* at 19-20); contended his criticism of Mr. Parcell's "excessive" reliance on historical data was erroneous, since three of the five growth measures that Mr. Parcell used were projections; and argued that although Mr. Hevert admitted that a company cannot grow indefinitely at faster rate than the market in which it sells its product, his growth rates far exceeded quarterly real GDP growth rates. (*Id.* at 19-21).

261. With respect to the CAPM, the DPA argued the Hearing Examiner erroneously concluded that Mr. Parcell had rejected his study results because he did not include them in his averaging of the results of his ROE models. The DPA pointed out Mr. Parcell testified that although he did not include these results in his averaging, they nonetheless should be considered in determining Delmarva's ROE because they indicated that capital costs are at historically low levels and therefore Delmarva's cost of capital was lower than in previous years. (*Id.* at 22, citing Exh. 15 (Parcell) at 34). Furthermore, the DPA argued that if the Hearing Examiner found fault with Mr. Parcell's analysis in this regard, Mr. Hevert's CAPM results suffered from the same flaw since he testified that the results of his CAPM studies should not be considered in determining Delmarva's ROE. (*Id.* at 23, citing Exh. 3 (Hevert) at 20-21).[50]

[50] The DPA noted that in his rebuttal, Mr. Hevert testified that only the results of his Sharpe ratio-derived CAPM model studies should be disregarded. (DPA EB at 23).

262. The DPA next argued Mr. Hevert's bond yield plus risk premium analysis should be rejected. First, it noted that another Commission had rejected Mr. Hevert's model. Second, the DPA noted it relied heavily on historical data for one of its inputs, and the Hearing Examiner had criticized the DPA's DCF model for using historical data for one of the growth measures for the DCF. Last, the study relied on authorized ROEs that had not been seen for 10 years. (*Id*. at 24).

263. Finally, the DPA contended that to the extent the Hearing Examiner's recommended ROE contained adders for a small size effect and flotation costs (which it did, according to Mr. Hevert), it should be rejected because this Commission has consistently rejected flotation cost adjustments and because there was no evidence of any small size effect for utilities. (*Id*. at 24-25).

264. <u>Discussion and Decision.</u> We once again confirm that we rely primarily on the DCF to determine the appropriate ROE for the utilities we regulate.[51] Our decision on this important issue should and will be based on the facts presented to us in the case we are deciding, not on the specific ROEs awarded in other jurisdictions, which are dependent on the characteristics of those utilities. We understand that the experts for the various parties may differ with respect to their opinions on this issue, in favor of their respective clients and against the opposing

[51] *See e.g.*, *Delmarva Power*, Docket No. 09-414; *Delmarva Power*, Docket No 05-304; *Delmarva Power*, Docket No. 91-20.

side; to us that is good litigation and provides us with the most informed record on which to make our decision.

265. In reaching our conclusion we are mindful of the priciples sert forth in both the *Bluefield* and *Hope* decisions and cited by the two experts in their respective testimonies, which require a return on a utility's investment to be sufficient to attract capital on reasonable terms, maintain the financial integrity of the utility, and provide an opportunity to achieve a level of revenue that is comparable with investments of similar risks.

266. In that context, we reject the Hearing Examiner's recommendation. We specifically reject his belief that he was presented with only two options -- 10.25% and 9.35%. Rather, as we have indicated in prior decisions, the ranges determined by the witnesses who testify on this issue in the various proceedings establish the "zone of reasonablness" within which this Commission has the authority to set just and reasonable rates.[52]

267. We also recognize, and anchor to some extent, our decision on the fact that Delmarva's currently-approved ROE is 9.75%. We do not believe that the record reflects any significant changes in the economic environment faced by Delmarva since December 2012, when we last approved an ROE for this Company. Although there is some evidence of a modest increase in

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[52]*See* PSC Order No. 8011, ¶ 285 at 113 (August 9, 2011*) and generally*, *Federal Power Comm'n v. Hope*, 320 U.S. 591(1944); *Federal Power Comm'n v. Natural Gas Pipeline*, 315 U.S. 585, 586 (1942); see also *Permian Basin Area Rate Cas*es, 390 U.S. 747, 767, 806-813 (1967).

interest rates since then, we note that the Company's request in this case is 50 basis points less than in its prior case and that 10.25% is 50 basis points higher than what the Company settled for only three months before it filed this Application.

268. We note that Delmarva continues to face a similar economic environment as occurred in late 2012: Low interest rates, a continued slow recovery from the housing bubble-induced recession of 2008-09, and its stated intend to file rate cases more frequently, even as often as annually. Thus on a macro basis, there seems to be little reason to totally depart from the ROE peviously approved for Delmarva in Docket No. 11-528.

