BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF DELMARVA POWER & LIGHT COMPANY FOR AN INCREASE IN ELECTRIC BASE RATES AND MISCELLANEOUS TARIFF CHANGES (FILED SEPTEMBER 18, 2009)	**PSC DOCKET NO. 09-414**
IN THE MATTER OF THE APPLICATION OF DELMARVA POWER & LIGHT COMPANY FOR APPROVAL OF A MODIFIED FIXED VARIABLE RATE DESIGN FOR ELECTRIC RATES (FILED JUNE 25, 2009)	**PSC DOCKET NO. 09-276T**

FINAL FINDINGS, OPINION AND ORDER NO. 8011

BEFORE COMMISSIONERS:

ARNETTA McRAE, Chair
JOANN T. CONAWAY, Commissioner
JAYMES B. LESTER, Commissioner
J. DALLAS WINSLOW, Commissioner
JEFFREY J. CLARK, Commissioner

APPEARANCES:

For the Applicant, Delmarva Power and Light Company ("Delmarva"):

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Delmarva Power and Light Company

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For the Delaware Public Service Commission Staff ("Staff"):

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Deputy Attorney General

LAWRENCE W. LEWIS, ESQ.
State Solicitor

For the Division of the Public Advocate:

G. ARTHUR PADMORE, Former Public Advocate
MICHAEL D. SHEEHY, Public Advocate

For Intervenor Delaware Division of Natural Resources and Environmental Control ("DNREC"):

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Deputy Attorney General

For Intervenor Delaware Energy Users Group ("DEUG"):

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

For Intervenor Wal-Mart Stores East, LP and Sam's Club East, LP ("Wal-Mart"):

HOLLY RACHEL SMITH, ESQ.
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I. PROCEDURAL HISTORY

1. On May 1, 2009, Delmarva Power & Light Company ("Delmarva" or the "Company") filed with the Delaware Public Service Commission (the "Commission") a request and supporting testimony (the "Request") from Anthony J. Kamerick, PHI Holdings, Inc. ("PHI") Senior Vice President and Chief Financial Officer, to defer certain increased pension charges on its financial statements required under SFAS 87 (as amended) for regulatory accounting purposes. We opened Docket No. 09-182 to consider the Request.

2. On June 25, 2009, Delmarva filed petitions and supporting testimony from Joseph F. Janocha, PHI Rates & Technical Services Section Manager, Regulatory Affairs, to implement a modified fixed variable ("MFV") revenue-decoupled rate design for Delmarva's electric and natural gas distribution businesses. We opened Docket Nos. 09-276T and 09-277T to consider these petitions.[1]

3. On September 18, 2009, Delmarva filed an application (the "Application") to increase electric distribution base rates by $27,618,487 (an approximate 4% increase in a customer's total bill and an approximate 19% increase in the distribution portion of the bill) and certain tariff revisions, including an MFV rate design. The Application included testimony from Messrs. Kamerick and Janocha; W. Michael Von Steuben, PHI Regulatory Affairs Department Manager of Revenue Requirements; William M. Gausman, Senior Vice President of Asset Management & Planning for PHI Service Company ("ServCo"); Kathleen A. White, PHI's Assistant Controller; Timothy J. White, PHI Regulatory Affairs Department Manager for Policy

[1]In July 2009 the General Assembly enacted 26 *Del. C.* §1500(b)(8), directing us to implement revenue decoupling for all electric and natural gas distribution companies. As will be discussed *infra*, the General Assembly repealed §1500(b)(8) in July 2010.

Coordination; Elliott P. Tanos, PHI's Manager of Cost Allocation; and Dr. Roger A. Morin, a Georgia State University finance professor.

4. On October 6, 2009, we suspended the Application pending evidentiary hearings and a final decision concerning the justness and reasonableness of the proposed rates, tariffs and rate design. Pursuant to 26 *Del. C.* §306(c), we approved an interim $2.5 million increase in intrastate operating revenues effective November 17, 2009, subject to refund; waived the statutory surety bond requirement in connection with those interim rates in light of Delmarva's promise to comply with any refund order; and waived certain Minimum Filing Requirements ("MFRs"). We assigned the docket to Senior Hearing Examiner Ruth Ann Price, directing her to conduct public comment sessions and evidentiary hearings as necessary to produce a full and complete record concerning the justness and reasonableness of the proposed increased rates, tariffs and rate design; submit proposed findings and recommendations to us; rule on intervention and *pro hac* motions, and determine the form and manner of public notices. We set an intervention deadline of November 6, 2009, and instructed Delmarva to publish notice of its Application in *The News Journal* and the *Delaware State News.*

5. The Division of the Public Advocate (the "DPA") intervened as of right on October 9, 2009.

6. DEUG, DNREC and Wal-Mart filed motions to intervene, which were granted without objection.

7. On November 7, 2009, in Order No. 7681, we consolidated Docket No. 09-276T into Docket No. 09-414.

8. On December 14-16, 2009, the Hearing Examiner conducted public comment sessions in Wilmington, Dover and Laurel. One person attended the Laurel session; no one attended either the Wilmington or Dover sessions. Several customers provided written and e-mailed comments.

9. On January 13, 2010, Delmarva filed supplemental direct testimony on the pension issue from Jay C. Ziminsky, PHI Regulatory Affairs Department Manager, Revenue Requirements. On January 27, 2010, in Order No. 7727, we consolidated Docket No. 09-182 into Docket Nos. 09-414/09-276T.

10. On February 10, 2010, Staff filed direct testimony from Ralph C. Smith, a certified public accountant and senior utility regulatory consultant with Larkin & Associates, PLLC; Donna H. Mullinax, Vice President and Chief Financial Officer of Blue Ridge Consulting Services, Inc.; Howard Solganick, Principal of Energy Tactics & Services, Inc. (as a subcontractor to Blue Ridge); and James A. Rothschild, Principal of Rothschild Financial Services, Inc. The DPA filed direct testimony from James D. Cotton and Andrea C. Crane, Principals of The Columbia Group, Inc. DEUG filed direct testimony from Michael P. Gorman, Managing Principal of Brubaker & Associates, Inc. Finally, Wal-Mart filed direct testimony from Steve W. Chriss, Manager of State Rate Proceedings for Wal-Mart Stores, Inc. DNREC did not file any testimony.

11. On March 1, 2010, Staff submitted direct ring fencing testimony from John Antonuk (President) and Randall Vickroy (senior consultant) of Liberty Consulting Group, Inc. ("Liberty").

12. On March 19, 2010, Delmarva filed rebuttal testimony from Messrs. Kamerick, VonSteuben, Janocha, Tanos, Gausman, and Ziminsky, Dr. Morin, and Ernest L. Jenkins, Sr., a PHI Vice President of People Strategy and Human Resources.

13. On March 31, 2010, Delmarva submitted supplemental rebuttal ring fencing testimony from Mr. Kamerick and Steven M. Fetter, President of Regulation UnFettered.

14. On April 19, 2010, Delmarva placed its full requested rate increase into effect under bond and subject to refund pursuant to 26 *Del. C.* §306(b).

15. Evidentiary hearings were held on April 15 and 16 and May 26, 2010. During the hearings, the participants presented a proposed settlement regarding a revenue-decoupled rate design and other cost of service issues. Delmarva, Staff, the DPA and Wal-Mart each proffered a witness to testify that the settlement was in the public interest and would result in just and reasonable rates. At the conclusion of the evidentiary hearings, the Hearing Examiner closed the record and established deadlines for simultaneous post-hearing opening and reply briefs. Delmarva, Staff, the DPA and DEUG submitted post-hearing opening and reply briefs.

16. On October 1, 2010, the Hearing Examiner issued proposed findings and recommendations (the "HER").

17. On October 25, 2010, Delmarva, the DPA and DNREC filed exceptions to the HER.

18. On October 28, 2010, Staff filed a Motion to Strike DNREC's exceptions on the procedural ground that they raised issues that DNREC had not raised in the evidentiary hearings.

19. On November 10, 2010, during a regularly-scheduled and duly-noticed meeting, we heard oral argument on and denied Staff's Motion to Strike DNREC's exceptions, and heard

oral argument on the HER and the participants' exceptions thereto. At the conclusion of oral argument, we tabled our deliberations pending a presentation on how the proposed decoupling mechanism would work in practice. That presentation took place on December 2, 2010.

20. On December 21, 2010, we reconvened to deliberate in public session. Although three public comment sessions had already been held, we nonetheless permitted several members of the public in attendance to provide further oral comments. At the conclusion of those public comments, the participants advised us that they had reached an agreement in principle and would strive to present a proposed settlement agreement for our consideration at our next regularly-scheduled meeting on January 11, 2011.

21. The participants apparently executed the proposed settlement agreement in the first week of January 2011. The Deputy Public Advocate executed the proposed settlement for the DPA due to Public Advocate G. Arthur Padmore's retirement effective December 31, 2010. As of January 1, 2011, no new Public Advocate had been nominated or confirmed.

22. On January 10, 2011, the Attorney General advised the Deputy Public Advocate that he did not have statutory authority to execute the settlement for the DPA. The Attorney General opined that only a person appointed by the Governor and confirmed by the State Senate could exercise the Public Advocate's duties. The Deputy Public Advocate advised the Commission Chair of the Attorney General's opinion.

23. Also on January 10, 2011, Staff notified us by letter sent via electronic mail and facsimile that it was revoking its agreement to the settlement, and asked us to table our deliberations until a later date.

24. We met on January 11, 2011 to consider Staff's withdrawal of its consent to the settlement agreement and its request to table our deliberations to a later date. Delmarva opposed Staff's request, contending that if there was no settlement in light of Staff's withdrawal and the vacancy of the Public Advocate's office, then we should deliberate on the HER and the exceptions thereto. Staff contended that the oral argument on the HER and exceptions had taken place so long ago that we would need to reacquaint ourselves with the record and the arguments. We voted to table the matter for one week and scheduled a meeting for January 18, 2011.

25. On January 17, 2011, the Attorney General moved for leave to intervene out of time, contending that his participation was necessary to ensure that ratepayers' interests were protected. We granted that petition on January 18, 2011.[2]

26. On January 18, 2011, we met at a duly-noticed meeting to deliberate in open session on the HER and the exceptions thereto. At that meeting, all participants except the Attorney General presented us with a revised revenue decoupling and cost of service settlement, which will be discussed in detail *infra*, and sought our approval thereof.

27. At the conclusion of our deliberations on January 18, we issued a minute order setting forth the rate base, return on equity, cost of debt, overall rate of return and revenue requirements that appeared to result from our decisions at that meeting, and stated that we would issue a more detailed opinion at a later date. On January 27, 2011, we issued an amended minute

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[2]The Attorney General stated that he adopted as his own "all pleadings, filings, exhibits, memoranda and briefs previously filed in this docket by or on behalf of the Public Advocate." (Petition of the Attorney General of the State of Delaware for Leave to Intervene Out of Time, ¶4). All references to the "Public Advocate" or the "DPA" hereafter in this Final Findings, Opinion and Order shall be deemed to refer to the Attorney General.

order setting forth the correct amounts of rate base, operating expense and revenue requirement as confirmed by the participants. This is our Final Findings, Opinion and Order in this Docket.

II. DISCUSSION, FINDINGS AND OPINION

A. OVERVIEW OF THE PARTICIPANTS' REVENUE REQUIREMENTS POSITIONS

28. Delmarva selected an historical test year and test period comprised of the twelve months ended March 31, 2009. (Ex. 33 (Von Steuben) at 4).[3] After adjustments to the test year rate base and expenses, the Company requested, on brief, a revenue increase of $24,232,000, derived from a rate base of $461,303,000; an overall rate of return of 7.97%/8.09% (with/without revenue decoupling) and cost of equity ("COE") of 10.75%/11.00% (with/without revenue decoupling) on a capital structure consisting of 52.48% long-term debt and 47.52% common equity; and pro forma operating income of $22,448,000. (Delmarva Initial Post-hearing brief at 3 (Comparison of the Parties);[4] Ex. 65 (Morin) at 48 and Ex. RAM-14).

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[3]References to the prefiled testimony introduced at the evidentiary hearings will be cited as "Ex. __ (Witness' Name) at __" for direct testimony; "Ex. __ (Witness' Name – S) at __" for supplemental testimony; and "Ex. __ (Witness' Name – R) at __" for rebuttal testimony. The transcripts will be cited as "Tr. at ___."

[4]References to the participants' briefs and exceptions are cited herein as follows:

29. Staff recommended a revenue increase of $6,390,000, based on a rate base of $427,865,000, an overall rate of return of 6.70%/7.18% (with/without revenue decoupling) and COE of 8.50%/9.50% (with/without revenue decoupling); and pro forma operating income of $24,888,000. (Ex. 59 (Mullinax) at Rev. Exs. DHM-1, DHM-3.1; Ex. 84 (Rothschild) at Sch. JAR 1; Ex. 63).

30. The DPA determined that a revenue requirement decrease of $4,669,038 was required, based on a rate base of $401,297,734, an overall rate of return of 6.43%/7.41% (with/without decoupling) and COE of 7.52%/9.58% (with/without revenue decoupling); and pro forma operating income of $28,562,173. (Ex. 64 (Cotton) at Schs. JDC-1, JDC-2, JDC-3; Ex. 80 (Crane) at 25).

31. DEUG sponsored testimony recommending a 9.9% COE and a 7.56% overall rate of return (Ex. 77 (Gorman) at 2 and Ex. MPG-1), but did not address any other revenue requirements. Neither DNREC nor Wal-Mart addressed any revenue requirements issues.

Delmarva's Initial and Reply Post-Hearing Briefs: "DPL OB" and "DPL RB."

Delmarva Exceptions: "DPL E."

Staff's Opening and Reply Briefs: "Staff OB" and "Staff RB."

DPA's Opening and Reply Briefs: "DPA OB and DPA RB."

DPA Exceptions: "DPA E."

DEUG's Opening and Reply Briefs: "DEUG OB" and "DEUG RB."

DNREC's Exceptions: "DNREC E."

B. <u>UNCONTESTED ISSUES</u>

32. The following issues are not contested in this docket:

- The proposed capital structure
- Weather Normalization (Adj. #1)
- Remove Employee Association Expense (Adj. #6)
- Adjust for Increased Postage Expense (Adj. #12)
- Integrated Resource Plan ("IRP") Amortization (Adj. #15)
- Ongoing IRP Costs (Adj. #16)
- Request for Proposal Amortization (Adj. #17)
- Amortization of Advanced Metering Infrastructure ("AMI") Costs (Adj. #20)
- Amortization of Refinancing Costs (Adj. #21)
- Wilmington Franchise Tax (Adj. #22)
- Remove Post-1980 Investment Tax Credit (Adj. #23)
- Restate Interest on Customer Deposits (Adj. #24)
- Accrued OPEB Liability Balance (Adj. #26)
- Miscellaneous Tariff Changes

33. Staff and the DPA accept in this case the conceptual bases of Delmarva's interest synchronization and cash working capital ("CWC") adjustments (Adjs. #27 and #28), but the amounts of such adjustments differ because of their positions on other issues. The DPA also contends that we should order Delmarva to present a new CWC study in its next base rate case, noting that the study used in this case was based upon the a five-year-old study from Docket No. 05-304, and CWC studies should "be updated in virtually every case." (Ex. 64 Cotton) at 25).

34. Delmarva asks the Hearing Examiner to specifically recognize the uncontested adjustments "to allow the Company and the participants in future proceedings to appropriately reflect accepted Commission ratemaking practices." (DPL OB at 34).

35. **The Hearing Examiner's Findings and Recommendation.** Except for the amortization of incremental AMI costs (to be discussed *infra*), the Hearing Examiner recommended approval of the uncontested adjustments. She rejected Delmarva's request for specific recognition of the uncontested adjustments as a policy matter, finding that they had either been agreed to during discovery or through the exchange of additional data that resolved the objecting entity's concerns, and noting that she had encouraged the participants to meet and discuss resolution of the issues presented. (HER at 61-62). She did not address the DPA's contention regarding a new CWC lead-lag study in Delmarva's next base rate case.

36. **Exceptions.** There were no exceptions to the Hearing Examiner's recommended approval of the uncontested adjustments or her recommendation not to specifically approve the ratemaking treatment of the uncontested issues. The DPA did not except to the HER's failure to discuss its CWC proposal.

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

treatment of those issues. We note that the parties agreed on two specific items. The "Generation Request for Proposal" costs of $4,355,377, which reflect costs incurred through June 2009, should be amortized over a period of ten years with the unamortized amount included in rate base. The "Integrated Resource Plan" costs of $3,587,410, which reflects costs incurred through June 2009, should be amortized over a period of ten years with the unamortized amount included in rate base. Finally, we do not address the DPA's CWC proposal. We trust this is something the participants will discuss among themselves before Delmarva's next rate case. (Unanimous).

C. TEST YEAR AND TEST PERIOD

38. **Delmarva.** As noted, Delmarva used an historical test year and test period consisting of the twelve months ended March 31, 2009. (Ex. 33 (Von Steuben) at 4).

39. **DPA.** The DPA does not contest the selected test year and test period, but does object to what it sees as Delmarva's consistent violation of the test period concept. The DPA advances one overarching theme: strict adherence to the test period. Arguing that the Commission must follow its own regulations (DPA RB at 8-9), the DPA quotes the MFRs defining the test year and test period:

> 1.2.1 Test Year Defined. The test year is the actual historical period of time for which financial and operating data will be required. The test year data must include the actual "Per Books" results of operation for a 12-month period at the end of a reporting quarter. In addition, the twelve month period must end no later than seven months prior to the filing of the application, but no sooner than one month after the final closing of the test year (post reversal of actual entries), so that actual expenditures are reflected in the books of account. For example, if the actual results of operations for the twelve months ending March 30, 200x, are used for the purposes of the test year, the application must be filed no sooner than April 30, 200x, but no later than October 31, 200x.
>
> 1.2.2 Test Period Defined.

> 1.2.2.1 The test period consists of twelve consecutive months ending at the end of a reporting quarter utilized by the utility to support its request for relief. The test period may be the same as the test year or may include some of the months included in the test year and some months projected, such as six months "actual" and six months "projected," but may not include more than nine months projected.

(26 *Del. C. Admin.* §§1.2.1, 1.2.2, 1.2.2.1). The DPA then states that MFR §1.3.1 permits a utility to proffer exhibits in the form of a fully projected test period, provided:

> such period shall consist of twelve consecutive months ending not later than the end of the first year during which the proposed rates are to become effective;
>
> it is supported by relevant testimony establishing a verifiable link between the test period defined in section 1.2.2 and the projected test period; and
>
> it is in format consistent with such test period.

(*Id.* at 7).

40. Thus, the DPA contends that the MFRs provide a utility the option of using either: (1) an historic test period consisting of data from twelve months of completed operations (as Delmarva does here), to which no adjustments may be made; or (2) a partially-projected test period consisting of at least three months' actual data and nine months of projections, which must be updated (i.e., adjusted) as actual data becomes available. (DPA OB at 3). The DPA asserts that §1.3.1 does not support Delmarva's post-test period adjustments because it applies *only* to a fully-forecasted test period. The DPA contends that Delmarva could have chosen a partially projected (3 months actual and 9 months projected) test period to recognize that its circumstances would change going forward, which would have permitted it to adjust its rate base and expenses as the projected test period months produced actual figures. (*Id.* at 5-7). The DPA

surmises that Delmarva did not choose this course because it would have been required to "update the *entire test period*¸ as required by the Code, to full actual Company data within 60 days, thereby eliminating its ability to cherry-pick its favorable adjustments." (DPA RB at 8, emphasis in original). The DPA contends that adjusting test period actual data for post-test period expense and rate base increases or decreases while ignoring revenues violates the matching principle. (*Id*. at 10).

41. The DPA dismisses Delmarva's reliance on *Delmarva Power & Light Co. v. Public Service Commission,* 337 A.2d 517 (Del. Super. 1975) because: (1) that case was decided under a version of the Public Utilities Act under which the Commission selected the test period instead of the utility; and (2) in that case Delmarva sought to update its projections with actual filed data and its proposed budget for the next year, which differs from what it does in this case. (DPA RB at 7; Tr. at 1135). Thus, the DPA concludes that we must reject each post-test period adjustment that was not made to normalize or annualize expenses incurred or rate base added during the test period.

42. **Staff.** As set forth *infra* in this Order, Staff challenges several of Delmarva's post-test period adjustments, but does not take the DPA's strict test period position.

43. **Delmarva Response.** Delmarva rejects the DPA's position, calling it an "extreme regulatory policy in which out-of-period adjustments would never be made." (DPL OB at 41-42). It contends that the DPA's position does not reflect current regulatory policy in Delaware (and other states), and is contrary to Delaware law and our prior decisions. (*Id*. at 42-43, citing *Delmarva Power*, 337 A.2d 517 (Del. Super. 1975); *In the Matter of the Application of Delmarva Power & Light Company for an Increase in Its Electric Base Rates and for Certain*

Revisions to Its Electric Service Rules and Regulations, PSC Docket No. 91-20, Order No. 3389 (Del. PSC Mar. 31, 1992) at ¶¶50, 52; *In the Matter of the Application of the Delaware Division of Chesapeake Utilities Corporation for a General Increase in Natural Gas Rates and Charges Throughout Delaware and for Approval of Other Tariff Changes*, PSC Docket No. 95-73, Order No. 4104 (Del. PSC Dec. 19, 1995)).

44. Delmarva notes that 26 *Del. Admin. Code* §1.3.1 provides that:

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

Delmarva contends that its adjustments are reasonably known and measurable, were presented prior to the filing of rebuttal or with its rebuttal, and are "virtually identical" to adjustments that were uncontested and/or approved by the Commission in Docket No. 05-304. (DPL OB at 41).

45. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner did not separately address the DPA's blanket assertion that all out-of-test-period adjustments are inappropriate; however, she obviously rejected this argument in light of her recommendation of certain of those adjustments.

46. **Exceptions.** The DPA did not file written exceptions to all of the Hearing Examiner's findings and recommendations rejecting its position, but pressed its contention during oral argument.

47. **Discussion.** We did not discuss this issue as a stand-alone issue during our deliberations, but rather addressed it in the context of specific adjustments. Notwithstanding this, we believe that it is appropriate to address the issue separately in this written order.

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

49. Obviously, we must follow our own regulations. We believe, however, that we have correctly construed §1.3.1. Contrary to the DPA's apparent position, the word "updating" (or "updated") in §1.2.3.1 is not synonymous with the phrase "modifications in test period data occasioned by reasonably known and measurable changes in current or future rate base items, expenses or revenues …" in §1.3.1. Rather, we think it clear that "updates" as used in §1.2.3.1 refers to the projections that a utility may use in a partially-projected test period. That is, a utility using a partially-projected test period of six months' actual results and six months' projected results will submit rate base, expense and revenue levels based on six months of actual results and what it expects those levels to be for the next six months. In addition to this, however, the utility can *also* suggest that its test period rate base, expense or revenue level be adjusted based on an event that is reasonably likely to occur, although outside the selected test period. Thus, for a utility using a partially-projected test period, there may be a certain wage and salary level based on six months of actual data and six months of projected data, but the utility may also seek to increase that proposed expense level for ratemaking purposes to include, for example, a union contract that requires annual increases, even though some or all of those increases will take place outside the partially-projected test period. Another example is costs that a utility will be required

to incur outside the (historical or partially-projected) test period to comply with a new government regulation. In such a case, the test period expense level (even when updated for actual results) will not be representative of what can be expected in the rate effective period.

50. Furthermore, after reviewing the *Delmarva Power* case, we conclude that: (1) nothing in it supports the distinction the DPA attempts to draw; and (2) what we were ordered to do in that case is fully consistent with our MFRs, the decisions we have previously reached, and the decision we reach here. The DPA's contention that the *Delmarva Power* case was decided under a version of the Public Utilities Act under which we selected the test period does not bear scrutiny. Nothing in that case suggests that the *Commission* was obligated to choose the utility's test period; in fact, the court observed that "[t]he *participants* agreed on 1972 as a test year." *Delmarva Power*, 337 A.2d at 518 (emphasis added). The DPA offers no other support for his contention that the Commission was obligated to select the test period. And in any event, we could have selected the test period in *this* case; we did not have to agree with the one that Delmarva proposed, even if no one objected.

51. Second, we read *Delmarva Power* as obligating us to *consider* certain information outside the test period even when an historical test period is used, at least under certain circumstances. In that case, Delmarva used an historic test year of 1972, and submitted estimates for 1973 and 1974 sometime during the proceeding but before the final hearing. At the final hearing, however, the Company sought to submit actual results for 1973 and a budget for 1974. We refused to consider those submissions on the ground that we had not had sufficient time to thoroughly investigate them. The Superior Court found that we erred in refusing to consider the submissions because it did not appear to the court (and there was no evidence) that Delmarva's

method of calculating the actual 1973 results was "significantly different" from its method of calculating the actual 1972 results that we had investigated and accepted. *Id*. at 519. Under these circumstances, the Court concluded that it was unlikely that verifying the 1973 results would have taken "undue time or effort." *Id.* The Court cited Delaware Supreme Court precedent for the proposition that "[w]hile the Commission has discretion in setting the test year, this does not mean that it may arbitrarily refuse to consider later available accurate information," and explained that "[l]ater information is especially important as a check on the continuing validity of the test year, experience [sic] in a period of rapid change like the present." *Id.* This is exactly the construction we have consistently given our MFRs. We have found no authority from Delaware courts construing our MFRs in some other way, and none has been cited to us.

52. For the foregoing reasons, we reject the DPA's strict test period position. (Unanimous).

D. <u>CONTESTED RATE BASE ISSUES</u>

1. <u>Reliability Plant Additions April-July and August-December 2009</u>

53. **Delmarva.** Delmarva seeks to include in its cost of service the annualized rate base and depreciation effect of reliability projects placed in service from April through July 2009 and from August 2009 to December 2009; remove the corresponding reliability projects included in Construction Work in Progress ("CWIP") and any associated Allowance for Funds Used During Construction ("AFUDC") from cost of service; and include the effect of any distribution retirements occurring during the test period. Delmarva contends that these adjustments prevent double-counting and appropriately match benefits and costs during the rate effective period. (Ex. 29 (Gausman) at 8). It states that the projects represent planned and emergency replacements

and repairs to address potential system overloads, remedy operating voltage drops, meet specific design standards to maintain acceptable reliability performance levels, and replace infrastructure. (*Id.* at 11-15). Delmarva argues that these project costs are appropriately included in rates because they address reliability issues for existing customers and are not related to satisfying demand from new customers. (DPL OB at 41).

54. **Staff.** Staff does not oppose the April-July 2009 additions, noting that we approved a similar adjustment in Docket No. 05-304. (Ex. 58 (Mullinax) at 36). It does oppose the August-December 2009 additions, calling them "arbitrary," suggesting that Delmarva provided inadequate details about them, and arguing that Delmarva chose the December 2009 cutoff date simply because it was the end of the calendar year. (*Id.* at 35-36, 39-40). Staff contends that the August-December 2009 plant additions are too remote from the end of the test period to be included in rate base, that the four months represented by the April-July additions was sufficient time for Delmarva to close the projects to plant in service; and that they must be rejected for the test period concept to have any meaning, especially since Delmarva could have used a partially-forecasted test period. (*Id*. at 40). Finally, Staff argues that Delmarva will obtain a windfall profit if these projects are in rate base because they are financed with cheaper short-term debt; since the capital structure does not include short-term debt, the financial effect is the same as using more expensive long-term debt to pay for them. (*Id*. at 39).

55. **DPA.** The DPA opposes both adjustments for several reasons. First, it advances its blanket objection to all post-test period adjustments. (DPA OB at 16). Second, it contends that the adjustments violate Delmarva's average rate base methodology. (*Id.* at 12). The DPA explains that Delmarva took its total rate base each month, added those 12 months together,

divided them by 12 and submitted that figure as its test period rate base; consequently, any additions during the year only received a fractional amount of value. For example, the DPA observes that a September 2008 addition of $1.00 of plant in service was worth approximately 50 cents in rate base (averaged over the remaining six months of the test period), and a March 2009 addition of $1.00 in plant in service was worth approximately 8 cents (1/12). However, Delmarva inappropriately added the entire $16 million worth of this plant into rate base dollar-for-dollar, not at some average of $16 million. (*Id*. at 12-13, citing Ex. 54 (Cotton) at 19-20). Finally, the DPA contends that Delmarva had not shown details regarding the plant added, or explained why existing customers needed this plant or "why it is necessary to ignore good utility regulation and Commission rules when considering it." (DPA OB at 15-16).

