

**BEFORE THE  
PUBLIC SERVICE COMMISSION  
OF MARYLAND**

IN THE MATTER OF THE APPLICATION	*	
OF DELMARVA POWER AND LIGHT	*	
COMPANY FOR AN INCREASE IN	*	CASE NO. 9192
ITS RETAIL RATES FOR	*	
THE DISTRIBUTION OF ELECTRIC ENERGY	*	

**INITIAL BRIEF OF THE OFFICE OF PEOPLE’S COUNSEL**

**I. INTRODUCTION AND PROCEDURAL HISTORY**

On May 6, 2009 Delmarva Power and Light Company (Delmarva, DPL or Company) filed an Application for an increase in its retail rates for the distribution of electric energy in its Maryland service territory. The Company requested an increase in base rate revenues in the amount of \$14.145 million for the test year ended December 31, 2008 with certain proposed adjustments for what the Company claimed were “known and measurable” changes during the rate effective period. Application, p.2. The Company requested an overall authorized rate of return on rate base of 8.58 percent, which originally included a proposed 11.25 percent return on common equity.<sup>1</sup> See Morin Direct, pp.81-82. (DPL Ex.30).The Company proposes that if its rate increase is accepted, the increase should be allocated in such a way as to “narrow the differentials in class rates of return.” Application, p.5.

The Company has also proposed novel ratemaking treatment for pensions, other post employment benefits (OPEB) and uncollectibles. Furthermore, it is seeking recovery of certain expenses to maintain system reliability which occurred beyond the test year. Application, p.3-4.

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<sup>1</sup> Which was precisely the requested return on equity requested and rejected by the Commission in the Company’s last rate case two years ago (Case No. 9093). See *Re Delmarva Power and Light Co.*, 98 Md.PSC 288,313 (2007).

The Office of People's Counsel (OPC or People's Counsel) was an active party to the Commission proceeding. OPC filed the testimony of witnesses Effron, Wallach and King addressing the issues of revenue requirements, cost allocation and rate design, and cost of capital. The only other party to the proceeding was Commission Staff.

Parties other than DPL filed Direct Testimony on August 24, 2009. Supplemental Testimony to address treatment of pension expense was filed on September 8, 2009. Rebuttal Testimony was filed on September 11, 2009 and Surrebuttal Testimony was filed on September 21, 2009. Hearings were held September 22 through 25, 2009. During the hearing, DPL also presented the Rejoinder Testimony of various witnesses.

Evening public hearings were held on October 13, 14 and 15, 2009. However, it was discovered that the notices of hearing printed in newspapers of general circulation had not contained sufficient information to allow customers to know that the company was seeking increased rates. Therefore, the Commission ordered that notice be republished and that evening hearings be held again in the same locations before mid- November. See Order No. 82971(October 21, 2009). Obviously, this brief (and the Reply brief) will be filed before the Office of People's Counsel will have the benefit of any public comment at those hearings. Therefore, OPC requests permission to supplement its brief with information from the evening public hearings if that proves necessary.

## **II. SUMMARY OF ARGUMENT**

The Office of People's Counsel recommends that DPL's requested increase in rates of \$14.145 million be rejected in its entirety based upon adoption of a variety of adjustments proposed by OPC and the Staff. OPC believes that if any increase at all is warranted, it will be small based upon the record developed and should be no more than the \$2.266 million originally proposed by OPC witness Effron.<sup>2</sup> Any increase in rates should be distributed among the rate classes following the recommendation of OPC witness Wallach.

### **III. ARGUMENT**

#### **A. The Record Does Not Support DPL's Request for a Rate Increase**

OPC's analysis of the Company's rate base, operating income and expenses led its witness, Mr. Effron to conclude that DPL has a current revenue deficiency of \$2.266 million based on twelve months of actual test year data ended December 31, 2008. Mr. Effron incorporated the recommendations of OPC witness King regarding rate of return to reach his conclusion.

#### **1. Uncontested Adjustments**

The parties agreed to a number of uncontested adjustments. Additionally, after reviewing Mr. Effron's testimony, the Company accepted some adjustments proposed by OPC. The adjustments agreed to by DPL are briefly described below.

#### **a. Adjustments Accepted By Delmarva**

#### **2. Executive Long Term Incentive Compensation**

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<sup>2</sup> On brief, OPC is proposing additional adjustments to take into account information gleaned at the hearing. OPC may also agree with certain Staff adjustments once Staff's brief is reviewed.

DPL accepted OPC's recommendation to remove \$511,000 of executive long term compensation. (Effron, p.9, OPC Ex.8; Von Steuben Reb., p.2, DPL Ex.5).<sup>3</sup>

### **3. Regulatory Commission Expense**

DPL agreed with OPC's testimony that this expense should be reduced by \$113,000. Additionally, the Company agreed that the amortization of its previous rate case expenses should be limited to recovery of the remaining un-recovered costs. The unrecovered balance, when amortized over 5 years, is \$138,000 less than what the Company had proposed. The total adjustment (\$113,000 plus \$138,000) is \$ 251,000 (Effron Dir., p.14, OPC Ex.8; Von Steuben Reb., p.3 DPL Ex.5; see also T.925-928,934).

OPC did not take any position in testimony on the reasonableness of the Company's rate case expenses. However, some observations about the expenses requested by the Company are certainly in order. The Company estimates that its expenses to prepare and litigate this one case will be \$671,167. See Von Steuben Direct, Sch. WMV-5, p.9. To provide some context, that amount is approximately a quarter of OPC's entire budget for Fiscal Year 2010 (which includes among other items salaries, rent, benefits, training, travel, office supplies, computers and witness/consultant fees). The Company also indicates that its external legal costs (meaning outside counsel not directly employed by the Company) for this single proceeding are \$500,000. While such a mind boggling amount should not be surprising given the number of attorneys representing the Company (at least five)<sup>4</sup>, it hardly seems necessary as Staff managed to litigate the entire case with one attorney and OPC assigned two attorneys to the case. (A third OPC attorney was present for only one witness). If OPC were to spend a comparable amount for a rate

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<sup>3</sup> For ease of reference, OPC will refer to written testimony using the witness' name whenever possible.

<sup>4</sup> Additionally, there appeared to be additional support provided by paralegals or legal assistants at the hearing. It was not clear to OPC whether those were Company personnel or outside law firm personnel.

case, OPC could participate in only a handful of cases per year rather than the dozens it is involved in before the Commission and federal agencies.

The level of rate case expense should be closely scrutinized by the Commission. OPC sees no reason why this sort of routine rate case could not be handled by in-house counsel for the Company and would encourage the Commission to reduce the amount of rate case expense by the total amount of external legal expense (\$500,000).

**4. Accrued Liability for OPEB Balance in Rate Base**

DPL acknowledged that OPC witness Effron's testimony to reduce rate base by \$2,921,000 was correct. (Effron, Dir. p.8 OPC Ex.8; Von Steuben Reb. p.3 DPL Ex.5).

**5. Normalize Non- Executive Compensation**

DPL reviewed and accepted OPC witness Effron's adjustment to normalize non-executive compensation to reflect average expenses. The effect of that adjustment reduces operating expense by \$599,000. (Von Steuben Reb., p.3 DPL Ex.5 )

**6. Change in Amortization Period for Accumulated Deferred Taxes**

DPL accepted OPC witness Effron's proposal to amortize the deferred tax liability over seventeen rather than five years. The effect of this adjustment reduces annual expenses by \$283,000. ( Effron Dir.,p.19 OPC Ex. 8; Von Steuben Reb., p. 4 DPL Ex. 5 ).

