PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
1333 "H" STREET, N.W., SUITE 200, WEST TOWER
WASHINGTON, D.C. 20005

OPINION AND ORDER

September 27, 2012

FORMAL CASE NO. 1087, 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, Order No. 16930

Before the Commission:

Betty Ann Kane, Chairman
Lori Murphy Lee, Commissioner

Appearances:

Peter E. Meier, Kurt Emge, Marc K. Battle, Theodore F. Duver, Jillian L. Marwell, Richard M. Lorenzo, Arthur W. Adelberg for Potomac Electric Power Company; Sandra Mattavous-Frye, Karen R. Sistrunk, Herbert Jones, Brian O. Edmonds, Arthur L. Brown, Barbara L. Burton, Lawrence C. Daniels, Jennifer L. Weberski, Rishi Garg, John M. Adragna, Barry Vohen, Kevin J. Conoscenti, Bethany Pribila, Scott H. Strauss, Jeffrey A. Scharg, J.S. Gebhart, Sharon Coleman, Anjali G. Patel, Eli D. Eilbott, Jason T. Gray for Office of People's Counsel; Fred B. Goldberg for AARP; Frann G. Francis, W. Shaun Pharr, Nicola Y. Whiteman for the Apartment and Office Building Association of Metropolitan Washington; Brian Caldwell for the District of Columbia Government; Leonard Lucas, III, Leonard E. Lucan, Heather Cameron for the United States General Services Administration; Marc Biondi for the Washington Metropolitan Area Transit Authority; Robert I. White, Nancy A. White, Randy E. Hayman for the District of Columbia Water and Sewer Authority.

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INTRODUCTION AND EXECUTIVE SUMMARY

In this case the Potomac Electric Power Company ("Pepco" or "Company") initially sought a distribution revenue increase of $42.1 million. Pepco's requested increase would have raised the typical monthly residential customer bill in the District by 5.4%, which amounts to $5.20 for the average residential customer. Pepco also requested that the Commission increase its Return on Equity ("ROE") to 10.75%.

The Commission's decision to reduce Pepco's rate request to $24 million dollars, cuts Pepco's request by 42%. For the typical residential consumer, this would increase the monthly bill by $2.60, half of what Pepco requested. This is, on average, a monthly increase of less than 3% for residential customers.

It is important to note that more than one-third (37% or about $9.0 million) of this rate increase is due to the implementation of Advanced Metering Infrastructure (AMI) costs authorized by the Council of the District of Columbia in June 2009.[1]

This decision reduces Pepco's ROE from 10.75% to 9.5%. It also rejects Pepco's request for a Reliability Investment Recovery Mechanism ("RIM") surcharge, proposed as an alternative to traditional ratemaking.

Pepco's rate increase is being distributed among the customer classes in a manner that continues to gradually adjust rate structures so that rates are eventually cost-based for all customer classes. The special low-rate Residential Aid Discount (RAD program) is being continued for low-income Pepco customers.

In making this decision, we reaffirm our commitment to use all the regulatory authority at our disposal to ensure that Pepco's reliability continues to improve in all areas of the District of Columbia. Though the June "derecho" outages occurred after the record closed in this case, the Commission is holding a hearing on October 11, 2012, to examine the adequacy of Pepco's storm restoration activities associated with that event.

Although the increase we approve today results in less than a 3% increase on the average monthly bill, we do not take the increase lightly and neither should Pepco. We recognize that Pepco has substantially complied with our old performance standards. However, we have raised those standards and we fully expect Pepco to meet them. Failure to meet the new standards could result in fines and/or other punitive measures.

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1 D.C. Code § 34-1562(c-d) (2010 Repl.) (directs that Pepco "net any utility cost savings resulting from AMI deployment from the regulatory asset [containing the costs of AMI implementation]" and affirms the Commission's authority "to review the prudence of costs associated with implementation of AMI."). Based on the record in this proceeding, the Commission has determined that the AMI expenses were prudently incurred. No party presented compelling evidence against the prudence of AMI expenses.

I. BACKGROUND

1. This base rate case began on July 8, 2011, when Pepco, a subsidiary of Pepco Holdings, Inc. ("PHI") filed its Application with the Public Service Commission of the District of Columbia ("Commission") requesting a $42.1 million increase in its rates and charges for electric distribution service in the District of Columbia.[2] Pepco is the sole distributor of electric power to homes and businesses in the District of Columbia. The Commission does not regulate the cost of electricity itself but only sets rates for that limited portion of Pepco's bill that is for distribution service.[3]

2. The Company initially sought an overall rate of return of 8.64% for its distribution service, including a return on common equity of 10.75%, an increase from the 8.01% overall rate of return and 9.625% return on equity that was authorized in Pepco's last general rate case. As a result of agreements reached during the course of evidentiary hearings held January 30 through February 3, 2012, the Company revised its requested revenue increase downward to $39.75 million based on the Company's post-hearing adjusted rate base of $1.16 billion.[4]

3. Pepco's Application asserts that "regulatory lag" causes its revenue to fall behind its cost for electrical services and prevents the Company from earning its Commission-authorized rate of return for distribution service.[5] To address this problem, Pepco seeks to continue its Bill Stabilization Adjustment ("BSA"), which decouples (or separates) revenues from variations in kilowatt hour ("kWh") sales per customer. Moreover, the Company seeks the Commission's approval "in principle" of a Reliability Investment Recovery Mechanism ("RIM") surcharge, that would allow automatic annual rate adjustments to recover the costs of capital investments made to improve the

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2 *Formal Case No. 1087, 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. 1087")*, Pepco's Application, filed July 8, 2011. Pepco's Direct Testimony is hereinafter referred to as "Pepco___"; its Supplemental Direct Testimony as "Pepco (2_)"; its Rebuttal Testimony as "Pepco (3_)"; its post-hearing exhibits submitted in response to bench questions during the evidentiary hearings as "Pepco Exhibit No. ___"; its post-hearing initial brief as "Pepco Br."; and its post-hearing reply brief as "Pepco R.Br."

3 For example, though the average Residential customer in the District of Columbia pays a monthly electric bill of $100 or more, the distribution service portion of that bill is approximately $14.10 a month.

4 Pepco Br. 1-2.

5 Regulatory lag typically refers to the time it takes to complete the regulatory process necessary for cost recovery through new rates or to receive other regulatory permissions. *See Formal Case No. 1087*, Order No. 16570, ¶ 14. Pepco describes regulatory lag as the delay between the time when a utility's rate of return on equity deviates from the target set by regulators and the time when an offsetting rate decrease or increase is put into effect. Pepco (B) at 6 (Lowry).

reliability of Pepco's distribution system.[6] The Company submits that its RIM surcharge would address regulatory lag by providing for annual rate adjustments to promptly recover the costs of upgrading its aging infrastructure.[7] The RIM would benefit ratepayers, the Company asserts, by allowing Pepco to attract capital at reasonable costs, while decreasing the number of expensive rate cases filed. Pepco claims its RIM proposal is necessary to maintain and strengthen its investment grade ratings and to compete for capital in the market.[8] The Company also seeks cost recovery for its investments in Advanced Metering Infrastructure ("AMI"), including the cost of new AMI meters, the costs associated with its AMI communications network and related software, and costs associated with the early retirement of non-AMI meters.[9] Pepco proposes to recover its incremental customer care expenses for enhancing customer service, which includes four major components, personnel, telecommunications infrastructure, storm readiness, and customer education and market research. Pepco also proposes to recover the costs of adding a third transformer to its Northeast Substation, whose installation is necessary to provide service starting in June 2012.

4. Pepco contends that traditionally, in the District of Columbia, the residential customer classes have paid Pepco somewhat lower class rates of return ("RORs") than the commercial customer classes.[10] The Company submits, however, that the wide disparities that now exist in customer class RORs should be narrowed. The

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6 Pepco's Application at 5-6. The Company requests that the Commission approve the RIM proposal in principle. This includes the review and approval of the categories of work that will be included within the RIM as well as the rate recovery method. The Company would then form a Work Group with Staff, Office of People's Counsel and other Commission-appointed parties to complete the details of the operation of the RIM. The Company recommends that the Commission approve the following concepts for the operation of the RIM within the context of this rate base proceeding :

- Approval of the categories of projects to be initially recovered through the RIM;
- Establish the reporting requirements to track the progress of RIM projects and provide management reports;
- Approve the tariff that establishes the parameters for the operation of the RIM surcharge and recovery of and on investments incurred between base rate cases; and
- Approve the annual filing in March of each year that establishes the current year detailed project list and recovery rate and true up of work performed during the prior year. Pepco (I) 33:21-34:24 (Gausman)

7 Pepco's Application at 6. *See also* Pepco (A) at 12-13 (Kamerick); Pepco (B) at 5-6, 38-39 (Lowry).

8 Pepco's Application at 6-7.

9 Pepco (A) at 9 (Kamerick).

10 *See, e.g., Formal Case No. 1076, 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, ¶ 342, n. 691 (March 2, 2010) ("Historic rate patterns in the District of Columbia have been that the residential classes pay lower class RORs than the commercial class RORs.").

Company proposes to move gradually (one-quarter of the way) toward more equal class rates RORs by raising distribution rates more for residential than for commercial customers. Overall, the Company's proposals would add about $5 to the monthly bill for a typical residential customer's distribution service, for single-family residents and individually-metered condominiums and apartments. This average $5 a month increase would include increasing the minimum monthly customer charge from $6.65 per month to $10.40 per month for the standard residential class.[11] Pepco used its discretion to set the Streetlight Service class's ROR at 1%, producing a $45,222 increase from that class.

5. Other Pepco rate design proposals involve the design of the component parts of each individual class rate so that, together, they fulfill the class revenue target (*i.e.,* the contribution of each customer class to Pepco's overall jurisdictional revenue requirement). These rate design issues stem from Pepco's proposal to switch from old rate structures that recovered the Company's costs based primarily on the volume of a customer's energy usage, to new rate structures in the new deregulated era where Pepco is a "wires only" company whose costs are primarily fixed costs for installing distribution ("wires"). To recover the class revenue target for each customer class, Pepco states that it has designed individual class rates to place greater emphasis on recovering the Company's fixed costs through customer and demand charges, with less emphasis on volumetric charges, while taking gradualism into account.

6. The Commission held a pre-hearing conference on September 8, 2011. By Order No. 16570, the Commission designated the issues for consideration and set the procedural schedule for this proceeding.[12] We also granted petitions to intervene filed by the American Association of Retired Persons ("AARP"); the Apartment and Office Building Association of Metropolitan Washington ("AOBA"); the District of Columbia Government ("DCG" or "District Government"); the District of Columbia Water and Sewer Authority ("WASA"); Washington Metropolitan Area Transit Authority ("WMATA"); and the General Services Administration ("GSA").[13] The Office of People's Counsel of the District of Columbia ("OPC") is a party as of right.[14]

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11 Pepco (L)-1, p. 3 of 19 and Pepco (L)-3, p. 1 of 15 (Janocha).

12 *Formal Case No. 1087,* Order No. 16570, ¶ 34, Attachment A (October 3, 2011). The Commission's orders in this proceeding (*Formal Case No. 1087*) are hereinafter referred to as "Order No.___ at (page or ¶ number) (Date)." Orders in other Commission proceedings are cited in the following format: *Formal Case No.___, Case Name,* Order No.___ (Date). Court decisions are cited as "*Case Name,* ___ A.3d ___, ___ (D.C. (Year))." Transcripts of the Commission's Evidentiary Hearings as cited as "Tr.___."

13 *See* Order No. 16489, ¶ 4 (August 4, 2011); *see also* Order No. 16525, ¶ 4 (September 1, 2011), Order No.16570, ¶ 4, n. 7 (October 3, 2011).

14 *See* D.C. Code § 34-804. (OPC is a party, as of right, in any Commission investigation, valuation, reevaluation, concerning any public utility operating in the District of Columbia). In this case, OPC's Direct Testimony is designated as "OPC__"; its Rebuttal Testimony as "OPC (2_)"; its post-hearing initial brief as "OPC Br."; and its post-hearing reply brief as "OPC R.Br." The direct testimony of an intervenor is identified by party in the form (for example) "DCG _," "WMATA__"; with rebuttal testimony denoted

7. Pepco submitted supplemental direct testimony on October 24 and 26, 2011. The Commission convened eight (8) community hearings, including hearings held at locations in each ward of the city, on November 8, 9, 18, 19, 21, and 22, 2011. OPC, AARP, AOBA, the District Government, WMATA, and GSA all submitted direct testimony on December 7, 2011. Rebuttal testimony was filed by all the parties on January 16, 2012.

8. The Commission held evidentiary hearings on January 30 through February 3, 2012. Given the uncertainties in the record concerning Pepco's plans and budgeting for future capital expenditures to improve reliability in the District of Columbia and the importance of those matters to understanding Pepco's request for Commission approval "in principle" of a RIM surcharge for accelerated recovery of its future reliability improvement costs, the Commission asked Pepco during the January 31st hearing to provide it with a comparison of the projected and actual costs of reliability projects in the test year.[15] The Commission also asked Pepco to submit information about the costs during the test year (and rate effective period) of certain reliability projects included in Pepco's Reliability Enhancement Plan ("REP"), as well as the predicted impact that these projects would have on reliability.[16]

9. At the February 2, 2012, hearing, OPC requested that the Commission summarily reject Pepco's Application, arguing that Pepco failed to present evidence to

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as (for example) "AOBA (2__)"; post-hearing initial briefs as (for example) "DC Govt Br."; and post-hearing reply briefs as (for example) "WASA R.Br."

15 The Company distinguishes between projected budgeted amounts, the amounts that are actually spent, and electric equipment placed in service (EPIS). *See, e.g.*, Tr. 510-511, 514-515 (Pepco witness Gausman); Pepco Exhibit No. 70 submitted in response to Tr. 515 question from Chairman Kane; Pepco Exhibit No. 93, at 2 and Attachment 1 (Gausman) submitted in response to Tr. 526-528, 534 questions from Chairman Kane.

16 *See* Tr. 503- 528. The Commission sought from Pepco a detailed explanation of each budget item and project listed in PSC Exhibit No. 2, Attachment B, where there is more than a $100,000 difference between the actual and the projected costs. Specifically, Pepco was asked to provide, on a project-by-project basis, a brief description of each budget item or project (including whether a budget item includes more than one project, and a list of the projects in the budget item that have sub-projects), a description of the Company's goals and objectives for the project, why the Company considers this budget or project item to be related to reliability, the current status of each project, and documents the Company's plans for each budget item or project through the rate effective period. *See* Tr. 541-543. The Commission also asked Pepco to file an exhibit that, for each of the projects covered by Pepco's $61.8 million Reliability Enhancement Plan ("REP") included in the Company's Capital Budget, describes each project, states whether the Company included the project in the REP that was reviewed by the Commission in Order No. 16237, details the amount of money spent on each of the REP projects within the test year, forecasts the likely D.C.-specific SAIDI and SAIFI impacts of each project, identifies which projects address the most prevalent causes of outages on the Pepco D.C. system, and ranks each project in order of its cost-effectiveness towards improving reliability or preventing deterioration of service in the District of Columbia.

meet its burden of proof.[17] The Commission denied this motion, suspended the briefing schedule, and gave OPC and intervenors 10 days (following the filing of Pepco's written responses to bench questions asked January 31st) to review Pepco's submissions and to file any motions. The Commission directed Pepco to respond to any such motions within five days.[18]

10. Thereafter, on February 20 and 21, 2012, the Company filed its responses to the Commission's bench requests, which Pepco identified as Exhibits Nos. 68 through 90 and Exhibits Nos. 91 through 94, respectively. Pepco requested that the exhibits be entered into the evidentiary record.[19] OPC objected, arguing that any decision on the admissibility of Pepco's post-hearing exhibits be deferred until after OPC and the intervenors were afforded an opportunity to conduct discovery, submit testimony, and conduct cross examination of the Company's sponsoring witnesses on Pepco Exhibits Nos. 91-94.[20] Thereafter, Pepco filed a motion on March 2, 2012, requesting the Commission to lift the suspension of the procedural schedule and to set a briefing schedule so that the case could conclude without delay.[21]

11. By Order No. 16742, the Commission amended the procedural schedule to allow the parties an opportunity to conduct limited discovery, to file supplemental testimony, and to conduct cross-examination in a limited supplemental hearing focusing on Pepco Exhibits 91 through 94 as they relate to Issue Nos. 11 and 18. OPC witnesses

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17 *See* Tr. 940-946; *Formal Case No. 1087*, Motion of OPC for Summary Denial of Pepco's Application and Termination of Proceeding or, In the Alternative, for Suspension of Hearings and Briefing Schedule and Related Procedural Relief (February 2, 2012).

18 *See* Tr. 1712- 1713; Order No. 16742, ¶ 7 (March 21, 2012).

19 *See Formal Case No. 1087*, Pepco's Responses to Various Data Requests Received from the Bench During the Evidentiary Hearings and Updated List of Cross Examination Exhibits (February 20, 2012). Witness Gausman's Reponses to Data Requests Received from the Bench During the Evidentiary Hearings and Updated Final List of Cross Examination Exhibits (February 21, 2012).

20 *See Formal Case No. 1087*, Objection of OPC to the Admission of Potomac Electric Power Company's Late Filed Exhibits, and Motion for Deferral of Ruling on Admissibility Pending Completion of Discovery, Testimony and Hearing Procedures (March 2, 2012). OPC reiterated its position that the proceeding should be dismissed. *Id.* at 2. OPC also stated that it had contemporaneously filed a data request to Pepco regarding Pepco Exhibits No. 91-94. AOBA, the District of Columbia Government, the General Services Administration and AARP filed comments supporting OPC's Objection and Motion. *See Formal Case No. 1087*, Reply Comments of AOBA (March 2, 2012), District Government's Opposition to Pepco's Motion to Lift Suspension and Deny Requests for Further Proceedings (March 6, 2012), AARP's Opposition to Pepco's motion to Lift Suspension and Deny Request for Further Proceedings (March 7, 2012), and GSA's Opposition to Pepco's Motion to Lift Suspension and Deny Request for Further Discovery (March 9, 2012).

21 *Formal Case No. 1087*, Motion of Pepco to Lift Suspension, Set a Briefing Schedule, and Deny any Request for Further Proceedings (March 2, 2012).

Mara and Dismukes filed supplemental written testimony on April 25, 2012. Pepco witness Gausman submitted supplemental written rebuttal testimony on May 22, 2012.

12. The Commission held supplemental evidentiary hearings on June 11 and 12, 2012. Testimony and evidence on the RIM, including Pepco Exhibits 91-94, submitted by Pepco in response to the Commission bench questions on January 31st, was subjected to cross-examination and admitted into evidence. OPC witnesses Mara's and Dismukes' supplemental written testimony also was subjected to cross-examination and admitted into evidence. All the parties filed post-hearing initial briefs on June 25, 2012, and reply briefs on July 9, 2012. A Community Brief was filed on July 9, 2012 on behalf of DC consumers of Pepco's services.[22]

II. TEST PERIOD[23]

13. The process of ratemaking[24] involves the making of an honest and intelligent forecast of probable future values based upon all relevant circumstances, including primarily known performance during a period of time in the immediate past (i.e., a test period). The validity of the test period approach rests upon the assumption that the relationship among revenues, expenses, and rate base which were established in the test year will continue into the near future, when the prescribed rates will be in effect.[25]

14. **Pepco.** Pepco's application reflects a test year ending September 30, 2011, consisting of six months actual (October 2010 through March 2011) and six months forecasted (April 2011 through September 2011) data, adjusted for known and measureable changes of the condition which are expected to prevail during the rate-

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22 The Community Brief was signed by four ANC Commissioners; the Chairman, former Acting Chair and a Board member of the D.C. Consumer Utility Board; and 16 other people who are D.C. residents and members of community groups in the District of Columbia (*e.g.*, DC Tenant's Coalition, AARP, H Street Main Street, Manor Park Citizens Association, and the Dupont Park Civic Association).

23 Designated Issue No. 2 asks, "Is Pepco's test year reasonable? Designated Issue No. 2a asks, "Are Pepco's budgeted or forecasted amounts for the forecasted portion of the proposed test year (April 2011 – September 2011) reasonably forecasted and based on reasonable projections?" Designated Issue No. 2b asks, "Are the proposed adjustments to the test year data for known and measureable changes reasonable?" Pepco's and the parties' specific proposed rate base adjustments are discussed under Issue Nos. 3, Rate Base and 5, Operating Expenses.

24 Designated Issue 1 asks, "Is Pepco's proposed $42,101,000 increase in base distribution rates just and reasonable?" This is the overarching issue of the rate proceeding and will be addressed in the rate base and operating expense adjustments discussed herein.

25 *Formal Case No. 1053, 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. 1053*"), Order No. 14712, ¶ 7, (January 30, 2008), citing *Pepco v. Public Serv. Comm'n*, 350 A.2d 126 (D.C. 1977).

effective period, which Pepco contends is consistent with what was allowed in Formal Case No. 1053.[26] Pepco witness Hook states that Pepco's partially forecasted test year complies with Commission Rule 200.4[27] and provides for a more current test period which will be more predictive of the rate effective period than would a fully historical test year, and will help mitigate regulatory lag.[28] The Company maintains that the forecasted portion of the test year is reasonable since it is based on the Company's approved 2011 budget.[29]

15. According to the Company, the six months of actual data for test year sales and revenues is based on actual sales and revenues taken from the Company's financial records; while the forecasted sales and revenue data are developed using the most current customer information and various economic indicators, such as household growth, employment growth, income levels, and electricity prices.[30] Pepco contends that the Company's budget provides a reasonable basis for its partially forecasted test year.[31] Pepco witness Lowry recommends that the Commission consider initiating a proceeding to consider the use of a fully forecasted test year in future base rate applications.[32]

16. **OPC.** OPC witness Ramas acknowledges that Pepco's proposed test year is permissible under Commission regulations; however, she states a preference for a test year based on recent, actual, and verifiable data. In this case, witness Ramas contends that the use of a forecasted test year has been problematic due to Pepco's failure to provide the supporting data necessary to evaluate the accuracy of Pepco's forecasts and that large variances exist between the forecasted and actual amounts (subsequently obtained by OPC during discovery) in some rate base and operating income adjustments. OPC argues that if the Company chooses to submit forecasted data, it should be required to demonstrate that its forecasts are reasonable.[33]

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26 *Formal Case No. 1053,* Order No. 14712, ¶ 13.

27 Commission Rule 200.4 states "[t]he historical test year is the preferred proposed test year. However, the proposed test year may include forecasted data; [p]rovided, that the proposed test year does not include more than six (6) months of forecasted data. *See* 15 DCMR § 200.4.

28 Pepco (F) at 2-3 (Hook); Pepco (2F) at 2(Hook Supp).

29 Pepco (F) at 5.

30 Pepco (2E) at 1-2 (McGowan); Pepco (F) at 4, Pepco (2F) at 4.

31 Pepco (2F) at 2-3 (Hook Supp); Tr. 442.

32 Pepco (B) at 64 (Lowry).

33 OPC Br. 15-16; OPC R.Br. 5-6; OPC (A) at 15 (Binz); OPC (B) at 6-14 (Ramas).

17. **Pepco Rebuttal.** Pepco witness Kamerick argues that rates set using a historical test year are outdated before they take effect.[34] He contends that OPC's recommendation that the Company be made to provide "sufficient underlying and supporting information" when it uses a partially forecasted test year lacks specificity as to what is sufficient and may prove difficult and burdensome for the Company. Pepco asserts that the Company provided the Commission with the information required in Commission Rule 200 et seq., and will provide the update required in Rule 213.2.[35]

18. In its brief, the Company asserts that development of the test year was reasonable and that with the exception of the Company's projected plant additions, which are no longer contested in this proceeding, no party contests the reasonableness of the forecasted portion of the test year. Pepco again notes that the Commission Rules permit a partially forecasted test year and that to require updates to actual (as proposed by OPC) would increase regulatory lag.[36]

19. OPC counters that Pepco's forecast has been shown to be based on unreasonable projections which required substantial adjustments in order to make them more reasonable and reflective of test year and rate effective period. As proof, OPC points out that the Company agreed to reduce its average test year plant-in-service by $12.7 million.[37] OPC argues that the removal by Pepco of 57% of its forecasted plant additions from its proposed test year forecast makes it clear that a fully forecasted test year would be detrimental to District ratepayers. Consequently, OPC argues that the Commission should reject Pepco's call for consideration of the use of a fully forecasted test year.[38]

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34 Pepco (3A) at 13, 14 (Kamerick Rebuttal).

35 Pepco R. Br. 5-6. Commission Rule 213.2 provides, "[w]ithin one hundred eighty (180) days of the completion of the rate proceeding, a utility shall file an actual historical cost-of-service study for the entire proposed test year. *See* 15 DCMR § 213.2.

36 Pepco Br. 12-13.

37 Pepco initially proposed an adjusted rate base of $1.17 billion. Pepco (F) at 8-9, Pepco (2F) at 3 (Hook); Pepco (2E) at 1-2 (McGowan), Pepco (I) at 25-31, Pepco (2I) at 2 (Gausman). OPC recommends a rate base of $1.14 billion based on numerous adjustments proposed by OPC witness Ramas. OPC Br. 18. The Company accepted several OPC's adjustments that updated forecasted amounts with the actuals resulting in a revised adjusted rate base of $1.16 billion. Pepco Br. 13-14; Pepco R. Br. 10.

38 OPC R.Br. 7-8.

DECISION

20. Commission Rule 200.4 clearly permits Pepco to use up to six months of forecasted test-year data. The Commission finds that the Company's use of the test year ending September 30, 2011, consisting of six months actual (October 2010 through March 2011) and six months projected (April 2011 through September 2011) data, adjusted for known and measureable changes of the condition which are expected to prevail during the rate-effective period, is allowed by Commission Rules and prior precedent. OPC's primary contention is that the Company's summary data did not provide the level of specificity necessary to conduct a thorough and complete review of the Company's application specifically noting that the information did not demonstrate how the budgeted data were used to derive the forecasted amounts in the test year. Pepco asserts that the Company subsequently provided OPC with the requested data in discovery.[39] We conclude that Pepco's submission in this regard substantially complied with 15 DCMR §200.5 of the Commission Rules.[40] We note that Pepco, OPC and AOBA addressed potential problems with using a forecasted test year and recommended that we consider new rules or clarify existing rules related to forecasted data in the test year.[41] We will take these recommendations under advisement for future rate proceedings.

III. RATE BASE[42]

21. Rate base represents the investment the Company makes in plant and equipment in order to provide service to its customers.[43] It is the value of a company's property used and useful in providing service minus accrued depreciation.[44]

22. **Pepco.** Pepco initially proposed an adjusted rate base of $1.17 billion based on an unadjusted rate base of $1.10 billion, to which it proposed $66.87 million in adjustments. According to the Company, its proposed adjustments to rate base are

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39 In response to OPC's requests for the 2011 operating and capital budgets in the "most detailed format available," Pepco provided three pages: one page was provided for the capital budget; one for the Company's operating budget; and one for the Shared Service budget. OPC (B) at 11 (Ramas).

40 *See* 15 DCMR § 200.5.

41 *See, e.g.,* OPC Br. 15-16; Pepco R. Br. 7-8; and AOBA R. Br. 5.

42 Designated Issue No. 3 asks, "Is Pepco's proposed rate base just and reasonable?" Designated Issue 3a asks: "Are the projected plant additions and retirements for the forecasted portion of the proposed test year (April 2011–September 2011), reasonably projected?" Designated Issue 3b asks: "Are Pepco's proposed adjustments to the average test year rate base just and reasonable?"

43 *See Washington Gas Light Co.,* 1 D.C.P.S.C. 142 (1975).

44 *Pepco v. Public Service Comm'n,* 380 A.2d 126, 133 n.8 (D.C. 1977).

known, measurable, and reflect projects that will be completed and providing service to customers prior to or during the rate effective period.[45] Pepco removed its proposed Adjustment No. 48 Reduction to Feeder Undergrounding Capital Budget because OPC dropped its related Adjustment No. 11 after the Company accepted OPC Adjustment No. 13 Reduction to Forecast Net Plant Additions.[46]

23. **OPC.** OPC contends that Pepco's forecasted plant additions are significantly overstated and, therefore, proposed several adjustments to the Company's proposed rate base.[47] OPC indicates that Pepco's total distribution plant additions were $58 million, which is $78.4 million (or 42.5%) less than the forecasted amount for the same period. OPC argues that, although Pepco never provided it with the information to determine actual plant attributed to D.C. jurisdictional distribution plant, it must be less based on the significant variances on a total Pepco basis. Therefore, OPC recommends that the average test year plant in service balance should be reduced by $12.74 million on a D.C. jurisdictional basis. OPC concludes that this adjustment reduces depreciation expense by $313,000 and accumulated depreciation by $157,000.[48]

24. **Pepco Rebuttal.** Pepco attributes the variance between the budgeted and actual plant additions to the timing of the capital spending, *i.e.*, the difference in time when projects are completed and recorded into plant in service on the Company's books. The Company does not oppose OPC's proposed reduction to forecasted net plant additions, and it included RMA No. 47 (Reflection of Actual vs. Projected DC Distribution Cut-Ins) in the Company's revised revenue requirement request. This adjustment adopts the recommendation by OPC.

DECISION

25. The Commission has reviewed the Company's proposed adjustment to reduce forecasted plant additions in the amount recommended by OPC and finds it reasonable. With Pepco's acceptance of OPC's adjustments to forecasted plant additions, electric plant in service is reduced by $12.74 million. OPC's proposed adjustments to reduce the meter blanket capital budget and feeder underground capital budget are rendered moot.[49]

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45 Pepco (F) at 8-9, Pepco (2F) at 3 (Hook); Pepco (2E) at 1-2 (McGowan), Pepco (I) at 25-31, Pepco (2I) at 2 (Gausman).

46 Pepco Br. 1-2.

47 OPC R.Br. 9.

48 OPC (B) at 15- 20, OPC (B)-4, Schedule 13 (Ramas).

49 Tr. 732.

A. Unopposed Adjustments (RMA Nos. 1, 2, 3, 10, 11, 12, 13, 14, 15, 16, 17, 18, and 19).[50]

26. The unopposed portion of the rate base including adjustments agreed upon by the parties include the following rate making adjustments: RMA No. 1, Inclusion of Projected Completed and In Service, RMA No. 2, Inclusion of Subtransmission Plant, RMA No. 3, Recovery of Upgrade to Control Center Energy Management System, RMA No. 10, Removal of Formal Case No. 939 Disallowed Gainsharing and Wages, RMA No. 11, Removal of Supplemental Executive Retirement Plans ("SERP"), RMA No. 12, Removal of Exempt and Executive Incentive Plan Costs, RMA No. 13, Annualization of Software Amortization, RMA No. 14, Removal of 25% of 69kV Lines, RMA No. 15, Reflection of Ending Amortization-Formal Case No. 1053 Rate Case Costs, RMA No. 16, Recovery of Formal Case No. 1076 Rate Case Costs; RMA No. 17, Recovery of Formal Case No. 1087 Rate Case Costs, RMA No. 18, Recovery of Deferred Customer Education Costs, and RMA No. 19, Recovery of Deferred AMI Costs Incurred through December 31, 2008.

DECISION

27. Inasmuch as no party challenges any of these adjustments and as the Commission has reviewed them and independently found them just and reasonable, we approve the adjustments.

B. Pepco Proposed Adjustments

1. 2011 Pension and OPEB Expense

28. **Pepco.** Pepco seeks, in RMA No. 8, to increase rate base by $3.76 million and Operation and Maintenance ("O&M") costs by $723,000. Pepco witness Hook states that this adjustment reflects Pepco's parent company, PHI's final 2011 periodic pension and other post-employment benefit ("OPEB") costs based on information provided by Tower Watson, the outside actuary utilized by the Company. Pepco indicates that rate base is adjusted to reflect the 2011 level of distribution-related D.C. allocated portion of Pepco's net of tax prepaid pension/OPEB. Pepco adjusts operating income to reflect the 2011 pension and OPEB incurred, including expenses charged directly to the Company and Pepco's portion of the expense related to the PHI Service Company employees. Pepco also includes the Company's portion of the Service Company net of tax prepaid

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50 The Company withdrew its request for recovery of steel plate fees RMA No. 38. Pepco (2F) at 11-12 (Hook).

pension/OPEB in rate base. The prepaid pension/OPEB was projected based on the forecasted activity in 2011 and held constant for 2012.[51]

29. **AOBA.** AOBA recommends that this adjustment be modified. AOBA witness Oliver contends that the Company's proposed adjustment for pension and OPEB expenses includes a pass-through of the PHI Service Company ("Service Company") pension and OPEB costs, which at any given point in time may be unrelated to Pepco, for which the Commission has no regulatory oversight. Because these costs may change due to factors unrelated to Pepco's operations or the level of service required from the Service Company, AOBA argues that these costs should not be recoverable. AOBA points out that in an arms-length transaction these costs would generally be included in the overhead charges that are embedded in the negotiated rates for the services. AOBA argues that the Service Company should not be treated as simply an arm of the utility.[52]

30. **Pepco Rebuttal.** Pepco witness Hook counters that the Commission does scrutinize pension and OPEB costs, regardless whether the costs relate to Pepco or Service Company employees, in the context of a rate case. Pepco maintains that pension and OPEB costs associated with Service Company employees performing tasks for Pepco were included and approved by the Commission in Formal Case Nos. 1053 and 1076. Hook reiterates that the annual net periodic costs for pension and OPEB for all PHI entities is established on annual basis by Towers Watson. She further states that Pepco provided extensive discovery on the 2011 level of expenses.[53] In response to AOBA's pass through argument, she states that costs are not being added to the District distribution-related O&M, but rather the Company is adjusting the test year level of expenses (whether it is related Pepco employees or Service Company employees doing work for Pepco) to reflect the latest actual information available which is contained in Towers Watson 2011 valuation report.[54] Hook concludes that AOBA's proposed adjustment would essentially remove all pension and OPEB costs associated with Service Company employees doing work for Pepco which she contends is contrary to Commission precedent and should be rejected.[55]

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[51] Pepco Br. 10; Pepco (F) at 16-17, Pepco (F)-1 at 12 (Hook), Pepco (2F) at 8 (Hook Supp); Pepco (E) at 11(McGowan).

[52] AOBA Br. 7-8; AOBA at 42-43, AOBA (A)-7 (Oliver).

[53] Pepco (3F) at 2-3 (Hook Rebuttal).

[54] Pepco (3F) at 4-5.

[55] Pepco Br. 66-67.

DECISION

31. AOBA requests that the Commission deny the pass-through of all Service Company pension and OPEB expenses. AOBA's argument is similar to the argument AOBA made in Pepco's last two rate cases where AOBA argued that there was no comparison of the cost of services provided by PHI against what the cost would be if the services were provided by Pepco or an independent third party. The Commission finds that the Company's treatment of these costs is generally similar to that in Formal Case No. 1053 and Formal Case No. 1076 where the Commission approved Pepco's recovery of similar allocated costs. The Commission, in Formal Case No. 1053, found that the Service Company charges reduced Pepco's costs through economies of scale, and ultimately reduced costs to ratepayers.[56] In Formal Case No. 1076, we found that no party had provided sufficient evidence that the Service Company had provided inefficient or ineffective service to Pepco, or that the costs were unreasonable.[57] AOBA has presented no new evidence which would persuade us to reconsider our rulings and, therefore, the Commission approves this adjustment.

32. AOBA does raise a legitimate concern about the Company's potential exposure to variation in Service Company costs absent the Company treating these costs as an arms-length business transaction. While we appreciate AOBA's concern, there is nothing in this record which indicates that these costs are unreasonable. The Commission has ordered an independent audit and operational review of the Service Company and Pepco which will scrutinize, among other things, the reasonableness of the costs being incurred by the Service Company and allocated to Pepco.[58]

Reflection of Ending of Amortization of Flotation Costs

33. **Pepco.** Pepco's proposed RMA No. 20 reduces the amortization of flotation costs associated with the Company's November 2008 stock issuance. The amortization of these costs will end in mid-June 2012, so the cost of service has been adjusted to reflect the levels that will be experienced in the twelve month period following the test year. The adjustment will reduce rate base by $227,000 and amortization expense by $101,000.[59] Under cross examination, Pepco witness Hook indicated that the intent of this adjustment is to remove any costs associated with the 2008 issuance because the amortization period would have ended.[60] In subsequent

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56 *Formal Case No. 1053*, Order No. 14712, ¶ 169.

57 *Formal Case No. 1076*, Order No. 15710, ¶ 207.

58 *See Formal Case No. 1076*, Order No. 16087.

59 Pepco (F)-1 at 24 (Hook); Tr. 1480.

60 Tr. 277-278.

testimony, Pepco witness Hook clarified her previous position stating that the purpose of the adjustment was to reduce, not totally eliminate the entire amortization.[61]

34. **OPC.** OPC contends that Pepco's proposed adjustment should completely remove the entire amount of the amortization, $404,000, which Pepco's adjustment does not.

DECISION

35. We are persuaded by OPC's argument. Company Witness Hook testified that the amortization of these costs would end in mid-2012 prior to the rate-effective period.[62] Including these costs in the current case would permit Pepco to continue to recover the costs throughout the rate effective period indefinitely. It would be inappropriate to continue to recover these costs, when the amortization period is over. We agree with OPC that, the Company should remove $404,000 rather than $101,000 (as proposed by Pepco) from amortization expenses and $295,000 rather than $227,000 (as proposed by Pepco) from rate base to totally remove all costs associated with the 2008 stock issuance. Based on the foregoing, the Company is directed to remove the full $404,000 from amortization expense and $295,000 from rate base.

2. Credit Facility Costs

36. **Pepco.** Pepco indicates that RMA No. 21 adjusts rate base and operating income to reflect the inclusion of Pepco's share of the costs associated with PHI's new $1.5 billion credit facility effective August 1, 2011. Pepco states that the credit facility supports the issuance of commercial paper, *i.e.*, short-term debt, on an as-needed basis, assuring investors and rating agencies that the Company has a committed line of credit with banks in the event of a liquidity problem. Pepco notes that the Commission in Formal Case No. 1076, found this arrangement to be beneficial to District ratepayers.[63] The adjustment increases rate base by $454,000 and O&M expense by $319,000.[64]

37. **AOBA.** AOBA argues that for nearly two years Pepco has not reflected any short-term borrowing in its quarterly SEC filings. AOBA claims that this is due to the Company's significant cash balance in the PHI Money Pool (which AOBA alleges performs a similar liquidity function as the Credit Facility) that for the most recent five-quarters reflect an average Money Pool balance of $93 million.[65] AOBA asserts that

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61 Tr. 1483.

62 Pepco (F) at 20:20-21:1.

63 *See Formal Case No. 1076*, Order No. 15710, ¶¶ 120–122 (March 2, 2010).

64 Pepco Br. 10; Pepco (2F) at 12 and (2F)-2 at 25 (Hook Supp).

65 AOBA Br. at 9; AOBA R. Br. at 33.

Pepco has not relied on the Credit Facility despite the significant volatility in the financial markets. AOBA contends that the Credit Facility is to assure adequate liquidity, yet when Pepco encountered a liquidity problem in the fall of 2008, PHI issued $250 million of comparatively high cost 30-year bonds with an interest rate of 8%. Moreover, despite extremely low costs for short-term borrowings, Pepco has not found the use of its Credit Facility economically attractive.[66]

38. AOBA also submits that Pepco's Credit Facility request is inconsistent with the Company's recommended capital structure in that it includes no short-term debt. AOBA claims that the Credit Facility is not being used and provides little or no benefit to District ratepayers and that, in fact, Pepco could probably cover any contingencies with a smaller line of credit. AOBA argues that despite Pepco's claim that the credit facility is a key component of the Company's liquidity position and facilitates the issuance of commercial paper borrowings, Pepco has not issued any short-term debt in the last three years. AOBA maintains that the Credit Facility provides Pepco with a means of arbitraging its financing and increasing its profitability between rate cases by using short-term debt for financings for which it is provided a return based on its much higher weighted costs of long-term debt and equity. Therefore in order to prevent Pepco from engaging in interest rate arbitrage, AOBA contends that Pepco should be required to include a reasonable amount of short-term debt in its capital structure.[67]

39. Assuming the Commission accepts that the maintenance of a Credit Facility is prudent, AOBA contends that Pepco has not justified its available credit limit or the cost of the facility. Although AOBA makes no rate base adjustment; it proposes an adjustment to reduce O&M by $333,000.[68] AOBA recommends that any revenue derived from the Money Pool be credited to ratepayers and not shareholders.[69]

40. **Pepco Rebuttal.** Pepco counters that the Money Pool does not perform a similar function as the Credit Facility. Pepco witness McGowan states that the Money Pool is a cash management mechanism used by PHI to manage the short-term investment and borrowing requirements of its participating subsidiaries. It allows participants to forego the bid-offer spread on borrowings and investments that are normally charged by third-party intermediaries. McGowan indicates Pepco can borrow from the Money Pool only if other affiliates have excess deposits in the Pool, which changes daily, and only if the interest rate offered by the Money Pool is lower than the interest rate Pepco can obtain in the commercial paper market.[70]

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66 AOBA Br. at 9.

67 AOBA R.Br. 33-35.

68 AOBA (A) at 13, 28, 44-45, AOBA (A)-7 at 3 (Oliver).

69 AOBA Br. 48.

70 Pepco (3E) at 8 (McGowan).

41. Pepco contends the Credit Facility, on the other hand, is a key component of Pepco's liquidity position with rating agencies and investors, and facilitates the issuance of commercial paper on an as-needed basis. It assures rating agencies that the Company has adequate liquidity to fund its working capital and has a source of available credit in the event of a liquidity problem. Pepco argues that almost every investment grade company in the United States, if not all, maintains a significant Credit Facility. The fact that it has not needed to issue commercial paper recently is not predictive of potential future need and use, and Pepco argues that it would be short-sighted and inappropriate not to maintain a Credit Facility.[71]

42. Pepco argues that the lack of inclusion of any short-term debt in its capital structure in no way obviates the need for the Credit Facility. Pepco concludes that the costs associated with the Credit Facility were prudently incurred and, therefore, appropriately included in the cost of service noting that the Commission rejected a similar argument in Formal Case No. 1076.[72]

DECISION

43. AOBA reiterates the arguments that it made in Pepco's last rate case that the Company requests that ratepayers bear a portion of the costs of the Credit Facility is inconsistent with the Company's decision not to include short-term debt in its capital structure. Once again we are not persuaded by AOBA's arguments. In Formal Case No. 1076, we determined that Pepco's actual capital structure at that time, which did not include short-term debt, was reasonable and compared reasonably to that of other electric utilities. As explained below, we again affirm Pepco's capital structure as reasonable. (*See* Issue 7c for discussion on Capital Structure). Additionally, we conclude that short-term debt as it is used by Pepco provides temporary funding for the Company's construction requirements which are permanently financed with either long-term debt or common equity. We recognize that the Credit Facility supports liquidity and the Company's short-term financing needs.[73] AOBA has not provided any persuasive evidence to the contrary.

44. The Commission is also convinced that the Credit Facility and the Money Pool serve two separate and distinct functions. The Credit Facility ensures that the Company has adequate liquidity in the event of a liquidity crisis. The Money Pool, on the other hand, functions as a "cash management mechanism."[74] We see no reason to

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71 Pepco (3E) at 8-9 (McGowan).

72 Pepco Br. 17-19; Pepco R. Br 14-16; Pepco (3E) at 8-15 (McGowan Rebuttal).

73 *See Formal Case No. 1076*, Order No. 17510, ¶ 120.

74 Pepco Br. 17 -19; Pepco R. Br 14-16; Pepco (3E) at 8-15 (McGowan Rebuttal).

revisit our policy determination made in Formal Case No. 1076. We agree with Pepco that because the Company has not had the need to issue commercial paper does not mean that there won't be a need in the future. Turning to the issue of Pepco's credit limit and costs, both the old and new Credit Facilities are for $1.5 billion, with Pepco allocated $250 million. We have reviewed the credit limit and costs underlying the Company's participation in the Credit Facility and find them reasonable.

45. However, we do agree with AOBA that revenue (interest) derived from the Money Pool should be credited to ratepayers. In response to a discovery request, Pepco indicated that it participated in the Money Pool in 2010 and 2011 as an investor, which resulted in the Company receiving interest income.[75] Because ratepayers are the source of the funding for these investments, the interest earned should be credited to ratepayers. To properly credit ratepayers, $232,000 in interest earned during the test year should be reflected on the Company's books as additional Other Revenues.[76] With this change, the Commission approves the Company's adjustment.

Recovery of Organizational Review Project Severance Costs

46. **Pepco.** Pepco's RMA No. 28 is associated with PHI's sale of Conectiv Energy ("Conectiv") and the phasing out of Pepco Energy Services' ("PES") retail energy supply business. Pepco contends that PHI conducted a comprehensive review of the corporate service organization to ensure that costs previously associated with Conectiv would not be charged to and adversely affect regulated utility services. Pepco indicates that the Organization Review Project ("ORP") resulted in a $28 million O&M expense savings[77] and as a result of realizing savings, Pepco incurred employee severance costs. The Company proposes to reduce O&M expense for ORP-related severance costs, which was recorded in the fourth quarter of 2010, and to amortize that amount over a three-year period, with the average unamortized balance included in rate base, to reflect Pepco's share of ORP-related severance costs. Pepco states that because ORP-related savings will produce benefits for several future periods, it is both appropriate and consistent with Commission precedent (citing Formal Case No. 939, Order No. 10646) to amortize related severance payments over future periods. Pepco indicates that this will reduce the District-allocated O&M severance costs by $3 million

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[75] *See* Commission Exhibit Nos. 26 and 27.

[76] Interest earned for the 12-months ending September 30, 2011, totaling $555,351 was allocated to the District using the allocators the Company applied within RMA No. 21, Inclusion of Credit Facility Costs. *See* Commission Exhibit No. 26. In addition, the Commission notes its increasing concern with the Money Pool transactions, including the significant cash balances that Pepco is carrying while at the same time under spending certain budgets. The Commission plans to review the Company's Money Pool transactions and the impact of Pepco's participation on District ratepayers.

[77] Pepco (A) at 28 (Kamerick).

and increase amortization expense by $1.66 million. Pepco represent that the average unamortized deferred severance costs reflected in rate base is $2.34 million.[78]

47. OPC. OPC opposes Pepco's request to be reimbursed for severance costs which in effect would charge ratepayers for costs related to the divestiture. OPC avers that these employees were eliminated as part of the sale of Conectiv and a change in the direction of PHI. OPC reiterates that one of the goals of PHI was to not negatively impact the utility companies under its control and to ensure that ratepayers would not experience an increase in costs as a result of the change. However, ratepayers are now being asked to pick up severance costs totaling $5.0 million over three years, plus pay a return on the unamortized balance included in rate base ($26,000 in revenue requirements assuming OPC's requested rate of return). Further OPC contends that no severance costs were assigned to the sale, *i.e.*, charged to PHI or the buyer of Conectiv.[79]

48. Although having no direct bearing on this case, OPC recommends that the RFP ordered in *Formal Case No. 1076* be revised to require the management audit to examine whether Pepco is adhering to the Affiliate Transaction Code of Conduct.[80] OPC points out that there is nothing in Pepco's Compliance filing nor is there anything that requires Pepco to provide any information regarding its test period transactions with the Service Company or its affiliates. As a result, OPC avers that there is nothing in the Compliance Filing which addresses these affiliated charges in sufficient detail such that OPC and the Commission would know the amount of affiliated charges included in the test year. OPC recommends that the Commission institute a proceeding to review current Compliance Filing Requirements and that the Compliance Filing Requirements include information regarding affiliated transactions.[81]

49. **Pepco Rebuttal.** Pepco argues that while the primary goal of the ORP was to reduce corporate costs previously allocated to Conectiv, the ORP cut costs by $8 million beyond those identified as costs associated with Conectiv. Pepco contends that the $8 million equals 28.57 percent of the $28 million total savings. Pepco states that the Commission has previously allowed cost recovery for severance-related costs that provide benefits to ratepayers. Therefore, at a minimum 28.57 percent or $1.4 million ($4.9 million x 28.57 percent) of District-allocated severance costs should be allowed.[82]

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78 Pepco (F) -1 at 32 (Hook).

79 OPC (D) at 11-12 (Bright).

80 OPC Br. at 64.

81 OPC Br. 64; OPC (D) at 10-14 (Bright).

82 Pepco (3F) at 25-27 (Hook Rebuttal).

50. Pepco contends that the cause of the ORP severance costs is irrelevant and that the recovery of the ORP severance-related costs is consistent with Commission precedent. The Company contends that in 1995, the Commission permitted Pepco to recover the costs of a Voluntary Severance Program holding that it found no basis to exclude the costs of this program from Pepco's cost of service and that Pepco's ratemaking treatment of the costs and benefits is appropriate for ratemaking treatment.[83] Pepco witness Hook states that ORP related savings will benefit District customers. She states that while full recovery is appropriate, at a minimum, the Commission should permit recovery of a prorated share of severance costs that are related to the $8 million in savings outside of the costs previously allocated to Conectiv, which would result in a deferral of $1.4 million.[84]

DECISION

51. Pepco relies on the Commission's decision in Formal Case No. 939 as support for cost recovery of the severance-costs related to its divesture of Conectiv in this case. Formal Case No. 939, however, is distinguishable from the case at hand. In Formal Case No. 939, the Commission mandated that Pepco cut non-essential management employees as part of a cost containment effort. In that case: (1) Pepco employees were involved; (2) the savings realized were the result of not filling vacant positions; (3) it produced annual savings; and (4) the revenue requirement in that proceeding was reduced. The annual savings to District of Columbia ratepayers as a result of this program was approximately $4 million. Thus in Formal Case No. 939 there was a direct, substantial, and measurable benefit to District ratepayers.

52. In this case, Pepco's proposed adjustment has no direct, substantial, or measurable benefit to District ratepayers. The severance costs were related to the sale of Conectiv not services provided to Pepco or that benefited Pepco ratepayers. Further, the costs are not measurable here. Thus there is no basis for prorating the costs. Pepco proffers that the ORP was undertaken as a means to offset the potential negative impact the sale of Conectiv would have on the operating utilities. However, we agree with OPC that to charge the utilities for these severance costs would be counter to the purpose for the ORP.