269. Turning to the specific methodologies utilized by the parties in this case, we find that the two experts' DCF analyisis have common ground. The average results of Delmarva's witness' studies are around 9.5%; the DPA's witness' range also includes 9.5%. Thus, this is a good starting place in determining what circumstances, if any, should be re-evaluated since the resolution of the prior case in December 2012 in determing the appropriate ROE in this case.

270. We recognize, as the Hearing Examiner did, that interest rates have gone up since Delmarva's last rate case (which settled), but the impact of those changes on equity costs is less than clear. Certainly, we do not believe there is a linear relationship of equity costs and the upward move in interest rates such that the two increase in tandem with each other. The Company's own witness was unwilling to agree to the

converse of that proposition, and, as Staff noted in its exceptions, he reduced his recommended ROE from his recommendation in Docket No. 11-528 by 50 basis points.[53] The average of his constant growth and multi-stage DCF studies are under 9.6%. Compared to Mr. Parcell's DCF analysis, this results in the intersection of the various analyses, including mean and median, at close to 9.5%.[54]

271. We have reviewed and considered the CAPM, risk premium and CE studies conducted by the two experts in support of their recommendations. Some of those studies suggest a somewhat higher return than the DCF models support. In addition, the current Commission-approved return is slightly higher than 9.5%. Accordingly, we will approve a ROE in this case of 9.7%. We believe this return properly reflects the various considerations articulated by the parties, the record before us, and our preference to give primary weight -- as we have over the years -- to the DCF results. We recognize that a return both higher and lower could be supported in this docket. But in our collective judgment, and based on our experience, we believe that 9.7% is the appropriate return and that it is supported by the record developed in this case. Our decision does not indicate any

[53]In fact as Staff noted, Mr. Hevert reduced his upper recommended range in his rebuttal testimony so that only the high growth scenario supported his recommended ROE, while in his direct testimony -- filed six months earlier -- both the medium and high range scenarios supported his recommendation. (Staff EB at 15).

[54]Like Mr. Hevert, Mr. Parcell also reduced his recommended ROE from Delmarva's last case. In Docket No. 11-528, he recommended a return of 9.55%, or 20 basis points higher than the return he recommended here. *See* Docket No 11-528, Exh. (Parcell) at 2.

adjustment for flotation costs or a small size effect. (3-1, Commissioner Clark voting no).

G. Class Cost of Service Study ("CCOSS")

272. As we explained in Docket No. 09-414, a fully-allocated CCOSS attempts to determine the individual costs to serve each customer class.[55] Moreover, it is intended to provide information to enable the regulator to allocate revenue requirements among the various customer classes. The unitized rate of return (UROR) is the ratio of any class' rate of return to the utility's rate of return, and is useful to see how well individual classes compare to each other. Ideally, all customer classes will closely approach a 1.0 UROR. A CCOSS frequently involves judgment in allocating costs among customer classes, and since the data used to develop allocation factor are not always complete or timely, regulators must often deal with uncertainty in a CCOSS.

273. Company witness Tanos explained how he designed the Company's CCOSS. (Exh. 8 (Tanos) at 4-6). He testified that functionalized costs are classified as demand-related or customer-related based on cost causation. (*Id.* at 5). Demand-related costs are fixed costs that are dependent on kW requirements and represent the instantaneous demand imposed on the system; customer-related costs are fixed costs associated with the number of customers served. (*Id.*). Once classified, the functionalized costs are apportioned to the particular

[55] *See* Order No. 8011 (August 8, 2011), ¶ 312.

customer groups. Distribution costs that serve only a particular customer class are directly assigned to that class. (*Id.*). The remaining costs are allocated to the customer groups based on a method that is considered most consistent with cost causation. (*Id.* at 5-6).

274. Mr. Tanos testified about the CCOSS model that Delmarva used to directly assign or allocate each element of rate base, revenues, and O&M expenses to the respective customer classes. (*Id.* at 6). The cost model includes allocation factors used to assign the specific components of Total Distribution cost to the customer classes. After allocating the Total Distribution costs, the costs are aggregated by customer class to determine the cost to serve each class and to compute the class rate of return for that class. (*Id.*).

275. Mr. Tanos testified that the Delaware CCOSS allocated Delmarva's costs to the retail customer class as follows: Residential; Residential Space Heating; General Service Secondary Small (Rates SGS-ND and MGS-S); General Service Secondary Large; General Service Primary; General Service Transmission; Street Lighting and Traffic Signals. (*Id.* at 7). He explained that Delmarva used the same basic cost of service model that it used in PSC Docket No. 11-528. He testified that the CCOSS reflects Delmarva's total distribution rate base, revenues, and expenses of Delmarva for the 12 months ended December 31, 2012. (*Id.*).