56. **Delmarva Response.** Delmarva asserts that we rejected a strict test period argument in Docket No. 05-304, and that the DPA offered nothing to support a different result in this case. (DPL RB at 18). It claims that the costs of the adjustments are known and measurable and are "virtually the same" as the ones we approved in Docket No. 05-304. (Ex. 33 (Von Steuben) at Sch. WMV-20; DPL OB at 41; DPL RB at 17). It argues that the plant is in service and providing benefits to existing customers, regardless of whether it was completed and in service before or after four months following the end of the test period, and that Staff's witness conceded that the plant was used and useful and providing service. (DPL OB at 41, 43). It contends that the plant was needed to address existing reliability problems caused by system overloads, voltage drops, and reliability performance levels. (Ex. 33 (Von Steuben) at 29). It claims that its cutoff period is not arbitrary because it coincides with the end of the calendar year and limits the scope of additions covered by the adjustment. (DPL RB at 17). It asserts that it

provided sufficient information about the projects, including a list of each project and the associated plant additions by month. (*Id*. at 18). It notes that the Maryland Commission accepted these adjustments in Delmarva's case before that Commission. Finally, it calls Staff's short-term debt issue "irrelevant" because these plant additions are not CWIP. (*Id.* at 18-19).

57. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner allowed the April-July 2009 plant closings to be included in rate base but disallowed the August-December 2009 additions. She rejected Staff's and the DPA's contentions that Delmarva had not provided a sufficient explanation of the projects, finding that it had "describe[d] at length the nature of these projects and why they are needed to support the integrity of the distribution system." (HER at 94). However, she found that the August-December 2009 additions were "too attenuated from the test period to continue to make the historical test period meaningful" and "these costs are for plant that is not in service." (*Id*. at 96).

58. **Exceptions.** The DPA and Delmarva filed exceptions to the Hearing Examiner's recommendation. The DPA objects to including any of the plant additions in rate base, and repeats its average rate base argument. (DPA E at 4-5).

59. Delmarva excepts to the Hearing Examiner's denial of the August-December 2009 additions. First, it claims that a "fundamental" ratemaking tenet is that rates should reasonably reflect a utility's costs and expenses during the rate effective period. (DPL E at 53). Second, it states that a reliability investment is considered "closed" when it is placed in service on the Company's books and records, and all of the projects here were closed by the end of December 2009. (*Id*.). Third, it calls the DPA's and Staff's positions "unreasonable" and "contrary to Delaware law, which prohibits arbitrary rejection of known and measurable costs."

(*Id*. at 53-54). Fourth, it contends that the Hearing Examiner erred in concluding that this plant is not in service, and that her recommendation is inconsistent with both the evidence and Delaware law. (*Id*. at 54). Fifth, it argues that it is irrelevant that the plant was not in service during the test period because it is and will be in service during the rate effective period. (*Id*. at 55). Sixth, it contends that the Hearing Examiner did not find that the projects were not needed for existing demand or that they would not benefit existing customers. (*Id*.). Last, it asserts that the Hearing Examiner's departure from precedent denies it the consistency necessary for it to "effectively and reliably" operate its business. (*Id*. at 56).

60. **Discussion.** We conclude that under the circumstances presented in this case, both the April-July 2009 and August-December 2009 reliability plant should be included in rate base. As previously discussed, we reject the DPA's strict test period construction. We agree with the Company's position that the August 2009 – December 2009 reliability closings are no different from the April 2009 – July 2009 closings. We agree with Delmarva that these costs are known and measurable, and that they are necessary to make the test period more reflective of the period during which the rates approved in this case will be in effect. *See In re Delmarva Power & Light Company*, PSC Docket No. 91-20, 1992 Del. PSC LEXIS 15, Order No. 3389 (Del. PSC March 31, 1992) at 34. We are also persuaded that these plant additions are necessary to preserve the reliable operation of the distribution system and are not being made to serve future customers. While we note that the test period is there for a reason, we believe it is appropriate to include these costs in rate base based on the evidence presented. (Unanimous).

2. CWIP/AFUDC

61. **Delmarva.** Delmarva includes $13,311,425 of CWIP in rate base and makes a corresponding $253,479 AFUDC offset to earnings. (Ex. 33 (VonSteuben) at 36-38). It claims that the CWIP is used and useful, is serving customers and should be treated as plant in service for rate base purposes. (*Id*. at 39). It acknowledges that we excluded CWIP from rate base in Docket No. 05-304, but argues that we should exercise our discretion to include it here based on the circumstances of this case, where many of the projects were "technically complete" and serving customers but had not been transferred to plant in service. It explains that although all eligible CWIP accrues AFUDC, AFUDC does not accrue on completed construction work that is in service but is awaiting the necessary engineering identification of all property units before it can be transferred to plant in service, routine work normally completed within a short time or property ready for service when purchased (i.e., meters, office furniture and equipment). (*Id*. at 36-37). It contends that we recognized that not all CWIP accrues AFUDC in Docket No. 91-20, but allowed CWIP in rate base in that case. It notes that the distribution function normally has a very low effective AFUDC ratio compared to construction projects, and even AFUDC-accruing distribution projects are generally in CWIP for less time than other functions. (*Id.*). Finally, it contends that including CWIP in rate base reduces the effect of regulatory lag. (*Id.* at 36).

62. **Staff.** Following our decision in Docket No. 05-304, Staff excludes CWIP from rate base. (Ex. 58 (Mullinax) at 38-39). According to Staff, FERC regulations require a project ready for service to be recorded as plant in either FERC Account 101 (Electric Plant in Service) or Account 106 (Completed Construction Not Classified) and depreciated. Until a project is transferred to either of these accounts, no primary plant account is assigned; depreciation cannot

start; the project is still considered CWIP; and is not considered to be in service. (*Id*. at 40-41). Staff further contends that "ready for service" is an engineering estimate that the assets are ready to be or are energized, and may or may not be providing service. The assets at issue here were not placed in service and were not accruing depreciation. (*Id*. at 40). It further argues that Delmarva's claim that "many of the projects are technically complete" implies that not *all* of them are. (*Id*. at 41). It acknowledges our discretion regarding CWIP, but contends that Delmarva proffered almost identical testimony in Docket No. 05-304 that had not convinced us in that docket. (Staff OB at 42). It argues that the amount of AFUDC as a percentage of CWIP is less than 2%, just as in Docket No. 05-304, and regardless of which witness' cost of capital recommendation is accepted, the overall rate of return will not be less than 2%. Thus, as in Docket No. 05-304, including CWIP in rate base would have a considerable adverse impact on the revenue requirement – unlike in Docket No. 91-20, where the revenue requirement effect of including CWIP in rate base was essentially equal to the overall authorized rate of return. (*Id.*). It argues that if CWIP is included in rate case, then revenues should be adjusted to reflect projected additional revenues over the same time period. (*Id.* at 43). It further contends that ratepayers should not be responsible for timing differences between when work is completed and ready for service and when all costs are recorded so that the projects can be transferred to plant in service. Finally, it advances the same windfall profit argument that it made in opposition to the reliability plant adjustment. (*Id.*).

63. **DPA.** The DPA also opposes this adjustment, contending that the CWIP was not used and useful within the test period. (DPA OB at 14). The DPA argues that if a lag had caused a delay in the Company transferring plant that was used and useful during the test period

onto its books, it could have amended its application to say so. (*Id*. at 15). Furthermore, a partially projected test period would have encompassed this plant. (*Id*.). Finally, the DPA also complains about the lack of discussion or specificity regarding the adjustments or the plant items or of why the plant was not included in the historical rate base in the first place. (*Id*.).

64. **Delmarva Response.** Delmarva asserts that Staff's contentions "exalt form over substance," because "the fact that the assets are not accounted for as plant-in-service is purely an accounting technicality" and "[t]he substance is that rates should reflect the cost of assets used to provide service to customers." (DPL RB at 15). It claims that Staff's and DPA's suggestion that its position poses a risk that ratepayers will pay for assets that provide them no benefit is wrong. (*Id*. at 16). It says it demonstrated that the assets no longer accrue AFUDC, and that Staff erred in arguing that there was a cost/revenue mismatch. Finally, it denies the possibility of windfall profits because rate base CWIP earns the same return as other rate base assets. (*Id*. at 16-17).

65. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner rejected this adjustment. (HER at 102-03). She agreed with the DPA that Delmarva had not shown which projects were "used and useful" in providing service to customers, and that without such a showing, it had not met its burden of proof. She acknowledged the lag between when a project is technically complete and when the costs thereof are actually transferred into service but concluded that "this lag still does not overcome the fact that the Company did not include in its filing an explanation of which projects were providing service to customers and which were not." (*Id*.). She further found that, as in Docket No. 05-304, there was only minimal AFUDC to offset the $13.3 million of CWIP. In this case, the AFUDC was only 0.2% of CWIP, which the Hearing Examiner found was "far less" than the Company's requested return. (*Id*. at

103). As in Docket No. 05-304, including CWIP in rate base in this case "creates a significant detrimental impact on revenue requirement … ." (*Id*.).

66. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. It asserts that the CWIP either already is, or soon will be, providing service to customers. (DPL E at 58). It contends that CWIP is a designation that identifies projects included on its books and records as ongoing and yet to be completed; however, many projects identified as CWIP are already providing service or will be doing so during the rate effective period, and accounting lag is the only reason they have not been transferred to plant in service. (*Id*.). It argues that the Hearing Examiner's recommendation lacked a reasoned basis because: (1) the testimony was that all of the projects were either already in service or would be soon; (2) she cited no record evidence for her conclusion that including CWIP would have a detrimental impact on revenue requirement, nor was it clear to Delmarva what a "significant detrimental impact" would be; (3) that the amount of CWIP is significant is not a "principled basis" for excluding it, and no other capital investment is subject to such a test; and (4) if the amount of CWIP is substantial, excluding it from rate base places "a substantial, unjustified burden" on Delmarva's shareholders. (*Id*. at 59). Delmarva further asserts that since the Hearing Examiner did not rely on Staff's other arguments, she must have deemed them meritless. As to matching of revenues, Delmarva asserts that if test period incremental revenue CWIP was not accruing AFUDC, then it was in service and providing value to customers, and if it was in service, any revenues associated with it would be synchronized to the non-revenue-accruing CWIP. (*Id*. at 59-60). Last. Delmarva claims that Staff's short-term debt contention is unsupported, and that if CWIP is providing service to customers, it should earn the same return as other assets. (*Id*. at 60).

67. **Discussion.** We agree with the Hearing Examiner and exclude CWIP from rate base. In Delmarva's last electric distribution base rate case, Docket No. 05-304,we exercised our discretion to exclude CWIP from rate base based on the evidence in that case that the amount of AFUDC as a percentage of CWIP was less than 2%. We concluded that including CWIP in rate base under these circumstances would have a "considerable adverse impact" on Delmarva's revenue requirement. *In re Delmarva Power & Light Company,* Docket No. 05-304, 2006 Del. PSC LEXIS 121, Order No. 6930 (June 6, 2006) at 22.

68. The facts of this case are strikingly similar. The amount of AFUDC as a percentage of CWIP in this case is 0.2%; thus, including it in rate base would have a similar detrimental impact on Delmarva's revenue requirement as we found in Docket No. 05-304. Delmarva concedes that we have discretion to include CWIP in rate base, and does not argue that the facts of this case are any different than those presented in Docket No. 05-304. Indeed, we observe that Delmarva made almost the identical arguments in this case as it did in Docket No. 05-304. Nothing in this record persuades us to reverse our decision in Docket No. 05-304. Thus, we decline to include CWIP in rate base. (This requires an adjustment to remove the AFUDC credit associated with the CWIP from Delmarva's earnings, which both Staff and the DPA acknowledge). (4-0, Commissioner Winslow abstaining).

E. CONTESTED OPERATING EXPENSE ISSUES

1. Delmarva's Share of PHI Credit Facility Costs

69. **Delmarva.** Delmarva includes in test period expenses the cost of its share of PHI's $1.5 billion credit facility, including amortization of the start-up costs and annual

commitment fees. It claims that the credit facility allows it to borrow in the commercial paper market and is a primary source of short-term liquidity. (Ex. 33 (Von Steuben) at 33-34).

70. **Staff.** Staff does not oppose this adjustment.

71. **DPA.** The DPA opposes including this cost in Delmarva's cot of service. It argues that the credit facility is used either to supplement CWC or to support Delmarva's overall capital structure. If the former, it contends that Delmarva is already being fully compensated through the CWC lead-lag study in rate base; and if the latter, it asserts that Delmarva did not include the facility (or *any* short-term debt) in its capital structure. (DPA OB at 24-25).

72. **Delmarva Response.** Delmarva responds that these costs are not included in its cost of capital since there is no short-term debt in its capital structure. In addition, it notes that the District of Columbia Commission accepted a similar credit facilities adjustment in Potomac Electric Power Company (Pepco) Formal Case No. 1076. Furthermore, Delmarva asserts that the lead-lag study only recovers the return on the time lag between the payment of interest and the receipt of customer payments, and has nothing to do with the facility's start-up or annual maintenance costs. (DPL OB at 45 citing Ex. 34 (Von Steuben-R) at 37).

73. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner did not discuss this issue.

74. **Exceptions.** The DPA excepts to the Hearing Examiner's failure to address the issue. It contends that because Delmarva's capital structure does not contain any short-term debt, the cost of such debt must be excluded from operating expenses because "[r]atepayers should not be charged with expenses for debt that no one suggests benefits them." (DPA E at 2).

75. **Discussion.** We conclude that the credit facility costs should be included in the cost of service. We accept Delmarva's testimony that the credit facility is not a substitute for short-term debt or CWC, and is not encompassed within either item. (Ex. 34 (Von Steuben-R) at 37-38). We note that the DPA does not disagree that the capital structure contains no short-term debt; hence, it is obvious that the facility's costs are not included in the capital structure. We are further persuaded that the CWC lead-lag study only recovers the return on the time lag between the payment of interest and the receipt of customer payments. (*Id.* at 38). Thus, we approve the inclusion of the credit facility costs in the cost of service, including the unamortized balance in rate base. (Unanimous).

2. <u>Regulatory Commission Expense</u>

76. **Delmarva.** Delmarva includes in its cost of service a three-year normalized amount of rate case expense, which includes $40,000 for its retention of expert witness Steven Fetter to rebut Staff's ring fencing proposals. (Ex. 34 (Von Steuben-R) at 10).

77. **Staff.** Staff reduced the rate case costs to reflect the lower cost of Delmarva's cost of capital witness as reflected in his contract, to which Delmarva agreed. (Ex. 34 (Von Steuben-R) at 9; DPL OB at 46). Staff also normalized regulatory commission expenses over five years because Delmarva's rate case history showed that it had filed a rate case every five years on average. (Ex. 58 (Mullinax) at 12-13). Finally, at the evidentiary hearing Staff removed the $40,000 of costs for Mr. Fetter because that expense would not be incurred in any year of the rate effective period and hence would be non-recurring. (Staff OB at 11).

78. **DPA.** The DPA did not contest this adjustment.

79. **Delmarva Response.** Delmarva contends that Staff's proposed five-year normalization period is "contrary to Commission precedent." It argues that Staff's proposal assumes that it will not file another rate case until 2015, even though the evidence showed that it plans to file a rate case as early as 2011 to capture the first year of AMI costs and savings. (*Id.*). It states that it is likely to file rate cases more frequently due to AMI and continued reliability improvements. (DPL OB at 46). It argues that we have described the appropriate normalization period as "'an educated guess,'" and claims that we should look forward to its future rate case plans, as opposed to looking backwards at its rate case history. (*Id*. at 47-48, quoting *In re Tidewater Util., Inc. & Pub. Water Supply Co.*, 1999 Del. PSC LEXIS 275 at *28, Docket No. 99-446, Order No. 5592 (Del. PSC Sept. 20, 1999)).

80. Delmarva also disputes Staff's disallowance of Mr. Fetter's $40,000 fee, asserting that Delaware precedent does not support disallowance of a reasonably incurred rate case expense even if it was incurred only for a single or non-recurring issue in a case. (DPL OB at 46). Delmarva contends that we can only disallow an expense if it is the result of waste, bad faith or abuse of discretion,[5] and that it is "undisputed" that rate case expenses are "'normally accepted operating expenses.'" (*Id.*). It argues that Staff did not contend that the cost was incurred in bad faith, wastefully or inefficiently, since it only retained Mr. Fetter after Staff "unilaterally introduced ring fencing into this proceeding." (*Id*. at 46-47).

81. **Staff.** Staff counters that *Delmarva Power* does not address the situation presented here because the costs at issue there were fuel costs, which are recurring. (Staff RB at

[5]Citing *Delmarva Power & Light Co. v. Pub. Svc. Comm'n*, 508 A.2d 849 (Del. 1986), in turn citing *Diamond State Tel. Co.*, 103 A.2d 304 (Del. Super. 1954) and *Application of Wilmington Suburban Water Corp.*, 203 A. 2d 817 (Del. Super. 1964), *aff'd*, 211 A.2d 602 (Del. 1965).

15-16). Staff further observes that *Wilmington Suburban,* on which the *Delmarva Power* court relied, states that while we cannot arbitrarily disallow an actual expense based upon a theory of reforming the capital structure of a corporation, "the Commission's findings should not be based upon a non-recurring expense or non-recurring income, a windfall." (*Id*. at 16, quoting *Wilmington Suburban*, 203 A. 2d at 835). Additionally, Staff contends that we have held that the presumption of managerial good faith waste/bad faith/abuse of discretion standard has relevance only for determining the level of expense used for prospective ratemaking. (*Id*., quoting *In the Matter of the Application of Artesian Water Co., Inc. for an Increase in Water Rates,* 1991 Del. PSC LEXIS 12, *18, Docket No. 90-10, Order No. 3274 ((Del. PSC May 28, 1991)). Staff argues that the only solid record evidence for determining the appropriate normalization period is Delmarva's rate case history, which shows that it has filed a rate case, on average, every five years. Staff argues that the purpose of normalization is to develop a normal expense level to be recovered in rates on an ongoing basis, not to provide dollar-for-dollar recovery of expenses; that if Delmarva files a rate case next year, the normalization period in that case will be recalculated to take that into account; and that Delmarva acknowledges that if it files a new rate case later than it claims, it will overrecover such expenses. (*Id*., citing *In re Tidewater Utilities, Inc.,* 1999 Del. PSC LEXIS 275 at *28). Finally, Staff notes that Delmarva had stated in a previous docket that revenue decoupling would likely reduce the frequency of rate cases, which seemed inconsistent with its testimony in this case that it would be filing rate cases more frequently. (Tr. at 1112-13).

82. **DPA.** The DPA does not oppose this adjustment or the level of claimed regulatory commission expense.

83. **Delmarva Response.** Delmarva calls Staff's analysis "seriously flawed," contending that *Artesian Water* involved the removal of nonrecurring items to reflect normal test period miscellaneous revenues and did not support removal of witness fees associated with unique issues. It argues that Staff cited no authority for disallowing a witness' fee or other rate case expense because it was nonrecurring, and claims that "a particular case's expenses are by definition non-recurring" since that rate case will not be relitigated in the rate effective period. Moreover, it notes that its next rate case likely will raise issues not raised here, so Mr. Fetter's fee is a "proxy" for costs it will incur in future rate cases. Delmarva contends that rate case expense is a long-recognized element of operating expenses, and Staff had not shown that the expense was wasteful, inefficient or incurred in bad faith. Last, Delmarva argues that Staff caused it to incur the cost by introducing the ring fencing issue, and its revenue requirement includes the cost of Staff's ring fencing expert. (DPL RB at 20-21).

84. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended Staff's proposed five-year normalization period. (HER at 64-65). She stated that "there appears to be no credible reason to deviate from a five-year normalization period as this Commission has used in other cases." (*Id*. at 64). She found Delmarva's stated plans to file another rate case in 2011 to be "tentative," and noted that plans can change. She concluded that "[e]xperience is a known and measurable quantity for this adjustment making use of a five-year normalization period appropriate." (*Id*.). She rejected Staff's proposal to exclude witness Fetter's fee from rate case expense, however, noting that "Staff's aggressiveness" on this issue caused Delmarva to retain Mr. Fetter, and that Staff should have expected Delmarva to incur costs in contesting its proposals. (*Id*. at 64-65).

85. **Exceptions.** Delmarva excepts to a five-year normalization period. It complains that the Hearing Examiner "downplayed the significance" of its undisputed testimony regarding its future rate case plans related to AMI and continued reliability improvements, and erred in accepting Staff's contention that such plans were "tentative." (DPL E at 23-24). It argues that we should avoid looking backwards when it is clear that circumstances are changing, especially where (as here) looking backward ignores that Delmarva was subject to a rate freeze prior to Docket No. 05-304. (*Id*. at 24). It also takes issue with the Hearing Examiner's failure to address our decision in *Tidewater,* in which we rejected reliance on historical experience and credited testimony that the utility intended to file rate cases more frequently in the future. (*Id*.)

86. **Discussion.** We agree with the Hearing Examiner that Mr. Fetter's fee should be included in rate case expense. Although Staff did not except to the Hearing Examiner's recommendation to include it, we note that Delmarva incurred this cost because we raised the ring fencing issue. Delmarva was entitled to defend itself. (Unanimous).

87. We reject the Hearing Examiner's recommendation to use a five-year normalization period. We acknowledge that our precedent on this issue has not been entirely consistent. *Compare Artesian,* 1991 Del. PSC LEXIS 12, PSC Docket No. 90-10, Order No. 3274 (May 28, 1991) at 25-27 (rate case history used to determine normalization period) with *Tidewater,* 1999 Del. PSC LEXIS 275, Docket No. 99-446, Order No. 5592 (Sept. 20, 1999) at *28 ("[t]he issue of the appropriate normalization period entails an educated guess as to when the Company will file its next rate case application"). We acknowledge Delmarva's argument that the rate freeze contributed to the historical average time between rate cases. While we believe that past history can be a reliable indicator of future intentions, and are not saying that such past

history should be ignored, we are also convinced that under the circumstances presented here, a three-year normalization period is more likely to reflect the period between rate cases. (3-2, Commissioners Conaway and Clark voting nay).

3. Normalization of Injuries and Damages (I&D) Expense

88. **Delmarva.** Delmarva included in its cost of service a three-year normalized level of I&D expense for the period ending March 31, 2009. It asserts that I&D expense exhibits significant variability, rising by 9% between 2007 and 2008, and again by 17% in 2009; that we have adopted a normalization approach for variable expenses; and that we approved normalization of such expenses in Docket Nos. 03-127 and 05-304. (DPL OB at 49-50).

89. **Staff.** Staff accepts this adjustment.

90. **DPA.** The DPA opposes the adjustment, arguing that there is not substantial record evidence to support normalization. The DPA contends that an historical test period is presumed normal unless proven otherwise, and that Delmarva had not met its burden of explaining why the test period I&D expense level required normalization. It asserts that it is "not particularly unusual or abnormal" for a test period expense level to be lower than that in prior years because there will be variations in the data in any given test period. (DPA OB at 19-20).

91. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner did not discuss this issue.

92. **Exceptions.** The DPA does not take written exception to the Hearing Examiner's recommendation, although this issue is subject to its strict test period interpretation.

93. **Discussion.** We approve a three-year normalization period for I&D expense. We have long held that normalization is the appropriate ratemaking treatment for volatile expenses

such as these. Indeed, we approved a three-year normalization period in Delmarva's last electric distribution base rate case, Docket No. 05-304. We have already rejected the strict test period position, and we see no other reason to depart from our established practice. We further note that the three-year normalization period is consistent with the normalization period we have approved in this case for rate case expense. (Unanimous).

4. <u>Normalization of Uncollectible Expense</u>

94. **Delmarva.** Delmarva initially used the test period level of uncollectible expense in its cost of service, but in rebuttal it agreed with Staff that uncollectible expenses should be normalized, and so includes a three-year normalized level of uncollectible expense for the three years ending March 31, 2009. (Ex. 34 (Von Steuben-R) at 18; DPL RB at 23-24). It contends that this treatment is consistent with Commission precedent. (DPL RB at 24).

95. **Staff.** Staff agrees with this adjustment.

96. **DPA.** The DPA opposes this adjustment, observing that "the portion of the Company's projection that is based on actual data comes from the period January 2009 through June 2009, or three months beyond the Test Period end." (DPA OB at 20-21, citing Ex. 33 (Von Steuben) at Sch. WMV-6).

97. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner did not discuss this issue.

98. **Exceptions.** The DPA does not take written exception to the Hearing Examiner's recommendation, although this issue is subject to its strict test period interpretation.

99. **Discussion.** We approve a three-year normalization period for uncollectible expense. We have long held that it is appropriate to normalize volatile expenses such as

uncollectible expenses. Indeed, in Delmarva's last electric distribution base rate case, Docket No. 05-304, we approved a three-year normalization period for such expenses (and we note that no participant in that case challenged the adjustment). We have already rejected the DPA's strict test period position, and the DPA has not provided us with any other persuasive reason to depart from our precedent. Additionally, a three-year normalization period is consistent with the normalization period we have approved in this case for rate case expense and I&D expense. (Unanimous).

5. Wage & FICA Adjustment

100. **Delmarva.** Delmarva includes in test period wage and FICA expense several wage increases during and after the test period: two union wage increases that became effective in June 2008 and February 2009 respectively (within the test period); one union wage increase scheduled to become effective in June 2009 (post-test period); two union wage increases that the Company estimated would become effective in February 2010 and June 2010 (post-test period); and a non-union merit wage increase effective on March 1, 2010 (post-test period). (Ex. 33 (VonSteuben) at 14; Ex. 34 (VonSteuben-R) at 15-16). It claims this treatment is consistent with our treatment of such expenses in its last electric and gas cases, and that it reflects "known wage changes required to be made to be reflective of the rate effective period through April 2011." (DPL OB at 51-52, citing Ex. 34 (Von Steuben-R) at 19-20).

101. **Staff.** Staff accepts the annualization of the test period wage increases (Tr. at 656), but opposes the out-of-period wage and FICA increases. First, it argues that the two estimated union wage increases are not reasonably known and measurable, but are merely estimates. (Staff OB at 13). It points out that the estimated union wage increases had still not

taken effect as of the time of briefing in this matter, and since many issues are discussed in union negotiations, it was possible that concessions made during those negotiations would affect the wage level. (*Id.*, citing Tr. at 464-65, 650, 658-60; Ex. 35). Second, it contends that these increases occur far outside Delmarva's test period. (*Id.* at 13). It acknowledges that we accepted similar adjustments in Docket Nos. 91-20 and 05-304, but argues that we should reconsider our decision on this issue, because it did not appear that the issue was fully vetted: in Docket No. 05-304, neither Staff nor the DPA truly focused on the fact that two of the proposed wage increases had not yet been negotiated, and in Docket No. 91-20 (in which Delmarva used a partially projected test period), we addressed just one contractual wage increase that was to become effective only three months after the test period ended. (*Id.* at 14, citing *Delmarva Power*, Docket No. 91-20, Order No. 3389 at ¶¶1, 153, 155). At oral argument, Staff pointed out that the new collective bargaining agreements had not been entered into as of the time the record was closed. (Tr. at 1131).

102. **DPA.** The DPA also opposes this adjustment, claiming that all wage increases after March 31, 2009 must be disallowed because they are beyond the close of the test period. Additionally, the estimated 2010 1.5% wage increases for Locals 1238 and 1307 are simply projected and are not known and measurable. (DPA OB at 28).

103. **Delmarva Response.** Delmarva contends that we must reject the DPA's position because under Delaware law, we "may not simply impose a bright line rule that 'arbitrarily refuse[s] to consider accurate post-test period information in setting utility rates.'" (DPL RB at 24-25, quoting *Delmarva Power*, 337 A.2d 517. It argues that Staff "offers no discussion or evidence" establishing a violation of the matching principle, and that we rejected this argument

in Docket No. 05-304. Similarly, it dismisses Staff's contention that the issue was not thoroughly vetted in the last case, claiming that "a simple review of the Hearing Examiner's recommended decision and the Commission's order in Docket No. 05-304 establishes that the Commission had before it a complete and thorough record upon which to decide this issue." (*Id*. at 25). It asserts that as of June 29, 2010 it negotiated a new collective bargaining agreement that included larger wage increases for the next three years than it included in its revenue requirement in this case. (*Id*. at 25-26). Moreover, the Company contends that even if these were estimates, we approved the Hearing Examiner's recommendation in Docket No. 05-304 to include them because they were reasonably predicted based on history. (*Id*. at 26). Finally, it rejects Staff's observations regarding union negotiations as irrelevant, conjectural and unsupported. (*Id*.).

104. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner acknowledged Delmarva's desire to include these post-test period wage adjustments in its cost of service, but noted that it had selected the test period for the case. (HER at 66). She agreed with Staff and the DPA that the post-test period estimates wage increases for Locals 1238 and 1307 were too speculative to be known and measurable. However, she agreed with Delmarva and included the February 2009 and June 2009 union wage increases, finding that they were "exactly the type of adjustments that are sufficiently concrete and within a reasonable extension of the test period to be included." (*Id*.). She did not discuss the non-union March 2010 merit wage increase that Delmarva also sought to include in cost of service.

105. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation to exclude the 2010 union and non-union wage increases. It argues that the Hearing Examiner did not address its testimony that the increases would reflect its expenses during the rate effective

period, and notes that it entered into collective bargaining agreements with its unions in June 2010. (*Id*. at 25). It is "[p]articularly trouble[ed]" that the Hearing Examiner did not address its arguments rebutting Staff's contentions. It contends that the Hearing Examiner both ignored the evidence and "unjustifiably" departed from both our precedent and the basic ratemaking tenet that rates must be set to permit the utility a reasonable opportunity to cover its costs and earn a return in the rate effective period. Delmarva contends that this cannot occur if "known, verifiable and measurable" adjustments such as these are rejected. It notes that we approved the Hearing Examiner's recommendation to accept eight out-of-period wage increases in Docket No. 05-304, finding that they were either currently in effect, a result of union negotiations, or reasonably predicted based on history. It contends that the issue was fully vetted in Docket No. 05-304. Finally, it claims that the March 2010 non-union merit wage increase that the Hearing Examiner omitted is known, measurable and representative of expenses during the rate effective period, and that neither the DPA nor Staff offered any contrary evidence. (*Id*. at 25-27).

106. **Discussion.** We are sympathetic to the position that several of the increases take place far outside the selected test period. However, this seems to be one of those adjustments that the *Delmarva Power* decision would require us to consider in determining the cost of service. The wage increases at issue here are reasonably known and measurable, and their inclusion in the cost of service is more representative of the period during which rates set here will be in effect. The June 2009 wage increase took effect shortly after the close of the test period, and the March 1, 2010 increase took effect during the course of this case. And while we are not considering the fact that Delmarva reached new collective bargaining agreements with its unions since it is not part of the record, we do observe that in prior cases union contracts have

included annual wage increases. *See Delmarva Power*, Docket No. 05-304. Thus, we reject the Hearing Examiner's recommendation, and approve Delmarva's request to include all of these wage increases in its cost of service. (Unanimous).

6. <u>Employee Benefits Expense</u>

107. **Delmarva.** Delmarva increased test period expense by 8% for medical expenses and 5% for vision and dental expenses, based on work by its benefits consultant, Lake Consulting, Inc. ("Lake"). (Ex. 33 (VonSteuben) at 15).

108. **Staff.** Staff rejects this adjustment on several grounds. First, it notes that Lake did not provide its work to Delmarva until May 2009, after the test period had ended, and the proposed adjustment is outside the test period. (Ex. 58 (Mullinax) at Ex. DHM-14). Second, the estimates are not "reasonably known and measurable." Third, it does not appear that Delmarva considered the impact of the modifications to its benefit plans or what its own insurer(s) have advised it regarding such expenses. Fourth, there is no evidence that any of the companies surveyed provide coverage to Delaware employees, or that the expense trend in the geographic area surveyed is representative of the expense trend in Delaware. In this regard, Staff dismisses the Maryland PSC's acceptance of this adjustment in Delmarva's most recent rate case there, noting that the surveyed companies were located in the Virginia-Maryland-District of Columbia area, where its Maryland employees work, and that geographic area is well known to be more expensive than Delaware. Last, Staff argues that its prior acceptance of this adjustment is irrelevant because it is not bound by a position it took in a different case involving different facts and circumstances. (Staff OB at 15-16).

109. **DPA.** The DPA does not oppose this adjustment.[6]

110. **Delmarva's Response.** Delmarva contends that an adjustment based on estimates is reasonably known and measurable, citing our decision in Docket No. 05-304 on wage and FICA expenses. It further argues that Staff did not show that Delaware's benefit costs are lower than in Maryland or the District of Columbia, and points out that the Lake study was specifically targeted to the mid-Atlantic states, particularly those in which Delmarva operates. (DPL RB at 27-28).

111. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner rejected Delmarva's adjustment. She rejected the strict test period argument, but accepted Staff's contention that the proposed expense level was based on estimates and that the adjustment did not take into account the recent known modifications Delmarva had made to its employee benefit plans. The Hearing Examiner found that 'this could have been a credible adjustment had the Company done some basic work in establishing what its actual health care expenses would be in the effective period." (HER at 74). Without such support, she was unable to recommend approval of this adjustment. (*Id*.).

112. **Exceptions.** Delmarva describes the Hearing Examiner's recommendation as "not supported by the evidence or by common sense" and "unreasonable." It asserts that it "implicitly" adjusted for possible changes to its plans by adopting the low end of Lake's estimates. It claims it is "contrary to common sense" to assume that medical and dental expenses will not increase in the rate-effective period, and inconsistent with *Delmarva Power's* mandate

[6]Delmarva states that the DPA did not provide any argument or basis for disallowing this adjustment (DPL OB at 58), but the DPA does not appear to have addressed this issue in its post-hearing briefs.

that rates should be just and reasonable in the foreseeable future as well as the present. (*Id*. at 35, citing *Delmarva Power*, 337 A.2d 517). (DPL E at 34-35).

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

7. <u>Pro Forma OPEB Expense</u>

114. **Delmarva.** For revenue requirement purposes in this case, Delmarva did not use its test period OPEB expense level, but rather adjusted it to the amount provided by its independent actuary. (Ex. 33 (Von Steuben) at Sch. WMV-10); DPL OB at 59).

115. **Staff.** Staff does not oppose this adjustment.

116. **DPA.** The DPA rejects this adjustment based on its uniform opposition to post-test period adjustments. (DPA OB at 22).

117. **Delmarva Response.** Delmarva contends that its adjustment is sufficiently known and measurable and is necessary to make OPEB expenses more closely reflect the expenses to be incurred over the rate effective period, and that we approved a similar adjustment in Docket No. 05-304. (DPL OB at 60; DPL RB at 28).

118. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner did not discuss this issue.

119. **Exceptions.** The DPA does not except to the Hearing Examiner's failure to discuss this issue.

120. **Discussion.** We accept Delmarva's proposed adjustment and reject the DPA's strict test period construction. This adjustment is reasonably known and measurable, consistent with our previous ratemaking treatment of the expense, and is necessary to make these expenses more closely reflect the expenses to be incurred over the rate effective period. (Unanimous).

8. Pension Expense (Adj. #9)

121. This issue was one of the most hotly contested in this case. There are two parts to this issue. We address first the appropriate level of pension expense to include in Delmarva's revenue requirement. Then we address whether Delmarva should be permitted a return of and on its 2008 pension loss and if so, the appropriate amortization period.

a. Appropriate Level of Pension Expense to Be Included in Rates.

122. **Delmarva.** Delmarva proposes using its estimated 2010 pension expense as determined by its independent actuary, resulting in a $2,460,000 decrease to test period operating income. (DPL OB at 60, citing Ex. 33 (Von Steuben) at 16 and Sch. WMV-11).[7]

123. **Staff.** Staff recommends including a normalized level of pension expense (2008 actual expense and 2009 actuarial estimate) in Delmarva's cost of service. It contends that the actuarial loss the plan experienced during 2008 was the primary driver of Delmarva's increased pension costs, because in every year from 1999 through 2007, Delmarva had net pension income. It further observes that the 2009 return on Delmarva's pension assets was positive and its 2009 year-

[7]Delmarva originally proposed to include the independent actuary's 2009 pension expense estimate. See Ex. 33 (Von Steuben) at 16 and Sch. WMV-11).

end balance substantially exceeded the 2008 year-end balance. Moreover, Delmarva's actuary projects pension costs to decline substantially from their 2009 level over the course of the next four years – from $95,253,000 in 2009 down to $51,971,000 in 2013. (*Id.* at 34; Ex. 53 (Smith). at 18 and Appendix C, p. 11).

124. Staff argues that the District of Columbia PSC rejected Pepco's request to use the 2009 actuarial estimate in its revenue requirement. It acknowledges that the Maryland PSC approved use of the 2009 actuarial estimate, but notes that no participant in that proceeding recommended using a normalized expense level. (Staff OB at 34, *citing* Tr. at 518-19). It argues that we have held that normalization is appropriate "when the level of a utility's test period expense is out of line with its past experience so as not to be representative of the future level of those expenses," and contends that the Company's proposal to use the 2009 actuarial estimate is not representative of the future level of pension expense. (*Id*. at 35, quoting *Delmarva Power*, Docket No. 91-20, Order No. 3389 at ¶¶93, 97). It observes that there was no reason not to use the actuarial estimate in Docket No. 05-304 because it was consistent with Delmarva's past experience. Here, the estimate is substantially out of line with past experience, and is much higher than the expected future pension cost level estimates. Using the 2009 estimate alone for pension expense would embed into rates a pension revenue requirement that reflects the extreme high point of the abnormal and extraordinary market turmoil in 2008. (*Id*. at 36).

125. Staff next argues that Delmarva's claims - that: (1) the large 2008 actuarial loss will be reflected in pension expense for the next ten years since it will be amortized through annual pension expense based on the average future working lives of the participating employees; (2) the "small" 2009 gain did not offset the "large" 2008 loss; (3) the declining

discount rate in 2009 added to the loss to be amortized; and (4) although 2010 pension expense will be "slightly" lower than 2009, it will not return to historical levels for many years) (Ex. 34 (VonSteuben-R) at 22) – demonstrate why normalization is appropriate. Normalization smoothes out fluctuations in volatile expenses, and assures that the test period expense level is not based solely on an extraordinarily abnormal amount. Staff contends that this is especially important here, where the expense level approved in this case will carry through in rates until rates are reset in a new base rate case. (*Id.* at 36).

126. Staff disputes Delmarva's contention that ratepayers benefitted from the $971,000 of pension income included in current rates that reduced the rates that ratepayers would otherwise have had to pay. It points out that Delmarva admitted that the revenue requirement associated with the pension asset included in current rates is $1.758 million, which means that ratepayers actually *paid* $787,000 of net revenue requirement annually related to pensions. (*Id*. at 36-37, citing Tr. at 516).

127. Finally, Staff rejects Delmarva's rebuttal proposal to use an average of 2009 and 2010 estimated expense in the event we adopt a normalization approach (Ex. 34 (VonSteuben-R) at 23), arguing that that approach would result in a fully-forecasted test period for this expense. It contends that the abnormally high 2009 pension expense estimate already included in its proposed normalization adjustment will flow through rates until they are reset in a new case, and including 2010 estimates – which, although not as high as 2009, are still higher than Delmarva has experienced in the past – would skew the expense level even higher. (Staff OB at 37).

128. **DPA.** Based on its strict test period position, the DPA likewise opposes Delmarva's proposed pension expense level, pointing out that the test period level of pension

expense was only $4,448,660 compared to the $15,264,500 2009 actuarial estimate Delmarva includes in its cost of service. (DPA OB at 21).

129. **Delmarva Response.** Delmarva contends that both Staff and the DPA ignore our decision in Docket No. 05-304, in which we approved the use of the actuarially-determined estimate as the appropriate pension expense to include in the revenue requirement. (DPL RB at 28). Delmarva claims that the DPA misreads the evidence: the $15 million number is company-wide; Delmarva's allocation is less than $3.4 million. (*Id*. at 29). It asserts that Staff's normalization approach does not meet the standard established in Docket No. 91-20 because the amount Staff recommends would not be representative of pension expense in the rate effective period. (*Id*.). If pension expense is normalized, Delmarva contends that using 2009 and 2010 estimated expense will better reflect what can be expected during the rate effective period, and scolds Staff for rejecting this approach at the same time Staff uses those same estimates to support its contention that pension expense will decline between 2009 and 2013. (*Id*. at 30).

130. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner recommended normalizing pension expense using the average of the income/expense for 2008 and 2009. (HER at 90). She noted "with interest" that the Company's actuary believed that the 2009 expense level was "an anomaly" and that pension expense would "decrease substantially" in the coming years. This, she found, "gave credence to Staff's contention that normalization provides a more realistic expense level for the 2009 time period for the rate effective period." (*Id*.).

131. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. First, it contends that such treatment is inconsistent with our decision in Docket No. 05-304, in

which we used Delmarva's actuarially-estimated pension expense level for the test period. (DPL E at 50-51). Second, it questions whether the Hearing Examiner understood what she was recommending because she misstated Staff's position. (*Id*. at 51). Third, it argues that the Hearing Examiner's reliance on the actuary's expectation that pension expense would decrease over time did not support using an average of 2008 actual and 2009 estimated pension expense because including actual expense in the average assumed that pension expense was likely to return to that level in the near future. Delmarva says this is "simply incorrect" because pension expense is not expected to return to 2008 levels for many years and because the 2008 loss would be reflected in pension expense for the next ten years. (*Id*. at 51-52, quoting Ex. 34 (Von Steuben-R) at 23). Hence, if the Hearing Examiner believed a normalization approach was appropriate, she should have used an average of 2009 and 2010 expense levels. (*Id*. at 52). Last, the Company contends that the Hearing Examiner's reliance on projected pension expense in coming years is logically inconsistent because she rejected other post-test period expense increases as "too speculative" or "too attenuated" from the test period; thus, she lacked a "principled basis" to find that expense decreases supported Staff's position. (*Id*.).

132. **Discussion.** We are persuaded by the Hearing Examiner's recommendation and Staff's position on the appropriate level of pension expense. Initially, we reiterate that normalization is appropriate when the test period level of an expense is out of line with its past experience so as not to be representative of the level of those expenses in the future. *Delmarva Power*, Docket No. 91-20, Order No. 3389 at ¶¶ 93, 97. In this case, we believe that Staff's proposal to use a normalized expense level comprised of the average of the actual 2008 pension expense and the actuarially-determined 2009 pension expense will more closely reflect the

amount of expense to be incurred during the rate effective period. We reject Delmarva's proposal to use either the 2009 actuarially-determined expense alone, or to normalize the expense using the actuarially-determined 2009 expense and estimated 2010 pension expense, because both the 2009 and 2010 expense amounts are abnormally high when examined in light of prior years (Ex. 53 (Smith) at 14-15), and we believe this would result in overrecovery of the pension expense. In this regard, we observe that the record reflects that Delmarva's own actuary expects pension cost to decline substantially from its 2009 level over the course of the next four years. (*Id.* at 18 and Appendix C, p. 11). We also note that including the 2009 actuarially-determined pension expense that is included in our approved normalization will flow through rates until rates are reset in a new base rate case.

133. We acknowledge Delmarva's argument that the pension expense included in rates was lower because of the existence of the pension asset; however, the fact remains that there was still a positive revenue requirement associated with including pension expense in rates. The pension asset reduced the level of expense, but there is no dispute that the rates approved in Docket No. 05-304 included a positive $787,000 of revenue requirement. (Tr. at 516; Ex. 49 (Ziminsky-R) at Sch. JCZ-2).

134. We are further persuaded by the discussion of our sister Commission in the District of Columbia:

> While Pepco argues that its pension costs should be based on the final 2009 Watson Wyatt Worldwide actuarial report, AOBA correctly points out that, even if the estimates for 2009 are reasonably accurate, there is no basis to assume that they will remain at the 2009 level for 2010 and beyond. Pepco states that there has been significant improvement and stability in the capital markets, and, as noted previously, the Company acknowledges that the stock market has shown recent signs of improvement. As stock

> prices improve, pension costs will decline as shown in the actuarial report. The record shows that pension expense is projected by Pepco to significantly decline from 2009 to 2011. The actuarial report estimates that pension costs will decline from a high of $95.25 million in 2009 to $69.1 million in 2011. Moreover, the 2009 projections do not reflect the PHI entities' … contribution to the pension plan assets. We agree with OPC that pension costs for the rate-effective period will likely be higher than the historic test year amounts, and that costs are likely to be lower than the current year level as a result of the cash infusion into the plan.
>
> Based on the record, it is clear that the extreme volatility experienced by Pepco will not likely continue in the future and that an averaging that recognizes 2009 as an anomaly is appropriate. A two-year average (2008-2009) will appropriately recognize the higher expense incurred by Pepco, also will recognize that 2009 was an unusually bad year and provide the Company's pension assets with an opportunity to rebound. Therefore, for this case and this case only, Pepco's pension costs will be estimated for the rate-effective period based on a two-year (2008-2009) average of actual pension costs.

In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service, Formal Case No. 1076, Order No. 15710 (DC PSC March 2, 2010) at 48-49.

135. We therefore reject Delmarva's proposals regarding the appropriate level of pension expense, and accept Staff's proposed normalized amount. (Unanimous).

b. <u>Delmarva's Amortization Proposal for the 2008 Pension Loss</u>

136. **Delmarva.** Delmarva requests permission to create a regulatory asset of $8.972 million of pension loss (representing both its own loss and its allocation from PHI ServCo) and to amortize this regulatory asset over five years with rate base treatment of the unamortized

balance. (Ex. 49 (Ziminsky-R) at 7; Ex. 53 (Smith) at 6).[8] The $8.972 million represents the difference between (1) the $8,001,610 of actuarially-estimated pension expense for 2009 and (2) the ($970,783) of pension income that the Company calculates is inherently included in present rates. (Ex. 48 (Ziminsky-S) at 3-4 and Schs. JCZ-1 and JCZ-3; Ex. 53 (Smith) at 4). Delmarva contends that its proposal is appropriate because the dramatic increase in 2009 pension expense resulted from economic conditions outside its control, and because pension expense is similar to storm damage expense. (Ex. 48 (Ziminsky-S) at 3-4; DPL OB at 76-77). It sought our approval of its deferral request by December 31, 2009, but since we did not act by the end of 2009, the 2009 pension expense remains recorded as an expense in Delmarva's 2009 financial statements. (Ex. 53 (Smith) at 5). Delmarva directs our attention to the South Carolina Commission's approval of an identical request by South Carolina Electric & Gas Company, asserting that we should follow that Commission's lead in approving the requested ratemaking treatment, and contending that "it is patently unfair to require the Company to absorb this extraordinary expense when customers have received the benefit of reduced rates due to excess pension fund returns for the past several years." (DPL OB at 75-76).

137. **DPA.** The DPA opposes Delmarva's proposed ratemaking treatment. First, it disputes Delmarva's claim that ratepayers benefitted from the pension asset being in rate base. It points out that the revenue requirement associated with the pension asset is actually almost $1.8 million, so ratepayers are paying approximately $800,000 in current rates. (Ex. 80 (Crane) at 42-43; Tr. at 809-10). Second, it contends that the proposal constitutes retroactive ratemaking.

[8]Delmarva originally requested a three-year amortization with rate base treatment for the unamortized balance. (Ex. 48 (Ziminsky-S) at Sch. JCZ-3; Ex. 53 (Smith) at 6).

(DPA RB at 11). Third, it notes that the New Jersey, Maryland and District of Columbia Commissions rejected identical requests by Atlantic City Electric, Delmarva and Pepco. Fourth, it argues that Delmarva's proposal shifts risk to ratepayers without a commensurate reduction in the cost of equity to account for the reduced risk to shareholders. Fifth, it observes that many of Delmarva's customers experienced losses as a result of the economic downturn, but they are not being reimbursed. Sixth, Delmarva's financial results will not be affected by our decision since it has closed its 2009 books. (*Id.* at 11-12). Seventh, it notes that even with these higher-than-anticipated pension costs, Delmarva paid PHI $28 million, and PHI paid its shareholders $178 million, in dividends during the first nine months of 2009; thus, there was no evidence that Delmarva's financial integrity was jeopardized or that it was financially incapable of providing safe and adequate utility service. (Ex. 80 (Crane) at 45; DPL RB at 12). Last, the DPA argues that the return on equity awarded in Docket No. 05-304 reflected risk to shareholders, including the risk of higher-than-expected expenses in certain areas. (DPL RB at 12).

138. **Staff.** Staff also opposes Delmarva's proposal. First, it argues that the requested treatment constitutes retroactive ratemaking. (Staff RB at 22-28; Tr. at 1084-86). Second, it notes that the Commission has never authorized an automatic deferral mechanism for pension expense, and Delmarva has not demonstrated that this expense requires special ratemaking treatment. Third, it expresses concern that guaranteeing recovery of the "abnormally high" 2009 pension expense could deter Delmarva from making just and reasonable reforms to its pension plans. (Ex. 53 (Smith) at 8-9). In this regard, it cites the United States Government Accountability Office's March 30, 2009 report observing an apparent trend away from defined benefit plans in favor of other types of retirement benefit plans (such as defined contribution and

401(k) plans), and further observes that eleven different utilities had reduced or eliminated participation in defined benefit pension plans. (*Id*. at 9-12). Fourth, it notes that the Maryland and District of Columbia commissions denied identical proposals from Delmarva and Pepco, finding that pension costs were "classic, ongoing costs of running a utility company" and did not qualify for "specialized ratemaking treatment." (Staff OB at 30-31, quoting *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; *see also In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, Formal Case No. 1076, Order No. 15710 (D.C. PSC Mar. 2, 2011). Fifth, it observes that the District of Columbia Commission disagreed with the argument that the proposed ratemaking treatment would not discourage Pepco from making changes to its pension plans, and contends that it is "only logical" that guaranteed recovery diminishes one's incentive to control costs. (Staff OB at 30). Next, it argues that Delmarva's discussion of defined benefit plans does not address the regulatory issue presented, but even if it did, Delmarva conceded that many of these supposedly "unique" positions are linemen, which are filled by people who become union members and receive specialized training as journeymen or apprentices; they do not come to Delmarva already having these skills. (*Id*. at 30, citing Tr. at 422-25). Similarly, Staff contends that the defined benefit pension plan benefit provided to existing DPL and PHI employees cannot aid in attracting new employees because employees hired after January 1, 2005 are not eligible to participate in it. (Staff OB at 30, citing Ex. 2 (Kamerick) at 29 and Ex. 46 (Jenkins) at 17). Seventh, it argues that Delmarva's reliance on the South Carolina PSC's decision is misplaced because that Commission established a regulatory asset to *forestall* the filing of a base rate case (and a corresponding increase in electric rates), which is not the case here, and did not address any of the arguments regarding single issue ratemaking, traditional ratemaking principles and the like. (Staff OB at 32). Eighth, it contends that it is irrelevant to the issue of retroactive ratemaking that Delmarva originally filed its Request in May 2009 because under accounting rules, Delmarva had to receive approval to record the pension expense on its books as a regulatory asset before the end of 2009 and that did not occur. (Staff OB at 32). Finally, it argues that Delmarva's claim that ratepayers benefitted from the pension income generated by the defined benefit pension plan in prior rate cases is inaccurate because the revenue requirement associated with the pension asset in rate base produced a net additional revenue requirement to ratepayers. (Staff OB at 33, citing Tr. at 516 and Ex. 49 (Ziminsky-R) at Sch. JCZ-2).

139. **Delmarva Response.** Delmarva argues that it would not be discouraged from making changes to its pension plans, noting that it had made changes in 1999 and 2005, and that it had also eliminated all retiree health and welfare benefits for management and certain union employees hired after January 1, 2005. (Ex. 46 (Jenkins-R) at 16-17). It contends that defined benefit plans are prevalent and important because it is hard to find, hire and train skilled employees in the electric utility industry, and it wants its employees to remain with it as long as possible. (*Id*. at 17-18). It asserts that pension expense is determined more by asset performance and discount rate – over which it lacks control – than by plan design and funding decisions over which it has some control, citing a Vanguard presentation showing that 80% of pension expense volatility is related to the discount rate and investment returns, and only 20% to plan design. (Ex. 49 (Ziminsky-R) at 3 and Sch. JCZ R-3). It claims that a 25 basis point change in the

discount rate changes PHI's pension liability by $40 million, and a 10% change in the value of its pension trust affects annual pension expense by some $10 million. (*Id.* at 3-4). It asserts that Staff ignores ERISA and FASB requirements in determining annual pension expense and funding. (*Id.* at 4). It again cites the South Carolina PSC's approval of South Carolina Electric & Gas' requested deferral. (*Id.* at 5). It compares this expense to storm restoration expense, citing decisions from other jurisdictions allegedly deferring and amortizing storm restoration expenses. (*Id.* at 5). It argues that its proposal is not retroactive ratemaking because it raised the issue before the end of 2009, but we chose to consolidate the issue into this docket. (*Id.*). It claims its proposal is warranted given the size of the expense and the "extraordinary" circumstances that created it. (*Id.* at 5-6). Finally, it contends that ratepayers benefitted in the past from income earned on the pension asset. (Tr. at 498-99, 502, 511-12).

140. **The Hearing Examiner's Findings and Recommendation.** After praising the participants for their "cogent, well developed, thoughtful and disciplined arguments on this most important issue …" (HER at 87-88), the Hearing Examiner rejected Delmarva's proposal. She called the requested regulatory asset treatment "an accounting convention," which she found should not be used "as a reason or justification for the Company to overstate its revenue requirement." (*Id.* at 88). She concluded that "the principles of traditional ratemaking should not be abandoned in this case." (*Id.*). Agreeing with the Maryland and District of Columbia Commissions, she found that "the Company has a mechanism under traditional rate-making principles to care for this expense." (*Id.*). She concluded that Delmarva had not demonstrated "why now it should recover these expenses when it did not allow ratepayers to enjoy the fruits of

the good years when it experienced pension income," and that its proposal was "lopsided in its favor." (*Id*.). She concluded:

> Further, the Company's proposal in this instance gives me the unpleasant feeling that Delmarva believes its ratepayers should be its private insurance company. Whenever there is a financial downturn or an unfortunate economic event, the Company appears to believe the ratepayers should bail it out and make it whole. What Delmarva has experienced with the recent economic downturn is nothing more than the vicissitudes of business (as painful as that may be) that all companies in the United States are grappling with – nothing more. Although Delmarva's ratepayers are captive customers; they are not hostages who should be required to open their wallets every time the Company suffers an economic setback.

(*Id*.).

141. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. It argues that federal law requires PHI to contribute to the pension plan in accordance with formulas generally designed to ensure that the fund can meet its obligations, and that we have typically allowed it "to recover in rates any difference between its actuarially-determined annual pension expense and its share of the return earned on PHI's pension fund assets." (DPL E at 42). In years where the return on the pension assets exceeds its pension expense, the rates charged to customers reflect a "negative" pension expense in that the excess return offsets other costs that would increase base rates, and this is what happened in Docket No. 05-304. It claims that customers have received a benefit of $4,853,915 as of April 2010 as a result of the credit included in Docket No. 05-304. (*Id*.).

142. Delmarva contends that none of the Hearing Examiner's reasons justifies her recommendation, which "is at odds with the cardinal rule of regulation that rates must afford utilities an opportunity to cover their reasonable costs of operation, including a fair return on

investment in assets used to provide service." (*Id*. at 44). It claims that "there is no reasonable scenario under which it can have that opportunity if it is required to absorb an unforeseen pension expense equal to nearly one-third of its annual earnings. (*Id*.; *see also id.* at 49).

143. First, Delmarva contends that the Hearing Examiner's description of a regulatory asset as "an accounting convention" makes no sense. It frames the issue as whether it should be allowed to defer the 2008 pension loss and recover it in its revenue requirement over time, and that we have the authority to allow deferral and amortization of such expenses. If we permit deferral and amortization, the expense is properly included in Delmarva's revenue requirement, and no such "overstatement" will occur. (*Id*. at 44-45).

144. Second, Delmarva argues that the Hearing Examiner's statement that it "did not allow ratepayers to enjoy the fruits of the good years when it experienced pension income" is factually incorrect because the Docket No. 05-304 rates included a $970,783 credit. (*Id*. at 45). It disputes Staff's and the DPA's point that the rates still included a positive revenue requirement associated with pension expense, arguing that the revenue requirement would have been higher in the absence of earnings on the pension fund in prior years. (*Id*. at 48).

145. Third, Delmarva rejects the Hearing Examiner's characterization of Delmarva's customers as "hostages" who should not "be required to open their wallets every time the Company suffers an economic setback." (*Id*. at 45). It asserts that there is no evidence that it has a history of seeking to recover costs through a deferral mechanism or otherwise whenever it experiences an economic setback. It claims that it only made the request in this case because the circumstances were so "highly unusual – a multi-million dollar pension fund shortfall due to the worst economic crisis since the Great Depression." (*Id*.). It characterizes as "absurd" the

Hearing Examiner's "attempt to downplay the significance of the 2008 economic collapse by characterizing it as 'nothing more than the vicissitudes of business … that all companies in the United States are dealing with – nothing more.'" (*Id*. at 45-46).

146. Fourth, Delmarva states that the Hearing Examiner ignored the South Carolina Commission's decision approving the creation of a regulatory asset for South Carolina Electric & Gas Company's 2008 pension expense. It points out that the facts presented in that case are identical to those presented in this case – i.e., that prior to the 2008 financial crisis, SCE&G had excess pension fund earnings that reduced its rates. (*Id*. at 46-47).

147. Fifth, Delmarva claims "ample precedent" for deferral of extraordinary costs, likening the pension expense to expenses incurred in restoring the system after major storms. It argues that these commissions "have recognized that denying deferral and recovery of such costs can deprive a utility of its lawful opportunity to earn a fair return on its investment." (*Id*. at 47).

148. Sixth, Delmarva disagrees that its request constitutes retroactive ratemaking. It claims that it filed its request in May 2009, but we decided to consolidate that application with the electric base rate case, thus preventing it from receiving approval to record the pension expense as a regulatory asset on its books prior to the end of 2009. (*Id*. at 48).