**B. Adjustments To Rate Base**

**1. Delmarva Has Arbitrarily Increased Rate Base with the Proposed Reliability Plant Adjustment**

Commission practice has been to use an average test year rate base to determine the revenue requirements for regulated electric utilities. To do otherwise is contrary to sound ratemaking practice. As OPC Witness Effron testified "the theory supporting this approach is that an average rate base results in a proper matching of test year investment,

revenue and expenses and achieves a consistency among the elements in the determination of revenue requirements. . . . Adjusting the average test year rate base for post-test year plant additions distorts the relationship between rate base and operating income.”<sup>5</sup>

Contrary to Commission practice and sound ratemaking principles, Delmarva proposes three adjustments to recognize post test year plant additions related to reliability. The combined effect of the adjustments would be an increase in rate base of \$24.788 million.<sup>6</sup> Delmarva claims that it is permissible to deviate from the Commission’s general practice because the plant additions are all reliability related. However, while reliability improvements are to be encouraged as part of a utility’s mandate to provide safe and reliable service to its customers, these expenditures are not unique. In fact, they are the *sine qua non* of providing electric distribution service: on-going and routine expenditures. Indeed, Company Witness Gausman agreed that reliability improvements are routine and on-going. See Tr. 166-168. Yet, despite the fact that both Delmarva and its sister utility, PEPCO, have made ongoing and routine reliability improvements for decades, neither Company proposed adjustments to rate base for post –test year reliability plant additions in their last rate cases.<sup>7</sup> In fact, all Maryland electric utilities make the same kinds of investments related to system reliability; however, OPC has not uncovered a single instance of Commission approval of recovery of post year reliability plant additions in electric rate base.<sup>8</sup> When asked on cross-

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<sup>5</sup> Effron Direct, p. 4 (OPC Ex.8).

<sup>6</sup> Id., p. 3.

<sup>7</sup> Case Nos. 9092 and 9093.

<sup>8</sup> As Mr. Effron noted in his testimony, the Commission allowed an exception to the rule against reflecting post test year plant additions for Washington Gas Light (WGL) in Case No. 9104. However, that exception seemed to be based upon a finding that the plant additions were unique in that they were intended to ameliorate a potentially

examination what precedent the Company relied upon for this adjustment, Mr. Von Steuben could point only to Case No. 8492, where the Commission approved recognition of the rate impact of the Hay Road plant coming into service. Tr. 79-80. However, that case involved a combined cycle gas fired generation plant coming into service shortly after the Commission's order was to take effect. Before deregulation in 1999, there were instances where the Commission allowed such post test year plant additions to be reflected in rates, mainly so that the company in question would not have to file another immediate rate increase when the plant came on line. Those instances are certainly distinguishable from these routine reliability plant additions.<sup>9</sup>

While the appropriate and reasonable thing would be for the Commission to reject the adjustment, if the Commission decides to approve Delmarva's request, the "total" adjustment must be modified. As OPC witness Effron noted, one of the Company's rationales is that the rate adjustment is necessary to account for "rapidly rising capital expenditures for system reliability." Gausman Direct ,DPL Ex 7, p.17. Proper regulatory accounting requires that these rising expenses be normalized, that is, the rates should reflect only capital expenditures that are in excess of the Company's normal capital spending. Effron Dir. ,p. 7. Therefore, in the event the Commission decides that reflection of some of these expenses is necessary, the appropriate way to handle them would be to determine an average reliability spending baseline and allow recovery only of spending in excess of the baseline. Mr. Effron suggests that since the Company's average annual reliability spending is \$16,380,000, only actual spending in excess of this

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dangerous condition due to leaks on WGL's gas system. There is no such claim that the plant additions proposed by Delmarva in this case are of the same nature as those in the WGL case.

<sup>9</sup> See *Re Delmarva Power and Light*, 84 Md. PSC 131, (1993). It should be noted that Case No. 8492 was a settlement, further distinguishing the treatment of the generation plant there from the distribution reliability plant at issue here.

annual rate of capital spending should be included in rates. See Effron Dir., p. 7.

However, as noted, this is only a second best way to deal with the Company's request.

### **C. Operating Income Adjustment**

In general, operating income is test year revenues minus operations and maintenance expense (O&M), depreciation on plant in service and taxes. As noted previously, the Company accepted a number of adjustments proposed by OPC that affect its operating income. This section will discuss the remaining adjustments where there are still areas of disagreement.

#### **1. Uncollectible Accounts Expense**

The controversy surrounding the adjustment for uncollectible expense does not have to do with whether there *should* be such an adjustment. Rather, the issue is how the adjustment is made. Boiled down to its essence, OPC recommends that the Commission adopt a method for determining uncollectible expenses that is based upon actual experience while the Company proposes a method based upon a series of estimates of possible future write-offs.

Delmarva proposed an uncollectible accounts expense of \$1,582,000 based upon a projection that is the result of applying a reserve percentage of 1.275 % applied to largely forecasted revenues for the last three quarters of 2009 (almost a full year later than the test year in this case.) See Effron Dir., p.11. As discussed by Mr. Effron, there are logical problems with the Company's approach, chief among them being that it is unreasonable to use forecasted *possible* amounts when we have "actual net write-off experience." Effron Dir., p.13. To remedy the distortion caused by Delmarva's method, Mr. Effron recommended that the ratio used in the calculation of pro forma uncollectible accounts should be modified and the modified ratio should be applied to 2008 test year revenues, not the forecasted 2009 revenues. *Id.* at 12.

Mr. Effron's approach is both logical and simple to verify mathematically. As he testified:

I recommend that the normalized uncollectible accounts ratio be determined by averaging the net write-offs (the total write-offs net of recoveries) as a percentage of billed revenues for 2007 and 2008. This method of determining the uncollectible accounts ratio recognizes only the actual net write-off experience and does not include estimates or accruals for possible future write-offs.

Id. at 13. Using that method, Mr. Effron calculated a net write-off ratio of 0.830%. See Effron Dir., Sch. C-1.1. When applied to the Company's pro forma test year revenues of \$119,267,000, an uncollectible accounts expense of \$990,000 results. This is \$ 592,000 less than the amount calculated by Delmarva. The Company's test year expenses should therefore be reduced by \$592,000.

## **2. Cambridge Environmental Costs Should Not Be Included In Revenue Requirements**

As it did in Case No. 9093, the Company is requesting that it be allowed to recover costs associated with environmental remediation associated with a coal manufactured gas plant in Cambridge that served customers decades ago. The cost the Company seeks to include in rates is \$812,000 (the total cost is over \$4 million to be amortized over five years). In Case No.9093, the Commission properly rejected Delmarva's request to recover the costs of the remediation as the plant was not used and had never been used to provide electric distribution service to Maryland customers.<sup>10</sup> Indeed, as the plant in question manufactured gas, the plant is not distribution related at all. Nothing has changed since Case No. 9093 in relation to the Cambridge facility and the Commission should continue to reject Delmarva's request.<sup>11</sup>

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<sup>10</sup> See 98 Md. PSC 288,303 (2007).

<sup>11</sup> In the event the Commission decides to grant Delmarva's request, Mr. Effron recommended that Delmarva's proposal to amortize the costs over five years be rejected in favor of the amortization period of ten years used by Baltimore Gas and Electric for similar environmental remediation. Effron Dir., p.16-17. Delmarva agrees with OPC on this point. Von Steuben Rebuttal, p.8.

**D. The Proposed Pension , OPEB And Uncollectible Accounts Tracker Should Be Rejected**

Delmarva proposes a “tracker” to reconcile fluctuations in pension, post retirement benefits other than pensions (OPEB) and uncollectible accounts expense. The tracker is very similar to a mechanism proposed by the Company in Case No. 9093 and rejected by the Commission. OPC recommends that the Commission reject the tracker in this case as well.

As a matter of good regulatory policy, the tracker should be denied as it “would guarantee virtual dollar for dollar recovery of OPEB and pension costs and would reduce the incentive to control those benefit costs ....” Effron Dir.,p.20. The same is true regarding the incentive to control uncollectible expenses. Id. at 21. Furthermore, it is contrary to sound principles of ratemaking to isolate and treat differently just this set of costs. As Mr. Effron testified:

Just about all other expenses included in the Company’s base rate cost of service are also subject to fluctuation. The Company has not explained why pension, OPEB and uncollectible accounts should be treated differently from these other expenses that go into the determination of its base rate revenue requirement....

As general matter, reconciliation mechanisms are contrary to sound ratemaking practice, as such mechanisms tend to either reduce or eliminate incentives to control costs. Such mechanisms should be reserved for expenses that are of such exceptional magnitude and volatility that unexpected adverse fluctuations can cause irreparable financial harm.