276. Mr. Tanos testified that pursuant to the settlement agreement in Docket No. 09-414, the parties conducted a workshop to address deficiencies that Staff had identified in its CCOSS in that case. (*Id.* at 7-8). Based on the discussions at the workshop, Delmarva agreed to: (1) use Delaware specific load survey data to estimate residential non-coincident peak demands; (2) use weather normalized sales and revenue data; (3) use an updated analysis of system losses; (4) allocate Account 369 (Service Lines) on the basis of a derived allocator; and (5) disaggregate traffic signal customers from the general street lighting class. (*Id.* at 8).

277. Staff witness Dr. Pavlovic contended that Delmarva's CCOSS was flawed and should not be used to distribute its revenue requirement among the customer classes for rate design purposes, particularly because it disregarded cost-causation principles. (Exh. 10 (Pavlovic) at 5, 12). Dr. Pavlovic argued that Delmarva's CCOSS failed to comport with cost-causation principles in three primary ways: (1) Delmarva only apparently functionally separates underground and overhead facilities and then used the same demand allocator for both underground and overhead facilities, which in effect undid the separation; (2) its demand allocators [Secondary Demand or "DEMSEC" and Line Transformer Demand or "DEMTRNSF"] do not reflect any diversity at the load center level as discovered via responses from Staff's Data Requests; and (3) it employs four composite allocators that use an arbitrary 50/50 weighting of other allocators. (*Id.* at 12).

Dr. Pavlovic testified that it is extremely unlikely that exactly 50% of Delmarva's transformers serve single customers and 50% serve multiple customers. (*Id.* at 15 (citing PSC-COS-30 and PSC-EPT-10 and 11)). Hence, Staff urged the Commission not to accept Delmarva's CCOSS.

278. DPA witness Dr. Dismukes testified that he disagreed with Delmarva's use of two allocation factors in the CCOSS: (1) a labor allocator to allocate general and common plant accounts; and (2) an allocator derived from a 50% weight on number of customers and 50% energy sales to allocate Accounts 907 through 913. (Exh. 14 (Dismukes) at 33). Dr. Dismukes reasoned that Customer Service, Information, and Sales Accounts listed in Accounts 907 through 913 are widely accepted as customer-related expenses and are more associated with the number of customers on the utility's system than the total amount of energy sold to end-use customers. (*Id.* at 35-36). He therefore recommended that the Commission adopt a customer-based allocation factor for these accounts and prepared an alternative CCOSS using his recommended allocation factors of total distribution plant for general and common plant accounts and a customer-based allocation factor for Accounts 907 to 913. (*Id.* at 33, 35-37).

279. Dr. Dismukes also identified issues with Delmarva's load data research: (1) the load data Delmarva used in the CCOSS was based on calendar year 2011 usage, even though it used financial data for a 2012 test year; and (2) Delmarva had not verified the validity of its load research sampled since an April

2008 analysis that used September 2007 billing data. (*Id.* at 32-33).

280. DEUG witness Phillips testified that Delmarva's CCOSS generally comported with normally accepted cost of service study methods; however, he contended that the classification and allocation of certain distribution plant accounts should be modified to classify a portion of those costs as customer-related. (Exh. 16 (Phillips) at 3). DEUG contends that DEUG's revised CCOSS reflected that at current rates, the rates associated with the General Service Secondary and General Service Primary rate classes were above cost of service. (*Id.)*. DEUG witness Phillips argued that certain distribution investments must be made to connect a customer to the system, and therefore these investments are considered customer-related; therefore, the CCOSS should classify and allocate a portion of distribution plant costs associated with Accounts 364 through 367 on a customer basis because this approach is consistent with general ratemaking policy objective, such as customer equity, conservation and revenue stability. (*Id.* at 3, 18). Phillips proposed that the Commission use the MDS approach for determining CCOSS which is based on the principle that there is a minimum cost incurred by any utility when it extends its primary and secondary distribution systems and connects an additional customer to them. (*Id.* at 10-11).

281. Regarding Staff's arguments, Mr. Tanos disagreed that Delmarva's demand allocators assumed zero diversity. He

reiterated how each of Delmarva's demand allocators were identified and how he applied the respective customer class demands to allocate the costs related to the facilities. (Exh. 22 (Tanos-R) at 2-3). He testified that using a 50/50 weighting of class diversified demands and customer maximum non-coincident demands recognized this aggregation and was a reasonable and manageable approach to achieve a fair allocation of these costs. (*Id.* at 4). Mr. Tanos also testified that almost every new residential subdivision in Delaware is installed with underground facilities, so there was no basis to conclude that commercial customers are responsible for the majority of undergrounding costs. (*Id.* at 5-6). He further testified that there was no simple way to merge Delmarva's Customer Information System, AMI load data and GIS distribution system component data into one system and to link the distribution component information to the massive load information for cost analysis and cost assignment purposes. (*Id.* at 7). He concluded that Delmarva's CCOSS provided a reasonable and practical approach to achieve a fair allocation of the cost to serve each customer class. (*Id.*).