53. There is no showing that Pepco benefited in reduced A&G costs by the allocated portion of the $8 million in extra savings. Additionally, not all the alleged $8 million in extra savings were necessarily related to employee severance costs. OPC

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83 *See Formal Case No. 939, 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,* Order No. 10646 at 116 (1995).

84 Pepco Br. 30-31.

witness Bright's testimony indicates that 20 percent of the positions were either vacant or budgeted (but unfilled) such that the elimination of these positions did not represent any real savings.[85] Only $113,433 of the $20 million in severance costs incurred was charged to Conectiv by the Service Company. Pepco has failed to rebut OPC's testimony. The $8 million costs savings calculated by Pepco witness Hook represents the difference between the $28 million in annual savings and the $20 million in severance costs. The $28 million represented $26 million in projected employee savings based on 135 actual employees, 23 budgeted employees, and 13 contractors plus $2 million in estimated savings related to audit fees, insurance premiums, and leases associated with Conectiv companies. Because the cost savings included budgeted employees and $2 million in costs that were incurred specifically by Conectiv, the alleged $28 million costs savings were not real. Pepco has failed to persuade us how the costs relate to Pepco. Therefore, OPC's adjustment to remove severance regulatory asset and amortization is accepted and Pepco's recovery of ORP severance costs is rejected.

Flotation Costs

54. **Pepco.** Pepco's RMA No. 39 increases rate base by $355,000 and amortization expense by $404,000 to reflect flotation costs for a 2012 common stock issuance. Pepco indicates that because the exact details of the issuance have not been finalized, the Company uses the actual costs for its November 2008 issuance as a proxy. As in Formal Case No. 1076, Pepco assumes a two-year amortization period, with the average unamortized costs reflected in rate base.[86]

55. **OPC.** OPC recommends that this adjustment be rejected because it is outside the test year and not known or measurable. OPC argues that although the Company announced in its initial brief that an issuance did occur in March in 2012, there is nothing in the record as to the size, actual date of the issuance, and the amount of the issuance. OPC argues that assuming a stock issuance occurs in 2012, it has been nearly four years since the last equity offering which occurred in November 2008. Therefore, a two-year amortization period is neither just nor reasonable.[87]

56. **Pepco Rebuttal.** Pepco contends that the adjustment should be allowed because, although it is outside the test year, it will be incurred during the rate effective period. Pepco indicated in its brief that the stock offering took place in March 2012 during the pendency of this proceeding and within the period of time for which the

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85 *See* Tr. 1055-1058; *see also* OPC Br. 63.

86 Pepco (F) at 29 (Hook). Pepco (F)-1 at 43 (Hook).

87 OPC Br. 45-48.

Commission has permitted cost recovery.[88] Pepco witness Hook acknowledges that Pepco last issued common stock in 2008, a period of three to four years between issuances. However, Hook reiterated that the two-year amortization period was based on the period approved in Formal Case No. 1076.[89] On brief, Pepco announces that the stock offering took place in March 2012 during the pendency of this proceeding and within the period of time for which the Commission has permitted cost recovery.[90]

DECISION

57. Although the stock issuance occurred in March 2012, the Company has not provided this Commission with the information necessary such as the size, value and cost of the issuance necessary to substantiate this rate adjustment. Instead, the Company uses the cost incurred in the 2008 stock issuance as a proxy for the cost of its March 2012 issuance. This proffer is not sufficient to warrant an allowance for flotation costs because the costs are neither known nor measureable. In determining the appropriate adjustment, we know of no better data than the expense incurred in the Company's March 2012 common stock issuance. We are aware that the purpose of a financing cost adjustment is to protect the common stockholders from dilution of their investment in the event a sale of additional common stock takes place. Without more information, however, the Commission has no choice but to reject this proposed adjustment.

Northeast Substation

58. **Pepco.** RMA No. 43 reflects Pepco's request to recover the costs associated with the installation of a third transformer at the Northeast Substation. The Company asserts that this project is a continuation of the Northeast Substation work previously approved by the Commission in Formal Case No. 1053. There, the Company indicated that two additional substation power transformers, as well as 69kV sub-transmission supply lines from the Benning station and 13kV network feeder groups, would be added to the substation to support additional load as the load was recognized in the Company's system planning process.[91] Pepco maintains that the project was the least-cost plan for providing capacity to the substation that supplies capacity to the northeast Massachusetts Avenue section of the District.[92] Pepco witness Gausman testifies that the transformer would relieve the developing overload on the existing

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88 Pepco Br. 32.

89 Tr. 262-269, 275-276; Pepco Br. 32.

90 Pepco Br. 32.

91 Pepco Br. 19; Pepco (2I) at 5 (Gausman Supp).

92 Pepco (2I) at 6 (Gausman Supp).

feeders supplying the area north of Massachusetts Avenue, N.W. and that for the 2012 summer, overloads of 7 percent to 11 percent were forecasted to exist on two feeders. During the summer of 2011, these feeders experienced an actual overload of 3 percent and 9 percent.[93] Overall Gausman avers that the Northeast substation project is designed to increase the reliability of the electric system and service existing and developing load on the electric system.[94] The Company asserts that the costs were prudently incurred and necessary to provide service.[95] Pepco's letter to the Commission dated May 2, 2012, states that the third transformer was put in service and began serving customers April 29, 2012.[96] Pepco indicates that there is some additional cable and conduit work that occurred after mid-April that will give the project more functionality and allow Pepco to transfer even more load to the new transformer but in fact the third transformer is and has been supplying benefits to customers since mid-April.[97] Pepco proposes to increase rate base by $12.5 million and depreciation expense by $307,000, and to decrease accumulated depreciation by $153,000 and accumulated deferred income taxes by $1.2 million.[98]

59. **OPC.** OPC argues that completion of this project is too remote from the test year and will not be used and useful for the entire rate effective period. OPC notes that the Commission's policy generally disallows the inclusion of costs incurred outside the test year absent "extraordinary," "unique" and "compelling" circumstances. OPC contends that no "unique" and "compelling" circumstances have been demonstrated here. Moreover, OPC asserts that the project costs are too uncertain. OPC avers that the project will increase the capacity from 72 MVA to 140 MVA and will serve load growth that is currently planned for the Pennsylvania Avenue Quarter in 2014. OPC argues that the additional revenue that will be generated by this load is not reflected in the test year, thus, allowance of the project in plant in service will result in a mismatch of the components of the revenue requirement calculation.[99] OPC contends that although the transformer may be energized, energizing was not sufficient to allow the transfer of load from a network group currently supplied by Benning or to relieve existing overloaded 13kV feeders. OPC asserts that the anticipated load balancing, for which the third transformer was installed, would not occur until the installation of the 13kV conduit and

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93 Pepco (3I) at 33-34 (Gausman Rebuttal).

94 Pepco (2I) at 8. (Gausman)

95 Pepco (2F) at 9-10, Pepco (2F)-2 at 47. (Hook Supp); *see* Pepco (2I) at 5 (Gausman Supp) for a discussion of the needs for the third transformer at the Northeast Substation.

96 Pepco R. Br. 16-18.

97 Pepco R. Br. 16-18.

98 Pepco (2F)-2 (Hook Supp).

99 OPC (B) at 24-26; OPC (B)-4, Schedule 2 (Ramas).

cable. Thus OPC concludes that the project appears not to be complete and Pepco cannot establish the existence of the "unique" and "compelling" circumstances necessary to justify inclusion of the out-of-test year costs of the Northeast Substation in rate base.[100]

DECISION

60. Initially, Pepco, in Formal Case No. 1053, notified the Commission that it was constructing the Northeast Substation, which, among other things, would ultimately include four transformers, to maintain reliability in its distribution system. In that case, we found that the Northeast substation was necessary for reliability.[101] In this instance, OPC challenges only the Company's rate base treatment of the third transformer costs.

61. On a case-by-case basis, the Commission has allowed in rate base completed projects that are outside the test year in certain "unique and compelling" circumstances, where (1) the project's completion date is not too remote from the test year; (2) the cost of the project is reasonable; and (3) the project will clearly be beneficial ("used and useful") to ratepayers during the entire rate effective period.[102] In this case, the Commission finds that these three factors are present in this phase of the Northeast substation project, collectively constituting "unique and compelling" circumstances warranting the inclusion of the third transformer costs in rate base.

62. The record in this proceeding reflects that the transformer began serving existing Pepco customers on April 29, 2012. The in-service-date is within seven months after the end of the test year ended September 30, 2011; a point in time not considered too remote under the Commission's precedent on out-of-period adjustments.[103] Secondly, no party to this proceeding has offered any evidence that the cost of project is unreasonable. OPC asserts that the project costs are unknown, but provides no testimony or other evidence to support its assertion in the face of Pepco's evidence showing the project costs to be $18.5 million.[104] Moreover, unlike in Formal Case No. 1053, OPC has

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100 OPC Br. 24-27.

101 Order No. 14712 , ¶ 101.

102 *See, e.g., Formal Case No. 1053*, Order No. 14712, (January 30, 2008); *Formal Case No. 870, In the Matter of the Application of District of Columbia Natural Gas, a Division of Washington Gas Light Company, for Authority to Increase Existing Rates and Charges for Gas Service*, Order No. 9146, at 452, 483-85, (October 18, 1988); *Formal Case No. 905, In the Matter of the Application of Potomac Electric Power Company for an Increase in Retail Rates for the Sale of Electric Energy*, Order No. 9868, at 651, 682-83 (October. 23, 1991); *see also Formal Case No. 912, In the Matter of the Application of Potomac Electric Power Company for an Increase in Retail Rates for the Sale of Electric Energy*, Order No. 10044 at 512, 569 (June 26, 1992).

103 *See Formal Case No. 1053*, Order No. 14712, ¶ 96.

104 Pepco (3I), p.5, Table 1.

not proffered any revenue estimates associated with Pepco's purported new load growth[105] and leaves it to the Commission to speculate on any additional revenue generated by the increase in load capacity. Thus, OPC has failed to meet its burden to show why potential revenues from the substation, as it serves load growth in the future, should be included in the determination of Pepco's present rate base.

63. Finally, in its brief, OPC asserts that the cable and conduit work were essential to the load balancing, *i.e.*, the transformer's total activation, and, thus, was not used and useful in the rate effective period. However, Pepco argues that this was a new issue first introduced on brief and that no OPC witness testified to this issue during the course of the case.[106] In any event, the record shows that the 3rd Transformer was energized on April 29, 2012, prior to the summer load period. Moreover, Pepco witness Gausman testified that the cable and conduit work was to provide more functionality and allow Pepco to transfer even more load to the new transformer.[107] OPC has offered no evidence which refutes the fact that the third transformer is providing service to customers.[108] Thus, the transformer is already in service and providing service and reliability benefits to District ratepayers for the entire rate effective period. In the Commission's judgment, based on the record evidence, the transformer was installed to serve existing overload conditions. Moreover, the transformer significantly improves Pepco's ability to provide safe and reliable service to customers during the rate effective period. It also increases Pepco's ability to address any potential overload affecting the area served specifically by the Northeast substation and generally, Pepco's distribution system. Based on the foregoing, the Commission finds that Pepco's RMA No. 43 is reasonable and rejects OPC's adjustment No. 2. The Company's adjustment increases rate base by $11,135,000 and depreciation by $307,000.

C. Cash Working Capital (Issue No. 3c)[109]

64. **Pepco.** Pepco states that cash working capital ("CWC") represents the amount of investor owned capital required to carry out the day-to-day operations of Pepco. CWC represents the difference (or revenue lag) in the number of days it takes to collect revenues versus the number of days required to pay expenses. Pepco indicates that the net revenue lag days are applied to the average daily expenses during the test

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105 Order No. 14712, ¶75.

106 Pepco R.BR. at 17.

107 Tr. at 437:15-21, 438:17-20.

108 Pepco R. Br.16-18.

109 Issue No. 3(c) asks, "Is Pepco's proposed cash working capital allowance reasonable?"

period to arrive at the working capital allowance.[110] The Company represents that it used the most recent lead-lag study that was filed with and approved by the Commission in Formal Case No. 1053. According to the Company, it will perform a new lead-lag study once AMI has been completely implemented and the full deployment of smart meters has occurred in the District.[111]

65. Pepco states that its composite revenue and expense lags for the twelve months ending September 30, 2011 were 52.66 days and 30.43 days respectively. The net result is a net lag of 22.23 days, which when applied to average District of Columbia daily expenses of $641,093, results in a cash working capital allowance of $14,251,497. The Company makes two adjustments to its proposed cash working capital allowance: (1) it removes $101,465 in D.C.-allocated withholding taxes in recognition that the Company has the use of employee payroll withholding from the payroll date until the funds are remitted to the government; and (2) it adds the D.C.-allocated imprest funds requirement of $183,162. With these adjustments, the cash working capital allowance reflected in the Company's unadjusted rate base is $14,333,194.[112]

66. **OPC.** OPC recommends that cash working capital be reduced by $1,574,000 based on two proposed modifications: the first modification revises federal income taxes included in Pepco's analysis; and the second reduces the revenue lag as a result of the implementation of AMI.[113] OPC maintains that the inclusion of federal income taxes in the calculation of cash working capital has the effect of reducing the cash working capital requirements while imputing a negative balance will have the opposite effect, increasing cash working capital. OPC argues that it is inappropriate to assume negative federal income taxes for cash working capital purposes and charge ratepayers for federal income taxes in rates. OPC recommends that Pepco replace the $12,739,169 of federal income taxes included in its cash working capital calculation with Pepco's adjusted test year federal income tax expense of $17,493.000. [114]

67. OPC also argues that Pepco's cash work capital adjustment fails to reflect the deployment of the AMI system which Pepco has included in the adjusted test year as if fully installed and deployed. OPC contends that the implementation of the AMI system will reduce the revenue lag as the meter function will be fully automated. OPC recommends that the revenue lag be reduced by two days, from 52.66 days to 50.66 days.

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110 Pepco (F) at 30 (Hook).

111 Pepco (F) at 32, Pepco (2F) at 3 (Hook Supp).

112 Pepco (F) at 31-32, Pepco (F)-1 at 47 (Hook).

113 OPC (B) at 27, OPC (B) -4, Schedule 3 (Ramas).

114 OPC (B) at 27-28.

OPC further recommends that the Commission require Pepco to conduct a new lead-lag study by its next rate case.[115]

68. **Pepco Rebuttal.** Pepco opposes OPC's recommendation to modify the manner in which Pepco uses federal income taxes. According to Pepco witness Hook, the federal income taxes used by Pepco represents federal income tax expense based on D.C. distribution-related operations and that it is irrelevant whether the tax is being paid currently or deferred. Moreover, Hook contends that a deferred tax expense should not be included in the determination of cash working capital. Hook states that lag days should be applied only to the currently payable portion of the expense.[116] Current federal tax expense is negative due to the large deferrals associated with tax depreciation on new plant assets, including bonus depreciation beginning in 2010. Thus, the substantial increase in the amount of federal income taxes being deferred resulted in the currently payable portion of federal income tax being negative for the test year. She notes that when the timing differences reverse, current tax expense will be higher and will reduce working capital. The large deferrals of federal income tax expense have an offsetting benefit to customers in that the large deferrals results in a higher accumulated deferred tax balance which reduces rate base. Moreover, federal income expense as approved by the Commission has always been total expense regardless of whether it is paid currently or deferred[117]

69. As it pertains to the effect of the implementation of AMI on lag days, Pepco states that it has no plans to change rendition groups or customer billing cycles in the near future. Therefore, it will be using the same schedule as when the last lead-lag study was conducted.[118] According to Pepco, the installation of remotely-readable meters will not change the meter-read-bill date lag. Additionally, the rendition group and billing schedule, which serve as the basis of the meter-read-bill date, will not change in the rate effective period. Hook states that the full functionality of AMI's impact on revenue lag days is not reflected in this case. The adjusted test year does not include all items which could potentially impact revenue lag days such as dynamic pricing. Therefore, she maintains that the lag days should remain as they are and be updated when a full year of post-deployment data is available.[119]

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115 OPC (B) at 28-29.

116 Pepco (3F) at 18-19 (Hook)

117 Pepco (3F) at 18-20 (Hook Rebuttal).

118 Pepco (3F) at 20-21 (Hook).

119 Pepco (3F) at 20-23.

DECISION

70. CWC are investor funds that are required in order to pay bills before cash from the sale of utility service actually begin to flow back to Pepco. Inclusion of the CWC in rate base provides the Company with an opportunity to recover the cost of financing these funds. In this instance, OPC witness Ramas modified her position and the Company agreed to set federal income tax expenses to zero for purposes of calculating cash working capital.[120] As a result, the Company's revised proposed cash working capital allowance is $14,109,000.[121] The Commission accepts Pepco's modified cash working capital adjustment as agreed to by Pepco and OPC. However, we reject OPC's proposed adjustment to reduce the revenue lag by two days since OPC failed to substantiate the basis for its proposed two days reduction. In that regard, we note that OPC witness Ramas acknowledges that she has not performed any studies or analysis to support OPC's proposal to reduce the revenue lag by two days.[122]

71. We do agree with OPC that the Company should conduct a new lead-lag study. Pepco witness Gausman testifies that the AMI meters were installed and fully activated in May 2012. He also testifies that all aspects of the fully integrated system will be in service by the second quarter of 2012, and that the Company began to recognize savings toward the end of the 2011 and in the first and second quarters of 2012.[123] Gausman represents that specific areas of savings include improved meter reading, billing activities, and asset optimization.[124] Based on the foregoing, the Commission directs Pepco to prepare and file an updated lead-lag study based on at least one (1) year of AMI data by no later than July 31, 2013. However, if Pepco cannot meet the July 2013 filing deadline then Pepco should provide its reasons and proffer a filing deadline for the 2013 calendar year in its compliance filing.

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120 Tr. 730-731; Tr. 1481.

121 Pepco Br. at 22.

122 Tr. 305-308.

123 Pepco (I) 12-14.

124 Pepco (I) at 17 (Gausman).

IV. TEST YEAR SALES AND REVENUES[125]

A. Weather Normalization of Sales and Revenues

72. Pepco's customer growth rate averaged 1.7 percent over the years 2005 to 2010 and is projected to average 3.3 percent over 2011 through 2015.[126] The megawatt hour sales for the District consist of six months actual sales of 5,642,548 megawatt hours and six month projected sales of 6,092,536 megawatt hours. Electricity sales revenue for the District consists of six months actual of $196,099,000 and six months projected of $214,812,000.[127] Pepco maintains that sales and revenues are properly normalized. The test year revenues include the Bill Stabilization Adjustment ("BSA"), which assures that distribution revenues, on a per customer basis, match levels currently authorized by the Commission. The BSA eliminates any revenue variations not related to customer growth and variations due to weather.[128] No party challenges the Company's test year sales and revenues, nor does any party take issue with Pepco's weather-normalized sales and revenues.[129]

DECISION

73. The purpose of weather normalization is to provide a reasonable projection of sales and revenue for the rate-effective period so that rates set by test year revenues and costs can be reasonably representative of the future. Inasmuch as we have independently reviewed each, we find them acceptable for purposes of this proceeding. However, Pepco witness Janocha's testimony in response to a bench question does raise some concern regarding the data inputs utilized in Pepco's weather normalization.[130] The Commission continues to believe that it is important that we understand the inputs including the detailed calculations of the weather normalization process, and that the BSA test year data is accurately calculated. Accordingly, in all future rate cases, Pepco is directed to present, as part of its rate case application, a weather normalization study using updated data, which includes the Company's weather normalization methodology and a detailed explanation regarding its weather normalization of sales and revenues.

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[125] Designated Issue No. 4 asks, "Are Pepco's projected test year sales and revenues just and reasonable and reasonably projected?" Designated Issue No. 4a asks: "Has Pepco properly weather-normalized its sales and revenue?"

[126] Pepco (A) at 11 (Kamerick); Tr. 40.

[127] Pepco Br. at 24.

[128] Pepco (2L) at 2 (Janocha).

[129] OPC (B) at 30 (Ramas).

[130] Tr. 693.

V. OPERATING EXPENSES[131]

74. Pepco's projected test year unadjusted O&M expense is $175,441,000 for six months of actual and $135,021,000 for six months of projected test year data. The six months of projected data are based on the Company's 2011 budgeted data.[132]

A. Unopposed Adjustments (RMA Nos. 25, 27, 31, 32, 33, 34, 36, 37, 38, 41, and 44)

75. Operating income is derived by subtracting expenses (including taxes) Pepco incurs in providing service to customers from the revenues the Company receives for electric distribution service.[133] Expenses include what Pepco spends to operate and maintain its distribution system; to pay employee wages and benefits; to purchase materials and supplies; to pay interest on the Company's debt; to pay federal, state and local taxes; and the costs of other direct business expenses. In this case, certain proposed adjustments by Pepco are either unopposed or accepted by the parties which include RMA No. 25, Reflection of Three-Year Average Regulatory Expense; RMA No. 27, Reflection of Savings from Post-Conectiv Energy Divestiture ORP; RMA No. 31, Removal of Adjustments to Deferred Compensation Balances; RMA No 32, Removal of Employee Association Costs; RMA No. 33, Removal of Industry Contributions and Membership Fees; RMA No. 34, Removal of Institutional Advertising/Selling Expenses; RMA No. 36, Inclusion of Interest Expense on Customer Deposits; RMA No. 37, Reflection of Increased D.C. WASA rates; RMA No. 38, Reflection of D.C. Steel Plate Fees (an adjustment which was withdrawn by Pepco), RMA No. 41 Reflection of Unitary Tax, and RMA No. 44, Removal of Non-Utility Property Tax.

DECISION

76. Inasmuch as no party challenges the adjustments and the Commission has reviewed them and independently find them just and reasonable, we approve the adjustments.

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131 Designated Issue No. 5 asks, "Are Pepco's operating expenses just and reasonable?"

132 Pepco (F) at 4-5 (Hook); Pepco (2E) at 2 (McGowan Supp).

133 *See Office of the People's Counsel v. Public Service Comm'n,* 399 A.2d 43 (D.C. 1979).

B. Pepco's Proposed Adjustments

Annualization of Wage Increases

77. **Pepco.** Pepco proposes in RMA No. 22, Annualization of Wage Increases, to increase O&M expense by $927,000 to reflect the annualization of employee salary and wage increases which occurred during the test year (March 1, 2011, for management employees and May 31, 2011, for union/bargaining unit employees). The Company also includes in this adjustment the projected increases for management and union employees that will take place within twelve months of the end of the test year. Incremental labor costs associated with major storm restorations have been removed pursuant to Formal Case No. 1076.[134] Wage increases were also adjusted to take into account changes in employee levels, consistent with the treatment approved in Formal Case Nos. 1053 and 1076.[135]

78. **AOBA.** AOBA opposes Pepco's adjustment arguing that: (1) the wages and salaries of Service Company employees should not be treated in a similar manner as Pepco employees; and (2) Pepco has not shown that the change in the number of Service Company employees was necessitated by Pepco's service requirements.[136] AOBA witness Oliver argues that Service Company employees are not Pepco employees and their salaries and wages should be recovered like other service providers who bill Pepco for services, *i.e.*, included in the service provider's negotiated rate for providing service. According to AOBA, Pepco has failed to provide any support for this adjustment that would demonstrate a direct relationship between the number of Service Company employees and the level of services provided to Pepco.[137]

DECISION

79. AOBA's arguments here are similar to arguments it put forth in Formal Case Nos. 1053 and 1076 related to other Pepco-Service Company transactions, *i.e.*, Pepco has failed to support or justify the reasonableness of these costs.[138] We rejected AOBA's argument then, and we reject it again for the same reasons. Generally, the Commission has included allocated Service Company costs in rates unless evidence is

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134 Pepco (F) 21-22 (Hook).

135 Pepco (F) at 21-22, Pepco (F)-1 at 26 (Hook); Pepco Br. 8.

136 AOBA Br. 9-10

137 AOBA at 46 (Oliver); AOBA Br. 9-10.

138 *Formal Case No. 1053,* Order No. 14712 ,¶¶ 169, 170 (January 30, 2008); *Formal Case No. 1076,* Order No. 15710, ¶¶ 201, 207 (March 2, 2010).

presented that the costs and the allocation thereof are inconsistent with the Company's Cost Allocation Manual and therefore, are neither appropriate or reasonable. No such showing has been made by AOBA in this proceeding. Nor has AOBA provided any evidence that would call into question how Service Company employee costs or its head count should compare in relation to the costs for employee services provided by other service providers or Pepco's service requirements, respectively. Just as Pepco is required to present sufficient evidence in support of its proposed adjustments, AOBA is required to do likewise in support of its proposed adjustments. We appreciate AOBA's efforts to ensure that ratepayers are only assessed appropriate and reasonable costs for services provided and needed. The Commission has and will continue to review the costs and allocation between Pepco and the Service Company. The recently completed KPMG Audit found that the Service Company complied with the Cost Allocation Manual ("CAM") and that using the CAM would result in an accurate allocation of costs. The Commission has recently ordered a management audit of Service Company charges to Pepco.[139] The purpose of the management audit is to review Pepco's operations and the level of PHI costs that are charged to Pepco in order to determine whether they are reasonable. The results of the management audit should answer any questions related to the services provided by the Service Company and the costs for such services. The Commission accepts Pepco's RMA No. 22, Annualization of Wage Increases.

3. Annualization of Employee Health and Welfare Costs

80. **Pepco.** Pepco's RMA No. 23 (Annualization of Employee Health and Welfare Costs) increases O&M expense by $379,000 to reflect changes in employee health and welfare costs in the rate effective period, which Pepco contends is consistent with the treatment approved in Formal Case Nos. 1053, Order No. 14712 and 1076, Order No. 15710.[140] The proposed increase is comprised of: (1) an eight percent increase of projected test year medical costs; (2) a five percent increase of test year dental costs, and (3) a five percent increase of projected test year vision costs. The Company indicates that it adjusted its medical, dental, and vision plan costs to reflect the anticipated percentage increase developed by PHI, based on an analysis of medical trend survey of health care costs in the Mid-Atlantic region prepared by Lake Consulting, Inc. ("Lake"), an independent actuarial firm.[141]

81. **OPC.** OPC contends that: (1) the forecasted test year costs should be revised to reflect actual test year costs; and (2) the escalators used to project the increase in employee benefit costs should be reduced. OPC asserts that the test year should reflect the actual medical, dental, and vision costs for the entire test year ending September 30,

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139 *See Formal Case No. 1076*, Order No. 16585, ¶¶ 27-28 (October 14, 2011).

140 Pepco (F) 22 (Hook).

141 *Id.* at 22, Pepco (F)-1 at 27(Hook).

2011, which reflect a variance of $611,000, and not $120,753 as previously indicated.[142] OPC states that based on the per-Company allocation to distribution and the D.C. allocation factor, O&M expense should be reduced by $587,000.[143]

82. OPC contends also that the escalator factors proposed by Pepco do not reflect changes in its employee benefit plans that would offset potential cost increases. OPC witness Ramas challenges the use of the Lake Survey as a guide in determining the inflation factors for medical, dental, and vision increases. She argues that the trends in the Survey are for the first quarter of 2011 and are not specific to 2012, the period in which the new rates will be in effect.[144] Additionally, the trends in the survey do not account for changes made by Pepco to control its benefit costs. Ramas states that, in January 2012, Pepco's plans included an increase of the co-pay for office visits, the deductible for PPO Medical, and the portion of medical costs to be paid for by both management (currently 19%) and union employees (currently 14.7% (HMO) and 16.7% (PPO)) to 20%. These increases are not reflected in the Lake Survey. OPC recommends that the projected post-test year medical, dental, and vision cost increases of 8%, 5%, and 5% respectively be rejected. OPC argues that the amount should be limited to the test year cost level, adjusted to reflect the updated actual.[145] Ramas contends that actual medical, dental, and vision costs for the entire test-year ending September 30, 2011, was $611,000 less than forecasted and recommends that the forecasted portion of the test year expenses be revised to reflect actuals.[146]

83. **Pepco Rebuttal.** As it relates to revising the forecasted portion of the test year to reflect actual amounts, Pepco counters that variances from forecasts will naturally arise due to both the timing of when claims are paid and as a result of the seasonality in the level of plan utilization. Pepco contends that the level of expense reflected in the budgeted months take into consideration that the Company will incur one or more high cost claims in a given year and that the variance of $120,753 presented by OPC is less than one percent of the total $14.5 million company-wide health benefit expense reflected in the test year, which indicates that the 2011 budget was accurate. Thus, Pepco

[142] Tr. 1498-1500; OPC Br. 35.

[143] OPC Br. 38.

[144] In Pepco's Rebuttal, Witness Hook stated that the conclusion was based on a misinterpretation of an introductory statement in the survey. The statement is intended to convey that the data was prepared in the first quarter of 2011. However, the annual trends represent the upcoming 12 months. Recent survey data as of the 3rd Quarter 2011 was provided to OPC in OPC Data Request 13-12.

[145] OPC (B) at 34-36 (Ramas).

[146] Tr. 1499-1500.

concludes that OPC's recommendation to replace forecasted data with actual data is unnecessary.[147]

84. As to whether Lake's analysis reflects changes made by Pepco to control benefit costs, Pepco witness Hook states that it engages Lake on an annual basis to monitor trends and provide data for use in developing a reasonable annual budget and in designing and reviewing appropriate benefit changes. PHI consulted with Lake in developing the benefit changes that were effective in January 2012. She maintains that the costs trends selected are conservative relative to the mean and median cost trends reported in the Lake Survey. Both the mean and median cost trends in the Lake Survey were approximately two percent above the eight percent factor selected by the Company. The five percent selected for dental and vision plans were at the low end of the reported range in the Survey. Hook asserts that changes in the benefit plans were reflected by the lower costs trends used to develop the percentage increases. Therefore, OPC's disallowance of the increases is without merit.[148]

85. Pepco further states that OPC's contention that the medical trends are not specific to the 2012 period, but instead relate to the first quarter of 2011, is a misinterpretation of the introductory statement in the survey, which signifies that the data was prepared in the first quarter of 2011, not for the first quarter of 2011. Annual trends represent the upcoming 12 months. Pepco argues that recent survey data for the second and third quarter of 2011 (provided in response to OPC Data Request 13-12) shows that the cost trends selected by the Company were conservative. Pepco reiterates that the trends used by the Company in this adjustment are reflective of the rate effective period.[149] Pepco witness Hook concludes that it is unfair and inappropriate to update certain costs to actual and not all other costs.[150] She argues that some elements of O&M will be higher than what was projected and others, lower. Hook insists that, if you look at the total O&M and update that to actual, the test year period would be significantly higher on an actual basis in total.

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147 Pepco (3F) at 8-9 (Hook Rebuttal).

148 *Id.* at 9-10.

149 *Id.* at 12-13.

150 Tr. 1524.

DECISION

86. The Commission finds that Pepco's test year estimates do not unreasonably distort rates for the rate effective period. The cost differences between the test year forecasted and the test year actual for employee benefits have increased showing a variance of 4.21 percent (based on the $14.5 million in total Company-wide health benefit expenses). However, the Commission does not believe that the isolated forecast to actual variance demonstrated in employee benefits provides evidence that Pepco's total forecasted test year costs were unreasonable. A variance of only 4.21 percent between the costs included in the test year and the actual costs incurred for a single component of total expenses is not unreasonable. The Commission finds that the modest variance between the forecasted and actuals supports the reasonableness of the inflation factors derived from the medical trend survey provided by Lake. Thus, we do not find that the forecasts substantially overstate Pepco's employee health and welfare costs. Merely because the actual cost is lower than the forecasted costs does not render the estimate unreasonable.

87. We also find that Pepco's reliance on the Lake Survey is reasonable. PHI did take into account the planned increases in its determination of health benefit costs. Pepco witness Hook testifies that "[c]osts associated with medical, dental, and vision plans are adjusted to reflect anticipated percentage increases developed by PHI's Human Resources department, based on the analysis of health care cost trends in the Mid-Atlantic supplied by Lake Consulting, Inc."[151] The Company states and OPC acknowledges that the Lake Survey was used as a guide to determine the proposed increase. The mean and median cost trends in the Lake Survey was approximately two percent above the eight percent factor selected by the Company. Similarly, the 5% cost trend selected for dental and vision plans were at the low end of the range reported in the Lake Survey.[152] Hook explains the Company's consideration of a leverage effect when determining the plan changes and percentage increases and states that "if the Company were to make no benefit plan design changes, then the cost trend would have been higher than the eight percent used for medical and the five percent used for vision and dental plans."[153]

88. OPC contends that the medical trend survey was for the first quarter of 2011 and not specific to the 2012 period. Pepco argues that OPC misrepresents the introductory statement in the survey. The statement is intended to convey that the data was prepared in the first quarter of 2011. According to Pepco, the annual trends

151 Pepco (F) at 22 (Hook).

152 Pepco (3F) at 10 (Hook Rebuttal).

153 Pepco (3F) at 10-11.

represent the upcoming 12 months. Projected inflation and utilization as measured cost trends are characteristically forward looking, and, thus reflective of the level of expenses to be incurred in the upcoming annual period. Moreover, recent data as of the third quarter of 2011, supports that the cost trends included in the Company's filings are conservative relative to the mean and median reported in the Lake Survey.[154] We agree. As the Company points out, the trends are reflective of the rate effective period. Moreover, we have independently reviewed the Lake Survey and find Pepco's proposed employee health and wealth benefit increases reasonable. We conclude, based upon the evidence submitted by Pepco in this proceeding that the Company has carried its burden in regard to these costs. Thus, the Commission accepts the Company's adjustment to annualize employee health and welfare costs.

89. On brief, OPC argues that (1) the Company's forecast is not supported by "expert judgment"; and (2) the "unsworn and unexamined figure "of the consultant is not evidence."[155] We find OPC's attack on the Survey itself confusing, especially when OPC's own witness states that she did not contest the validity of the survey.[156] Pepco witness Hook is not precluded from basing her opinion on the results of the survey. The survey is not being offered for the truth that Pepco's escalators should be set at levels reflected in the survey, but rather to establish the reasonableness of the escalators selected by Pepco. The probative value assigned to any piece of evidence is a matter of the discretion of the Commission. We believe that the survey can be reasonably relied upon by Pepco in determining health benefit plan costs.

Reflection of Three-Year Average Storm Costs/Hurricane Irene

90. **Pepco.** Pepco's RMA No. 26 (Reflection of Three-Year Average Storm Costs) normalizes O&M expense associated with storm restoration efforts to their three-year average level, reducing test year storm costs by $765,000, based on the average of the actual amounts recorded as of September 2009 and September 2010, and the combined actual and forecasted amounts for the test year ending September 30, 2011. Pepco contends that its proposed adjustment is consistent with the treatment approved in Formal Case No. 1053.[157]

91. In RMA No. 42 (Reflection of Extraordinary Weather Event - Hurricane Irene Storm Costs) Pepco proposes to reflect approximately $2.1 million in incremental

[154] Pepco (3F) 12-13 (Hook Rebuttal)

[155] OPC R.Br. 14-16.

[156] Tr. 753.

[157] Pepco (F) 23; Pepco (F)-1, Adjustment No. 26 (Hook).

costs associated with Pepco's restoration efforts in the District in response to Hurricane Irene. Pepco contends that these costs are over and above the level of storm costs normally incurred. Pepco requests that it be allowed to recover these costs over a three-year period, with the unamortized balance reflected in rate base. The adjustment increases the regulatory asset by approximately $1.2 million and amortization expense by $720,000.[158]

92. **OPC.** OPC opposes Pepco's RMA No. 26 and recommends that test year expenses be reduced by $849,000. OPC argues that any normalization of costs should be based on actual costs and exclude forecasted costs. OPC also recommends that a six-year period not a three-year period be used because during two of the past three years there have been several significant storms that have a larger impact on storm restoration costs than in prior years.[159] OPC argues that a six-year period will smooth out the large impact of the high level of storm costs incurred over the last two years and result in average storm costs of $2.8 million. OPC further argues that a six-year period average storm costs compares more favorably with the amount permitted in Formal Case No. 1076 ($1.65 million) and will result in a normalized level of restoration costs.[160] OPC states that storm costs fluctuate from year to year and that a three-year average is unreasonable. OPC argues that actual test year distribution-related restoration costs were significantly higher during the test year as a result of a snowstorm that occurred on January 26, 2011 and the impact of Hurricane Irene.[161] OPC's proposed adjustment reduces rate base by $1.2 million, amortization expense by $720,000 and O&M expense by $129,000.[162]

93. OPC also recommends disallowance of the proposed Hurricane Irene regulatory asset and the resulting amortization. OPC argues that the costs should not be reflected in determining the storm restoration cost level. OPC contends that, while Hurricane Irene was a significant storm event, it does not warrant special treatment, especially when the vast majority (83%) of the restoration costs was incurred in Maryland.[163]

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158 Pepco (2F) at 9, Pepco (2F)-2 at 46 (Hook Supp).

159 OPC (B) 38-39; Tr. 757-761. OPC witness Ramas proposes that costs be normalized using Pepco actual storm costs reflected for the twelve months periods ending December 31, 2006 and 2007, and the twelve periods ending September 30, 2008, through September 30, 2011. OPC (B) at 41:3-6. OPC witness Ramas states that the Company subsequently updated the storm costs to $2.3 million.

160 OPC (B) 39-40 (Ramas).

161 OPC R. Br. 17-18.

162 OPC(B)-4, Schedule 5 (Ramas).

163 OPC (B) at 40-44 (Ramas).

94. **Pepco Rebuttal.** Pepco witness Hook argues that the use of forecasted data and a three-year average are appropriate and consistent with the Commission's decision in Formal Case No. 1053. She contends that a six-year period is a very long time frame to use for averaging costs and that regulatory costs have been traditionally averaged over three years since 1990. Pepco contends that OPC has not offered any compelling rationale for departing from this precedent.[164] OPC presents no evidence that a six-year average level is more indicative of future storm costs than a three-year level.[165] Hook asserts that storm restoration costs are a normal part of cost of service and should be included in rates at a level that can be reasonably reflective of the future.

95. Pepco also maintains that including the costs in the averaging adjustment and, in particular, use of a six-year average would deny Pepco recovery of the majority of the Hurricane Irene restoration costs. Hook avers that this would be particularly onerous given the public praise the Company received for its restoration efforts. The reward for a strong effort should not be a denial of recovery of the full costs incurred. Removing Hurricane Irene costs from the averaging process will provide the Company with full cost recovery of costs associated with the Company's quick and laudable restoration efforts. Moreover, by removing the impact of the hurricane, it renders the remaining average costs more reflective of the level appropriate for setting rates under normal circumstances.[166]

DECISION

96. The Commission approves Pepco's adjustment to normalize O&M expense associated with storm restoration efforts to its three-year average consistent with Formal Case Nos. 1076 and 1053.[167] There is no evidence that demonstrates that OPC's proposed six-year average is more representative of future storm expense than the three-year level. OPC witness Ramas merely asserts that the most recent three years significantly distorts the average because of the level of storms that have happened in two of the last three years. In fact, she concedes that she uses six-years only because that was the data available, but she would have preferred a ten-year average, if the data were available. Consistent with our decision in Formal Case No. 1053 and Formal Case No. 1076, the Commission approves Pepco's normalization of costs using a three-year average based on its partially projected test year.

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164 Pepco (3F) at 13-14 (Hook Rebuttal).

165 Pepco Br. 27-28.

166 Pepco (3F) at 15-17 (Hook Rebuttal).

167 *See Formal Case No. 1053*, Order No. 14712, ¶¶ 195, 199; *Formal Case No. 1076*, Order No. 15710, ¶ 137.

97. On the other hand, we do agree with OPC that while Hurricane Irene was a major storm event, it does not warrant special regulatory asset recognition. Storm restoration costs are a normal part of providing service and should be included in rates at a level that can be reasonably reflective of the future costs. We agree that storm-related expenses during the test year should be analyzed to determine whether or not the level of expense is representative of levels likely to occur during the rate-effective period. In view of the lack of better information on the record pertaining to storm occurrences and because we believe that recognition of Hurricane Irene storm costs is appropriate, we will permit Pepco to modify its adjustment to include Hurricane Irene costs in its three-year average storm-related costs calculation. Therefore, Pepco Adjustment No. 42 (Reflection of Extraordinary Weather Event – Hurricane Irene) is rejected. Rejecting Pepco Adjustment No. 42 reduces amortization expense by $720,000 and rate base by $1,207,000. Instead, Pepco Adjustment No. 26 (Reflection of 3-year Average Storm Costs) is modified to include $2.159 million of Hurricane Irene costs in the calculation of three-year average storm costs. The result of this modification increases O&M expenses by $720,000.

Increased Fuel Costs

98. **Pepco.** RMA No. 29, (Reflection of Increased Fuel Costs), increases O&M expense by $150,000 to reflect the increasing cost of fuel for Pepco vehicles. Pepco proposes to re-price the cost of fuel used during the test period at the latest available (May 2011) invoice prices. According to the Company, fuel costs have increased dramatically over the actual incurred and budgeted levels embedded in the test year. The average price per gallon for unleaded fuel increased from $2.96 during the test year to $3.80 in May 2011 and from $3.11 to $3.71 for the bio-diesel blend during the same time periods.[168] The Company then applies the difference to the number of gallons used in the test year to arrive at the total increase in costs. According to Pepco, consistent with how fuel stock was historically treated prior to deregulation and the Company's divestiture of its generating station; fuel stock was reflected in rate base at 13-month average quantities and re-priced at the end of period prices in an attempt to make prices more representative of what will occur in the rate effective period.[169]

99. **AOBA.** AOBA opposes Pepco's adjustment arguing that (1) gasoline and biodiesel fuel costs have not continued to increase as anticipated by Pepco and (2) Pepco's fuel cost estimates make no adjustment for any decrease in gas consumption due to improvements in vehicle fuel efficiency. AOBA contends that fuel costs are significantly below the level Pepco experienced in May 2011, and with the increasing use

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[168] Pepco (F) 24-25 (Hook).

[169] Pepco (3F) at 24-25 (Hook Rebuttal); Pepco (F)-1 at 33(Hook).

of hybrids and more efficient bio-diesel vehicles, a well-managed vehicle fleet would reflect noticeable year-to-year improvements in fuel efficiency as measured in miles per gallon. In the absence of specific data related to fuel improvements, the adjustment should be rejected and the level of fuel costs should reflect the 12 months ending September 30, 2011.[170]

100. **Pepco Rebuttal.** Pepco concedes that fuel prices have not escalated as rapidly as they did at the time when this case was filed. Nevertheless, Pepco argues that fuel prices are still higher than the level reflected in the unadjusted test year. Pepco states that fuel costs have continued to increase since the conclusion of the test year, and Pepco's adjustment to increase O&M to reflect those increases is appropriate.[171] Moreover, the impact of vehicular efficiency improvements that AOBA suggests are speculative at best. The quantification of any potential efficiencies related to fuel efficiencies would be difficult to estimate, and the increased costs associated with replacing older vehicles with new ones has not been reflected in the cost of service.[172] Factors such as the miles driven also impact efficiency. Pepco states that it would be inappropriate to reflect potential efficiency savings.[173]

DECISION

101. The Commission is persuaded that the Company has reasonably estimated the increase in average fuel costs based on May 2011 fuel prices compared to average test year fuel prices. In regard to fleet efficiency improvements, AOBA has not provided any adjustment amount that would reflect improvements due to vehicle fuel efficiency. Accordingly, we reject AOBA's recommendation and approve Pepco's adjustment as reasonable.

Pepco RMA No. 30 – Additional Vegetation Management Expense

102. **Pepco.** The Company proposes in RMA No. 30 to increase its vegetation management ("VM") O&M expense by an additional $500,000 to reflect additional vegetation management expenditures. The Company states it has introduced an Enhanced Integrated Vegetation Management ("EIVM") program in the District due to the high density tree coverage and the vulnerability of Pepco's overhead distribution system to tree damage. According to Pepco, it is a comprehensive and proactive program

170 AOBA (A) 49; AOBA (A)-7 at 5 (Oliver).

171 Pepco Br. 31.

172 Pepco Br. 31.

173 Pepco (3F) at 7, 8-9 (Hook Rebuttal).

designed to address tree-related outages and increase reliability by removing hazardous trees, and trimming and removing vegetation above its lines to prevent damage from falling limbs.[174] The Company indicates that in 2010 that it trimmed 422 miles which decreased to 392 in 2011.[175] The Company's budgeted spending for tree trimming was $1.67 million in 2011.[176]

DECISION

103. Pepco requests an additional $500,000 to reflect additional vegetation management expenditures related to its EIVM program. Inasmuch as no party challenges this adjustment and as the Commission has reviewed it and independently found it to be reasonable, we approve the Company's adjustment for proposed vegetation management. We note that the miles of trees trimmed have declined from 2010 to 2011, however, the costs of tree trimming have increased. The Commission is interested in whether ratepayers are receiving the appropriate value for their dollars. The Commission directs that budgeted vegetation management dollars, including this incremental funding, be fully spent on vegetation management and not be diverted to other purposes at Pepco's discretion. However, to ensure that the dollars authorized address the need identified and to allow the Commission to further evaluate the EIVM program, the Commission directs Pepco to file in Formal Case No. 766, an annual plan for EIVM with quarterly targeted milestones and quarterly reports detailing its EIVM efforts. With regard to the annual plan, we direct Pepco to explain for all District vegetation management, what the Company's proposals and priorities would be, and what the reasonably forecasted expected SAIDI/SAIFI results for D.C. would be based on Pepco's recommended budget. The annual plan and the first quarterly report should be submitted by no later than December 31, 2012. Each quarterly EIVM report shall include, at a minimum, the following information:

- A list of feeders and neighborhoods that have been identified for EIVM work;
- The purpose and benefit of the EIVM work;
- What EIVM work has been performed and where, (by feeder and physical location) including the percentage of the feeder that is underground and whether any portion of the feeder serves Maryland customers;

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174 Pepco (I) at 29-30 (Gausman); Pepco (F) at 25, Pepco (F)-1 at 34 (Hook).

175 Pepco Exhibit No. 69.

176 Pepco (I) at 29:6-10. The Company's budgeted spending for tree trimming was $1.6 million in 2011, an increase from its actual spending of $1.2 million in 2010. See Commission Exhibit No. 3; see also Formal Case No. 766, Pepco 's 2012 Annual Consolicated Report at 257 (March 15, 2012).

- The proposed start date, the actual start date, and the end date of the EIVM work, by feeder and physical location;
- A report on projected and actual spending for the EIVM in each quarter. The Company is to provide an explanation where the variance is greater than ten percent;
- A list of all "hazard trees" identified by Pepco by feeder, neighborhood and physical location. This list is to specify for each identified hazard tree (1) trees that have been removed or are planned to be removed as well as (2) trees that Pepco believes it cannot remove under District of Columbia regulations, Urban Forestry Administration policy, or because of neighborhood opposition;
- A list and the location of all meetings held or scheduled to be held by Pepco representatives with community groups in connection with the EIVM;
- The number of hazard trees removed from (1) the right-of-way and (2) from private property, if applicable; and
- A statement of progress with respect to the targeted milestones established in the Annual EIVM plan. Each fourth quarterly report is to compile the quarterly milestone progress reports to show the year's accomplishments.

Benning Environmental Liability Charge

104. **Pepco.** Pepco RMA No. 35 (Removal of Benning Environmental Liability Charge) reduces O&M expense by $3.9 million by removing from the cost of service a December 2010 charge to O&M expense for future environmental remediation required at PHI's oil-fired generation facility at Benning Road. The facility was previously owned by Pepco and was transferred to Pepco Energy Services ("PES") in 2001. Pepco represents that the entire expense amount of $13.5 million was apportioned between Pepco and PES, then further assigned within Pepco to generation, transmission, and distribution based on the time frame the facility was owned by Pepco versus PES.[177] The Company is not requesting recovery of this expense at this time due to the uncertainty regarding the final cost of remediation and the possibility of partial insurance reimbursement; instead it asks the Commission to approve deferral of the costs in a regulatory asset for review in a future proceeding.[178]

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177 Pepco (F) 26-27 (Hook).

178 Pepco (F) 26-27; Pepco (F)-1 at 39 (Hook).

DECISION

105. The Commission accepts Pepco's adjustment to remove the Benning Environmental Liability Charge. The adjustment reduces O&M costs by $3,888,000. However, we are not approving the establishment of a regulatory asset. Pepco can separately track and quantify such costs for future consideration in the next rate case.[179]

Interest Synchronization

106. The final interest synchronization amount will be calculated based upon the Commission's decision related to the weighted cost of debt and adjusted rate base.

C. OPC Proposed Adjustments

Removal of Non-Recurring Meter Expense

107. **OPC.** OPC recommends that meter expense be reduced by $314,000 to remove a non-recurring write-off of meter costs recorded December 2010 and that miscellaneous general expenses be reduced by $44,000 to remove a write-off of prior period costs, also recorded in December 2010. OPC indicates that the non-recurring write-off represents a one-time cost of $753,080 that was incorrectly charged and subsequently expensed. The costs were for the period from August 2010 to December 2010, predating the test year, and therefore, should be removed from the test year.[180]

108. **Pepco Rebuttal.** Pepco contends that the $753,080 charge to the Meter Expense-FERC 586 account was made to correctly record prior labor, contractor, material, and overhead costs to the appropriate expense account.[181] These costs were on-going meter-related costs that were originally charged to capital and recorded in construction work in progress, but were subsequently determined during an account reconciliation to be more appropriately included in Meter Expense-FERC account 586. Although OPC argues that this is a one-time expense and should be removed from the test year, OPC does not argue that the costs were imprudent or inappropriate. Pepco asserts that the journal entry is not a write-off but a reclassification of costs to the account where it should have been originally charged. Pepco is not opposed to removing the portion of costs outside the test year. The Company proposes in RMA No. 45, Removal

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179 There are many issues that Pepco would need to address prior to regulatory asset treatment. For example, if there is a future land sale, does the original divestiture sharing agreement apply? Will such environmental costs be used to offset revenue from sales? Is the land still part of rate base? All of these issues and others should be fully discussed in Pepco's next rate case.

180 OPC (B) at 44-46; OPC (B)-23 and (B)-24 (Ramas).

181 Pepco (3F) 27-28 (Hook).

of Out-of-Period Meter Expense Adjustment, to reduce Meter Expense by $81,000 for the period August through September 2010. However, Pepco contends that costs related to October through December 2010 are legitimate recoverable costs.[182]

DECISION

109. Pepco agrees to reduce Meter Expense-FERC Account 586 by $81,000 to reflect the removal of the costs outside the test year. The Commission has independently reviewed RMA No. 45 and finds it appropriate and reasonable. This adjustment reduces O&M expense by $81,000.