149. Next, Delmarva dismisses the DPA's argument that shareholders were compensated for the risk of excess pension costs in the return on equity, asserting that it was "unreasonable to assume that investors placed any weight on the risk of such an extreme scenario back in 2005" when the Commission approved Delmarva's 10% return on equity. (*Id*. at 49).

150. Last, Delmarva disputes the DPA's contention that it overstated the amount by which 2009 pension expense exceeded the pension costs included in existing rates by not

including the revenue requirement impact of the pension asset included in rate base in Docket No. 05-304. It acknowledges that it experienced a shift from pension income to pension expense on its income statement, but this did not reduce its prepaid pension asset balance to zero, as the DPA's argument assumed. It claims that the current situation is no different than that in Docket No. 05-304, where we rejected the DPA's position that the prepaid pension asset should be excluded from rate base. Thus, it properly computed the amount it seeks to defer. (*Id.* at 49-50).

151. **Discussion.** We reject Delmarva's proposal for the reasons set forth by the Hearing Examiner, Staff and the DPA. We agree with them that we should not abandon the traditional ratemaking practice of including this expense in Delmarva's cost of service. As the DPA observed, many of Delmarva's customers suffered similar losses, but they have no place to turn to make them whole.

152. We are also convinced by the logic of our sister commissions in Maryland and the District of Columbia, both of which rejected identical proposals. The Maryland PSC rejected the proposal because it was:

> … an extraordinary form of ratemaking that we reserve only for very large, non-recurring expense items that have the potential to seriously impair a utility's financial well-being and that do not contribute to the Company's rate base. Pension and OPEB costs fail this test, even in a bad year – they are classic, ongoing costs of running a utility company, and cannot, in our view, qualify for specialized rate treatment. We find again, as we did in 2007, that a pension and OPEB surcharge breaches the historical ratemaking bargain, and the economic challenges of the last two years offer no reason for us to jettison these long-settled principles. We therefore reject the Company's surcharge and amortization proposals and direct it to continue recovering these expenses through rates.

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. 83035 (Md. PSC Dec. 30, 2009) at 15-16.

153. The District of Columbia PSC reached the same conclusion on similar reasoning:

> The Commission rejects Pepco's alternative proposal seeking the creation of a "regulatory asset" for recovery of its pension costs. Our decision here is in accord with our recent ruling in Formal Case No. 1053, where we rejected a comparable tracking proposal. It also accords with the recent decision of the Maryland Public Service Commission, which rejected a similar request by Delmarva Power & Light for a surcharge, or amortization, of large pension and OPEB costs incurred because of the recent economic downturn. None of the other jurisdictions to which Pepco has applied (Maryland, New Jersey and Delaware) has authorized Pepco to treat its 2009 pension expenses as a regulatory asset.
>
> Ordinarily, the risks of stock market fluctuations are borne by the utility. Traditional ratemaking analysis is well-suited to address fluctuations in pension costs. Pepco did not demonstrate that its financial situation is as precarious, or that its pension fund losses were as extreme, as was the case for the South Carolina utility that received "regulatory asset" relief in the *South Carolina Electric and Gas Company* case. Regulatory asset treatment might diminish Pepco's incentives to control its pension costs. We also have considered the community comments objecting to high pension cost recovery by Pepco. The Commission finds that, on this record, Pepco failed to carry its burden of proof to justify a departure from traditional ratemaking procedures for recurring pension costs.

Pepco, DC No. 1076, Order No. 15710 at 61.

154. We reject Delmarva's reliance on *In re: Petition of South Carolina Electric & Gas Company (Electric Operations) for Authority to Defer Certain Charges to the Company's Financial Statements Resulting from the Impact of Recent Economic Developments on Pension Cost*, Docket No. 2090-36-E, Order No. 2009-81 (Feb. 17, 2009). We note that the South

Carolina PSC specifically stated that it would establish a regulatory asset to forestall the filing of a base rate case (and a corresponding increase in electric rates). *Id*. at 3. That is not the case here, where Delmarva filed its base rate case just 18 days after filing its Request. Furthermore, unlike the Maryland and DC PSC decisions, the South Carolina PSC did not address any of the arguments regarding single issue ratemaking, traditional ratemaking principles and the like, and thus it is unclear whether any participant to that proceeding raised such issues.

155. It is true that Delmarva originally filed its Request in May 2009 and we chose to consider it in the context of this rate case. But that does not address the issue of whether such treatment constitutes retroactive ratemaking. Under accounting rules, Delmarva was required to receive approval in order to record the pension expense on its books as a regulatory asset before the end of 2009. We did not grant such approval. Moreover, FASB rules would have required us to conclude that recovery of the pension loss in rates was "probable" in order to grant the requested regulatory asset treatment prior to the end of 2009. (Tr. at 524). Such a finding would have made it difficult for any other participant to challenge that conclusion in this rate case.

156. We are not persuaded by Delmarva's argument that ratepayers benefitted from the pension income generated by the defined benefit pension plan in prior rate cases. This argument ignores that the related pension asset was included in rate base, and that the revenue requirement thereon produced a net additional revenue requirement to ratepayers. The record evidence shows that the revenue requirement in current rates associated with the pension asset is $1.758 million, which means that ratepayers actually paid approximately $787,000 of revenue requirement related to the pension asset every year since the last rate case ($1,758,180 revenue requirement from including pension asset in rate base less $970,783 claimed revenue requirement savings). (Tr. at

516; Ex. 49 (Ziminsky-R) at Sch. JCZ-2). Thus, while ratepayers paid less than they might have had there not been a pension asset, that is simply part and parcel of the ratemaking calculus.

157. We are not insensitive to the fact that this is a substantial amount of money. But we find no reason to abandon our longstanding practice of including these expenses in the traditional ratemaking calculus. We find no record evidence that rejecting the deferral and amortization proposal will impair Delmarva's financial well-being. Indeed, we note the DPA's unrebutted testimony that Delmarva paid its parent PHI $28 million of dividends during the first nine months of 2009, and PHI paid shareholders $178 million during this same period. (Ex. 80 (Crane) at 45; DPL RB at 12). Thus, there is no evidence that Delmarva's financial integrity will be jeopardized or that it will be financially incapable of providing safe and adequate utility service if we do not approve its proposed ratemaking treatment. For these reasons, as well as the other reasons advanced by the Hearing Examiner, Staff and the DPA, we reject Delmarva's request to defer its 2008 pension losses and amortize them over time, with the unamortized balance included in rate base. (Unanimous).

9. Normalization of Storm Restoration Expense

158. **Delmarva.** Delmarva proposed to normalize storm restoration expense over the three years ending March 31, 2009. (Ex. 33 (Von Steuben) at Sch. WMV-13).

159. **Staff.** Staff does not oppose this adjustment.

160. **DPA.** The DPA opposes this adjustment, arguing for inclusion of the test period level of storm restoration expense. (DPA OB at 22). The DPA contends that the Company had not suggested why the expenses for the years ending March 31, 2007 and 2008 were higher that the test period, or why the test period expense level was "abnormally low." (*Id*.). If anything,

the DPA asserts, this expense level is trending downward, reflecting the productivity in the electric industry. (*Id.* at 22-23). It also rejects the contention that this treatment is consistent with our decision in Docket No. 05-304, stating that each case stands on its own facts, and the facts of this case are different than those in Docket No. 05-304. (*Id.* at 23).

161. **Delmarva Response.** Delmarva rejects the DPA's "rigid adher[ence]" to a strict test period. (DPL RB at 30). It cites our prior treatment of these expenses, and notes that test period storm restoration expense was between $2.7-$3 million lower than in the prior two years. (*Id.*). It claims that the DPA's reference to a downward trend "belies experience," and argues that the "logical outcome" of that position "is that there would eventually be no more storm restoration expense – an impossible result" since there will continue to be storms and hence there will continue to be storm restoration expense. (*Id.* at 31).

162. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner observed that although "at first blush" it appeared that storm restoration expense was decreasing, Delmarva's 2010 experience showed otherwise. (HER at 78). In light of the demonstrated volatility of this expense, the Hearing Examiner recommended the proposed normalization adjustment. (*Id.*).

163. **Exceptions.** The DPA does not specifically except to the Hearing Examiner's recommendation.

164. **Discussion.** We adopt the Hearing Examiner's recommendation to accept the Company's proposal to normalize storm restoration expenses using a three-year normalization period. We have held in previous cases that normalization is appropriate for expenses that are volatile and that tend to vary significantly from year to year. Storm restoration expenses are

volatile and tend to vary from year to year, and hence are exactly the type of expense that should be normalized. Thus, we approve the Hearing Examiner's recommendation. (Unanimous).

10. Cost of Commission-Ordered Management Audit

165. **Delmarva.** On August 18, 2009, we authorized Staff to retain consultants to audit the Company's Cost Accounting Manual ("CAM") as part of this proceeding. (Ex. 33 (Von Steuben) at 19). Delmarva includes the estimated $99,000 cost of the audit in its revenue requirement and proposes to amortize it over three years. (*Id*.).

166. **Staff.** Staff does not oppose this adjustment.

167. **DPA.** The DPA opposes this adjustment because it is an out-of-period expense, noting that we did not authorize the CAM audit until over four months after the end of the test period. Furthermore, it argues that if the amount of time between this case and the next rate case is four years, Delmarva would receive total revenue of $99,000 in each of those years, resulting in recovery of nearly $400,000 for a single estimated $99,000 expense. (DPA OB at 23).

168. **Delmarva Response.** Delmarva observes that it did not choose to incur this expense, but rather incurred it because we ordered the audit. Moreover, it argues that the DPA's contention that it will recover nearly $400,000 for a single $99,000 expense is flawed because it will amortize the costs over three years. (DPL OB at 68-69; DPL RB at 31).

169. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner did not address the DPA's arguments on this issue.

170. **Exceptions.** The DPA does not except to the Hearing Examiner's failure to address its arguments on this issue.

171. **Discussion.** We accept Delmarva's adjustment. We instructed Staff to retain a consultant to conduct this management audit, and under that circumstance we consider it to be a legitimate business expense. We further observe that Delmarva is not seeking to include a representative expense level in its cost of service, which would potentially enable it to overrecover if it does not file another rate case for a significant period of time, but, rather, proposes to amortize the expense over three years. Under these circumstances we think it appropriate to permit recovery of the expense in rates. (Unanimous).

11. Energy Advisors

172. **Delmarva.** The State of Delaware has established aggressive energy reduction goals, including reducing energy usage by 15% by 2015. Delmarva learned from focus groups that its customers desire assistance in understanding the complicated energy offerings available to them. The Company proposed included in its cost of service the cost associated with 22 energy advisors and specialists to assist and educate customers about energy efficiency options, such as advanced technology, more complicated pricing programs, weatherization options, load control programs and renewable generation. (Ex. 33 (Von Steuben) at 20; Ex. 34 (Von Steuben-R) at 26; DPL OB at 70).[9]

173. **Staff.** Staff agrees with the concept of the need for the energy advisor function but proposes that only the 13 employees actually hired by the Company as of March 1, 2010 should be included in cost of service.

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[9] In its initial filing, Delmarva proposed to add 23 energy advisors, but reduced its request to 13 upon reviewing Staff's direct testimony. (DPL OB at 69 n. 303).

174. **DPA.** The DPA opposes including any cost for energy advisors because it is an out-of-period expense and the cost is an estimate. (DPA OB at 24).

175. **Delmarva Response.** The Company agrees with Staff's proposal to include the 13 employees hired as of March 1, 2010. Delmarva contends that the positions are important in helping the State meet its energy reduction goals by providing customers with information necessary for them to make informed energy choices. (Ex. 34 (Von Steuben-R) at 26). It claims the positions are "vital" to educating customers about the revenue decoupled rate design, as discussed by witnesses Solganick and Crane. (DPL OB at 70). In this regard, Delmarva notes that Ms. Crane would require Delmarva to demonstrate that adequate resources are in place to address customer inquiries about revenue decoupling. (*Id.*, citing Ex. 80 (Crane) at 39). It contends that the costs are known and measurable and will not result in any new revenue to it; in fact, if successful, the advisors will result in reduced earnings. It concludes that disallowing the cost of these positions would send it and its customers "an inappropriate signal" regarding the importance of energy conservation to the economy and the environment. (DPL OB at 71).

176. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner accepted Staff's proposal to reflect in cost of service the 13 employees that were hired as of March 1, 2010. Even though the adjustment was outside the test period, she found that it was "known and measurable." She further found that the new employees would be "needed to provide effective implementation of the new decoupled rate design should the Commission approve it," and even if we did not approve it, they would be "critical in explaining to customers how to better manage their utility costs." Finally, she noted that the addition of the employees

would not result in any added revenue for Delmarva. Therefore, she recommended including the cost of the 13 energy advisors in the cost of service. (HER at 76-77).

177. **Exceptions.** The DPA excepts to the Hearing Examiner's recommendation, arguing that: (1) the expenses will be incurred outside the test period, if at all; (2) the proposed cost is an estimate; and (3) the record does not show that Delmarva has or had incurred expenses for energy advisors at any time period considered by the Hearing Examiner, nor was there any record evidence as to their actual cost and their actual number. (DPA E at 3-4).

178. **Discussion.** We adopt Staff's adjustment, which we note is supported by the Company. In light of the State's aggressive goals for reducing energy usage, these employees, specifically trained to address energy conservation and usage matters, would appear to be critical to achieving those goals. Moreover, it is undisputed that the 13 employees had been hired as of March 2010. (Ex. 33 (Von Steuben) at 12). It does not appear that the DPA seriously challenges Delmarva's calculation of the cost of the 13 energy advisors; the DPA claims the cost is an "estimate," but the employees' salaries and associated benefits are readily calculable. The cost of the 13 energy advisors that were providing service as of March 2010 are therefore reasonably known and measurable, and as we discussed earlier, our MFRs allow for reasonably known and measurable changes to test period data when such changes will make the test period more reflective of the rate effective period. *See* 26 *Del. Admin. Code* §1.3. Therefore, we find that the cost of the 13 energy advisors should be included in the cost of service. (Unanimous).

12. Supplemental Executive Retirement Plan ("SERP")

179. **Staff.** The SERP provides retirement benefits to Company executives over and above the benefits that they already receive under PHI's other retirement plans. Staff removed

these benefits from the cost of service on the ground that ratepayers should not be burdened with funding these additional benefits, especially in the current economic climate. (Ex. 58 (Mullinax) at 16). It notes that it did not challenge the inclusion of many executive retirement benefits in the cost of service, and points out that the SERP is additional executive compensation over and above what these executives will receive as part of those benefits. It contends that this expense is not necessary for the provision of safe, adequate and reliable utility service, and if Delmarva wants its executives to have such benefits, shareholders should pay for them. It further suggests that if the benefits are so important to Delmarva, it will not allow its executives to go without them simply because ratepayers are not paying for them in rates. (Staff OB at 23-24).

180. **DPA.** The DPA did not oppose this adjustment.

181. **Delmarva.** Delmarva rejects Staff's position. It asserts that Staff's only reason for excluding the SERP expense is that these benefits are "'on top of' its other retirement plans." (DPL OB at 71). It points out that its benefits consultant's study demonstrated that its SERP was below the median of those provided by the companies in its peer group, which put it at a disadvantage in attracting and retaining executive talent "integral" to providing safe and reliable service. (DPL RB at 32). Furthermore, it claims there is no record evidence to support Staff's assertion that it would continue to provide these benefits if ratepayers did not pay for them, and even if that were so, it is not a reason to disallow the costs. (*Id.* at 32-33). Finally, it argues that Staff does not contend that the expenses are "unreasonable, inappropriately incurred, or unnecessary to obtain and retain executive talent." (DPL OB at 71-72).

182. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner rejected Delmarva's inclusion of SERP expense in its cost of service. She accepted

Staff's contention that the SERP benefits are "additional compensation over and above the benefits these executives receive as part of their retirement benefits." She was not persuaded by Delmarva's testimony that the SERP benefits provide benefits to ratepayers, stating that "these benefits paid to the Company's executives are not necessary or instrumental in the provision of safe, adequate and reliable utility service." (HER at 71).

183. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. It first takes issue with her summary of the evidence, contending that she erroneously stated that the DPA contested the SERP adjustment. Second, it argues that she provided no analysis or discussion of why the SERP costs should be excluded "beyond the cursory statement that the costs are not necessary for the provision of service." It complains that she "summarily dismissed" its testimony that these expenses are necessary to "allow [it] to ensure long-term retention of executive talent" and argues that SERP benefits "are commonly used by utilities throughout the country as a form of compensation for their executives." Third, it contends that the Hearing Examiner failed to address its consultant's study showing that its SERP was below the median of peer group companies, which compromised its ability to attract and retain skilled executives even further. (*Id*.). Finally, it asserts that employee compensation is a matter involving its day-to-day operations within its business judgment, and should not be second-guessed in the absence of waste, bad faith or abuse of discretion. (DPL E at 31-32.).

184. **Discussion.** We reject the Hearing Examiner's recommendation. We are persuaded by Delmarva's argument that these benefits are necessary to attract and retain executive talent. Furthermore, these are true retirement benefits, as opposed to executive incentive payments (which we note Delmarva voluntarily excluded from its cost of service in this

case), and as such are not tied to the achievement of financial goals. Thus, we approve the inclusion of these expenses in Delmarva's cost of service. (Unanimous).

13. Non-Executive Incentive Compensation

185. **Delmarva.** The 2009 Annual Incentive Plan ("AIP") is the only incentive plan at issue here. It provides that payouts to non-executive employees will be made only upon attaining overall corporate earnings thresholds of 90% and 93% for Corporate Services and Utility Operations employees, respectively. (Ex. 58 (Mullinax) at 21 and Ex. DHM-18 at p. 2). Delmarva includes a three-year normalized level of non-executive compensation in its cost of service, arguing that:

- It could eliminate the incentives and increase base salaries, but management decided to pay lower base salaries and provide the opportunity to earn higher performance-based rewards. (Ex. 46 (Jenkins-R) at 12);

- The programs help focus employees' attention and efforts on achieving company goals, many of which are explicitly customer-oriented. The financial goals help motivate employees to keep costs down and benefit ratepayers. (*Id.*);

- The specifics of the incentive programs differ from job to job or among levels but all have employee measures such as safety and all have customer satisfaction components. Although all have financial components such as O&M expense control, managing capital expenditures and achieving targeted income levels, achieving these goals reduces Delmarva's revenue requirement. (*Id*. at 12-13);

- The plans' financial goals benefit customers by allowing Delmarva to set reasonable investment levels to meet reliability, safety and service obligations and commitments at reasonable cost. (*Id*. at 13);

- The plans ensure that employees are spending money carefully and taking care of Delmarva's assets. (*Id*. at 14); and

- The programs can lengthen the time between rate cases and mitigate the size of rate increases when cases are filed. (*Id*.).

186. **Staff.** Staff removed all non-executive incentive compensation from test period expense. It notes that in Docket No. 05-304, we excluded the amount of non-executive incentive compensation expense attributable to achievement of financial goals on the ground that shareholders should pay for the achievement of those goals since they benefit from them. It contends that the AIP is driven first and foremost by financial performance, which benefits shareholders. It points out that since the decision in Docket No. 05-304, the economic climate has only worsened: the Delaware unemployment rate in December 2009 had grown to 9%, compared to 6.7% in January 2009, and the 1.8% rise in Delaware personal income in 2009 trailed the 3.4% increase in consumer prices over the same period. (*Id*.; Ex. DHM-19, p. 1 and Ex. DHM-20, p. 14). In contrast, Delaware's unemployment rate was only 3.7%-3.8% in April-May 2006 when we deliberated in Docket No. 05-304. (Tr. at 421-22).

187. Staff rejects Delmarva's contentions that the AIP helps it to attract and retain employees and motivates them to provide safe and reliable service. It notes that Delmarva made the same arguments in Docket No. 05-304; there was no evidence that safety and reliability would be adversely affected if did not make such payments; and the AIP itself provides that it can be "terminate[d]" at any time. (Ex. 58 (Mullinax) at 21 and Ex. DHM-18, p. 6). It observes that the amount of non-executive incentive compensation in 2008 significantly exceeded such amounts in the preceding five years (increasing from $20,207,487 in 2004 to $43,381,019 in 2008). (*Id.* at 22-23 and Ex. DHM-21). It also points to Delmarva's admission that it was possible that no incentive compensation payments would be made in 2009 or 2010. (*Id*. at 23 and Ex. DHM-22).

188. Staff argues that the AIP does not specifically refer to the achievement of safety/customer satisfaction/reliability goals. It rejects Delmarva's claim that these components are encompassed in the "balanced scorecard" on pages 3-4 of the AIP because the AIP does not describe the balanced scorecard's components, and even if it did, payment is only made if the earnings thresholds are achieved, regardless of whether the safety and customer service goals are met. (Tr. at 419-20, 475). It further argues that Delmarva's plans to file rate cases on a more routine basis belie its claim that such programs help lengthen the time between rate cases, and that Delmarva admits that ratepayers would not benefit from the incentive programs under those circumstances. (*Id*. at 453-54). Last, it noted a recent trend among other commissions to disallow all or a portion of incentive compensation payments. (Staff OB at 20).

189. **DPA.** The DPA also urges disallowance of these expenses. It sees no distinction between executive incentive compensation (which Delmarva did not include in its revenue requirement) and non-executive incentive compensation, since payment under both is tied to the achievement of financial objectives. The DPA is troubled by the claim that the compensation payments improve safety or customer service because this suggests employees would be unsafe or would not try to satisfy customers without them. (DPA OB at 27-28).

190. **Delmarva's Response.** Delmarva claims that its proposal is an "appropriate way to mitigate the variability of incentive expense with a given test period" and provides "a representation of typical incentive levels as opposed to the fluctuations related to potentially having a test period level of incentive expense be too high or too low as compared to the normalized level." It notes that the Maryland PSC adopted this approach in its most recent base rate case, and that the DPA made this recommendation in Docket No. 05-304. (DPL OB at 72).

191. Delmarva argues that we departed from past precedent in disallowing any portion of incentive compensation in Docket No. 05-304, and asks us to reconsider our decision because it believes that a compensation structure that includes incentive compensation tied to the achievement of a "balanced scorecard" of goals is preferable to one based more heavily or exclusively on salary. It claims that the financial triggers ensure that employees are mindful of cost implications. It asserts that Staff's and DPA's argument that employees should not have to be incentivized to provide safe and reliable service is inconsistent with compensation theory, because employees are more likely to excel if there is a financial incentive for doing so. Finally, it claims that in *Commonwealth Edison Co. v. Ill. Comm. Comm'n*, 924 N.E.2d 1065, (Ill. App. 2009), the court only disallowed 50% of the incentive compensation payments, which it asserts undercuts the argument that compensation payments should be disallowed. (DPL RB at 33-34).

192. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner stated that she had reviewed Delmarva's testimony and concluded that it was inadequate to recommend including even 50% of the costs as permitted in *Commonwealth Edison*. She found that Delmarva's testimony "hinted at, but did not provide sufficient concrete benefits to ratepayers" for her to recommend including these costs. (HER at 69).

193. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation, arguing that the record does not support her conclusion. It cites its testimony that such compensation is an important part of employee compensation generally; is used to motivate employees to be more efficient and productive; is important in attracting and keeping skilled workers and achieving customer-oriented goals; and is preferable to a compensation structure based more heavily or exclusively on base pay. It claims that the Hearing Examiner

"unreasonabl[y]" assumed that "a productive, efficient and skilled work-force has limited or no benefit to the Company's customers." It further contends that relying on incentive compensation plans is "consistent with recognized compensation theory," and is more likely to motivate employees. (*Id.*). Third, it notes that in Docket No. 05-304 we expressed our belief that such plans have value. It argues that the AIP's value to customers should not be diminished by its financial triggers" because those triggers ensure that employees focus on the cost implications of decisions, which are important for Delmarva's overall financial soundness and in keeping rates low. Fourth, it again contends that the *Commonwealth Edison* court allowed 50% of the cost of the incentive plan to be recovered in rates. Fifth, it points out that the Maryland Commission permitted it to include this expense in rates. Last, it argues that the decision of how to compensate its employees is within management's discretion, and cannot be disallowed unless it is the product of waste, bad faith or abuse of discretion. (DPL E at 28-30).

194. **Discussion.** This is not the first time we have considered such expenses. We acknowledge that prior to Docket No. 05-304, we included these expenses in Delmarva's cost of service. However, in Docket No. 05-304, we were persuaded, based on the facts presented to us, that the majority of the incentive compensation payments were triggered by the achievement of financial goals rather than goals related to achieving safety, reliability and customer service goals. In balancing the interests of Delmarva and its customers, we concluded that only the amount of those payments that Delmarva demonstrated were attributable to the achievement of safety, reliability and customer service goals should be included in its cost of service.

195. We heard much argument regarding the standard that we must apply in determining whether these expenses should be included in the cost of service. Delmarva asserts

that they must be included unless they are the product of waste, bad faith or abuse of discretion. *See, e.g., Delmarva Power & Light Company v. Public Service Commission*, 508 A.2d 849 (Del. 1985). Staff asserts that we must find that they are necessary and accepted expenses before considering whether they are the product of waste, bad faith or abuse of discretion. *See id.* We need not address either of these arguments because we conclude that Delmarva has not met its burden of proving the amount of non-executive incentive compensation expense that is attributable to the achievement of safety, reliability or customer service goals.

196. During oral argument on this issue on November 10, 2010, our counsel asked Delmarva how much of the claimed non-executive compensation was attributable to these goals. (Tr. at 1143). Delmarva responded with a number (Tr. at 1265-66), to which Staff objected as being outside the record. When we met again to deliberate, Delmarva did not provide us with any record support for the calculation of the amount of non-executive incentive compensation related to the achievement of safety, reliability and customer service goals. (Tr. at 1447). Had there been any record evidence of the amount of non-executive incentive compensation attributable to the achievement of safety, reliability and customer service goals, our determination may have been different. But there is no such evidence. Consequently, we reject Delmarva's proposal to include any non-incentive executive compensation in its cost of service, based on the facts presented in this case. (Unanimous).

14. <u>Executive Compensation Costs</u>

197. In light of the current economic environment, Delmarva removed certain executive compensation from test period expense. (Ex. 33 (VonSteuben) at 16). Staff was unable to ascertain from Delmarva's filing or its discovery responses what items were removed,

and therefore excluded an additional $709,096 of such expenses. (Ex. 58 (Mullinax) at 25-26, 28 and Ex. DHM-24). Delmarva contended that Staff had double-counted much of what it already had removed. Ex. 34 (VonSteuben-R) at 40 and Sch. WMV R-4). By the time Mrs. Mullinax testified, Delmarva had documented its exclusions, and it and Staff agreed that the only issues remaining in Staff's adjustment were: (1) the dividends paid on unvested shares of restricted stock awarded as part of the LTIP; (2) Delmarva's contribution to executives' deferred compensation to compensate for IRS-imposed limits; and (3) the cost of perquisites such as tax preparation fees, financial planning fees, club dues, spousal travel, and housing/meals/transportation costs for Senior Vice President/CFO Paul Barry prior to his relocation after being hired. (Tr. at 626-27; Ex. 63 at Revised Ex. DHM-4.9.1).

198. **Delmarva.** Delmarva proffers many of the same justifications for including these expenses in its cost of service that it asserts for non-executive incentive compensation: (1) they are part of the total compensation package; (2) they are necessary to attract and retain talent; and (3) its total compensation package is somewhat below the midpoint of the competitive range market median of practices (although its executive compensation consultant did not recommend any increase). (Ex. 46 Jenkins-R) at 8). Delmarva claims that perquisites such as transportation allowances or use of Company vehicles facilitate the executives' movement to and from company facilities and community-related events cost-effectively and reliably, and that the financial and tax planning services and physicals are intended to promote the executives' wellness and allow them to focus on PHI's needs, which benefits Delmarva and its customers. (*Id*. at 7). Delmarva did not address Staff's removal of Mr. Barry's housing, meals and transportation costs.

199. **Staff.** Staff acknowledges that the monetary amount at issue is small, but contends that the principle is significant because these are benefits over and above what is necessary for the provision of safe, adequate and reliable utility service. (Staff OB at 23). It argues that Delmarva's justifications for including these expenses are unpersuasive because its witnesses admitted that: (1) three of the five most highly compensated executives identified in PHI's 2008 Proxy Statement and Annual Report to Shareholders had retired or were otherwise no longer with PHI and their replacements were being paid quite a bit less (Tr. at 416-17); (2) four of the five most highly compensated executives started their careers with PHI or its predecessors as lower-level employees who were not afforded such perquisites (*Id*. at 440-47); (3) the one that left (Mr. Barry) was employed for only a short time (*Id*. at 447); and (4) Delmarva likely would not cease providing these executive perquisites if ratepayers are not responsible for them. (*Id*. at 448). It argues that benchmarking off what other companies do creates a never-ending upward spiral because some company is always going to give its executives more, and that while such benefits may be normal in the competitive sector, Delmarva has a monopoly on electric distribution service. It contends that if Delmarva wants its executives to have these extra benefits, shareholders should pay for them. (*Id*.). It concludes that in this economic climate, ratepayers should not be asked to pay expenses that are unnecessary for the provision of safe, adequate, and reliable utility service. (Staff OB at 22-23).