282. Regarding the DPA's arguments, Mr. Tanos testified that since the cost of service year ended December 2012, the most recent set of annual demand measures were based on 2011. (*Id.* at 8). Further, he stated the Company performs regular monthly checks of sample statistical reliability as part of the monthly load profiling process and the validity of the sample is also checked. (*Id.*). Mr. Tanos also testified that he had used a

labor allocator to allocate the costs of General and Common Plant because: (1) the expense accounts to which it was applied were labor-oriented or labor-based; (2) the labor ratio approach was recognized by FERC; and (3) using the labor allocator was currently the dominant method for allocating general plant in the industry. (*Id.* at 10-11). Mr. Tanos also disagreed with the DPA's argument that Customer Information and Sales Expenses (FERC Accounts 907 to 913) should be allocated based on the total number of customers. (*Id.* at 11). He stated that using only the number of customers to allocate the costs of those accounts would assign the vast majority of such costs essentially to the Residential class, whereas these O&M accounts included services that benefit all customers who receive electric service. (*Id.*).

283. Mr. Tanos testifed that he also disagreed with DEUG's recommendation that a MDS approach should be used to classify distribution plant costs because it was flawed. First, he noted that Delmarva does not make distribution investment decsions based on a hypothetical minimum system to connect customers who have no load, i.e., a phantom system that no utility would build. (*Id.* at 12). Second, the MDS had fundamental flaws that can disproportionately impact the residential class customers. Third, there was a practical concern for a MDS analysis because of the availability of the data needed to conduct such an analysis. Finally, the MDS approach had many inherent problems and shortcomings that have led companies to abandon such methods. (*Id.*). Mr. Tanos also advised that DEUG had recommended use of

the MDS for Delmarva in PSC Docket No. 05-304 and that the Commission had rejected that approach in that docket. (*Id.* at 13). In addition, in this docket, DEUG did not prepare an independent MDS analysis of Delmarva Delaware's system, but rather used data from a Maryland MDS analysis. (*Id.* at 14). Mr. Tanos concluded that Delmava's CCOSS was consistent with the Company's submissions in prior cases; that it was the starting point for the approved rate designs in those cases; and that it provided a reasonable and practical approach to achieve a fair allocation of costs to the respective customer classes. (*Id.* at 16).

284. Hearing Examiner Recommendation. The Hearing Examiner recommended that Delmarva's CCOSS be adopted "as is" with the changes agreed upon at the Commission-ordered workshop. (HER at 130). The Hearing Examiner based his recommendation primarily on the fact that the Commission had approved Delmarva's approach in Docket Nos. 05-304, 09-414, and 11-528. (*Id.* at 130-31). He also recommended that the Commission order Delmarva to include all available AMI data in the CCOSS in its next rate case, 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. He further required that the data must be current as of one month prior to the filing date of Delmarva's next rate case. (*Id.* at 132). The Hearing Examiner

also determined that DEUG's position should not be adopted. (*Id.*).

285. Exceptions. Delmarva excepted to the Hearing Examiner's recommendation that it incorporate all available AMI into the CCOSS in its next rate case and that the AMI data used be current as of one month of the date of filing. Delmarva argued that until a full year of AMI data is available, it is not possible for it to use the available AMI data to develop the CCOSS for ratemaking purposes; therefore, the consequence of adopting the Hearing Examiner's recommendation would be to prohibit the Company from filing its next rate case until it has a full year's worth of AMI data. This recommendation serves to modify the MFRs and is beyond the authority of the HE. (DPL EB at 80). In addition, Delmarva argued that it was problematic for it to develop reliable demand allocators differentiated by overhead and underground distribution systems.

286. Staff argued that Delmarva failed to present sufficient record evidence to show that the CCOSS, and the Company's method of allocation for the costs of its distribution system, followed the principles of cost causation; hence, its CCOSS model should not be adopted in this proceeding. First, Staff argued that there was no record evidence that residential customers had a greater demand for the more expensive underground installations than commercial customers. (Staff EB at 46-47). Second, Staff contended that Delmarva had failed to prove that half of its transformers serve single customers and half serve

multiple customers, noting that it had failed to present any empirical studies to confirm the proposed 50/50 demand split for its line transformers. (*Id.*). Third, Staff argued that the Hearing Examiner erroneously stated that Delmarva's cost allocation approach used in its CCOSS had been "approved by the Commission" in prior dockets. (*Id.* at 48). Finally, Staff clarified that it was not advocating the use of AMI data in this proceeding (as stated in the HER) and had not argued that Delmarva used a "single allocator" for underground and overhead distribution facilities; rather, the single allocator was a reference to one allocator that failed to reflect the differences in the customer classes' use of the overhead and underground facilities. (*Id.*). In sum, Staff urged the Commission not to use the existing CCOSS to set rates in this docket.