Effron Dir., p.21. Mr. Effron recognized the Commission’s previous dismissal of this type of tracker as he used similar language in his testimony as the Commission used when it rejected the tracker in Case No.9093. As the Commission stated:

We reject the Company's request to implement OPEB and pension tracker mechanisms. Tracker mechanisms that guarantee dollar-for-dollar recovery of OPEB and pension costs lessen the Company's financial incentive to control the benefits of costs of its retirement plans. The Company has not proven to us that the rider is just, reasonable and an appropriate mechanism for recovery of costs. We have approved riders for fuel, universal service and environmental surcharges, but the Company has not demonstrated that POPEB charges are sufficiently similar to these types of expenses to justify a Company surcharge based on revenue recovery of POPEB costs. Implementation of a tracker mechanism is an extraordinary form of ratemaking usually reserved for very large

expense items that have the potential to impair seriously a utility's financial well-being, which is not the case here for OPEB and pension costs. We therefore deny the Company's request for a POPEB rider.<sup>12</sup>

The Company has not claimed, nor can it show, that it faces such dire conditions if the tracker is not approved. Therefore, its request to implement the tracker should be rejected.

If the Commission were to give any serious consideration to the tracker, OPC recommends that the Commission should also take into account the reduction in financial risk experienced by the Company as a result. A tracker would make the Company's common stock considerably less risky in the same way that a bill stabilization adjustment reduces the Company's overall risk. If a tracker is approved, it would be appropriate to reduce the return on common equity to reflect that risk. In OPC's view, an appropriate reduction to the return on common equity would be at least fifty basis points.

**E. Delmarva's Proposal To Defer Certain Pensions Expenses Should Be Rejected**

Delmarva proposes to defer and amortize the difference between the level of pension expense currently included in the Company's rates and the expense actually incurred by the Company from January 1, 2009 through November 30, 2009. The Company's request should be denied.

It is undisputed that the Company proposal constitutes single-issue, selective ratemaking. Effron Supp. Dir., p. 1 (OPC Ex.9); VonStueben Reb., p.24. Nonetheless, the Company presses this disfavored form of ratemaking upon the Commission, stating that, because it is a big expense, it should be treated "no different from that of a major storm." Von Steuben Reb., p.24. However, the reason single-issue ratemaking is generally avoided is that all expenses for regulated companies change year to year. As Mr. Effron testified, "it is inappropriate to isolate

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<sup>12</sup> See *Re Delmarva Power and Light*, 98 Md. PSC 288 ,319 (2007).

one expense that has increased and to seek special ratemaking treatment to recover the effect of that increase without consideration of any other factors affecting the Company's revenue requirement. To do so would be to circumvent the whole rate case process, where all changes in the Company's costs are considered." Effron, Ex.9, p.2.

Tellingly, the Company has never made such a proposal to return money to ratepayers if expenses suddenly decline. Mr. Effron noted that " there have been periods when stock values have increased, resulting in reductions to pension expenses from the level of expenses embedded in base rates. I don't recall Delmarva, or any other utility company, proposing to defer the effect of such decreases in pension expenses and to credit customers for those decreases outside of the context of a base rate case."Id., p.2.

**F. Cost Of Capital And Rate Of Return**

OPC's recommends an overall return of 7.68 percent reflecting a cost of equity of 10 percent. King Direct, OPC Ex.3 ,p. 2 In contrast, Delmarva's witness, Dr. Morin, initially recommended that the Commission award Delmarva an overall return of 8.58% which included an 11.25 percent return on equity . On the stand, Dr. Morin slightly revised his return on equity recommendation to be 10.75 percent if risk adjustment was made for the BSA and 11 percent if no risk adjustment for the BSA was adopted. Tr . 754.

Like other businesses, a regulated utility's capital may be obtained through sales of stock (i.e., equity ownership) or through borrowing by issuance of bonds or by taking on other debt obligations. Under the theory of the "cost of capital" standard, *see Fed. Power Com'n v. Hope Natural Gas Co.*, 320 U.S. 591, (1944), in establishing a rate of return the Commission "assumes that the cost of money devoted to the enterprise produces a proper percentage that can then be applied to the property values devoted to the business to establish a cost of doing business that is

both fair to the company and to the user of its service.” Leonard Saul Goodman, 1 *The Process of Ratemaking* Pt. 9 (Public Utility Reports, Inc.1998), 2005 WL 998304 (PUR).

The term “cost of capital” may also be expressed as “the annual percentage which a utility must receive to maintain its credit, to pay a return to the owners of the enterprise, and to insure the attraction of capital in amounts adequate to meet future needs.” Charles F. Phillips, Jr., *The Regulation of Public Utilities* 388 (3rd ed. 1993) [“Phillips, Reg. Pub. Util.” at \_\_\_\_]. To obtain this percentage, the Commission (1) estimates the capital attraction rates for each component of the regulated company's capital structure; and then (2) combines the various costs of capital into one overall rate of return in accordance with the percentage each component bears to the overall capitalization. Stated mathematically, the cost of capital is the composite of the cost of the several classes of capital used by a utility -- debt, preferred (and preference) stock, and common stock (par value plus earned and capital surplus) -- weighted on the basis of an appropriate capital structure. Phillips, *Reg. Pub. Util.* at 388.

**1. Delmarva’s Capital Structure Should Include Short Term Debt**

The selection of appropriate capital structure is crucial because each class of capital demands a different cost rate and, thus, the Commission must ultimately estimate the appropriate proportion of each class in order to ascertain the appropriate weighted average cost of capital. While in theory a company may find the ideal mix of equity and debt, in practice achieving this goal is a “major challenge to most companies, and particularly to companies in capital-intensive industries such as electric utilities.” King Dir., p.3 ( OPC Ex.3 ).

On one hand, the cost of equity capital is usually higher than the cost of debt capital because it bears more risk and thus requires a higher return paid to investors. Since “the return to equity – dividends and retained earnings – is not tax deductible, equity capital also affects

ratemaking by requiring a gross-up for income taxes.” *Id.* On the other hand, as the proportion of debt increases, the financial risk that the Company might not be able to honor its debt instruments increases. *Id.* If such occurred, rating companies would lower the utility’s bond rating and thereby raise the utility’s capital because the Company has to offer higher interest payments to sell its bonds. In other words, “at some point, that risk overwhelms the benefit of lower debt costs, and the capital structure becomes too ‘leveraged,’ that is, it has too much debt for the earnings to sustain.” *Id.* That being said, “cost efficiency” is the “primary concern” when determining a utility's appropriate capital structure and, generally speaking, “capital structures are not determined by bond rating criteria or the stated goal of a company to achieve a certain rating.” *Re Bangor Hydro-Electric Company*, 197 P.U.R.4th 197 (Me. P.U.C., 1999).

Mr. King proposed a capital structure of three components: (1) 46.93 percent common equity; (2) 47.18 percent long term debt; and, (3) 5.89 percent short-term debt. King Dir., p.3. The total amount of short term debt in the Company’s capital structure (net of Construction Work in Progress (CWIP)) was \$94,464,028. This short term debt was used to finance current Company operations. *Id.* at 4.

While too much debt will overwhelm a company, the primary concern for regulators is that a “less-than-efficient capital structure which contains *excessive equity* is properly treated . . . as *likely to result in higher rates . . .*” *In re Zia Natural Gas Co.*, 998 P.2d 564, 567 (N.M. 2000); *see also, e.g., Turpen v. Oklahoma Corp. Comm'n*, 769 P.2d 1309, 1381 (Okla.1988) (it is “widely recognized that when excessive common equity ratios are used for ratemaking purposes, utility customers are forced to bear an unwarranted capital cost and tax burden). Delmarva objects to the inclusion of short term debt, claiming that it provides only temporary funding for construction requirements, which are permanently financed with either long term debt or

common equity. Kamerick Reb. DPL Ex. 2, p.6. Delmarva does acknowledge that it carried an “abnormally high level “of short term debt during the test year. Id. at 7; Kamerick Sch. AKL R-1. The Company urges the Commission to ignore the high debt level, saying it was necessary to build a cash reserve for construction and operations against the possibility that the Company would not be able to access credit during the financial crisis. Id. ,pp.7-8. However, the existence of the financial crisis does not explain the extent of the short term debt typically carried by the Company. Mr. King noted that the Company carried very large short term debt balances at various times *throughout* the test year, not just post-financial collapse. Delmarva had very large short term debt balances in January, February, August and September, 2008.King Surrebuttal (OPC Ex.4), p 3. The reason for the high short term debt balance (building the cash reserve up) is largely irrelevant. The Company has not explained why, even if did borrow to build a cash reserve, that borrowing should be excluded from the capital structure. The high level of borrowing funded operations; it exists; it *is*.<sup>13</sup> It should be counted in the capital structure.