200. **Delmarva Response.** Delmarva contends that executive benefits are an important part of its overall executive compensation package and are required to attract and retain executive talent. (Ex. 46 (Jenkins-R) at 11). It asserts that its consultant's studies show that PHI's total direct executive compensation is somewhat below the midpoint of the

competitive range of the market's median range of practices (nevertheless, the consultant determined that total compensation and benefits were reasonable and did not recommend an increase for 2009). (*Id.*). It claims that removing these expenses from rates denies it cost recovery and penalizes it even though its compensation package is below those of its competitors, and that excluding them from rates would be tantamount to a finding that they are excessive and wasteful. (*Id*.).

201. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner found that "these items do not provide direct benefit to ratepayers" and recommended that we "continue [the] policy espoused in PSC Docket No. 05-304 and approve Staff and DPA's adjustment for this item." (HER at 70).

202. **Exceptions.** Delmarva excepts to the Hearing Examiner's finding and recommendation. It contends that her finding that the costs do not provide a direct benefit to ratepayers "is belied by the record, which establishes that executive compensation is an essential tool in attracting and keeping highly-skilled and talented executives." (DPL E at 30-31).

203. **Discussion.** We accept the Hearing Examiner's recommendation. Although it is a relatively small amount, we note that we have already approved the inclusion of SERP benefits in the cost of service. These items are not necessary for the provision of safe and adequate utility service. We therefore decline to include them in Delmarva's cost of service. (Unanimous).

15. ServCo Audit

204. **Staff.** Staff expresses concern about the amount of ServCo costs allocated to Delmarva. Since 2006, PHI has allocated approximately 27% of ServCo expenses to Delmarva, and the actual dollars allocated have increased from $110.1 million in 2006 to $127.3 million in

2009 on an annualized basis. It notes that in *Pepco* the District of Columbia PSC identified ServCo allocations as a primary issue to be addressed. Finally, it points out that Liberty's November 19, 2009 presentation regarding ServCo allocations to Delmarva did not address the reasonableness of those charges; instead, Liberty conducted a high-level review of the allocations and CAM to identify potential issues that might require further detailed examination. (Ex. 58 (Mullinax) at 42-45). Staff stated that it was willing to coordinate its efforts with those of other commissions conducting such audits to reduce costs. (Staff OB at 27 n. 11; Tr. at 1414).

205. **Delmarva.** Delmarva opposes Staff's recommendation. It claims that a comparison of its administrative and general ("A&G") costs to those of a utility peer group showed that its A&G cost ratios were consistently lower than the peer group average as a percentage of both retail revenues and net plant. (Ex. 2 (Kamerick) at 29-30 and Sch. AJK-3; Ex. 3 (Kamerick-R) at 7). Next, it states that a Hackett Group study shows that PHI's A&G costs are lower than eight other electric utilities. (Ex. 3 (Kamerick-R) at 7 and Sch. AJK-R2). It contends that it files annual reports detailing its transactions with all affiliates, including ServCo, and that it has provided independent auditors' reports to Staff for the years 1997, 1998, 2001, 2004 and 2007. (*Id*. at 7). Finally, it argues that the Securities & Exchange Commission and independent auditors on behalf of the New Jersey BPU and the Maryland PSC have audited its CAM compliance several times since 1998, and have found no evidence of waste, bad faith or abuse of discretion. (*Id*. at 8).

206. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner recommended that we order such an audit. She noted Staff's concern with affiliate transactions and saw its recommendation as "in keeping with its theme of investigating" such

transactions. Given the increase in such costs, she believed that we would want to ensure that ServCo costs allocated to Delmarva "are for purposes that benefit and serve ratepayers." (HER at 72).

207. **Discussion.** We adopt the Hearing Examiner's recommendation. We are not persuaded by Delmarva's argument that it has been audited several times over the preceding years, as many of those audits are several years old and much can change in a short time. While we are concerned about the increasing level of ServCo costs being allocated to Delmarva, for which ratepayers are responsible, we are also sensitive to imposing additional costs on Delmarva (and ultimately the ratepayers, depending on the test period for the next rate case). Thus, we direct Staff to make reasonable efforts to coordinate with any neighboring jurisdictions conducting audits of the same or similar issues. (Unanimous).

16. Deferred Incremental AMI Costs (Company Adj. #20)

208. In its original filing, Delmarva proposed to amortize over three years a total of $1,047,163 (Delaware jurisdictional) of incremental AMI-related expenses incurred through July 2009 that it had deferred as a regulatory asset pursuant to Order No. 7420. (Ex. 33 (Von Steuben) at 30). Staff did not object to recovery of these costs, but contended that the appropriate amortization period was 15 years because that period more accurately reflected the life of the assets. (Ex. 58 (Mullinax) at 36). The DPA originally objected to including any AMI-related amounts, arguing that Order No. 7420 did not say what Delmarva claimed and that Delmarva should not collect any AMI costs until the meters are fully deployed and in service. (Ex. 54 (Cotton) at 22-23). However, both Delmarva and the DPA subsequently abandoned their

positions and agreed to Staff's proposal to amortize the costs over 15 years. (DPA OB at 17; DPL OB at 37).

209. **The Hearing Examiner's Proposed Findings and Recommendation.** Although the Hearing Examiner acknowledged that Delmarva and Staff had reached agreement on this adjustment, and referred to the issue as uncontested (*see* HER at 61), she apparently forgot that the DPA had agreed to a 15-year amortization of these costs because she set forth the DPA's position as that advanced by witness Cotton in his direct testimony. While she found "probative" Delmarva's testimony regarding the costs for which it was seeking recovery, she concluded from this testimony that the costs were not for assets that were used and useful in providing electric service. She recommended that Delmarva revisit the issue when the meters were operational, and that we clarify whether we had authorized creation of a regulatory asset for these costs in Order No. 7420. (HER at 97-98).

210. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. It surmises that the Hearing Examiner may have been confused by the DPA's discussion of the issue in its Opening Brief, in which it seemed to continue to contest it. (DPL E at 57). Delmarva also contends that the recommendation that we clarify whether we created a regulatory asset is unnecessary in light of the "unambiguous directive" in Order No. 7420 permitting Delmarva "to establish a regulatory asset to cover recovery of and on the appropriate operating costs associated with the deployment of the advanced metering infrastructure and demand response equipment." (*Id*. quoting PSC Order No. 7420).

211. **Discussion.** We reiterate our decision in Order No. 7420 that Delmarva is authorized to create a regulatory asset for recovery of and on the appropriate costs associated

with the deployment of AMI. It does not appear that there was any disagreement among the participants that took a position on this issue as to the amount Delmarva had recorded as a regulatory asset, and by the close of briefing, no participant was contending that these costs related to assets that are not used and useful. Therefore, we reject the Hearing Examiner's recommendation that we table the issue until such time as the meters are operational, and approve amortization of $1,047,163 of AMI related costs over 15 years with the unamortized amount to be included in rate base. (Unanimous).

F. COST OF CAPITAL

1. Capital Structure

212. Delmarva proposes a pro forma capital structure as of June 30, 2009 of 52.48% long-term debt and 47.52% common equity. (Ex. 65 (Morin) at 56 and Sch. RAM-14). No participant offering cost of capital testimony challenges the capital structure. However, the DPA observes that it had contended in prior utility rate cases that short-term debt should be included in a utility's capital structure when it is "regularly and consistently utilized for financing," but that we rejected this position in *Artesian Water*, Docket No. 04-42, because the utility had not included any CWIP in rate base. (Ex. 80 (Crane) at 10). In this case, Delmarva seeks to include CWIP in rate base; therefore, if we adopt Delmarva's proposal, the DPA contends that the capital structure should be changed to include short-term debt. (*Id*. at 11). The DPA further argues that Delmarva's capital structure should be amended to include short-term debt if we approve its request to include its credit facility costs in its revenue requirement, because "[t]he Company cannot have it both ways, i.e., exclude short-term debt from the capital structure but include the cost of the credit facility in its revenue requirement." (*Id*. at 12).

213. **The Hearing Examiner's Findings and Recommendations.** The Hearing Examiner did not specifically address this uncontested issue.

214. **Discussion.** No participant challenged Delmarva's selected test period, and as has been seen, we have excluded CWIP from rate base; thus, we need not address the DPA's argument. And although the DPA contends that we should include short-term debt in the capital structure if we include the credit facility costs in Delmarva's cost of service (which we have done), we reject this contention for the reasons set forth in our discussion of the credit facility cost¸ *supra.* (Unanimous).

2. Cost of Long-Term Debt

215. **Delmarva.** Delmarva proposes a 5.45% embedded cost of long-term debt. (Ex. 65 (Morin) at Schs. RAM-16 and -17). The schedules showing its debt issuances include a first mortgage bond issuance of $250 million maturing in December 2013, and another for $100 million maturing in September 2019. (*Id.*).

216. **Staff.** Staff relies on Delmarva's schedules showing its long-term debt issuances. However, Staff notes that Delmarva calculated its proposed embedded long-term debt cost without considering the impact that PHI's unregulated operations might have had on the interest rates for those two issuances, given their timing. (*Id.*). Based on Liberty's conclusions that: (1) Delmarva would not have issued the $250 million of first mortgage bonds in fall 2008 absent PHI's unregulated subsidiaries' extreme liquidity requirements at that same time and (2) both issuances would have had a higher bond rating by about one "notch"[10] but for the impact of the

[10]One "notch" equates to approximately one-third of the way between adjacent bond ratings. (Ex. 84 (Rothschild) at 10).

unregulated activities, Staff calculated what the interest rate on these issuances would have been (1) if the $250 million issuance had been made at the average rate available in the first quarter of 2009 and (2) excluding the impact of PHI's unregulated activities. It concludes that the interest rate on the $250 million issuance would have been 5.31% and 4.73% rather than 6.40% and 5.00%. (*Id*. at 10-11 and Sch. JAR-4 p. 2). These lower rates reduce the embedded cost of long-term debt from 5.45% to 5.08%, which Staff uses to calculate its overall rate of return. (*Id*. at 11 and Sch. JAR-1; Sch. JAR-4 p. 1).

217. Staff argues that Delmarva misapprehends its testimony regarding the unregulated affiliates' impact on the cost of debt, claiming that its witness was clearly referring to Delmarva's calculation of its embedded cost of debt. Staff contends that if Delmarva did not issue the $100 million of first mortgage bonds in September 2009, then its calculation of its long-term debt cost should have been different because the 5.45% includes the $100 million issuance shown in its schedules, but its cost of capital witness did not recalculate the cost of long-term debt with this issuance removed. Next, Staff asserts that Delmarva does not identify what actions it might have taken that could have affected its provision of electric service, or how such actions would have affected its provision of electric service, and moreover, PHI did take actions that affected the provision of electric service. As for Delmarva's contention that several other utilities issued debt at or around the same time in 2008 as Delmarva, Staff argues that there was no evidence about the circumstances leading to those issuances. (Staff OB at 50-52).

218. Staff next argues that Delmarva's own documents and testimony specifically state that PHI accelerated financing activities for its utility subsidiaries that had been scheduled for 2008 and 2009, and thus show that the unregulated subsidiaries' collateral needs caused it to

issue debt in 2008. Staff contends that the debt issuance directly resulted from the unregulated affiliates' liquidity crises that caused them to call back their loans to Delmarva from the money pool, which had the ripple effect of requiring Delmarva to find some other financing source. Next, Staff argues that one would expect that current bond yield spreads are different from those Staff used because the financial calculations were prepared at different times, and the same can be said for any adjustment or calculation involving bond yields. Moreover, Staff contends that Delmarva did not explain how using current spreads would have affected Staff's calculation. (*Id*. at 52-54). Staff contends that while it may not have used the words "waste, bad faith or abuse of discretion," that was the logical conclusion from the facts presented, because there was no evidence that Delmarva itself had ever been in a financial bind at the time PHI accelerated the debt issuance. (Staff RB at 1-2). Finally, Staff argues that the concept of co-insurance does not apply here because adding risky assets does not lower the cost of debt to Delmarva's regulated operations and because the risky activities in which Delmarva's unregulated affiliates were engaging were a direct cause of Delmarva having to issue debt when it did. (*Id*. at 3).

219. **Delmarva Response.** Delmarva argues that Staff's recommended reduction in its long-term debt cost is "unfairly punitive and wrong" and "speculative." (Ex. 16B (Kamerick-RF) at 35-36). First, it claims that it did not complete the September 2009 $100 million issuance. Second, it asserts that Staff "seems to admit" that its position is speculative because it made its embedded cost of debt computation without consideration of what impact non-utility activities might have had on the amount. Third, Delmarva claims that if it had not issued the bonds and the economic downturn continued or worsened into 2009, it likely would have taken more costly actions that could have adversely affected its provision of service. Fourth, it contends that

Staff's recommendation is based on its incorrect beliefs that only the unregulated subsidiaries' collateral needs caused Delmarva to issue debt in 2008 and that appropriately utility-focused management would have sought to avoid issuing debt at that time. Delmarva argues that more than 40 utilities issued over $15 billion of debt during the last five months of 2008. [11] Next, it asserts that Staff's proposed reduction in the cost of debt is based on speculation as to how much higher the rating would have been, noting that the current yield spread data is much different from the data Staff used. (*Id.* at 35-36). Furthermore, it contends that its right to recover its operating costs is governed by the business judgment rule, and Staff had not established that it had committed waste, acted in bad faith or abused its discretion in issuing the bonds when it did. (DPL OB at 9). Last, it argues that Staff ignores the concept of co-insurance, under which the probability of a PHI default is reduced by the consolidation of the operating companies under one corporate entity. (*Id*. at 10).

220. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner recommended Staff's proposed cost of long-term debt. She concluded that Delmarva's argument that the reduction was punitive and incorrect was "not based in fact" because "[n] one reasonably denies that PHI's unregulated subsidiaries' liquidity needs caused PHI to call back money lent to Delmarva and to accelerate the utility financings that had been scheduled for months later." She found that Mr. Kamerick's testimony on the dates and circumstances of the bond issuances supported Staff's recommendation and that those facts were not speculative. She stated that "[i]t is clear from the record that it was the unregulated utilities

[11] We note that Mr. Kamerick's testimony mistakenly refers to 2009; the attachment to his testimony refers to 2008. (*See* Ex. 16B (Kamerick-RF) at Sch. AJK-3).

that caused PHI to seek financing at a point in time that cost the Company a higher interest rate," and therefore it was 'appropriate and reasonable" to adjust the interest rate to account for that higher interest rate. (HER at 19).

221. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. First, it takes issue with her conclusion that "no one reasonably denies" that the unregulated subsidiaries' liquidity needs triggered Delmarva's debt issuances, and spends significant time explaining the factual scenario supporting its position that Delmarva's business needs alone dictated the timing of its bond issuance. (DPL E at 7-11). Second, Delmarva contends that the Hearing Examiner may have been relying on Staff's erroneous testimony that the unregulated subsidiaries withdrew funds that Delmarva had borrowed from the PHI money pool, and argues that that testimony "ignores, or simply misunderstands" that no PHI subsidiary has a right to money pool funds. (*Id*. at 11-12). Third, it contends that the business judgment rule precludes us from second-guessing Delmarva's decision to issue the bonds when it did because the facts demonstrate that it did not commit waste, act in bad faith or abuse its discretion. (*Id*. at 12-15). It contends that the manner in which it chooses to structure itself and affiliate with both regulated and unregulated subsidiaries are matters subject to its business judgment, not ours. (*Id*. at 15). Similarly, it contends that the issuance of the $250 million of bonds in September 2008 was driven by the financial crisis, which severely restricted access to the commercial paper markets, and thus was also a matter for its business judgment. (*Id*. at 16).

222. **Discussion.** After reviewing the record, we are persuaded by Delmarva's arguments on this issue. We find no evidence of waste, bad faith or abuse of discretion in the action that Delmarva took or the timing of that action, in light of the global financial meltdown

that the world experienced in 2008 and the ensuing Great Recession. Thus, we reject the Hearing Examiner's recommendation and find that the appropriate cost of Delmarva's long-term debt is 5.45%. (Unanimous).

3. Cost of Equity ("COE").

223. **Delmarva.** Because Delmarva is a wholly-owned subsidiary of PHI and its stock is not publicly traded, cost of capital witnesses must examine groups of proxy companies as a substitute to determine the appropriate COE for Delmarva. Delmarva witness Roger A. Morin applies four COE models - a Capital Asset Pricing Model ("CAPM"), an empirical ECAPM; a Discounted Cash Flow ("DCF") analysis and a risk premium ("RP") analysis - to two proxy groups of companies: (1) 22 investment-grade, dividend-paying combination electric and natural gas companies having (a) at least 50% of their revenues from regulated utility operations and (b) a market capitalization of less than \$500 million;[12] and (2) the electric utilities comprising the Standard & Poor's ("S&P") Electric Utility Index. (Ex. 65 (Morin) at 4, 20, 38 and Sch. RAM-2).[13] He then applies a 30 basis point upward adjustment for flotation costs. (*Id*. at 41-45). After applying its COE models, Delmarva requests a COE ranging from 10.75% (with

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[12] ALLETE; Alliant Energy; Amaren Corp.; Avista Corp.; CMS Energy Corp.; Consolidated Edison; DTE Energy; Duke Energy; Empire Dist. Electric; Entergy Corp.; Exelon Corp.; MGE Energy; Northeast Utilities; North Western Corp.; NSTAR; NV Energy, Inc.; PG&E Corp.; Public Services Enterprise; TECO Energy; UniSource Energy; Wisconsin Energy; and Xcel Energy, Inc. (Ex. 65 (Morin) at Sch. RAM-2).

[13] Allegheny Energy; Ameren Corp.; CMS Energy Corp.; CenterPoint Energy; Consolidated Edison; DTE Energy; Dominion Resources; Duke Energy; Edison International; Entergy Corp.; Exelon Corp; FPL Group; FirstEnergy Corp.; Integrys Energy; NiSource, Inc.; PG&E Corp.; PPL Corp.; PHI Holdings; Pinnacle West Capital; Progress Energy; Public Services Enterprise; Sempra Energy; Southern Co.; TECO Energy; Wisconsin Energy; and Xcel Energy, Inc. (Ex. 65 (Morin) at Sch. RAM-2).

revenue decoupling) to 11% (without revenue decoupling), which it claims is the "minimum" necessary for it to attract capital on reasonable terms in the current capital markets, which he described as "severely constrained." (Ex. 2 (Kamerick) at 8; Ex. 65 (Morin) at 3).[14]

224. **CAPM.** Dr. Morin testifies that there is no such thing as a truly risk-free rate; therefore, in an RP model such as the CAPM, the ideal proxy for the risk-free rate has a term to maturity equal to the security being analyzed. He uses the 4.3% interest rate on 30-year Treasury bonds prevailing at the time of his direct testimony for his risk-free rate CAPM input. (Ex. 65 (Morin) at 16-17, 19). He states that common stocks are more similar to very long-term bonds than to short- or intermediate-term Treasury notes because their cash flows in the form of dividends last indefinitely. Additionally, utility assets generally have very long-term useful lives and should be matched with very long-term maturity financing instruments. He acknowledges that long-term Treasury bonds are subject to potential interest rate risk, but only if they are sold before they matured. (Ex. 65 (Morin) at 17). Finally, since common equity has an infinite life span, the inflation expectation embedded in its market-required rate of return will equal the inflation rate anticipated to prevail over the very long term. (*Id*. at 18).

225. For his beta input, Dr. Morin calculates the average betas of his two proxy groups (0.72 and 0.76), and uses the average of these averages (0.74). However, he claims that since the

[14] None of the cost of capital witness made any adjustment to the COE in the event we adopted Delmarva's proposed pension deferral and amortization proposal or its proposed Volatility Mitigation Rider ("Rider VM"). We have rejected Delmarva's pension deferral and amortization proposal, and as will be discussed *infra*, we likewise reject the proposed Rider VM.

betas were estimated on five-year historical periods, they do not capture the increase in capital costs that has occurred since the 2008 financial crisis began. (*Id*. at 20-21).

226. Dr. Morin calculates a 6.5% market RP input based on the results of forward-looking and historical studies of long-term RPs. For the historical study, he uses the Morningstar *Stocks, Bonds, Bills and Inflation, 2009 Yearbook* (the "*Yearbook*")[15] historical market RP of common stocks over the income component of long-term Treasury bonds, which is 6.5%.[16] For his forward-looking estimate, he examines a 2003 article that estimated the average *ex ante* expected returns for S&P 500 companies over the 1983-1998 period as 7.2%, which he claims is "reasonably close" to the 6.5% historical estimate and "almost identical" to the 7.1% historical estimate derived if the "disastrous performance of the capital markets during 2008 is excluded from the historical average." Inserting his 4.3% risk free rate, his 0.74 beta and his 6.5% market RP into the CAPM equation, Dr. Morin derives a 9.1% COE (9.4% with the flotation cost adjustment). (*Id*. at 20-23).

227. **ECAPM.** Dr. Morin contends that CAPM-based COE estimates underestimate the return required from low-beta securities and overstate the return required from high-beta

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[15]There are two versions of the "*Yearbook*" – Classic and Valuation. Dr. Morin apparently used the Valuation version; Mr. Rothschild used the Classic version. Dr. Morin notes that the *Yearbook* study covered 20-year bonds rather than 30-year bonds, because 30-year bonds were not always traded or available through the entire period. He states that the difference in yield is not "material." (Ex. 65 (Morin) at 22).

[16]Dr. Morin concurs with the *Yearbook*'s recommended use of the income component rather than the total return. Since the intent is to develop an expected market RP, the income component of total bond return is a better estimate of expected return than total return because investors do not generally anticipate long-term capital gains or losses. (Ex. 65 (Morin) at 21).

securities. Thus, he also calculates Delmarva's COE using an ECAPM model. Inserting his calculated values into the ECAPM equation, Dr. Morin derives a 9.5% COE for Delmarva (9.8% with flotation costs). (*Id*. at 24-26).

228. Dr. Morin states that his CAPM COE estimates are "not significantly above the cost of new debt capital and likely understate the cost of equity capital under current unsettled market conditions." Consequently, they should be accorded less weight under current circumstances because: (1) the betas used in the CAPM analysis do not fully reflect the impact of the ongoing financial crisis; and (2) the Federal Reserve has substantially reduced government interest rates to jumpstart the stalled economy, but (3) the cost of corporate debt and cost of equity for utilities has substantially increased relative to Treasury bond yields. (*Id*. at 28).

229. **RP.** Dr. Morin testifies that in light of the current state of the capital markets, it is inappropriate to use government bond yields in an historical RP analysis because they do not capture the trends in utilities' capital costs. He calculates the historical RP by computing the actual realized return on equity for the S&P Utility Index for each year, using the actual stock prices and dividends of the index, and then subtracting the long-term utility bond return for that year, based on an annual time series analysis applied to the utility industry as a whole over the 1930-2007 period. The average historical RP over this period is 5.0% over both long-term utility bond returns and yields. Using the current 5.6% yield on A-rated utility bonds and the historical 5.0% estimate, Dr. Morin's RP-derived COE is 10.6% (5.6% + 5.0%), and 10.9% with a flotation cost allowance. (*Id.* at 29-30).

230. **DCF.** Dr. Morin testifies that the "standard" DCF model assumes a constant average growth trend for both dividends and earnings, a stable dividend payout policy, a discount

rate in excess of the expected growth rate, and a constant price-earnings multiple, which implies that price growth is synonymous with earnings and dividend growth. It also assumes that dividends are paid at the end of the year, although they are actually paid quarterly. (*Id*. at 33).

231. Dr. Morin uses the consensus projected earnings growth estimates developed by Zacks Investment Research, Inc. ("Zacks") and *Value Line* as proxies for the expected dividend growth component. He rejects using historical growth rates to estimate expected future growth because they have little relevance as proxies for future long-term growth and are already incorporated in analysts' growth forecasts; moreover, several electric utilities have experienced negative growth rates. He also rejects the sustainable growth method to estimate future growth because he claims: (1) it is only accurate if one assumes that the return on book equity ("ROBE") is constant over time and no new common stock is issued (or, if it is, it is issued at book value); (2) it requires an estimated COE for implementation, but a "fundamental contradiction in logic" occurs if that input differs from the recommended COE; and (3) empirical finance literature demonstrates that analysts' forecasts are more significantly correlated to measures of value (such as stock prices and price-earnings ratios). Similarly, dividend growth estimates are not meaningful to investors' growth expectations because (1) such forecasts are not readily available, and (2) some utilities are expected to continue to lower their dividend payout ratio over the next several years, which violates the constant growth model's payout ratio assumption. He states that investors focus more on earnings; therefore, earnings growth (which supports future dividends and share prices) is more meaningful for their long-term expectations. (*Id*. at 34-37).

232. Dr. Morin applies his DCF model to his two proxy groups, using both the *Value Line* and Zacks average long-term growth forecasts and expected dividend yields:

	VL Avg L-T Growth + Expected Dividend Yield = COE	VL Median COE	Zacks Avg L-T Growth & VL Expected Dividend Yield = COE	Zacks Median COE
22-Utility Group	6.4% + 5.2% = 11.5%	11.6%	6.0% + 5.0% = 11%	10.7%
S&P Elec Util	5.5% + 5.4% = 10.8%	11.2%	6.7% + 5.4% = 12.2%	11.4%

(Ex. 65 (Morin) at 38, 40-41 and Schs. RAM-6, RAM-7, RAM-9, RAM-11). Limiting the S&P group to only the utilities deriving a majority of their revenues from regulated utility operations, the medians are 11.2% and 11.4% respectively. (*Id*. and Schs. RAM-10, RAM-12).

233. **Flotation Cost Adjustment.** Delmarva argues that equity capital is not free, and because it has not previously expensed such costs, investors must be compensated for flotation costs on an ongoing basis in order to have the opportunity to earn the authorized return on equity. (*Id.* at 41-42). Delmarva acknowledges that it does not issue its own equity, but contends that denying a flotation cost allowance ignores that the parent-subsidiary relationship "merely transfers [the issuance costs] to the parent." (Ex. 65 (Morin) at 45). Thus, Delmarva applies a 30-basis-point adjustment to each of its COE estimates. (Dr. Morin's direct testimony, *passim*).

234. **Summary of Delmarva's COE Models.** The following summarizes Delmarva's COE model results, including flotation costs:

Study	Result	Median
CAPM	9.4%	
ECAPM	9.8%	
RP	10.9%	
DCF – Elec & Gas – Value Line	11.5%	11.5%
DCF – Elec & Gas – Zacks	11.2%	11.5%
DCF - S&P Elec Utils – Value Line	11.1%	11.7%
DCF – S&P Elec Utils - Zacks	12.5%	11.7%

235. Delmarva's requested COE ranges from 10.75-11% with flotation costs. (*Id*. at 46). Dr. Morin testifies that the proposed revenue decoupling rate design reduces Delmarva's risk by 25 basis points. (*Id.*). With that adjustment, his recommended ROE is 10.75%. (*Id.*).

236. **Staff.** Staff witness James A. Rothschild recommends a COE of 8.50% with revenue decoupling and 9.5% without revenue decoupling, applied to Delmarva's requested capital structure. (Ex. 84 (Rothschild) at 4, 6, 12). He uses CAPM and DCF models to derive his recommended COE. He also applies a market-based CAPM, but rejects the ECAPM.

237. **DCF.** Mr. Rothschild applies his DCF model to Dr. Morin's proxy group of combination electric and gas utilities.[17] He notes, however, that because these companies could have as much as 49% of unregulated operations based on the selection criteria, the COE for this group is probably higher than appropriate for Delmarva due to the upward influence on the COE caused by unregulated operations. Consequently, he warns that his recommended COE could be "conservatively high." (*Id*. at 12).

238. Mr. Rothschild uses a "sustainable growth/retention rate" ("br+sv") methodology[18] to determine the proxy groups' earnings growth. This methodology separates the

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[17]Mr. Rothschild excludes North Western Corp. from the group because *Value Line's* standard edition does not cover it. (Ex. 84 (Rothschild) at 12). Furthermore, although he applies his COE models to the S&P Electric Utility Index Group, he does not believe that group is sufficiently comparable to Delmarva and so does not consider those results in his final recommendation. (*Id*. at 11).

[18]The sustainable growth version of the DCF model is $k = D/P + (br + sv)$, where "br" represents the growth rate resulting from retained earnings, and "sv" quantifies the sustainable growth that can occur if a company is consistently able to sell new common stock at a price above book value. It is called a "sustainable growth" method because it results in a permanent increase to a company's book value per share. (Ex. 84 (Rothschild) at 26).

two ways that earnings create cash flow - dividends and retained earnings. Earnings paid as dividends have a different value to investors than earnings retained in the business. Dividends are the investor's only source of cash while he owns the stock, and when the stock is sold, the sale price depends on investors' expectations of future dividends at that time. The return on retained earnings depends on the opportunities available to the company. When an investor increases his investment in a company by purchasing more stock, the transaction occurs at market price, but when that same investor's investment in a company increases because earnings are retained, the reinvestment occurs at book value. When the market price exceeds book value, retained earnings are worth more than earnings paid as a dividend and vice versa. (*Id*. at 13-15).