Remove Accounts Receivable Write-Off Employee Reimbursements

110. **OPC.** OPC asserts that in December 2010, Pepco recorded $115,617 to FERC account 930.2 (Misc. General Expense) as a write-off of a portion of an accounts receivable balance for employee reimbursements. Pepco determined that there was an incorrect posting to the account from the payroll system that should be removed from test year expense. OPC contends that this is an out-of-period and non-recurring cost that should be removed from the test year resulting in a reduction to O&M expense of $44,000.[183]

111. **Pepco Rebuttal.** Pepco does not oppose OPC's adjustment and included RMA No. 46, Removal of One-Time Entry to Misc. General Expense in its final revenue requirement.

DECISION

112. Based on the above, the Commission approves OPC's adjustment resulting in a $44,000 reduction to O&M expense as just and reasonable.

VI. DEPRECIATION[184]

113. **Pepco.** Pepco contends that it has properly computed depreciation expense and accumulated depreciation expense in the respective individual adjustments-RMA Nos. 1, 2, 4, 5, 10, 11, 12, 14, and 43. Pepco states that to the extent plant in

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182 Pepco (3F) 28-29 (Hook Rebuttal).

183 OPC (B) at 46 (Ramas).

184 Designated Issue No. 6 asks, "Are Pepco's depreciation adjustments reasonable?"

service was adjusted in each of these ratemaking adjustments, a corresponding adjustment was made both to depreciation expense (to add the annual level of depreciation expense associated with the plant addition) and to accumulated depreciation (to reflect the average addition to the accumulated depreciation balance for the new plant in the first year). Pepco asserts that this is consistent with adjustments approved by the Commission in previous cases, for example the annualization of the Northeast Substation in Formal Case No. 1076.[185]

114. Pepco witness White advises that consistent with Formal Case No. 1076, Pepco revised its accounting procedures and records in Account 108, Accumulated Provision for Depreciation, scrap salvage related to the retirement of assets in situations where it is not practical to track the scrap for every retirement. Pepco conducted an analysis to estimate the percentage of scrap material collected in common bins which relates to retired wire and cable assets versus the percentage of wire and cable that are true scrap, *i.e.*, useable. The Company will collect this scrap in a common bin, but the percentage estimate established as a result of the analysis will be used to record salvage from retired assets. Additionally, Pepco will record capitalized third party reimbursements as a credit to Account 108 due to the potential of making net salvage more negative. This will have no impact on net salvage recorded in Account 108.[186]

115. **OPC.** Witness Ramas states in her direct testimony that since the Company has stated that the depreciation incorporated in its rate application, with the exception of depreciation of AMI meters, is based on the depreciation rates approved by the Commission in Formal Case No. 1076, OPC does not take issue with Pepco's depreciation adjustments. However, OPC made adjustments to certain fall-out issues that resulted from its recommended adjustments to plant, including a $307,000 reduction to the depreciation expense for removal of the third transformer at the Northeast substation.[187]

DECISION

116. Issue No. 6 asks whether Pepco's Depreciation adjustments are reasonable. Depreciation is the method companies use to recover the original costs of their investments as well as any net salvage. The Commission finds that Pepco's depreciation rates related to its electric distribution and general plant are reasonable for purposes of this proceeding. Pepco's depreciation rates were last adjusted in Formal Case No. 1076 based on the electric distribution and general plant of Pepco as of December 31, 2007. Given the changing nature of depreciation rates and the significant

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185 Pepco (2F) at 4-5 (Hook).

186 Pepco (G) at 7-8 (White).

187 OPC (B) at 49-50.

impact of plant depreciation on utility costs of service, the Commission finds that a more current study, based on the year ending no earlier than December 31, 2011, should accompany any new electric rate application. Accordingly, the Commission directs Pepco to conduct a new depreciation study, which Pepco shall file, together with associated workpapers, at least 90 days prior to its next general rate case filing.

117. OPC represents that since the Company has stated that the depreciation incorporated in its rate application, with the exception of depreciation of AMI meters, is based on the depreciation rates approved by the Commission in Formal Case No. 1076, OPC does not take issue with Pepco's depreciation adjustments. However, OPC made adjustments to certain fall-out issues that resulted from its recommended adjustments to plant, including a $307,000 reduction to the depreciation expense for removal of the third transformer at the Northeast substation. Regarding depreciation associated with the third transformer, OPC's recommendation to reduce depreciation expense by $307,000 is denied because the Commission finds Pepco's rate treatment of the third transformer reasonable. The Commission has addressed all other fall-out issues related to the various adjustments arising from additions to plant and of AMI implementation throughout this Order.[188]

VII. RATE OF RETURN/COST OF CAPITAL[189]

118. As in all base rate proceedings, the Commission must determine a reasonable rate of return including capital costs and the appropriate capital structure for Pepco. We need not discuss in great detail the legal standards and guidelines governing our responsibility to determine a fair and reasonable rate of return and the purpose of that determination. Our continuing basic reliance on *Washington Gas Light Co. v. Public Service Commission,* 450 A.2d 1187, 1209-1215 (D.C. 1982) is amply described in many of our discussions on rate of return in rate cases. In this decision also we will adhere to the standards derived from the Supreme Court's decisions in *Bluefield* and *Hope,*[190] as set forth in *Washington Gas Light Co.*

119. The Company's authorized rate of return is determined by the "cost of capital" method. That method seeks to determine what return the Company must offer its

188 For example, in our discussion of rate base, we addressed OPC's Adjustment No. 13, which recommends that the average test year plant in service balance be reduced by $12.74 million on a D.C. jurisdictional basis and depreciation expense be reduced by $313,000. *See* OPC (B) at 15- 20, OPC (B)-4, Schedule 13 (Ramas). By accepting OPC's adjustment, the Commission has ruled on the appropriate depreciation rate for this adjustment.

189 Designated Issue No. 7 asks, "Are Pepco's requested cost of capital and capital structure reasonable?

190 *Bluefield Waterworks & Improvement Co. v. Pub. Ser. Comm'n,* 262 U.S. 679 (1923); *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591 (1944).

investors to attract capital investment in its stocks and bonds necessary to finance it construction and operations. With these standards forming the backdrop for our consideration of Issue No. 7, we turn to its various components and the evidence presented on the record of this proceeding by the parties.

A. Overall Cost of Capital

The overall costs of capital recommended by the parties to this proceeding are summarized as follows:

	Capitalization	Ratio	Cost Rates	Return
Pepco				
	Long-Term Debt	50.77%	6.60%	3.35%
	Common Equity	49.23%	10.75%	5.29%
		100.00%		8.64%
OPC				
	Short-Term Debt	7.32%	1.0%	0.007%
	Long-Term Debt	45.36%	6.60%	2.99%
	Common Equity	47.31%	9.25%	4.26%
		100.00%		7.32%
AOBA				
	Long-Term Debt	50.77%	6.60%	3.35%
	Common Equity	49.23%	9.20%	4.53%
		100.00%		7.88%
WMATA				
	Long-Term Debt	50.77%	6.60%	3.35%
	Common Equity	49.23%	9.87%	4.86%
		100.00%		8.21%

B. Cost of Common Equity (Issue No.7a)[191]

Pepco

120. Pepco witness Hevert recommends that Pepco be allowed a return on equity ("ROE") of 10.75 percent. Hevert relied on the Constant Growth Discounted Cash Flow ("DCF") method, the Capital Asset Pricing Model ("CAPM") and the Bond Yield Plus Risk Premium approach to determine the Company's ROE giving greater weight to the DCF method since the Commission has relied substantially on the DCF method in arriving at the cost of equity. Although Hevert did not make any explicit numerical

191 Designated Issue No. 7a asks, "What cost of common equity should Pepco be authorized to earn?"

adjustments to the cost of equity, he urges the Commission to take into consideration certain business risks related to Pepco, specifically the regulatory environment in which Pepco operates and the Company's capital investment plan.[192]

121. In preparing to perform his various analyses of Pepco's appropriate return on equity, Hevert selected 10 proxy utilities for his DCF analysis that he deemed comparable to Pepco.[193] The dividend yield in his DCF analysis is based on the proxy companies' current annualized dividend and the average closing stock prices over a 30, 90, and 180-day trading period ending May 31, 2011. He adjusts the dividend yield to account for periodic growth in the dividends by applying one-half of the expected annual dividend growth rate (1 + .5g). This adjustment assumes that dividend increases will be evenly distributed over calendar quarters and is representative of the coming twelve-month period. He calculates the long-term earnings growth rate for the same 30-, 90-, and 180-trading days using Zack's, First Call, and Value Line growth estimates.[194] Pepco's DCF analyses of the ten comparables based on 30-day, 90-day and 180-day average stock prices are as follows:

Constant Growth DCF[195]

	Mean Low	Mean	Mean High
30-day Average Stock Price	9.58%	10.71%	11.87%
90-day Average Stock Price	9.72%	10.85%	12.01%
180-day Average Stock Price	9.83%	10.96%	12.12%

122. Pepco undertakes both a CAPM and Bond Yield plus Risk Premium analysis, in assessing the reasonableness of its DCF results. Pepco qualifies its CAPM results stating that the extraordinary levels of market volatility resulted in a flight to risk-averse investments, *i.e.*, Treasury bonds, resulting in the risk-free rate being lower, in part due to historically low Treasury yields and on a historical basis, the market risk premium being below the pre-financial crisis level of 2008. Consequently, he believes that the market risk premium should reflect current, forward-looking data.[196] Hevert also asserts that beta coefficients reported by Value Line and Bloomberg, which are calculated over 60 and 24 months, respectively, may not be a reasonable measure of current market risk.

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192 Pepco (D) at 55 (Hevert).

193 The companies include American Electric Power; Cleco Corp; Empire District Electric; Great Plain Energy, Inc.; Hawaiian Electric, IDACORP, Inc.; Pinnacle West Capital; Portland General; Southern Company; and Westar Energy. *See* Pepco (D) at 31, Table 4: Final Proxy Group (Hevert).

194 Pepco (D) at 37-40 (Hevert).

195 Pepco (D) at 41, Table 5: DCF Analyses Results (Hevert).

196 Pepco (D) at 43-44 (Hevert).

With those qualifications, Pepco estimates the risk-free rate of 4.34% on the current yield of 30-year Treasury bonds and 4.88% on the near-term projected yields on 30-year Treasury bonds.[197] He did not use a historical average for the Market Risk Premium, but instead developed two forward-looking (ex-ante) estimates, one using the Constant Growth DCF model and the second, a constant Sharpe Ratio. Hevert relies on a twelve-month estimate of the proxy group mean adjusted beta coefficient of 0.732. He argues that its twelve-month calculation period captures a more current period reflective of the current market environment than the Bloomberg two-year period. He opines that the 0.732 beta coefficient is reasonable compared to the levels before the financial market crisis.[198]

123. The Bond Yield Plus Risk Premium approach is based on the principle that equity investors bear the residual risk associated with ownership, and therefore require a premium over the return they would have earned as a bondholder. The Bond Yield Risk Premium is equal to the difference between allowed returns on equity and 30-year Treasury bond yields. Witness Hevert conducts a regression analysis[199] to estimate the relationship between risk premia and interest rates. Allowed returns on equity were derived from 496 electric utility cases (January 1992 through May 2011) as reported in Regulatory Research Associates. The equation's coefficients were significant at the 99.00% confidence interval.[200] From January 1992 through May 2011, the average risk premium was approximately 5.47 percent and the average Treasury yield was approximately 5.57%. Based on regression coefficients derived, however, the risk premium would equal 6.20% when using the current 30-day average of the 30-year Treasury bond yield resulting in a ROE of 10.54%. Based on near- (4.88%) and long- (5.45%) term projections of 30-year Treasury bond yields, the resulting ROE is 10.76% and 10.98%, respectively.[201]

124. Hevert submits that the regulatory environment in which Pepco operates and the Company's extensive capital investment plan should also be considered when arriving at the required cost of equity. It's also important, he states, that the authorized ROE consider the capital market conditions in which Pepco must contend, as well as

197 Pepco (D) at 43-45 (Hevert).

198 Pepco (D) at 41-51.

199 A regression analysis is used to ascertain the casual effect of one variable on another. One typically assesses the statistical significance of the estimate relationship.

200 Pepco states that in order to ensure that the regression coefficients were not biased as a result of serially correlated error terms the equation was also estimated using the Prais-Winston corrective routine. That equation continues to produce a negative slope coefficient and a range of ROE estimates from 10.55% based on the 30-day average of historical 30-year Treasury yield to 10.99% based on the long-term forecast for the 30-year Treasury yield.

201 Pepco (D) at 53-55 (Hevert).

investors' expectations and requirements relating to both risks and returns. He avers that the Company's credit profile is directly affected by the Commission decision regarding the appropriate ROE and capital structure, which, in turn, affects the Company's internal cash flow generation (*i.e.,* Funds Flow from Operations (FFO)) and its ability to meet its financial obligations as they become due. He indicates that S&P currently ranks the District of Columbia as posing greater regulatory risk than any jurisdictions in the proxy group companies.[202]

125. Pepco's witness also contends that the Commission should factor in the Company's capital expenditure plan. Pepco estimates that from 2011 to 2015 it will invest approximately $816.7 million, a 42.88 percent increase over the previous five-year period, in its District of Columbia infrastructure. This substantial capital expenditure plan increases the investment risk and an inadequate authorized return would put downward pressure on key credit metrics.[203] Additionally, the Company will require continued access to external capital, at reasonable terms in order to finance its capital expenditure plan. Pepco's ability to generate internal cash flow and access the capital markets will be directly affected by what happens in this proceeding. When compared to the proxy group companies, it is clear that Pepco's capital expenditure program is accelerating more rapidly than the average of the proxy group companies. The financial community recognizes the additional risks associated with Pepco's significant capital expenditure program and those risks are reflected in market valuation multiples.[204]

Mean ROE Estimates[205]

Ex-Ante CAPM Results with Twelve Month Beta Coefficient

	Sharpe Ratio Derived Market Risk Premium	DCF Derived Market Risk Premium
Current 30-Year Treasury Yield (4.34%)	9.62%	10.44%
Projected 30-Year Treasury Yield (4.88%)	10.17%	10.99%

202 Pepco (D) at 56 -60

203 Pepco (D) at 61.

204 Pepco (D) at 60-65 (Hevert).

205 Pepco (D) at 80, Table 7 (Hevert).

Ex-Ante CAPM Results with Average Bloomberg & Value Line Beta Coefficient

	Sharpe Ratio Derived Market Risk Premium	DCF Derived Market Risk Premium
Current 30-Year Treasury Yield (4.34%)	9.68%	10.50%
Projected 30-Year Treasury Yield (4.88%)	10.22%	11.05%

Bond Yield Plus Risk Premium

	Current (4.34%)	Near-Term Projected (4.88%)	Long-Term Projected (5.45%)
30-Year Treasury Yield	10.54%	10.76%	10.98%

126. Based on the above results, Pepco witness Hevert estimates a ROE of 10.75%.[206] The allowed ROE for other PHI affiliated utilities are: 10.30% for Atlantic City Electric (NJ) with a test year ending March 31, 2011; 9.83% for Pepco (MD) with a test year ending December 31, 2011; 10% for Delmarva Power (MD) with a test year ending December 31, 2010, and 10.0% for Delmarva Power (DE) with a test year ending December 31, 2010.[207]

127. In support of Hevert's recommended ROE, Pepco witness Cannell provides testimony addressing: (1) the investors' perspective of risk due to the investment commitments currently being undertaken by electric utilities in general and Pepco in particular; (2) investors' perception of risk as impacted by current macroeconomic conditions; (3) investors' expectations for a constructive regulatory environment for Pepco so as to ensure the Company's continued access to the capital markets; and (4) investors' expectations for Pepco's ROE.[208] In Cannell's opinion, the Company's requested 10.75% ROE reflects the risk levels in the macroeconomic and capital markets environments, and recognition on the part of both credit agencies and investors that company-specific risks exist. She testifies that a 10.75% authorized ROE would help maintain the Company's financial heath and assist in maintaining access to the debt and equity capital markets.[209]

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206 Pepco (D) at 78 (Hevert).

207 Pepco Exhibit No. 41.

208 Pepco (C) at 3-4 (Cannell).

209 Pepco (C) at 54.

128. **OPC.** OPC witness Woolridge recommends a ROE of 9.0% which includes a BSA adjustment. He utilizes two proxy groups to determine his recommended ROE, the proxy electric utilities utilized by Pepco witness Hevert (Hevert Proxy Group) minus Empire District Electric Co. (removed because Empire suspended quarterly dividends), and a larger set of electric companies, 28 in all, ("Electric Proxy Group") to obtain a better perspective of what ROE would be reasonable for Pepco.[210] According to Dr. Woolridge, the Hevert Proxy Group received 98% of revenues from regulated utility operations, has a S&P BBB bond rating, a current equity ratio of 46.9% and an earned ROE of 9.2%, with median operating revenues and net plant of $2,254.6 million and $6,174.1 million, respectively. For the Electric Proxy Group, the median operating revenues and net plant were $4,078.0 million and $8,678.2 million, respectively. This Group receives 79% of its revenues from regulated operations, has a S&P A-/BBB+ bond rating, a current common equity ratio of 45.4%, and a ROE of 10.3%. Although he uses the Hevert Proxy Group to develop a recommended ROE for Pepco, he notes that Pepco appears less risky based on its bond rating of A (S&P) and A3 (Moody's) than the Hevert Proxy Group and more closer in risk to the Electric Proxy Group. [211]

129. Dr. Woolridge calculates the dividend yields for the proxy groups for the six-month period ending December 2011 using the average of the six-month and December 2011 dividend yields to calculate the spot dividend yield. He then adjusts the spot dividend by 1+.5 g to reflect one-half of the expected growth rate for the upcoming year. For the growth rates, Dr. Woolridge uses *Value Line's* 5-year and 10-year historical growth rates in earnings per share (EPS), dividends per share (DPS), and book value per share (BVPS), *Value Line*'s projected growth rates in EPS, DPS, and BVPS, Yahoo, Reuters and Zack's EPS forecasts, and internally generated growth based on retained earnings and expected returns on equity.[212] Based on the foregoing, Dr. Woolridge calculates the estimated DCF to be 9.4% for the Hevert Group and 9.3% for the Electric Proxy Group. He estimates the CAPM cost of equity for the Hevert and Electric Proxy Groups combined to be 7.6 %, using a risk-free rate of 4.0% (based on yields of U.S. Treasury bonds), a beta of .70 derived from the Hevert and Electric Proxy Groups, and a risk premium of 5.10 percent. Dr. Woolridge states that his 9.0% recommendation is reasonable because the electric utility industry is among the lowest risk industries as measured by Value Line's beta. Capital costs for utilities, as indicated by long-term bond yields, have declined to pre-financial crisis levels, and interest rates and inflation are relatively low.[213]

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210 OPC (C) at 11-12 (Woolridge).

211 OPC (C) at 12-13 (Woolridge).

212 OPC (C) at 28-30 (Woolridge).

213 OPC (C) at 28, 36, 46-48 (Woolridge).

130. Dr. Woolridge maintains that Mr. Hevert's return on equity analysis is too high due to his exclusive use of the forecasted EPS growth rates of Wall Street analysts and Value Line in estimating the growth component in the DCF risk premium approaches. He also expresses a concern with Mr. Hevert's Proxy Group, which he alleges are combination gas and electric utilities. Dr. Woolridge notes that Mr. Hevert exclusively relied upon EPS growth rate forecasts of Wall Street analysts and Value Line. However, those growth rates are overly optimistic and upwardly biased. Using these growth rate forecasts leads to an overstated DCF-based equity cost rate.[214]

131. With regard to Mr. Hevert's CAPM analysis, Dr. Woolridge notes that Mr. Hevert uses risk-free rate 30-year Treasury bond yields of 4.34% and 4.88%, while recent 30-year Treasury bond yields are approximately 3.0%. Hence, Mr. Hevert's CAPM cost of equity estimate is overstated. Mr. Hevert's risk premium estimate is overstated because he used an overstated EPS forecasted growth rate to estimate his DCF estimate for the S&P 500, which then has the 30-year Treasury bond yield subtracted from it to determine the risk premium. The result is an inflated risk premium and inflated CAPM cost of equity estimate. Dr. Woolridge further supports his position by comparing the projected EPS growth rate with historic and projected growth in nominal GDP in the U.S. Long-term nominal GDP growth is about one-half of the EPS growth rate that Mr. Hevert uses in his risk premium analysis. Dr. Woolridge contends that EPS growth tends to lag behind nominal GDP growth. He also criticizes Mr. Hevert's application of the Sharpe Ratio for a risk premium method. In particular, he criticizes Hevert's use of the Chicago Board Options Exchange's one-month volatility index (VIX). According to Dr. Woolridge, the VIX is too short-term to be used in long-term risk premium analysis.[215]

132. Dr. Woolridge observes that Ms. Cannell does not provide any insights into the appropriate allowed ROE for Pepco. He states that Ms. Cannell has performed no empirical studies that compare the business, financial, and overall investment risk of Pepco relative to other electric utilities and/or the companies in the Hevert Proxy Group. Additionally, she has not conducted any studies nor has she cited any empirical studies to support Mr. Hevert's recommendation of a 10.75% allowed ROE.[216]

133. **AOBA.** AOBA witness Oliver recommends a 9.2% ROE assuming a BSA is in place. He uses two proxy groups, the Hevert Proxy Group and the proxy electric group he used for Pepco in Formal Case No. 1076 ("AOBA Proxy Group"). The AOBA Proxy Group relies less on the data for vertically-integrated companies and more

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214 OPC (C) at 48- 52.

215 OPC (C) at 63-69.

216 OPC (C) at 70-71.

on the data for eastern utilities with substantial distribution operations. Mr. Oliver also uses the 5-year earnings growth rate projections from Thomson Financial Network, Zack's, and Value Line. The average growth rates using the above sources were 4.63% and 6.29% for the Hevert Proxy Group and AOBA Proxy Group, respectively. Oliver's DCF analysis results an average cost of equity estimate of 9.43%. [217]

134. Oliver also performed a CAPM analysis for both proxy groups. For the AOBA Proxy Group he determined a CAPM cost of equity range of 9.65% to 10.45%. For the Hevert Proxy group, he determined a CAPM cost of equity range of 9.55 percent to 10.35 percent. He uses betas of 0.69 - 0.71, a risk-free rate of 4.75 percent and risk premia in the range of 7% to 8% for these two proxy groups. For his PHI specific CAPM cost of equity analysis he uses a 0.80 beta and the same risk-free and risk premia that he uses for his two proxy groups. The average of his CAPM results in a 10.34% ROE.[218]

135. The average of Oliver's DCF and CAPM analysis is a ROE of 9.89%. Thereafter, he made two downward adjustments: the first, a 50 basis point adjust to reflect the BSA; and the second, a 20 basis point adjustment to reflect the greater risks associated with the generation activities of vertically integrated companies and the increased risk that can be attributed to the holding companies' unregulated business activities. These two types of activities are present in the proxy groups, but not with Pepco. Consequently, he recommends a ROE of 9.20 %.[219]

136. Oliver disagrees with the Hevert Proxy Group contending that it contains utilities from the western United States, which do not share Pepco's eastern urban/suburban characteristics. He also maintains that there is a general lack of comparability of PHI or Pepco with the companies that carry the greatest weight within the S&P 500 and that PHI is relatively attractive in comparison. He notes that Pepco witness Hevert's claim that there is a trend in capital expenditures for the Hevert Proxy Group is not compelling and that Pepco's planned increases in distribution expenditures do not appear to be matched by any of the companies in the Hevert Proxy Group.[220]

137. **WMATA.** Dr. Foster bases his recommended ROE upon the ROEs of two selected groups of electric utilities. His first group represents 93 rate cases during 2010 and 2011 with an average allowed ROE of 10.28%. His second group is composed of 20

217 AOBA (A) at 36-37 (Oliver).

218 AOBA (A) at 36-37; *see also,* AOBA (A)-5 at 3-4.

219 AOBA (A) at 36-37. It appears that AOBA witness Oliver mislabeled his exhibit AOBA (A)-5. The label reads "Recent Orders" and should read "CAPM."

220 AOBA (A) at 31-34.

comparable transmission and distribution electric utilities. The average allowed ROE for those 20 companies is 9.96%.[221]

138. Dr. Foster recommends a range of 9.78% to 9.9% for the allowed ROE. The 9.78% is derived from the first group's average ROE (10.28%) less a downward adjustment of 50 basis points for the BSA. The 9.96% is derived from the second group without a BSA adjustment. He did not make a BSA adjustment for the second group's allowed ROE since some of the companies in that group already have an adjustment similar to the BSA already reflected in their allowed ROEs. In order to make a fair comparison, no BSA adjustment should be made to that group. He believes that Pepco is less risky than many electric utilities because Pepco has no generating facilities, while most of the electric utilities have generating facilities. Generation is more risky than transmission and distribution.[222] Dr. Foster opines that Pepco has a less risky costumer profile than other electric utilities because it has a relatively large stable commercial class. Because the Washington Metropolitan area is relatively affluent and has not experienced the economic recession to the degree that the rest of the U.S. has, Pepco's business risk is less than other electric utilities.[223]

139. **Pepco Rebuttal.** Pepco witness Hevert updated his return on equity analysis; however, he did not change his recommended ROE of 10.75%. As part of his updated analysis, he removed Empire District Electric Company due to its recent suspension of dividend. He also performed a multi-stage form of the DCF model in which Pepco's stock price is set equal to the present value of future cash flows received over three stages. In the first two stages, cash flows are defined as projected dividends; while in the third stage, cash flows are defined as both dividends and the terminal stock price.[224] Hevert's updated analysis is shown as follows:

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221 WMATA (A) at 6-10; WMATA (A)-2 (Foster).

222 WMATA (A) at 6 (Foster).

223 WMATA (A) at 6-12.

224 Pepco (3D) at 2-4, 37-43 (Hevert Rebuttal).

Mr. Hevert Rebuttal Testimony Mean ROE Estimates[225]

Constant Growth DCF Results

Constant Growth DCF	Mean Low Results	Mean Results	Mean High Results
30-day Average Stock Price	9.25%	10.42%	11.52%
90-day Average Stock Price	9.37%	10.54%	11.65%
180-day Average Stock Price	9.40%	10.57%	11.67%
Multi-Stage DCF			
30-day Average Stock Price	9.96%	10.68%	11.23%
90-day Average Stock Price	10.07%	10.83%	11.48%
180-day Average Stock Price	10.24%	10.88%	11.41%

Ex-Ante CAPM Results with Eighteen Month Beta Coefficient

	Sharpe Ratio Derived Market Risk Premium	DCF Derived Market Risk Premium
Current 30-Year Treasury Yield (3.09%)	10.40%	10.09%
Projected 30-Year Treasury Yield (3.60%)	10.81%	10.51%

Ex-Ante CAPM Results with Bloomberg Beta Coefficient

	Sharpe Ratio Derived Market Risk Premium	DCF Derived Market Risk Premium
Current 30-Year Treasury Yield (3.09%)	10.91%	10.58%
Near Term Projected 30-Year Treasury Yield (3.60%)	11.33%	11.00%

225 Pepco (3D) at 3.

Ex-Ante CAPM Results with Value Line Beta Coefficient

	Sharpe Ratio Derived Market Risk Premium	DCF Derived Market Risk Premium
Current 30-Year Treasury Yield (3.09%)	10.36%	10.06%
Near Term Projected 30-Year Treasury Yield (3.60%)	10.78%	10.48%

Bond Yield Plus Risk Premium

	Current (3.01%)	Near-Term Projected (3.43%)	Long-Term Projected (5.30%)
30-Year Treasury Yield	10.03%	10.19%	10.93%

140. Pepco witness Hevert maintains that Dr. Woolridge's 9.0% ROE recommendation is incompatible with current market conditions and investor return requirements. As it relates to Woolridge's DCF growth rate estimates, Hevert argues that analyst-projected EPS growth rate estimates are valid, relied upon by investors and can be exclusively relied upon in this case. Contrary to Dr. Woolridge's position, analyst-projected EPS growth rate estimates are not upwardly biased. He states that dividends per share (DPS) or book value per share (BVPS) growth rates are not appropriate measures of growth for the constant DCF model. He asserts that EPS is more appropriate because earnings are the fundamental driver of a company's ability to pay dividends and because his regression analyses show that the only statistically significant variable in explaining his proxy companies' valuation levels is the projected EPS growth rate. He also disagrees with Dr. Woolridge's use of the sustainable growth rate in his DCF analysis because it fails to include external growth from stock issuance, and because the earned ROE projections are diminished because of the lag between additions to net plant and recovery in rates of the additions.[226]

141. Hevert also disagrees with Dr. Woolridge's CAPM analysis. On its face, Dr. Woolridge's CAPM estimate of 7.60% is only a 100 basis point premium over Pepco's cost of debt and is unreliable. Hevert updated his CAPM analysis to reflect current Treasury yields and different risk premia. With regard to the calculation of "beta" coefficients, Mr. Hevert believes the beta coefficients should come from a variety of sources rather than just one as Dr. Woolridge relied upon. Generally, Hevert's beta estimate is the same as Dr. Woolridge (0.70) with the exception of the Bloomberg beta of 0.752. Hevert also disagrees with Dr. Woolridge's estimate of risk premium in the

226 Pepco (3D) at 14, 17-27, 32-35 (Hevert Rebuttal).

CAPM model and claims that it is so low as to result in ROE estimates that are below Pepco's cost of debt.[227]

142. Hevert disagrees with Dr. Woolridge's assertion that a market price-to-book value ratio in excess of one indicates that the subject company is earning a ROE in excess of its cost of equity. He notes that there are many variables beyond earned equity returns that influence market to book ratios such as expected ROEs, expected dividend growth, dividend yield, standard deviation, earnings quality, regulatory climate, accounting conventions, and financial, business, and regulatory risk variables.[228]

143. Pepco witness Cannell believes that OPC's and AOBA's respective 9.0% and 9.2% ROE recommendations would be seen as inadequate to meet investors' requirement for risk compensation.[229] Pepco witness Kamerick believes that the recommended ROEs of all of the other parties are well below the national average. Of the 136 ROE decisions reported by Regulatory Research Associates for the 2009-2011 period, all but three are higher than OPC's and AOBA's recommendations, with only one being lower than these proposals. In addition, 90% of these 136 decisions are higher than WMATA's proposal.[230]

144. Hevert believes that AOBA witness Oliver's 9.2% ROE recommendation is incompatible with the level of volatility and risk aversion that continue to persist in the capital markets.[231] Initially, he disagrees with Oliver's proxy group composition because he fails to explain the screening criteria and because some of the companies derive a significant portion of their earnings from natural gas operations. While Oliver uses analyst-projected EPS growth rates, Hevert claims that he made a transposition error in his Exhibit AOBA (A)-5, page 1-2 calculations which results in an under-estimate of the DCF growth rates in Oliver's application of the DCF method to the Hevert proxy group correction resulting in Oliver's average DCF estimate of 10.35%. While he disagrees with Oliver's sole reliance on beta coefficients from *Value Line,* he believes that Oliver's estimates are within the range of the CAPM estimates included in Hevert's direct and rebuttal testimonies. He disagrees with Oliver's proposed 20 basis point downward adjustment in the allowed ROE to reflect the greater risk associated with the proxy companies having vertically integrated and unregulated activities. Hevert states that it is not possible to select a proxy group of comparable transmission and distribution utilities

227 Pepco (3D) at 44-51 (Hevert Rebuttal).

228 Pepco (3D) at 51- 56.

229 Pepco (3C) at 3 -4 (Cannell Rebuttal).

230 Pepco (3A) at 7 (Kamerick Rebuttal).

231 Pepco (3D) at 59-60 (Hevert Rebuttal).

at this time. Further, Hevert's screening criteria ensures that the proxy group is comparable in risk to Pepco.[232]

145. Finally, Hevert does not agree with WMATA witness Foster's use of allowed ROEs from around the country as the sole basis for estimating Pepco's cost of equity.[233]

Summary of Positions

A summary of the allowed ROE recommendations, before adjustments for BSA or RIM are as follows:

Party	ROE
Pepco	10.75%
OPC	9.0%-9.4%
AOBA	9.9%
WMATA	9.96%-10.28%

DECISION

146. In prior decisions, the Commission has relied primarily upon the DCF method to determine a utility's cost of common equity, because the Commission has consistently found the DCF method produces more reasonable results than other cost of equity methods. Nevertheless, the Commission's preference for the DCF model does not preclude consideration of other methods for calculating the cost of equity in some instances. The Commission's reliance on the DCF method does not foreclose parties from advocating the use of other methods.[234] In addition, in determining the just and reasonable cost of equity, the Commission considers the entire record, which may include comparative results derived from other models.

147. The DCF methods start with the determination of a risk-comparable sample. Given the positive correlation between risk and required return on equity, the companies in the risk-comparable sample should have approximately the same cost of equity. In this case, Pepco's Witness Hevert used a proxy group of ten companies. Included in this proxy group are vertically integrated utilities as well as utilities from the western U.S. AOBA Witness Oliver used two proxy groups in his DCF analysis: the

232 *Id.* at 61-70.

233 *Id.* at 72.

234 *See Formal Case No. 1076,* Order No. 15710, ¶ 70.

Hevert Proxy Group and the same Proxy Group he used for Pepco in Formal Case No. 1076. That latter proxy group makes less use of data for vertically integrated companies and greater use of data for eastern utilities with substantial distribution operations. OPC Witness Woolridge used two proxy groups: the Hevert Proxy Group, excluding Empire District Electric Co., and an Electric Proxy Group, comprised of 28 electric utilities. WMATA's witness used two proxy groups: 93 electric utility rate cases from 2010 and 2011 and 20 comparable transmission and distribution electric utilities.

148. In the DCF method, there are two primary components: the expected dividend yield and the expected growth rate. There is very little dispute over the dividend yield. However, there is significant disagreement over the expected growth rate. In this case, the unadjusted dividend yields calculated by all of the parties are in the range of 4.24% to 4.72%. The DCF formula adjusts the unadjusted dividend yield by a growth rate factor. Witnesses Woolridge and Hevert uses the multiplicative adjustment factor "1 + .5g" where "g" is the growth rate. It is unclear what adjustment factor Witness Oliver used, but it appears to be close to the "1+.5g" adjustment factor. In this case, the Commission decides to use the "1 + .5g" adjustment factor. Because of the significant differences in "g" among the witnesses, the adjusted dividend yields may encompass a broader range than the unadjusted dividend yields.

149. Regarding the second component of the DCF method, there are significant differences among witnesses concerning the expected growth rate. Each of the witnesses is attempting to determine the growth rate expected by investors in the stock market. The DCF growth rate is the investor-expected growth rate in dividends per share. However, investors may develop their growth rate expectations based on historical and projected data, dividends per share (DPS), earnings per share (EPS), and book value per share (BVPS). Hevert relies upon projections of EPS over the next 5 years by Zacks, *Value Line*, and First Call, and developed a DCF growth rate of 6.13% (6.05% in his rebuttal testimony). AOBA Witness Oliver also uses EPS projected growth rates from Zacks, *Value Line*, and Thompson Financial Network analysts with a growth rate range of 4.26% to 5.19% (4.26% to 6.65% with the correction for transposition error). OPC Witness Woolridge uses a wider variety of growth rates in his analysis. He used historic and projected growth rates in EPS, DPS, and BVPS from *Value Line,* projected EPS growth from First Call, Zacks, and Reuters, and sustainable growth rates. Dr. Woolridge explains that the sustainable growth rate is calculated as the expected return on equity times the retention rate (percentage of retained earnings). His DCF growth rate is 4.75%. WMATA Witness Foster did not perform a DCF analysis.

150. The range of DCF estimates are: 10.42% to 10.85% by Pepco; 9.3% to 9.4% by OPC; and 10.35% by AOBA.

151. Pepco, OPC and AOBA also performed risk premium analyses. Pepco Witness Hevert performed a Capital Asset Pricing Model (CAPM) analysis which produced a cost of equity range from 10.09% to 11.33%. This is in sharp contrast to OPC Witness Woolridge's CAPM result of 7.6%. The primary difference between Hevert's and Woolridge's CAPM results is that Woolridge uses a risk premium of 5.0%, while Mr. Hevert uses a risk premium of 10.06% to 10.50%. As it relates to the risk-free rates, Dr. Woolridge uses 4.0%, and Hevert revised his estimates and uses a lower 3.09%-3.60% range (on rebuttal). There was little difference in the beta estimates of the witnesses with Dr. Woolridge using .70 and Mr. Hevert using .70 to 75. AOBA Witness Oliver obtains a CAPM estimate of 10.34% using a risk-free rate of 4.75%, a beta of .70, and a risk premium of 5.48% to 5.70%.

152. The parties CAPM results are summarized as follows: 10.09% to 11.33% (Pepco), 7.6% (OPC), and 10.34% (AOBA). Mr. Hevert also used a "Bond Yield plus Risk Premium Approach" and obtained a cost of equity range of 10.03% to 10.93%. None of the other witnesses performed an analogous analysis. WMATA Witness Foster bases his analysis on the allowed return on equity of his two proxy groups with a range of 9.96% to 10.28%.

153. AOBA Witness Oliver makes a 20 basis point downward adjustment to account for the greater risk associated with the generation activities of vertically integrated companies and the increased risk that can be attributed to holding companies' unregulated business activities. According to him, these two types of activities are present in the Proxy Groups but not present in Pepco's distribution operations.

154. In evaluating these estimates, the Commission determines that: (1) projected EPS growth rates are overstated and should not be exclusively relied upon; (2) more weight should be given to the DCF method because of the instability of risk premia in the CAPM and other risk premium methods; and (3) in setting the allowed ROE, it may be appropriate to recognize that many of the proxy group companies have generation or unregulated operations. Based on this, we determine that Pepco's DCF estimate is inflated because of its sole reliance on projected EPS growth rates and its inclusion of vertically-integrated firms in the risk-comparable sample.

155. Because of that, Dr. Woolridge's and Mr. Oliver's DCF results of approximately 9.4% to 10.35% and Mr. Hevert's "Mean Low Results" of 9.25% to 10.24% are given more weight in our determination. In weighing the results of the various methodologies, we conclude that, based on the record evidence, an allowed rate of return on common equity ranging from 9.75% to 10.25%, exclusive of a BSA adjustment, constitutes a range of reasonableness for purposes of this proceeding. We also find that this ROE is consistent with the range of allowed ROE range reflected in

Regulatory Research Associates published allowed ROEs as presented by WMATA witness Foster.

156. It has been the Commission's practice to use the midpoint of the range of reasonableness as the ROE. Thus, we believe that an allowed ROE of 10.00% (9.50 percent with BSA) is more appropriate in this proceeding to reflect the Commission's desire for continued improvement in the quality and reliability of Pepco's service, the economy of the District of Columbia, and the impact of both on citizenry and businesses of the District of Columbia. This allowed ROE is within the range of reasonableness. Moreover, the case law is well-settled that the establishment of a rate of return on common equity at any point within the range of reasonableness is clearly within the Commission's statutory authority to set, just, reasonable, and nondiscriminatory rates.[235] The ROE we adopt balances the needs of Pepco and the interests of the ratepayers of the District of Columbia.

C. Cost of Debt[236]

157. **Pepco.** Pepco calculates its cost of long-term debt to be 6.60%. Pepco states the cost of long-term debt was obtained from Company-specific contractual interest payments associated with the debt. The cost rate calculation methods are consistent with the methods approved by the Commission in prior rate proceedings and recently utilized in Formal Case No. 1076.[237]

158. **OPC.** OPC does not challenge the Company's proposed long-term debt cost rate of 6.60%. However, OPC recommends that the Commission adopt short term debt at a rate of 1% based on the current three-month LIBOR of 0.50% and an additional 50 basis points to cover the Credit Facility costs.[238]

159. **AOBA.** AOBA accepts Pepco's cost of long-term debt. However it contends that Pepco should be required to refinance its December 2008 bonds with an effective cost rate of 8.04%, while interest rates are at or near historical low levels.[239]

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235 *See Federal Power Commission v. Hope,* 320 U.S. 591, 64 S.Ct. 281 (1944); *Federal Power Commission v. Natural Gas Pipeline,* 315 U.S. 585, 586; *see also Permian Basin Area Rate Cases,* 390 U.S. 747, 767, 806-813, 88 S. Ct. 1114 (1967).

236 Designated Issue No. 7b asks, "Has Pepco properly determined its cost of debt?"

237 Pepco (E) at 9, Pepco (2E) at 3, Pepco (E)-3 and (E)-4 (McGowan).

238 OPC (C) at 15 (Woolridge).

239 AOBA (A) at 38 (Oliver).

160. **Pepco Rebuttal.** Pepco responds to AOBA's request stating that, because of the make-whole provision associated with the December 2008 bonds, it would not be in ratepayers' best interest to refinance the bonds. Pepco maintains that refinancing the bonds would result in a negative net present value of approximately $27 million. This will result in increased costs to Pepco customers.[240]

DECISION

161. The Commission traditionally has adopted a cost of debt that is reasonable and accurately reflects the Company's costs. Pepco presents evidence that its current cost of long-term debt is both. OPC presents no support for its inclusion of short-term debt. AOBA also offers no persuasive support for its recommendation that Pepco refinance its December 2008 bonds (which have a cost rate of 8.04%) since interest rates are currently at or near historical all time lows.

162. In *Formal Case No. 1076*, AOBA argued the issuance of the December 2008 bonds was imprudent, because the cost rate was 140 basis points greater than that of any of Pepco's other bonds. Pepco stated that the market warranted the issuance of long-term debt at that time; short-term credit was tight; banks and other liquidity-constrained companies were being downgraded; commercial paper market was severely constrained; and Pepco could not issue commercial paper. Because of the uncertainty in the capital markets, Pepco made a decision to pre-fund its anticipated 2009 funding needs when the market allowed, in December 2008.[241] The Commission found that there was nothing in the record to suggest that Pepco's action was imprudent at the time the decision to issue the bonds was made, nor was there any basis to assume at that time that the credit market conditions would improve in the near term. AOBA provided no evidence in that case that the issuance was imprudent when made.

163. We do not determine prudence based on 20-20 hindsight, but whether the issuance was reasonable at the time. Moreover, we are persuaded in this proceeding that the make-whole provision included in the terms of the bonds makes it disadvantageous to refinance the bonds. AOBA provides no evidence otherwise. According to Pepco, refinancing the bonds would result in a negative net present value of approximately $27 million which will result in increased costs for ratepayers. Based on the foregoing, the Commission accepts Pepco's cost of long-term debt of 6.60%.

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[240] Pepco (3E) at 12-13 (McGowan Rebuttal).

[241] *Formal Case No. 1076*, Order No15710, ¶¶ 81-82.

D. Capital Structure[242]

164. **Pepco.** Pepco uses an actual capital structure as of March 31, 2011. Pepco contends that the Company's proposed capital structure is consistent with the Company's goals and objectives and is necessary to maintain its current credit ratings. Pepco further asserts that the proposed capital structure is reasonable given a mean common equity ratio of 51.21% (range between 47.44% and 58.72%) for the proxy group companies identified by the Company. The Company also states that the proposed equity ratio is consistent with those of similar electric utilities referenced by Regulatory Research Associates (April 2011 edition) and *Value Line* (published May 27, 2011). For 2010 and 2011 year-to-date, Regulatory Research Associates reported medians of 49.36% and 49.37% for the common equity ratios of electric utilities while Value Line's forecasted range was from 49.0% to 49.5% for the average equity ratio of the electric utilities on the east coast.[243]

165. **OPC.** OPC proposes that the Commission adopt the average quarterly capital structure for PHI for the four quarters ending September 30, 2011, which consists of 7.32% short-term debt, 45.36% long-term debt, and 47.31% common equity. OPC contends this capital structure is reflective of the capitalization ratios for the Hevert Proxy Group and includes short-term debt, which is normal for PHI. OPC proposes that the short-term debt cost rate be set at 1%, an additional 50 basis points more than the London Bank Offered Rate ("LIBOR") to cover credit facility fees.[244] Dr. Woolridge contends that Pepco's capital is not consistent with those in the Hevert Proxy Group. He states the average capital structure for the Hevert Proxy Group is 46.6% common equity, while the capital structure proposed in this proceeding is 49.23% common equity. He also recommends that Pepco's capital structure be based on the parent company's capital structure just like his proxy group and not the operating subsidiaries.[245]

166. **AOBA.** AOBA agrees that Pepco's proposed capital structure reasonably comport with Pepco's average capital structure for the five quarters ending September 30, 2011, and adjusted for the unamortized amount of debt issuance costs and debt reacquisition costs.[246] AOBA witness Oliver contends that little weight should be given to Pepco witness McGowan's contention that Pepco's proposed capital structure is

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242 Designated Issue 7c asks, "Is the capital structure that Pepco uses to develop its overall cost of capital reasonable and appropriate?"

243 Pepco (E) at 5-6, Pepco (2E) at 3-4, Pepco (E)-2 (McGowan).

244 OPC (C) at 14-15, OPC (C)-5 (Woolridge).

245 *Id.* at 49.

246 AOBA at 27 (Oliver).

necessary to maintain its credit rating. He also disagrees with Hevert's contention that Pepco's proposed common equity percentage compares favorably with those of other electric utilities.[247]

167. **WMATA.** WMATA accepts the capital structure of Pepco as proposed.[248]

168. **Pepco Rebuttal.** Pepco opposes the capital structure proposed by OPC witness Woolridge because it uses the consolidated capital structure of the holding company rather than the operating company's capital structure. The Company contends that the use of a consolidated capital structure reflects the financing requirements associated with non-regulated operations and that Pepco's capital structure is well within the bounds of the proxy companies holding company equity ratios for the quarter ended September 30, 2011.[249] Pepco witness McGowan notes that the Commission adopted the specific capital structure of Pepco in both Formal Case Nos. 1053 and 1076. He also notes that short-term debt is not considered permanent financing. He alleges that Woolridge's capital structure calculation includes several errors which if corrected will result in common equity ratios for Pepco consolidated of 50.1%, including short-term debt, and 52.3% excluding short-term debt. In light of this, Pepco's proposed capital structure is reasonable.[250]

DECISION

169. The issue before the Commission is the reasonableness of Pepco's capital structure, not the attempted identification of a theoretically optimum capital structure for Pepco. The Commission's general policy is to use the Company's capital structure, unless it would lead to an unreasonable return. In reviewing the capital structure, the Commission has typically determined the reasonableness of a company's capital structure by comparison to industry averages, including a review of the proxy group from which the return on equity is derived, to determine if the Company's equity ratio is beyond the range of reasonableness in comparison to the proxy group. There is no basis to depart from our policy in this proceeding. No party has presented any persuasive testimony that Pepco's capital structure is unreasonable. They merely present alternative capital structures. As long as we find Pepco's capital structure reasonable, it does not matter that there may be alternatives that also may be reasonable. OPC recommends that we impute short-term debt into Pepco's capital structure. However, the Company does not use

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247 *Id.* at 24-25.

248 WMATA (A)-3 (Foster).

249 Pepco (3D) at 94-97 (Hevert Rebuttal).

250 Pepco (3E) at 4-7 (McGowan Rebuttal).

short-term debt for permanent financing. Neither OPC nor AOBA have presented any convincing evidence showing that Pepco's capital structure is unreasonable. There may come a time that the Commission may want to reconsider this position, but it sees no reason to do so now.

E. Bill Stabilization Adjustment[251]

170. **Pepco.** Pepco maintains that a 50 basis point reduction in the ROE is not warranted. Pepco argues that the fact that the Company's revenues may be affected by the BSA[252] does not bear on the estimated cost of equity unless it can be demonstrated that: (1) the Company is materially less risky than the proxy group by virtue of the BSA; and (2) the financial markets react to the incremental effect of the mechanism. Pepco argues that revenue stabilization structures are becoming increasingly common. Revenue decoupling has been implemented by electric utilities in 18 states. In fact, Pepco asserts revenue stabilization mechanisms are in effect for many of the proxy companies.

171. Moreover, Pepco states that public policy has placed an increased focus on alternative regulation and revenue stabilization structures, and as such, base rate proceedings are not the only forum in which investors and analysts are made aware of the issue. The implementation of alternative regulation mechanisms has become increasingly visible to investors. Equity and credit analysts consider revenue stabilization mechanisms as a component in their overall risk assessment of a subject company. Therefore, it is safe to assume that the effect, if any, of revenue stabilization mechanisms are reflected in proxy companies' market prices. Pepco witness Hevert states that in his review of 35 utility cases in other jurisdictions, no commission has made explicit adjustments to the authorized ROE in response to the implementation of decoupling mechanisms and of those jurisdictions that made explicit adjustments, only the District and Maryland made 50 basis points adjustments, the remaining four cases resulted in adjustments of 10 to 25 basis points.[253]

172. The fact that more than half of the commissions did not make a specific adjustment to the authorized ROE is information that is available to, and considered by, investors. With the exception of the Maryland Public Service Commission and the

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251 Designated Issue 7d asks, "Should Pepco's authorized Return on Equity ("ROE") be adjusted for a Bill Stabilization Adjustment ("BSA") and, if so, by how many basis points?"

252 The BSA decouples Pepco's revenues from kilowatt-hour sales, tracks monthly under- or over-collection in the Company's authorized revenue requirement by customer class and adjusts the customer's distribution rate for these historical variations in revenue. The BSA credit or surcharge is capped at 10% of the test-year average base rate for the month. If the surcharge or credit exceeds the cap, the difference is carried over to the next month.