To attempt to downplay the importance short term debt now carries in the Company’ s capital structure, Mr. Kamerick reduced the Company’s short term debt by “its abnormally high cash balance.” Kamerick Reb., p.8.Even after that bit of “recalculation”, the Company was still left with an average 2008 short term debt balance of \$50.4 million, certainly an amount too big to ignore. The existence of a “normalized” balance this high does not support the Company’s proposition that short term debt should be excluded from the capital structure. See King SR,p. 3.

It is certainly not unprecedented for the Commission to include short term debt in the capital structure. For example, short term debt was included in Potomac Edison’s capital structure in Case No. 8341. See *Re Potomac Edison Co.*, 82 Md. PSC 470, 485 (1991). Short

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<sup>13</sup> Many apologies to Descartes for the corruption of his principle.

term debt has also been included in the capital structure for PEPCO. See e.g., *Re Potomac Electric Power Co.*, 82 Md. PSC 172,199 (1991).

**2. The Commission Should Adopt A Return On Equity For Delmarva Which Is Based On A Fair Comparison With Other Utilities**

Mr. King employed all five generally accepted methodologies to develop his equity return. He regards the Discounted Cash Flow (“DCF”) methodology as *the* reliable indicator of equity return and consequently gives the DCF the greatest weight. There are three iterations of the DCF: The classic, the FERC 2-step and the sustainable growth model, ranked in order of their usefulness according to Mr. King. Despite his relatively low regard for the CAPM and risk premium analyses, nonetheless, Mr. King also performed the equity calculation using those methodologies. King Dir., p.22. In his Exhibit CWK-1(Sch.9), Mr. King shows his equity results according to their ranked weights. The composite, weighted return on equity developed from an analysis of comparable companies is 10.47 percent. As will be further discussed below, Mr. King added 0.07 percent to account for flotation costs and then subtracted 0.50 percent to account for the reduction in risk due to the BSA. The end result is an equity return of 9.97 percent which Mr. King rounded up to 10 percent. King Dir., p.22.

By law, Delmarva shall charge “just and reasonable rates” for the utility services that it renders. PUC § 4-201. Thus, the “rate-making process . . . i.e., the fixing of ‘just and reasonable’ rates, involves a balancing of the investor and the consumer interests.” *Lewis v. Mayor and City Council of Cumberland*, 189 Md. 58, 67 (1947). Three standards have been derived to assist regulators in determining an investor-owned utility’s appropriate return on equity in accordance with *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). The first is the “comparable earnings” standard, i.e., that the earnings must be “commensurate with the returns on investments in *other enterprises having corresponding risks.*”

*Id.* p.5. The second standard is that earnings must be sufficient to assure "confidence in the financial integrity of the enterprise," and the third standard is that they must allow the utility "to attract capital." *Id.*

In applying the comparable earnings methodology, the financial integrity and capital attraction standards are also met if the companies which are ultimately chosen and the methods to derive the rate of return as applied to the chosen companies are fairly and accurately comparable to Delmarva. *Id.* at 7. The devil in the comparable earnings methodology, however, lies in the details of choosing the other companies which will serve as a fair and accurate comparison as well as choosing a method from which the rate of return is derived.

Mr. King excluded sixteen of the 35 companies proposed as comparables by Dr. Morin because a number of them were engaged in unregulated activities, making them dissimilar to Delmarva. *Id.* at 8. To determine which of the companies listed by Dr. Morin should be considered truly comparable, Mr. King applied two criteria: that the companies receive at least 50 percent of their revenue from regulated electric operations and no more than 25 percent of their revenues from unregulated activities. Additionally, building upon FERC practice, Mr. King excluded any company whose S & P bond rating is more than one grade above or below Delmarva's. The nineteen companies who met these criteria were then analyzed by Mr. King using all five equity return methodologies. See King Dir., pp.8-9, CWK-1, Schedules 3 through 8.

The Maryland Commission, consistent with most other jurisdictions, historically has relied upon the Discounted Cash Flow ("DCF") procedure as the principal methodology for obtaining an indication of the rate of return of equity required by equity investors in any company or group of companies. See *Re Md. Natural Gas, A Div. of Washington Gas Light Co.*,

79 Md. P.S.C. 298 (1988) (“In determining the cost of equity, we rely mostly on the DCF studies, consistent with our practice of many years.”).<sup>14</sup> With application of the DCF method, the present value of future expected net cash flows is calculated using a discount rate. The discount rate that equates those future cash flows with the market value of the stock is the investor’s required rate of return.<sup>15</sup>

Using the “classic DCF” approach, where it is generally accepted that the growth rate of earnings per share (“EPS”) is the most reliable indicator of the “g” factor<sup>16</sup>, the average DCF return totaled 11.17 percent for the electric utility comparison group when the average electric company earnings growth rate of 5.91 percent was added to those companies’ 5.25 percent dividend yield.<sup>17</sup> King Dir., p.11.

While Mr. King believes that the “classic DCF” formula is “a reliable basis for estimating returns to equity,” he also concurs with the Commission’s belief that “the DCF methodology cannot be completely accurate in predicting investors' expectations for the rate-effective period.” *In Re Baltimore Gas and Elec. Co.*, 88 Md. P.S.C. 47, 72 (1997). Accordingly, Mr. King also has applied other methodologies to offer guidance as to whether the classic DCF results are appropriate. *Id.* at 12. Applying a modified DCF formulation relied upon by the Federal Energy

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<sup>14</sup> See also *In Re Potomac Edison Co.*, 84 Md. P.S.C. 62, 86 -87 (1993 (“Having considered the evidence presented, we will again place primary reliance upon the DCF model for determining APS' cost of equity.”); *In re Baltimore Gas and Elec. Co.*, 88 Md. P.S.C. 47, 72 (1997) (“Indeed, in past proceedings it has been acknowledged by most parties that the DCF method is the single most precise predictor of investor expectations of all of the methods utilized.”).

<sup>15</sup> Underlying the DCF methodology is the presumption that, when purchasing stock, a rational investor considers two components, the first of which is the stock’s present dividend (i.e., the immediate cash flow) and the second is the prospect for future dividend growth. The sum of the present and future rates of these two flows equals the return that investors require. “Investors adjust the price they are willing to pay for the stock until the sum of the dividend yield and the annual rate of expected future growth in dividends equals the rate of return they expect from other investments of comparable risk.” OPC Ex., p.9. Investors’ expectation of capital appreciation is realized through dividend growth which is assumed will also increase the stock’s price. *Id.* at 10.

<sup>16</sup> See King Dir. ,p. 11.

<sup>17</sup> The DCF approach is usually represented by the following formula:  $k = \frac{d}{p} + g$ , where  $k$  = required rate of return,  $d$  = dividend in the immediate period,  $p$  = market price and  $g$  = expected growth rate in dividends. Capital appreciation is captured though “g.” King Direct Test. at p. 9.