287. DEUG argued in its exceptions that Delmarva's CCOSS failed to reflect a reasonable customer component in the classification and allocation of certain distribution plant costs resulting in proposed rates for the GSP customer class, in particular, that are inflated and that would produce revenues substantially above the cost of service. (DEUG EB at 1-2). DEUG also argued that Delmarva's CCOSS completely disregarded that the costs of constructing, maintaining, and repairing a widespread distribution network to serve numerous residential customers is necessarily greater than the costs of providing distribution service to a relatively few industrial customers. (*Id.* at 3).

288. Discussion and Decision. The Commission adopts Delmarva's CCOSS for the reasons discussed by the Hearing Examiner. Although Delmarva needs to review the issues raised by Staff (regarding demand allocators and cost allocation) and by DEUG (regarding a customer component), the Commission believes Delmarva best understands its own distribution system and has created a CCOSS that reasonably allocates the costs for it. Regarding the load data that Delmarva uses for its next rate case, the Commission agrees with Staff and the DPA that the load data to be used for the CCOSS should be consistent with the test period the Company uses. If Delmarva cannot use such load data that is consistent with its chosen test period, it should attempt to work the issue out with Staff and DPA or, barring such agreement, file a petition for an exception from this portion of the Order and should explain why it cannot use load data consistent with the test period. As for the use of AMI data for its CCOSS, Delmarva will continue to use the data it has for rate case purposes rather than being required to wait until it has a full year of AMI data sufficient to use in the CCOSS. (Unanimous).

H. General Rate Design and Revenue Distribution Issues

289. Delmarva witness Santacecilia testified that the Company's goal in modifying any rate structure was to provide retail electric delivery rates that reflect the underlying costs to provide electric service. (Exh. 6 (Santacecilia) at 2-3). She further testified that the design of electric delivery rates

which accurately reflect costs can be evaluated by the degree to which the rate structure meets two criteria: (1) the extent to which rates for customers in a given service classification fully recover the delivery costs allocated to that class; and (2) the extent to which the rate structure for service classifications accurately reflect the functionalized costs associated with providing delivery serve to that class. (*Id.* at 3). Using a Unitized Rate of Return ("UROR") was a straightforward way to achieve the first goal. To balance both the UROR goal and the concerns involving customer impacts, Ms. Santacecilia suggested a two-part method for the allocation of the revenue requirement between service classifications. Any service classification with a UROR outside the bandwidth of 0.90 to 1.10 of the total UROR would receive a revenue requirement increase that would move their UROR to within the bandwidth. The remaining increase would be spread to all service classes equally. In addition, Ms. Santacecilia recommended a cap so that a service classification could not receive an increase of more than approximately 150% of the overall average delivery percentage increase. (*Id.* at 3-4). Regarding designing delivery rates to better reflect functionalized costs, delivery costs can be functionalized into two categories: demand costs and customer costs. Ms. Santacecilia proposes maintaining the current rate structure that consists of a customer charge and a delivery charge. (*Id.* at 5).

290. Because Staff believed that Delmarva's CCOSS is based on incorrect assumptions, it argued that the Commission should

reject Delmarva's resulting rate design and revenue requirement distribution proposals. (Staff AB at 94-95). Staff further argued that using the UROR to distribute the revenue requirement was futile because the underlying principle for the UROR procedure is flawed, i.e., no economic theory requires that all classes produce the same ROR. (*Id.* at 95; Exh. 10 (Pavlovic) at 19). In addition, Staff argued that Delmarva failed to use a billing component for demand for more than half of its customers. Although Delmarva argues that the "appropriate demand data" needed to determine proper allocation of costs is not available, in fact this assertion is incorrect. (*Id.*) Staff argued that such data is available to measure demand via the AMI meters. (*Id.*; Exh. 5 (Ziminsky) at 17; Exh. 8 (Tanos) at 6).

291. The DPA argued that Delmarva's proposed rate design was unjust and unreasonable for residential customers and that gradualism should be applied in light of the recent rate increases that they have experienced. (DPA AB at 153-56).

292. DEUG argued that its adjusted CCOSS should be used as a guideline in the revenue allocation and rate design in this proceeding. (Exh. 16 (Phillips) at 18). In addition, DEUG argued that its revised CCOSS should be used to allocate any distribution revenue increase in this proceeding, as well as in the design of distribution rates. (*Id.* at 3).