253 Pepco (D) at 73 (Hevert).

District, the most prevalent adjustment for implementation of a decoupling mechanism is 10 basis points. Investors consider the range of revenue stabilization and cost recovery mechanisms in place at a utility company. They do not consider a specific mechanism in isolation. Thus he concludes that the BSA should have no effect on the recommended ROE.[254]

173. **OPC.** Dr. Woolridge recommends a 20 basis point downward adjustment to his estimate of ROE. Although Dr. Woolridge does not explicitly state the magnitude of the downward adjustment, based on his recommended cost of equity range of 9.0% to 9.4%, with a midpoint of 9.2%, one can infer this 20 basis point adjustment from his 9.0% recommended ROE.[255]

174. **AOBA.** AOBA's witness Oliver contends that there should be a downward adjustment to PEPCO's ROE of 50 basis points if the BSA is adopted.[256]

175. **WMATA.** Dr. Foster makes a downward adjustment of 50 basis points to the upper part of the range of his first group of electric utilities. He does not make a BSA adjustment to his second proxy group since some of the companies in the group already have an adjustment similar to the BSA already reflected in their allowed ROEs.[257]

176. **Pepco Rebuttal.** Pepco witness Hevert contends that the proxy companies that he relies upon already reflect the effects of risk-mitigating adjustments similar to the BSA. He notes that since Formal Case No. 1076, there have been decoupling mechanisms approved with no specific ROE adjustment. He alleges that according to a survey conducted by the Brattle Group, utilities with decoupling mechanisms had a slightly higher cost of capital than those without decoupling mechanisms. He asserts that he is not aware of any companies that had a multiple notch increase in their credit rating as a result of the implementation of decoupling mechanisms.[258]

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254 Pepco (D) at 67-74 (Hevert).

255 OPC (C) at 47 (Woolridge).

256 AOBA (A) at 32 (Oliver).

257 WMATA (A) at 12-13 (Foster).

258 Pepco (3D) at 79, 84-90 (Hevert Rebuttal).

DECISION

177. The Commission finds that it is appropriate to maintain a 50 basis point downward adjustment to Pepco's authorized ROE in light of our approval of a continuing BSA. The BSA insulates Pepco from losing revenue, and also results in lower Pepco business risk and a lower cost of capital. The benefit flowing to the utility and its shareholders as a result of the BSA requires a concomitant benefit to ratepayers who are essentially guaranteeing that the utility will collect its revenue per customer as determined in its last base rate case. A downward adjustment to the allowed ROE to reflect the BSA provides the appropriate balancing of stockholder and ratepayer interests in this case.[259]

F. RIM Adjustment[260]

178. **Pepco.** Pepco states that it does not believe an adjustment to its authorized ROE is appropriate for the same reasons an adjustment is inappropriate for the BSA.[261] Pepco contends unless the implementation of a RIM-type mechanism can be shown to have a demonstrable and measurable effect on the risk of the Company relative to its peers, then an ROE adjustment is unwarranted.[262] Pepco again states that capital expenditure recovery mechanisms (for gas and electric utilities) are in effect in more than 25 states. While the recovery of capital expenditures was not the focus of these cost recovery mechanisms, revenue stabilization mechanisms and cost trackers (which serve a purpose similar to the RIM) are currently in effect at each of the electric subsidiaries of the proxy group companies as well.[263] In the absence of a RIM, Pepco argues that its ROE should be increased since many of its peers have investment recovery mechanisms in place. A reduction in the ROE would counteract one of the main purposes of the RIM,

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[259] In *Formal Case No. 1053*, the Commission established a 50 basis point reduction in the ROE, stating that "implementation of the BSA insulates Pepco from losing revenues which, in turn, lowers the Company's business risk and results in a lower cost of capital." *See Formal Case No. 1053*, Order No. 15556, ¶ 30 (September 9, 2009). Subsequently, in *Formal Case No. 1076*, the Commission reaffirmed the 50 basis point reduction in the ROE. *See Formal Case No. 1076*, Order No. 15710, ¶ 110 (March 2, 2010). The BSA will continue after this rate case. Obviously, a new test year will be used for future BSA calculation.

[260] Designated Issue No. 7e asks, "Should Pepco's authorized ROE be adjusted for a RIM or alternative cost recovery mechanism, and if so, by how many basis points?"

[261] Pepco (2D) at 2-10, Pepco (D)-8 and (2D)-1 (Hevert).

[262] Pepco (2D) at 3-4 (Hevert).

[263] Pepco (2D) at 4-5; Pepco (2D)-1 (Hevert)

to mitigate regulatory lag and to allow the Company a better opportunity to earn its allowed ROE.[264]

179. **OPC.** Because OPC is fundamentally opposed to a RIM mechanism of any kind, it proposes no adjustment.

180. **AOBA.** AOBA believes that because of possible countervailing factors there should be no adjustment to reflect the RIM.[265]

181. **WMATA** recommends a 10 basis point downward adjustment to the allowed ROE if a RIM is approved.[266]

DECISION

182. Because the Commission is denying Pepco's request for a RIM (see discussion *infra*), consideration of a RIM adjustment to the ROE is moot.

VIII. PHI SERVICE COMPANY COSTS[267]

183. **Pepco.** Pepco witness White maintains that the charges from the Service Company are fair and reasonable and in accordance with the Company's Cost Allocation Manual ("CAM") that was filed with the Commission on April 30, 2011. The CAM has been independently examined by PriceWaterhouseCoopers who found that the Service Company allocations and charges to be consistent with the CAM and Service Agreement.[268]

184. White explains that PHI uses the full costing method (fully distributed cost alignment method) in which both direct and indirect costs are indentified and charged for goods and services. As described in the CAM, the principle for assigning both direct and indirect costs to PHI affiliates is based on a three-tiered approach. First, the specific PHI affiliate will be directly assigned when practical. Pepco states direct assignment accounts for the majority of PHI operating costs, e.g., overhead linemen and associated materials

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264 Pepco (2A) at 4 (Kamerick Rebuttal).

265 AOBA (A) at 35 (Oliver).

266 WMATA (A) at 16 (Foster).

267 Designated Issue No. 8 asks, "Are the PHI Service Company costs charged by Pepco reasonable?"

268 Pepco (G) at 6-7 Pepco (2G) at 2 (White Supp).

and contractors, are directly recorded in the utilities' books and records, while shared services such as corporate accounting are directly recorded in the Service Company books and records.

185. Second, certain Service Company costs are directly charged to the operating company because the costs are related to services performed on behalf of that affiliate. For example, work performed on a specific utility's compliance filing will be directly charge to that utility. Third, other shared services that are not directly chargeable to an operating company (because the service benefits multiple companies) are allocated based on one of the allocation methods included in PHI's Service Agreement, such as the preparation of PHI's annual SEC 10-K annual report which benefits many companies. In limited cases, costs incurred by an affiliated company on behalf of another affiliate are directly charged to the benefiting affiliate based on the full costing method.[269]

186. According to Pepco witness Kamerick, the Company asserts that the charges from PHI's Service Company, the majority of which are allocated to administrative and general ("A&G) expenses, are fair and reasonable in accordance with PHI's CAM,[270] and competitive when compared to other similar utilities. Pepco maintains that its A&G costs as a percentage of retail revenues was 5.6% while the average A&G costs of a peer group of utilities was 9.5% of retail revenues. Pepco states that A&G cost as a percentage of net plant was 3.5%; while that of the peer group was 4.6%. Kamerick contends that an independent examination by outside auditors found the charges and allocations to be consistent with the CAM and the Service Agreement, and reasonable when compared to peer companies. After PHI completed the sale of Conectiv Energy and divested itself of Pepco Energy Services ("PES") retail energy supply business, PHI embarked on a reorganization (the Organizational Review Project ("ORP"))[271] to "right size," *i.e.*, reduce personnel and the use of outside contractors to lower costs, which resulted in a saving of nearly $28 million. Kamerick represents that as a result of the sale of Conectiv and the divestiture of PES, approximately $20 million of costs that were previously allocated to Conectiv will still remain. Kamerick concludes that as a result of a Cost Containment Survey, the Company has embarked on a number of initiatives to mitigate rising costs.[272]

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269 Pepco (G) at 4-6 (White).

270 The Company filed its most recent CAM on April 30, 2011.

271 The ORP resulted in the elimination of 171 full time equivalent positions at the Service Company which would offset the costs increases to the remaining affiliates.

272 Pepco (A) at 24-30 (Kamerick), Pepco (A)-1, -2 (Kamerick); Pepco (2A) -5 (Kamerick); Pepco (G) at 4-7 (White), Pepco (G)-2 (White); Pepco (2G) at 2 (White Supp).

187. **OPC** OPC witness Bright testifies that PHI Service Company provides administrative and support services to affiliates. She notes that since the cost of services provided by the Service Company are shared among the PHI affiliates that a reduction in the number of companies receiving those services will necessarily increase the cost of services to the remaining companies if the total costs being allocated are not reduced. Bright further states that PHI recognizes that the corporate costs for the remaining businesses would increase and embarked on the ORP with the sale of Conectiv and the winding down of PES. She states that Pepco RMA No. 27 calculates an annual saving to Pepco Power Delivery O&M of $9.6 million due to the reduction in the Service Companies employees and $1.9 million of actual cost savings due to the sale of Conectiv Energy. Bright further notes that Pepco RMA No. 28 reduces the number of employees at the Service Company. In order to eliminate the positions necessary to reduce costs at the Service Company, the affected employees were offered a severance package. The costs of the severance charges were divided among Pepco, ACE, DP&L and the remaining unregulated subsidiaries. She states that Pepco is requesting that it be allowed to capitalize the severance costs, amortize the amount over three years, and include the average unamortized deferred severance costs, net of accumulated deferred taxes in rate base in this case. OPC opposes this adjustment because the reason for the reduction in employees was the change in the business direction of PHI. No severance costs were charged to PHI or Conectiv.[273]

188. OPC further asserts that one of the goals of PHI was that the utility companies under PHI would not be negatively impacted or the costs to ratepayers increased as a result of the change. However, ratepayers are now being asked to pick up the severance costs totaling $5.0 million over three years, plus pay a return on the unamortized balance included in rate base or $26,000 in revenue requirements at OPC's requested rate of return. No severance costs were assigned to the sale, *i.e.,* charged to PHI or the buyer of Conectiv.

189. To address the issue of Service Company costs, Bright notes that the Commission ordered an independent management audit in Formal Case No. 1076.[274] OPC recommends that the RFP for the audit be revised to require the management audit to examine and determine whether Pepco is in compliance with the Commission's new Code of Conduct.[275]

190. Further, OPC notes that the base rate case filing requirements have not changed over the years, however, the structure of utilities, in this case, Pepco, has

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[273] OPC (D) at 7-11 (Bright).

[274] *See Formal Case No. 1076*, Order No. 16585 (October 14, 2011).

[275] OPC (D) at 7-11 (Bright).

changed. OPC points out that there is nothing in Pepco's 21-day compliance filing[276] nor is there anything that requires Pepco to provide any information regarding its test period transactions with the Service Company or its affiliates. As a result, there is nothing in the compliance filing which addresses these affiliated charges in sufficient detail such that OPC and the Commission would know the amount of affiliated charges included in the test year. OPC recommends that the Commission institute a proceeding to review and update the current rules associated with the 21 day compliance filing requirements. The 21-day compliance filing requirements should include information regarding test year affiliated transactions.[277]

DECISION

191. The question of whether Service Company costs are reasonable is related to (a) whether the costs in and of themselves are reasonable and (b) whether the costs have been properly allocated per the Company's Cost Allocation Manual (CAM). With respect to the latter, the CAM and its supplements contain the definitions of allocators as they are applied to the various services allocated. Several recent reviews, notably the KPMG Audit issued on February 18, 2011, persuade the Commission that the CAM and affiliate transaction rules are adequate and reasonable. The area of concern that still remains is whether the cost of the services provided or incurred by the Service Company on behalf of regulated utilities, including Pepco, is reasonable. The Commission is confident that, based upon its review and treatment of the allocated costs, the divestiture of Conectiv has not adversely affect the costs allocated to Pepco. While we do see evidence that the costs relative to historical performance were consistent we see no evidence that the allocations of Service Company costs were unreasonable. The upcoming management audit will review the reasonableness of the Service Company costs.[278] Without any compelling evidence to the contrary, the Commission accepts the Service Company's allocations as reasonable based on their historical consistency.

192. The Commission will take OPC's recommendation under advisement, that the Commission institute a proceeding to review current 21-day compliance filing requirements as it relates, among other things, to affiliate charges.

276 The 21-Day Compliance Filing is required by Commission rules. *See* 15 DCMR § 200. 10.

277 OPC (D) at 11- 14 (Bright).

278 *See* Formal Case No. 1076, Order No. 16585, ¶¶ 27-28 (October 14, 2011).

IX. ADVANCE METERING INFRASTRUCTURE DEPLOYMENT COSTS[279]

193. **Pepco.** Pepco believes that it is appropriate to include AMI project costs in this rate case because, among other things: (1) it has complied with all the relevant Commission orders; (2) the AMI support systems are complete and operational; (3) all the meters will be installed by December 2011; (4) all aspects of the fully integrated AMI system will be in service by the second quarter of 2012; (5) the Company will begin to realize savings toward the end of 2011 and in the first and second quarters of 2012; (6) the full non-depreciated costs of the removed meters will be retired and moved into a regulatory asset; and (7) Commission Order No. 15629 stated that the regulatory asset for collection of AMI costs was to be used between base rate cases for the implementation of AMI.[280]

194. Pepco proposes four adjustments to the test year related to AMI meters and IT system costs, which the parties contest.[281] These adjustments are RMA No. 4, Reflection of AMI Meters; RMA No. 5, Reflection of AMI Communications Equipment and Software; RMA No. 6 Recovery of AMI Regulatory Asset; and RMA No. 7, Reflection of Ongoing Level of AMI Operating Costs and Savings.

RMA No. 4, Reflection of AMI Meters

195. RMA No. 4 reflects the full value of AMI Smart Meters, whose installation began in October 2010 and is scheduled to be completed by December 2011. The Company states that the cost of procuring and installing the meters, net of the Department of Energy ("DOE") grant funds is recorded as CWIP upon acquisition, and the net AMI costs are transferred to EPIS upon installation at which time Pepco begins to account for the depreciation of the installed meters. As Pepco replaces the non-AMI meters, the Company records their retirement and the depreciation of the non-AMI meter ceases, which results in a loss of the remaining net book value of the non-AMI meter. The loss is initially recorded on the Company's income statement, subsequently reclassified as a regulatory asset (*see*, RMA No. 6), and then amortized against future recovery of AMI costs.[282]

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279 Designated Issue No. 9 asks, "Are Pepco's costs for the deployment of AMI reasonable?" Designated Issue No. 9a asks, "Are cost saving attributable to AMI appropriately reflected in Pepco's operating expenses (e.g., reduced meter reading expense, pension costs, etc.)?" Designated Issue No. 9b asks, "Is the accounting treatment of old meters reasonable?"

280 Pepco (I) at 12-14 (Gausman).

281 The AMI system is comprised of electronic meters that enable wireless communications between the customer's meter and the Company. The system delivers data to the Company for billing purposes and customer energy use information. *See* Pepco (I) at 14 (Gausman).

282 Pepco (2G) at 2-3 (White Supp).

196. The Company believes the group method of depreciation provides for an adjustment to earnings rather than recording the loss to Account 108, which is permissible under FERC and GAAP.[283] Pepco states that a portion of the costs of the AMI meters is embedded in the unadjusted 13-month average EPIS, accumulated depreciation, accumulated deferred taxes, and depreciation expense because of the accounting involved in tracking the acquisition and installation of the AMI meters. The Company proposes a 15-year depreciable life[284] for the AMI meters. However, the AMI meters are currently depreciated at the non-AMI meter rate of 2.75% as established in Formal Case No. 1053. The allocated DC portion of the 13-month average EPIS for the capitalized meters is $19.1 million, before the removal of $996,000 in accumulated depreciation, and accumulated deferred taxes of $6.54 million. Annual depreciation expense is $48,000.[285]

197. **OPC.** In its brief, OPC withdraws OPC Adjustment No. 10, Reduction to Meter Blanket Capital Budget because, if the Commission accepts OPC Adjustment No. 13, Reductions to Forecast Net Plant Additions, agreed upon by OPC and Pepco, then OPC's proposed changes to the number of AMI meters in inventory becomes moot.[286] OPC witness Mara had challenged the number of AMI meters to be placed in inventory given a lower actual failure rate.[287] Also, OPC challenges Pepco's depreciation rate for AMI meters, which uses a 15-year life, absent a depreciation study and recommends a reduction to depreciation expense through OPC Adjustment No. 14.[288]

198. **AARP.** AARP witness Alexander questions whether sufficient evidence exists to determine that the AMI system is "used and useful," that the costs were prudently incurred, and the resulting benefits documented as promised. She opposes all AMI proposed adjustments until Pepco provides sufficient evidence that AMI is of benefit to customers, used and useful, and the costs were prudent. She contends that as of October 31, 2011, the Company had installed 210,735 out of the expected 270,000 AMI meters and activated only 1,186 residential smart meters. She argues that there are no distribution-related organizational benefits associated with any of the AMI meters until they are activated.[289]

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283 Pepco (2G) at 2-3 (White Supp).

284 Pepco witness Spanos testifies that based on his research he estimates that AMI meters to have 15-year service life with a net salvage value of negative 5%. *See,* Pepco (2M) at 3-5 (Spanos Supp).

285 Pepco (F) at 12-14 (Hook), Pepco (F)-1 at 8 (Hook); *see also*, Pepco (2G) at 2-3 (White Supp).

286 OPC Br. at 23-24.

287 OPC (E) at 39-41 (Mara).

288 OPC (A) at 6 (Binz); OPC (B)-4, Schedule 14 (Ramas).

289 AARP (A) at 11-14 (Alexander).

199. Further, Alexander questions how the Company can reflect estimated savings when no actual benefits have been tracked or documented. Thus, AMI is not offering any of the promised benefits to customers. Based on the above, witness Alexander recommends that the Commission postpone the approval of Pepco's AMI cost recovery. She recommends that the Company be required to submit a detailed plan for the Commission's review and approval that will track all the costs and promised benefits associated with this investment and report this information on a quarterly basis to the Commission.[290]

200. **Pepco Rebuttal.** Pepco witness Spanos disagrees with OPC's recommendation that a new depreciation study should be performed before any change in the depreciation rate is implemented. He contends that the Commission already found in Formal Case No. 1076 that a 15-year average life expectancy for AMI meters was reasonable and conducting a full depreciation study for AMI meters is not possible given that the meters are new. Spanos proffers that it will take 5 to 10 years to develop historical data that could be analyzed. He contends that OPC's recommendation will result in under recovery in the early years which will require future customers to make up for the shortfall later.[291]

201. According to Pepco witness Gausman, Commission Order No. 14712, in Formal Case No. 1053 established that the Commission would grant rate base treatment for post- test period project completion costs, on a case by case basis, if sufficient facts establishes that the completion date of the project is prior to the rate effective period and not too remote in time from the test period. The AMI meters will be installed and activated at or around the time that the rate effective period begins, eight months from the end of the test year. The Company's cost for the project is not expected to be significantly different from the 2007 estimate. The benefits have been met because the Commission has already found, in Formal Case No. 1056, that a cost benefit ratio of 1.871 is adequate.[292]

202. As to AARP's contention that the AMI system will not be fully operational until June 2012 and that Pepco has not tracked actual benefits, Pepco represents that as of January 2012, 244,000 meters have been installed, which represents about 90% of all meters required for the District of Columbia. The number of active meters has increased from 1,196 to 70,026 as of January 9, 2012, with all meters scheduled to be activated by May 2012.[293]

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290 AARP (A) at 16-17 (Alexander).

291 Pepco (3M) at 2-5 (Spanos Rebuttal).

292 Pepco (3I) at 51-53.

293 Pepco (3F) at 51.

DECISION

203. Since the Company accepts OPC proposed Adjustment No. 13, Reductions to Forecast Net Plant Additions, OPC's proposed Adjustment No. 10, Reduction to Meter Blanket Capital Budget becomes moot. In regard to AARP's argument that Pepco has not provided sufficient evidence that AMI is of benefit to customers, that the meters are not used and useful, and the costs prudent, Pepco witness Gausman reports that as of January 2012, 244,000 meters have been installed, which represents approximately 90% of the meters required for the District. Further, Pepco witness Gausman reported that the number of active meters has increased from 1,196 to 70,026 as of January 9, 2012. During this case Pepco reported that all the meters were scheduled to be activated by May 2012 and that the AMI meters would be installed and activated within eight months from the end of the test year.[294] Although Pepco as of the end of August still has to install 8,111 or less than 3%, the installation of smart meters appears likely to be completed before the rate effective period. The cost of this project is not expected to be significantly different from the 2007 estimates, and the project has a cost-benefit ratio of 1.87.[295]

204. Since the Commission found a 15-year service life of AMI reasonable as it relates to recovery of certain AMI-related costs in Formal Case No. 1076, we accept Pepco's proposal for AMI depreciation to reflect a 15-year life and reject OPC's Adjustment No. 14. In the next depreciation study, Pepco should review its net salvage value for AMI meters. Unless a new justification can be provided, Pepco shall continue to use zero percent net salvage in the calculation of depreciation for AMI meters.[296]

205. Finally, concerning evidence that AMI is of benefit to customers, that issue was resolved by the Council when it enacted the AMI legislation approving the

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[294] As of August 2012 Pepco has installed 264,105 smart meters or just over 97% of the meters in the District. *See Formal Case No. 1056*, Potomac Electric Power Company's Report – August 2012 Monthly Report Describing Pepco's Progress Deploying Its AMI System, filed September 20, 2012 (the percentage is found by dividing the number of meters installed by the sum of the number of meters installed and remaining non AMI meters). As of July 31, 2012, Pepco has activated "approximately 237,400" or roughly 88% of the smart meters in the District. *See Formal Case No. 1056*, Status Update Report of the Advanced Metering Task Force in Response to Commission Order No. 16071 at 3, filed September 20, 2012 (the percentage is found by dividing the number of meters activated by the sum of the number of meters installed and remaining non AMI meters).

[295] Pepco (3F) at 51-52.

[296] During the hearing Witness Spanos indicated that, although the -5% net salvage is the most appropriate rate, Pepco was not recommending a -5% net salvage rate with its depreciation adjustment for AMI meters in this proceeding at this time. In other words, Pepco's proposed revenue requirement increase (of $39.7 million) reflects zero percent net salvage for installed meters. See TR. 566.

installation of AMI subject only to Pepco receiving "sufficient federal funding" to be determined by the Commission.[297] The Commission confirmed the AMI is cost effective with federal funding. Based on the foregoing, we accept Pepco RMA No. 4 reflection of AMI meters as reasonable and reject AARP's requests that the costs be postponed. The ratemaking impact of the project is as follows:

Line Item	Rate Base	Expense
Electric Plant in Service	$19,103,000	
Accumulated Depreciation	$(996,000)	
Accumulated Deferred Taxes	$(6,543,000)	
Depreciation Expense		$(48,000)

RMA No. 5, Reflection of AMI Communications Equipment and Software

206. **Pepco.** RMA No. 5, the second adjustment, reflects the costs associated with the AMI Communications Network (communication equipment [general plant] which will be depreciated over 15 years) and Customer Benefit System Integration ("CBSI") software (amortized over 5 years); items that Pepco alleges will be in service "within a reasonable time from the end of the test period." Pepco also includes the cost of software projects (to be amortized over 5 years) that will serve both Pepco and Delmarva Power & Light Company, which was recorded with PHI.[298] During the hearing, Pepco provided a schedule showing that $1.724 million of the $2.4 million DOE grant was used for AMI communication equipment and software.[299] Additionally, Pepco witness Gausman explained that Pepco considered a number of alternative communication systems, and based its selection of the Silver Spring Network on several factors (i.e., the ability to remotely upgrade software, security features, and cost).[300]

207. **AOBA.** AOBA questions the manner in which costs are reported by the Company in its financial records and the appropriateness of Pepco's request for rate base treatment for assets over which it has no direct control and that have no marketable value.[301]

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297 *See generally* D.C. Code § 34-1562.

298 Pepco (3I) at 14 (Gausman Rebuttal), Pepco (F)-1 at 9 (Hook).

299 Tr. 325-326, *see* Pepco Hearing Exhibit No. 66.

300 Tr. 551-554.

301 AOBA (A) at 42 (Oliver).

DECISION

208. The Commission finds that the DOE grant funds have been properly credited against the total cost to ratepayers in the Company's calculation of this adjustment. The Commission accepts Pepco's adjustment. The software and communication equipment are necessary and essential for the AMI infrastructure. Moreover, we find the software amortization and general equipment depreciation periods reasonable. Based on the foregoing, the adjustment has the following impact:

Revenue Requirement Line Item	Rate Base	Expense
Electric Plant in Service	$2,552,000	
Service Co. Assets	$1,900,000	
Accumulated Depreciation	$(32,000)	
Accumulated Amortization	$(160,000)	
Accumulated Deferred Taxes	$(79,000)	
O&M Expense		$422,000
Depreciation Expense		$63,000
Amortization Expense		$320,000

RMA No. 6, Recovery of AMI Regulatory Asset

209. **Pepco.** RMA No. 6, the third adjustment related to the AMI system, adjusts the cost of service to reflect commencement of the recovery of AMI costs (project management costs, design and consulting services and incremental increases in O&M costs associated with the various IT systems) which have been deferred in a regulatory asset. This adjustment has four components, the first was already discussed in RMA No. 4; the second, the loss related to the early retirement of non-AMI meters (*i.e.*, customer will be credited with the differential between what the Company recovered in depreciation in current rates versus what it recorded on its books for non-AMI meters); the third, the depreciation of the new AMI meters; and finally, the incremental cost incurred after December 31, 2008 (Pepco made the assumption that incremental costs, including a return component, would build through March 31, 2012, after which time recovery over a 15-year period is expected to begin).[302] In regard to the third item, depreciation of AMI meters, Pepco notes that because the new smart meters cost less, due

302 Pepco (3I) at 14-16, Pepco (F)-1 at 10 (Hook); *see also* Pepco (I) at 18 (Gausman) .

in part to the DOE grant, the depreciation does not offset the reduction in the regulatory asset created by the depreciation of the declining balance of the old meters. Pepco witness Gausman indicates that the full un-depreciated cost of the removed meters will be retired and moved into a regulatory asset consistent with accounting requirements. Therefore, Pepco submits that it is appropriate at this time that the Commission determines the time period for recovery of these costs.[303]

210. **OPC.** OPC contends that Pepco's incremental AMI costs are significantly overstated. The actual costs incurred for the seven-month period ended October 2011 were $845,392, $2.58 million less than the amount Pepco forecasted. For the remaining period from November 2011 through March 2012, Pepco forecasted $1.8 million of additional incremental costs associated with AMI and its deployment. OPC's Adjustment No. 1 recommends that the actual costs be used for the period March 2011 through October 2011 and that the forecasted costs to be incurred for the period, November 2011 to March 2012, be reduced by 24.7% based on the actual versus budgeted costs for the period March 2011 to October 2011. These proposed changes will reduce rate base by $3.9 million, increase accumulated deferred taxes by $1.6 million, increase accumulated amortization by $134,000, and reduce amortization expense by $268,000.[304] OPC accepts Pepco's adjustment related to the recovery of the loss on the early retirement of the non-AMI meters.

211. **Pepco Rebuttal.** Pepco witness Hook is not opposed to OPC's proposed adjustment.[305] The Company accepts OPC Adjustment No.1.[306]

DECISION

212. The Commission has reviewed the adjustment and accepts the adjustment as modified by OPC as just and reasonable. The Company's modified adjustment will increase rate base by $24.93 million and amortization expense by $3.3 million.

RMA No. 7, Reflection of Ongoing Level of AMI Operating Costs and Savings

213. **Pepco.** RMA No. 7, the final adjustment related to the AMI system, reflects the on-going level of AMI-related savings, net on-going incremental costs, of $1.03 million.[307] Pepco reports savings due to the: (1) elimination of manual meter

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303 Pepco (I) at 13 (Gausman).

304 OPC (B) at 50-53; OPC (B)-4, Schedule 1 (Ramas).

305 Pepco (3F) at 33-34 (Hook Rebuttal).

306 Tr. 1713; OPC (B)-4, Schedule 1 (Ramas).

307 Tr. 321-323.

reading costs; (2) implementation of remote turn-on/off functionality;[308] (3) improved billing activities; (4) reduction of off-cycle meter reading costs; (5) elimination of support costs for Pepco's data collection system; (6) improvement in the handling of customer complaints; and (7) the optimization of assets. On-going incremental costs include customer education, IT costs for the AMI wireless communication system, and work force costs to maintain the communication systems.[309] Pepco asserts that cost savings attributable to AMI's implementation are properly reflected in its direct testimony.[310]

214. **OPC.** Although OPC does not take issue with Pepco's stated savings because Pepco's projected incremental cost savings are consistent with Pepco stated savings in Formal Case No. 1056, it points out that the savings will not be fully realized by the second quarter of 2012. OPC recommends that: (1) Pepco show, in a subsequent rate case, that its AMI system is fully functioning and that the benefits outweigh the costs (if not, the Commission should reduce rate base going forward or impute savings to offset the lack of full functionality); (2) Pepco reports on a bi-annual basis the functionality of its AMI network and the issues that exist; (3) the Commission, on a bi-annual basis conduct a cost-benefit analysis of the AMI system; and (4) the Commission ensure that all operational savings realized as a result of the AMI system be used to reduce rates.[311] OPC argues that requiring Pepco to conduct a cost/benefit analysis to determine the prudency of Pepco's AMI costs is consistent with the Commission's responsibility to ensure that rates are just and reasonable.[312] OPC points out that the National Association of Regulatory and Utility Commissioners ("NARUC") encourages states to carefully scrutinize AMI costs and the risk/reward of the investments and the Maryland Public Service Commission has decided to require cost/benefit analysis in all future proceedings where Pepco seeks cost recovery.[313]

215. **AARP.** AARP contends that Pepco has not provided sufficient evidence of the benefits of AMI. AARP witness Alexander points out that the AMI system is not fully installed and will not be fully operational until June 2012. AARP argues that until

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308 On March 30, 2012, Pepco petitioned the Commission to initiate a rulemaking to amend its rules in order to accommodate the full use of the AMI and Smart Meter remote disconnection features. This matter is still pending before the Commission. Since this issue is still before the Commission, the Commission while accepting the adjustment as modified by OPC, makes no final decision regarding the level of AMI-related savings Pepco anticipates receiving due to the implementation of remote turn-on/off functionality.

309 Pepco (I) at 13-18 (Gausman); Pepco (F) at 16 (Hook).

310 Pepco (2F) at 5 (Hook Supp).

311 OPC (E) at 75-76 (Mara); OPC Br. 67-69.

312 OPC Br. at 67.

313 *Id.* at 67-69.

activated there are no distribution-related operational benefits" associated with the meters. Therefore, AARP objects to the Company reflecting estimated savings in its request for cost recovery, because no actual benefits have been realized. AARP also points out that currently, there are no AMI-enabled programs related to alternative pricing programs available to customers, the usage and billing information available on Pepco's website are basic and undeveloped, and Pepco will not implement the remote connection and disconnection function of the meters until the fourth quarter of 2012. Nevertheless, Pepco includes estimated cost savings associated with the full implementation of remote connection and disconnection when not only the feature is not functional, but Pepco has delayed its implementation until the Commission's Consumer Bill of Rights permits the same.[314]

216. Additionally, Pepco seeks recovery of $107,000 and $1.1 million in customer education costs in 2010 and 2011 respectively, when in fact it has incurred only $229,471 in costs from January 2011 through October 2011. AARP asserts that Pepco's actual expenditures are significantly lower than estimated. Moreover, AARP contends that Pepco has not documented that the consumer education campaign has been a success. AARP argues that there have been no realized customer savings documented, despite Pepco's estimate that it would realize saving of approximately $29 million in electricity costs. AARP argues that it would be more appropriate for Pepco to seek cost recovery when the AMI system is functional and operational, and the costs and benefits known and measurable. AARP recommends that Pepco be required to track and report to the Commission on a quarterly basis information regarding the costs and benefits associated with the deployment of AMI, like it is required to file with the Maryland Public Service Commission.[315] AARP also argues that Pepco should be required to address each of the categories of benefits it used in the business case approved in Formal Case No. 1056.[316]

217. **Pepco Rebuttal.** Pepco witness Gausman states the Company is not opposed to OPC's recommendations (2) and (4). The Company is not opposed to providing a bi-annual report to the Commission as to the functionality of the AMI network and the identification of any outstanding issues, but recommends that it be only for a period of two years after all the meters have been installed. He agrees with OPC

314 AARP at 9-14 (Alexander). The Consumer Bill of Rights currently require that Pepco first visit the customer's premise and attempt to contact the customer to obtain payment prior to disconnection of service. *See* 15 DCMR § 312 (2009).

315 *See Maryland PSC Case No. 9208, In the Matter of Baltimore Gas and Electric Company for Authorization to Deploy a Smart Grid Initiative and to Establish a Surcharge Mechanism for the Recovery of Cost* and *Maryland PSC Case No. 9207, In the Matter of Potomac Electric Power Company and Delmarva Power and Light Company Request for Deployment of Advanced Meter Infrastructure,* Advanced Metering Infrastructure Performance Metrics Reporting Plan-Phase I, in which the Maryland PSC approved the reporting requirements as proposed by the utilities in a Letter Order dated August 18, 2011.

316 AARP at 14-19 (Alexander).

witness Mara that all operational benefits should be used to reduce rates, which is exactly what the Company proposed in this case. The AMI project's full operational benefits have been included in this case, with future benefits focusing on dynamic pricing and energy reduction goals. However, Pepco opposes OPC's recommendation for a bi-annual cost/benefit analysis with a review of the same in a future rate case. Gausman argues that the decision to approve AMI has been made and the Commission has issued an order authorizing the program. To conduct a bi-annual cost/benefit analysis or to review in a future rate case the cost/benefit analysis that the Commission depended upon to originally approve the sufficiency of AMI funds is not appropriate because it would not be appropriate to re-evaluate the decisions made by the Commission upon which the Company relied. Gausman argues that the Commission's review as to whether to go forward with AMI has been completed. The prudency review of the costs, methods, and accomplishments in carrying out the decision to go forward with AMI is the subject of the current proceeding.[317]

DECISION

218. We have previously addressed AARP's concerns about whether it is appropriate to award Pepco cost recovery of AMI.[318] RMA No. 7 relates to whether Pepco properly reflects the cost and savings attributable to AMI. OPC does not take issue with Pepco's stated savings, however it recommends several reporting requirements and continued monitoring.[319] We are in agreement with both OPC and AARP that it is important that District of Columbia ratepayers realize the full potential benefits of AMI. Now that Pepco has begun the activation of AMI, it is important that ratepayers know the capability of the system and receive the maximum benefit from it. The functionality of the AMI network is an integral part of this. Therefore, Pepco is directed to report, beginning June 1, 2013, through June 1, 2015, on an annual basis the functionality of its AMI network. In its annual report, Pepco is required to track projected savings versus actual savings, and the issues that exist; providing a full and complete analysis of any significant (+/- 20%) variance. Additionally, in all subsequent rate cases after the AMI system is fully activated, Pepco is required to show that all operational savings realized as a result of the AMI system have been used to reduce rates.[320]

219. We are in agreement with Pepco, however, that it would not be appropriate to conduct another cost/benefit analysis. The Commission previously made a

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317 Pepco Br. at 68-69; Pepco (3I) at 30-32 (Gausman Rebuttal).

318 *See infra.*, ¶ 205.

319 OPC (E) at 75-76 (Mara); OPC Br. 67-69.

320 *See Formal Case 1056*, Order No. 15629, ¶ 11 (December 17, 2009).

determination that Pepco's AMI plan was cost-effective.[321] As Pepco states, decisions are made based on the information available at that time. The prudence of the investment in AMI must be judged by what Pepco's management knew, or could have known, at the time the costs were incurred.[322] The relevant inquiry hinges on whether at the time they were made, the decisions were reasonable in light of existing and reasonably foreseeable circumstances.[323] Moreover, the legislation approving AMI did not require the Commission to make periodic reviews and/or analyses of the cost/benefits of the project. Accordingly, we will not revisit the benefit/cost ratio of the AMI project.[324] Therefore, we reject OPC requests for a bi-annual cost-benefit analysis of the AMI system and a showing in subsequent rate cases that its AMI system is fully functioning and that the benefits outweigh the costs.

X. PEPCO'S CUSTOMER CARE INITIATIVE AND PROPOSAL TO ADD ENERGY ADVISORS AND ENERGY ENGINEERS [325]

220. **Pepco.** The Company seeks to recover the costs of its customer care initiative, which address customers' complaints and information requests about reliability issues, increased savings through energy efficiency, and the implementation of AMI in the District.[326] There are five component parts to the Company's Customer Care Initiative that are included in RMA No. 24, Annualization of Incremental Customer Care Expenses: (1) adding additional personnel at its call centers (not Energy Advisors) ($4.859 million);[327] (2) improving infrastructure (hardware and software) ($1.080 million); (3) storm readiness ($1.5 million);[328] (4) customer education and research ($1 million);[329] and (5) adding Energy Advisors and Energy Engineers ($0.813 million).[330]

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321 Order No. 15629, ¶ 9.

322 *See Formal Case No. 869*, Order No. 9216 at 59 (March 3, 1989).

323 *Formal Case No. 874, In the Matter of the Gas Acquisition Strategies of District of Columbia Natural Gas, a Division of Washington Gas Light Company,* Order No. 9793 at 15 (August 27, 1991).

324 *District of Columbia Natural Gas, a Div. of Washington Gas Light Co.* 125 P.U.R.4th 498 D.C.P.S.C. 1991 (August 27, 1991).

325 Designated Issue No. 10 asks, "Are Pepco's customer care initiative and the Company's proposal to add energy advisors and energy engineers reasonable?"

326 *See* Pepco Br. 73-76; Pepco (J) at 2-25 (Dickerson); Pepco (2J) at 1-2 (Dickerson); Pepco RMA No. 24.

327 *See* Pepco Exhibit No. 90 at 30 (Pepco RMA No. 24, calculated on the basis of DC plus Maryland).

328 Pepco Exhibit No. 90 at 30.

329 *See* Pepco Exhibit No. 89 which reduced customer education and research by $200,000 to remove institutional advertising.

Pepco argues that these incremental resources are necessary to improve day-to-day service quality for Pepco as measured against industry metrics such as Telephone Service Factors, Average Speed of Answer, Average Handle Time, and Abandonment Rate.

221. **OPC.** OPC objects to cost recovery for Energy Engineers. OPC supports Pepco's plan to add five Energy Advisors[331] but it sees no present need for Energy Engineers whose job description is focused on assisting customers with direct load control programs and dynamic pricing since these programs are not currently offered by Pepco. Moreover, other work being done by Energy Engineers duplicates assistance already being provided to District residents by the District's Sustainable Energy Utility ("SEU") and the District Department of the Environment (DDOE) which already provides free home energy audits.[332] Accordingly, OPC requests that RMA No. 24 be modified by eliminating the two proposed Energy Engineers which reduces Pepco's adjustment from $813,000 to $565,000.[333]

222. **AARP.** AARP requests that the Commission reject in its entirety Pepco's $3.6 million a year Customer Care Initiative.[334] AARP argues that Pepco should improve its substandard customer services, document the costs and prudency of those improvements, and then seek cost recovery for them in a future rate case.[335] Additionally AARP contends that Pepco should be required to meet performance standards before any rate increase is approved for Pepco's customer care costs.[336] AARP claims that the vast majority of the Energy Advisors and two Energy Engineers costs were not incurred during the test year.[337] Moreover, AARP questions whether these costs are appropriate since the bulk of the work for these positions relate to efficiency and conservation programs. Pepco has not been authorized to implement any energy efficiency or conservation programs after 2010 when the Clean and Affordable Energy Act of 2008

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330 *See* Pepco Br. 73 and Pepco Exhibit No. 90 at 30 (Pepco RMA No. 24, calculated on the basis of D.C. plus Maryland).

331 OPC Br. 71, n. 184, citing OPC (E) at 78-79 (Mara).

332 OPC Br. 71-72; OPC R. Br. 29-30.

333 *See* OPC (E) at 13, 77-79, 82 (Mara); OPC (A) at 20 (Binz). OPC Exhibit (B)-2 (Ramos) shows OPC RMA No. 9 reducing Pepco's O&M expenses by $94,000.

334 AARP Br. 1, 10-12; AARP R.Br. 6-8; AARP Exhibit at 8, 28-29, 31 (Alexander).

335 AARP (A) at 8, 29- 31 (Alexander).

336 AARP (A). at 31-32.

337 AARP (A) at 29; *Accord*: AARP Br. 10.

required the Mayor to contract with a private entity to conduct sustainable energy programs on behalf of the District of Columbia.[338]

223. **AOBA.** AOBA objects to Pepco's recovery of the incremental costs of its new Energy Advisors and Energy Engineers.[339] AOBA submits there is no evidence that Pepco has tested this service concept or demonstrated its effectiveness. AOBA asks the Commission to follow the lead of the Maryland Public Service Commission, which recently rejected Pepco's request to recover comparable costs for a proposed Energy Advisor program.[340]

224. **Pepco Rebuttal.** The Company answers OPC's attack on the cost of Energy Engineers by arguing that Energy Engineers have a wide range of responsibilities going beyond helping customers with load control programs and dynamic pricing.[341] According to Pepco, the Maryland Commission's recent rejection of Energy Advisors rested on concerns about estimated/uncertain costs that are not present here. Pepco states that all of the costs of these Energy Advisors and Engineers are incremental. The personnel were either hired from external resources or were hired from internal resources, with their positions back-filled by the Company before they moved into their new positions. Pepco argues that the costs are certain and known and measurable and that all positions for which the Company seeks cost recovery are filled at this time with all these personnel meeting customers' needs for energy information and not limited to improving reliability and storm preparedness.[342] Finally according to Pepco, the reporting requirements proposed by AARP are redundant to the EQSS reports and should be rejected by the Commission.[343]

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338 AARP (A) at 33-34 (Alexander). "Pepco's assertion that these costs should be recovered because the employees are already in place does not address the prudency of their being hired nor the value to the public. Until so proved, these costs should not be recovered." AARP R.Br. 8.

339 AOBA Br. 10-11, objecting to the inclusion of these costs in Pepco RMA No. 24; AOBA (A) at 13, 47-48 (Oliver).

340 AOBA (A) at 47- 48 (Oliver).

341 As Pepco witness Dickerson explained, Energy Engineers' duties are not restricted to addressing questions related to dynamic pricing and load control. They are responsible for, among other activities, assisting commercial customers in understanding the benefits of various types of heating and air conditioning systems, and performing energy audits to educate costumers about how to decrease energy usage. Pepco Br. 76, citing Pepco (3J) at 2 (Dickerson Rebuttal).

342 Pepco Br. 77-78; Pepco (3J) at 5-16 (Dickerson Rebuttal); Pepco R.Br. 38-39.

343 Pepco R.Br. 39-40.

DECISION

225. The Commission is called upon to consider claims of imprudence and out-of-test-year-costs in assessing Issue No. 10. OPC, AOBA, and AARP raise claims about imprudence while AARP's claims also reflect concerns about the alleged out-of-test-year character of some of Pepco's customer care costs. We also address AARP's request for improved performance standards and better reporting by Pepco on customer care issues.

226. ***Imprudence/Prudence.*** The Commission has discretion in applying the "prudence/imprudence" standards as prescribed in *Pepco v. Public Service Commission.*[344] Those standards indicate that Pepco may make a generalized submission initially about the costs of its customer care initiative, but that if a party raises "a serious doubt as to the prudence of expenditure" then the burden of persuasion falls upon Pepco to show that the challenged costs are reasonable. In this instance OPC, AARP, and AOBA have raised "serious doubts" about the prudency of Pepco's incremental costs for its Customer Care Initiative, particularly the costs of new Energy Advisors and Energy Engineers. The Commission's decision on whether to allow these costs turns, in part, on its assessment of how useful and important these incremental services are, in fact, to improving Pepco customer service.

227. We have examined each aspect of Pepco's Customer Care Initiative and make the following findings. *(1)* Personnel. Given the consumer complaints in this record about the need to improve Pepco's customer services (*see* Community Comments, *infra*), we have no trouble in concluding that the Company acted prudently in hiring additional personnel to upgrade the performance of its Call Center. Only AARP disputes Pepco's cost recovery for this upgrade. Pepco's evidence adequately established the prudence of hiring the new personnel at issue (other than Pepco's five new Energy Advisors and two new Energy Engineers).[345] (2) *Infrastructure (hardware and software).* The Commission will allow recovery of these costs to pay for increasing Pepco's current call-taking capacity, reducing busy signals due to call volume during emergencies, and adding a toll-free number to Pepco's local customer service number. *(3)* Storm Readiness. The Commission approves the prudency of Pepco's test-year storm readiness expenses. *(4)* Customer Education and Research. The Commission accepts Pepco's revised

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344 *Pepco v. Public Service Comm'n*, 661 A.2d 131, 140 (D.C. 1995), explains the way that burden of proof works on prudency issues in Pepco rate cases:

> utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent . . . However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant [*i.e.,* Pepco] has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent. [661 A.2d at 140]

345 *See* Pepco (3J) at 7-10, 12-15 (Dickerson Rebuttal).

submission, which slightly lowers its revenue requirement for this item.[346] *(5) Energy Advisors and Engineers*. The Commission rejects Pepco's adjustment seeking to recover the costs of Energy Advisors and Energy Engineers. Given that dynamic pricing is not currently offered in the District and weatherization advice and other services are available from the SEU and DDOE, the Commission agrees with OPC and AARP that Pepco's Energy Engineers are unnecessary. We also find that Pepco did not meet its burden in demonstrating why cost recovery would be appropriate for its Energy Advisors, given the "serious doubts" raised by AARP and AOBA about whether the bulk of their work, concerning efficiency and conservation programs, is more appropriately being done by others (not Pepco) in the District of Columbia. Eliminating the Energy Advisors and Engineers reduces expenses by $308,000.

228. ***Out-of-Test-Year Adjustments.*** The Commission's decision, denying cost recovery for the incremental personnel costs of Energy Advisors and Energy Engineers moots AARP's complaint that these costs were incurred outside the test year.[347]

229. ***Improved Performance Standards and Better Reporting on Customer Care Issues.*** Pepco is correct that its customer care service is already meeting some standards and that its annual reports to the Commission already contain some of the customer care information that AARP is seeking. The outage and storm restoration information provided by Pepco is particularly important. The Commission agrees with AARP, however, that Pepco should provide some additional, more focused reporting on its customer care services provided to District customers. Each quarter, Pepco shall provide information to the Commission showing monthly call volume and staffing levels in its Call Center, including both contract and direct employees. This quarterly report also shall include the monthly volume of escalated complaints, broken out by type of complaints and including those related to major service outages.

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346 *See* Pepco Exhibit No. 89. After the hearings, Pepco removed $200,000 for advertising that was institutional in nature in Customer Education and Research in its updated revenue requirements. This revision reduced the adjustment to O&M expense from $3,581,000 to $3,506,000. The Commission accepts this modification to Pepco's Customer Education costs.

347 To the extent that AARP's "out of test period" objection is broader, going beyond Energy Advisors and Energy Engineers, this Commission must reject it. Testimony filed by Pepco witness Dickerson (Pepco (3J) at 6-8, 10-16) established that the Company's increased customer costs were incurred within the test year or a year thereafter (not "too remote in time from the end of the test year"); that the increased customer services purchased with these expenditures will be beneficial to ratepayers during the rate effective period; that both these costs and their impact on rates are "known, certain and measurable" (unlike the situation in Maryland); and that these increased customer costs do not generate offsetting revenues that should be taken into account under the "matching principle" of out-of-test-year adjustments. *See, e.g., Office of People's Counsel v. Public Service Commission*, 610 A.2d 240, 246-247 (D.C. 1992) (reviewing Commission precedent on out-of-test-period adjustments); *Formal Case No. 1053*, Order No. 14712, ¶¶ 90, 95, 101 (January 30, 2008); *Formal Case No. 989, In the Matter of the Office of the People's Counsel's Complaint for A Commission-Ordered Investigation Into the Reasonableness of Washington Gas Light Company's Existing Rates and In the Matter of the Application of Washington Gas Light Company, District of Columbia Division, For Authority to Increase Existing Rates and Charges for Gas Service*, Order No. 12689 at n. 42 (March 28, 2003).

230. Finally, we are aware the Commission in Maryland recently cut back on Pepco's requested cost recovery for increased customer care expenses.[348] To ensure that DC ratepayers get the benefit of the increased customer care personnel they are paying for (and whom Maryland ratepayers are not paying for), we direct Pepco to have its Call Center give some reasonable priority to DC customer calls. The Company is directed to report back to us on how it is implementing this directive in its quarterly reports to this Commission by no later than December 31, 2012. To be clear, where Pepco provides shared services to both Maryland and the District of Columbia, as is true in the case of its Call Center, this Commission directs Pepco to provide D.C. ratepayers with all the services that our D.C. ratepayers are paying for under today's decision. The impact of any "hiring freeze" or cut-backs in Pepco personnel or Pepco service, because of the Maryland PSC's decision, should be confined by Pepco so that it affects only Maryland, not the District of Columbia.

XI. COSTS OF RELIABILITY IMPROVEMENT PROJECTS IN THE TEST YEAR[349]

231. **Pepco.** In its filing, the Company maintains that its test year reliability projects are reasonable and prudent and help to improve reliability in the District. Pepco stated that its test year reliability expenditures are related to its Comprehensive Reliability Plan ("CRP) which the Commission accepted, pending updating of Pepco's EQSS performance targets.[350] According to Pepco neither OPC nor any other party contended that any test-year reliability expense was incurred imprudently. Pepco argues that this Commission has held that without affirmative evidence showing mismanagement, inefficiency, or bad faith, an investment decision is presumed to be prudent. Pepco contends that no such evidence has been presented in this proceeding.[351]

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348 *See Maryland PSC Case No. 9286, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service*, Order No. 85028, p. 54-57 (July 20, 2012).

349 Designated Issue No. 11 asks, "Do Pepco's costs for reliability improvement projects in the test year represent reasonable and prudent expenditures?"

350 Pepco Br. 78-79; Pepco (I) at 4-10, Pepco (2I) at 7- 9 (Gausman). *Formal Case Nos. 766 & 991*, Order No. 16327, ¶ 4 (April 21, 2011) stated that the CRP was a useful indication of the steps Pepco envisions for improving reliability and we accept it as such.