Regulatory Commission (“FERC”), also referred to as the “FERC 2-step DCF,” *see e.g.*, *Williston Basin Interstate Pipeline Company*, Docket No. RP00-107-000, 104 FERC P 61036, 61,099 (July 3, 2003), Mr. King calculated a rate of return for the electric comparison group of 10.70 percent. *See generally*, King Direct, p.13-14 and CWK-1, Schedule 5. Mr. King noted that this modified DCF was developed to moderate the concededly unrealistic expectation underlying the “classic DCF” formulation wherein growth in earnings that departs significantly from the overall growth of the economy can last indefinitely. To reflect that earnings growth will trend toward the rate of increase in the total market, the modified DCF uses a two step approach, using for its first step the same analysts’ forecasts as with the “classic DCF” but using for the second step an estimate of long-term nominal rate of growth in Gross Domestic Product (“GDP”).<sup>18</sup> See King Dir., p. 13.

The final DCF analysis performed was the “sustainable growth model” which examines each company’s ability to generate increases in the book value of its stock. This method recognizes that a regulated company’s earnings and dividend growth will be driven indirectly by book value growth. King Dir., p. 14. The model attempts to calculate an increase in book value based upon some projection of retained earnings and the price of new shares of stock at prices that exceed book value. To calculate returns using this model, Mr. King relied upon Value Line,”which is the only source that provides five-year forecasts of all the relevant variables.” King Dir., p.15. The average DCF return using the sustainable growth model is 10.29 percent for the comparison group. King Dir., p.16.

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<sup>18</sup> In developing its “g” factor for the DCF formula, FERC assigns two-thirds weighting to the analysts’ forecasts and one-third weighting to the GDP growth forecast. *See Williston Basin, supra*.

As noted previously, there are some shortcomings of the sustainable growth model which, in Mr. King's view, leave it subject to challenge. Most of the weakness in the model is due to the underlying assumptions, which do not necessarily withstand scrutiny. Those weaknesses are discussed by Mr. King at page 16 of his testimony. The major problems include the circular reasoning in the model (one of the inputs to the growth calculation is return on book value yet the purpose of the calculation is to determine book value) and the fact that the entire calculation is based upon one source—Value Line. It is those weaknesses that cause Mr. King to “discount its value as a definitive measure of required equity return.” King Dir.,p.17.

Mr. King then applied the method known as the Capital Asset Pricing Model (“CAPM”) to his group of comparable utilities, which produced a return to equity of 8.98 percent. King Dir., p.20. Both the DCF and the CAPM models use common stock price behavior to draw inferences about the cost of equity. The DCF combines a stock's dividend yield and its predicted dividend growth rate. The CAPM relates changes in a stock's price to changes in the overall market for security prices. Through CAPM, a stock's total risk is divided into two components: the specific risk unique to the company, and market risk, that portion which can not be diversified away. Central to the CAPM is the notion that, “since investors can diversify away company specific risk, they should not be rewarded for bearing this type of risk.” James C. Bonbright, et al., 3 *Principles of Public Utility Rates* 14,p.325 (2d ed. 1988) (hereinafter “Bonbright, PPUR Ch. \_\_\_”). Accordingly, a measure of market risk -- called beta - is required to capture “the extent to which a stock's return moves with market returns.” *Id.*

In short, to successfully complete all of the variables in the CAPM formula,<sup>19</sup> an expert's *judgment* is required to determine the value of a number of the inputs, including *beta*. And

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<sup>19</sup> The CAPM formula is as follows:  $k = R_f + \beta(R_m - R_f)$ , where  $k$  = the prospective market cost of common equity for a specific investment,  $R_f$  = the “risk-free” rate of return,  $\beta$  = the company-specific beta and  $R_m$  = the overall stock market return on stocks for the prospective period.

therein lies the rub.<sup>20</sup> As noted, beta measures the extent to which a stock's return moves with market returns or, as technically stated, the degree of covariance of the stock with that of the market overall. As Mr. King notes, however, “But neither the fluctuations of the stock nor those of the market are constant or even consistent with each other over any extended period of time. As a result, there are as many estimates of beta for a given company as there are analysts making the measurement.” King Dir., p.18.<sup>21</sup> Additionally, the experts have fundamental disagreements about on what to base the risk free rate of return ( $R_f$ ) and on the return to the overall market ( $R_m$ ). As Bonbright writes, “CAPM has been castigated on both theoretical and practical problems . . . [but] its limited popularity is probably more a result of the estimates it produces and their volatility.” Bonbright, PPUR Ch3,p.14,p.327. For the same reasons, Mr. King gave little weight to CAPM results in his weighting of results.

Mr. King also reviewed Dr. Morin’s computation of the risk premium approach. The theory underlying this approach is that, because “the required rate of return is higher for riskier securities than less risky securities . . . the equity of a company has a higher required or expected return than its debt.” Bonbright, 3 PPUR Ch 14, p.322. The “differential between the cost of equity and debt is the required premium for enticing investors to accept the greater risk associated with equity.” *Id.* Since the return to debt is known and measurable, risk premium tests attempt to identify the premium that investors require for investment in stocks relative to bonds. King Dir., p.21. Using the average difference between bond returns and stock returns

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<sup>20</sup> W. Shakespeare, *Hamlet*, Act III, Scene 1: “To die, to sleep;/ To sleep: perchance to dream: ay, there's the rub . . .

<sup>21</sup> Indeed, reviewing the *betas* for the electric comparison group as derived by Value Line and Thomson Financial reveal that there is little or no consistency among the beta values for the respective companies, and there is no case where the betas from these two sources match. *Id.* and Schedule7, CWK-1.

over from 1931 through 2007 and adding that figure to the current yield on utility bonds, Dr. Morin derives a return indication of 11.1 percent before flotation costs.<sup>22</sup>

While the “risk premium method sounds simple and quite appealing . . . there are conceptual as well as measurement problems in implementing the technique.” Bonbright, 3 PPUR Ch. 14 at 322. See also *Re The United Illuminating Company*, 246 P.U.R.4th 357 (Conn. D.P.U.C.) (“the risk premium approach suffers from so much subjectivity that it can be essentially used to produce whatever outcome is desired.”). Thus, Mr. King properly gave the risk premium approach the least weight in his analysis.

**3. The Commission Should Limit Flotation Costs To Those Which Are Verifiable and Reasonable**

If a Company sustained flotation costs,<sup>23</sup> OPC agrees that they would ordinarily be recoverable “either as an explicit expense item in the revenue requirement or as an adder to the rate of return.” King Dir., p.23. He recommends an adder of seven basis points to the rate of return (0.07 percent) to allow the holding company (PHI) to recover stock flotation costs. Id. This is stark contrast to the inflated amount (30 basis points) sought by the Company. Mr. King demonstrated that using the Company approach would translate into an annual recovery of \$12.6 million if applied to all of PHI’s equity capital. Under the Company proposal, *PHI would recover over half of all the flotation costs it has incurred since its creation!* King Dir., p. 23. Mr. King used the same methodology to calculate flotation costs as he did in Case No. 9093. His methodology was accepted there and should be adopted as well in this proceeding.<sup>24</sup>

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<sup>22</sup>King Dir., p.21.

<sup>23</sup> Flotation costs are costs associated with issuing, or “floating” new stock, which include commissions to the underwriter, legal and consulting fees, and administrative costs. Flotation costs are conventionally measured as the difference between the gross proceeds from a stock sale and the net proceeds that the issuing company receives. *King Dir.*, p. 22.

<sup>24</sup> See 98 Md.PSC 288,314 (2007).

**4. Delmarva's Equity Return Should Be Reduced To Account For Reduced Risk Due To the BSA**

In Case No. 9093, the Commission approved a Bill Stabilization Adjustment (BSA). The BSA removes a significant amount of (if not most) business risk that the Company could experience. It removes the risk due to weather and it removes the risk due to energy efficiency efforts. It also removes the risk of declining sales due to a downturn in the economy. As Mr. King stated "...it makes Delmarva one of the least risky business enterprises in the nation." King Dir., p.24.

Recognizing this lack of risk in Case No. 9093, the Commission reduced Delmarva's equity return by 50 basis points. OPC urges the Commission to continue to reflect that lack of risk by reducing the return on equity by at least 50 basis points in this case.