293. Ms. Santacecilia testified on rebuttal that using the UROR method to distribute the revenue requirement is proper because Delmarva is regulated and as such bases its prices on

costs appropriately assigned and/or allocated to the rate classification that incurred them. (Exh. 21 (Santacecilia-R) at 2). Ms. Santacecilia further stated that the Commission should reject Staff's proposal to continue the current rate design structure because continuing its use would maintain the current imbalances between the class rates of return without quantifying whether the current imbalances reflect Commission policy. Ms. Santacecilia also disagreed with Staff's contention that rate structure should be premised on value of service. (*Id.* at 2-3). She testified that although providing value is of paramount importance, Delmarva believes that customers are best served when they are paying the costs associated with safe and reliable delivery of electricity to them and that rates are premised on the cost of service. (*Id.).*

294. Ms. Santacecilia argued that the DPA's recommended modification to the rate design should be rejected because the over-earning class would continue to subsidize, and even maintain a higher portion of subsidization to, the under-earning rate classes than Delmarva's proposal. In addition, she noted that the DPA's proposed modification respected Delmarva's goal of moving every rate class to a rate of return equal to the system return, but did so more gradually. Ms. Santacecilia also testified Delmarva was attempting to move the rate structure towards a customer/demand rate design that is more appropriate for distribution base rates. (*Id.* at 4). Hence, she urged the Commission to reject the DPA's recommendation that the

demand/energy component costs be allocated equally to the demand and energy portion of the rates for the Medium General Service Secondary (MGS-S) class. Ms. Santacecilia reasoned that the MGS-S class already had both an energy and a demand charge, so it would be inappropriate to allocate all of the non-customer charge-related increase into the demand charge.

295. Ms. Santacecelia also addressed DEUG's suggested alternative allocation based on capping the increase for the GST rate class at one-half of the system average increase, which involved the removal of any power factor credit for the GST class for purposes of calculating their rate of return, by stating that power factor credits have not traditionally been handled in the manner suggested by DEUG. (*Id.*). All customers served under service classifications Large General Service-Secondary ("LGS"), General Service-Primary ("GS-P"), and General Service Transmission ("GS-T") are encouraged to keep their power factor above 90% by receiving a credit to do so and they are all charged for their behavior if their power factor falis below 90%. Hence, DEUG's suggestion of removing any power factor credit for the GS-T class in calculating its rate of return would shift the revenue requirement from the LGS, GS-P, and GS-T into the remaining classes. She testified that any modification of the treatment of power factor credit (or charge) should be applied uniformly. (*Id.* at 5).

296. Hearing Examiner's Recommendation. The Hearing Examiner rejected the DPA's argument that the Commission should

use gradualism in this case. (HER at 133). In addition, the Hearing Examiner disagreed with DEUG's argument that Delmarva's rate design for the General Service Transmission ("GST") class of customers failed to take into account that those customers who were offered a credit for the power factor improvement which in turn reduced the costs and benefits for the entire system. The Hearing Examiner stated that there was no record evidence of any reduced costs because of the power factor credit. (HER at 134). The Hearing Examiner approved Delmarva's rate design but did not discuss Delmarva's proposed UROR, its UFRC Tariff, or LED lighting tariff.

297. Exceptions. Delmarva argued that the Commission should adopt the Hearing Examiner's recommendation to reject the DPA's and DEUG's arguments regarding the proposed rate design. (DPL EB at 83). As noted by Delmarva, the Hearing Examiner rejected the DPA's arguments for gradualism and DEUG's modifications for the power factor credit. Delmarva also argued that Staff had largely accepted Delmarva's rate design. (*Id.*). Hence, Delmarva urged the Commission to approve its rate design.

298. Staff had no exceptions regarding Delmarva's rate design other than to urge the Commission not to adopt Delmarva's CCOSS. (Staff EB at 49).

299. The DPA argued that the Hearing Examiner failed to provide any basis for his recommendation to reject applying the principle of gradualism for the proposed customer charge increase. (DPA EB at 78). The DPA pointed out that designing

rates and distributing revenue requirement requires a balance between just, fair and reasonable rates and policy goals, such as: (1) Protection from rate shock; (2) rate continuity; (3) rates informed by, but not based solely on, cost allocation; and (4) customer understanding. (DPA EB at 78-79). It noted that the weight assigned to any of these factors can change depending on the circumstances and the important of the policy. (*Id.* at 79). It observed that the Commission had emphasized gradualism in Docket No. 05-304 and had set customer charges halfway between the customer charge and Delmarva's proposed customer charge to move those charges toward cost of service while limiting the rate impacts that would have resulted from Delmarva's proposed rate design. (*Id.,* citing *Delmarva Power*, Order No. 6930 at ¶¶277-78, 289, 298).

300. DEUG's arguments focused on its suggested rate increase cap for the GST class. Without it, the GST class would have a rate of return of 28% without the credit for power factor improvement. (DEUG EB at 4). DEUG also argued that because the GST class receives service at transmission level, the only cost of distribution service it receives is the cost of metering and billing it. Hence, DEUG recommended that Rate GST customers receive no more than one-half of the system average percentage increase granted by the Commission in this proceeding. (*Id.*).

301. Discussion and Decision. We approve Delmarva's proposed rate design with one change. For the rate design for the GST customer class, we agree with DEUG that this class rate

increase shall be limited to 50% of the amount of what the GST customers' increase would have been based on the approved CCOSS. The remainder of the rate increase for the GST customers shall be allocated to the other customer classes. (Unanimous).