351 Pepco Br. 79-82, citing the standards for "prudency" in *Formal Case No. 494, In re Chesapeake & Potomac Telephone,* Order No. 4887 at 4 (1964); *State of Missouri ex rel Southwestern Bell Telephone v. Public Service Commission of Missouri,* 262 U.S. 276, 290 (1923) (Brandeis, J., concurring) ("[T]he term 'prudent investment' * * * is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown."); *In re Trans-Allegheny Interstate Line,* 119 FERC ¶ 61,219 at ¶ 68 (2007) (stating that the FERC "generally does not require that utilities seeking to recover costs through their rates demonstrate initially that all expenditures for which they seek recovery were prudent. Rather, participants in rate proceedings seeking to challenge the expenditures must first

232. **OPC.** OPC argues that Pepco failed to provide sufficient evidence to determine whether its reliability improvement projects in the test year are reasonable.[352] To the contrary, OPC reports, many of the projects listed by Pepco for the test year are simply items listed in the RIM to represent cost categories for yet to be defined projects.[353]

233. OPC challenges Pepco's submission that the Company's test-year reliability expenditures must be presumed to be prudent, because there is no evidence challenging the prudence of any specific Pepco reliability investment.[354] Instead, OPC argues that the case law defining "prudence" stands "at most for the proposition that Pepco is not required in its case-in-chief to demonstrate that all of its proposed expenditures are prudent. Once evidence is advanced challenging the prudence of its expenditures, however, the burden of proof and, ultimately, of persuasion falls to the Company.

234. While Issue No. 11 focuses on the prudence of test-year reliability improvement project costs, OPC also raises claims here about limiting the scope of projects covered by Pepco's proposed RIM surcharge, and the propriety of including out-of-test-period costs in rate base. Whether a project should or should not be included in the proposed RIM is not adequately explained, OPC submits.[355] To the contrary, the Company lumps together, and seeks to include in the RIM, both properly-included "reliability driven projects" (on the one hand) and improperly included "load/demand driven projects" not justified based on reliability (on the other hand).[356]

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create a serious doubt as to the prudence of the expenditures before the burden shifts to the filing utility… The [FERC] and the courts have long recognized that a protestor has a burden to do more than make mere unsubstantiated allegations.")

352 OPC Br. 72, 73- 76; OPC R. Br. 30-33; OPC (E) at 9, 26-41, 79-80 (Mara); OPC (A) at 20 (Binz).

353 OPC (E) at 26 (Mara). *Accord*: OPC Br. 74. "In contrast, a good example of the type of documentation that Pepco should provide for each project is the justification of the Automated Sectionalizing and Restoration ("ASR") scheme and network protector monitors. This justification includes costs, reasons, alternatives, and expectations of reliability improvement." OPC (E) at 9, 26, 80 (Mara). OPC rejects Pepco's suggestion that OPC should have conducted greater discovery to unearth the details about these matters. *See* OPC Br. 75-76.

354 OPC argues that Pepco's definition of "prudence" (1) improperly shifts the burden of proof from Pepco to OPC and intervenors; (2) ignores that Pepco has failed to provide evidence adequate to establish the prudence of its test year projects; and (3) disregards undisputed evidence that Pepco did not evaluate whether its proposed test year reliability improvement projects would actually improve reliability until its rebuttal testimony, after it selected those projects. OPC R.Br. 30-31.

355 OPC (E) at 9-10 (Mara).

356 OPC (E) at 9-10, 27 (Mara). OPC claims that Pepco's business practices in fact "separate reliability projects from load driven projects." *Id.* at 34.

235. **WMATA.** WMATA states that nearly 40% of Pepco's reliability expenditures occurred in 2011, so they should be "known and measurable" as well as "used and useful" and thus (according to Pepco) they should qualify for rate base treatment.[357]

236. **Pepco Rebuttal.** The Company responds that OPC's claims about test year reliability improvement costs rest on a "fatally flawed" misunderstanding of the Commission's prudency standards.[358] Pepco asserts, that OPC "was unable to cite to any legal precedent in the District of Columbia or any other jurisdiction" that supports OPC's view that "determining the prudency of an investment involves making sure the investment is really needed, that it is undertaken efficiently, and that the benefits of the investment are realized." Given the total absence of any evidence challenging the prudence of any Pepco reliability investments, at the time they were made or otherwise, Pepco argues that the Company's "test-year reliability investments must be presumed to be prudent."[359]

237. The Company reiterates that it is not seeking any "double recovery" of costs through both the RIM and its test year cost of service.[360] In response to OPC's complaints about Pepco's proposed reliability expenditures in the future, Pepco argues these are irrelevant to assessing the prudence of its actual test-year expenditures.

Supplemental Proceedings

238. To obtain more information about Pepco's reliability expenditures during the test year, and the way that Pepco budgets and keeps track of monies for construction projects,[361] the Commission requested additional information from the Company during

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357 *See* WMATA (A) at 15-16 (Foster).

358 Pepco R.Br. 40-41.

359 Pepco Br. 81-82; Pepco R.Br. 40.

360 Pepco (3F) at 30-31 (Hook Rebuttal). *Accord:* Pepco R.Br. 41-42 ("The Company is not seeking to recover test year reliability expenditures through the RIM."); Tr. 540, 1612-1613 (Pepco witness Gausman); Pepco (I2) at 5 (lines 13-17) ("there will be no double recovery for reliability projects") and at 15 n.4 ("[A]nything that was recovered through any of the existing rate making adjustments would be excluded from any projects that would be included within the RIM mechanism") (Gausman Supp Rebuttal).

361 According to Pepco witness Gausman, under the method that Pepco keeps track of its financing, monies actually spent are (a) out of CWIP, and spent on plant that is used and useful, and (b) viewed by the Company as falling somewhere in between "budgeted" amounts and "Electric Plant in Service" (EPIS). *See* Tr. 514- 515 (Gausman). There is a time delay which could be several months, witness Gausman said, "between when [a capex item is] actually built and put in service versus when it is moved to plant in service." Tr. 510- 511. One reason why this occurs is that Pepco keeps its capex projects "open" on its books to accumulate all the outstanding costs associated with the project, before the project is listed as EPIS. *See* Tr. 511 (Gausman). Pepco argues that it is the former date (when an item is actually put in

the hearings. Pepco's responses[362] included the following information in Pepco Exhibit 93:

> for the forecasted portion of the test period, the Company's budgeted (projected) plant closings were $41,876,726 compared with actual plant closings of $16,348,438. * * * the data reveals that the Company projected capital spending of $76,299,877 while it actually spent $63,683,602, a difference of $12,616,275 or 16.5% * * * [363]

239. According to Pepco, its Exhibits 93 and 94 provide information not about the RIM but instead regarding the reliability projects that were placed in service during or shortly after the test year and are at issue for inclusion in rate base in this proceeding.[364]

240. OPC's post-hearing testimony severely criticizes what it contends are Pepco's sloppy budgeting practices, with their lack of clearly-defined goals and objectives for each project, and their cost overruns on several reliability projects that the Company undertook during the test year.[365]

241. Written post-hearing supplemental rebuttal submitted by Pepco in May 2012 confirms that, wholly apart from the RIM, the Company is seeking rate base recovery in this case of some post-test-year reliability costs. According to Pepco, Exhibits Nos. 93 and 94 set out the only reliability plant additions that the Company is

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service) "that should trigger cost recovery as that is the date when the reliability plan is used and useful and providing service to customers. The latter date is merely an accounting entry, which may occur much later than the used and useful date." Pepco (I2) at 19 (Gausman Supp. Rebuttal).

362 The Company's materials, submitted in response to Commission's bench questions, included Pepco Exhibit 70 (comparing Pepco's distribution construction for calendar year 2011 budget vs. actual expenditures) and Pepco Exhibits Nos. 91, 92, 93 and 94 (comparing budgeted with actual amounts for Pepco's reliability related projects). Pepco Exhibit No. 94, Attachment 5 indicates that during the test-period (October 2010 through September 2011) Pepco spent some $50.9 million on capex overall, and it shows how much money was spent on each of the Reliability Enhancement Plan (REP) projects that comprise the $61.8 million capital REP expenditures referred to in Pepco witness Gausman's testimony.

363 Pepco Exhibit No. 93 (Gausman) responding to questions from Chairperson Kane at Tr. 526.

364 Pepco (I2) at 5 (Gausman Supp. Rebuttal) ("As these capital additions are being considered for inclusion in rate base in this proceeding, they will not be included in any future RIM filing if the RIM is accepted by the Commission."). *Accord id.* at 6-7 ("[OPC] witness Mara appears not to understand that the information requested by the Commission and provided by the Company involves the reliability projects in the Company's REP and in the six-month projected test year, not the projects that will be considered in any future RIM filing. As the Company stated in Exhibit 93, while the projects included in the Exhibit are similar to the types of projects that would be likely to begin initial recovery through the RIM if it is implemented, the projects detailed in the Exhibit are only those at issue for inclusion in rate base in this proceeding. (Pepco Exhibit 93.) Thus, they would not be included in any future RIM filing.").

365 *See* OPC (E2) at 3-5, 6-12 (Mara Supp.).

seeking to include in its rate base.[366] The Company states that this information "involves the reliability projects in the Company's REP and in the six-month projected [portion of the] test year, not the projects that will be considered in any future RIM filing."[367]

242. With respect to OPC's claims of "cost overruns" on reliability projects during 2011, Pepco responds by defending the flexibility of the Company's budgeting process:[368]

> as in any estimating process, some estimates will prove to be less than actual costs, while some will prove to be greater. The Company manages the budget in total in an effort to provide funding to projects that are identified to have the highest priority. For example, Exhibit 93 shows that, if you remove the variance on the selective undergrounding project, Pepco was under budget for all remaining projects only by 3%. Further, Pepco is consistently reevaluating its reliability projects based on the requirements of its system to help ensure that the work being performed is the most appropriate to maintain the system's reliability. During the course of a given year, severe storms and other emergencies may cause the Company to spend money on projects that could not have been reasonably anticipated when the budget was approved. Similarly, the Company may judge that some or all planned work for a particular part of a system need not be undertaken that year as the system is in better shape than originally anticipated.
>
> * * * the reliability budget, and the work performed pursuant to that budget are dynamic. The Company regularly adjusts and reevaluates the budget to help ensure that the most important projects are undertaken. Such reevaluations mean that actual spending may differ from budgeted amounts, but the Company is committed to spend what is required to complete the most important projects that are necessary to maintain the continued reliable operation of the system.[369]

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366 Pepco (I2) at 2, 6-7 (Gausman Supp. Rebuttal). "Both Exhibits 93 and 94 provide information regarding the reliability projects that were placed in service during or shortly after the test year and are at issue for inclusion in rate base in this proceeding." *Id.* at 5.

367 Pepco (I2) at 6 (Gausman Supp. Rebuttal).

368 Pepco argues that it must retain budgeting flexibility and that OPC errs in contending that "the Company should not deviate from" an initially set budget "regardless of any other reliability issues that may arise during the year." Pepco (I2) at 9 (Gausman Supp.Rebuttal).

369 Pepco (I2) at 7-9 (Gausman Supp. Rebuttal).

DECISION

243. OPC initially raised two specific challenges to the prudence of Pepco's reliability improvement expenses during the test year. OPC Adjustment No. 10 sought a $738,000 reduction in plant in service on the ground that Pepco overstated the number of AMI meters it needs. OPC Adjustment No. 11 sought a $2.9 million reduction in plant in service to remove unapproved "feeder undergrounding" costs.[370] Testimony at the evidentiary hearings indicated that Pepco did not incur $25.5 million of its originally-budgeted amount for reliability construction projects[371] in the test year ending September 30, 2011.[372] To recognize this discrepancy, Pepco accepted OPC witness Ramas's adjustment reducing plant in service by $12.7 million.[373] Therefore, OPC withdrew these adjustments as moot,[374]

244. The Commission finds that, apart from the costs covered by OPC's macro adjustment, Pepco's costs for reliability improvements in the test year were reasonable and prudent. Other miscellaneous questions and claims, belatedly raised by OPC concerning the prudency of Pepco's test-year reliability costs, are discussed below.

1. The Standard for Assessing "Prudency." As explained above in our opinion, the Commission's standard for assessing "prudency" mean that Pepco's initial case-in-chief could present a generalized case (consistent with the Commission's initial filing requirements), which would then leave it to OPC and other intervenors to identify and challenge the prudency of any specifically-identified expenditures.[375] If OPC and other intervenors can raise a serious doubt as to the prudence of an expenditure then Pepco has the burden of proving that the specifically-challenged expenditure is prudent.

2. *Other OPC Questions and Objections. (a) Sloppy Budgeting.* OPC's submissions under Issue No. 11 conflate its complaints about budgeted RIM costs (for which Pepco is not seeking immediate cost recovery) with OPC's complaints about the

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370 OPC witness Mara agreed that, at least up until the time of the Evidentiary Hearings, OPC's only specific challenges to Pepco's reliability expenditures during the test year were covered by OPC adjustments Nos. 10 and 11. *See* Tr. 969-972 (colloquy between Chairman Kane and OPC witness Mara).

371 Tree trimming and vegetation management, which significantly affect reliability, are O&M expenses, not capital expenses. *See* Tr. 466, 467; Tr. 464- 470 (Pepco witness Gausman). In a colloquy with Commissioner Lee, the Company promised to spend the funds budgeted for vegetation management on tree trimming (and not on something else). Tr. 498-499.

372 Pepco Exhibit No. 93 (Gausman) responding to questions from Chairperson Kane at Tr. 526.

373 *See* Tr. 515-516 (Pepco witness Gausman).

374 *See* Tr. 731-733 (OPC witness Ramos). *And see* Tr. 515-516 (Pepco witness Gausman) (Pepco accepts OPC's macro adjustment); Pepco Adjustment No. 48-Removal of Feeder Underground Project.

375 *See e.g., Pepco v Public Service Comm'n*, 661 A.2d 131, 140 (D.C. 1995).

prudence of some test-year reliability improvement costs (for which Pepco is seeking immediate cost recovery in this case). OPC's general critique of Pepco's sloppy budgeting process, including Pepco's lack of clearly-defined goals and objectives for each project, and Pepco's lack of bang-for-the-buck analysis, is future oriented. It is not a basis for disallowing recovery of any costs that Pepco is presently seeking to recover.

(b) *Cost Overruns.* The Commission finds that OPC's belatedly-raised claims about "cost overruns"[376] do not provide a basis for finding imprudence or denying Pepco recovery of its costs on those "cost overrun" reliability projects that were incurred during the test year ending September 30, 2011. Nor does OPC appear to ask for that remedy. Pepco's general description of the ups-and-downs of its budgeting process seems adequate to rebut any charge of "imprudence."[377] That is not to say, however, that Pepco's budgeting process should not be improved by the addition of such things as more extensive use of cost-benefit bang-for-the-buck analysis of categories of projects similar to what the California Public Utilities Commission has adopted.[378]

(c) Out-of-Test-Year Adjustments. OPC has not clearly articulated its objection to Pepco's out-of-test-year adjustments. The Commission rejects this vague OPC claim.

Furthermore, there is no overlap or "double recovery" of costs concerning RIM cost recovery and its regular rate case cost recovery.[379] Testimony at the evidentiary hearings confirm that, without seeking double recovery, Pepco has moved a few items out of the RIM-recovery category and into its claims for post-test-year recovery without regard to the RIM.[380] As stated earlier in this Opinion and Order, those claims for post-test-year recovery satisfy our criteria for cost recovery.[381]

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376 *See* OPC (E2) at 7-12 (Mara Supp.).

377 *See* Pepco (I2) at 7-9 (Gausman Supp. Rebuttal).

378 For example in Decision 10-06-048, the California Public Utilities Commission directed Pacific Gas & Electric to "present a value of service study to help it and the Commission decide to what extent, if any, electric distribution reliability should be improved to satisfy its customers' needs. In developing future reliability improvement programs or projects PG&E must be able to demonstrate the need for such programs or projects, and if there is a need, whether the program or project represents the optimal solution when considering alternatives and cost-effectiveness in the identification and prioritization processes."

379 *See, e.g.,* Pepco (3F) at 30-31 (Hook Rebuttal); Pepco (I2) at 5-7, 15 & n. 4 (Gausman Supp.Rebuttal). Tr. 540 ("So anything that was recovered through any of the existing ratemaking adjustments would be excluded from any projects that would be included within the RIM mechanism.") (Pepco witness Gausman); Tr. 1612-1613 (Pepco witness Gausman).

380 *See* Tr. 558-559 ("… we've conferred with [Pepco witness] Hook, and she says to look at her [out-of-test-year] adjustment[s] number two for the Benning Road and number 43 for the northeast substation, third transformer") (Pepco counsel Lorenzo, further responding to the same question from Chairman Kane at Tr.539-540); Tr. 295-303 (Pepco witness Hook describing these out-of-test period adjustments).

381 With respect to the third transformer at its Northeast Substation, in particular, Pepco advised the Commission by letter dated May 2, 2012, that the third transformer at its Northeast Substation was

XII. IMPACT OF D.C. AND FEDERAL TAXES [382]

245. **Pepco**. The Company states that it computed the effect of D.C. and federal taxes on its rates using the same methods that were approved in Formal Case Nos. 1053 and 1076.[383] Only one disputed tax issue remains to be resolved.[384] Pepco indicates that tax deductions for its Medicare Part D expenses were reduced by the recently-enacted Patient Protection and Affordable Care Act. This new federal statute reduces the tax deductibility of Medicare Part D benefits starting in 2013. The Company argues that this cut-back creates a shortfall in its deferred tax benefit receivable balances (future tax benefit receivables) and requires it to recover an additional $434,000 from District ratepayers over three years which is included in RMA No. 9, Recovery on Tax on OPEB Medicare Tax Subsidy.[385]

246. According to Pepco witness Hook, the Commission years ago included in Pepco's rates the cost changes that resulted from changes in the corporate tax rate. The witness submits that tax law changes limiting the deductibility of Medicare Part D expenses should be given similar ratemaking treatment. Accordingly, the Company

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energized and began serving customers on April 29, 2012. Testimony from Pepco explained: "This work is required to relieve a developing overload on the existing feeders supplying the area that is identified as North of Massachusetts Avenue (NoMA). In the summer of 2012, overloads of 7% to 11% are forecasted to exist on two feeders. During the summer of 2011, these feeders experienced an actual overload of 3% and 9%." Pepco (3I) at 33-34 (Gausman Rebuttal). *See generally Office of People's Counsel v. Public Service Comm'n*, 610 A.2d 240, 246- 247 (D.C.App. 1992) (reviewing Commission precedent on out-of-test-period adjustments); *Formal Case No. 1053,* Order No. 14712, ¶¶ 95, 101, 90 (January 30, 2008) *Formal Case No. 989*, Order No. 12689 at 8-14 & n. 42-70 (March 23, 2003); *OPC v. Public Service Comm'n*, 989 A.2d 190, 194-195 (D.C. 2010) (on the meaning of the out-of-test-period "matching principle" as applied to an earlier transformer installed at Pepco's Northeast Substation).

382 Designated Issue No. 17 asks, "Does Pepco's presentation of its revenue requirement properly reflect the impacts of current District of Columbia and federal tax regulations?"

383 *See* Pepco (F) at 4, Pepco (2F) at 6 (Hook).

384 Other disputed tax issues were settled. One such issue involved DCG's dispute with Pepco's proposal to collect taxes from the District Government measured by volumetric kWh consumption from the streetlight and traffic signal classes, whose new tariffs generally do not include any volumetric kWh component except for the purpose of collecting taxes and surcharges. The Commission is advised, however, that DCG "no longer disputes whether the per kWh assessment of taxes and surcharges should apply" to SL/TS rates. District Govt. Br. 2. In addition, OPC challenged the federal income tax figures that Pepco used to calculate cash working capital. This issue (Issue No. 3c) was settled when Pepco agreed to set federal income taxes equal to zero (instead of a large negative number) for purposes of calculating Cash Working Capital. *See* Tr. 1481; Tr. 730-731 (OPC witness Ramas). Other potential tax issues were undisputed. *See* Pepco Br. 101-103.

385 Pepco Br. 15-16; Pepco (H) at 2-4 (Winston).

proposes to recover the increase in its tax expense over a three-year period, with the unamortized amount reflected in rate base.[386]

247. **OPC.** OPC urges the Commission to reject Pepco's request for regulatory asset recovery of the newly-created shortfall in its deferred taxes that was created by the cut-back in Medicare Part D tax deduction/subsidies.[387] According to OPC, Pepco should have written off the deferred tax asset related to these future deductions.[388]

248. OPC criticizes the Company for not getting the Commission's permission before recording, as a regulatory asset, the shortfall in deferred taxes related to Medicare Part D.[389] The Company simply assumed that it was probable that the Commission would allow retroactive recovery of these taxes.[390] OPC disagrees with the Company's reliance on the precedent that the Commission included in Pepco's rates the cost changes that resulted from changing corporate tax rates from 46% to 34%. OPC argues that the change in the future tax deduction for the Medicare Part D subsidy does not approach the significance of those earlier dramatic changes in corporate tax rates and, therefore, does not warrant changing Pepco's allowance for tax expenses.[391] According to OPC, a more analogous example was provided in Formal Case No. 1076, where the Commission rejected Pepco's proposal for "regulatory asset" treatment of a \$6.5 million pension expense shortfall in 2009.[392] OPC also claims that the FERC orders cited by Pepco in support of its position are distinguishable.[393]

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386 Pepco Br. 15-16; Pepco (F) at 18-19 and Exhibit (F)-1 at 13 (Hook).

387 *See* OPC Br. 111-114; OPC R. Br. 53-55; OPC (D) at 5, 14-22 (Bright); OPC (A) at 19 (Binz); OPC Adjustment No. 15; OPC (B)-2 (Ramas).

388 OPC Br. 111.

389 OPC Br. 111-112; OPC R.Br. 53-55; OPC (D) at 17-18 (Bright).

390 OPC (D) at 19; *accord*: OPC Br. 113-114.

391 OPC (D) at 19-20.

392 OPC Br. 113, citing *Formal Case No. 1076*, Order No. 15710 at ¶¶ 194-195 (March 2, 2010).

393 OPC claims that in *PJM Interconnection LLC*, 110 FERC 61,234 (2005), the utility requested FERC's permission to record RTO costs as a "regulatory asset." And in *Virginia Elect & Power Co.*, 125 FERC 61,391 (2008), OPC says, the FERC approved the use of a regulatory asset, as an accounting matter, to recover RTO formation costs at a later date, but reserved judgment for a later FERC proceeding that would decide whether these RTO costs were "appropriately recoverable." OPC claims that, by contrast, Pepco's right to recover the increased tax costs is being decided now in *Formal Case No. 1087*. OPC R.Br. 54-55.

249. Even if the Commission decides to allow Pepco to recover the shortfall in its deferred taxes as a regulatory asset over three years, OPC contends that, the amount of the regulatory asset should be reduced.[394] OPC states that the old full-blown tax deduction/subsidy for Medicare Part D expenses did not go into effect until 2003, and that D.C. ratepayers first received the benefit of that tax deduction/subsidy in March 2009 when the rates set in Formal Case No. 1053 went into effect. OPC argues that, contrary to Pepco's submission, the inclusion of deferred taxes in rate base increased rates for ratepayers and therefore it was not a benefit. Ratepayers did not receive any benefit for any of the deferred taxes before the rates established in Formal Case No. 1053 went into effect.[395]

250. **Pepco Rebuttal.** Pepco argues that tax deduction cut-backs for Medicare Part D expenses were appropriately treated for ratemaking purposes in the same manner that Pepco earlier treated the 1986 reductions in the federal income tax rate from 46% to 34%. In both instances, Pepco established deferred tax balances based on the law in effect at the time they were recorded. In both instances, a law change required that those balances be revalued. In both instances, the deferred taxes were included in rate base. Pepco argues that it is logical and appropriate that the change be treated in a similar fashion regardless of the relative amounts of the change.[396] The Commission ruled in Formal Case No. 889 that the ratemaking adjustment for deferred taxes should be returned to customers over 3 years. Pepco is requesting the same treatment for the Medicare related deferred taxes.[397]

251. Contrary to OPC's submissions, Pepco submits that the current Medicare Part D change was not analogous to the Commission's denial of Pepco's request to record a pension expense shortfall in Formal Case No. 1076. There, Pepco contends, the Commission stated that pension costs are similar to the fluctuations of stock market costs, which are traditionally borne by the utility and reasoned that regulatory asset treatment might diminish Pepco's incentives to control its pension costs.[398] Pepco argues that there is no comparable reason to deny Pepco regulatory asset treatment of tax expenses on the ground that Pepco should be incentivized to control such costs. The tax treatment of

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394 OPC Br. 111, 114-115; OPC R.Br. 53, 55.

395 OPC R.Br. 55. *And see* OPC (D) at 20-21.

396 Pepco Br. 16 ("it is not the significance of the amount of the deferred tax balance that should dictate its treatment, but the situation that causes the issue"); Pepco (3H) at 2-3 (Winston Rebuttal). "Since the change in the law is effective starting in 2013, the deferred tax adjustment is based upon estimates. As the actual effective date of the law approaches, those estimates will be trued up, if necessary, with a corresponding true-up to the regulatory asset." *Id.* at 3.

397 Pepco (3H) at 3.

398 Pepco R.Br. 13.

Medicare Part D deductions is a matter of law, and cannot be controlled by Pepco. Because Pepco's tax expenses for Medicare Part D are more analogous to the prior decrease in tax expenses, and not at all analogous to the Commission's finding regarding pension expense in Formal Case No. 1076, Pepco maintains that it is entirely reasonable for it to conclude "that it is probable that Pepco could recover these costs" in a regulatory asset.[399]

252. Additionally, Pepco argues that no prior regulatory approval was necessary because the standard for creating a regulatory asset, in SFAS No. 71, is only that cost recovery must be "probable," *i.e.,* "reasonably expected on the basis of available evidence or logic" but neither certain nor proved. According to Pepco, the FERC has consistently ruled that this standard does not require prior regulatory approval.[400]

253. The Company argues, finally, that OPC errs in contending that customers have not benefitted from the Medicare Part D subsidy. Deferred taxes are cumulative, Pepco points out, and have been included in every filing Pepco has made with the Commission since 2004.[401] OPC claims that whenever a tax law change occurs that impacts deferred taxes in rate base, the only amounts that should be included in Pepco's deferred tax balance in rate base should be those occurring after the first base rate case following the change in law. Pepco replies that, under OPC's reasoning, Pepco could not include in its rate base the deferred taxes for all bonus depreciation deductions claimed between 2001 and 2007 (since 2008 is the first year in which Pepco filed a base rate case after enactment of the bonus depreciation rules). This kind of treatment would be contrary to the Commission's general regulatory treatment of deferred tax balances and should be rejected.[402]

DECISION

254. The Commission finds that Pepco's approach to treating increases in Medicare Part D expenses that occur due to legislative cutbacks in associated tax deductions is reasonable. The Commission has previously approved Pepco's treatment of changes in federal income taxes, and testimony during the Evidentiary Hearings confirms that Pepco's treatment in this matter is consistent with the way that Pepco has previously treated changes in federal income taxes.[403] When tax deductions are cut back, the Company's costs go up, and it is logical that ratepayers might be asked to supply the

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399 Pepco R.Br. 13.

400 Pepco Br. 17.

401 Pepco Br. 17, citing Pepco (3H) at 4 (Winston Rebuttal).

402 Pepco (3H) at 4-5 (Winston Rebuttal).

403 Tr. 1537-1538 (colloquy between Pepco witness Winston and Chairman Kane).

shortfall. The cut-back in future tax benefit receivables is being recovered by Pepco as a regulatory asset over three years. Consistent with past practice, the impact was reflected in the Company's financial results when the law was enacted, not the later date when the law became effective.[404]

255. OPC argues that, because of the delay in "flowing through" the tax deduction cut-back to ratepayers, there never was any shortfall in pre-collected taxes related to 2004, 2005, 2006, 2007 and the first three months of 2008. However, Pepco's rebuttal in Pepco (3H) at 4-5 (Winston rebuttal) is persuasive that its treatment of this "deferred tax balance" issue is correct and consistent with past Commission practice.

256. We also accept this adjustment as reasonable, subject to a reporting requirement: Pepco must file specific testimony with the Commission in future rate cases that confirms that it has "trued up" for ratemaking purposes its initial estimates of the adjustment we approve today for taxes on Medicare Part D expenses.[405]

XIII. JURISDICTIONAL COST ALLOCATION[406]

257. The Commission approved Pepco's jurisdictional cost allocations in the Company's last two rate cases. By rejecting OPC's proposed coincident peak method, reaffirmed the validity of the traditional average and excess noncoincident peak ("AED-NCP") method for allocating Pepco's system-wide costs to the District of Columbia. The opinions stated, however, that the Commission might reconsider the AED-NCP method, to determine whether it should be replaced with another method such as the AED-4CP method used by the Maryland PSC, once Pepco's Advanced Metering Infrastructure (AMI) is in place and better data on customer usage becomes available.[407]

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404 Tr. 1538-1539. OPC witness Ramas acknowledged during the evidentiary hearings that Utah had adopted Pepco's approach to treating the change in taxes on Medicare Part D. *See* Tr. 769-775.

405 Pepco witness Winston testified that Pepco "trues-up" for accounting purposes its initial estimates of the adjustment for taxes on Medicare Part D expenses. *See* Tr. 1538-1540 (Pepco witness Winston). The Commission's reporting requirement ensures that Pepco will perform the "true up" for ratemaking purposes as well. We note that the Commission in Maryland, in its recent July 20, 2012 decision, accepted Pepco's Medicare Part D adjustment. *See Maryland PSC Case No. 9286, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service*, Order No. 85028, pp. 20-21 (July 20, 2012).

406 Designated Issue No. 13 asks, "Is Pepco's proposed Jurisdictional Cost Allocation Study for distribution service reasonable?"

407 *See Formal Case No. 1076*, Order No.15710, ¶¶ 281, 289 (March 2, 2010) and *Formal Case No. 1053*, Order No.14712, ¶¶ 253-256.

258. **Pepco**. The Company states that it uses well-settled methods, including the AED-NCP methodology, to allocate its costs between Maryland and the District. It argues that this is reasonable and consistent with the Commission's directives in past cases.[408]

259. **OPC**. OPC challenges the Company's position, arguing that the AED-NCP method over-allocates subtransmission distribution costs to the District of Columbia even though its witness winds up agreeing with Pepco's jurisdictional cost allocation.[409] OPC argues that the traditional AED-NCP method, which considers both demand and energy consumption, was appropriate only when Pepco was an electric generating company whose costs were driven predominantly by energy consumption. Today, however, Pepco has been restructured into a "wires only" distribution company whose costs (and cost planning) are driven by demand (not energy consumption). OPC argues that this makes the old AED-NCP method inappropriate.[410]

260. The old AED-NCP method is supported by Pepco primarily because it is the traditional method, OPC states, not because AED-NCP is "the most accurate or most reasonable way to allocate the Company's subtransmission costs."[411] OPC points out that any argument that a coincident peak allocator is inappropriate is undermined by the Company's use of a coincident peak allocator, the AED-4CP method, when performing the jurisdictional cost allocation in Maryland."[412]

261. OPC offers an alternative way of allocating Pepco's subtransmission costs between Maryland and the District of Columbia, utilizing the Single Coincident Peak method (1CP) instead of the AED-NCP method.[413] Ultimately, however, OPC witness

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408 Pepco Br. 87; Pepco R.Br. 44-46; Pepco (K) at 11-17, (2K) at 1-2, and Exhibit (K)-1 (Tanos).

409 OPC Br. 91-97; OPC R.Br. 43-45; OPC (F) at 5, 7 (Pavlovic); *see also* OPC (A) at 20 (Binz).

410 *See* OPC Br. 92, 95; OPC R.Br. 44; OPC (F) at 7-14 (Pavlovic).

411 OPC Br. 91; OPC R.Br. 43.

412 OPC Br. 97; OPC R.Br. 45.

413 OPC submits that "[e]nergy usage is not one of Pepco's three engineering and operating criteria" and "Pepco uses summer peak forecasts as the basis of planning for future load growth, not forecast energy." OPC R.Br. 45, citing OPC (F) at 10-11 (Pavlovic). Relying on NARUC's Manual for allocating electric utility costs, OPC argues that the 1CP method is appropriate because "the single highest peak demand is the overriding consideration" that drives Pepco's costs and planning for providing transmission service. OPC states: "The NARUC Manual discusses two alternative coincident peak methods that are appropriate to (1) systems that experience seasonal peak demands of comparable magnitude [where the Average Seasonal System Coincident Peak method is appropriate], and (2) systems where significant variations in monthly peak demands are present [where the Average of the 12 Monthly System Coincident Peak (12 CP) method is appropriate]. Because Pepco neither has comparable seasonal peaks nor significant variation in monthly peaks, the 1CP is the appropriate allocation method for subtransmission facilities." OPC (F) at 12-13 (Pavlovic); OPC Br. 92-96.

Pavlovic concludes that the impact of this new approach is "*de minimis*," so he recommends that the Commission simply accept Pepco's jurisdictional cost allocation.[414]

262. OPC's post-hearing reply brief omits this concession. Instead, OPC argues that Pepco has not demonstrated that the AED-NCP method remains a reasonable method of allocating subtransmission costs by jurisdiction. OPC concludes that the Commission should replace that method with the 1CP approach advocated by Pavlovic and the Office.[415]

263. **District Government.** DCG argues that OPC's 1CP jurisdictional cost allocation method is appropriate for the future once smart meters are in widespread use. However, DCG agrees with Pepco that the traditional AED-NCP method should be used in the present case.[416]

264. DCG does take issue with the way Pepco allocates jurisdictional costs affecting the Street Light and Traffic Signal ("SL/TS") rates. Three D.C. Government customers are covered by the TS rate class in the District, but DCG states that Pepco's jurisdictional cost allocation study identifies zero customers in the Maryland TS rate class. Given that traffic signals are used in both D.C. and Maryland, DCG worries that it may be subsidizing the costs of Pepco's traffic signal customers in Maryland. To the extent this is occurring, Pepco's jurisdictional cost study is not reasonable, and the District's TS costs should be reduced to eliminate any cross-jurisdictional subsidization of Maryland's TS costs."[417]

265. **Pepco Rebuttal.** Traditional AED-NCP methodology is well-established, Pepco submits, and is supported not only by Commission precedent and NARUC's cost allocation method, but also by the Company's load requirements throughout its District of Columbia service territory." According to Pepco, "the network requirements of the

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414 OPC (F) at 13-14, 5-6 (Pavlovic). Using Pepco's 2011 forecast Jurisdictional Allocation Study to calculate the impact on D.C. jurisdictional costs of using the 1CP method applied to subtransmission costs, OPC finds that "Pepco's D.C. jurisdictional subtransmission costs and expenses are reduced by $98,227." Because this impact is *de minimis*, OPC recommends that the Commission accept Pepco's jurisdictional cost allocation study. OPC (F) at 13-14 (Pavlovic).

415 OPC R.Br. 45.

416 DCG explains that "[a]s long as Pepco bills on a demand, energy, and customer basis, the AED method should remain in use so that consistent rates of return are measured over time. After one year of experience with smart meters, a record of customer demand on the system will be established. At that time, this Commission should then decide whether to change its cost allocation, rate design, and billing methods to customer and demand related concepts." DC Govt (2A) at 5 (Petniunas Rebuttal).

417 DC Govt Br. 6-7. DCG also submits that, in the future, Pepco's jurisdictional cost allocation between D.C. and Maryland should more clearly identify SL plant in service (SL Account 373). Moreover, DCG suggests that Pepco should be more explicit in specifying that Street Lighting accounts are related to SL Service (not SL Energy). DC Govt (A) at 14-15 (Petniunas).

subtransmission system are more complex than OPC has described, and the system has the same general functionality that it did when the Commission first approved the AED-NCP method for jurisdictional cost allocations.[418]

266. Opposing the 1CP method, Pepco argues that 1CP is based upon a single hour of system peak, which is inconsistent with how the Company designs, builds and operates its distribution facilities. Distribution facilities are much closer to connected load requirements, and their respective undiversified demands place much more demand on the Company's installed plant requirements.[419] The Commission properly rejected the 1CP method in Formal Case Nos. 1053 and 1076, Pepco asserts, and it should reaffirm the traditional AED-NCP method for jurisdictional cost allocation in the present case.[420]

267. Turning to DCG's complaints, Pepco replies that in Maryland, Pepco bills its traffic signal service under the SL or GS rate class schedules. Pepco does not have a separate TS rate class designation for Maryland service. Traffic signal services are charged under a different designation in Pepco's Maryland service territory, but there is no subsidization between the jurisdictions. Pepco avers that there is simply no basis in fact, for DCG's speculation that traffic signal service in Maryland is billed to traffic signal customers in the District.[421]

DECISION

268. The Commission approves, as reasonable for this Pepco rate case, the well-established, traditional AED-NCP method of jurisdictional cost allocation. No party has presented a compelling reason to reject Pepco's AED-NCP methodology it uses in this case.[422]

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418 Pepco R.Br. 44; *and see* Pepco (3K) at 8 (Tanos).

419 Pepco R.Br. 45. *And see* Pepco Br. 87-88 ("1CP method is inappropriate because it fails to accurately reflect the geographically more localized peak load characteristics of the system. The 1CP method also is inequitable because when one uses a single hour and reviews the composite underlying load responsibility by jurisdiction and class it results in considerable variation each hour.") Pepco points out that, on cross-examination, OPC witness Pavlovic agreed that distribution facilities are installed primarily to meet localized demands. *Id.* at 89, citing Tr. 987-988.

420 Pepco Br. 88-89. Pepco notes that switching to the 1CP method, for jurisdictional cost allocation, "would only have a 0.3% effect on rates" – a minor impact independently counseling against making such a switch. *Id.* at 89. The impact on class cost of service and class RORs would be greater, Pepco notes: "If the Commission were to approve the allocation method proposed by OPC, the street lighting class, which consists of the District Government, Park Service, and the Architect of the Capitol, would have no distribution plant investment allocated to it despite the fact that it benefits from the Company's distribution system for over 4,000 hours per year." Pepco R.Br. 45 n.207, citing Pepco Exhibit 81.

421 Pepco R.Br. 45-46. *See also* Pepco (3K) at 8 (Tanos).

422 We are persuaded by Pepco that there is no basis for DCG's concern that the District might be subsidizing the costs of Maryland traffic signals.

269. We credit the persuasive evidence in this record that criticizes the 1CP cost allocation method for D.C. that is advocated by OPC and DCG.[423] Testimony submitted by Pepco in response to the Commission's bench questions included a comparison of jurisdictional cost allocation methodologies, comparing the traditional AED-NCP method with the AED-4CP method that the Maryland PSC uses, and with the 1CP method proposed by OPC. The outcomes are similar for jurisdictional cost allocation: The AED-4CP method results in an operating income and rate of return that is $73,286 and 0.01% greater than the results of the AED-NCP method, respectively. The 1CP method results in an operating income and rate of return that is $136,417 and 0.03% greater than the results of the AED-NCP method, respectively."[424] Further testimony submitted by Pepco (and acknowledged by OPC witness Pavlovic) shows that the Company does not build or plan its system on the basis of CP (which reflects overall system peak). Instead, Pepco builds and plans its system in significant part on the basis of NCP (which reflects the highest load on more localized, particular elements of the system). Consistent with NARUC principles, the Company has long used a blended jurisdictional cost allocator, the AED-NCP method.

270. In the future, this Commission may decide to re-examine the AED-NCP method, and consider whether it should be replaced with something else, such as the AED-4CP method that the Maryland PSC uses for jurisdictional cost allocation, once AMI is in place and better data on customer usage becomes available.[425] We agree with AOBA witness Oliver, however, that even after AMI meters are installed, it may take some time to study residential patterns of consumption and for good data on customer usage to become available for the Commission's consideration.[426]

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[423] For purposes of jurisdictional cost allocation, the choice of a 1 CP method (rather than the traditional AED-NCP method) makes only a small difference. *See* Pepco Exhibit No. 81 at 1-2 (Tanos) responding to questions from Commissioner Lee at Tr. 635-636 ("The 1CP method results in an operating income and rate of return that is $136,417 and 0.03% greater than the results of the AED-NCP method, respectively.") The impact of the 1CP method on class CCOSS is significant, however, because it would dramatically lower the class cost of service for off-peak users like the SL/TS classes (which DCG favors). *See* discussion of CCOSS and the 1CP method at **pp. 93-93** ***infra***.

[424] Pepco Exhibit 81, Pages 1-2 (Tanos) responding to questions from Commissioner Lee at Tr. 635-636.

[425] *Accord: Formal Case No. 1076*, Order No. 15710, ¶ 289.

[426] Opposing OPC's suggestion for re-design of District rates shortly after the AMI system is placed in service in the second quarter of 2012, AOBA witness Oliver indicated it will take time to develop an understanding of the variation in individual customers' demands from month-to-month and the stability of billing determinants that would be used in computing charges per kW or per kWh for customers in each rate class." AOBA (2A) at 15 (Oliver Rebuttal). *See also* Tr. 1046-1047 (OPC witness Pavlovic) (one needs at least one full year of data from AMI meters to calculate R demand charges).

XIV. Quality and Reliability of Pepco's Electric Distribution Service-Impact on Rates Proposed in This Case in This Case?[427]

271. **Pepco**. The Company opposes any adjustment of its base rate as a sanction for the quality and reliability of its electric distribution service in the District of Columbia.[428] Pepco emphasizes that the Company has met all of the Commission's major SAIDI/SAIFI reliability standards for the District in the past, and argues that it would be unjust and unreasonable to lower its base rates to penalize it for unreliable service.[429]

272. The Company claims that it has not only met the Commission's reliability standards but also improved its reliability since 2006, and that it ranked in the second quartile of Mid-Atlantic utilities for both SAIFI and SAIDI measures in 2009 and 2010. The Company asserts that it needs its new proposed base rates for capital expenditures to meet the Commission's reliability standards. Even if the Company had failed to meet applicable standards, a point which the Company does not concede, Pepco notes that the appropriate penalty under the Commission's regulations is a civil penalty not a base rate reduction.[430] Pepco argues any reduction in base rates would be a further penalty signaling greater uncertainty and risk to investors, and undermining its ability to invest in reliability-enhancing projects.[431]

273. **OPC**. OPC alleges that the quality and reliability of Pepco's distribution service in the District is poor and warrants a reduction in Pepco's proposed base rates.[432] Accordingly, OPC suggests several options for the Commission's consideration. ***Option 1.*** If Pepco is granted a return on equity (ROE) higher than 9.0%, OPC argues that the Commission should approve a 25 basis point reduction to reflect the low quality and reliability of Pepco's service.[433] ***Option 2.*** If the Commission approves any increase for

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427 Designated Issue 12 asks, "Does the quality and reliability of Pepco's electric distribution service in the District of Columbia warrant an adjustment to the base rates proposed by Pepco in this case? If so, what is the basis for the adjustment and what should the adjustment be?"

428 Pepco Br. 83-86.

429 *Id.* at 83-84, citing *Formal Case No. 1082, In the Matter of the Investigation Into the Distribution Reliability Performance of the Potomac Electric Power Company,* Order No. 16002, ¶ 8 (October 6, 2010) ("OPC does not assert that Pepco failed to comply with the existing reliability standards that are set forth in the EQSS, so its basis for civil penalties is unclear. As Pepco points out, the Company meets the only applicable reliability standards, which are those currently existing under the EQSS.").

430 Pepco (2I) at 9-11 (Gausman).

431 Pepco (2A) at 6 (Kamerick).

432 OPC Br. 81-91; OPC R.Br. 36-43; OPC (E) at 41 (Mara); OPC (A) at 6 (Binz).

433 OPC Br. 81, 90; OPC (A) at 6 (Binz); OPC (C) at 48 (Woolridge).

reliability projects, it should only allow 50% of the associated revenue requirement to be included in rates at this time, with the remaining 50% carried as a regulatory asset and included in rates only after Pepco complies with the Commission's new Electric Quality of Service Standards ("EQSS") rules for a full year.[434] ***Option 3.*** The Commission should require Pepco to credit consumers with $2 million on a one-time basis to compensate for the poor reliability over the past several years.[435]

274. OPC insists that a lowered base rate for poor performance is not a fine or penalty. Instead, OPC maintains that the Commission would be setting just and reasonable rates commensurate with the level of service provided. OPC submits that where a public utility is providing inefficient and inferior service, it deserves a lower return than would be appropriate for those utilities that are furnishing efficient and reasonable service."[436]

275. OPC argues that it is irrelevant that Pepco complied with the previous EQSS reliability standards for D.C. What is important, OPC submits, is that Pepco's D.C. service reliability has been poor, as OPC's testimony and the Commission's past orders establish.[437] OPC states that it is well documented that Pepco's reliability has been in decline for more than a decade, and the current state of reliability remains less than acceptable.[438] OPC states that during the past 10 years, Pepco has continued to perform at the lowest quartile when compared to other utilities and has infamously earned the reputation as the most hated company in the country.[439] OPC rejects Pepco witness Gausman's testimony, which compares Pepco's reliability to other utilities in the Mid-Atlantic, because the Commission's stated goal is for Pepco to be in the top quartile of all utilities, not simply comparable to the Mid-Atlantic group, 42% of whose utilities are in the bottom quartile.[440] The Commission has investigated a variety of Pepco outages, and

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434 OPC (A) at 6 (Binz).

435 OPC Br. 81, 90; OPC (A) at 6.

436 OPC R.Br. 39.

437 OPC R.Br. 41-43.

438 OPC (E) at 41, 8 (Mara). OPC reviews the history of Pepco's distribution system reliability, starting with the series of manhole explosions and fires that Pepco experienced in February and March 2000, and extending to the present. *See id.* at 15-16. Over the last several years, OPC notes, the Commission has issued a number of orders that are critical of Pepco's reliability. *Id.* at 16-17. OPC cites a series of Pepco reports, from 2007, 2008, 2009, 2010 and 2011 recognizing Pepco's low ranking ("large city reliability survey") under SAIFI, SAIDI, and CAIDI standards, and the need for Pepco to improve the reliability of its electric service. *Id.* at 19-25. *See also* OPC Br. 82-88. OPC indicates that in July 2012, the Commission noted that "Pepco's recent poor performance has caused it to be the subject of severe criticism in the press, in legislative circles, and in comments throughout the D.C. metropolitan area." *Formal Case Nos. 766, 982, 991, 1002,* Order No. 16427, ¶ 47 (July 7, 2011)..

439 OPC Br. 82.

440 OPC Br. 89; OPC (E) at 47 (Mara).

it has ordered more demanding EQSS standards in an effort to improve Pepco's reliability and quality of service.[441]

276. According to OPC, Pepco is not focused on reliability and some type of monetary penalty is required to stimulate improvement in D.C. reliability.[442] OPC claims that Pepco's pattern of poor electric distribution system reliability in D.C. continues today.[443] Citing a series of 2011 Commission orders that express continuing concern about Pepco's reliability, OPC asserts while it is troubling that Pepco's reliability continues to lag behind that of its peers, it is at least equally troubling that Pepco still does not appear to have an organized, well-thought-out plan to improve its performance.[444]

277. OPC points out that the Maryland Public Service Commission recently levied a $1 million fine on Pepco for its deficiencies in maintaining reliability in Maryland.[445] OPC urges the Commission to follow the lead of the Maryland PSC and to disallow Pepco's recovery of any reliability expenditures due to the Company's earlier imprudent management.[446] OPC submits that Pepco's historical and continued poor electric distribution service warrants an adjustment to Pepco's base rates through the Commission's adoption of one of OPC's three options.[447]

278. **AOBA.** AOBA suggests that if the Commission believes that it cannot adjust the returns provided to Pepco's shareholders to reflect poor performance without impeding the Company's ability to attract capital that may be needed to support improvements in system reliability, then an alternative is to limit the amount of executive compensation included in rates for District of Columbia customers. By doing so, the onus is placed on shareholders to assess whether management's performance warrants a sharing of their earned returns.[448]

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441 OPC (E) at 8 (Mara).

442 OPC (E) at 46 (Mara).

443 OPC Br. 88-89.

444 OPC (E) at 8, 43-44 (Mara).

445 *See* OPC Br. 86-87; Tr. 141 (Pepco witness Lowry). The Maryland PSC recently imposed a $1 million fine on Pepco, as well as a multi-million dollar deduction for "catch-up" reliability costs, and a reduction in Pepco's ROE for "historic system neglect." *See Maryland PSC Case No. 9286, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service*, Order No. 85028, pp. 35-39, 107-109 (July 20, 2012).

446 OPC Br. 88.

447 OPC Br. 90; OPC R.Br.36-37.

448 AOBA Br. 44; AOBA (A) at 68-69 (Oliver).

279. **Pepco Rebuttal.** The Company's rebuttal emphasizes that it satisfied all the pre-2011 D.C.-wide reliability standards for SAIFI and SAIDI.[449] Pepco argues that this should be dispositive of Issue No. 12 since there is no basis in law or logic for OPC's attempt to distinguish the penalties it proposes from fines for failure to comply with the Commission's standards.[450] According to Pepco, OPC presents no analysis or evidence to justify any of its three optional penalties.[451]

280. Quite apart from this, Pepco reiterates that it needs additional financing to meet the Commission's new reliability performance standards in the future.[452] Consequently, Pepco argues handicapping the Company with unwarranted financial penalties like OPC's first proposal by reducing the company's ROE would be self-defeating. According to Pepco that would make it more difficult and expensive for Pepco to raise funds as investors will view the regulatory environment as unsupportive and more risky, to the detriment of the Company's customers.[453]

281. OPC's option 2 proposing to withhold 50% of the revenue requirement for reliability projects is vaguely defined, unworkable, and similarly counterproductive, according to Pepco. Withholding financial resources that the Company needs to meet the new reliability standards will increase its cost of raising capital, to the detriment of customers. Pepco contends that OPC's proposed one-time $2 million credit to Pepco ratepayers) is arbitrary and unreasonable, and without any legal or quantitative support.[454] OPC presents no analysis of this Commission's civil penalty authority to support option 3. Moreover, because Pepco met D.C.'s EQSS reliability standards in place at the time, the Company asserts there is no legal support for penalties associated with the quality and reliability of Pepco's electrical distribution service in the District of Columbia since Pepco continues to meet the only applicable standards.[455]

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449 *See* Pepco Br.84-85; Pepco R.Br. 42; Pepco (3A) at 8 (Kamerick Rebuttal); Pepco (3I) at 6-8 and Table 1 on p.7 (Gausman Rebuttal). According to Pepco, and contrary to the claims made by OPC witness Dismukes, OPC Exhibit (G)-2 shows that electric reliability standards within D.C. are better than the indices for the entire Pepco service region. *Id.* at 8-9.