**G. Cost Allocation/Rate Design**

**1. Summary**

Delmarva proposed an allocation and design of rates for the requested increase of \$14,145,000, based upon the testimony of two witnesses, Mr. Janocha and Mr. Tanos. The rate allocation and design testimony was accompanied by a Cost of Service Study (COSS) which indicated that for the twelve months ending December 31, 2008 the residential class treated as a single group<sup>25</sup> was contributing in rates at 105% of the Company's average rate of return.<sup>26</sup> Mr. Janocha provided testimony on the rate allocation and design; Mr. Tanos' testimony supported the COSS and the results of that study.

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<sup>25</sup> In the prior proceeding in Case 9093, the Commission directed "the Company in its next filing to (a) provide NCP calculations for the residential heating and non-heating customers as suggested by OPC; and (b) submit more recent load and peak data, as suggested by Staff." 98 Md. PSC 288,322. The COSS in this case reflects this direction.

<sup>26</sup> OPC Exhibit No. 5 (Wallach Direct), p. 4.

In addition to the COSS, a significant factor which has consequences for all of the rate design testimony is the impact of the Bill Stabilization Adjustment (BSA) instituted two years ago in the prior Delmarva base rate proceeding, Case 9093, with the goal to provide rate stability for Delmarva.<sup>27</sup> The BSA adjusts to eliminate sales related revenue losses which would impair Delmarva's earnings. In the event of sales related revenue increases due to causes such as abnormal weather, the BSA would similarly reduce the impact to customer bills.<sup>28</sup> Significantly, the Commission indicated in Case 9093 that "we will refine the details of the BSA in a further proceeding."<sup>29</sup>

In part because of the BSA, OPC is recommending a different approach to allocating a change in revenues, if authorized, from the approach proposed in the testimony of Delmarva's witness, Mr. Janocha. OPC's witness, Mr. Wallach presented an illustrative design for the residential rate class based on the Company's requested rate of return and revenues. Essentially, as Mr. Wallach explained in his testimony, residential revenues should be increased "only by the amount necessary to achieve the rate of return authorized by the Commission in this proceeding."<sup>30</sup> This recommendation for allocating the amount of the overall increase to customers is an effective method of rate design whether an increase or decrease in revenues is authorized in this case. The proposed OPC method further prevents subsidies to classes that are determined to be under-contributing to the system return and prevents an over-allocation to the residential class which is particularly sensitive to price increases during times of economic distress such as the current period.

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<sup>27</sup> *Re Delmarva Power and Light Company*, 98 Md. PSC 288, 296 (2007).

<sup>28</sup> 98 Md. PSC 288, 315.

<sup>29</sup> 98 Md. PSC 288, 296.

<sup>30</sup> OPC Exhibit No. 5, (Wallach Direct), p. 7.

A second major issue in this case is Delmarva's request to further increase its residential customer charge after requesting and implementing a significant increase to the customer charge only two years ago. Among other concerns with the requested increase in the customer charge, Mr. Wallach indicates that unless this fixed charge is revised only in the same degree as any change in revenues, there is a concern that amounts will be included into base rates which were intended for recovery in the BSA, a sliding charge adjustment which moves in both directions.<sup>31</sup> Thus sliding charges previously recovered in the BSA energy surcharge would become fixed in recovery, if care is not taken in setting the level of any alteration to the current customer charge.

Mr. Wallach also analyzed some continued weaknesses in the Delmarva COSS which have been resolved in part consistent with the Commission Order from Case No.9093 but still hamper the accuracy of the results for residential customers' contribution to the system return. Mr. Wallach indicated that the COSS is still overstating the residential class's share of costs and that therefore the increase necessary to bring the residential class to Delmarva's requested rate of return is less than indicated by the COSS.<sup>32</sup>

Finally, all of the parties are in agreement that while elimination of the winter trailing tail block is a proper change in the design of rates, that retention of some winter/ summer differential is desirable and consistent with the operation of the Delmarva distribution system.

**2. OPC's Recommendation To Allocate The Recovery Of The Revenue Requirement Established In This Proceeding Based On The Rate Of Return Authorized To Delmarva Is The Legal And Appropriate Approach To Setting Rates In This Case.**

The proposals in this proceeding reflect certain key principles applied to develop rates which ultimately will be implemented for customer bills. While there are divergent recommendations from the parties on the reasonable and appropriate level of the revenue

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<sup>31</sup> OPC Exhibit No. 5 (Wallach Direct), pp. 6-7.

<sup>32</sup> OPC Exhibit No. 5 (Wallach Direct), p. 9.

requirement for Delmarva in this case, any new rates adopted should be based on principles of fairness and equity. In considering the appropriate allocation and design of rates, the Commission has historically relied on the need to develop rates consistent with cost causation and responsibility. In addition, the need to give appropriate price signals and to introduce significant rate changes under an approach of gradualism are significant elements of the rate design process which has long been viewed as more an art than a science.<sup>33</sup> In the consideration of the prior application by Delmarva in Case No. 9093, the Commission explicitly recognized the value of all three of these principles and noted especially its reliance on the principle of gradualism in developing Delmarva's rate design.<sup>34</sup>

In this case Delmarva's witness, Mr. Janocha, proposed to limit the movement of the classes towards unity with Delmarva's system return for Maryland. Mr. Janocha looked at the UROR or unitized returns<sup>35</sup> developed from the Delmarva COSS and moved each class closer to unity by 70 percent. This approach left certain classes (including residential customers) still above unity and some others remained below unity (or under contributing). Mr. Janocha does not provide a specific rationale for failing to move all classes to unity but references his consideration of factors other than cost causation or responsibility.<sup>36</sup> He simply describes a "moderate" shift of the residential class away from unity.<sup>37</sup> However, this shift creates the subsidy from the residential class to the benefit of the other classes who are not set at unity.<sup>38</sup>

Tr. 208.

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<sup>33</sup> *Re Electric Utility Rate Structures* 68 Md.PSC 94, 126 (1977).

<sup>34</sup> 98 Md.PSC 288, 322 and 323.

<sup>35</sup> UROR is a standard ratemaking calculation showing the relative return of a class to the average return for the system. A UROR of 1.0 is unity; above 1 is greater than the average return and below 1 is less than the average return.

<sup>36</sup> Delmarva Exhibit No.11 (Janocha Direct), pp. 3-4.

<sup>37</sup> Delmarva Exhibit No. 12 (Janocha Rebuttal), p. 4.

<sup>38</sup> This increase is described by Delmarva as a total monthly bill increase of \$3.89 or 2.6% for a Standard Offer Service (SOS) customer using 1,000 kWh per month. Delmarva Exhibit No. 11 (Janocha Direct), p.12.

Mr. Wallach, testifying for OPC, indicated that Delmarva's proposal "for allocating the requested revenue increase to customer classes, in combination with its proposal to dramatically increase the residential customer charge, unduly and unreasonably burdens consumers...."<sup>39</sup> Mr. Wallach recommends that the Commission reject Delmarva's approach in favor of his approach which would move residential rates in the direction of the return and revenues authorized by the Commission. He provides an illustrative design based on the Company's requested return. The allocation results in a 10.3% increase in residential revenues.<sup>40</sup>

Mr. Wallach explains that even though revenues would increase by this percentage that the rates adopted in this case would show an increase from the most recent prior rate case of 18%. This difference in the increase as reflected in revenues and rates is an effect of the institution of the BSA in a time period where sales revenue related losses were occurring. Rates must be set to recover the loss of revenues between the 2006 and 2008 test-year periods as well as any future intended increase or decrease authorized. Mr. Wallach explains that because the sales -related revenue losses were previously recovered through the energy surcharge in the BSA, if the full revenue request by Delmarva were authorized, an 18 percent rate increase will effectively fold the BSA surcharge recovery of the sales-related deficiency into base rates.<sup>41</sup> This effect is consistent with a sliding scale mechanism and in the event that sales increase the sliding scale could reverse in a future case; however, it should be noted that if energy efficiency measures are implemented successfully by Delmarva any future increase in revenues would be diminished. Also, the timing and selection of the test period showing losses or increases is to a large extent under the control of Delmarva which chooses the timing of any application for a

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<sup>39</sup> OPC Exhibit No. 5 (Wallach Direct), p.2.