I. Rider for Utility Facility Relocation Charge ("UFRC") and Outdoor Lighting Tariff

302. Ms. Santacecilia testified that the new Rider UFRC was intended to provide a mechanism to implement the recovery of costs related to relocation of Delmarva's delivery facilities as required to accommodate projects sponsored by State agencies and as allowed by 26 *Del. C.* § 315. (Exh. 6 (Santacecilia) at 9). She stated that the initial UFRC would be 0.0%. (*Id.*). She also stated that the Company proposed to add several new "LED" lighting options to its OL Tariff. (*Id.* at 10).

303. Staff, the DPA, and DEUG did not specifically address the Rider UFRC or the OL Tariff. Delmarva did not file rebuttal testimony regarding these issues.

304. The Hearing Examiner's Recommendation. The Hearing Examiner's Report did not discuss the issues of the Rider UFRC or the OL Tariff.

305. Exceptions. Delmarva noted that although Ms. Santacecilia testified regarding the Rider UFRC and the addition of LED light offerings within the OL Tariff, the Hearing Examiner did not specifically address these topics. (DPL EB at 83). In addition, Delmarva noted that none of the parties objected to the

Rider UFRC or the OL Tariff. Hence, Delmarva argued that there was no basis for denying these two items. (*Id*.).

306. Discussion and Decision. As part of the uncontested issues that the Commissioners discussed and approved, the Commission specifically approved the Rider UFRC, which was explained as the recovery mechanism to be used if Delmarva needed to relocate its facilities to accommodate a project for an agency of the State of Delaware, and the OL Tariff for LED lighting options. (Unanimous).

IV. ORDER

AND NOW, this 5th day of August, 2014, IT IS HEREBY ORDERED:

1. That the Commission rejects the Company's request to change from using the average rate base method to the year-end rate base method;

2. That the Company's rate base shall include its plant closings from January 2013 through and including August 2013;

3. That the Company's rate base shall not include its forecasted plant closings from September 2013 through and including December 2013;

4. That Construction Work In Progress shall be excluded from rate base, and the earnings adjustment for Allowance of Funds Used During Construction ("AFUDC") shall be reversed;

5. That the Company's claimed $10,887,807 of Cash Working Capital by $3,933;

6. That the Company's rate base shall be increased by the amount of the pre-paid pension asset and decreased by the amount of the OPEB liability;

7. That the Company's Credit Facility costs should be reflected in the AFUDC rate;

8. That the Company's proposed ratemaking treatment of its deferred IRP and RFP costs is rejected;

9. That the Company's proposed ratemaking treatment of its deferred Medicare Subsidy Deferred Costs is rejected;

10. That the Company's revenue requirement shall include only the test period wage and FICA expense, annualized to reflect an entire year of such costs;

11. That the Company's revenue requirement shall not include any amount for Non-Executive Incentive Compensation costs;

12. That the Company's revenue requirement shall include $37,450 of Relocation Expenses;

13. That the Company's revenue requirement shall include its test period expense levels for Employee Benefits;

14. That the Company's revenue requirement shall not include any amount for Supplemental Executive Retirement Plan costs;

15. That the Company's revenue requirement include a normalized amount of $425,615;

16. That the Company's revenue requirement shall include its requested amount of Regulatory Expenses;

17. That the Company’s revenue requirement shall include only the $2,456,025 of Dynamic Pricing program-related costs incurred through the end of the test period;

18. That the Company’s revenue requirement shall not include any costs associated with its Direct Load Control program since no program costs were incurred during the test period;

19. That the Company’s revenue requirement attributable to Corporate Governance Expenses shall be reduced by $400,138;

20. That the Company’s revenue requirement attributable to Meals and Entertainment expenses shall be reduced by $298,182;

21. That the Company’s revenue requirement attributable to Membership Fees and Dues shall be reduced by $63,095;

22. That the Wilmington Franchise Tax shall be removed from the customer assessment in setting rate for customers who do not reside in Wilmington;

23. The appropriate adjustments shall be made to the interest component of the debt structure in Delmarva’s capital structure to properly reflect the lower interest expense associated with the rate base approved in this proceeding;

24. That the Company’s proposed Class Cost of Service Study (“CCOSS”) be approved, including the four changes agreed upon at the Commission-ordered workshop in Docket 09-414;

25. That the Company’s rate design be approved except that the rate increase to the GST customer class shall be limited to 50% of the amount of what the GST customers' increase would have been based on the approved CCOSS, and the remainder of the rate

increase for the GST customers shall be allocated to the other customer classes;

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

27. That the appropriate return on equity for the Company is 9.7%;

28. That the Commission approves the uncontested adjustments, but only for the purpose of resolving this proceeding;

29. That the approved revenue requirement increase resulting from the Commission's decisions in this Docket is $15,096,000, as shown on **Exhibit "A"** hereto; and

30. That the Commission reserves the jurisdiction and authority to enter such further Orders in this Docket as may be deemed necessary or appropriate.