450 Pepco R.Br. 42.

451 Pepco Br. 84-85, noting that OPC's own witness Woolridge states (OPC (C) at 47) that he "did not recommend any adjustment to ROE for reliability performance in this case."

452 By Order No. 16247, the Commission adopted new EQSS standards. *See* Order No. 16427 (July 7, 2011) in *Formal Case Nos. 766, 982, 991, 1002* (setting new SAIFI and SAIDI reliability performance standards for the District of Columbia so that by 2020 Pepco is expected to be among the best performing utilities in the nation).

453 Pepco (3A) at 8-10 (Kamerick Rebuttal).

454 Pepco Br. 85-86.

455 Pepco Br. 86.

DECISION

282. The Commission rejects OPC's proposed adjustments to Pepco's base rate as a sanction for the quality and reliability of its electric distribution service. OPC has not shown a basis in the D.C. statutes for imposing a civil fine or penalty against Pepco. The Commission has the power to award a lower ROE, within the range of reasonableness, to reflect disappointing service and reliability by Pepco, but we find that a reduced ROE is not warranted or appropriate in this case. Although Pepco's prior performance was not stellar, it has nevertheless substantially complied with the pre-2011 SAIFI/SAIDI reliability standards.[456] Pepco's reliability performance is measured according to these EQSS standards, which were developed with the full participation of OPC and other relevant stakeholders. Though it has not been widely recognized, Pepco's service in the District in recent years was in fact significantly more reliable than it has been in Maryland, in part, thanks to D.C.'s reliability standards.[457]

283. The EQSS standards represent minimum acceptable performance. Recognizing that Pepco's performance could be better, the standards have been revised to require increasing improvement in reliability beginning in 2013 through 2020.[458] In order to help ensure that ratepayers will enjoy the increased reliability that these new standards are intended to provide, it is essential to have a financially healthy Pepco. Withholding monies now from Pepco by arbitrarily reducing Pepco's ROE might only result in increasing the Company's cost of capital and a more expensive bill for D.C. consumers over the long term, and impede the Company's ability to make the improvements in D.C. reliability and service that this Commission has mandated. Even OPC witness Woolridge "does not recommend any adjustment to ROE for reliability

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456 The Commission's examination of Pepco witness Gausman reveals that, for the years 2006 through 2010, the Company met D.C.'s major electricity quality of service standards (EQSS)-- SAIDI and SAIFI – as set forth in 15 DCMR §§ 3603.10, 11, 12 and 13 of the Commission's regulations. *See* Tr. 1599-1601 (colloquy between Gausman and Chairman Kane). Other reliability standards in 15 DCMR § 3603.7 and § 3603.8 call for the Company to restore service to 100% of customers within 24 hours following a non-major service outage. The Company complied 95% to 100% of the time with those service restoration standards. Tr. 1600, 1602-1603 (colloquy between Pepco witness Gausman and Chairman Kane) (drawing on Pepco's quarterly and annual reports filed with the Commission).

457 Overall, witness Gausman confirmed on the witness stand that the reliability indices within the District of Columbia are better than the indices in the entire Pepco service region. Tr. 1563 (Gausman). As Chairperson Kane remarked during the hearings "Maryland, in its latest order, found * * * that the service in Maryland was significantly less reliable than it has been in the District, in part thanks to our standards." Tr. 1237.

458 *See Formal Case Nos. 766, 982, 991, 1002,* Order No. 16427. Contrary to OPC's assertion, Commission orders addressing Pepco's reliability have been directed at improving the reliability of Pepco's distribution system above our EQSS standards which reflect the minimal level of electric system reliability performance. Our recent adoption of new EQSS standards hold Pepco to higher standards for delivering power and restoring service so that by 2020 Pepco will be among the best performing utilities in the nation. *See* Order No. 16427, ¶ 50.

performance in this case and believes that the Commission should consider adjusting Pepco's base rates in future proceedings based on Pepco's reliability performance."[459]

284. We recognize that limiting the amount of ratepayer-reimbursed executive compensation may be an effective method of improving reliability. However, the issue has not been adequately explored on the record in this case and no party has proposed a specific rate adjustment targeting Pepco's executive salaries.[460] OPC recently filed a petition asking the Commission to consider whether, in the future, Pepco's executive salaries should be subject to meeting D.C. reliability standards. The Commission has decided to grant OPC's petition and all interested persons will be given an opportunity to participate in the proceeding in a separate order.

285. OPC, AOBA, GSA, and several District consumers have asserted that Pepco is using a rate hike to recover "catch up" costs caused by the Company's own failure to properly maintain its system. These parties note that the Maryland Public Service Commission not only recognized that Pepco had acted imprudently in maintaining its system but also fined the company $1 million for its poor performance. Although the parties ask us to follow the Maryland PSC's lead, we are not similarly situated to Maryland. The civil penalty statutes in the District are different from those in Maryland. Pepco complied with D.C.'s reliability standards, and our statutes do not authorize a civil penalty against Pepco in these circumstances. Nor would a civil penalty be warranted. Moreover the Maryland PSC's disallowance of "catch-up" costs was based on extensive evidence, submitted by both Staff and OPC in Maryland, showing the amount of the "catch-up" for which Pepco was seeking compensation.[461] No such evidence was presented here.

XV. THE COMPANY'S REVENUE REQUIREMENT

286. The Commission finds that Pepco's District of Columbia adjusted rate base for the test period is $1,151,822,000, and that a fair rate of return (including capital costs and capital structure) on that D.C. rate base is 8.03%. The Commission further finds that the level of return required when the 8.03% rate of return is applied to the adjusted test year rate base of $1,151,822,000 is $92,491,000.

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459 OPC (C) at 47 (Woolridge).

460 *Formal Case Nos. 766 and 991,*Order No. 16623, ¶ 45 in *Formal Case Nos. 766 and 991* did require Pepco to identify (and to include in its 2012 Consolidated Report) "total compensation levels (including bonuses, options and deferred compensation) for its ten most senior managers over the last five years (2006-2011) and show how that compensation has been affected by Pepco's electric service reliability."

461 *See Maryland PSC Case No. 9286, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service*,, Order No. 85028, pp. 39, 36 (July 12, 2012).

287. The Commission finds that the adjustment that will increase Pepco's test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order is $24,376,000, which includes a proper allowance for taxes.

XVI. CUSTOMER CLASS DISTRIBUTION OF PEPCO'S RATE INCREASE [462]

A. Class Cost of Service Study[463]

288. **Pepco.** The Company proposes to move gradually ("one-quarter of the way") toward a more equalized set of class rates of return by raising distribution rates (which are only part of each customer's bill) more for residential than for commercial customers. Overall, Pepco proposes to allocate approximately 52% of its requested rate increase to the residential class, primarily through increases in the monthly customer charge.[464] Pepco justifies its proposed class revenue requirements relying on its Class Cost of Service Study ("CCOSS") which shows significant disparities in class rates of return ("ROR"). The Company's class cost of service study (CCOSS) shows that current earned returns vary widely by customer class. At the low end of the range, with returns in the negative range, are the residential classes (standard R, R-All Electric, and the RAD class) (with class RORs ranging from negative (–) 5.96% to negative (–) 3.10%) and the streetlight energy class (with a class ROR of negative – 5.20). The high end of the range generally contains the large commercial high voltage class (Schedule GT-HV-other) at 16.47% and the Metro-Rapid Transit class at 13.89%. Generally, the residential classes provide significant negative earnings on distribution service while commercial classes provide above-average rates of return.

289. To develop its CCOSS, Pepco used the same model that the Commission approved in past Pepco rate cases.[465] In the present case, Pepco also allocates embedded AMI plant costs among customer classes in its CCOSS. Technical corrections were made in the CCOSS, which have only a minor impact on class ROR, Pepco states.[466]

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462 Designated Issue No. 14 asks, "Is Pepco's proposed distribution of its revenue requirement reasonable?"

463 Designated Issue No. 14a asks: "Is Pepco's proposed Class Cost Allocation Study reasonable?"

464 Pepco (L)-1:2

465 Pepco Br. 89; Pepco (K) at 9, 5-9, 18-22 (Tanos). To comply with past Commission directives, Pepco also submitted a distribution marginal class cost of service study; however, it has not used the results of that study in any way. Pepco (L) at 17 and Exhibit (L)-5 (Janocha).

466 Pepco (2K) at 2-4 (Tanos), referencing OPC Data Request No.5, Question 11.

290. To comply with past Commission directives, Pepco also examined the issue raised by OPC regarding whether the Company's CCOSS over-allocates the cost of expensive underground facilities to the residential class.[467] To begin with, the Company explains that its distribution facilities are primarily underground (UG), as opposed to overhead (OH), as shown by the following plant investment data:

	Primary	Secondary	Total
UG ($m)	$605 m (90.7%)	$609 m (92.0%)	$1,213 m (91.4%)
OH ($m)	62 m (9.3%)	53 m (8.0%)	115 m (8.6%)
Total	$667 m (100%)	$662 m (100%)	$1,328 m (100%)

291. According to Pepco, its data show that UG facilities account for 91.4% of its total installed distribution plant investment (primary and secondary). Moreover, installed secondary is a major plant investment component in serving residential customers. When recognizing that about 87% of total UG served customers are residential, and this UG residential customer group is about 58% of the total residential population, the resulting plant allocations are entirely reasonable. The Company's CCOSS concludes that the residential class accounts for approximately 31% of Pepco's UG distribution investment for "primary, secondary, and services," using "a composite allocation factor of both class and maximum customer demands.[468]

292. **OPC.** OPC argues that the Company's CCOSS is unreasonable because it over-allocates distribution costs to the residential customer class.[469] OPC contends that two errors exist in Pepco's class cost of service study. One error, which OPC ultimately dismisses as *de minimis*, understates residential class costs by using the traditional AED-NCP allocator (instead of a more accurate 1CP allocator) to allocate subtransmission costs among Pepco's various different customer classes in D.C.[470] The other CCOSS error is more significant, OPC argues, because it over-allocates underground facilities costs (which are higher than the costs of overhead facilities) to the residential class by approximately 50%.[471] As a result, OPC claims, Pepco overstates the disparities that now exist in its customer class RORs, and overstates the extent to which the residential class is being subsidized by Pepco's commercial classes.[472] When OPC recalculated class cost of service, it found that the "residential rate of return moves from –5.11% to –4.81% and the

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467 *See* Pepco (K) at 4, 9- 11 (Tanos).

468 Pepco (K) at 10-12.

469 OPC Br. 98-104; OPC (F) at 17, 5 (Pavlovic).

470 OPC R.Br. 47-48.

471 *See* OPC R.Br. 48-49; OPC (F) at 17, 21 (Pavlovic); OPC (F) at 20- 21; OPC Br. 102-104.

472 *See* OPC (F) at 18, citing OPC (F)-3 at 5; OPC Br. 102.

Total Commercial rate of return for classes GS, GT and Metro moves from 13.53% to 10.79%."[473]

293. **AOBA**. Taking the opposite point of view, AOBA argues that Pepco's CCOSS understates the extent to which the residential class is subsidized by other customer classes, and it urges the Commission to press the limits in reducing the severe disparities that now exist in customer class RORs. The Company's CCOSS shows severe disparities between customer class RORs, AOBA states, with commercial customers (the GS and GT classes), Metro-RT, Residential Time-Metered (RTM) customers, and master metered apartments (MMAs) providing heavy subsidies to Residential (R and AE) and RAD customers.[474] AOBA asserts that while some rate classifications earned returns of more than two times the system average returns the Company's CCOSS shows negative rate of return for Pepco's Residential (excluding MMAs), RAD, and Street Lighting-Energy classes. Moreover, with the exception of the Metro-Rapid Transit rate, AOBA submits that rates of return for the majority of rate classes have moved further from, rather than closer to, the system average since the Company's last rate case.[475]

294. Indeed, AOBA argues that cross-subsidies among customer classes are even worse than Pepco's CCOSS shows because of a significant tax allocation error that AOBA witness Oliver contends was overlooked in earlier Pepco rate cases.[476] AOBA submits that a more appropriate approach to determining customer class income tax responsibilities, in Pepco's current situation, is to allocate taxes among classes in proportion to their rate base responsibilities.[477]

295. AOBA argues that there is no basis for using Coincident Peak demand methods to rework Pepco's CCOSS as OPC proposes. Citing the NARUC's manual on electric utility cost allocation principles, AOBA states that "customer-class noncoincident demands (NCPs) and individual customer maximum demands are the load characteristics that are normally used to allocate the demand component of distribution plant.[478] AOBA

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[473] OPC (F) at 21- 22 (Pavlovic).

[474] *See* AOBA Br. 25-31. OPC witness Pavlovic conceded on cross-examination by AOBA that he was aware of only one other electric utility (other than Pepco) whose CCOSS found a negative rate of return for the residential class. *See* Tr. 1000-1005 (OPC witness Pavlovic).

[475] AOBA (A) at 52-53 (Oliver).

[476] AOBA Br. 47, 48; AOBA R.Br. 23.

[477] AOBA R.Br. 25; AOBA Br. 30-31; AOBA (A) 17, 57-59. When federal taxes are allocated to customer classes according to their rate base costs (regardless of net income), AOBA claims that the result shows even greater subsidization of the Residential (R and R-AE) classes by the commercial classes. *Id.*

[478] AOBA (2A) at 3-4 (Oliver Rebuttal); AOBA (2A) at 5. *And see* AOBA R.Br. 27.

argues there is no evidence that the load diversity on Pepco's Primary Lines is so limited that it would warrant Coincident Peak demand measures to allocate those costs.[479]

296. AOBA dismisses OPC's other proposed adjustments to the CCOSS. Though separate factors should be used for allocating the cost of overhead and underground distribution facilities, AOBA contends the effect of those changes in the Company's allocations will be small, if not *de minimis*. AOBA criticizes OPC's proposed method for using "inappropriate measures of demand" and not properly weighted class responsibilities for allocating these costs.[480]

297. **District Government (DCG).** The District Government urges a rate freeze for low income residents served by the Residential Aid Discount ("RAD"), and lower rates for the streetlight ("SL") and traffic signal ("TS") classes. Overall, DCG contends that Pepco's CCOSS should be used as a guide for ratemaking purposes but only tangentially. The Commission should not strictly follow Pepco's CCOSS for revenue distribution and rate design, DCG asserts.[481]

298. As to the SL/TS classes, DCG argues that Pepco' s CCOSS is unreasonable to the extent that it fails to recognize the off-peak nature and lower cost causation of the SL/TS classes. These classes are predominantly off-peak and do not contribute to peak load, DCG asserts, but the CCOSS improperly allocates costs to them as though they contributes to peak use.[482] Moreover, even though SL/TS customer growth has remained essentially constant, the District has been consuming less energy over time to support its street lights and traffic signals. DCG complains that Pepco's CCOSS allocates costs to the SL/TS classes as though they require new facilities to accommodate customer growth.[483]

299. DCG supports OPC's recommendation to allocate distribution costs among classes using the 1CP coincident peak method.[484] This methodology will assign lower costs to classes that consume off-peak. According to DCG, a correctly calculated CCOSS will recognize that the rate of return for the SL/TS class is 10.94%, not the negative (-) 5.20% represented by Pepco. DCG contends that a 1CP method reveals that

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479 AOBA (2A) at 5-6.

480 AOBA R.Br. 27; AOBA (2A) at 6-8

481 DCG (A) at 18, 20 (Petniunas).

482 DC Govt Br. 7-8. Testimony from DCG witness Petniunas similarly criticized Pepco's CCOSS for failing to take into account of time-of-use, seasonality, and marginal cost considerations. *See* DC Govt (A) at 18-20, 4 (Petniunas); DCG (2A) at 6-7 (Petniunas Rebuttal). *Accord:* Tr. 1181-1182, 1202 (DCG witness Petniunas) (off-peak nature of SL/TS service should be considered in setting SL/TS rates).

483 DC Govt Br. 8.

484 *See* DC Govt Br. 9-10, citing Tr. 1027- 1028 (OPC witness Pavlovic).

Pepco is already earning well over its system-wide rate of return of 8.64% on the SL/TS classes.[485] There was a settlement on SL/TS rates, which mooted most of DCG's other complaints about how Pepco's CCOSS assesses the cost of serving the SL/TS classes.[486]

300. Addressing AOBA's arguments, DCG argues that Pepco's CCOSS correctly allocates taxes, in accord with Commission precedent, based on the income and cost allocation of each customer class. There is no basis for AOBA's proposal to allocate the cost of Pepco's taxes among customer classes based on the rate base of each class. The standard method used in the industry" is that "cost allocation should be based on income, not on wealth (rate base). While AOBA's approach assumes that taxes are based on wealth (rate base), DCG contends that in fact, income taxes are based on income, so that Pepco correctly allocates taxes based on the income and cost allocation of each class.[487]

301. **WMATA.** WMATA proposes that class revenue targets should be adjusted "one third of the way" toward more equal class RORs.

302. **Pepco Rebuttal.** Pepco relies on the same arguments it uses to refute OPC's claims on jurisdictional cost allocation to answer OPC's attack relying on the 1CP method to criticize the Company's CCOSS.[488] The Commission's decision in Formal Case No. 1076 rejected OPC's complaint (similar to OPC's and DCG's present claims) about the way that Pepco's CCOSS allocates the costs of primary and secondary underground and overhead facilities among customer classes. The opinion in that case, Pepco points out, holds that "OPC's concern with the assignment of overhead and underground facilities does not undermine Pepco's allocation of rate base and operating expenses to the Residential class.[489]

303. In response to AOBA's claims, Pepco argues that it properly allocated the cost responsibility for taxes among customer classes based upon the customer class taxable income, and not on the basis of "level of plant" or class rate base. Moreover, Pepco states that the federal tax rate for each customer class should be the same as the total Company tax rate when designing rates. According to Pepco, AOBA's contrary

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485 DC Govt Br. 9-10; DCG (2A) at 2, 7-8 (Petniunas Rebuttal). At the hearing, however, DCG witness Petniunas made it clear that he is not recommending a switch to the 1CP method at the present time. *See* Tr. 1180-1183, 1202 (DCG witness Petniunas).

486 *See* Order No. 16790, ¶ 4, Settlement Agreement ¶ 3 (Pepco agrees to complete a study on whether its cost of service studies properly account for SL and TS seasonality and off peak usage).

487 DCG (2A) at 12- 14 (Petniunas Rebuttal)..

488 Pepco Br. 90-91.

489 Pepco Br. 91, citing *Formal Case No. 1076*, Order No. 15710, ¶ 311.

proposal is inconsistent with the revenue targets that would be set under a regime of equalized class RORs, which uses the same federal tax rate for each rate class.[490]

304. The Company's rebuttal testimony revises its CCOSS, to respond to OPC's criticism about AMI cost allocation but the Company indicates that the changes are minor and do not affect its proposed class RORs.[491] Responding to DCG's concern about the allocation of metering costs and AMI adjustments to the SL/TS classes, Pepco modified its proposed customer charge for the SL and TS classes to a two-tiered structure that now distinguishes between metered (Federal Government) and unmetered (DC Government) service.[492]

DECISION

305. The Commission finds that Pepco's CCOSS, as corrected by Pepco, is reasonable as a basis to set class revenue requirements and class RORs. OPC's proposal will not change the basic fact that there are now severe disparities between customer class RORs.[493] Moreover, there is no warrant in the present case for replacing the use of AED-NCP with OPC's proposed 1CP methodology for allocating subtransmission costs in Pepco's CCOSS. The weight of the evidence is that the 1CP method of cost allocation, championed by OPC and DCG, is not appropriate, because Pepco's subtransmission system is designed in sections to meet the maximum expected loads for that localized section.[494] We credit the testimony presented by Pepco that the function or operation of its subtransmission system has not changed as a result of its divestiture of generation. Accordingly, the 1CP allocation method based on loads at the overall system level is not appropriate for allocating the costs of subtransmission facilities among customer classes in Pepco's CCOSS. The Commission is, however, interested in refining Pepco's overhead/underground cost study. In its next rate case, Pepco is to prepare and submit an updated CCOSS that considers customer class loads, as well as the number of customers in a class, in allocating the costs of overhead and underground distribution facilities among customer classes.

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490 Pepco Br. 90.

491 *See* Pepco (3K) at 9 (Tanos Rebuttal) (revising CCOSS to reflect OPC's point about AMI cost allocation); Pepco (3L) at 6 (Janocha Rebuttal).

492 *See* Pepco (3L) at 9 (Janocha Rebuttal).

493 When OPC recalculated class cost of service, using its proposed 1 CP method, it found that the residential rate of return moves from –5.11% to –4.81% and the Total Commercial rate of return [for classes GS, GT and Metro] moves from 13.53% to 10.79%. OPC (F) at 21- 22 (Pavlovic). *Accord:* Tr. 993 (OPC witness Pavlovic). These are still severe disparities.

494 Moreover, OPC witness Pavlovic, who favors the 1CP method, acknowledged on the witness stand that NARUC's electric utility allocation manual (p. 90) supports the use of the NCP method for allocating Pepco's distribution costs. *See* Tr. 979.

306. We are not persuaded by AOBA's claim that the Company's CCOSS erroneously allocates federal tax responsibility among the classes. Taxes are levied on the sums of money paid by customers for electric service, not on the basis of class rate base or some underlying "costs" of the seller to provide the service. We agree with AOBA, however, that the Company's CCOSS (and even OPC's CCOSS) shows that severe disparities now exist between customer class RORs.

307. The settlement between Pepco and DCG on SL and TS rates moots several of DCG's complaints about Pepco's CCOSS. In particular, paragraph three (3) of the Settlement Agreement ¶ 3 provides:

> **Seasonality and Off-Peak Usage Study**. Pepco agrees to complete, within six months of the issuance of the final rate order in Formal Case No. 1087, a study on whether Pepco's cost of service studies properly account for SL and TS seasonality and off peak usage as contemplated by the decision in Formal Case No. 1076. Pepco and DCG shall agree on the scope of the study promptly following issuance of the final rate order and DDOT will cooperate with the performance of the study by providing data and analysis that is within its control and as Pepco reasonably requests. Either party may use the results of this study as it deems appropriate.[495]

Moreover, Pepco addressed the District Government's concern, about the way its CCOSS allocates metering costs and AMI adjustments to the SL/TS classes. The Company modified its proposed customer charge rate design for the SL and TS classes to create a new two-tiered charge, distinguishing metered (Federal Government) from unmetered (D.C. Government) service.[496] This moots (by granting) DCG's request for more direct cost allocations and separate rate classification on SL/TS rates.

B. Impact on Customer Class Rates

308. **Pepco.** The Company proposes to move gradually ("one-quarter of the way") toward more equal class RORs by raising distribution rates more for residential than for commercial customers. To begin with, Pepco proposes to increase the distribution rates of the Residential class, which currently has a class ROR below zero, by one-quarter of the way toward its proposed new overall jurisdictional rate of return of 8.64%. This will result in the Residential class receiving $15.4 million (about 37%) of the Company's originally requested $42.1 million revenue increase with the residential AE class receiving an additional $6.5 million revenue increase. The other customer class with a negative class ROR, the Streetlight Energy Class, will be adjusted one-half of the way from its present negative (-)5.20% class ROR toward a zero ROR, producing an additional $328,500. Pepco set the Streetlight Service class's ROR judgmentally at 1%,

495 *See* Settlement Agreement, ¶ 3.

496 *See* Pepco (L) at 9 (Janocha).

producing a $45,222 increase from that class. Next, each remaining commercial class ROR is adjusted half of the way toward the overall jurisdictional rate of return of 8.64%. Since this step still results in a revenue deficiency, each commercial class's ROR is adjusted by a constant factor until the overall jurisdictional revenue increase proposed by Pepco is reached. No revenue increase is being proposed for customers served under the Residential Aid Discount (RAD) Rider.[497]

309. The Company submits that its class revenue targets are reasonable because they represent a gradual move to cost-based rates and move most classes' unitized rates of return ("UROR") closer to one, signaling a more equal set of class RORs.[498]

Customer Class RORs under Pepco's Proposals[499]

	Current			Pepco's Proposed	
	Class Revenues	class ROR	UROR	new class ROR	UROR
1. Residential					
Residential R	$37.70m	-3.10%	-0.46	-0.27%	-0.03
RAD	$ 3.22m	-5.96%	-0.88	-5.97%	-0.69
RTM	$ 0.95m	11.36%	1.67	13.38%	1.55
R- AE	$ 9.68m	-4.71%	-0.69	-1.43%	-0.16
2. Small Commercial					
GS					
GS-LV	$43.03m	15.09%	2.22	15.58%	1.80
GS-HV	$ 0.06m	18.57%	2.73	16.34%	1.89
SL Energy	$ 0.20m	-5.20%	-0.77	- 2.67%	-0.31
SL Service	$ 0.52m	0.11%	0.02	1.00%	0.12
TN	$ 0.096m	45.66%	6.72	38.02%	4.40
3. Large Commercial					
GT-LV	$136.16m	12.32%	1.81	14.53%	1.68

497 Pepco Br. 91-93.

498 Pepco Br. 93; Pepco (L) at 4-6, Exhibit (L)-1 (compare row 9 with row 35), and (2L) at 2-3 (Janocha).

499 *See* Pepco (L) at 4-6 and Exhibit (L)-1 pages 1 and 2 (Janocha). Test-year results, reflected in the chart, are based on the 12 month period ended September 30, 2011, utilizing Average & Excess allocation methodology, with 6 months actual and 6 months projected data.

GT-HV-69KV	$ 0.40m	12.91%	1.90	14.98%	1.73
GT-HV-other	$ 44.12m	16.47%	2.43	17.47%	2.02
Metro-RT	$ 5.84m	13.89%	2.05	15.62%	1.81
Total D.C.jur.	$281.983m	6.79%	1.00	8.64%	1.00

310. **OPC.** OPC advocates an across-the-board *pro rata* distribution of any increase or decrease in Pepco's rates.[500] OPC claims that Pepco overstates the cross-subsidization of the residential class that now exists. Because the Commission has wide latitude in setting class revenue requirements, based on a wide range of cost and non-cost factors.[501] OPC argues that, in the present case, there are several non-cost factors[502] that support limiting any Residential class rate increase to an across-the-board amount.[503] OPC also argues that when a class cost of service study is done correctly in the present case, the "residential rate of return moves from – 5.11% to – 4.88% and the Total Commercial rate of return (for GS, GT and Metro customers) moves from 13.53% to 10.79%."[504] Moreover, OPC states that, since Pepco's last rate case (Formal Case No. 1076), unemployment rates in D.C. are unchanged, and mean wages in DC are unchanged or have fallen.[505] Given that the class rate of return disparity is less severe than Pepco present and that there is no improvement in the current economy's impact on District ratepayers, OPC witness Pavlovic argues that the residential classes' revenue

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500 *See* OPC Br. 97-98, 108; OPC R.Br. 47-49; OPC (F) at 6 (Pavlovic); OPC (A) at 20 (Binz).

501 *See, e.g.*, OPC R.Br. 51-52, citing *Formal Case No. 1076*, Order No. 15710, ¶ 340 ("courts have never imposed a requirement of uniformity among the rates of return from different customer classes") and ¶344 ("The Commission must balance the competing interests in a way that is reasonable and fair to all stakeholders."); OPC (2F) at 8 (Pavlovic Rebuttal).

502 Relying on the principle that there should be a relationship between price and quality of service, OPC argues that any Residential rate increase should be limited because the quality of Pepco service received by the Residential class is inferior to that received by other classes. OPC Br. 104- 106. A central reason why this is so, OPC states, is that the Residential class is served, disproportionately, by overhead distribution lines, which are less reliable than Pepco's underground distribution system. OPC Br. 104-106, citing OPC (E) at 32, 44-45 (Mara).

503 OPC Br. 97-98, 107-108. OPC also notes that, historically, residential rates have produced a class rate of return lower than those of the commercial classes. To be sure, OPC acknowledges, the Commission raised the class revenue requirement for the residential classes in Pepco's last rate case, so as to narrow the gap between class RORs. OPC notes, however, that the Commission stated that no further movement toward equalized class RORs was justified in that proceeding, given the severe economic downturn that D.C. ratepayers were experiencing. OPC (F) at 15-16 (Pavlovic); OPC (2F) at 8 (Pavlovic Rebuttal).

504 OPC Br. 99; OPC (F) at 22 (Pavlovic).

505 OPC (F) at 16, citing OPC (F)-5 (Pavlovic).

requirement should be increased by no more than the overall percentage increase in Pepco's revenue requirement.[506]

311. OPC criticizes Pepco's "one quarter of the way" proposal as inconsistent with principles of gradualism, since it will result in an approximately 43% increase in the residential revenue requirement.[507] Equally without merit, OPC argues, are AOBA's recommendations on class RORs, which will require a doubling of residential revenue (a 123% increase) to achieve zero ROR for the residential class. AOBA's recommendations are result-oriented, OPC claims, seeking to maximize the revenue requirement placed on the residential class and to minimize the revenue impact on the commercial classes.[508]

312. OPC argues that, contrary to AOBA's submission, Pepco's revenue shortfall is not caused by class revenue distribution.[509] Instead, it is caused by D.C.-system-wide recovery shortfalls, which the Commission is addressing with both temporary short-term expedients like the BSA and the structural long-term solution of aligning rate structure with cost causation by eliminating kWh components from Pepco's distribution rates.[510] While AOBA claims that "the total base rate subsidy" for the Residential, RAD and street lighting cases is $44 million, OPC argues that the correct figure is $34.9 million (with $31.3 million attributable to the Residential class alone). OPC points out that, whether or not the Residential RAD and Street lighting classes have negative class RORs, they still make a significant contribution to Pepco's total revenue requirement.[511]

313. Nothing in cost of service practice or theory supports AOBA's proposal to allocate the cost of Pepco's income taxes among customer classes based on their class rate base, OPC states. Instead, income taxes are calculated in cost of service studies as a function of operating income. OPC contends that to allocate taxes as AOBA suggests would simply amplify disparities in class RORs.[512]

314. **AOBA**. AOBA submits that the Commission should reduce the severe disparities that now exist in class RORs.[513] AOBA witness Oliver identified four basic

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506 OPC (F) at 16 (Pavlovic).

507 OPC R.Br. 49.

508 *See* OPC (2F) at 4-6, 17 (Pavlovic Rebuttal).

509 OPC R.Br. 51.

510 OPC (2F) at 9- 12 (Pavlovic Rebuttal).

511 OPC (2F) at 12-14 (Pavlovic Rebuttal).

512 OPC (2F) at 14-16 (Pavlovic Rebuttal); OPC R.Br. 50.

513 AOBA argues that OPC's claims about the CCOSS are flawed. *See* AOBA (2A) at 8-13.

concerns about Pepco's proposed distribution of its revenue increase among customer classes. First he argues that Pepco's proposal is based on a CCOSS that distorts class responsibilities for income taxes and understates the disparities in class RORs. Next he asserts that the Company's proposal is based on a flawed CCOSS. Third, the proposal fails to eliminate negative class RORs for the Residential, RAD and SL/TS classes. Finally, AOBA argues that the Company's proposal fails to address the fact that Master Metered Apartments (MMA) customers, although billed under multiple applications of the Company's residential rates, provide Pepco a rate of return in excess of the system average and, therefore warrant, a lesser revenue increase than other customers served under Rate Schedules R and AE.[514]

315. Two subclasses of residential subclasses – specifically RTM customers and MMAs that are served under rate schedules R and R-AE – provide class RORs well in excess of Pepco's requested overall rate of return of 8.64%. AOBA argues that MMAs, therefore, warrant a lesser revenue increase than other customers served under Rate Schedules R and AE.[515] Indeed, AOBA seeks "a downward adjustment to charges billed to MMAs under those rate schedules."[516]

316. The core problem according to AOBA is the highly subsidized class RORs for standard (non-RAD) Residential service. AOBA asserts that the residential sector is the fastest growing of all the customer rate classes.[517] According to AOBA, there has been a widening gap between expenses and revenues for the Residential class since 2008.[518] Moreover, AOBA argues that there is a negative rate of return for the bulk of the Company's non-low-income customers that now rivals the negative rate of return for RAD services which cannot be perpetuated any further. Pepco's proposals in this case, AOBA notes, would simply perpetuate negative class RORs for the Residential (R and AE), RAD and SL/TS classes.[519] OPC's proposed across-the-board distribution of Pepco's rate increase, AOBA argues, would increase the disparity between the highest and lowest class RORs.[520]

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[514] AOBA Br. 32, 45, 46-47.

[515] AOBA Br. at 32; AOBA R.Br. 23; AOBA (A) at 62, 69 (Oliver).

[516] AOBA Br. 44, 48-49.

[517] AOBA Br. 40, citing WMATA (A) at 14 (WMATA witness Foster); AOBA R.Br. 6-8 ("the vast majority of the Company's projected customer growth is expected to be in residential customer classes from which the Company presently derives negative rate of return"); AOBA R.Br. 23, 24 ("few commercial entities can maintain sound economic footing when their fastest growing class of service (the Residential class) is providing negative returns.").

[518] AOBA Br. 41, citing WMATA (A) at 15.

[519] AOBA (A) at 62, 70.

[520] AOBA (2A) at 8-10 (Oliver Rebuttal).

317. Recognizing the limits imposed by gradualism, AOBA proposes that one-third (33%) of any reduction in the Company's overall revenue request should be spread among all classes on an across-the-board basis. The remaining two-thirds (67%) should be distributed among rate classes having greater than system average rates of return to affect a further narrowing of class rate of return differentials and reduce subsidies between rate classes."[521]

318. **District Government**. Objecting to what is characterized as Pepco's proposed 166% rate increase for the SL and TS classes, DCG requests that any rate increase for these classes be set equal to the average increase for all other customer classes (Pepco has requested 14.9%).[522] While Pepco focuses narrowly on cost of service, DCG argues that the Company improperly ignored gradualism, continuity, and historical "non-cost" equitable principles in setting class revenue targets for SL/TS.[523] According to DCG, street lighting and traffic signals have significant public and social benefits, including crime prevention, promotion of social interaction, promoting business, and facilitating pedestrian and vehicular traffic. Traffic signals and street lights thus provide significant "value of service" and are off-peak to a great degree. Historically, the rates of return for SL and TS rates have always been very low or negative, and DCG argues that they should continue to remain low.[524] DCG argues that tying the SL/TS rate increase to the overall DC percentage increase is supported by gradualism, equity and continuity,[525] the stability of revenues of this class, its cost of service, the value of its service, the DC Government's conservation efforts,[526] marginal costs,[527] and the

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521 AOBA Br. 33; AOBA (A) at 63 (Oliver).

522 DC Govt Br. 12, 15-16; DCG (A) at 6, 21, 23 (Petniunas). *See* DCG (2A) at 19 (Petniunas Rebuttal).

523 DC Govt Br. 12-13, 15; DCG (A) at 4-5, 21 (Petniunas).

524 DCG (A) 22-23 (Petniunas).

525 *See* DC Govt Br. 13-14 citing *Formal Case 1053*, Order 14712, ¶¶ 337-338 (January 30, 2008) and *Formal Case 1076*, Order 15710, ¶¶ 351-352 (March 2, 2010).

526 Overlooked by Pepco, DCG argues, is the SL/TS classes' long-term trend of conservation: Since June 1995, SL/TS energy consumption has been reduced by 11.45%, with about half that reduction (5.42%) occurring since 2005. DC Govt Br. 15; *see* DCG Exhibit (A)-3. The greatest reduction has occurred in the TS class (-22%). While Pepco has the TS class at the same rate as the SL class, DCG suggests that, because of the conservation differences between the two classes, these rates might be differentiated. DCGovt (A) at 24 (Petniunas).

527 DCG points out that, in the past, the Commission priced SL and TS rates based on marginal energy costs alone (variable generation costs), avoiding all demand charges (including generation, transmission, sub-transmission, and distribution demand costs). DCG (A) at 22-23 (Petniunas).

historical low or negative rates of return for this class.[528] service, the DC Government's conservation efforts,[529] marginal costs,[530] and the historical low or negative rates of return for this class.[531]

319. The District Government concludes by requesting a freeze on the RAD rate at its present level. According to DCG, a RAD rate freeze is appropriate in these very difficult economic times when the DC unemployment rate is still high, with many low-income families living at, or below, the poverty level and having difficulties paying their bills.[532]

320. Opposing AOBA's views on MMAs, DCG acknowledges that the MMA class ROR is now at the level of 10.48% when viewed under Pepco's CCOSS, and at 10.78% when measured under OPC's CCOSS. However, DCG argues that actually, the MMA class offers a much lower rate of return than other commercial customers. DCG asserts that indeed MMA class gets lower rates by being priced on Residential rates than do comparable General Service Customers. The difference is that the MMA owning landlords get a tax deduction for their utility services, including electricity. If an MMA class member is in a 30% tax bracket, for example, then a $100.00 electricity bill would only cost the landlord $70.00 after taxes. The Residential customer, on the other hand, would have to pay the full $100.00.[533] DCG witness Petniunas suggests that the Commission should take into account the tax deductibility of MMA landlord bills in determining the final rate of return and rate increase for the MMA class.[534]

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528 DCG (A) at 22-24 (Petniunas); DC Govt Br.14, citing Washington Gas Light Co. v. Public Service Commission, 450 A.2d 1187, 1202-1208 (D.C. 1982).

529 Overlooked by Pepco, DCG argues, is the SL/TS classes' long-term trend of conservation: Since June 1995, SL/TS energy consumption has been reduced by 11.45%, with about half that reduction (5.42%) occurring since 2005. DC Govt Br. 15; *see* DCG Exhibit (A)-3. The greatest reduction has occurred in the TS class (-22%). While Pepco has the TS class at the same rate as the SL class, DCG suggests that, because of the conservation differences between the two classes, these rates might be differentiated. DCGovt (A) at 24 (Petniunas).

530 DCG points out that, in the past, the Commission priced SL and TS rates based on marginal energy costs alone (variable generation costs), avoiding all demand charges (including generation, transmission, sub-transmission, and distribution demand costs). DCG (A) at 22-23 (Petniunas).

531 DCG (A) at 22-24 (Petniunas); DC Govt Br.14, citing Washington Gas Light Co. v. Public Service Commission, 450 A.2d 1187, 1202-1208 (D.C. 1982).

532 *See, e.g.*, DCG (2A) at 16-19 (Petniunas Rebuttal); *and see* DC Govt Br. 2-3; DC Govt R.Br. 4-6. The issues about setting the class ROR for the RAD class are discussed in more detail under Issue No. 15g.

533 DCG (2A) at 15 (Petniunas Rebuttal).

534 DCG (2A) at 15 (Petniunas Rebuttal).

321. **GSA.** GSA notes that over the last several rate cases the federal agency has urged the Commission to act to reduce the huge interclass subsidies that now exist, with larger general service customers subsidizing residential customers. GSA points out that the CCOSS performed by Pepco, and even OPC's CCOSS, shows that the residential class is earning a negative ROR that does not even cover Pepco's cost of serving that class.[535] Meanwhile, GSA points out commercial customers, including federal agencies, pay rates far above cost of service."[536] GSA is not optimistic, believing that because of potential rate shock these disparities will likely be reduced only slightly by the class revenue distribution approved in this case.[537] GSA supports WMATA's "one third of the way" proposal (or alternatively, AOBA's proposed class revenue spread) to alleviate the "huge interclass subsidies paid by General Service Customers to the residential class."[538]

322. **WMATA.** WMATA proposes that class revenue targets should be adjusted "one third of the way toward more equal class RORs. WMATA argues that the major issue highlighted in this rate case is subsidies to the residential class.[539] To address this issue, WMATA would allocate 27.2% of Pepco's revenue increase to the Residential AE rate so that its class ROR was zero and allocate 59% of Pepco's revenue increase to the Residential rate so that its class ROR was 0.66 of UROR.[540] No increase would be assigned to the RAD class by WMATA. The Company's remaining revenue requirements would be distributed proportionately across-the-board to Pepco's non-residential classes. All rate classes except TN and RAD would share in the revenue increase. WMATA states that its proposal would eliminate negative class RORs in the residential sector (except for RAD), and narrow the disparities between class RORs.[541]

323. WMATA argues that, while customer classes need not have equal RORs, each class should cover its expenses and provide some reasonable rate of return to the utility. Pepco's CCOSS shows that several residential sectors now have negative RORs--specifically, the Residential class (-3.10% class ROR); the Residential All Electric class (-4.71% class ROR) and the RAD class (-5.96% class ROR). WMATA states that the situation has only gotten worse over time, and that other classes have been subsidizing the residential class increasingly since 2006.[542] WMATA submits that the Commission's

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535 GSA (B) at 3-5 (Goins Rebuttal).

536 GSA R.Br. 2.

537 GSA (A) at 12-13 (Goins).

538 GSA R.Br. 2, 7; GSA (B) at 5-6 (Goins Rebuttal).

539 WMATA Br. 1.

540 WMATA Br. 5.

541 WMATA Br. 4-5; WMATA (A) at 22-24 (Foster).

542 WMATA (A) at 18-19 (Foster). Over the years from 2006 to 2011, WMATA submits, the negative class RORs have gotten worse for Residential (deteriorating from –2.43% to –3.10%),

decision in Pepco's last rate case (Formal Case No. 1076) – taking a "one quarter of the way" approach toward more equal class RORs-- has not narrowed the widening gap between class RORs.[543] Taking a series of quarter-of-the-way steps toward UROR, WMATA points out, will never reach the goal (as a mathematical matter) of setting all class RORs at the level of UROR.[544]

324. **Pepco Rebuttal.** The Company defends its proposed class RORs as comporting with Commission directives which seek to gradually reduce interclass differences and place a greater emphasis on customer charges and demand rates.[545] Pepco views its "one quarter of the way" proposal as a way to narrow the disparities in class RORs, consistent with gradualism, and not as a mechanism by which, over the course of four rate cases, Pepco will eliminate the disparities in class RORs and equalize all class RORs.[546] The fact that the Company's proposed distribution lies in the middle of the recommendations of other parties supports the reasonableness of the Company's position."[547]

325. To address DCG's concerns, Pepco responds that "the total percentage increase to SL and TS customers, for distribution, generation, transmission, and surcharges is 3.2%, or only 56% of the proposed 5.7% increase to the residential class."[548] Witness Janocha updated the Company's proposed customer charge for both the SL and TS rate schedules to $9.89 and the per lamp charges to $0.36055 per month.[549] However, he contends that there is still a negative class ROR for the SL class which implicitly recognizes non-cost issues associated with SL service such as low risk to the system, public safety and welfare, predictable usage patterns, and long-term trends of conservation in a rate class.[550]

Residential- AE (deteriorating from –3.20% to –4.71%) and RAD (falling from –3.67% to –5.96%), while the commercial classes have paid increasing subsidies. For example, over the same period from 2006 to 2011, the GS-HV class ROR increased from 14.80% to 18.57% and the Metro-RT class ROR increased from 12.36% to 13.89%. *Id.*

543 WMATA Br. 5.

544 WMATA Br. 6-7.

545 Pepco R.Br. 47.

546 *See* Tr. 684- 688 (Janocha). By contrast, Pepco's "one quarter of the way" proposal for raising the Residential Customer Charge is meant to arrive at a Customer Charge that fully recovers fixed customer costs, in a series of four steps over four rate cases. *See* Tr. 684-685, 686-688 (Janocha).

547 Pepco Br. 94.

548 Pepco Br. 98.

549 Pepco (3L)-1 at 2 (Janocha Rebuttal).

550 Tr. 679- 680 (Janocha).

DECISION

326. The Commission enjoys wide latitude in setting customer class revenue requirements. Traditionally, in setting class revenue requirements, we have considered the class cost of service for each class, as well as a broad range of other factors.[551] The courts have never imposed a requirement of uniformity among the rates of return from different customer classes.[552] For example, customer class rates of return may vary based on the risk to Pepco, because the level of risk is a valid factor to be considered in rate design.[553] Differences can be based not only on quantity, but also on the nature, time, and pattern of use, so as to achieve reasonable efficiency and economic operation.[554] Other valid non-cost factors that may be considered in setting both customer class revenue requirements and rate designs, include "equitable considerations" such as value of service and ability to pay, the quality of service delivered, historical rate patterns, the need to conserve energy resources, and other market-place realities, as well as principles of gradualism and rate continuity.[555]

327. **The Commission's General Approach**. The options available to the Commission for setting class revenue targets in the present case cover a wide spectrum and include: (1) OPC's across-the-board approach; (2) Pepco's proposed "one quarter of the way" approach toward more equal class rates of return, which would allocate approximately 52% of the proposed rate increase to the Residential classes; (3) WMATA's "one third of the way" approach toward more equal customer class RORs; and (4) AOBA's "press the limits" approach to reducing disparities in class RORs. Other than OPC's proposal, all these options involve some departure from a strict across-the-

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[551] *See, e.g., Washington Gas Light Co. v. Public Serv. Comm'n*, 450 A.2d 1187, 1199- 1209 (D.C. 1982); *Formal Case No. 1076*, Order No.15710, ¶ 340 (March 2, 2010). There is also a District statute that states, "in supervising and regulating utility or energy companies, the Commission shall consider the public safety, the economy of the District, the conservation of natural resources, and the preservation of environmental quality." *See* D.C. Code § 34-808.02

[552] *See, e.g., Washington Gas Light Co. v. Public Serv. Comm'n*, 450 A.2d 1187, 1207 (D.C. 1982); *Apartment House Council of Metro. Washington, Inc. v. Public Serv. Comm'n*, 332 A.2d 53, 57 (D.C. 1975) ("equal return from customer classes is not required"); *Formal Case No. 1076*, Order No. 15710 ¶ 340 ("The courts have never imposed a requirement of uniformity among the rates of return from different customer classes."), ¶ 342 ("Historic rate patterns in the District of Columbia have been that the residential classes pay lower class RORs than the commercial class RORs"), ¶ 340 n. 687 (one factor in setting class RORs is that "at the retail level the costs of electricity are commonly tax deductible business expenses for retail business customers but not for retail Residential customers").

[553] *See, e.g., Formal Case No. 1053*, Order No. 14712,¶ 337.

[554] *See, e.g., Apartment House Council of Metro. Washington, supra*, 332 A.2d at 57; *Formal Case No. 1076*, Order No. 15710 ¶ 340 n. 689 (March 2, 2010).

[555] *See, e.g., Washington Gas Light Co., supra*, 450 A.2d at 1199- 1209; *Formal Case No. 1076*, Order No. 15710, ¶ 340 n. 690 (March 2, 2010); *Formal Case No. 869*, Order No. 9216 at 133-134 (March 3, 1989).

board approach with some additional revenue burden being imposed on the residential class that has a comparatively low class ROR.

328. The Commission agrees with Pepco, AOBA, GSA, and WMATA that the Commission should move to reduce the wide disparities that now exist in class RORs. To be certain, this Commission has repeatedly held and confirmed by the Court of Appeals, that equal class RORs are not required and that the Commission has statutory authority to consider many valid cost and non-cost factors in setting class revenue targets and rate designs.[556] Historic rate patterns in the District of Columbia have been that the residential classes pay lower class RORs than the commercial class RORs. The Commission is not compelled to equalize class RORs for residential and commercial retail Pepco customers. We believe, however, that the severe disparities in class RORs that now exist call for corrective action.

329. The Commission is concerned, in particular, that the residential class is now earning a negative class ROR.[557] While we reject AOBA's "tax allocation" argument for adjusting the Company's CCOSS, AOBA's submission about taxes illustrates the distortions that arise when severe disparities in class RORs are allowed to persist. Other customer classes are significantly burdened by the subsidy now flowing to the residential class. As we pronounced in Pepco's last rate case, the Commission is resolute in moving in a deliberate and reasonable fashion over a series of Pepco rate cases to put an end to negative class RORs.

330. In this instance, we reject OPC's proposal to increase residential rates by only an across-the-board amount. That would simply exacerbate the disparities in class RORs. Instead, our decision is to reduce the disparities in class RORs, moving all class RORs closer to the overall D.C. jurisdictional ROR, and making progress toward eliminating negative class RORs.

331. **Residential Rates**. The Commission's decision in this case reduces Pepco's requested $42.1 million revenue increase for the District to $24.376 million. Out of that D.C. jurisdiction-wide increase, $11.030 million (or 45%) will go to increase the residential class (including R, AE, RAD, and RTM) revenue target. This will reduce the severe disparities in class RORs that now exist and make progress toward eliminating negative class RORs. However, no further movement toward more equalized class RORs is warranted in this case. The economic recovery has been sluggish, and unemployment remains high in the District. The Commission heard extensive community comments

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556 *See, e.g., Washington Gas Light Co., supra,* 450 A.2d at 1199-1209; *Formal Case No. 1076,* Order No. 15710, ¶ 342 (March 2, 2010); *Formal Case No. 869,* Order No. 9216, 10 D.C.P.S.C. 22, 133-145 (1989).

557 Residential class generally refers to R, AE, RAD, and RTM classes. Within these four residential classes, RTM is the only class having a positive class ROR. However, RTM only has a 1.55% revenue share of total residential revenues. *See* Pepco (L)-1, page 1.

confirming the dire economic situation of many D.C. residents, particularly senior citizens, the disabled, and those on fixed incomes.[558] These considerations of equity, the economy of the District, and gradualism, play a significant role in our decision today. The special low RAD rate should soften the impact of a rate increase for low-income Pepco customers in the District.

332. The Commission must balance the competing interests in a way that is reasonable and fair to all stakeholders. We have decided to recover the residential rate increase primarily through an increase in the Customer Charge. As discussed below,[559] we are increasing the Customer Charge for residential classes by $2.60 to $9.25. This will move the design of residential distribution rates away from volumetric (kWh) rates, and towards rates that are based more on customer and demand charges, as is appropriate in the new era where Pepco is a "wires only" electric distribution company.[560]

333. In making this decision, we have very specifically considered the need for rate gradualism[561] and other equitable considerations.[562] While our ruling will reduce the severe disparities that now exist in class RORs, and narrow the gap between the very low residential class ROR and the higher commercial classes' ROR, it still leaves the residential class with a negative class ROR. The Commission is acting in a responsible and measured way to narrow the gap in customer class RORs, and to eliminate negative class RORs, as all the parties agree should be done, consistent with the constraints of gradualism, equitable considerations, the state of the economy, a sluggish economic recovery, and high unemployment in the District of Columbia.