<sup>40</sup> Mr. Wallach's illustrative analysis can be adjusted to distribute the requested revenue increase in the same manner as the residential class or in other ways without affecting the allocation to the residential class. OPC Exhibit No. 5 (Wallach Direct), p. 3 including footnote 2.

<sup>41</sup> OPC Exhibit No. 5 (Wallach Direct), pp. 6-7.

change in revenues. The record reflects that the BSA operated as an adjustment to offset lost sales revenues in the amount of over \$7 million dollars during the period since the BSA was instituted in the prior rate proceeding.<sup>42</sup>

**3. The Delmarva COSS Will Continue To Over Allocate Costs To Residential Customers Unless The Commission Directs Further Steps To Address The Diversity Of Residential Load In Development Of Allocators For Line Transformers And Residential Services.**

OPC, as in the prior Delmarva rate proceeding in Case 9093, again identifies problems with the approach used to allocate distribution plant in the Delmarva cost of service study.<sup>43</sup>

Two issues are analyzed by Mr. Wallach in direct testimony in the current proceeding:

1. The allocation of line transformers based on a simple average of Class MDD and Customer NCP may understate the diversity of load on these facilities.
2. Delmarva's allocation of services based on Customer NCP (which implies zero diversity in customers' loads) does not account for the sharing by several residential customers of a single service line to a multi-family building.

Mr. Wallach illustrates the manner in which Delmarva could include further consideration of factors affecting load diversity including the number of customers served on line transformers and living in multi-family dwellings. A level of diversity of load for residential customers was already confirmed with Delmarva following Commission direction from Case No.9093 to combine the residential heating and non-heating customers as a single class in the cost study.<sup>44</sup> Delmarva further treated these two groups as a single class for calculation of the

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<sup>42</sup> OPC Exhibit No. 2, pp. 1-2. (cross-examination exhibit) and Tr. 202.

<sup>43</sup> The Commission examined the lack of availability of test year inputs affecting the COSS and directed some of the changes recommended by OPC in Case No. 9093. 98 Md. PSC 288, 321. However, improved and refined information is still sought by OPC on certain of the factors involved in developing the allocators for distribution plant.

<sup>44</sup> 98 Md. PSC 288, 322.

noncoincident demand for the heating and non-heating groups.<sup>45</sup> The significance of recognizing load diversity is that if the COSS understates this factor than the residential class contribution to distribution costs is overstated and thus over-allocation of costs to the residential class results.<sup>46</sup>

Mr. Wallach provided a detailed illustration of the effect of understating diversity using as an example the allocation of line transformers. He explained that distribution serving small customers tends to have greater diversity, because each piece of equipment typically can serve more small customers than large customers.<sup>47</sup> As he states, “[t]he greater the number of customers on a particular component, the greater the variation in loads and load shapes (that is, load diversity), the lower the contribution per customer to the group peak, and the lower the cost per customer.”<sup>48</sup> He shows the potential for lower coincidence factors<sup>49</sup> (and therefore greater diversity) for certain residential customer uses such as air conditioning and electric furnaces indicating that a lower weighting of the customer NCP allocator is appropriate.<sup>50</sup> Delmarva’s calculation of the distribution line transformer allocator uses a 50/50 weighting of Class MDD (maximum diversified demand) and customer NCP (non-coincident peak demand). The purpose of the weighting according to Mr. Tanos is to capture a mid-point reflecting the contribution of both allocation factors for this equipment class.<sup>51</sup> One of Mr. Tanos’ concerns is that the specific distribution plant installation characteristics of the Delmarva system be considered; however no study to refine Mr. Wallach’s analysis was provided.<sup>52</sup> In rebuttal, Mr. Tanos

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<sup>45</sup> Delmarva Exhibit No. 13 (Tanos Direct), p. 11.

<sup>46</sup> OPC Exhibit No. 5 (Wallach Direct), p. 9.

<sup>47</sup> OPC Exhibit No.5 (Wallach Direct), p. 11.

<sup>48</sup> OPC Exhibit No. 5 (Wallach Direct), pp. 11-12).

<sup>49</sup> Load diversity is reported as a coincidence factor, a ratio of a customer group peak to the sum of their maximum demands. OPC Exhibit 5 (Wallach Direct), p. 10.

<sup>50</sup> OPC Exhibit No. 5 (Wallach Direct), p.14.

<sup>51</sup> Delmarva Exhibit No. 14 (Tanos Rebuttal), p. 8.

<sup>52</sup> OPC Exhibit No. 5 (Wallach Direct), p. 12.

replied simply that “the amount of customers served by a single transformer will vary.”<sup>53</sup> Mr. Wallach at this time is not recommending changes to the Company’s allocators for line transformers but only performing an illustrative calculation “to indicate how Delmarva’s allocator for line transformers may be understating diversity.”<sup>54</sup>

Mr. Wallach’s second assessment that diversity of customer load for allocation of services is greater than zero is not given serious consideration by Mr. Tanos, even though as with the line transformer allocation, Delmarva did not provide the information necessary for Mr. Wallach to go beyond estimates of the impact of shared services on the residential services allocator.<sup>55</sup> However, Mr. Wallach has simply recommended further study and refinement of allocation factors based on information that is available to Delmarva.<sup>56</sup> This recommendation should be adopted with a requirement that Delmarva provide the type of information requested by Mr. Wallach in any future rate case proceeding.<sup>57</sup>

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<sup>53</sup> Delmarva Exhibit No. 14 (Tanos Rebuttal), p. 7.

<sup>54</sup> OPC Exhibit No. 7 (Wallach Surrebuttal), p. 5.

<sup>55</sup> OPC Exhibit No. 5 (Wallach Direct), p. 15.

<sup>56</sup> Cross-examination by Delmarva of Mr. Wallach indicates that such additional facts are available and might lead to further accuracy in the results reducing any over allocation to residential related to the allocation of line transformers or services in the COSS. Tr. 480-483. In a discussion with Counsel for Delmarva, Mr. Wallach was questioned regarding physical factors of Delmarva’s system such as the location of the service drop which could affect the allocation of costs to customers. Customer-owned elements of the system would be eliminated from the COSS, of course.

<sup>57</sup> This type of additional input may produce more valuable analysis for the COSS for example than Staff’s request for a theoretical consideration of minimum system allocations which are largely shown to over allocate to smaller customers. See in this regard the discussion of flaws in the minimum system approach in the rebuttal testimony of Delmarva’s witness Mr. Tanos. Mr. Tanos states that “Staff’s theoretical calculations simply label customer-related a range of distribution plant costs, but have little factual support...” and also “for smaller users explicitly, the minimum system can include a large portion of their load requirement and result in an over allocation of costs for these accounts or double counting.” Delmarva Exhibit No. 14 (Tanos Rebuttal), pp. 4-5. Among the other listed problems were that the minimum system is difficult and burdensome to identify. *Id.* Even Staff’s Witness Mr. Ermer found it difficult to isolate the practical purpose of a minimum system study for Delmarva. Tr. 364-367. There was really no way to practically identify the minimum system. *Id.*

Also, study of the minimum system is unnecessary because significant elements of Delmarva’s system are already allocated based on customer related costs obviating a need to identify a minimum system which would only skew the customer related allocation of costs. Both customer-related plant costs for services and meters are classified as customer related in the COSS. Delmarva Exhibit No 14, (Tanos Rebuttal), p. 4.

Further, in the cases presented by Staff for consideration in response to an on the record data request from the Commission, it was also clear that there was great potential with the minimum system approach for double-counting with adverse impacts to residential customers which were difficult to offset or correct. See in this regard

**4. Delmarva's Requested Increase In the Customer Charge Improperly Shifts Energy Charges into a Fixed Fee.**

Delmarva has filed this case only two years after its prior rate case application which was reviewed with new rates set in 2007. Given this filing for another increase in rates so close to the prior application, Delmarva has an additional burden to justify any change in rate design as appropriate given the Commission's clear articulation of a need to avoid "rate shock" for ratepayers in the previous Delmarva rate case matter. This underlying factor that ratepayers have recently experienced significant changes to the design of rates with a Bill Stabilization adjustment and a significant increase of 25% to the customer charge is an additional element of the rate setting process to consider in determining the appropriate design of rates.