239. Mr. Rothschild derives his DCF COE as follows. First, he calculated dividend yields of 5.17% and 4.50% (based on the average market price for the year ending December 31, 2009 and the spot market price on December 31, 2009, respectively). He adjusted these yields to account for the DCF model's general use of the dividend expected over the next year. Next, he obtained the stock price from: (1) the closing prices of the proxy group's stocks on December 31, 2009; and (2) an average of the group's high and low stock prices for 2009. (*Id*. at 34-35 and Sch. JAR-5, p. 1).

240. Mr. Rothschild next estimates the future expected return on equity ("r") for the proxy group by considering *Value Line's* future expected return on book equity ("ROBE") (11.26%), the future expected ROBE consistent with Zacks' five-year EPS consensus projection (10.5%) and the average recent actual ROBE (10.72%). In this regard, he observes that it is not possible to determine precisely what investors expect, so there is room for some "narrow" difference of opinion. He emphasizes that the ROBE in the sustainable growth methodology is

not the same as, and must not be confused with, the *cost* of equity: the expected ROBE only says something about the COE after that earned return is brought into context by relating it to the market-to-book ratio resulting from that expectation. If the market price is low, the COE will be higher than the future expected ROBE, and if the market price is high then the ROBE will be less than the COE. (*Id.* at 35-36 and Sch. JAR-3, p. 1) (emphasis in original; *see also* Tr. at 896-97).

241. Finally, Mr. Rothschild quantifies reinvestment growth ("sv") by applying the proxy companies' actual market-to-book ratios and the compound annual growth rate of stock forecasted to be issued for them. (*Id.* at 36).

242. Combining these inputs, Mr. Rothschild derives COEs between 9.55% (spot stock price) and 9.86% (average 2009 stock price) for the electric and gas proxy group. He reduces these results by 0.15% to recognize that Delmarva's proposed capital structure contains a larger percentage of common equity than the proxy companies. (*Id.* at 36-37 and Sch, JAR-5, p. 1).

243. Mr. Rothschild acknowledges that the constant growth DCF model is frequently used in utility rate proceedings, but warns that it suffers a substantial loss of mathematical integrity when analysts' unadjusted five-year earnings per share ("EPS") growth rates are used as a proxy for long-term sustainable constant growth. He notes that analysts' projected growth rates can provide guidance in determining future cash flows, but should not be used alone to calculate expected growth for the constant growth DCF equation.[19] His sustainable growth DCF model does not rely on an assumption of constant growth, and, unlike the approach using

[19]Mr. Rothschild testifies that COE witnesses typically use Zacks and *Value Line* projected EPS growth rates in their constant growth DCF models; however, for the reasons discussed in his testimony, he does not believe this is appropriate. (Ex. 84 (Rothschild) at 21-23).

analysts' growth forecasts, does not require adjustment because the values for the retention rate and future expected ROBE are the same in the beginning and end years. (*Id*. at 17, 18, 20, 26).

244. Last, Mr. Rothschild believes there is no inherent bias in the DCF model results when the market-to-book ratio is different than 1.0; this only occurs when the form of DCF model being used is defective or if the DCF results are being used for some purpose other than establishing utility rates (such as maintaining a specific stock price). (*Id*. at 15-17).

245. **CAPM.** Mr. Rothschild calculates Delmarva's CAPM COE using both traditional and market-based CAPMs. The traditional CAPM COE is derived by adding a risk premium to a theoretical risk-free rate; the market-based CAPM develops the relationship between the COE and beta by graphing the actual return and the actual beta. He adjusts the results of both CAPM studies by a net +1.07 to account for both a net average decrease in the risk-free rate and a net increase due to financial conditions caused by the Great Recession. (*Id*. at 37-38, 54).

246. ***Traditional CAPM.*** Mr. Rothschild testifies that the appropriate risk-free rate for the traditional CAPM is the normalized short-term debt rate. This is not the current actual short-term Treasury bill interest rate, which can be "substantially artificial" because the Federal Reserve uses short-term treasury bills as a tool to control economic conditions. He derives his 2.63% normalized short-term debt rate by subtracting the average difference between short-term treasury bills and long-term treasury bonds (called the "maturity" or "horizon" premium") from the long-term debt rate. Next, he calculates an average beta of 0.72 for his proxy companies. Finally, he calculates his market RP over the cost of short-term debt for Delmarva of 4.26% by: (1) examining the *Yearbook*'s 9.6% compound annual (geometric) actual return earned by the

average industrial company from 1926-2008; (2) determining that the average RP over this period was 5.9% (9.6% minus 3.7% compound annual (geometric) average return on short-term treasury bills); and (3) multiplying the 5.9% RP by the 0.72 beta. As noted previously, he adjusted this RP upward by 1.07% to account for both a net average 0.74% decrease in the risk-free rate and a net increase of 1.80% due to the financial conditions caused by the Great Recession. Delmarva's COE derived from Mr. Rothschild's traditional CAPM model is 9.02%. (*Id*. at 48-54 and Schs. JAR-3 and JAR-8).

247. ***Market-Based CAPM.*** To derive his market-based CAPM COE for Delmarva, Mr. Rothschild plotted the actual historical relationship between the earned return on equity and beta for ten different portfolios. Although this provides a starting point, the unadjusted results should not be used because: (1) the inflation allowance that investors demand today could be materially different than in the past; and (2) the RP that investors demand for any given beta may not be the same today as it was on average for the historical period. To compute the historic actual returns, he uses the compound annual (geometric) returns achieved from each group of companies as reported in the *Yearbook*. He explains that these returns do not necessarily represent what investors expect future returns to be, but the theory behind examining earned returns over a long time is that "if returns gravitate to a central mean, then the returns achieved over a long period of time will provide guidance." He notes that the *Yearbook* reduces its historical returns by 0.6% to account for the portion of such returns that resulted from the expansion of price/earnings ratios because its authors do not believe that growth is repeatable. Since the *Yearbook* makes no other adjustments, everything else (including interest rates and inflation) is assumed to revert back to the mean. (*Id.* at 56-57).

248. To implement his market-based CAPM method, Mr. Rothschild:

- Graphs the actual 1926-2008 earned return data from the 2009 *Yearbook* using the compound annual (geometric) return; he concludes that the average actual return of 9.70% was earned by a company with a beta of 1.0;

- Uses the Security Market Line graph to solve for the 1926-2008 average COE based on the 0.72 beta applicable to Delmarva and concludes that the average actual return of 8.15% was earned by companies with a beta of 0.72; and

- Increases the historically indicated risk premium by a net 1.05% to account for both a net average decrease in the risk-free rate of 0.75% and a net increase of 1.80% to account for the financial conditions of the Great Recession.

(*Id*. at 68 and Sch. JAR-8, p. 2). Mr. Rothschild's market-based CAPM produces a 9.22% COE for Delmarva. (*Id*. at Sch. JAR-8 p. 2; Tr. at 883).

249. ***Adjustment for Current Market Conditions.*** Mr. Rothschild then adjusts his CAPM results to make them applicable to current market conditions. He testifies that the Great Recession caused two distortions to the RP: (a) investors' flight to quality has caused very low-risk U.S. treasury securities to contain a much lower RP than normal; and (b) investors' fears over worldwide economic conditions have caused them to require a much higher RP to invest in higher risk securities. To derive his adjustment, he first subtracts the interest rate on long-term inflation-indexed treasury bonds (2.03%) from the interest rate on 30-year Treasury bonds as of December 31, 2009 (4.63%) to derive the current market inflation expectation (2.60%). According to the *Yearbook*, historical actual inflation is 3% (a 0.40% difference). He quantifies the abnormally low RP in U.S. treasuries to be 1.07%, obtained by subtracting the average maturity premium of 2.00% from the current interest rate of 4.63% on long-term U.S.

treasuries.[20] The resulting actual current maturity premium of 2.63% is recognized to be 1.07% lower than the 3.70% average maturity premium. (Ex. 84 (Rothschild) at Ex. JAR-8, p. 2).

250. Mr. Rothschild quantifies the increase in the RP necessary to entice investors to invest in riskier investments by comparing the difference between the current interest rate spread between BB-rated corporate bonds and U.S. treasuries and the typical average spread between BB-rated corporate bonds and U.S. treasuries. This spread was 1.80% higher than normal, meaning that in financial markets impacted by Great Recession fears, investors were demanding a substantially higher RP to invest in BB-rated bonds than they had in the past. Since BB-rated bonds are much closer in risk to an equity investment than U.S. treasuries, Mr. Rothschild added this 1.80% to his RP result. The net result of the adjustments to account for differences in the maturity premium, the extra premium to entice investors to invest in riskier assets, and to adjust for the difference between current and historical average expectations for inflation, is a net increase of 1.07% to the CAPM-indicated COE. (*Id*. at Sch. JAR-8, p. 2).

251. **Flotation Cost Adjustment.** Mr. Rothschild opposes Delmarva's flotation cost request. He observes that we rejected such an allowance and reiterated our consistent rejection of such adjustments in Delmarva's last base rate case He also notes the Hearing Examiner's finding in that case that utility stocks were, and had been, selling above book value. (*Id*. at 76-77, quoting *Delmarva Power*, Docket No. 05-304, Order No. 6930 at ¶¶252, 275). In the instant case, the average market-to-book ratio of the proxy companies is well above 1.0. He acknowledges Delmarva's assertion that PHI's stock was trading at approximately 75% of book

[20]The maturity premium of 2.00% is the difference between the average return earned by investors on 30-year U.S. treasury bonds between 1926-2008 of 5.70% and the average return of 3.70% earned by investors on short-term U.S. treasury bills between 1926 and 2008.

value at September 10, 2009, but argues Delmarva used the wrong percentage of book value. Mr. Rothschild states that net book value is the correct value to use in determining whether the book value that equates to rate base will increase or decrease as a result of a new stock offering. Using Delmarva witness Kamerick's testimony regarding PHI's book value per share, total book value and goodwill, Mr. Rothschild calculated a net book value per share of $9.25. At the time of Delmarva's market-to-book computation, PHI's stock price was about $10.50. Therefore, PHI's market-to-book ratio after excluding goodwill (which is not included in rate base) is 1.13, or 13% above book net book value, and the Company still benefitted from selling stock at $10.50 per share because net book value will still increase. (*Id*. at 76-77 and Sch. JAR-3, p. 1).

252. Furthermore, flotation costs are unwarranted on an economic basis. PHI has paid underwriters $28.7 million over the last 20 years for the entire PHI system (an average of approximately $1.4 million per year), and its total book value is approximately $4.1 billion, or $2.7 million without goodwill. Even excluding goodwill, the annual financing cost as a percentage of net book value was 5 basis points per year, far less than Delmarva's requested allowance. (*Id*. at 78-79).

253. **Summary of Staff's COE Recommendations.** Staff's COE studies produce equity cost estimates ranging from 9.02% to 9.93%:

Study	Result
DCF - Comb. Group, Avg. Market Price Y/E 2009	9.86%
DCF – Comb. Group, 12/31/09 Spot Market Price	9.55%
DCF – S&P Elec Util Index Group, Avg Market Price Y/E 2009	9.93%
DCF – S&P Elec Util Index Group, 12/31/09 Spot Market Price	9.68%
CAPM	9.02%
Market-Based CAPM	9.22%

(*Id.* at Schedules JAR-5 and JAR-8).[21] After reducing the results by 0.15% to account for Delmarva's larger percentage of common equity, the average of Staff's DCF results for the combination electric and gas utilities is 9.55%, and the average of Staff's CAPM analyses is 9.12%. (*Id.* at 4-5). Placing primary emphasis on the results of his DCF analyses, Staff recommends a cost of equity of 9.5% for Delmarva before consideration of the appropriate decrement to the COE for the reduced risk resulting from revenue decoupling. (*Id.*).

254. **COE Reduction for Impact of Revenue Decoupling.** Finally, Mr. Rothschild testifies that revenue decoupling will substantially minimize non-diversifiable risks (the risks caused by overall economic conditions). He states that it will almost completely insulate Delmarva from losing revenues as a result of economic downturns, and thus will attenuate the correlation of overall economic growth to its earnings and their contribution to PHI's stock price. He contends that the best way to quantify the impact of revenue decoupling on Delmarva's risk would have been to analyze how revenue decoupling would have changed its income historically, but Delmarva did not conduct such a study. Therefore, he examined the effect on the cost of capital of implementing a revenue stream where ratepayers are required to make up any shortfall in the revenue servicing the debt that finances securitized assets; this reduces the risk to bond investors so that they will invest in debt that pays interest at very low-risk AA or AAA risk categories. He recognizes that ratepayers will not make up shortfalls under the proposed revenue-decoupled rate design, but notes that the rate design will maintain Delmarva's income regardless of reduced usage. He observes that the cost of AA-rated debt as of January

[21] As noted earlier, although Mr. Rothschild applies his DCF method to Dr. Morin's S&P Electric Utility Index group, he gives these results no weight because the group is not a good fit to Delmarva. (*Id.* at 11).

13, 2010 is approximately 5.54%, or 3.96% less than his recommended COE. Based on this differential, he concludes that a reduction of at least 100 basis points in the COE is appropriate, and recommends revisiting the level of the reduction if and when Delmarva shows how revenue decoupling would have affected earnings variability over the last ten years. Thus, Staff's recommended COE with revenue decoupling is 8.5%. (*Id*. at 79-83 and Sch. JAR-1).

255. **DPA.** DPA witness Andrea C. Crane recommends a COE of 9.58% without revenue decoupling and 7.52% with revenue decoupling, derived from applying a constant growth DCF model and a traditional CAPM to the same proxy companies that Dr. Morin used. (Ex. 80 (Crane) at 7, 14-15).[22] The DPA recommends further reducing the COE if other Delmarva risk-reducing proposals are approved (i.e., the deferral and amortization of the 2008 pension loss and Rider VM, although it did not quantify those reductions. (*Id*. at 7).

256. **DCF.** Ms. Crane calculates dividend yields using an average of the stock price over the last three months for each proxy company (4.81%); a spot stock price as of January 29, 2010 (4.84%); and the average dividend yields reported in the January 2010 AUS Utility Reports (4.2% for electric companies; 4.4% for combination electric and gas companies). Based on these results, she proposes a dividend yield of 4.81%. She then increases this dividend yield by one-half of her recommended growth rate (the half-year convention) to reflect the fact that the DCF model is prospective and dividend yields may grow over the next year. (*Id.* at 16).

257. Ms. Crane states that although the DCF model's growth rate is the dividend

[22]Ms. Crane notes that Dr. Morin used two proxy groups, and that some of the same companies appeared in both. As a result, he gave twice as much weight to the companies that appeared twice, which created "a natural bias" in his results. Ms. Crane combined the companies selected by Dr. Morin into one comparable group. (Ex. 80 (Crane) at 16).

growth rate, cost of capital witnesses commonly examine several growth factors to determine the growth rate. She examined 5- and 10-year historical growth in earnings, dividends and book value, and *Value Line* projections in earnings, dividends and book value. These range from a low of (1.3%) to a high of 6.3%. Based on this, she concludes that a 5% growth rate is appropriate. She acknowledges that this is lower than the 5-year earnings and dividend growth projections, but justifies it on the ground that "security analysts have traditionally been overly optimistic in their forecasts, as demonstrated by recommendations made immediately prior to the most recent downturn in the market." She further observes that it is "well above" the 5- and 10-year historic growth rates in earnings, dividends and book value as well as the projected 5-year growth rate in book value. Inputting these growth rates and dividend yields into the DCF model, the DPA estimates Delmarva's DCF-derived COE to be 9.96%. (*Id.* at 17-19 and Sch. ACC-5).

258. **CAPM.** Ms. Crane uses the yield on 30-year Government bonds as of January 28, 2010 of 4.57% for her risk-free rate. She also uses the proxy group's average beta of 0.74, and the historic risk premium of stocks relative to long-term government bonds using geometric mean returns of 5.35%. She contends that geometric mean returns are the appropriate returns for this analysis because they are being used to develop an historic relationship between long-term risk free rates and market risk premiums, not to develop an expected outcome. Inputting these values into the CAPM equation, the DPA's estimated CAPM-derived COE is 8.53%. (*Id*. at 21-23 and Schs. ACC-6 and ACC-7).

259. **Summary of DPA's Recommended COE.** The DPA's DCF and CAPM estimates suggest a COE of 8.44% to 9.96% for Delmarva. Ms. Crane notes that we rely

primarily on the DCF, so she assigned her DCF results a 75% weighting and her CAPM results a 25% weighting. This results in the DPA's recommended 9.58% COE. (*Id.* at 23).

260. **Flotation Cost Adjustment.** The DPA also rejects Delmarva's flotation cost adjustment. First, Ms. Crane notes that Delmarva does not issue common stock, and so does not incur the flotation costs of a publicly-traded stock. Second, she points out that we considered and rejected a flotation cost adjustment in Docket No. 05-304. (*Id*. at 20).

261. **COE Reduction for Impact of Revenue Decoupling.** The DPA rejects as "wholly inadequate" Delmarva's 25 basis point COE reduction if revenue decoupling is implemented. Ms. Crane states that Delmarva's filing is predicated on shifting as much risk as possible from shareholders to ratepayers, using the pension deferral and amortization proposal and Rider VM as examples. She observes that revenue decoupling will transfer from shareholders to ratepayers almost all of Delmarva's revenue risk: because nearly all customers will have flat rate customer and demand charges, Delmarva will receive the same amount of revenue regardless of variations in usage for any reason, i.e., weather, conservation, economic conditions, more efficient appliances, etc. This "results in a tremendous benefit to shareholders" and is "worth considerably more" than 25 basis points. (*Id*. at 6, 12-13).

262. In calculating the DPA's proposed reduction to the COE for revenue decoupling, Ms. Crane first notes that Delmarva faces two kinds of risks: (1) reduced revenues due to multiple factors; and (2) increased costs. The equity risk premium awarded to shareholders is intended to compensate them for the increased risk they bear relative to bondholders. Ms. Crane notes that the equity RP between her proposed 9.58% COE and Delmarva's 5.45% cost of long-term debt is 4.13%. She reduces this RP by 50% to 2.07%. Thus, if revenue decoupling is

accepted, the DPA recommends that the Delmarva's COE premium be reduced by 50% to reflect the fact that shareholders will no longer bear the revenue risk. This produces a 7.52% COE for DPL if we approve revenue decoupling. Ms. Crane opines that her recommendation better values the reduced risk from revenue decoupling than Delmarva's. (*Id.* at 13-14).

263. **DEUG.** DEUG witness Michael P. Gorman recommends a COE of no more than 9.9%, and less if we approve revenue decoupling, derived from applying a constant growth DCF analysis, a sustainable growth DCF analysis, a multi-stage DCF analysis, a CAPM analysis and an RP analysis to the same proxy groups that Delmarva used. (Ex. 77 (Gorman) at 2, 12, 16; DEUG OB at 4). DEUG encourages us to recognize today's low-cost capital market environment and the economic hardships facing Delmarva's customers and "award Delmarva a return on equity that reflects fair compensation for its operating and financial risks, while at the same time minimizing the rate increase necessary to provide fair compensation to Delmarva and recover its cost of service." It recognizes that the 2008 global financial crisis temporarily increased the cost of capital in the market, but while the capital markets (and utility security values) have since recovered, the overall economy has not. (*Id.* at 2-3 and Ex. MPG-2 p. 1).

264. Mr. Gorman observes that: (1) the rating agencies describe the electric utility industry as "maintaining strong investment grade credit" and "well positioned to weather the current economic downturn;" (2) the electric utility index has outperformed the market from 2004-2008 according to Edison Electric Institute ("EEI");[23] (3) Moody's and Fitch Reports

[23]Mr. Gorman notes that the EEI Index underperformed the market during the first three quarters of 2009, but states that this is "not unusual for stocks that are considered 'safe havens' during periods of market turbulence." (Ex. 77 (Gorman) at 7). He quotes EEI as saying that "[t]he Utility sector – with its conservative, stable business models and large regulated asset base –

(which primarily focus on Delmarva's stand-alone financial and operating risk) view Delmarva as low-risk; and (4) S&P's operating risk assessment of Delmarva is negatively affected by its affiliation with higher-risk unregulated activities. The proxy groups' senior secured credit ratings of A- (S&P) and A3 (Moody's) are identical to Delmarva's, and the proxy groups' financial risk is comparable to Delmarva's based on their common equity ratios. Furthermore, the proxy companies and Delmarva have "excellent" S&P business risk profiles, and, based on their EEI rating of "Regulated," the proxy companies have similar operating risk to Delmarva. However, the S&P proxy group has greater financial and operational risk than Delmarva, based on their average common equity ratios and EEI "Mostly regulated" ratings. (*Id*. at 4-10, 12-15).

265. **DCF. (1) Constant Growth DCF.** This analysis attempts to estimate the results of analysts' growth outlooks. Mr. Gorman observes that these projections are for a "relatively short period of time," and so may not reflect long-term sustainable growth. He uses an average of the weekly high and low stock prices over the 13-week period ended January 29, 2010 for his stock price input. He states that an average stock price is less susceptible to "aberrant market price movements" than a spot price, and his selected 13-week period is short enough to contain data that reasonably reflects investors' expectations, but long enough to smooth out any market variations. For his dividend yield, he uses the most recently paid quarterly dividends reported in *Value Line* and adjusts them for the following year's growth. (*Id*. at 16-17).

266. **(a) Using Analysts' 3-5 Year Growth Rate Projections**. Mr. Gorman's first constant growth DCF analysis examines a consensus of professional security analysts' earnings

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suffered less in the crushing bear market than did many other industries, and has predictably trailed those that bounced off very depressed bear market lows." (*Id*., quoting *EEI Q3 2009 Financial Update*).

growth estimates. He uses the average of Zacks, SNL Financial and Reuters growth rate estimates as of February 3, 2010. He says that analysts' growth estimates are more accurate predictors of future returns than growth rates derived from historical data, and are more likely to reflect the growth estimates that influence stock prices than growth rates derived from only historical data. He derives average and median growth rates of 5.47% and 5.17% for the combination electric and gas group, and 5.59% and 5.43% for the S&P electric utility group. His estimated COEs for the proxy groups using these projections are 10.13% and 9.86% (average and median) for the combination electric and gas group, and 10.59% and 10.37% (average and median) for the S&P Electric Utility group. The results range from 9.86% to 10.59%, with a midpoint of 10.23%. (*Id*. at 18-19 and Exs. MPG-4 and 5).

267. Mr. Gorman warns that DCF analyses using analysts' projections are driven by growth rates that exceed a reasonable estimate of long-term sustainable growth. He notes that the average growth rates for the proxy groups (5.47% and 5.59%) are higher than the 4.9% expected long-term growth in the U.S. Gross Domestic Product ("GDP"), which is a proxy for expected long-term sustainable growth. He says that financial literature and texts support the proposition that utilities cannot indefinitely sustain a growth rate exceeding the overall economy's growth rate because utilities' earnings/dividend growth is created by increased utility investment or rate base, which in turn is driven by service area economic growth and demand for service. He notes that utility sales growth has lagged behind GDP growth; consequently, GDP growth is a reasonable proxy for a utility's *highest* sustainable long-term growth rate. The historical perspective shows that the earnings growth outlook for the next 3-5 years is "unusually

robust," which supports his position that such earnings growth projections are higher than the sustainable long-term growth rate. (*Id*. at 20-21).

268. **(b) Sustainable Growth Rate Methodology.** This methodology estimates sustainable growth based on the percentage of retained and reinvested earnings. Reinvested earnings increase the earnings base and will increase the earned return on equity when they are put into service and the utility earns a return on them. The methodology is tied to the percentage of earnings retained: as the payout ratio declines, the earnings retention ratio increases. An increased earnings retention ratio stimulates growth because a utility funds more investment with retained earnings. (*Id.* at 23).

269. Mr. Gorman observes that *Value Line* projects the proxy groups' dividend payout ratio to decline over the next 3-5 years. He testifies that dividend payout and earnings retention ratios can be used to develop a sustainable long-term earnings retention growth rate to determine whether analysts' 3-5 year projected growth rates can be sustained indefinitely. He calculates average and median sustainable growth rates ranging from 4.99%-6.07% for the proxy companies. (*Id*. at 23-24 and Exs. MPG-9 and 10).

270. Mr. Gorman notes that the average growth rates of 5.47% and 5.59% resulting from analysts' projected growth rates and 3-5 year projected dividend payout ratios of 57.85% and 55.95% would require earned ROBEs of 12.98% and 12.69% to support the estimated long-term sustainable growth; however, *Value Line* projects group average ROBEs of 11.26% and 11.94% respectively. This supports his conclusion that analysts' 3-5 year earnings growth projections are not sustainable and will decline over time. (*Id*. at 24).

271. Mr. Gorman's COE estimates using the sustainable growth rate DCF methodology are 9.97% (average and median) for the combination electric and gas group, and 10.93% and 10.51% (average and median) for the S&P Electric Utility group. He concludes that an appropriate range is 9.97% to 10.51%. He relies on the median result for the S&P group rather than the average because he believes the average is skewed by very high and very low estimates for some of the proxy companies, which may be attributable to their non-regulated operations. Based on this range, his sustainable growth DCF methodology COE estimate is 10.24%. (*Id*. at 24-25 and Ex. MPG-11).

272. **(2) Multi-Stage DCF.** Mr. Gorman states that the constant growth DCF model cannot reflect the rational expectation that a period of high/low short-term growth can be followed by a growth rate change to a rate that better reflects long-term sustainable growth. Thus, he performs a multi-stage DCF analysis to reflect the outlook of changing growth expectations. This model, which reflects the possibility of non-constant growth for a company over time, consists of three growth periods: short-term (first five years); transition period (years 6-10) and long-term growth period (year 11 forward). He relies on analysts' consensus forecasts and long-term GDP forecasts for the short- and long-term growth rates, and an annual linear change from short-term to long-term growth for the transition growth rate. He uses the same 13-week stock price and most recent quarterly dividends as he uses for the constant growth DCF analyses. The average and median COE estimates resulting from these analyses are 9.68% and 9.61% for the combination electric and gas group, and 10.07% and 9.94% for the S&P Electric Utility group, with a range from 9.61% to 10.07% and a midpoint of 9.84%. (*Id*. at 25-27 and Ex. MPG-12).

273. **Summary of DEUG's DCF Results.** Averaging the midpoint results of each of the DCF analyses, DEUG's DCF-derived COE is 10.10%. Mr. Gorman cautions that the result of his constant growth DCF model using analysts' projected growth rates should not be used alone "because the current growth rate and dividend yield estimates represent contradictory investment outlooks." He further observes that the sustainable growth DCF growth rate model may not reflect short-term growth outlooks. (*Id*. at 27).

274. **RP.** Mr. Gorman's bond yield plus RP model is based on the principle that investors require higher returns for assuming greater risk. He calculates two equity RP estimates for the 1986-2009 time period: (1) the difference between the required returns on utility common equity and Treasury bonds; and (2) the difference between commission-authorized COEs and A-rated utility bond yields. He observes that utility stocks have consistently traded at a premium to book value over this period, demonstrating that authorized returns have: (1) been sufficient to support market prices that at least exceed book value; (2) supported their ability to issue additional common stock without diluting existing shares; and (3) enabled them to access equity markets without adversely affecting existing shareholders. (*Id*. at 28-29 and Ex. MPG-13).

275. Mr. Gorman testifies that the equity RP should reflect the relative market perception of risk in today's utility industry. His RP analyses show that the average indicated equity RP over Treasury bonds has been 5.16%, with most of the observations falling between 4.40%-6.08%. The average indicated equity RP over Moody's A-rated bond yields has been 3.71%, with a range of 3.03%-4.44%. He opines that using a range of RPs is appropriate because the RP can vary based on market conditions and changing risk perceptions. Furthermore, he believes that his selected time period is appropriate for drawing accurate

conclusions regarding contemporary market conditions. A relatively long time period during which stock valuations reflect premiums to book value indicates that authorized returns and corresponding equity RPs supported investor expectations and provided utilities with access to equity markets on reasonable terms and conditions, smoothes out market aberrations that might distort the equity RPs; and is generally accepted for developing an RP study like his that uses "'expectational'" data. (*Id*. at 29-30 and Exs. MPG-14 and 15).

276. DEUG's first equity RP analysis produces an estimated COE ranging from 9.60%-11.28%, with a midpoint of 10.44%. The second produces a COE ranging from 8.74%-10.15%, with a midpoint of 9.45%. Averaging the two midpoints produces an RP-estimated COE of 9.95%. (*Id*. at 31-32 and Ex. MPG-17).