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558 *See* Community Hearing, Ward 7, Tr. 9, 28 and 33 (November 19, 2011).

559 *See* pp. 125.

560 Thus, the R and AE customer charge will increase from $6.65 to $9.25. The RAD customer charge will increase from $2.50 to $5.10 and RTM customer charge will increase from $11.17 to $13.77. Pepco has proposed to increase RTM customer charge from $11.17 to $15.55, *See* Pepco (L)-2, at 89.

561 The Commission must fairly balance a wide variety of considerations, of which gradualism is one. *See, e.g., Watergate East, Inc. v. Public Service Comm'n*, 665 A.2d 943, 949 (D.C. 1995) (court approves significant rate increase for Watergate, noting that "gradualism is but one of many factors to be considered and weighed in setting rate designs" and that it should not trump other considerations such as the need for reasonable cost recovery).

562 OPC argues that "quality of service" is one of the factors that can be considered in setting class RORs, and that the residential class received a lower quality of service from Pepco than other customer classes. However, other customer classes (as well as the residential class) also suffered because of Pepco's poor reliability. *See, e.g.*, Community Brief at 8 ("In addition to residential customers suffering from poor electric service, local businesses in Ward 8 suffer when there are power outages."), citing testimony of ANC 8C Chair Mary Cuthbert at Community Hearing, Ward 8, Tr. 6-9 (November 8, 2011).

334. **Residential Aid Discount ("RAD").** As explained more fully below in our discussion of the RAD rate (*see* Issue 15g[563]) the Commission has decided to modestly raise the Customer Charge for the RAD class by $2.60. The original conception of the RAD rates (RAD-R and RAD-AE), sometimes obscured by periodic RAD "rate freezes" at a particular dollar per month rate, was that they are a discount off the standard residential rate (R and AE). Today's decision reaffirms that concept and directs Pepco, which is now in the process of revising its billing formats, to display the amount of the RAD discount (in dollars) on the face of each District RAD customer's bill. Thus RAD customers will be able to understand the amount and benefit of the discount.[564]

335. **Master Metered Apartments ("MMA").** AOBA seeks a downward adjustment to the MMA class ROR, on the ground that the MMA class is already providing Pepco with a class ROR well in excess of Pepco's overall requested D.C. jurisdictional ROR of 8.64%. There is some merit in DCG's countervailing point, however, that the cost of electricity is a tax deductible business expense for MMA owners, which justifies imposing on the MMA class a somewhat higher class ROR than the D.C. jurisdictional ROR.

336. In the present case, lacking a full record to support a separate MMA rate class, the Commission has decided to continue the historical treatment of MMAs as part of the residential class, and to assign class revenue responsibilities accordingly. We expect Pepco, in its next rate case, to present an updated CCOSS, breaking out the MMA class as a separate customer class and more accurately identifying the actual cost of serving the MMA class. This will enable the Commission to set a more cost-based class ROR for the MMA class.

337. **Streetlight Service and Streetlight/Traffic Signals (SL/TS).** Pepco proposes to set the Streetlight Service class' ROR at one percent (1%), producing a $45,222 revenue increase from that class.[565] The other parties did not put forward any other competing proposal. Traditionally, the SL Service class' ROR has been set at a very low class ROR. Taking these circumstances into account, the Commission approves as reasonable Pepco's proposed class ROR of 1.00% for the SL Service class.

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563 Designated Issue No. 15g asks, "Should RAD distribution rates be maintained at the same level or should they be altered as a result of changing requirements from this rate case?"

564 The Commission prefers to display the individual discount for RAD customers. However, if significant cost will be incurred, the Company is allowed to present the "average" discount on customers' bills initially.

565 *See, e.g.,* Pepco Br. 91-93.

338. The settlement on SL/TS rates did not decide the class ROR that is appropriate for the SL/TS classes.[566] The Commission in the past two rate cases rejected Pepco's requests for large percentage increases in SL/TS distribution rates, opting instead to increase the SL/TS class ROR by (roughly) the higher-than-D.C.-average percentage increase that was assigned to the Residential class.[567]

339. In this instance, the Commission has decided that a stronger movement is appropriate in the direction of eliminating the negative class ROR that now exists for the SL/TS classes. We are assigning a comparatively modest $220,000 increase to these customer classes, which is less than Pepco proposed. The impact will be an increase of only about 2 percent in the overall bill for the SL/TS classes for generation, transmission and distribution. Moreover, we note that the record indicates that the District Government may well see an offsetting decrease in its generation costs, since the time of Formal Case No. 1076. We have carefully considered DCG's arguments about gradualism and have decided that, given the small impact on the overall SL/TS bill and the continuing very low or negative class ROR for these classes, the increase we order today is appropriate for the SL/TS classes. It represents a gradual step toward eliminating a negative class ROR for SL/TS customers. Our decision takes into account all the conservation, low risk, non-cost, public safety and other factors cited by the District Government in favor of keeping SL/TS class rates low.

340. **Commercial Classes**. The Commission adopts Pepco's proposed method to distribute among the other commercial classes the remaining revenue burden, *i.e.*, the overall $24.376 million D.C. jurisdictional rate increase, minus the $11.030 million increase allotted to the Residential class minus the $45,222 increase allotted to the SL Service class minus the $220,000 increase allotted to the SL and TS customer classes.[568] The outcome brings class RORs closer together.

XVII. RATE DESIGNS[569]

341. **Overview**. The issues of "rate design" concern the design of the component parts of each individual class rate. These issues arise, in particular, from the fact that Pepco has switched from old rate structures that recovered Pepco's costs based primarily on a customer's energy usage, to new rate structures in the new deregulated era

566 *See* Order No. 16816, ¶ 7 (June 21, 2012), modifying and clarifying Order No. 16790 (May 25, 2012) (approving the Settlement Agreement on SL/TS rates); *accord:* Pepco Br. 98, n.506. The settlement covered only a select few SL/TS issues, such as how the "outage discount" would continue.

567 *See Formal Case 1053*, Order 14712, ¶ 337; *Formal Case 1076*, Order 15710, ¶ 352.

568 The settlement on WMATA (Metro-RT) rates did not settle what the Metro-RT class ROR will be. Instead, the settlement indicates that, whatever the class ROR is, it should be collected in equal monthly payments. *See* discussion of the Metro-RT rate in Issue No. 15.

569 Designated Issue No. 15 asks, "Is Pepco's rate design just and reasonable?"

that focus more on recovery of Pepco's fixed costs.[570] The Company submits that it is following the Commission's directives by presenting updated distribution rate designs for each customer class that place greater emphasis on customer and demand charges and less on volumetric charges, while taking gradualism into account.[571] A significant change proposed by Pepco, reflecting these policies, is an increase in its monthly customer charges for most customer classes of service.[572]

342. OPC agrees with Pepco that distribution rates should place a greater emphasis on customer and demand charges while reducing reliance on volumetric charges. AOBA generally supports across-the-board adjustments to the component parts of individual class rates. DCG urges a freeze on the RAD rate structure, and a variety of adjustments to the component parts of SL/TS rates. WMATA proposes a redesign of the Metro-RT rate, into equal monthly payments, which Pepco largely accepts.

A. Residential Class Rate Designs

1. Residential, Residential All Electric, and Residential Time Metered.[573]

343. **Pepco.** The Company proposes to increase the residential customer charge (for Residential ("R"), Residential All Electric ("R-AE") and Residential Time Metered Service ("RTM"), so that it moves one-quarter of the way towards the full customer-related costs calculated in Pepco's CCOSS.[574] This will increase the customer charge from $6.65 to $10.40 for R and from $6.65 to $12.39 for R-AE service. Pepco's remaining distribution class revenue requirement will be recovered through an equal proportional increase in the residential summer and winter volumetric rate blocks. This

570 The old rate structures were created during an earlier era in which Pepco generated electricity, and sold it to Pepco customers, who compensated Pepco based primarily on the volume of electricity they consumed. In the new deregulated era, Pepco is a "wires only" distribution company, which is compensated primarily for its fixed costs of installing wires to serve its customers. Today Pepco customers choose which electric generating company to buy electricity from, with the generator's volumetric bills for electricity being passed through to them by Pepco. The Company provides purchased electricity and provides it (SOS service) to those customers who do not choose an alternative supplier of electricity.

571 *See* Pepco (L) at 3-4 (Janocha); Pepco (2L) at 3 (Janocha); *Formal Case No. 1076*, Order 15710, ¶¶ 355, 361, 391, 396, 401, 406, 420, 421 (March 2, 2010).

572 Designated Issue No. 15a asks, "Is Pepco's proposed increase in monthly customer charges just and reasonable?"

573 The components of Pepco's proposed residential rates (R, R-AE) include a fixed customer charge, as well as rate blocks for different levels of energy usage (kWh) (covering the first 400 kWh, and in excess of 400 kWh) as well as rate riders. *See* Pepco (L)-2 at R-3 to R-4 (Pepco rate schedules for R and R-AE). Time-metered residential rates (R-TM) include a customer charge and a kilowatt-hour charge covering energy usage (kWh), and rate riders. *See* Pepco (L)-2 at R-5 (rate schedule R-TM). *See* Pepco (L) at 6-9 (Janocha).

574 Pepco Br. 95; Pepco (L) at 6-15 (Janocha) and Pepco (2L) at 3-4 (Janocha).

movement is proposed as an initial step toward potentially attaining a fully cost-based customer charge over the reasonable time frame of four successive distribution rate cases.[575]

344. Pepco argues that its rate designs are consistent with gradualism. The impact of its proposals will increase R customers' total bills from 2.41% to 39.39% based on customer usage levels.[576] The only residential customers who will experience rate increases of 30% or more are R customers with the lowest usage levels (between 0 and 50 kWhs per month), who account for less than 1% of the total residential customer population. Their average monthly bill will rise by just \$3.79 a month.[577] As an additional measure of the reasonableness of the proposed rates, the Company estimates that the daily cost of distribution service to a residential customer using 750 kWhs per month will be approximately \$0.70 under the proposed rates."[578] With respect to Time Metered Residential Service ("RTM class"), the impact on an average customer using 4,000 kWhs per month is 4.09% for the summer and 4.23% for the winter. The impact on RTM customers with the lowest usage level (1,000 kWh per month) is 5.85% for the summer and 6.03% for the winter or about \$9.81 per month.[579]

345. **OPC.** OPC takes no position on Issues Nos. 15a, e, f, and g.[580]

346. **AARP.** AARP opposes Pepco's proposal to increase the residential customer charge. AARP argues that this increase in fixed charges violates principles of gradualism and is particularly harmful to Pepco's lower-use customers.[581] AARP argues that customers using less than 600 kWh per month generally will see their bills increase

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575 Pepco (L) at 6-7, 9.

576 *See* Pepco (L)-3 and (L)-4 (Janocha). There is significantly less impact on customers with monthly usage levels at or above above 200 kWh, where the results range between 2.41% to 13.38%.

577 Pepco (L) at 7-8. *Accord:* Pepco Br. 95.

578 Pepco (2L) at 7 (Janocha); Pepco Br. 99.

579 Pepco (L) at 9 (Janocha); Pepco Br.99.

580 OPC Br. 110. OPC argues that, in general, until proper "wires only" distribution company rate designs are in place, the rates for customer classes with customer/kWh rate structures should be designed so that "the customer charge should be set to fully recover customer costs at the actual class rate of return with the remainder of the class revenue requirement recovered through the kWh charge." For other customer classes with customer/demand/kWh rate structures, "the customer charge and demand charges should be set to fully recover customer and demand costs at the actual class rate of return and the usage charge [should] be eliminated. OPC Br.109-110; OPC (F) at 6, 22-28 (Pavlovic); OPC (A) at 21 (Binz). OPC witness Pavlovic testified that if residential customer costs were calculated correctly they would be approximately \$26 per month, and that Pepco's residential customer charge should be set equal to that amount. Tr. 1025-1027, 1033-1036.

581 *See* AARP (A) 8-9, 34-37 (Alexander).

by more than the amount caused by Pepco's revenue increase alone.[582] AARP submits this is inappropriate in these difficult economic times. AARP asks the Commission to consider that residential customer charges were dramatically increased in Pepco's last rate case (from $2.00 to $6.65) and that the impact of Pepco's present proposal will harm lower use customers far in excess of other customers. AARP insists that it will violate principles of gradualism for Pepco to increase its residential customer charges so dramatically over the course of two Pepco rate cases. Finally, AARP argues that increasing residential customers' fixed monthly customer charge will discourage energy conservation.[583]

347. **AOBA.** AOBA does not characterize the Company's current rate designs as flawed. Nor would it characterize the BSA as correcting a flaw in rate design. According to AOBA, the rationale for instituting the BSA for Pepco is premised less on the perception of flaws in the Company's rate designs and more on the fact that the BSA will allow continuing efforts to encourage conservation and energy efficiency while safeguarding the Company's ability to earn its authorized rate of return.[584]

348. AOBA opposes the complete elimination of kWh charges from Pepco's rate designs and argues that a rate design based only on the use of customer and demand charges for residential or small commercial customers would snub consideration of load diversity or load factors for individual customers. By recovering a portion of the costs of service for each rate class through kWh charges, the Commission is provided an additional pricing parameter that can be used to account for differences in customer cost and demand cost responsibilities among the customers in each rate class.[585]

349. **WMATA.** WMATA argues that the Commission should direct the Company, as a first step in rate allocation, to move the Residential Customer Charge one-third-of-the-way to the full charge. Any remaining authorized rate increase should then be applied across all classes as proposed by WMATA Witness Foster."[586]

350. **Pepco Rebuttal.** Testimony provided by Pepco in response to questions from the Commissioners included a significant change of position by Pepco, which now submits that the Customer Charge for Residential and Residential-All Electric customers should continue to remain equal to each other.[587] The Company continues to justify its

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[582] *See* AARP (A) at 8-9, 34-37 (Alexander); AARP R.Br. 5.

[583] *See* AARP (A) 35-37; AARP Br. 15-16 and AARP R.Br. 8.

[584] *See* AOBA (2A) at 13 (Oliver Rebuttal).

[585] *See* AOBA (2A) at 13-14 (Oliver Rebuttal) ; AOBA (2B) at 15-16 (Oliver rebuttal).

[586] WMATA Br. 6.

[587] Pepco Exhibit No. 85, at 2 (Tanos and Janocha) submitted in response to questions from Chairman Kane at Tr. 1665-1668.

proposed monthly customer charges on that ground that they place greater emphasis on customer charges and demand rates than on volumetric charges, gradually increasing customer charges toward a charge that is more fully-reflective of customer-related costs."[588]

351. To explain how it calculates the customer charge for the residential classes generally, Pepco states that it uses the customer-related portions of rate base and expense items, together with the calculated customer-related portion of sale of electricity revenue, as a guide in the design of the customer charge component of the rate. The demand charge and customer charge are set at a level that allows the Company to recover the allocated revenue requirement for each class.[589]

352. The Company provides the following chart showing the residential customer charge figures (in $ per customer per month) that it calculated in the last several rate cases.[590] Pepco states that its calculations are based on its CCOSS and the Company's proposed revenue requirements for Formal Case Nos. 1053, 1076, and 1087, and that they set out "the average cost based on the total number of customers:

Customer Costs from Pepco's CCOSSs
Formal Case Number

Rate class	1053	1076	1087
Residential (excluding AE)	$17.07	$19.71	$21.65
R-All Electric	22.93	21.25	29.61
RAD	25.14	25.10	31.41
Total Residential	$18.75	$20.46	$24.21

353. The Company states that the main reason for the change in values between Formal Case No. 1076 and Formal Case No. 1087 is its inclusion of MMA class costs in the residential calculation. [591] Pepco acknowledges that its development of customer

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588 Pepco R.Br. 47.

589 Pepco Br. 96. *See also* Pepco Br. 95-96 (more detailed explanation) and Pepco Exhibit 88 (Tanos) (Pepco's CCOSS "uses the ratio of the unadjusted customer component to total sale of electricity to calculate the customer component of total proposed revenue"), submitted in response to questions from Chairman Kane at Tr. 1672. The Company further explained its definition of customer costs, and how those factor into calculating a proposed Customer Charge, in Pepco Br. 95-96 and Pepco Exhibit No. 87 (Tanos) responding to questions from Chairman Kane at Tr. 1669. *See also* Tr. 698-709 (Janocha); Tr. 1655- 1656 (Tanos).

590 *See* Pepco Exhibit No. 84, at 2-3 (Tanos) responding to questions from Chairman Kane at Tr. 1664-1665.

591 Pepco Exhibit No. 84 at 3. According to Pepco, this explains why the customer costs calculated for the R and R-AE classes are increasing differently. For billing purposes, approximately 98% of the

costs is affected by its proposed rate designs and how it allocates demand and customer revenue. The Company will reevaluate this approach as part of the next base rate case.[592] Overall, the Company characterizes its proposed increase in the residential customer charge as a gradual step toward full cost-based customer charges.[593]

DECISION

354. The Commission has wide discretion in setting the residential customer charge (for Residential "R," Residential All Electric "R-AE," Residential Time Metered Service, "RTM" and Residential Aid Discount "RAD") within the limits imposed by the class revenue targets for the residential classes. This is an important policy question for the Commission that is supported by the evidence showing what residential customer costs actually are, as well as by considerations of conservation, equity and gradualism.

355. The Commission agrees with Pepco that the Customer Charges for R and for R-AE should remain equal to each other. According to Pepco, its current residential customer charge of \$6.65 per month for these classes does not recover the full residential customer-related costs calculated in its CCOSS, which is over \$20 per month. OPC and the other parties do not dispute this. The Commission is concerned, however, that Pepco's calculation of customer costs in the present case has been colored by its consideration of class revenue requirements, which would not be a consideration in the calculation of customer costs under normal cost allocation principles. There is a different, more reasonable and well-supported calculation of residential customer costs in the record here in Formal Case No. 1087. It shows Pepco's calculation that R and R-AE customer related costs in the 2008 test year (which was used in Formal Case No. 1076) were \$131.20 per customer per year, or \$10.93 per month.[594] Thus there is reliable

MMA class is included in the Residential (R) class with the remainder included in Residential-AE. The MMA class's unadjusted rate of return of 10.48% substantially increased the Residential class unadjusted ROR, thus lowering both the proposed revenue requirement and the proposed unadjusted customer charge for the R class. Because only approximately 2% of the MMA class is included in the Residential-AE class, however, its class ROR was not significantly increased and its class revenue requirement was not significantly impacted by the inclusion of 2% of the MMAs. The MMA class unadjusted rate of return in *Formal Case No. 1076* was 6.88%, lessening the effect of its inclusion in that case. The change in rate of return for the MMA class was driven by the increase in the customer charge for Residential and MMA customers that the Commission approved in *Formal Case No. 1076*, so that it constitutes a larger portion of MMA customer bills. Pepco Exhibit No. 84 at 3.

592 Pepco Exhibit No. 87 (Tanos) responding to questions from Chairperson Kane at Tr. 1669- 1671.

593 *See* Pepco R.Br. 47; Pepco (L) at 6-7, 9 (Janocha). Pepco also states that the Customer Charge of \$10.93 per month adopted in *Formal Case No. 1076* was "an unadjusted customer charge reflecting a negative 4.15% rate of return. Had the Company offered a customer charge on a per customer basis consistent with its approach in *Formal Case No. 1053*, the average customer charge for all residential non-Time of Use (TOU) customers would have been \$20.46." Pepco Exhibit No. 84 (Tanos) at Page 2.

594 *See* Tr. 699 (colloquy between Pepco witness Janocha and Chairman Kane, noting that R and R-AE customer costs were \$10.93 per month in Pepco's CCOSS for 2008, while "the cost study that was used for the current rate case shows that the residential cost is \$21.65"); Commission Exhibit No. 13 in *Formal*

evidence in this record indicating that customer charges for the R and R-AE classes could be raised from their present level ($6.65 per month) to bring them closer to their reasonably-calculated actual costs.[595]

356. We disagree with AOBA's suggestion that an increase in Pepco's customer charge is unwarranted, in light of the BSA. AOBA argues that this is so because both the BSA (on the one hand), and rate designs that place greater emphasis on customer and demand charges and less on volumetric charges (on the other hand), operate to ensure Pepco's recovery of its cost of service.[596] The Commission points out, however, that the BSA does not ensure rate equity within a customer class; instead, it only ensures that each customer class will pay (as a whole) the class revenue per customer target set in Pepco's last rate case. Without a properly designed customer charge, and other properly designed rate components, a particular individual customer may pay more or less than its actual costs, depending on its load characteristics. The Company's movement toward more cost-based customer charges is a step toward ensuring that the individual customers within each customer class pay what their costs are, within the overall class revenue target set for the class as a whole.

357. Accordingly, we are increasing the Customer Charge for the residential classes by $2.60 (including R, AE, RAD and RTM). Thus, the R and AE customer charge will increase from $6.65 to $9.25. The RAD customer charge will increase from $2.50 to $5.10, and RTM customer charge will increase from $11.17 to $13.77. This modest increase in the customer charge is less than what was recommended by Pepco and by OPC witness Pavlovic. It provides a fair and effective means, however, by which Pepco can recover its allowed revenue increase from the residential classes. This will increase the residential customer charge by an average of only eight to nine cents per day.

358. In Pepco's next rate case, the Company is directed to provide updated customer cost calculations for each rate class and sub-class, based on CCOSS results at the requested rate of return.

Case No. 1087 (showing Pepco's calculations of customer costs for the R and R-AE classes in Formal Case No. 1076). Were the Commission to take judicial notice of CPI indexes in 2008, 2009, 2010 and 2011, which were roughly 140, 140, 142 and 147 respectively, the current customer cost figures for Pepco's R and R-AE classes might be as high as $138.23 per customer per year, or $11.52 per customer per month.

595 The Commission does not agree with AARP's overstated claim that raising the Customer Charge will severely discourage energy conservation and "negat[e] any alleged benefit to be gotten from the AMI deployment." (AARP Br.16) A customer's bill for the supply of electricity (which is different from Pepco's bill for distribution service) will continue to provide incentives for energy conservation.

596 As stated in AOBA R.Br. 28, "with or without a rate design which seeks greater cost recovery through customer and demand charges, the BSA will ensure that Pepco's overall revenue will be identical."

2. Residential Aid Discount Rider (RAD)[597]

359. The original RAD discount, some 30 years ago, was 6%. In the present case, Pepco is proposing that no revenue increase be allocated to customers served under the RAD Rider (including "RAD- Standard" and "RAD-AE").[598] AARP, the District Government, and WMATA support Pepco's proposal. This would yield a class ROR of negative (-) 5.97% for the RAD class. By contrast, AOBA would raise RAD class rates each year by the percent increase in the Consumer Price Index for Urban Wage and Clerical Workers ("CPI-W").

360. **Pepco.** The Company acknowledges that the RAD distribution rate cap expired on August 31, 2009, pursuant to the Pepco/Connectiv Merger Settlement Agreement. Pepco submits, however, that due to the current adverse economic climate no increase is recommended for RAD customers.[599] The volumetric rate blocks for RAD-Standard and RAD-AE would remain unchanged, under Pepco's proposal, and are lower than the corresponding proposed rate blocks for standard Residential service and R-AE service.[600]

361. **OPC.** OPC takes no position on Issues 15 a, e, f, and g.[601]

362. **AARP**. AARP agrees with Pepco that there should be no increase in either the RAD rates or the RAD customer charge.[602] Today, AARP advises, there are approximately 14,000 to 15,000 customers enrolled in Rate RAD and 5,000 additional customers enrolled in RAD AE. AARP recommends that the Commission seek to increase these enrollment figures. According to AARP, the current customer-enrollment process for the RAD program might be replaced by a streamlined process drawing on information possessed by the District Government[603]

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597 Designated Issue No. 15g asks, "Should RAD distribution rates be maintained at the same level or should they be altered as a result of changing revenue requirements from this rate case?"

598 Pepco Br. 100. The Company recommends that the RAD distribution rates be maintained at the same level as the current rates.

599 Pepco (2L) at 8 (Janocha).

600 Pepco Br. 100; Pepco (L) at 9-10 (Janocha). Pepco points out that Order No. 15710 in its last rate case prohibited any RAD block rates from exceeding the R and AE block rates.

601 OPC Br. 110. Earlier testimony submitted by OPC suggested that RAD rates might be raised by an across-the-board amount. *See* OPC (F) at 16 (Pavlovic) and OPC Exhibit (F)-6 at 2. *See also* OPC Br. 109-110; OPC (F) at 6, 22-28 (Pavlovic); OPC (A) at 21 (Binz).

602 AARP Br. 16; AARP R.Br. 9.

603 AARP (A) at 37-38 (Alexander).

363. **AOBA**. AOBA opposes the RAD rate freeze. Some level of subsidy for the low-income customers that qualify for RAD service may be necessary, AOBA concedes, however current RAD rates should be adjusted each year by reference to the Consumer Price Index for Urban Wage and Clerical Workers ("CPI-W").[604] This CPI-W adjustment can be either upward or downward. Taking the percent increase in CPI-W from the time of Pepco's last base rate case to the present time, AOBA states that its proposal would raise RAD customer revenue requirements by 4.94% in the present case.[605] AOBA also argues that Pepco's BSA should be adjusted so that, each year, the increases in RAD revenue are distributed proportionately, to all classes found to have greater than system average rates of return in the Company's most recent base rate proceeding.[606]

364. **District Government**. Given the poor state of the economy the District Government agrees with Pepco, AARP, and WMATA that there should be no increase in RAD distribution rates in this case.[607] Opposing AOBA's CPI-W proposal, DCG argues that the CPI-W is not a reasonable measure of changes to RAD customers' ability to pay since CPI-W reflects price rises in goods, while RAD customers who are not on social security will not see any increases in their incomes (if they are able to even find work).[608]

365. As to the size of the RAD discount in the future, the DCG comments that a higher RAD subsidy[609] might expand the RAD customer penetration rate. Although the RAD program has been in existence for almost 30 years, and the number of RAD class

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604 AOBA Br. 40; AOBA (A) at 17 (Oliver).

605 AOBA Br. 33-34, 47, 48. AOBA complains that there never seems to be an "appropriate" time to raise the class ROR for the RAD class. It submits that the "notion that RAD rates can never be increased has no basis and cannot be sustained indefinitely." AOBA R.Br. 30-31.

606 AOBA Br. 34; AOBA (A) at 64 – 65 (Oliver); AOBA R.Br. 30-31.

607 DC Govt Br. 17-18; DC Govt R.Br. 4-6, citing AARP's statistics on poverty and unemployment in DC (AARP Br. 4-5); DC Govt (A) at 6, 30 (Petniunas). DCG advises that "the unemployment rate in the District of Columbia continues to be stuck at persistently high levels since *Formal Case No. 1076*. Currently, it is the fifth highest in the country including Puerto Rico. While *Formal Case No. 1076* was being decided the District of Columbia had the seventh highest unemployment rate." DC Govt R.Br. 5 n.20.

608 DC Govt R.Br. 5; DCG (2A) at 17 (Petniunas Rebuttal).

609 One way to increase the RAD subsidy, the District Government suggests, might be to excuse RAD customers from paying Public Space Occupancy Surcharges (PSOS) (approximately $375,000 each year) and Delivery Taxes ($1.4 million each year). Were these surcharges eliminated, the RAD class revenue requirement would be reduced by $1.8 million and the "resulting savings for RAD customers would help to increase the RAD penetration rate." However, the DC Government states that, as things stand today, "the law requires" that both the Delivery Tax and PSOS "be collected on all rate classes that are subject to a volumetric charge." The Commission should review "the tax surcharge process, and work with the Council," the District Government suggests, to develop "a more cost-based surcharge approach for the RAD and other classes." DCG (A) at 13-14 (Petniunas).

customers has increased by 20% since 2007, it is only just now approaching the 20,000 to 25,000 DC households goal set by Pepco. Pepco's RAD customers still count for only 5.75% of the total number of residential customers.

366. One major factor that may be depressing RAD participation is the complexity of the rates as viewed by a potential RAD customer."[610] DCG suggests giving potential RAD customers a straight percentage discount based on the level of usage with the amount of the discount displayed on the RAD customer's bill. This amount could also include those surcharges (the RAD surcharge, and Sustainable Energy Trust Fund surcharge) which are avoided by participating in the RAD program. Though Pepco objects that this suggestion would require an unjustified amount of man-hours to implement, DCG argues that the Commission at least should require Pepco to create a more understandable RAD rider which explains the discount from residential rates, and conspicuously display such information on the Company's website."[611]

367. Though it generally supports streamlining the RAD program, DCG states that contrary to AARP's suggestion "the use of the TANF, SSI, Medicaid, and other means tested financial programs does not appear appropriate for initially certifying the RAD customer."[612] Those programs are administered by a separate agency that:

> does not capture and maintain utility account information that DDOE requires to enroll RAD customers. Applicants who receive TANF, SSI, etc. would still need to provide DDOE with account information to be enrolled, and the Commission would have to approve the categorical eligibility of these participants.[613]

DCG reports that the Commission recently approved a new "streamlined joint recertification process" that requires existing participants to recertify each year by October 1st, in order to continue to receive benefits under four separate Utility Discount Programs ("UDPs") administered by DDOE (one for electricity, one for natural gas, one for home telephone service, and one for water bills). DDOE sends only one application for the four UDPs, along with a later postcard reminder of the looming deadline.[614]

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610 DCG (A) 32, 30-32 (Petniunas).

611 DC Govt Br. 19.

612 DCG (2A) at 20 (Petniunas Rebuttal).

613 DCG (2A) 21 (Petniunas Rebuttal).

614 DCG (2A) at 21 (Petniunas Rebuttal) citing Order No. 16557 in *Formal Case No. 988*.

368. **WMATA**. WMATA would assign zero percent of Pepco's revenue increase to the RAD class. This would keep the class ROR for the RAD class at negative (-) 5.97%.[615]

369. **Pepco Rebuttal.** Replying to AOBA, Pepco states that it agrees with the District Government that RAD distribution rates should not be raised at this time because "the economy is unlikely to recover in the near future."[616]

370. Testimony submitted by Pepco in response to the Commission's bench questions confirmed that Pepco is seeking to continue the $2.50 Customer Charge that now prevails for its Residential RAD customers.[617] During the evidentiary hearings, Pepco witness Janocha seemed receptive to the idea that the RAD program could be simplified, allowing easier understanding of the savings possible under RAD, perhaps through restructuring the RAD rate level to provide a straight percentage discount based on the level of usage.[618] The Company's post-hearing responses, however, were more restrained in assessing the possibility of restructuring the RAD rate so that it would be a simple percentage discount from the Residential rate. As Witness Janocha stated in response to an in-hearing data request:

> the Company will be replacing its legacy billing system over the next several years. Until that time, and because customers can already compare RAD and other rate schedules using the Company's tariff and on-line resources, it would be an inefficient use of resources to prepare the type of analysis and materials proposed by DCG.[619]

371. The Company went on to state that a RAD tariff rider which provides a discount mechanism in the form of a rate credit (either per kWh, per kW or per customer)

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615 WMATA (A) at 23 (chart) (Foster).

616 Pepco Br. 101. *And see* Pepco R.Br. 49-50.

617 Pepco Exhibit No. 87 at 4 (Tanos), responding to questions from Chairperson Kane (Tr. 1669-1671). *Accord*: Pepco Br. 96.

618 Tr. 719 (colloquy between Commissioner Lee and Pepco witness Janocha).

619 Pepco R.Br. 50. *Accord:* Pepco Exhibit Nos. 79 and 80 (Janocha) responding to questions from Chairman Kane at Tr. 717-718, and Commissioner Lee at Tr. 719. "The Company's billing system currently does not have the functionality to perform a discount calculation. A preliminary assessment of the effort involved in developing discount functionality into the current billing system is that it potentially could involve approximately 500 hours for programming and testing of a new discount function. Additional effort would also be required to define and develop reporting capabilities. An additional consideration is that the Company is in the process of replacing both of its legacy billing and customer information systems over the next several years. The Company believes that it is not cost effective to make modifications to these legacy systems in view of the short time that they are expected to remain in service."

could be accommodated more readily than a discount based on a percentage calculation.[620]

DECISION

372. The Commission's opinion in Pepco's last rate case reviews the origins, purposes, history and design of the RAD program.[621] In that case, the Commission modestly increased the RAD class revenue requirement, through a new $2.50 RAD customer charge, while simplifying the RAD rate structure. The options available to the Commission in the present Pepco rate case, concerning the RAD rate, include the following: *(1)* *RAD Rate Freeze*: Pepco, AARP, the District Government, and WMATA recommend no increase in the RAD rate and no change in the RAD rate structure; *(2)* *RAD Rate Increase*: AOBA urges the Commission to raise the RAD class revenue requirement by a CPI-W amount each year (a 4.94% increase in the present case); *(3)* *RAD Simplification*: DCG asks the Commission to simplify the RAD rate structure and discount. Opposing this change, Pepco states that this will be an inefficient use of its resources. AARP urges streamlining of the RAD sign-up process.

373. **RAD Discount Level**. The Commission has decided to moderately increase the RAD class revenue requirement, by increasing the RAD Customer Charge by $2.60 (from $2.50 to $5.10 per month), and making no changes to the other components of the RAD rate. Our decision is supported by the outcome and rationale that we ordered for the RAD class in Formal Case No. 1076, where we also modestly increased the RAD class revenue requirement. The impact on low-income RAD customers is moderated by the fact that Pepco's SOS supply rates went down recently.

374. **Design/Structure of the RAD Rate**. We are sympathetic to the District Government's suggestion that the RAD rate might be further simplified, to make it easier to understand.[622] Pepco, however, is reluctant to make an immediate change. The Commission understands this concern, since a change in the design of the RAD rate may take time to implement, especially in view of the transition that is now occurring in Pepco's billing system to take in account the installation of AMI meters. The

620 Pepco R.Br. 50.

621 See *Formal Case No. 1076,* Order No. 15710, ¶¶ 364-388 (March 2, 2010). Testimony submitted by DCG summarizes the reasons supporting the RAD program, including studying the costs, consumption patterns, and load patterns of low-income ratepayers. *See* DCG (A) at 30-33 (Petniunas).

622 Two or more alternatives exist for simplifying the structure or rate design of the RAD rate. ***First***. DCG suggests giving potential RAD customers "a straight percentage discount to his/her rate, based on the level of usage. Once a customer knows the level of usage, the customer should know the discount, and be able to make a knowledgeable decision." DCG (A) at 31-32 (Pentunias). Under this option, a RAD customer's rate would be X% less than a regular Residential customer's rate. ***Second***. An $X/month reduction in the RAD Customer Charge is also possible. Under this option, a RAD customer's rate would be $X/month less than the regular Residential rate.

Commission directs Pepco to move with all deliberate speed, however, to display the amount of the RAD discount (in dollars) on the face of each D.C. RAD bill.[623] Thus, RAD customers will be able to understand the amount and benefit of the discount. To help make the RAD rate and the RAD discount more intelligible, and easier to understand, the Commission will update the RAD fact sheet that appears on our website, to explain the RAD discount program in more detail, after the compliance filing is approved in this case.[624]

3. Master Metered Apartments (MMAs)

375. **Pepco.** Testimony by Pepco witness Janocha confirms that the Customer Charge for master metered apartments (MMAs) is set at a multiple of the Residential Customer Charge, with the multiple equal to the number of units in the MMA.[625] Mr. Janocha conceded that setting the MMA Customer Charge in this fashion probably does not reflect the cost of serving the customer.[626] The Company could bill MMA customers on a different rate at minimal cost.[627]

376. **AOBA**. AOBA complains that there is a lack of cost basis for MMA customer charges and also an inappropriately high class ROR proposed for the MMA class. AOBA contends the Company's CCOSS shows that the MMA class now provides a class ROR of 10.48%, or roughly 1.5 times the system average rate of return, as contrasted with the negative –4.98% class ROR that Pepco computes for its Residential class. AOBA's CCOSS shows a class ROR of 12.61% for the MMA class, as contrasted with a negative 11.84% class ROR for the Residential class.[628] To address these issues, AOBA submits that as an interim means the Commission may wish to consider freezing the applicable customer charges of MMA accounts at their present levels and using the time between rate cases to devise longer-term approaches for ensuring more equitable treatment of MMA customers."[629]

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623 One of our earlier orders similarly directed Pepco to emphasize "the real dollar discount available under RAD (suggested by Staff and OPC; accepted by Pepco)" *Formal Case No. 869, In the Matter of the Application of the Potomac Electric Power Company for an Incerase in its Retail Rates for the Sale of Electric Energy*, Order No. 9216 at 257 (March 3, 1989).

624 The Commission in *Formal Case Nos. 813 and 945* already is examining how to increase participation in the RAD program. Those cases are the place for the Commission to consider AARP's suggestion that the Commission should encourage the District Government and Pepco to collaborate to create a system of "automatic enrollment" in the RAD program.

625 *See* Tr. 1703- 1707 (colloquy between Chairman Kane and Pepco witness Janocha).

626 Tr. 1709 (Pepco witness Janocha).

627 Tr. 716-719 (Pepco witness Janocha).

628 AOBA R.Br. at 29-30.

629 AOBA R.Br. at 30.

DECISION

377. The *status quo* for the MMA class rate design, as recommended by Pepco, will be maintained for now. The Commission accepts Pepco's proposed rate designs which treats MMA as a part of the R and AE customer classes for this case. In its next general rate case, however, Pepco is directed to present a CCOSS that shows the actual cost of serving MMAs, including the fixed costs that might be reflected in a Customer Charge for MMAs. Pepco is directed to analyze the MMA class return and rate structure as a stand-alone MMA distribution class within the CCOSS. With more accurate MMA cost information in hand, the Company is directed to propose a separate rate classification and schedule for MMAs in its next rate case.

B. Small Commercial Classes[630]

378. The small commercial customers served by Pepco are generally covered by its General Service (GS) rates, which include "GS ND" customers (with maximum monthly demand less than 25 kW), as well as "GS LV" customers and "GS 3A" customers (with maximum monthly demand between 25 kW and 99 kW). Street Lighting (SL) and Traffic Signals (TS) are also small commercial customer classes.

1. General Service Non Demand (GS ND)[631]

379. **Pepco**. Relying on the same rationale that it used to justify increasing the Customer Charge for the Residential rate classes, the Company proposes a "GS-ND" customer charge that moves one quarter of the way towards a charge that is fully reflective of the customer-related costs determined by its CCOSS. The remaining class revenue target would be recovered through an equal proportional increase in the summer and winter volumetric rate blocks. The objective is to move toward fully cost-based rates over a period of four successive rate cases.[632]

380. The impact on GS-ND customers' total bills ranges from –3.33% to 16.79% depending on usage. (For customers who use at least 200 kWhs a month, the impact ranges from –3.33% to 3.77%.) GS-ND customers who are facing the highest percentage increase (10.5% to 16.8%) are those with the lowest usage levels (between 0 and 50 kWhs per month). Pepco contends that these customers will see their Pepco rates

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630 Designated Issue No. 15f asks, "Are Pepco's proposed other rate designs reasonable for all rate schedules?"

631 The components of Pepco's proposed "GS ND" rate include a customer charge and a kilowatt-hour charge ("all kilowatt hours"), as well as rate riders. *See* Pepco (L)-2 at R-6 (Janocha).

632 Pepco Br.100; Pepco (L) at 10 (Janocha).

rise between $2.35 and $2.64 per month which is approximately equal to the proposed change in the customer charge.[633]

381. **AOBA.** AOBA accepts as "reasonable" Pepco's proposed rate components of a customer charge and a kWh charge in the GS ND class tariff. However, AOBA opposes increasing demand and customer charges within the commercial (nonresidential) rate schedules by greater percentages than its increases for kWh charges. Instead, AOBA argues that each component of the GS ND rate should be adjusted by an equal percentage amount. [634]

382. AOBA argues this makes sense because Pepco's customer charge proposals overlook the impact of its BSA. In the context of the BSA, AOBA states:

> increases in customer and demand charges for [the non-residential] classes are no longer necessary for the Company to ensure recovery of the revenue requirements assigned to those classes. Movements toward use of Straight Fixed-Variable ("SFV") rate designs represent an alternative form of revenue decoupling. With a use-per-customer revenue decoupling mechanism in place, pursuit of a SFV rate design concepts is unnecessary. With or without a rate design which seeks greater cost recovery through customer and demand charges, the BSA will ensure that Pepco's overall revenue collections will be identical.[635]

Moreover, AOBA argues, Pepco's proposal for increased customer charges ignores the overpayment by non-residential classes that subsidizes the residential class, and consequently understates the amount of the Company's already assured cost recovery from the non-residential classes.[636] Finally, AOBA argues:

> [t]he measures of kW use upon which the Company allocates demand-related costs within its CCOSS are not the same as the measures of demand upon which costs are billed under the Company's rate schedules. Most of the Company's demand-related costs are allocated on the basis of either measures of annual Coincident Peak ("CP") demands or measures of annual Non-Coincident Area Peak ("NCAP") demands. Monthly billing, on the other hand, is based on individual customer monthly maximum demands, which often do not equate in any month or on average over a year to the measures of CP and NCAP demand upon which costs

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633 Pepco (L) at 10-11 (Janocha); Pepco Br. 100.

634 *See* AOBA Br. 35-36, 47; AOBA R.Br. 28-29; AOBA (A) at 66- 67 (Oliver).

635 AOBA R.Br. 28.

636 *See, e.g.,* AOBA R.Br. 28.

> are allocated. For this reason, continued use of kWh measures to recover a portion of the Company's demand-related costs can serve to improve the equity of amounts actually billed to individual customers. In other words, the simple premise that demand-related costs should be recovered through demand-related charges generally ignores important differences between the measures of demand on which costs are allocated and the measures of demand upon which costs are billed.[637]

DECISION

383. The Commission enjoys wide discretion in setting the customer charge for the commercial classes. As explained above (¶ 356), AOBA's argument about the impact of the BSA on intra-class rate designs is flawed. The Commission has decided to accept Pepco's proposals on the rate design for GS ND rates as just and reasonable.

2. General Service - Low Voltage (GS LV) and General Service - Primary Service (GS 3A)[638]

384. **Pepco.** Old three-part rate structures – now in Pepco's General Service-Low Voltage ("GS LV") and General Service- Primary Service ("GS 3A") rate schedules[639] – are being modified by Pepco to increase the significance of customer and demand charges. Pepco explains that the Company's proposed GS LV and GS 3A rates:

> move toward a cost-based rate design, with an additional feature designed to mitigate potential intra-class impact. For Schedule GT LV, the proposed rate design modifies the customer and demand charges 50% of the way to full cost, while for Schedule GT 3A and GT 3B, the proposed rate design captures fully cost-based customer and demand charges.[640]

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637 AOBA R.Br. 28-29.

638 Three-component rates are proposed by Pepco for "GS LV" customers, including customer charges, kilowatt-hour charges, and kilowatt charges, as well as rate riders. *See* Pepco (L)-2 at R-6.2 and at R-6-4 (Pepco rate schedules).

639 Schedules GS LV and GS 3A both have 3 part rate structures consisting of a customer charge, a demand charge for loads above 25 kW, and a declining block seasonally differentiated volumetric charge. The current rate structure implicitly recovers the first 25 kW of demand based costs through the higher initial volumetric rate block. Pepco (L) at 11(Janocha).

640 Pepco Br. 100. The somewhat longer explanation in Pepco's written testimony is "[a]s an initial step toward moving to a cost-based rate design, the demand charge would be applied to all kilowatts of billed demand and the declining block volumetric rate would be replaced with a single, seasonally differentiated rate. In order to mitigate the intra class impact, particularly on customers with low levels of billed demand, the demand rate is designed to recover the same proportion of demand-related costs as the current rate structure. While this does result in a lower demand rate in the short term, applying the demand charge to all kilowatts facilitates a more equitable transition to demand-based rates over the long term. By contrast, if the level of cost recovery through the demand charge were increased under the existing rate

385. **AOBA.** AOBA accepts that the Company's proposals for three rate components in the GS LV and GS 3A class tariffs (customer charge, kWh charge, and kW charge) are reasonable. However, AOBA opposes increasing demand and customer charges within nonresidential rate schedules by greater percentages than its increases for kWh charges. Instead, AOBA argues that each component of the GS LV and GS 3A rates should be raised by an equal percentage amount to reach the class revenue targets for those classes.[641]

DECISION

386. The Commission approves Pepco's proposals on the rate design for GS LV and GS 3A rates as reasonable.

3. Street Lighting (SL)[642] and Traffic Signals (TS)[643]

387. **The Partial Settlement.** While this case was pending, Pepco and DCG reached a partial settlement on SL and TS rate issues.[644] By Order No. 16790 the Commission approved the Settlement Agreement,[645] which covered only certain issues including how the "outage discount" would continue to apply to SL and TS distribution service.[646] The Company also agreed to complete a study on whether Pepco's cost of service studies properly account for SL/TS seasonality and off peak usage.[647] Other

structure, low demand customers (those with demands of approximately 25 kW) would see lower volumetric rates without being exposed to the corresponding higher demand rates." Pepco (L) at 11-12 (Janocha).

641 *See* AOBA Br. 35-36, 47; AOBA (A) at 66- 67 (Oliver).

642 Designated Issue No. 15b inquires asks, "Is Pepco's proposed change in rate design to the rate schedule for Street Lighting ("SL") reasonable?"

643 Designated Issue No. 15c asks: "Is Pepco's proposed change in the rate schedule for Traffic Signals ("TS") reasonable?"

644 *See* Tr. 346-350.

645 *See Formal Case No. 1087*, Joint Motion for Expedited Approval of Agreement of Stipulation and Settlement (March 8, 2012) ("Settlement Agreement") filed March 8, 2012; *see* Order No. 16790 (May 25, 2012); Tr. 346-350.

646 Earlier, DCG had complained that the SL/TS rates still contain a component based on kWh usage, to calculate taxes and surcharges, so that whatever impact that kWh-based component had should be reduced by an "outage discount." *See* DCG (A) at 5, 27-29 (Petniunas). Pepco's rebuttal essentially conceded that the kWh figure used to calculate taxes and surcharges for the SL and TS rates should be adjusted by the functional equivalent of an "outage discount." As Pepco put it: "the level of sales used to develop these surcharges should be adjusted." Pepco (3L) at 8-9 (Janocha Rebuttal).

647 *See* Order No.16790, ¶ 4(c) (May 25, 2012) (summarizing the settlement agreement).

issues were not decided by Order No. 16790, including the SL/TS rate design issues described below and the class revenue target/ROR that Pepco may charge the District for SL/TS service.[648]

388. **Pepco.** The Company's proposed class revenue requirement for the SL/TS classes involves raising the class revenue requirement for the Streetlight Energy Class one-half of the way from its present negative (-) 5.20% class ROR toward a zero ROR, producing an additional $328,500. The Streetlight Service class's ROR was then set judgmentally at 1%, producing a $45,222 increase from that class.[649]

389. To recover these class revenue targets, the Company originally proposed SL and TS rate designs that largely eliminated volumetric charges, and instead adopted two new fixed charges: a new customer charge and a "per-light" charge.[650] Otherwise, Pepco proposed an across-the-board adjustment to the rate components in the street light schedules, until the class revenue targets were met.[651] Subsequently the settlement agreement resolved some of the disputes between Pepco and DCG concerning SL/TS rates.

390. After the partial settlement on SL/TS rates, Pepco described its proposed SL/TS rate designs as reflecting "a transparent cost-based approach that consists of a customer charge and a per-light charge, and includes a major storm allowance discount to the per-light charge." In addition, Pepco states, in response to DCG witness Petniunas's concerns about the allocation of metering costs and AMI adjustments to SL and TS classes, Pepco has modified its rate design to distinguish metered from unmetered service. The Company has also filed an errata to correct the number of devices used as billing determinants, as pointed out by witness Petniunas' testimony.[652]

391. **District Government.** Originally DCG asked that the SL/TS classes be exempted from all taxes and surcharges imposed on a kWh basis.[653] Ultimately, however, DCG abandoned that claim in favor of seeking an "average" (14.9%) increase

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[648] *See* Order No. 16816 (June 21, 2012); *accord:* Pepco Br. 98 n.506.

[649] Pepco Br. 91-93.

[650] *See* Pepco (L) at 13-15 (Janocha); Pepco (2L) at 5-6 (Janocha); (Pepco (I) at 35-36 (Gausman).

[651] Pepco (L) at 14 (Janocha).

[652] Pepco Br. 97.

[653] Originally, DCG asked that all volumetric-based surcharges for the SL and TS rate schedules be eliminated until such time as the Council (1) specifies a methodology for collecting such surcharges on demand-only rates, and (2) clarifies its intent to require the government to pay taxes to itself. DC Govt (A) at 6-14, 11 (Petniunas). The impact of accepting that DCG proposal would have eliminated over 75% of the revenues Pepco collects from the SL/TS classes. *See* DCG (A) at 7-9 (Petniunas).

for the SL/TS classes. DCG argues that gradualism, and the policy of avoiding "rate shock," support limiting any class revenue increases for the SL/TS classes to 14.9%.[654]

392. The issue of taxes and surcharges on SL/TS rates is raised again by DCG, post-settlement, in somewhat different form. On brief DCG advises that, in the future, Pepco's rate design should be based upon the demand (kw) each customer class puts on the system, not the volume of kwhs consumed. Though DCG states that it no longer disputes whether the per kwh assessment of taxes and surcharges should apply to SL/TS rates,[655] DCG nevertheless proceeds to argue that taxes and surcharges should be similarly assessed on a kw basis (presumably at some time in the future) to avoid the mismatch between demand and consumption measures.[656] DCG asserts, among other things, this means that the various statutes authorizing the assessment of taxes and surcharges also need to be changed to a demand-based measure of assessment. Relying on flexibility it claims to find in the current statute for collecting the D.C. Public Space Occupancy Surcharge, DCG invites the Commission to begin this process by allocating the costs of that D.C. surcharge among classes based upon some methodology other than kwhs such as class revenue.[657]

393. Turning to the rate design of the component parts of SL/TS rates, post-settlement, DCG complains that Pepco unreasonably proposes a per lamp monthly charge in its traffic signal service schedule 'TS' that is exactly the same as the per lamp charge that Pepco proposes in its street lighting service schedule SL.[658] According to DCG, the conservation trend is more dramatic for traffic signals than for street lights because, since 2005, DDOT has converted all traffic signals to energy-efficient LED lights, while street lights still employ a range of lighting technologies ranging from LED (at the low

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654 *See* DC Govt Br. 12; DCG (A) at 23 (Petniunas).