Also, as noted the COSS study results show at least two customer classes with contributions above the system average, specifically both residential and small commercial classes. Despite the recent authorization of a 25% increase in the customer charge, Delmarva is now seeking again another 25% increase in the fixed rate recovery through the customer charge. Along with Delmarva, Commission Staff also supports additional recovery in the customer charge relying on the need to continue to increase the amount of customer related costs (like meters) recovered based on cost causation from residential customers. Reflecting the principle of gradualism, however, Staff recommends a 16.67% increase in the customer charge moving the charge by one dollar from \$6.00 to \$7.00.<sup>58</sup>

Mr. Wallach also acknowledges the need for some increased recovery in the customer charge in the event of an overall increase in customer rates; his recommendation would increase the customer charge by the same percentage as revenues are increased i.e., approximately 62

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*Re Delmarva Power and Light Company* 73 Md. PSC 810,815-816 (1982). In fact after 1984 a time when there were significant revisions and an overhaul of rate allocation systems for electric companies, OPC found little if any discussion in the case law supporting use of the minimum system.

<sup>58</sup> Staff Exhibit No. 14 (Campbell Direct), p. 32.

cents in his illustrative rate design.<sup>59</sup> OPC has presented herein that this recommendation is the best approach to properly address the impacts of the BSA surcharge recovery in rates going forward.

Delmarva's witness, Mr. Janocha relies almost exclusively on a cost causation analysis. It is well settled under the law and Commission precedent that cost causation is an essential element of proper rate design. However, the Commission also may determine in this case as in the prior proceeding in 2007 to weigh any increase in customer charge in view of the precedents to avoid customer rate shocks.<sup>60</sup> Staff witnesses have recommended an increase of \$1 in the customer charge whether or not Staff's decrease case is adopted in an order in this case. The recommendation of Commission Staff to increase the customer charge in the event of a finding for a decrease would appear to conflict with the general context of Staff's case as presented so far in this matter and perhaps would send contradictory price signals for customers.<sup>61</sup> It is uncertain how raising the customer charge in a rate decrease scenario would send the appropriate price signal.<sup>62</sup> A single dollar increase in the charge will be adversely noted by customers especially on the back of the recent increase in 2007 to the fixed charge. Also the one dollar increase could also suffer the same problem noted earlier with locking into a fixed rate amounts properly adjusted and offset in the BSA or energy charges. Witness Wallach in rebuttal testimony described the fact that even under Staff's decrease case a significant lock in of the BSA adjustment is carried forward and would be inappropriately recovered not in a sliding mechanism but fixed into the new base rates on a permanent basis.<sup>63</sup> No party disagreed with

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<sup>59</sup> OPC Exhibit No. 5 (Wallach Direct), Exhibit JFW-2 page 2 of 2.

<sup>60</sup> 98 Md.PSC 288, 323. The Commission's prior holdings on rate "shock" would support little or no change to the customer charge in this case. See in this regard *Re Maryland Natural Gas, a Division of Washington Gas Light Company* 79 Md.PSC 298, 337 (1988) and *In Re Baltimore Gas and Electric Company* 91 Md.PSC 240, 254 (2000).

<sup>61</sup> Tr. 722.

<sup>62</sup> *Id.*

<sup>63</sup> OPC Exhibit No. 6 (Wallach Rebuttal), pp. 6-7.

this BSA related impact on rates and the customer charge. Mr. Wallach's testimony supports a close assessment of any change in the customer charge and demonstrates the real impact of any of the proposed changes in revenues. In the event of an increase the impact to customers is actually greater than the change in revenues. Similarly in the event of a decrease, the decrease is less than the claimed change in revenue requirements. Even if there is acknowledgement of BSA related impacts through other elements of rate setting like the establishment of Delmarva's rate of return, OPC recommends that the Commission also consider in setting rates in this case that bill impacts or rates could be more significant than in prior rate proceedings where the revenue requirement change was equal to the change in rates.

Considerable portions of testimony filed late in this case were devoted to a discussion of the effect of an increase in the customer charge specific to low usage customers. Mr. Wallach pointed out several reasons why an inappropriate burden is placed on this set of customers when the customer charge is increased. Mr. Wallach noted that the customer charge for a low usage customer may represent 20% of the monthly bill, this amount is an unavoidable fixed cost for that customer. Mr. Wallach also explains that a large increase disproportionately affects small customers' bills since the smallest customers (with the least-expensive distribution equipment) pay the average of customer costs attributable to all sizes of residential customers.<sup>64</sup> The BSA impacts also have a greater affect on small customers when recovery is permanently fixed in the customer charge instead of the volumetric energy surcharge. Mr. Wallach indicates that

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<sup>64</sup> OPC Exhibit No.5 (Wallach Direct), p. 17. He reiterated this conclusion in surrebuttal testimony stating

Mr. Janocha has it backwards with regard to the issue of intra-class subsidization. Under the Company's approach, whereby all costs classified in the COSS as customer-related are recovered through a fixed customer charge, the smallest customers (with the least-expensive distribution equipment) pay the average of customer costs attributable to all sizes of residential customers. To the extent that such costs vary with size within the class, setting the customer charge at the average of customer-related costs **results in a subsidy of large customers by small customers within the class.**

OPC Exhibit No. 7 (Wallach Surrebuttal), p. 4.

“recovering revenue losses through a fixed customer charge effectively allocates a fixed amount of revenue losses per customer, regardless of customer usage.”<sup>65</sup>

**5. Maintaining The Seasonal Differentiation In Rates Is Both Appropriate And Acceptable To The Parties.**

An original recommendation to take further steps to eliminate the summer winter differential for residential class rate design has been revised by the testimony of the witnesses on this issue. In Case No. 9093 the Commission permitted some reduction of the differential. For this reason, in its direct testimony Delmarva proposed to reduce the initial block by ten percent of the level that would have been in place after unbundling of rates in Case No. 8795 and move the residential cost recovery to the trailing block.<sup>66</sup> OPC’s witness Mr. Wallach recommended against this step which significantly reduces the summer winter differential. Mr. Wallach indicated in his analysis that seasonal differentiation is justified by the timing of peak loads and capacity restrictions on Delmarva’s system.<sup>67</sup> Subsequently Staff made a counterproposal which reinstates the summer winter rate differential with elimination of the winter tail block. In a final resolution of the issue Delmarva’s witness Mr. Janocha proposed to eliminate the declining block structure and include a seasonal differential which is equal to the level of differentiation which existed prior to the rate changes proposed in Case No. 9093.<sup>68</sup> The parties are in apparent agreement with this methodology as the approach to designing the summer winter rates and support continuation of the summer winter differential in rates adopted for the residential class in the proceeding. Witness Janocha acknowledged the value in the arguments of both Staff Witness

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<sup>65</sup> OPC Exhibit No. 5 (Wallach Direct), p. 18.

<sup>66</sup> Delmarva Exhibit No.11 (Janocha Direct), p.10.

<sup>67</sup> OPC Exhibit No. 5 (Wallach Direct), p.21.

<sup>68</sup> Delmarva Exhibit No.12 (Janocha Rebuttal), p. 8.

Mr. Campbell and OPC's Witness, Mr. Wallach.<sup>69</sup> This agreement would eliminate the trailing block for winter rates. This action is indicated as appropriate by Staff Witness Mr. Campbell because it supports conservation efforts.<sup>70</sup>

#### IV. CONCLUSION

Wherefore, consistent with the recommendations contained herein, the Office of People's Counsel respectfully requests that the Commission reject Delmarva's proposed increase in rates.

Respectfully submitted,

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October 26, 2009

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<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

410-767-8150

**CERTIFICATE OF SERVICE**

I HEREBY CERTIFY that on this \_\_\_\_\_ day of October, 2009, the foregoing Initial Brief of the Office of People's Counsel was either hand-delivered, e-mailed or mailed first-class, postage prepaid to all parties of record to this proceeding.

Respectfully submitted,

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Deputy People's Counsel