277. **CAPM.** Mr. Gorman uses *Blue Chip's* projected 30-year Treasury bond yield of 5.20% for his market risk-free rate. He says this rate is appropriate because such bonds are considered to have "negligible credit risk" and have an investment horizon similar to common stock. Because investor-anticipated long-run inflation expectations are reflected in both required common stock returns and bond yields, the nominal risk-free rate included in a long-term bond yield is a reasonable estimate of the nominal risk-free rate included in common stock returns. However, he cautions that because Treasury bond yields include RPs related to unanticipated future inflation and interest rates, they are not truly risk-free; thus, for companies with betas less than 1.0, using this yield as a proxy for the CAPM risk-free rate can overstate the estimated COE. He uses the average *Value Line* betas of 0.72 and 0.75 for the proxy groups. (*Id*. at 33-34 and Ex. MPG-18).

278. Mr. Gorman calculates two market RP estimates: a forward-looking one and one based on a long-term historical average. He derives the forward-looking market RP by estimating the expected return on the market as represented by the S&P 500 and subtracting the risk-free rate from that estimate. He estimates the expected return on the S&P 500 to be 10.78%, obtained by adding an expected inflation rate to the long-term historical arithmetic average real return (which represents the achieved return above the inflation rate). Subtracting the 5.20% risk-free rate results in a 5.58% market RP.[24] The historical market RP is 5.6%, obtained from the 2009 *Yearbook*. (*Id*. at 34-35).

279. Using these inputs, Mr. Gorman derives a CAPM-estimated COE ranging from 9.59%-9.80%, with a midpoint of 9.70%. (*Id*. at 37 and Ex. MPG-19).

280. **Summary of DEUG's COE Estimates.** Averaging the results of its DCF, RP and CAPM models, Mr. Gorman recommends a 9.9% COE for Delmarva. (*Id*. at 37). He states that this recommended COE will support Delmarva's current "A" investment grade bond rating, based on a comparison of its key credit rating financial ratios resulting from its proposed capital structure and his recommended COE to S&P's benchmark financial ratios using its new credit metric ranges, and that the S&P benchmarks show that the 9.9% COE will support internal cash flows adequate to maintain Delmarva's "A" bond rating. (*Id*. at 38-41 and Ex. MPG-20).

281. **Flotation Cost Adjustment.** Finally, Mr. Gorman rejects Delmarva's proposed flotation cost adjustment. He recognizes flotation costs as a legitimate cost of issuing public stock, but states that Delmarva's proposed adjustment is inappropriately based on a general study

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[24] Mr. Gorman notes that the *Yearbook* also calculates a forward-looking market RP, but he disagrees with its estimation methodology. (Ex. 77 (Gorman) at 35-36).

of market flotation costs that may not have any relationship to its actual costs, and that actual book costs should be used for the adjustment. Since Delmarva is not publicly traded, it is unclear what, if any, such expenses it may have. Moreover, while Delmarva's parent provides its equity capital, Mr. Gorman notes that it is unclear whether that equity capital is funded by common stock issuances, debt issuances or internally generated funds. Consequently, any flotation cost adjustment is not known and measurable. (*Id*. at 52).[25]

282. **Discussion.** The requirement of a fair return recognizes that utilities compete for capital with other investments. Accordingly, the return which a utility investor can expect should be commensurate with the returns that could be expected on other comparable-risk investments. See J. BONBRIGHT, A. DANIELSON, and D. KAMERSCHEN, *Principles of Public Utility Rates*, at 316 (2d ed. 1988). In keeping with this, the United States and Delaware Supreme Courts have held that the return to a utility should be sufficient to assure confidence in the utility's financial integrity, to maintain its credit, and to attract capital. *Federal Power Commission v. Hope Natural Gas Co*., 320 U.S. 591 (1944); *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 579 (1923); *Application of Wilmington Suburban Water Co.*, 211 A.2d 602 (Del. 1965). The United States Supreme Court has also instructed, however, that we are "obliged at each step of the regulatory process to assess the requirements of the broad public interest" entrusted to our protection, and that the "'end result'" of our orders "must be measured as much by the success by which they

[25] The participants also spend significant time criticizing the other participants' positions, but reciting those criticisms adds nothing to our analysis; thus, we will not set forth or discuss those criticisms in this Order.

protect those interests as by the effectiveness by which they 'maintain credit and … attract capital.'" *In re Permian Basin Area Rate Cases*¸ 390 U.S 747, 791 (1968) (ellipses in original).

283. We observed in Docket No. 05-304 that determining the appropriate cost of equity "has always been one of the most difficult issues we consider in a rate case." *Delmarva Power*, Docket No. 05-304, Order No. 6930 at 135 ¶269. The COE is one of the largest monetary issues involved in this case; indeed, Delmarva identifies it as one of the "most significant recommendations in terms of detrimental impact … ." (Ex. 3 (Kamerick-R) at 3).

284. For over 20 years, we have relied primarily on the DCF model in ascertaining the appropriate COE for utilities subject to our jurisdiction, although we consider the results of other COE estimation models in reaching our determination. *See, e.g., Delmarva Power*, Docket No. 91-20, Order No. 3389; *Delmarva Power*, Docket No. 05-304, Order No. 6930. The cost of capital witnesses reached the following conclusions based on their applications of various models:

	DCF	**CAPM**	**ECAPM**	**RP**	**FINAL POSITION**
DPL	10.7%-11.4%	9.4%	9.8%	10.9%	10.75-11%
STAFF	9.55%-9.93%	9.02%-9.22%	N/A	N/A	9.5%
DPA	9.96%	8.53%	N/A	N/A	9.58%
DEUG	10.10%	9.7%	N/A	9.95%	9.9%

285. As is apparent, the DCF-derived estimates ranged from a low of 9.55% to a high of 11.4%; the CAPM estimates ranged from a low of 8.53% to a high of 9.7%; the one ECAPM estimate was 9.8%; and the RP-derived estimates ranged from a low of 9.95% to a high of 10.9%. Thus, the record supports a COE anywhere from 8.53% to 11.4%. After reviewing the testimony of the four witnesses, we find convincing DEUG's testimony and analyses in support

of its recommended 9.9% COE; however, we will maintain Delmarva's COE at the currently-authorized 10%.

286. We accept DEUG's undisputed testimony that Moody's and Fitch Reports (which focus primarily on Delmarva's stand-alone financial and operating risk) view Delmarva as low-risk; that the proxy companies' A- (S&P) and A3 (Moody's) senior secured credit ratings are identical to Delmarva's senior secured credit ratings; that the combination electric and gas group's financial risk is comparable to Delmarva's based on their common equity ratios; that the proxy companies and Delmarva have "excellent" S&P business risk profiles; and that the proxy companies have similar operating risk to Delmarva based on their EEI rating of "Regulated." We also take note of DEUG's unrebutted testimony that a 9.9% COE will support Delmarva's current "A" investment grade bond rating, based on a comparison of S&P's benchmark financial ratios using its new credit metric ranges to Delmarva's key credit rating financial ratios resulting from its proposed capital structure and a 9.9% COE, and that the S&P benchmarks show that a 9.9% COE will support internal cash flows adequate to maintain Delmarva's "A" bond rating.

287. While we recognize that the difference in the revenue requirement between a 9.9% COE and a 10% COE is not that significant when spread over Delmarva's customer base, we are also not insensitive to the realities of the market. One reality that our experience has borne out is that the market perceives a double-digit COE as much greater than a single-digit one, even if the difference is only 10 basis points. Another reality is that regulatory boards in other states have authorized double-digit returns for utilities subject to their jurisdiction, and Delmarva must compete with those utilities for capital. Indeed, both Maryland and New Jersey have authorized double-digit returns around 10% for other PHI utilities. We also are aware of

our legal obligation to authorize a return that will assure confidence in Delmarva's financial integrity and allow it to maintain its credit in addition to allowing it to attract capital. The record shows that Delmarva has been able to maintain its investment grade bond ratings and attract capital with a 10% COE even in the worst economic crisis this country has seen for decades. (Ex. 2 (Kamerick) at 22, 25; Tr. at 1207). We are confident that maintaining the current 10% COE will continue to assure confidence in Delmarva's financial integrity, to allow it to maintain its credit, and to allow it to attract capital on reasonable terms.

288. Our determination of the appropriate COE does not include an allowance for flotation costs. We reiterate our conclusion from Docket No. 91-20 that "we do not believe that these costs should be recovered in rates." *Delmarva Power*, Docket No. 91-20, Order No. 3389 at ¶231. (Unanimous).

G. REVENUE DECOUPLING/COST OF SERVICE (Third Settlement Agreement)

1. Revenue Decoupling

289. In Regulation Docket No. 59, we considered whether to implement revenue decoupling mechanisms for the electric and natural gas distribution utilities subject to our jurisdiction. In that docket, Staff recommended a modified fixed/variable ("MFV") rate design, which would collect a utility's fixed costs through a customer/demand charge comporting with the cost causation principles underlying rate design; would stratify customer classes to mitigate the customer impact from this change in rate design; and would send the proper price signals to customers considering whether to engage in energy efficiency measures.

290. In Order No. 7240, dated September 16, 2008, in Regulation Docket No. 59, we approved the adoption of Staff's proposed modified fixed variable rate design for Delaware

distribution utilities in the context of a rate case, but reserved the flexibility to address such rate design changes outside the context of a rate case should the situation warrant.

291. In 2009, the General Assembly enacted 26 *Del. C.* §1500(b)(8) as part of the Energy Efficiency Resource Standards Act of 2009, which mandated revenue-decoupled rate designs for all Commission-regulated electric and natural gas utilities by the end of 2010. During the course of this proceeding, however, the General Assembly repealed that mandate (House Bill No. 378, signed on July 27, 2010), thus leaving it to us to determine whether revenue decoupling is appropriate for the electric and natural gas distribution utilities subject to our jurisdiction, and if so, what type of decoupling mechanism should be implemented.

292. On June 25, 2009, Delmarva filed an application for approval of an MFV rate design, applicable to all service classifications except General Service-Transmission, Outdoor Lighting and Outdoor Recreational Lighting, which it claims is "intended to better levelize and stabilize recovery of delivery-related costs from all customer classes over the course of each year," to "eliminate the relationship between delivery revenue and the level of customer electricity consumption," and to remove disincentives to promote conservation programs so as to better align the interests of customers, utilities, the environment and the State in the area of energy conservation, demand side management and demand response. Delmarva contends that moving forward with an MFV rate design is consistent with the goals of energy-related federal stimulus funding and demonstrates that the State of Delaware, the Commission, and Delmarva Power remain dedicated to achieving energy conservation. (Application in Docket No. 09-276T; (Ex. 40 (Janocha) at 7-8).

293. Under Delmarva's current rate design, the more electricity customers use, the more revenue Delmarva realizes on both delivery and supply. A volumetric charge is an appropriate mechanism to recover supply and commodity-related costs, but is not necessarily appropriate for delivery service, which are essentially fixed costs. An MFV rate design breaks the link between energy consumption and delivery-related revenues. Delmarva further points out that an MFV rate design removes a utility's disincentives to promote conservation and demand response programs, which better aligns the interests of customers, utilities, environment, and the State with respect to conservation goals. (Ex. 40 (Janocha) at 11).

294. Distribution costs are divided into two major categories: customer and demand. Customer costs are costs driven primarily by the number of customers served, such as metering, billing, and customer care. Demand costs refer to costs driven by the maximum load (demand) that must be served at any given time by any given system component: these are the infrastructure costs associated with reliable energy transmission and delivery, such as wires, transformers, substation equipment, system protection and control equipment. A common feature of customer and demand costs is that both are essentially fixed costs that do not vary with the amount of energy consumed. Delmarva contends that distribution rates should be designed with customer charge and demand components that recognize the customer's contribution to the overall load that the distribution system is designed to serve. The proposed MFV rate design generally addresses this criterion by attempting to align service classification cost recovery mechanisms to demand and customer charges to the greatest extent possible. (*Id.*).

295. The customer charge and distribution demand contribution ("DDC") for the proposed MFV rate design will be based on the transmission peak load contribution ("PLC"),

which is calculated on a customer-specific basis, is constant for the entire year and is not susceptible to seasonal fluctuations. The DDC billing determinant is based on peak summer loads and depends on summer usage patterns. It is fixed throughout the year. The demand billing determinant will be the transmission PLC. The stability of the proposed MFV rate design comes from using the transmission PLC for each customer. The relationship between the approved revenue requirement and the transmission PLC used for rate design must be maintained for total revenue decoupling that also addresses customer growth. To accomplish this, the transmission PLC is fixed on a premise basis until new distribution rates are approved in future base rate cases. Delmarva states that this approach achieves complete revenue stability for current customers. (*Id*. at 8-9, 13).

296. Delmarva performed analyses evaluating the impact of the proposed MFV rate design on a revenue-neutral basis and evaluating the combined effect of the proposed rate design modifications and revenue increase. These analyses showed that more than 73% of Residential ("R") customers would experience average overall monthly bill impacts between -5% and 5%, and that over 91% of R customers would experience average overall monthly bill impacts between -10% and 10%. In dollar terms, the average monthly bill impact associated with the MFV rate design for most adversely affected customers is approximately $6.14. (*Id.* at 12).

297. Delmarva also performed bill impact and frequency distribution analyses to demonstrate the combined effect of the proposed rate increase and proposed MFV rate design across the R and Residential Space Heating ("RSH") classes. In this analysis, Delmarva replaced the current monthly volumetric component of a customer's distribution charge with the DDC component. A customer's bill impact depends upon the relationship between his summer usage

and his usage during the rest of the year; therefore, a customer with fairly constant monthly usage throughout the year will be less affected than a customer whose summer usage is significantly higher than his non-summer use. Under the bill impact analysis, the average monthly bill impact on an R customer with a usage pattern at or near the class average usage pattern would be approximately $5.67 (4.6%). The frequency distribution analysis, showing the overall impact of the proposed MFV rate design and rate changes on customers in the R and RSH classes, demonstrates that more than 46% of such customers would see average bill impacts between -5% and 5%, and 75% would see bill impacts between -10% and 10%. (*Id.* at 13).

298. The participants met several times to discuss the proposed MFV rate design and to determine whether the impacts seen on either end of the frequency distribution analyses could be modified in an acceptable way. Ultimately, they entered into a settlement agreement on revenue decoupling and certain cost of service issues (the "First Settlement Agreement"),[26] which they presented to the Hearing Examiner on April 16, 2010. Under the terms of the First Settlement Agreement, the participants agreed that Delmarva would:

- Implement a two-part MFV rate design for electric distribution service, consisting of a customer charge component and a DDC component.

- The customer charge will be designed to recover the full amount of customer-related distribution costs within each customer class.

- The balance of distribution costs will be recovered through the DDC.

- The DDC will be equal to the customer's transmission PLC in effect at the time that new Commission-approved electric distribution rates become effective. The DDC will remain fixed on a customer-premise basis until changed as part of a new electric distribution base rate case. For a customer with a default PLC at the

[26] The cost of service issues will be discussed *infra*.

time new DDC charges are established, the DDC will be equal to the default PLC until an actual PLC is determined, and the DDC will then be adjusted to reflect the actual PLC.

- The DDC will be capped to mitigate its impact on R customers on the extreme high end of the impact frequency distribution.

(Ex. 39).

299. At the evidentiary hearings, all participants except DNREC presented a witness who testified that the First Settlement Agreement was in the public interest and reasonably resolved the issues raised by the non-Delmarva participants. (Tr. at 386, 389, 392, 399-407, 409-10, 808, 842). DNREC made a statement on the record supporting the First Settlement Agreement. (Tr. at 406-08).

300. On July 27, 2010, before the Hearing Examiner issued her findings and recommendations, the General Assembly amended 26 *Del. C.* §1500(b)(8) to remove the mandate for implementation of revenue decoupling by the end of 2010, leaving the determination of whether to even require revenue decoupling to us. Consequently, on August 27, 2010 all participants except DNREC submitted a revised Settlement Agreement (the "Second Settlement Agreement"), in which the only substantive change was the removal of the provision reciting the obligation to implement a revenue-decoupled rate design by the end of 2010. (Ex. 94; HER at 118-19). On August 30, 2010, DNREC advised the Hearing Examiner by e-mail that it would not sign the Second Settlement Agreement because it "feels strongly that any decoupling agreement must also clearly articulate how consumers will benefit from such a structure and that the current document lacks the necessary recognition and agreement on the environmental, energy conservation and efficiency, and rate mitigation programs and benefits for Delaware energy consumers." (Ex. 95).

301. After a conference call with the Hearing Examiner, the other participants advised her via a jointly-submitted letter that they believed that she should treat the Second Settlement Agreement as unopposed despite DNREC's withdrawal therefrom. (Ex. 96).

302. The Hearing Examiner recommended that the Commission approve the Second Settlement Agreement (since there were no real substantive changes from the First Settlement Agreement, which all participants had signed and had testified was in the public interest). She noted that it was supported by participants representing diverse interests, and that we are statutorily encouraged to accept settlements. Since DNREC had raised concerns about consumer protection, outlier rate mitigation and consumer education prior to the implementation of revenue decoupling, and since decoupling was no longer mandated for implementation by the end of 2010, the Hearing Examiner recommended that we consider whether it was appropriate to implement decoupling immediately. She suggested that we could wait to implement decoupling (1) until such time as programs are developed addressing DNREC's concerns; (2) until Delmarva presents a dynamic pricing proposal; or (3) until DNREC reports that its concerns have been satisfied and Delmarva implements dynamic pricing. (HER at 127, 129-30).

303. At our November 10, 2010 meeting, we expressed discomfort at the lack of detail in the Second Settlement Agreement about how the MFV rate design would work as applied to specific customers. We were reluctant to approve the proposed settlement unless and until we had a better understanding of how the proposed MFV revenue-decoupled rate design would work in practice. Thus, we tabled our deliberations on the substance of the Second Settlement Agreement pending an educational workshop to be presented by the participants on the

mechanics of how the proposed decoupling rate design would work. That workshop was conducted on December 2, 2010.

304. On January 18, 2011, the participants[27] presented us with a Third Settlement Agreement. In the Third Settlement Agreement, the participants agreed that:

- Docket No. 09-276T would remain open for the sole purpose of conducting workshops on a proposed MFV rate design and a future Commission decision regarding whether such a rate design should be implemented.

- At the workshops, which will be open to the public, the participants will develop an implementation plan for an MFV rate design, which plan will: (a) articulate the consumer benefits from the proposed rate design and (b) describe the integrated programs to be initiated to maximize energy conservation and reduce customer costs.

- A date for the first such workshop will be scheduled within 30 days of a final order in this case, and will be publicly noticed at least 35 days before that date through publication in the *Delaware News Journal* and the *Delaware State News;*

- The plan for implementing an MFV rate design will include but not be limited to:

  (a) a strategy for educating Delmarva's customers on issues concerning the MFV rate design, such as:

    (i) the purpose of the rate design;
    (ii) how it will affect customers' bills;
    (iii) impacts on existing low-usage customers and efforts to mitigate such impacts;
    (iv) programs/mechanisms to save customers money through conservation and demand response, including how customers can use these programs/mechanisms to manage energy costs; and
    (v) how customers can learn more about the proposed rate design and both current and future money-saving programs;

  (b) the programs and mechanisms that Delmarva will make available to help customers save money under the MFV rate design, such as:

[27] As of this date there was no longer a duly-appointed and confirmed Public Advocate in office. Although the Attorney General's office intervened to protect the interests of the Public Advocate's constituency, the Attorney General did not execute the Third Settlement Agreement.

(i) additional usage information and feedback mechanisms for customers to reduce energy consumption;
(ii) opportunities for customers to participate in time-of-day pricing to lower unit costs;
(iii) expanded opportunities for demand response, particularly during peak demand periods; and
(iv) energy efficiency programs and services in collaboration with the SEU;

(c) any proposed modifications to the existing MFV rate design; and

(d) a proposed date for implementation of MFV rates.

- Once a proposed plan for implementing MFV has been completed, the participants will present it to the Commission for its consideration.

(Third Settlement Agreement, Section A, ¶¶1-4).

305. **Discussion.** We approve these provisions of the Third Settlement Agreement as being in the public interest. However, we emphasize that our approval of this Third Settlement Agreement should not be construed in any way as signaling approval of a revenue-decoupled rate design, now or in the future. This order approves *only* the mechanics of the workshops and the conceptual framework of any revenue-decoupled rate implementation plan that may ultimately be presented to us for approval.

306. Furthermore, any revenue-decoupled rate plan eventually submitted to us for approval must demonstrate specifically what mechanisms are available for customers to manage their energy usage and/or engage in conservation and demand response activities. That is, at the very least we will expect that the AMI initiative will be fully operational so that customers will have the opportunity to monitor and manage their energy usage if they so choose; we will expect the plan to describe the energy efficiency options available to customers; and we will expect Delmarva to have appropriately educated customers regarding the proposed MFV rate design and

its impact on customers at various usage levels. We will have to be confident that customers have been provided with meaningful opportunities to take advantage of energy efficiency, conservation and demand response programs prior to *any* implementation of revenue-decoupled rates. In this regard, we note that a plan may be brought to us for consideration even if not all workshop participants agree with every provision of that plan. Any workshop participants objecting to any of the provisions of a plan may raise those objections when the plan is brought before us for consideration.

307. Finally, we decline at this time to determine whether a decrement to the COE for revenue-decoupled rates is appropriate and if so, what the appropriate decrement is. We believe it is premature to make this determination when we have not determined whether revenue-decoupled rates will ever be approved. Thus, we decline to give what would essentially amount to an advisory opinion. (Unanimous).

2. Cost of Service Study ("COSS")/Rate Design Issues

a. Service Classification TN.

308. Delmarva proposed a new service classification TN to meet what it calls the "unique needs and load characteristics" of power supplies used in CATV operators' systems. According to Delmarva, these power supplies have essentially constant, highly predictable consumption levels and operate at fairly high load factors, and so are appropriate candidates for unmetered service with an almost constant charge each month based on predicted load and customer-related costs. Currently, Delmarva bills CATV power supplies as separate metered accts under Rate Classification SGS-S, which includes activities and costs associated with metering and billing. As proposed, the TN rate design would consist of a customer charge and a

charge for the power supply devices' predicted consumption level, the latter of which would be set based on either the manufacturer's average power level or by historical metered data, at the customer's option. (Ex. 40 (Janocha) at 14-15).

309. Staff supported the proposed service classification TN and further recommended that government entities be permitted to use this classification for traffic signals at their option. Staff witness Solganick explained that traffic signals are essentially constant, have predictable consumption levels and operate at high load factors, and so satisfy the TN criteria. Staff observed that traffic signals, which operate 24 hours a day and are both peak and non-peak, are currently served under the OL class, which has a more off-peak character and benefits from SOS rates. If future SOS rates are adjusted to remove this anomaly or if competitive supply becomes more prevalent, Staff stated that Service Classification TN may be more appropriate for traffic signals. (Ex. 44 (Solganick) at 18).

310. The DPA opposed Service Classification TN. DPA witness Crane noted that only one customer – presumably Comcast – satisfied the criteria for this rate classification. She noted that cable operator power supplies are currently billed as separately-metered SGS accounts, but Delmarva acknowledged that many MGS accounts would be eligible for this rate. She testified that approving Service Classification TN would shift approximately $196,750 of revenue away from Comcast and onto other small and medium commercial customers. Finally, she argued that the proposed new rate, which Delmarva justified based on the usage pattern of CATV operators, was inconsistent with Delmarva's revenue decoupling proposal, which would eliminate volumetric charges for the vast majority of customers. (Ex. 80 (Crane) at 40-41).

311. In the Third Settlement Agreement, Delmarva withdrew its request for approval of Service Classification TN. However, the participants agreed that if the underlying basis for the SOS rate for traffic signals is changed, Delmarva will evaluate and propose a cost-based rate intended to reduce traffic signal costs for governmental entities if appropriate. (Third Settlement Agreement at Section B, ¶1).

b. <u>Cost of Service Study ("COSS")</u>

312. A fully-allocated COSS attempts to determine the individual costs to serve each customer class. 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 COSS 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 COSS. (Ex. 44 (Solganick) at 6-7).

313. Company witness Tanos presented Delmarva's COSS providing the line-item assignment of each component of rate base, revenues and operating expenses to the respective customer classes, and detailed the unbundled customer- and demand-related cost components by class. He testified that Delmarva's COSS generally retained allocation approaches used in its prior base rate case, and introduced a new method to calculate the demand allocation factors to improve the COSS, (Ex. 42 (Tanos) at 6-14).

314. Staff contended that Delmarva's COSS included numerous compromises that impaired its use for revenue allocation and rate design: (1) not updating the COSS to include its

proposed adjustments to test year data, so that the COSS did not correspond to the adjusted revenue requirements; (2) the mismatch created by using Delaware-specific load data for non-residential classes but PEPCO-Maryland average load factors for R and RSH customers; (3) using a 1996 Analysis of System Losses to develop demand and energy data; (4) not using weather-normalized data; (5) not updating the COSS for post-filing corrections in certain items; (6) using an 8.21% overall return rather than the requested 7.97% overall return; and (7) allocating service facilities to customers using a demand-related allocator even though they are classified as "customer-related." (Ex. 44 (Solganick) at 8-14).

315. On rebuttal, Delmarva addressed Staff's issues regarding the COSS, and specifically for updating it. Delmarva commented on Staff's recommended allocation of Account 369 – Services and Staff's position that the rate of return requested in this case should be applied in the COSS. Mr. Tanos testified that Staff's recommended updates would have a narrow impact on the results of the COSS. Moreover, he emphasized that Staff's recommended use of only customer counts to allocate service line costs did not appropriately reflect cost considerations, and assumed no cost differences, which according to Delmarva is incorrect for a cost assignment approach. Regarding Staff's discussion concerning the use of load survey data for the R classes from the Pepco service territory, Mr. Tanos explained that this data was used in the calculation of average load factors for the residential classes applied to the customer's kWh to determine the customer's NCP. Moreover, he presented statistics comparing the average kWh per customer for the two jurisdictions used in demand analysis. (Ex. 43 Tanos-R) at 2-8).

316. In the Third Settlement Agreement, the participants agreed to convene a workshop with a "focused agenda" on COSS and revenue allocation issues for the purpose of

developing an agreement on a COSS approach to be used in future rate cases. The date of the workshop shall be established within 60 days after Delmarva implements the rates resulting from this case, and shall be held no fewer than 90 days before it files its next electric distribution base rate case. The participants agree that Delmarva may defer the costs associated with this workshop for consideration in its next electric distribution base rate case, but no participant waives its right to challenge any such costs. (Third Settlement Agreement, Section B, ¶3).

c. <u>General Rate Design Issues</u>

317. The Third Settlement Agreement provides that electric distribution rates for the R and RSH service classifications shall be designed on an aggregate basis, with identical Customer Charges for the two classifications. (*Id*. Section B, ¶2). Additionally, any electric distribution revenue change among Delmarva's service classifications will be done on an across-the-board basis such that the percentage change in the distribution revenues will be the same for all service classifications, except that GS-T customers will receive no increase in distribution revenues. Last, the distribution energy charge component will be eliminated from the current rate design for the LGS rate class. (*Id*., Section B, ¶4).

318. **Discussion.** We approve these provisions of the Third Settlement Agreement as being in the public interest. We note that all participants save the Attorney General executed the Third Settlement Agreement. The signatories represent diverse interests; that they have all agreed to these provisions provides comfort that they are fair to all customer classes. We find that it is in the public interest not to approve the creation of Service Classification TN at this time, given the evidence that it would apply to only one customer and that it would transfer revenue currently collected from that customer to other small and medium commercial

customers. (Ex. 80 (Crane) at 40). We further find that it is in the public interest to convene a workshop to address issues raised by the COSS. The COSS has been a source of much disagreement in previous rate cases, and we believe that a consensus on the approach to be used in future cases can save significant time and effort, not to mention expense. We believe that that the provision that the GS-T class will receive no increase is fair in light of the record evidence that the UROR for the GS-T class is 5.63, indicating that distribution revenues received from this class far exceed the distribution-related costs of serving the class. (Ex. 40 (Janocha) at 5-6). We find that designing the rates for the R and RSH service classifications on an aggregate basis and making the Customer Charge identical for each is also in the public interest, given the evidence that theirURORs are nearly identical. (Ex. 40 (Janocha) at Sch. JFJ-1). Finally, we find the proposed across-the-board distribution of the rate increase resulting from this case to be in the public interest. We have approved this type of distribution in prior rate cases and no participant has challenged the proposal. (Unanimous).

H. VOLATILITY MITIGATION RIDER ("RIDER VM")

319. **Delmarva.** Delmarva proposes a surcharge mechanism called a Volatility Mitigation Rider ("Rider VM") to collect a rolling three-year average of pension, OPEB and uncollectible expenses, which it claims are volatile and largely beyond its control. (Ex. 2 (Kamerick) at 30; Ex. 33 (Von Steuben) at 39). Delmarva would reflect the difference between the actual expense and the amount recovered as a regulatory asset or liability, which would accrue carrying costs at the authorized rate of return, and would be recovered or credited in the next distribution base rate proceeding. (Ex. 2 (Kamerick) at 30; Ex. 33 (Von Steuben) at 39-40). It proposes to amortize the deferred balance back through the rider over some specified period of

time, and should the deferred balance reach either a positive or negative $10 million, the balance would be amortized through the rider as either a surcharge or a credit, and a new regulatory asset/liability would be created. (Ex. 33 (Von Steuben) at 40-41). Adopting the proposal would reduce Delmarva's requested revenue requirement increase by $6.6 million. (*Id.* at 40 and Sch. WMV-30).