BY ORDER OF THE COMMISSION:

/s/ Dallas Winslow
Chair

/s/ Joann T. Conaway
Commissioner

/s/ Jaymes B. Lester
Commissioner

/s/ Jeffrey J. Clark
Commissioner

Commissioner

ATTEST:

/s/ Alisa Carrow Bentley
Secretary

<u>Exhibit "A"</u>

Approved Revenue Requirement Increase

Order No. 8549 (April 2, 2014)

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF DELMARVA POWER & LIGHT COMPANY FOR AN INCREASE IN ELECTRIC BASE RATES (FILED MARCH 22, 2013)	)))))	PSC DOCKET NO. 13-115

ORDER NO. 8549

AND NOW, this 2nd day of April, 2014:

WHEREAS, on March 22, 2013, Delmarva Power & Light Company ("Delmarva" or the "Company") filed with the Delaware Public Service Commission (the "Commission") an application (the "Application") to increase electric distribution base rates, which Application was docketed as Docket No. 13-115; and

WHEREAS, by Order No. 8337 dated April 9, 2013, the Commission opened this docket to consider Delmarva's Application; designated Senior Hearing Examiner Lawrence to conduct any necessary evidentiary hearings and to submit his proposed findings and recommendations to the Commission; and authorized Delmarva to implement an annual $2.5 million increase in intrastate operating revenues effective June 1, 2013, pursuant to 26 *Del. C.* §306(c); and

WHEREAS, the Commission Staff, the Division of the Public Advocate ("DPA"), the Delaware Department of Natural Resources and Environmental Control ("DNREC"), the Delaware Energy Users Group ("DEUG") and the Caesar Rodney Institute (collectively, the

"Parties") intervened or otherwise participated in the proceedings; and

WHEREAS, on October 22, 2013, Delmarva placed an additional interim rate increase of $25,155,265 into effect pursuant to 26 *Del. C.* §306(a); and

WHEREAS, evidentiary hearings were held before Senior Hearing Examiner Lawrence on November 13, 14 and 18, 2013; and

WHEREAS, Senior Hearing Examiner Lawrence issued proposed Findings and Recommendations (the "Hearing Examiner's Report") regarding the Application on March 4, 2014; and

WHEREAS, Delmarva, Staff, the DPA and DEUG filed exceptions to certain matters addressed in the Hearing Examiner's Report; and

WHEREAS, the Commission met in public session on April 1 and 2, 2014, to hear oral argument and conduct deliberations on the issues addressed in the Hearing Examiner's Report and consider the exceptions taken to the Hearing Examiner's Report; and

WHEREAS, the Commission has resolved the issues in this matter as set forth below;

NOW, THEREFORE, IT IS HEREBY ORDERED BY THE UNANIMOUS VOTE OF ALL COMMISSIONERS:

1. That as a result of the Commission's deliberations referenced above, the Commission hereby approves an overall increase in Delmarva Power & Light Company's electric distribution rates of $15,096,574, the components of which are set forth below:

Description	Amount
Rate Base	$619,566,495
Overall Rate of Return	7.26%
Return on Equity	9.7%
Cost of Long-Term Debt	4.91%
Required Operating Income at Present Rates	$44,980,528
Gross Revenue Conversion Factor	1.70606
Operating Income Deficiency	$8,848,794
Total Revenue Requirement Increase	$15,096,574

These amounts are subject to verification by all parties and may be changed by further Order of the Commission upon such verification. A full Findings, Opinion and Order setting forth the Commission's reasons for its decisions on the various contested issues will follow at a later date.

2. That the Commission orders that new compliance tariff leaves be developed and filed with the Commission Staff no later than April 15, 2014, which shall include the new electric distribution rates and which shall become effective with service on and after May 1, 2014.

3. Since the new rates are less than the existing distribution rates placed into effect on October 22, 2013, pursuant to 26 *Del. C.* §306(a)(1), customers will be entitled to a refund of overpayments since Delmarva Power & Light Company's

full requested rate increase was placed into effect, with interest on the deferred amounts as calculated in accordance with Regulation Docket No. 11, which shall reflect Delmarva Power & Light Company's short-term borrowing costs.

4. The method and manner of such refund shall be approved by the Commission in a further Order.

5. That the Commission reserves the jurisdiction and authority to issue such further Orders as it deems necessary or proper.

BY ORDER OF THE COMMISSION:

/s/ Dallas Winslow
Chair

/s/ Joann T. Conaway
Commissioner

/s/ Jaymes B. Lester
Commissioner

/s/ Jeffrey J. Clark
Commissioner

____
Commissioner

ATTEST:

/s/ Alisa Carrow Bentley
Secretary