320. **Staff.** Staff opposes Rider VM. It first contends that the costs to be tracked are not outside Delmarva's control, noting that Delmarva has taken several steps to control pension, OPEB and uncollectible costs. Since management can and does exercise some influence over these expenses, Staff contends that guaranteeing their recovery would remove any incentive to continue those efforts. Second, Staff argues that Delmarva's shareholders have historically borne the risk of fluctuations in these types of expenses. The proposed rider would transfer that risk to ratepayers, providing guaranteed cost recovery without a commensurate reduction in the COE. Consequently, if we adopt this proposal, Staff asserts that we should order a corresponding downward adjustment to the authorized COE. Third, Staff argues that Rider VM is an unjustified departure from traditional test period ratemaking principles. Staff opines that Rider VM will make it more difficult for us and others to review and analyze these expenses. (Ex. 58 (Mullinax) at 46-50). Staff also points out that both the Maryland and DC PSCs rejected similar proposals by Delmarva and Pepco for the reasons Staff had proffered. Staff contends that the circumstances here are very different from the circumstances that prompted its mitigation proposal in Docket No. 05-304 (which we rejected) because at that time, ratepayers were about to experience an almost 60% increase in supply rates as a result of the end of the rate freeze. (Staff OB at 46- 47). Staff also distinguishes this case from the circumstances that persuaded us

to authorize Chesapeake Utilities Corporation to recover its coal gasification remediation costs through a rider, contending that: (1) we found that Chesapeake's expenses were "extraordinary" and "unexpected" incurred due to a change in law; and (2) pension, OPEB and uncollectible expenses are normal costs of doing business that will never end. (Staff RB at 28-29).

321. **DPA.** The DPA argues that proposed Rider VM is single-issue ratemaking and should be rejected. It contends that pension, OPEB and uncollectible costs are "integral to the utility business," and should not be treated differently from other cost of service elements. It calls the proposal "a slippery slope down the path to reimbursement ratemaking" that would reduce Delmarva's incentive to control costs. Next, it observes that Delmarva did not adjust its COE to reflect the transfer of risk from shareholders to ratepayers that would result from implementation of the rider. Finally, it points out that the Maryland PSC rejected Delmarva's proposal for the same reasons that the DPA puts forth. (Ex. 80 (Crane) at 49-52).

322. **Delmarva Rebuttal.** Delmarva claims that Staff and the DPA ignore the proposal's "benefits" to customers in reducing the amount of the required rate increase and improving the accuracy of cost recovery. Delmarva denies that Rider VM will reduce its incentive to control costs, claiming that pension and OPEB expenses are largely driven by the discount rate and asset performance, neither of which are within its control but both of which have a large impact on the magnitude of the expenses. Delmarva likens Rider VM to Staff's proposal in Docket No. 05-304 to mitigate the effect of the then-imminent supply rate increase. (Ex. 3 (Kamerick-R) at 10). It also cites our authorization of a rider mechanism for Chesapeake to recover the cost of remediating a coal gasification site. (DPL OB at 63-64).

323. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner recommended rejecting the proposed Rider VM, stating that "[t]he Company would have the Commission usher in a new era of ratemaking known as 'ratemaking through riders' or … 'reimbursement ratemaking.'" She found that Delmarva's "sole credible reason" for advancing the rider mechanism was to depart from test year rate of return ratemaking so as to recover these costs dollar-for-dollar. She was persuaded by Staff's and the DPA's arguments that Rider VM would reduce Delmarva's incentive to control costs, would shift risk from stockholders to ratepayers, and departed from traditional ratemaking principles. She dismissed Delmarva's comparison of its rider to the Chesapeake situation, noting that the rider there was intended to be a short-term device to reimburse Chesapeake for the specific remediation costs and that it was terminated once the need for it expired. (HER at 81-82).

324. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. It claims that it is important to moderate rate increases when possible, especially during challenging economic times, and adopting Rider VM in this case would reduce its revenue requirement request by $6.618 million. It asserts that the Hearing Examiner's justifications for rejecting the proposed rider "do not withstand scrutiny" because: (1) there is nothing new about riders; (2) nothing in the record suggests that it "has any plan to advocate broader use of riders in the future" (and even if it did that would not be a sufficient reason to reject the rider); (3) her remarks regarding future rider requests are "unfounded" and "speculati[ve];" (4) she "mischaracterized the record" because Delmarva did not propose the rider "simply to ensure recovery of costs, but rather to prevent harm to shareholders *and* customers" (emphasis in original); (5) the majority of the costs are outside its control; (6) the argument that the rider

reduces shareholder risk without a concomitant benefit to ratepayers is "without merit" because there was no evidence that it is more likely to operate to Delmarva's benefit; (7) Staff "lacks credibility" in contending that the rider departs from traditional ratemaking principles because it urged a mitigation proposal in Docket No. 05-304; (8) the rider is consistent with our treatment of Chesapeake's coal gasification remediation costs; and (9) nothing in the Chesapeake order indicates that we based our decision on the rider's finite duration. (DPL E at 37-41).

325. **Discussion.** We are persuaded by Staff and the DPA's arguments against the proposed rider. These are normal utility expenses; allowing dollar for dollar recovery of them would depart from traditional ratemaking practices and would reduce Delmarva's incentive to try to control them. We also note that our sister commissions in Maryland and the District of Columbia rejected the same proposal when Delmarva and its affiliates presented it to them, and we find their reasoning convincing. Thus, for the reasons advanced by Staff and the DPA, we reject Delmarva's request to implement Rider VM. (Unanimous).

I. UTILITY FACILITY RELOCATION CHARGE ("UFRC")

326. In 2005, the General Assembly enacted 26 *Del. C.* §315 establishing the UFRC for electric and natural gas distribution utilities. Similar to the Distribution System Improvement Charge ("DSIC") for water utilities, the UFRC allows expedited recovery of capital investments made by electric and natural gas utilities to relocate facilities pursuant to directives from the state Department of Transportation or other governmental agencies. Section 315 authorizes the Commission to adopt regulations to administer the UFRC. *Id*. at §315(f).

327. **Delmarva.** Delmarva proposes establishing the initial UFRC rate at 0%. (Ex. 40 (Janocha) at 16).

328. **Staff.** Staff recommends that we remove the UFRC rate from this case since there are no regulations for administering the UFRC. It contends that its recommendation does not adversely affect Delmarva because its UFRC is already 0%. (Ex. 58 (Mullinax) at 51).

329. **Delmarva Rebuttal.** Delmarva objects to Staff's position on the grounds that: (1) Section 315 does not require administrative rules to be established before setting a UFRC rate; (2) Section 315 subjects electric and natural gas utilities to the same statutory requirements as water utilities seeking to implement a DSIC rate, and there are no DSIC regulations; (3) the proposed UFRC rate is 0%; and (4) Delmarva included it in this case to establish a framework for future filings. (Ex. 41 (Janocha-R) at 13-14).

330. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner recommended that we decline to establish a UFRC rate until we determine whether administrative rules and regulations are necessary to assist in its administration. (HER at 76). She acknowledged Delmarva's right to recover certain costs through the UFRC, but that did not mean that there would not be disputes regarding the type of costs or capital expenditures that were included in an application. (*Id*. at 75-76).

331. **Exceptions.** Delmarva states that it does not object to postponing the establishment of its UFRC rate "if the Commission orders that a proceeding to enact any necessary regulations be initiated promptly." However, it does object to any open-ended postponement of the establishment of its UFRC rate, contending that it would be "denied an opportunity to recover costs associated with any relocation of its facilities." (*Id.*). Nor does it believe that regulations are necessary: Section 315 specifically allows electric and natural gas utilities to file a rate schedule establishing a UFRC rate, and the statute does not preclude such

filing until after we have promulgated regulations. Furthermore, it points out that the similar DSIC for water utilities is administered without regulations. (DPL E at 36-37).

332. **Discussion.** We adopt Staff's position, but we are sympathetic to Delmarva's arguments. Thus, we direct Staff to move forward promptly to propose rules and regulations for administering the UFRC. (Unanimous).

J. <u>RING FENCING</u>

333. **Staff.** Staff argues that an inherent danger inherent in a holding company structure is that the financial distress of a riskier unregulated affiliate will spread to a stronger regulated utility (the "contagion effect." Such contagion, according to Staff, can result in credit downgrades for the regulated utility and possibly bankruptcy. (Ex. 6B (Liberty) at 4-5 and Sch. LCG-2).[28]

334. Staff contends that in 2008, the retail marketing and trading businesses of Pepco Energy Service, Inc. ("PES") and the wholesale generation and trading activities of Conectiv Energy Holdings, Inc. ("CEH") triggered a PHI liquidity crisis that required additional and immediate access to liquidity sources and the capital markets to ensure that funds were available in the amounts required by the rating agencies. According to Staff, as a result of the unregulated

[28]According to Staff, S&P has recognized the risk that "a parent will weaken the utility's financial profile to some degree, if [the holding company's] own financial condition begins to slide." (Ex. 17). Staff also notes that Fitch Ratings identifies a downgrading in the utility's credit rating as a risk that a holding company imposes on a utility-subsidiary (Ex. 6B (Liberty) at 5-6 and Sch. LCG-2). One Fitch report showed that 51% of utility downgrades in 2002 and 46% in the first ten months of 2003 were attributable to holding company affiliation, while another showed that between 2000 and 2003, Consumers Energy, Tampa Electric and Carolina Power and Light all suffered downgrades of three ratings notches (an entire rating category) due to "affiliate contagion." (*Id.* at 5-6 and Sch. LCG-3).

affiliates' financial problems, as well as Staff's awareness of Constellation Energy's similar (and more severe) liquidity problems caused by the activities of unregulated affiliates, Staff retained Liberty to examine whether PHI's unregulated subsidiaries had had any negative effect on Delmarva's financial condition and credit rating, and whether implementation of ring fencing measures would be appropriate. Liberty conducted an extensive investigation of Delmarva and PHI, focusing primarily on events that transpired in late 2008. (*Id*. at 1-2, 11).

335. Staff asserts that Delmarva had used a PHI money pool to obtain inexpensive capital before the collateral calls on PES and CEH caused those entities to require repayment of their contributions to the pool in September and October 2008. Staff argues that as a result of PES' and CEH's cash requirements, Delmarva had to repay the money pool and find short-term capital from other sources. Staff argues that this caused Delmarva to accelerate its plans to issue debt securities from 2009 to October 2008, when it applied for approval to issue $250 million of First Mortgage Bonds. We granted that application, and Delmarva issued the debt in December 2008. Staff asserts that the acceleration of the bond issuance to November 2008 harmed Delmarva because it otherwise could have waited until the first half of 2009, and perhaps even longer, to issue this debt.[29] Although Liberty did not believe that utilities should speculate on market directional moves in timing long-term debt issuances, it testified that it is "prudent to retain flexibility and capacity to avoid having to enter the market at times of particular financial distress," and that while utilities should not "press the use of short-term debt so far as to

[29]Liberty believes that without PHI's pressure to issue $250 debt in November 2008, Delmarva would not have issued debt before the first quarter of 2009. (Ex. 6B (Liberty) at 23.)

foreclose options for dealing with financial contingencies, *the contingencies they face should be their own*." (*Id.* at 23-27) (emphasis added).

336. Staff recommends the following specific ring fencing measures, which it argues are necessary to protect Delmarva and its customers:

1. No distributions that would cause Delmarva's equity capital to fall below 40% of permanent capital;

2. No Delmarva participation in a money pool in which unregulated, non-utility businesses or operations also participate;

3. Establishment of separate credit facilities through solicitation processes that are completely independent and wholly unconnected;

4. Establishment of a bankruptcy-remote special purpose entity or class of preferred stock to protect Delmarva in the event of a PHI bankruptcy;

5. Maintenance of cash management systems for Delmarva distinct from PHI and any affiliate;

6. that inter-company loans, guarantees or credit support agreements with PHI or any affiliate or that create any expectation of any form of Delmarva support for non-utilities;

7. Maintenance of accounting books and records using systems separate from those of PHI and any affiliate;

8. Commission access to all books, records, documents, data, board minutes, presentations and forecasts of the Company, PHI and all PHI subsidiaries and affiliates;

9. No pledge or use of Delmarva assets, financial support, or cash flow as collateral for the benefit of any entity except Delmarva, and that any PHI and affiliate financing agreements and arrangements disclaim any informal representation, commitment, or expectation of such support;

10. Advance Commission approval for any Delmarva asset sales exceeding $20 million; and
11. Annual reporting to address the status of Delmarva's compliance with each of the ring fencing requirements.

(*Id.* at 28-29, 38-39).

337. **Delmarva.** Delmarva argues that Staff's proposed measures: (1) are unnecessary since PHI has already implemented them, either voluntarily, by statute, or in the Code of Conduct; (2) are "undeserved" and "unfairly punitive;" and (3) will result in unreasonable costs. (Ex. 16A (Kamerick-RF) at 3-7, 25; Ex. 25 (Fetter) at 6-7). Delmarva does not dispute that PHI's unregulated subsidiaries called back their loans to the money pool because of the collateral calls, and that we conditioned our approval of Delmarva's 2008 debt financing on the proceeds being used only for Delmarva-related activities. (Ex. 16A (Kamerick-RF) at 16, 20). However, it argues that neither it nor PHI should be "penalized" for "appropriate and beneficial financing actions" (i.e., the bond issuance) that resulted in maintaining investment grade ratings during the crisis. (*Id*. at 25). Delmarva claims that Liberty's examples of utility downgrades from 2000-03 are inapposite because that time period was abnormal due to deregulation, Enron, and "companies not filing financials on time." (*Id.*). It contends that the risks of its affiliation with PHI do not rise to the level of "particular unquantifiable risks" arising in the context of acquisitions, mergers and spinoffs, with "complex fact patterns," such as a foreign entity taking over a U.S. holding company and its regulated utilities, or the "largest private equity takeover of a major U.S. regulated utility," and so we need not be troubled by the dangers Staff identified. (Ex. 25 (Fetter) at 9). It claims that Liberty's recommendations come at an "inopportune time," and asserts that while ring fencing might reduce the cost of debt, the cost of equity might go up. It questions whether ring fencing will improve its credit rating, opining that the recommendations are "the wrong action at the wrong time," and customers and investors are

"better served by a smooth functioning entity within which legitimate cost-sharing is utilized, along with close interaction among all member of management." (*Id.* at 11-12, 14).

338. In the event that we are disposed to implement ring fencing protections, Delmarva argues that it already follows many of the Liberty recommendations. Specifically: (1) PHI already targets a high 40% equity ratio for Delmarva, and has demonstrated its commitment to maintaining that ratio by making capital contributions to the utilities; additionally, Delmarva's credit facility contains a leverage ratio covenant to maintain a Total Debt to Total Capitalization ratio no greater than 65% (that, is, a minimum 35% equity ratio) (Ex. 16A (Kamerick-RF) at 29-30); (2) Delmarva currently maintains its own bank accounts with no right of setoff between Delmarva and any of the affiliates, maintains separate cash transactions, and uses a cash management workstation that segregates all Delmarva cash-related activity; (3) PHI manages the utilities as independent companies, and Delmarva has never entered into an intercompany loan to an affiliate; (4) Delmarva already maintains its own separate accounting books and records and is a separate SEC registrant and filer; and (5) Delmarva's mortgage precludes it from pledging its assets to any entity. (*Id.* at 31-32). In addition, Delmarva points out that 26 *Del. C.* §215 requires utilities to obtain our approval for sales of any property that is considered an "essential part of its franchises, plant, equipment or other property, necessary or useful in the performance of its duty to the public." (*Id.* at 32; *see also* 26 *Del. C.* §215(a)(1)). Last, it does not object to providing us with an annual report on the safeguards taken to maintain separation between Delmarva and its affiliates. (Ex. 16A (Kamerick-RF) at 33).

339. Delmarva opposes Staff's recommendation that it be precluded from participating in a money pool that involves non-utility businesses. It argues that the pool works the same way

regardless of whether there is non-utility participation: that is, an entity deposits excess funds for an affiliate to borrow at any time, but the money must be returned when the depositor needs it, with interest. Limiting Delmarva's participation in the pool would eliminate a source of low-cost funds and constrain its borrowing flexibility. It further observes that with its exit from its non-regulated businesses, the money pool is effectively a utility-only pool. (*Id.* at 29-30).

340. Delmarva further opposes being required to establish separate credit facilities for PHI, its utility subsidiaries and its non-utility subsidiaries. It asserts that PHI's current credit facility has no cross-default provisions and provides Delmarva with uninterrupted access to funds in the event of a default by any other affiliate or PHI. Furthermore, a Delmarva-only credit line would increases the cost of credit for Delmarva ratepayers. (*Id*.).

341. Next, Delmarva contends that a bankruptcy-remote special purpose entity or class of preferred stock has only been used in very special cases. (*Id*. at 38).

342. Finally, Delmarva objects to providing the Commission with access to its non-utility affiliates' forecasts. It claims this information is confidential; moreover, such information is irrelevant and unnecessary for us to regulate Delmarva's Delaware distribution operations. Additionally, Delaware law already provides the Commission access to a regulated utility's books and records, so it is unnecessary for that reason. (*Id*. at 32).

343. **The Hearing Examiner's Findings and Recommendation.** The Hearing Examiner recommended that we approve and implement Recommendation Nos. 1, 5, 6, 7, 9 and 11. She found that PHI and Delmarva must have viewed these measures as "important and vital to protecting the integrity of both companies" since they are already in place, and rejected Delmarva's contention that implementing them would be too costly since Delmarva has already

implemented the practices or follows them. Thus, she recommended that these practices and procedures be adopted "for the best interests of Delmarva and its ratepayers… ." (HER at 114).

344. The Hearing Examiner found that Staff had not presented sufficient evidence for requiring Recommendation Nos. 2 and 4. She declined to recommend adoption of Recommendation No. 3 in light of the no-cross-default provision in PHI's current credit facility, finding that Delmarva was adequately protected from harm from other affiliate problems. She concluded that it Recommendation No. 8's requirements were reasonable, except that she would not recommend requiring PHI's affiliates to disclose their business forecasts because she did not see how they were critical to any affiliated interest transaction. Finally, she concluded that Recommendation No. 10's additional protection was necessary in light of 26 *Del. C.* §215(a)(1) (*Id.* at 114-15.).

345. **Exceptions.** Delmarva excepts to the Hearing Examiner's recommendation. It contends that Staff did not evaluate the cost of implementing any of its recommendations; the set of recommendations are rarely imposed around the country and no regulatory authority had imposed all of the recommendations on a utility; and the recommendations were moot given that PHI had sold CES and was shutting PES down. (*Id.* at 61, 69-70). Furthermore, because Delmarva already follows most of these practices on a voluntary basis, the measures are unnecessary, costly and punitive, and violate Delaware law by interfering with Delmarva's business judgment. (*Id.* at 61-62, 71-72).

346. Delmarva further asserts that the Hearing Examiner's recommendation that we specifically implement the measures that Delmarva already has in place "stands regulatory policy on its head" because "[r]egulation is ordinarily justified by the risk of harm to the public

interest," and where that risk does not exist, there is no need for regulation. (*Id*. at 68, citing *Home Box Office v. FCC*, 567 F.2d 9, 36 (D.C. Cir. 1977)). It contends that the measures might have been appropriate if the Hearing Examiner had found some "demonstrable risk" to the public from the absence of management controls, but such management controls exist in this case and there is no evidence that Delmarva had failed or would fail to observe them. (*Id*. at 68-69).

347. **Discussion.** We accept the Hearing Examiner's recommendation to accept certain of the proposed ring fencing measures and reject others. We do not believe that ring fencing measures are a solution in search of a nonexistent problem, as Delmarva contended at oral argument. Although PHI is now divesting itself of its unregulated subsidiaries, future PHI management could choose to enter into unregulated activities. And although we have not found that Delmarva ratepayers were negatively affected by the 2008 events involving PHI's unregulated subsidiaries, it seems clear that those events *could* have had a significant adverse effect on Delmarva and its ratepayers. We believe it is better to have measures in place to prevent such an effect rather than have to react to an event when it occurs.

348. We believe that we do have the authority and ability to impose ring fencing measures on Delmarva. We read Section 201(a) of Title 26 as vesting us with the authority to require measures to protect ratepayers in the event that a utility holding company makes decisions that could have a negative effect on the regulated utility. We are not persuaded that the business judgment rule precludes us from imposing measures designed to protect Delmarva's captive ratepayers from harm. We also observe that Delmarva already follows many of the recommended practices now, so it is not as if we are requiring Delmarva to do something that it does not currently do.

349. For these reasons, we accept the recommendations of the Hearing Examiner and directs Delmarva to comply with the following ring fencing measures:

1. Delmarva shall not make any distributions that would cause its equity capital to fall below 40% of permanent capital.

2. Delmarva shall continue to maintain cash management practices for that are distinct from PHI and any affiliate.

3. Delmarva shall not enter into any inter-company loans, guarantees or credit support agreements with PHI or any affiliate, or that create any expectation of any form of utility support for non-utilities.

4. Delmarva shall continue to maintain accounting books and records separate from those of PHI and any affiliate.

5. Delmarva and PHI provide the Commission with access to all books, records, documents, data, board minutes, presentations and forecasts of the Company, PHI and all PHI subsidiaries and affiliates; provided, however, that PHI affiliates shall not be required to disclose their business forecasts unless the Commission orders otherwise.

6. No Delmarva asset, financial support, or cash flow shall be pledged or used as collateral for the benefit of any entity except Delmarva, and any PHI and affiliate financing agreements and arrangements shall disclaim any informal representation, commitment, or expectation of such support.

7. Delmarva shall file a report with the Commission on an annual basis, commencing for the year, 2011, addressing the status of its compliance with each of these ring fencing requirements.

K. <u>REFUND MECHANISM</u>

350. On April 19, 2010, Delmarva placed its full requested rate increase of $26,195,000 into effect under bond and subject to refund pursuant to 26 *Del. C.* §306(b). The approved revenue requirement increase that results from the determinations we have made on the various contested and uncontested revenue requirement items is $16,371,203. Therefore, a refund is necessary. In Order No. 7897 dated January 18, 2011, we approved new rates to

become effective February 1, 2011; however, we observed that a refund would be necessary for the difference between the rates charged between April 19, 2010 and February 1, 2011, and that we would determine the manner and method of the refund in a later Order.

351. The refund details are:

- Any Delmarva customer that received service at any time between April 19, 2010 and February 1, 2011 is entitled to a refund for the difference between the rates that were effective on April 19, 2010 and the Commission-approved rates that became effective February 1, 2011. This includes customers who are still active customers as well as those that have left Delmarva's system.

- Refunds will be applied to customers' bills beginning with billing cycles on and after September 6, 2011 and continuing through October 7, 2011. If the entity entitled to a refund is no longer a Delmarva customer, Delmarva will issue a check to the person or entity in the full amount of the refund to be sent to the customer or entity at the last address Delmarva has on file for that person or entity.

- Interest on the amount to be refunded shall be calculated in accordance with 26 *Del. Admin. Code* §1003 (Interest on Commission Ordered Rate Refunds, Regulation Docket No. 11, Order No. 2696, effective January 1, 1986). Interest shall be calculated based on the overpayment of the billing periods being refunded and from April 19, 2010 through the date of the credit adjustment or date that the check is issued.

- Within sixty (60) days after the last refunds are posted or issued, Delmarva shall provide the Commission with a summary report of the refunds applied to customer accounts and/or issued to former customers. Interest shall be reported separately.

III. ORDER

AND NOW, this 9th day of August, 2011, IT IS HEREBYORDERED:

1. That the Commission approves the ratemaking treatment for the uncontested issues for purposes of this case. Specifically, the "Generation Request for Proposal" costs of $4,355,377, which reflect costs incurred through June 2009, should be amortized over a period of ten years with the unamortized amount included in rate base. The "Integrated Resource Plan"

costs of $3,587,410, which reflect costs incurred through June 2009, should be amortized over a period of ten years with the unamortized amount included in rate base.

2. That the Commission rejects the Division of the Public Advocate's strict test period construction.

3. That the Commission approves Delmarva Power & Light Company's adjustments to include in rate base the reliability plant additions from April through July 2009 and August through December 2009.

4. That the Commission rejects Delmarva Power & Light Company's adjustment to include Construction Work in Progress in its rate base. The credit for Allowance for Funds Used During Construction shall be reversed.

5. That the Commission approves Delmarva Power & Light Company's adjustment to include its share of the costs of the PHI credit facility in the cost of service, including the unamortized balance in rate base.

6. That the Commission approves Delmarva Power & Light Company's adjustment to normalize regulatory commission expense using a three-year normalization period, and its adjustment to include the fee for its ring fencing witness Steven M. Fetter.

7. That the Commission approves Delmarva Power & Light Company's adjustment to normalize injuries and damages expense using a three-year normalization period.

8. That the Commission approves Delmarva Power & Light Company's adjustment to normalize uncollectible expense using a three-year normalization period.

9. That the Commission approves Delmarva Power & Light Company's adjustment for wages and FICA.

10. That the Commission approves Delmarva Power & Light Company's adjustment for employee benefits expense.

11. That the Commission approves Delmarva Power & Light Company's adjustment for other post-employment benefits expense.

12. That the Commission rejects Delmarva Power & Light's adjustment to defer and amortize its 2008 pension loss over five years.

13. That the Commission approves Staff's proposed level of pension expense for ratemaking purposes, consisting of a normalized expense level based on the actual 2008 expense and the actuarially-determined 2009 expense.

14. That the Commission approves Delmarva Power & Light Company's adjustment to normalize storm restoration expense using a three-year normalization period.

15. That the Commission approves Delmarva Power & Light Company's adjustment to recover the cost of the Commission-ordered management audit through amortization over three years.

16. That the Commission approves the inclusion in operating expense of the costs associated with 13 energy advisors.

17. That the Commission rejects Staff's proposal to disallow the test period cost of the Supplemental Executive Retirement Plan.

18. That the Commission approves Staff's proposal to disallow the test period cost of non-executive incentive compensation.

19. That the Commission approves Staff's proposal to disallow certain test period executive compensation costs.

20. That the Commission approves Staff's recommendation for an audit of the costs allocated to Delmarva by PHI Service Company, with the caveat that Staff attempt to coordinate with other jurisdictions conducting similar audits.

21. That the Commission approves amortization of Delmarva Power & Light Company's deferred incremental AMI costs of $1,047,163 over 15 years, with the unamortized balance included in rate base.

22. That the Commission approves a 5.45% cost of long-term debt.

23. That the Commission approves a 10.0% cost of equity.

24. That the Commission approves a 7.61% overall rate of return.

25. That the Commission rejects Delmarva Power & Light Company's request for a flotation cost allowance.

26. That the Commission approves the Third Settlement Agreement.

27. That the Commission rejects Delmarva Power & Light Company's proposed Volatility Mitigation Rider.

28. That the Commission approves Staff's recommendation with respect to the Utility Facility Relocation Charge, with the further condition that Staff initiate a proceeding for the proposal of implementing regulations promptly.

29. That the Commission approves implementation of the following ring fencing measures:

(a) Delmarva shall not make any distributions that would cause its equity capital to fall below 40% of permanent capital.

(b) Delmarva shall continue to maintain cash management practices for Delmarva that are distinct from PHI and any affiliate.

(c) Delmarva shall not enter into any inter-company loans, guarantees or credit support agreements with PHI or any affiliate, or that create any expectation of any form of utility support for non-utilities.

(d) Delmarva shall continue to maintain accounting books and records separate from those of PHI and any affiliate.

(e) Delmarva and PHI provide the Commission with access to all books, records, documents, data, board minutes, presentations and forecasts of the Company, PHI and all PHI subsidiaries and affiliates; provided, however, that PHI affiliates shall not be required to disclose their business forecasts unless the Commission orders otherwise.

(f) No Delmarva asset, financial support, or cash flow shall be pledged or used as collateral for the benefit of any entity except Delmarva, and any PHI and affiliate financing agreements and arrangements shall disclaim any informal representation, commitment, or expectation of such support.

(g) Delmarva shall file a report with the Commission on an annual basis, commencing for the year, 2011, addressing the status of its compliance with each of these ring fencing requirements.

30. That the approved revenue requirement increase resulting from the Commission's decisions in this docket is $16,371,203, as shown on Exhibit "A" hereto.

31. 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/ Arnetta McRae
Chair

/s/ Joann T. Conaway
Commissioner

/s/ Jaymes B. Lester
Commissioner

/s/ Jeffrey J. Clark
Commissioner

Commissioner

ATTEST:

/s/ Alisa Carrow Bentley
Secretary