655 Taxes and surcharges, imposed on a kWh basis, account for over 75% of the distribution revenues that Pepco collects from the SL and TS classes. *See* DCG (A) at 7-9 (Petniunas). D.C. Code § 47-2501 B(I)(ii)) (2001 Ed.) requires that taxes and surcharges must be collected from all rate classes that are subject to a volumetric charge. *See* Tr. 1168-1174 (DCG witness Petniunas). DCG's initial post-hearing brief states, "the District no longer disputes whether the per kwh assessment of taxes and surcharges should apply to the SL energy class. Given the provisions in the Commission-approved partial settlement agreement between Pepco and DCG regarding application of the outage discount to the assessment of taxes and surcharges, the District is comfortable that its concerns have been reasonably addressed." DC Govt Br. 2.

656 DCG explains that "when taxes and surcharges are assessed according to the amount of kwhs consumed, the result is that a disproportionate amount of that class's total bill will consist of taxes and surcharges. In the case of the SL/TS class, approximately 84% of its total distribution bill goes to pay taxes and surcharges. This is unreasonable." DC Govt Br. 11.

657 DC Govt Br. 11-12. The statute confers considerable discretion to the Commission to formulate a reasonable method for collecting that charge, citing D.C. Code § 10-1141.06 (2008 Repl. Ed.); ***and see*** DC Govt Br. 2.

658 DC Govt Br. 16.

consuming end) to incandescent light (at the high consuming end). To recognize these facts, DCG argues that the TS class should be entitled to a smaller per lamp charge than the SL class.[659]

394. **Pepco Rebuttal**. The Company argues that its proposed revenue increase for the SL/TS classes is consistent with gradualism, since the impact on the overall SL/TS bill (for generation, transmission and distribution) is small.[660] Defending the imposition of taxes and surcharges on a kWh basis in its new proposed SL/TS rates, Pepco argues that because the Company is assessed taxes on a usage (*i.e.*, volumetric) basis all customers should be responsible for these costs in proportion to the energy they consume. Moreover, Pepco points out, if the surcharge were not added to SL/TS rates, another customer class would have to take responsibility for the revenue shortfall.[661] With respect to the SL verses TS lamp charge, Pepco argues that the savings that are experienced through lower consumption (by TS lamps) do not impact the costs associated with providing distribution service to the traffic signal class. Rather, those savings are realized through lower costs to the District Government to secure supply.[662]

DECISION

395. The settlement on SL/TS rates did not resolve the class revenue requirements (class RORs), or the rate design issues discussed here for those classes. The Commission Staff will monitor the provisions of the settlement during its implementation.

396. **Determination of the Class Revenue Requirement (Class ROR) for the SL/TS Classes. (A) Overall.** The Commission has wide discretion in setting the SL/TS revenue requirements, particularly since low SL/TS rates historically have been supported (as DCG argues) by a wide variety of valid "non-cost" factors. In the past two rate cases, the Commission rejected Pepco's requests for dramatic percentage increases in the SL/TS class ROR, opting instead to increase the SL/TS class revenue requirement (and class ROR) by (roughly) the higher-than-DC-average percentage increase that was assigned to the Residential class. As explained earlier **(pp. supra),** in the present case the Commission is approving a $220,000 increase for the SL/TS classes, representing approximately a 2%) increase in the overall bill for these classes. Today's decision

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659 DCG advises the Commission that about 43% of the "lamps" in the District are traffic signals, while the remainder are street lights. Because of their 100% LED technology traffic signals only consume about 12% of the total energy consumed by the SL/TS classes. Yet under Pepco's proposed SL/TS rate schedules, DCG complains, the distribution costs to DCG are the same to operate an efficient LED traffic signal as to operate a street light with a less-efficient incandescent bulb. DC Govt Br. 16-17

660 Pepco R.Br. 48; Pepco Br. 97-98.

661 Pepco Br. 98.

662 Pepco R.Br. 49.

reduces this subsidy, addresses the negative class ROR now being paid by these classes, while taking into account all the conservation, low risk, non-cost, public safety and other factors cited by DCG for keeping SL/TS class rates low.

397. **(B) Taxes and Surcharges on SL/TS: KWH vs. Class Revenue Basis for Pepco to Collect the DC Public Space Occupancy Surcharge**. Taxes and surcharges supply the majority of Pepco's monetary collections from the SL and TS classes, and eliminating or reducing those taxes and surcharges would very dramatically reduce the revenues obtained from the SL/TS classes. DCG asks the Commission to adopt a new basis for calculating the obligations of each customer class (class revenue, instead of kWhs) to pay the Public Space Occupancy Surcharge ("PSOS") that is owed by Pepco each year.[663] This switch would save money for the SL/TS classes because using class revenues as an allocator would cost the SL/TS classes less than the current kWh system for allocating among Pepco's customer classes the overall dollar amount of PSOS that Pepco owes.

398. The Commission declines to rule on this PSOS surcharge issue here in Formal Case No. 1087. We simply approve Pepco's long-standing practice, consistent with the District law, of collecting taxes and surcharges based on kWhs. As we explain below, DCG's request is one that might better be directed at the D.C. Council.

399. The PSOS surcharge is codified in D.C. Code § 10-1141.06 (2008 Repl. Ed.) which states in pertinent part:

> Each public utility company regulated by the Public Service Commission shall recover from its utility customers all lease payments which it pays to the District of Columbia pursuant to this title through a surcharge mechanism ***applied to each unit of sale*** and the surcharge amount shall be separately stated on each customer's monthly billing statement (emphasis added).

400. The statutory language "each unit of sale" does not readily lend itself to DCG's interpretation that it could mean "by class revenue." Moreover, the Court of Appeals has approved the current system that allocates class responsibility for paying Pepco's PSOS costs on a kWh basis.[664]

401. The issue about how to calculate the PSOS surcharge on each customer class in the future can be raised by DCG before the legislative branch. We think that the D.C. Council, and not this Commission, is in the appropriate forum to assess the merits of

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663 *See* DC Govt Br. 12. The two largest surcharges imposed on the SL/TS classes are the DC Delivery tax ($0.0077 per kWh) and the PSOS ($0.00194 per kWh). *See* DCG (A) at 7 (Petniunas).

664 *See Office of People's Counsel v. Public Service Comm'n of the District of Columbia,* 799 A.2d 376, 380 (D.C. 2002).

DCG proposal to modify a long-standing interpretation of the PSOS statute to obtain a lower Pepco bill for the SL/TS classes.

402. **SL/TS Rate Design**. Two rate design issues are raised concerning the component parts of the SL/TS rates, after the partial settlement on SL/TS rates:

403. **SL v. TS Lamp Charge.** The savings from new energy efficient TS lamps include savings-in-kw-demand, as well as kWh-energy-consumption. The Commission is sympathetic to DCG's argument that the "per lamp" charge in Pepco's tariffs might be reallocated between the SL and TS classes (which presently are lumped together in Pepco's CCOSS). Granting DCG's request might recognize the District Government's achievement in obtaining greater energy efficiency with its LED traffic lights. Pepco did not raise any substantive objection to DCG's request and other obstacles do not appear.[665] Accordingly, we direct Pepco to address this issue in its next rate case, when it should present a refined CCOSS that reallocates the "per lamp" charge in Pepco's tariffs between the SL and TS classes.

404. **Other.** Pepco also agreed that, in the future, its CCOSS will differentiate within SL/TS rates between the District Government's costs (unmetered) and the costs of the Federal Government (metered).[666] This accommodates DCG's request for more direct cost allocations and separate rate classification vis-à-vis the Federal Government.

C. Large Commercial Classes[667]

405. The Company's large commercial customers—generally defined as those whose maximum 30 minute demands equal or exceed 100 kilowatts during two or more billing months within 12 consecutive billing months are covered by tariff schedules "GT

665 There are a large number of traffic signals in the District., so "unduly volatile costs from an overly narrow cost basis" should not be an objection here (as it was in Formal Case 1076) where the proposal – rejected by the Commission-- was to recognize a new "broken out" Pepco charge that would have been based on only one major cost item for a critical feeder line). *See Formal Case No. 1076*, Order No. 15710, ¶ 313. The settlement agreement on SL/TS rates envisions that DCG in the future will be distinguishing its D.C. SL/TS costs more sharply from those of the Federal Government.

666 *See* Pepco Br. 97; Pepco (3L) at 9 (Janocha Rebuttal). The Settlement Agreement on SL/TS states that "Pepco and the District Government agree that the division of SL rates into metered and unmetered services as set forth in Pepco's proposed SL tariff is an appropriate method to address Advanced Metering Infrastructure ("AMI") and other metering costs, and therefore, no study will be required with respect to the inclusion of the costs of AMI smart meters in SL rates, although the amount of the reduction for such metering costs may still be subject to dispute." Order No. 16790, ¶ 4E (May 25, 2012) (describing the Settlement Agreement).

667 Designated Issue No. 15f asks, "Are Pepco's proposed other rate designs reasonable for all rate schedules?"

LV," "GT 3A" and "GT 3B." Tariffs with three rate components (customer charge, demand charge, and volumetric charge) are proposed by Pepco for these customers.[668]

1. Time Metered General Service - Low Voltage (GT LV)

406. **Pepco.** The Company proposes to modify the old rate design for schedule GT LV by increasing the customer and demand charges to move 50% of the way toward a full cost basis.[669]

407. **AOBA.** AOBA objects to Pepco's proposal to increase GT demand and customer charges by greater percentages than the increases proposed for kWh charges. Instead, AOBA argues that each component of the GT LV, GT 3A and GT 3B rates should be raised by an equal percentage amount to reach the class revenue targets for those classes.[670] AOBA argues in the context of the Company's BSA, increases in customer and demand charges for those classes are no longer necessary for the Company to ensure recovery of the revenue requirements assigned to those classes. Secondly, given Pepco's over-recovery from the GT class, its GT customer and demand charges are already closer to actual costs than Pepco anticipated."[671]

DECISION

408. The Commission approves Pepco's proposals on the rate design for GT LV rates as reasonable.

2. Time Metered General Service - Primary Service (GT 3A) and Time Metered General Service - High Voltage (GT 3B).[672]

409. **Pepco.** Pepco indicates that its Schedules GT 3A and GT 3B proposed rate design is based on fully cost based customer and demand charges.[673]

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668 *See* Pepco (L)-2 at R-8 to R-8.5(Janocha) (Pepco rate schedules for "GT LV," "GT 3A" and "GT 3B").

669 Pepco (L) at 12 (Janocha).

670 *See* AOBA Br. 35-36, 47; AOBA (A) at 66- 67 (Oliver).

671 AOBA Br. 35, 47; AOBA (A) at 67.

672 Designated Issue No. 15f asks, "Are Pepco's proposed other rate designs reasonable for all rate schedules?"

673 Pepco (L) at 12 (Janocha).

410. **AOBA**. AOBA argues that each component of the GT 3A and GT 3B rates should be raised by an equal percentage amount to reach the class revenue targets for those classes.[674]

411. **Pepco Rebuttal.** Based on a bench request, the Company clarified its position on its proposed Customer Charge for the GT- HV 69kV customer class:

> With respect to the GT- HV 69kV customer class, the reason for the customer charge of $20.32 is that in this proceeding the Company has proposed to collect the majority of the class revenue requirement through the demand component of the rate rather than through the customer cost component. The Company recognizes that the cost to provide service to this class is higher and could justify a greater proportion of the class revenue requirement being collected through the customer charge as compared to the demand charge. The Company will re-evaluate this approach as part of the next base rate case.[675]

DECISION

412. The Commission enjoys wide discretion in setting the customer charge for the commercial classes. The Commission approves Pepco's proposals on the rate design for GT 3A and GT 3B rates as reasonable.

D. Metro-RT

413. **Pepco**. Pepco's initial rate design for Metro service ("RT") was a fully cost-based rate consisting of a customer charge and a demand charge.[676] The Company subsequently accepted WMATA's proposal for Metro-RT rates.[677]

414. **WMATA**. WMATA proposes that it be billed in twelve equal charges over the course of a year.[678] Under this proposal, the only billing determinant is the number of delivery points. This simplified system eliminates the separate categories of

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674 *See* AOBA Br. 35-36; AOBA (A) at 66- 67 (Oliver).

675 Pepco Exhibit No. 87, at 4 responding to questions from Chairman Kane at Tr. 1669- 1671.

676 Pepco Br. 98-99. According to Pepco, its Bill Stabilization Adjust-ment (BSA) mechanism "assures that only the authorized level of revenue can be recovered from this customer." The only impact of this rate structure change, Pepco said, is "a more levelized bill" for WMATA over the course of a year. Pepco (L) at 12-13 (Janocha).

677 *See* Pepco Br. 99; Pepco (3L) at 8 (Janocha); Tr. 691 (Janocha).

678 WMATA Br. 7; WMATA (A) at 25-28 (Foster).

volumetric charges and demand charges. This rate design assures Pepco a constant, level revenue stream over the course of a year. Since WMATA's proposal is based on the number of delivery points, it would remain fair to both Pepco and WMATA regardless of whether new stations are being built."[679] Pepco's assured levelized revenue stream would more than cover the cost of serving WMATA. WMATA's targeted rate of return of 14% would be far higher than the system average.[680]

415. WMATA argues that, under its twelve-equal-charges per year proposal, it should no longer be subject to the BSA mechanism. WMATA argues that this is desirable because the BSA mechanism provides a disincentive to conservation. That is, under the present system, the less electricity WMATA consumes, the higher the BSA charge. This scenario would exist whether the BSA were based on volume units or demand units. Eliminating the BSA altogether would encourage WMATA to conserve electricity.[681] Under the agreed RT rate WMATA would realize 100% of the savings associated with reduced consumption, while Pepco would realize 100% of the authorized revenue for the RT class.[682] WMATA argues that its twelve-equal-payments-per-year proposal results in a "levelized bill," and is more fair and reasonable than Pepco's original proposal for the Metro-RT class.[683]

DECISION

416. The Commission approves of WMATA's proposed simplified billing system of twelve equal charges over the course of a year as reasonable. The Commission directs Pepco to remove the BSA mechanism from the Metro-RT rate because based on this new rate design change this single customer class revenue will be stable and predictable.[684]

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679 WMATA Br. 7.

680 WMATA (A) at 27 (Foster). Pepco R.Br. 49.

681 WMATA (A) at 28.

682 WMATA Br. 8.

683 WMATA (A) at 25- 27 (Foster).

684 The Commission agrees with WMATA that the equally monthly charges, which provides stability to Pepco's revenue, for the RT class eliminates the need for the BSA mechanism. In addition, in Rebuttal, Witness Janocha filed revised tariff pages for the RT class that no longer included the Bill Stabilization Adjustment as a rider, essentially agreeing that the BSA was no longer required. (See Pepco (3L)-2 page 2 of 4) However, the Commission may revisit this ruling (eliminating the BSA from the Metro-RT rate) if, in the future, another customer joins the Metro-RT customer class. The single customer nature of the class, at present, is what ensures the stable and predictable nature of its equal monthly charges.

E. Other Miscellaneous- Telecommunications Network Service ("TN") Temporary Service ("T")

417. **Pepco.** The Company proposes an across-the-board adjustment to each of the rate components for telecommunications network service (Schedule "TN"). For Temporary Service (Schedule "T"), Pepco states that the customer charge has been modified in the same manner as that for Schedule GS ND. Historically, these customer charges have been set at the same level, and this approach is continued in this rate case. The volumetric rates have been designed to recover the residual revenue increase allocated to Schedule T.[685]

DECISION

418. Pepco's proposals for the TN and T rates are undisputed. The Commission approves the rate design for TN and T rates as reasonable.

XVIII. TARIFF CHANGES[686]

419. **Pepco.** The Company states that its proposed tariff language changes are limited to implementing its proposed distribution rate design changes. The implementing tariff language is not separately disputed. [687]

420. **OPC.** OPC generally does not challenge Commission acceptance of Pepco's proposed tariff language" in the present case, although it thinks that all of Pepco's rates should be fundamentally redesigned once AMI is fully deployed in the District of Columbia.[688] OPC states that, in the event that the Commission approves a RIM surcharge, which it should not, the surcharge tariff language should reflect a demand charge rate design for the RIM.[689]

421. **AOBA.** AOBA objects to Pepco's proposed RIM tariff language on the RIM (in Exhibit Pepco (L-6)). AOBA points out that, for demand-metered commercial rate classes, the proposed RIM tariff fails to indicate which measure of billing demand – "on-peak-kW demand" or "maximum monthly kW demand" -- would be used to bill RIM charges. Moreover, AOBA notes that because Pepco has no short-term debt in its capital structure, it is difficult to decipher the part of the RIM tariff that states that the

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685 Pepco (L) at 15 (Janocha).

686 Designated Issue No. 16 asks, "Are Pepco's proposed changes in tariff language reasonable?"

687 Pepco Br. 101; Pepco (2L) at 8-9 (Janocha).

688 OPC Br. 110.

689 *See* OPC R.Br. 52; OPC Br. 110-111; OPC (F) at 26-28, 6 (Pavlovic).

Company's current short-term debt rate will be used to compute monthly interest on the monthly differences between actual and forecasted costs. Furthermore, AOBA notes that Pepco's proposed RIM tariff language does not incorporate the Company's explanation of how RIM surcharge revenue requirements would be assigned among customer classes.[690] AOBA contends that the proposed RIM tariff arbitrarily limits the time period for review of Rider RIM rate filings to a period of 60 days and that there is no mechanism spelled out for determining whether Pepco has furnished Commission Staff with "sufficient work papers for audit and review of the RIM surcharge.[691]

422. **District Government**. DCG contends that the Tariff language for SL and TS service should be amended to eliminate the language stating that the "charges under this schedule are for <u>electricity</u> only." According to DCG, the tariff language should say that SL and TS charges "are for <u>delivery</u> only," since Pepco's customers now purchase electricity from the competitive generation market, and Pepco is now a "wires only" distribution/delivery company.[692]

<u>DECISION</u>

423. The Commission's decisions on rate design and the RIM will dictate the implementing tariff language. Since the Commission rejects the proposed RIM in this proceeding, the parties' contentions regarding a RIM tariff are moot. We agree with DCG's tariff amendment replacing the word "electricity" with the word "delivery" in the SL/TS rate schedules.[693]

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[690] AOBA R.Br. 18-21.

[691] AOBA R.Br. 20.

[692] DCG (A) at 12 (Petniunas).

[693] Other tariff/rate design issues were abandoned by DCG. To be specific, DCG abandoned its earlier argument (*see* DCG (A) at 6, 11 (Petniunas)) seeking to eliminate all taxes and surcharges on SL and TS rates until the D.C. Council specifies a method for collecting such surcharges on demand-only rates. DCG's post-hearing briefs drop that argument and instead present very different claims about SL/TS rates.

XIX. RELIABILITY INVESTMENT RECOVERY MECHANISM [694]

424. **Pepco.** Pepco seeks Commission approval "in principle" of a Reliability Investment Recovery Mechanism ("RIM") that would recover future reliability improvement and construction costs on an accelerated basis. These surcharges, adjusted annually, would be added to Pepco's requested $39.7 million rate increase in this case beginning in July of 2013. Pepco is proposing the RIM in order to reduce the frequency of rate case filings and the chronic under-earning that is produced by regulatory lag inherent in traditional ratemaking. According to Pepco, the investments recovered through the RIM will include those necessary to attain the Commission's new reliability standards. Pepco maintains that the RIM only facilitates recovery of initial costs of these needed investments and the vast majority of cost recovery will not take place in advance of a fully litigated base rate case.[695]

425. Over the period 2011-2015 Pepco plans to embark on a ramped-up program of construction costing hundreds of millions of dollars to improve its system reliability. Two thirds of Pepco's D.C. construction budget is devoted to distribution construction.[696] Pepco witness Gausman states that Pepco's "Reliability and Load projects" reflect the construction of assets designed to increase the reliability of the electric system within the District and to serve the existing and developing load on the electric system.[697] The Company forecasts that its five-year budget outlays for improvements in the Reliability and Load categories will be $278 million more than it

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694 Designated Issue No. 18 asks, "Is Pepco's proposed Reliability Investment Recovery Mechanism (RIM) just and reasonable? Does Pepco's multi-year (2011-2015) construction budget in its RIM proposal provide a level of investment sufficient to fund projects that will result in significant reliability improvements? Should conditions be attached to a funding mechanism for reliability improvements such as RIM? If so, what conditions are appropriate? Should Pepco's recovery of reliability related costs through a funding mechanism be tied to reliability performance targets? Which projects (or types of projects) financed by any selected cost recovery mechanism can best satisfy the two reliability objectives specified in Formal Case Nos. 766, 982, and 991, Order No. 16347, ¶ 2 (May 5, 2011).

695 Pepco Br. 103. Pepco states that the "RIM is a necessary part of the Company's plan to meet the Commission's new performance standards over the long term." Pepco Br. 104.

696 The Company's total "District of Columbia construction budget for 2011 is $237.9 million," which includes the subcategories of "distribution" ($172.7m), "AMI" ($10.0m), "Transmission" ($44.2m), and "General, IT and Other (non AMI)" ($11.0m). "The distribution plant investment represents two thirds of the total Pepco District of Columbia 2011 construction budget." Pepco (I) at 4-5 (Gausman).

697 Pepco (I) at 8 (Gausman).

invested in these categories during the previous five years (2006 to 2010).[698] Pepco says this increase is driven by its District Reliability Enhancement Project ("REP").[699]

426. The Company claims that its multi-year RIM budget will result in significant reliability improvements. The proposed reliability budget is focused on the areas that will result in the greatest benefits for customers: poorest performing feeders, distribution automation, substation and feeder improvements, and replacement of infrastructure.[700] Pepco witness Gausman asserts that the investments included in Pepco's five-year construction plan are required if the Company is to have any chance at achieving the annual 9.3% improvement in SAIDI and 3.4% improvement in SAIFI required by the Commission's new year-by-year reliability standards adopted in Order No. 16427.[701] Relying heavily on the exhibit titled "Pepco Reliability Forecasts – Working Papers" in Pepco (3I)-1, Pepco claims that this document shows the potential improvement in SAIDI and SAIFI performance as compared to the proposed EQSS goals during this period. According to Pepco, its projected performance demonstrates that the Company has developed a plan that accurately identifies the projects and level of spending required to meet the EQSS goals of significantly improving reliability.[702]

427. Moreover, Pepco claims that all aspects of the electric system must be upgraded to achieve the new higher reliability standards. Pepco asserts that there is no one solution to system reliability. System reliability is only achieved by the cumulative impact of multiple enhancements and upgrades.[703]

428. According to Pepco, thirteen categories of costs would be recovered through the RIM surcharge. As Pepco witness Gausman explained, the types of capex that would come within the RIM include highway improvements; feeder reliability improvements; planned URD cable replacements; SPCC plans; pole replacement; and distribution automation among others. Pepco insists that no "double recovery" of costs

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698 On January 27, 2012, Pepco witness Gausman submitted a supplemental response (Commission Exhibit No. 7 at 5) updating the Company's 2012 construction budget and 2013-2016 forecast and updated RIM plan.

699 Pepco (I) at 10.

700 Pepco Br. 103- 104; Pepco (3I) at 20 (Gausman Rebuttal).

701 *See* Pepco (3I) at 14-16 (Gausman Rebuttal); Pepco (3I)-1 at 19.

702 Pepco Br. 107-108; Pepco R.Br. 57-58.

703 Pepco (3I) at 21-23 (Gausman Rebuttal). *Accord*: Tr. 194-195 (Pepco witness Lowry) (some RIM costs would support reliability improvements, while others would support higher future loads).

through the RIM and base rates is involved. Project costs recovered through rate base would not be included in future RIM surcharges.[704]

429. On rebuttal the Company significantly modified its RIM proposal. Responding to criticisms, Pepco amended its RIM proposal so that: (1) the annual RIM review will include a final "prudence" review of the "RIM-eligible assets that became used and useful in the previous calendar year"; (2) consumer protections are increased in the annual RIM review process, allowing discovery through data requests, intervenor testimony, and four months (instead of two) for the annual RIM review process;[705] (3) a 5-year limit is placed on the RIM surcharge, unless extended by the Commission after review at the four-year mark; and (4) recovery of 10% of the RIM-eligible costs is delayed in a "regulatory asset" to improve Pepco's incentives to contain the cost of RIM-eligible assets.[706] The Company makes it clear that it is seeking Commission approval of its proposed RIM only "in concept" or "in principle" and that further refinement of its RIM proposal should occur before it becomes effective.[707] Pepco's rebuttal testimony also makes it quite clear that its proposed RIM surcharge could recover the costs of more than just reliability improvements. As Pepco envisions it, the RIM surcharge would extend beyond reliability improvements to cover the costs of "load-supporting capex"[708] and all aspects of the electric system.[709] Overall, Pepco witness Lowry stated that Pepco witness Gausman's expansive list of proposed RIM projects might be overbroad and that Pepco is looking to the Commission to define what construction costs are eligible for RIM surcharge recovery.[710]

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704 *See* Tr. 1838-1840, 1867-1869, 1880-1882 (Gausman).

705 According to Pepco, however, the annual RIM review process would not address the Company's reliability enhancement plan (REP). Instead, "[s]takeholders and the Commission can have input through the current Working Group process and the review of the Company's reliability planning reports." Pepco (3B) at 3 (Lowry Rebuttal).

706 *See* Pepco (3B) at 2-6 (Lowry Rebuttal); Tr. 206-211, 220-225, 1258-1263, 1307-1312, 1339-1340, 1346 (Pepco witness Lowry) (summarizing Pepco's revised RIM proposal).

707 *See, e.g.,* Tr. 1300 (Pepco witness Lowry); Tr. 1559-1561 (Pepco witness Gausman).

708 Pepco (3B) at 24 (Lowry Rebuttal).

709 Pepco (3I) at 21-23 (Gausman Rebuttal).

710 *See* Tr. 220-221 (Pepco witness Lowry) ("One of the things that the Commission has to decide on is what types of capex are eligible for recovery. Mr. Gausman has listed a lot of things. You don't have to accept everything that's on that list; although there are arguments in favor of accepting them all."). *Accord*: Tr.1612 (Pepco witness Gausman) ("The projects that we've identified in the categories are one of the initiatives that we're looking for guidance and direction from the Commission."); Pepco (I2) at 10 ("the Company has proposed those categories for consideration by the Commission, which has the authority to determine which categories it ultimately will allow to be included in the RIM") (Gausman Supp. Rebuttal).

430. Pepco insists that multi-year rate plans, or expedited capex cost recovery mechanisms like its proposed RIM, will reduce the frequency of general rate cases, thereby decreasing regulatory lag and enhancing the incentives for Pepco to contain costs.[711] Some of the time saved in the regulatory arena can be devoted to closer scrutiny of the eligible capex. On the other hand, Pepco argues that continuing traditional ratemaking, without a RIM, will likely produce annual rate cases that will weaken Pepco's incentives to contain costs.[712] Even with its proposed RIM in place, Pepco states, there would still be the need for occasional base rate cases to address other sources of the Company's under earning.[713]

431. Traditional cost of service regulation ("COSR"), according to Pepco, provides strong efficiency incentives only under favorable business conditions that permit utilities to voluntarily postpone rate cases for several years.[714] Pepco asserts that these conditions do not exist today. Pepco argues that utility distributors today need to file rate cases fairly frequently, even under normal conditions. When faced with special stresses, such as an accelerated modernization program, traditional COSR will produce a kind of regulatory lag that produces chronic under earning and very frequent rate cases.[715] Traditional ratemaking, Pepco says, "cannot provide it with the timely rate increases it needs" to improve reliability "without chronic under-earning."[716] Moreover, according to Pepco, its Bill Stabilization Adjustment ("BSA"), a decoupling true-up device, is "insufficient to avoid serious regulatory lag during a period of accelerated system modernization."[717]

432. Without a RIM, Pepco indicates, it may well file a new general rate case every year for the next several years.[718] The Company states that capital expenditure recovery mechanisms like the RIM are common for electric and gas utilities, having been implemented in more than 25 States and such mechanisms are widely used by utilities engaged in accelerated system modernization because they address the key reason why

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711 Pepco (3B) at 12 (Lowry Rebuttal).

712 Pepco (3B) at 12.

713 Pepco (B) at 68 (Lowry).

714 Pepco (3B) at 15 (Lowry Rebuttal).

715 Pepco (3B) at 16.

716 Pepco (B) at 5 (Lowry).

717 Pepco (B) at 16.

718 Tr. 168 (Pepco witness Lowry).

cost grows more rapidly than billing determinants while at the same time not undertaking sweeping regulatory reforms.[719]

433. To be sure, Pepco witness Lowry acknowledges, traditional cost of service regulation creates some performance incentives to reduce costs. It may make sense where general rate cases are infrequent, and (as was true in the decades before 1970) when the growth in utility billing determinants kept pace with the growth in utility costs.[720] However, Lowery contends that when rate cases are held frequently without forward test years, on the other hand, the impact of regulatory lag is more likely to be financial attrition than beneficial efficiency improvement."[721]

434. Today, according to Pepco witness Lowry, cost outpaces growth in billing determinants for most energy distributors. Pepco needs to increase its capital spending and it may file general rate cases annually, sharply reducing the regulatory lag and cost-containment performance incentives that are associated with traditional regulation.[722]

435. To be sure, Pepco states, it is committed to improve reliability with or without the RIM. The Company warns, however, that meeting the Commission's higher standards, in the absence of some regulatory lag relief could result in higher costs of capital for the Company. While strategically timed rate cases may effectively address regulatory lag when a utility is bringing a single large asset into rate base, such as a power plant, Pepco argues that is not so when, as in Pepco's situation there is a need for on-going, continuous investments to address continued improvements in reliability and, inevitably, there will be substantial capital additions that will not be included in the most recently-set rates.[723] There is no evidence, Pepco claims, that regulatory lag is beneficial in these circumstances.

436. In sum, the Company argues that a RIM is necessary (instead of traditional ratemaking) to correct "chronic under-earning"; that its modified/revised five-year RIM surcharge will provide full consumer protections (discovery, participation, etc.); that

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719 Pepco (B) at 52-53; Exhibit Pepco (B)-3 (Lowry), Pepco (2D) at 4, 8 and Pepco (2D)-1 (showing capital investment recovery ratemaking mechanisms).

720 "For many vertically integrated electric utilities (VIEUs), infrequent rate cases also made sense in the 1990s and early years of the present century because there was a lengthy hiatus in the construction of generation plant." Pepco (2D) at 11 (Hevert).

721 Pepco (3B) at 10- 11 (Lowry Rebuttal).

722 Pepco (3B) at 11; Pepco Br. 106.

723 Pepco R.Br. 55-56.

Pepco is only seeking approval of the RIM "in principle" here in Formal Case No. 1087; that other RIM issues can be worked out with or in a Working Group; and that focusing on the single issue of Pepco's capex costs each year will improve public and Commission scrutiny and benefit everyone.[724] Pepco's post-hearing reply brief reaffirms the Company's readiness to hold a technical conference to discuss certain implementation issues" for the RIM.[725]

437. **OPC.** OPC opposes the RIM as "bad regulatory policy. Technical deficiencies plague the RIM, OPC argues, and independently justify its rejection. These include lack of definition,[726] inadequate consumer protections,[727] no performance standards,[728] and no supporting cost-benefit analysis.[729]

438. OPC submits that Pepco failed to carry its burden of proof to show that adopting a RIM is necessary to meet the Commission's reliability standards.[730] To the contrary, Pepco has stated that it will make the same reliability investments regardless of whether the Commission approves the RIM.[731] The Company's own testimony shows

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724 *See, e.g.,* Pepco (3B) at 9, 38-41 (Lowry Rebuttal).

725 Pepco R.Br. 52.

726 *See* OPC Br. 115, 140-154, 166-168; OPC R.Br. 56-58; OPC (G) at 5-7, 12, 16-18, 20-21, 25, 33-34, 39-42, 58-59, 83-86 (Dismukes); Tr. 850-851 (OPC witness Dismukes); OPC (G2) at 8 (Dismukes Supp.).

727 OPC argues that there are no significant consumer safeguards in Pepco's proposed RIM. No minimum filing requirements are specified for Pepco in its initial filing to start the annual RIM review process. Other parties' discovery rights are left unclear in the annual RIM review. Nor did Pepco specify a dispute resolution mechanism in the event ratepayers and the Company do not agree as to what projects should be included in the RIM. The absence of any specific cost containment measures in Pepco's RIM "essentially gives the Company a blank check in terms of RIM expenditures." Other States' capital investment recovery riders include many ratepayer protections that are missing in Pepco's RIM. *See* OPC (G) at 39-43, 85 (Dismukes).

728 *See* OPC (G) at 35-39 (Dismukes).

729 *See* OPC Br. 121; OPC R.Br. 72; OPC (G) at 11, 25-30 (Dismukes). Other OPC objections to the RIM include: (1) It would improperly call for ratepayers to fund Pepco's accelerated catch-up efforts to cure years of system neglect and poor performance. *See* OPC Br. 135-137; (2) The Maryland PSC recently rejected requests for a RIM from Washington Gas Light Company. *See* OPC (G) at 82-83 (Dismukes); Maryland Public Service Commission, *Case No. 9267, In the Matter of the Application of the Washington Gas Light Company for Authorituy to Increase its Existing Rates and Charges and to Revise its Terms and Conditions for Gas Service*, Order No. 84475 (November 14, 2011) at 107-108.

730 *See, e.g.,* OPC Br. 115; OPC R.Br. 55-56; OPC (A) at 17 (Binz); Tr. 368 (OPC witness Binz); Tr. 788-790 (OPC witness Dismukes).

731 OPC (G) at 11 (Dismukes); *accord*: OPC Br. 124-125 ("Pepco failed to demonstrate that implementation of the RIM will improve reliability").

that, under traditional regulation which involves some regulatory lag, it has the ability to attract, at reasonable cost, the capital it needs" to improve its reliability.[732] To put it another way, OPC argues that Pepco has not shown that a series of strategically-timed rate cases cannot be as effective as adopting" its sweeping, ill-defined, and unsupported infrastructure replacement" RIM surcharge mechanism.[733]

439. OPC argues that traditional test year ratemaking is preferable. OPC submits that Pepco's proposed RIM lacks justification under NARUC standards and traditional criteria for cost trackers, it saps incentives for efficient management particularly in combination with the BSA, it unduly shifts risk to ratepayers, and it undermines effective prudence review.[734]Though Pepco complains about regulatory lag, OPC claims that regulatory lag is actually an important component of traditional cost of service regulation, providing utilities with incentives for innovation and cost-effective investment. A RIM surcharge, by contrast, would dull these incentives.[735]

440. OPC argues that Pepco has not shown that regulatory lag is the cause of its inability to earn its' "ROE" or that regulatory lag is a chronic problem that requires non-traditional ratemaking solutions.[736] Citing Order No. 5739, OPC points out that this Commission earlier rejected similar Pepco arguments that "alternative regulatory mechanisms" (such as an inflation allowable in ROR, an end of period rate base, a new fuel clause, and a separate allowance for attrition) were in order to forestall the effects of regulatory lag. Other Commissions similarly have decided to adhere to traditional regulation when asked to adopt alternative regulatory mechanisms.[737] OPC claims that,

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[732] OPC (G) at 51 (Dismukes); *and see* OPC Br. at 83..

[733] OPC Br. at 79, 83. OPC points out that Pepco already has planned a series of successive rate cases for the future: a RIM filing in March 2013, another base rate case filing in 2013 (a year after the 2011 rate case rates went into effect), and another RIM filing in March 2014. OPC Br. 119- 120.

[734] *See, e.g.,* OPC (G) at 5-7, 84-89 (Dismukes); OPC (C) at 47 (Woolridge).

[735] OPC Br. 123; OPC (G) at 85, 86, 89 (Dismukes); Tr. 368 (OPC witness Binz). OPC witness Dismukes testified at great length that Pepco misunderstands regulatory lag and the function of regulatory risk. OPC claims that research has "shown that cost-plus regulatory methods, like the proposed RIM, invite inefficiencies and higher-than-necessary rates." OPC (G) at 86, 89 (Dismukes); OPC Br. 123.

[736] OPC (G*)* at 83, 79 (Dismukes). The Commission-approved BSA decoupling mechanism, OPC argues, protects Pepco against any risk that its revenues will seriously deteriorate. Even if regulatory lag challenges its ability to earn its authorized ROE, Pepco is a successful thriving company whose perceived regulatory lag "problem" is a short-term situation that "may only go on for like five years" according to the Company's own witness Lowry. OPC argues that Pepco has not demonstrated that traditional regulatory lag is a serious "chronic" problem that calls for a RIM surcharge. OPC Br. 116-118.

[737] *See* OPC R.Br. 76-78, citing a decision of the Massachusetts Department of Public Utilities that rejected a reliability infrastructure tracker with "striking similarities to Pepco's RIM proposal."

over the long term, under traditional rate regulation, utilities' actual earnings have exceeded allowed earnings more often than not.[738] OPC argues that the RIM is nothing more than an inefficient cost-plus reimbursement mechanism that encourages overcapitalization and inefficiency.[739]

441. Moreover trackers or surcharges are usually adopted, says OPC, where the costs in question are: (1) largely outside the control of the utility; (2) unpredictable and volatile; and (3) substantial and recurring. OPC argues that the likely investments included in Pepco's proposed RIM "do not meet all three standards simultaneously."[740]

442. OPC strongly objects to combining a RIM with Pepco's BSA decoupling mechanism.[741] According to OPC, the BSA virtually eliminates all usage-related revenue risks for Pepco, and coupling the BSA with the RIM could lead to capital inefficiency since together they would guarantee the value of and return on Pepco's new capital investments. Two Massachusetts utility companies were recently denied "capital trackers," OPC reports, in part because the Massachusetts PSC found that inefficiencies are likely to arise from the combined effect of decoupling and a poorly designed infrastructure replacement surcharge rider.[742]

443. OPC complains that Pepco's RIM omitted any performance-based targets, goals, or success measures.[743] Worse, OPC claims, Pepco's RIM is asymmetrically constructed such that ratepayers bear an undue amount of risk for investments that may not improve reliability, and may not be just and reasonable, while Pepco enjoys the benefits of accelerated returns in a manner that bypasses most of the safeguards provided by traditional cost-of-service ratemaking review.[744]

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[738] OPC Br. 118-119; OPC (G) at 51-52 (Dismukes). OPC claims that studies show that "regulatory lag had no statistically-discernible impact on utility financial performance during adverse or beneficial periods." OPC (G) at 50-51 (Dismukes). Eliminating regulatory lag, on the other hand, shifts risk, invites utility inefficiencies and higher-than-necessary rates, and "completely re-writes the established equities" to the detriment of consumers. *See* OPC (A) at 12 (Binz); OPC (G) at 86, 5-7, 45-48 (Dismukes). *And see* OPC (G) at 49(Dismukes).

[739] OPC (G) at 11 (Dismukes).

[740] *See* OPC (G) at 61-65 (Dismukes).

[741] *See* OPC (G) at 74- 78 (Dismukes).

[742] *See* OPC (G) at 76-78 (Dismukes) at 76-78, referencing Western Massachusetts Electric Company ("WMECo") and Fitchburg Electric Company ("FEC").

[743] OPC (G) at 35- 39; OPC (G2) at 8 (Dismukes Supplemental).

[744] OPC argues that Pepco's ill-defined RIM unfairly shifts regulatory risk, investment risk, and performance risk away from Pepco and entirely onto ratepayers (*see* OPC (G) at 54-57 (Dismukes). OPC

444. OPC further contends that Pepco's RIM would eviscerate the protections provided by a traditional prudence review.[745] The standards for assessing prudence necessarily require comparisons, OPC states, of projected versus actual costs and projected versus actual benefits. Moreover, OPC argues that prudence should require more than simply meeting the District's EQSS standards.[746] Relying on *Pepco v. Public Service Commission*, OPC states that the Court of Appeals has held that the proponent of a finding that an investment is prudent must provide evidence explaining "why it is necessary to spend money at the particular levels" proposed by the Company, and "what, if any, benefits would inure to ratepayers as a result of the proposed level of spending."[747] Once serious doubts are raised about the prudence of RIM investments, OPC argues, the burden shifts to the utility to explain "why it was necessary to spend money at those particular levels" proposed in the RIM and provide evidence that "explain[s] what, if any benefits would inure to ratepayers as a result of Pepco's level of spending" on RIM projects.[748]

445. OPC argues that, as Pepco witness Lowry testified, whether an investment is prudent involves an assessment of: 1) whether the capital expenditure is "really needed"; 2) whether the capital expenditure was "undertaken efficiently;" and 3) whether the benefits of the project, such as improved reliability, are actually realized.[749] OPC contends that a multi-year capex plan such as the RIM should reflect extensive evidence

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notes that the RIM contains no performance standards tied to "reductions in outage frequencies, outage duration, reduced O&M costs, or other potential benefits." Under the RIM, OPC complains, Pepco would recover (subject to a later prudence review) the cost of its reliability improvements, whether or not they actually result in efficiency improvements or cost reductions.

[745] OPC R.Br. 62.

[746] OPC R.Br. 61, 62. This is not a 20/20 hindsight or strict liability standard, OPC states, noting that if a RIM project's "actual costs ... were greater than projected costs," or if projected benefits were not realized, Pepco would be given an opportunity to explain. "If the explanation is satisfactory, the investment may be deemed prudent even if its actual costs were greater than its projected costs and its projected benefits were not realized." OPC R.BR. at 62-63.

[747] OPC Br. 154-155; OPC R.Br. 58-67.

[748] OPC R.Br. 64, quoting from *Potomac Elec. Power Co. v. Public Serv. Comm'n*, 661 A.2d 131, 138-139, 140 (D.C. 1995).

[749] OPC complains that Pepco "has not prepared any forecasts of the benefits of any of its RIM projects." While Pepco witness Lowry testified that "getting bang for the buck * * * is the heart of the cost effectiveness consideration," OPC notes the testimony of Pepco witness Gausman that the Company "does not have a project-by-project ranking system" or any sort of cost-benefit analysis for the RIM (as opposed to the REP, which contains a different set of projects). OPC Br. 159-161.

on the specific projects to be undertaken, their net benefits and efficiency compared with alternative means of improving reliability.[750]

446. OPC disputes Pepco's claim that the RIM will reduce regulatory costs. Pepco's RIM surcharge proposal contains numerous time-consuming reviews and procedures, OPC points out.[751] Pepco base rate cases would be needed even after approval of a RIM, and these cases, forced to evaluate ongoing RIM investments, would be more complex than traditional rate cases. There is no "stay-out" provision in Pepco's RIM. Pepco did not produce a cost-benefit analysis supporting the adoption of its RIM. OPC predicts that overall regulatory costs under a RIM regime will be similar to, or worse than, the costs of traditional regulation.[752]

447. OPC submits that Pepco fails to establish any nexus between implementation of RIM projects and any expected improvement in reliability.[753] Indeed, on the witness stand, Pepco witness Lowry stated that Pepco had not done any studies to quantify how RIM projects contribute to improvements in D.C. reliability. Instead, he stated that it is hard to link the capex specifically to the reliability.[754]

448. OPC argues that Pepco has compounded the problem of understanding the cost-effectiveness of the RIM by omitting tree-trimming (a major influence on reliability) while including many projects that are not reliability projects in the RIM.[755] The Company's opposition to RIM performance standards underlines the fact, OPC argues, that in fact the RIM is not related to reliability.[756]

449. OPC witness Dismukes, in post-hearing testimony, argues that it is essential to measure "bang for the buck" in order to assess the prudence of any RIM-related investments: "A determination that such projects are prudent necessarily depends on whether the Company's investments achieve their expected reliability impact."[757] OPC's witness asserts that there is a lack of cause and effect relationship between RIM

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750 OPC Br. 154-155.

751 OPC Br. 81-82, 85.

752 OPC Br. 122; OPC R.Br.74-74; OPC (G) at 79-82 (Dismukes).

753 OPC Br. 126.

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755 OPC Br. 127-129, 133.

756 OPC Br. 131.

757 OPC (G2) at 9-10 (Dismukes Supplemental).

investments and improvement in reliability because Pepco's proposed RIM surcharge will not cover enhanced vegetation management (one of "the many variables" that, along with weather, affect the reliability of Pepco's system).[758] This means, he argues, that Pepco cannot show that any particular RIM investment, and any particular dollar amount, results in the 'bang for the buck' that Pepco witness Lowry professes is the heart of the cost effectiveness consideration.[759]

450. OPC witness Dismukes indicates that "performance" is important in considering cost trackers and that Pepco should supply "metrics" that can be applied to categories of projects.[760] Acknowledging traditional definitions of "prudent investment,[761] Dismukes states that prudence reviews require measurements of investments against certain metrics and that the lack of up-front metrics makes a prudence determination more difficult for a capex cost tracker like the RIM that would be evaluated yearly.[762]

451. OPC witness Mara indicates that past experience does and should guide Pepco's future actions to improve reliability.[763] The Commission determines prudency on the basis of the reasonableness of investment decisions at the time they are made rather than afterwards.[764] He acknowledges that it is difficult to forecast or predict the reliability improvements that may be obtained from particular projects;[765] however, he

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758 OPC (G2) at 22 (Dismukes Supplemental).

759 OPC (G2). Tr.1252, lines 4-6.

760 *See* Tr. 1732, 1735 (Dismukes).

761 OPC witness Dismukes agreed with Justice Brandeis' definition: "There should not be excluded from the finding of the rate basis investments which under ordinary circumstances would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful and imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment unless the contrary is shown." Tr. 1747. Mr. Dismukes also agreed with Alfred Kahn's statement that: "Judgment of prudence can, in principle and in fairness, be made only as of the time when the pertinent commitments and expenditures were made." Tr. 1748.

762 Tr. 1743-1746 (Dismukes). "It's important to be able to understand how well the investments are being made under these tracker mechanisms and whether they're doing what they're intended to do, which is to improve the goals that are typically outlined in those metrics." Tr. 1774 (Dismukes).

763 *See* Tr. 1800-1801 (Mara).

764 Tr. 1799. Thus Mr. Mara agreed that if a project proved to be ineffective, that would not affect the prudency of the completed project, but it would be a factor going forward if the same project were to be proposed again. *See* Tr. 1799-1801, 1810-1811.

765 OPC witness Mara agreed that "it's difficult to predict the outcome of a project on an individual feeder" *See* Tr. 1805. According to OPC, Pepco said "that the methodology that they used could only look at the total system or a group of feeders for overall reliability in their proposed metric, whereas * * * [other

indicates, "tracking" past historical results "provides the means for forecasting" the reliability improvements that may result from current and future investments.[766]

452. OPC points out that Pepco has given inconsistent and incomplete testimony about the scope of the RIM.[767] OPC emphasizes that the RIM should be limited to reliability improvement projects only and not projects that could and should be undertaken as part of the normal course of Pepco's business.

453. OPC insists that Pepco has the burden of proof on the RIM budget and all other issues. While a utility need not demonstrate in its case-in-chief that each proposal is prudent, OPC argues that the utility bears the ultimate burden of proof.[768] OPC argues that Pepco provides insufficient information to show the prudence of its REP budget, *i.e.,* to show that the proposed REP investments are really needed, that they are undertaken efficiently, that they are prioritized in terms of expected improvements in reliability, and that these projected benefits are realized.[769]

454. OPC claims that the only evidence Pepco submits, purports to correlate the level of proposed expenditures with reliability improvements, is "Pepco Reliability Forecasts - Working Papers" for the REP in Exhibit Pepco (3I)-1 (Gausman).[770] OPC states however, that this exhibit says nothing about the RIM. Instead, it sets out forecasted reliability improvements from three components of the REP: vegetation management; feeder improvement work; and distribution automation (DA) implementation. OPC contends that vegetation management is indisputably not included in the RIM, and the analysis in Exhibit Pepco (3I)-1 is untested against historical experience, flawed, and unreliable.[771]

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information supplied by Pepco in discovery] "indicated * * * that they could provide reliability tracking by feeder and that, in and of itself, would allow for projections by feeder." Tr. 1804.

766 *See* Tr. 1803- 1805 (Mara).

767 *See* Tr. 1760-1761 (OPC witness Dismukes) (questioning, in particular, whether "emergency work" is or is not covered by the RIM).

768 OPC R.Br. 79-80, *Potomac Elec. Power Co. v. Public Serv. Comm'n*, 661 A.2d 131 (D.C. 1995), *Anaheim, Riverside et al v. FERC*, 669 F.2d 799, 809 (D.C. Cir. 1981), and other authorities.

769 OPC Br. 171; OPC R.Br. 80-81.

770 OPC Br. 182. *And see* OPC Br. 175-176 & n.628.

771 OPC Br. 177-178; OPC R.Br. 56-58, 81-82 & n.325.

455. OPC argues that Exhibit Pepco (3I)-1, notwithstanding its flaws, shows that Pepco could meet its EQSS obligations by expending substantially less in ratepayer dollars than it seeks approval to spend in this case. To be specific, OPC claims that Exhibit Pepco (3I)-1 indicates that by implementing three initiatives (vegetation management, distribution automation, and priority feeder improvement), Pepco can meet the new EQSS benchmarks (SAIFI through 2015 and SAIDI through 2014) at a fraction of the budgeted costs. OPC argues that Pepco is proposing to expend substantial sums on investments that are only tangentially related to reliability improvement. "This inflate[s] the apparent cost of reliability improvement and masks the true cost of improving Pepco's reliability to acceptable standards."[772]

456. OPC observes that the scope of Pepco's proposed RIM is enormous, covering $566.7 million in outlays for the years 2011 through 2015 (52% of Pepco's 2011-2015 capital budget).[773] According to OPC, Pepco seeks to include in its RIM all projects for which there is no automatic generation of new revenue. OPC argues that this is too broad, since the RIM should only be used for projects that improve system reliability beyond the current *status quo*. Load driven projects, emergency repairs, highway relocations, and the like, are *status quo* projects – part of Pepco's normal on-going operations – and are not primarily needed for reliability.[774] OPC submits that, if a RIM surcharge is adopted, it should cover only projects designed primarily to improve system reliability beyond Pepco's normal on-going improvement projects.

457. OPC witness Mara testified that it is not possible, based on the data now available, to determine which of Pepco's proposed reliability projects can best improve reliability in the worst performing neighborhoods.[775] OPC states that, in fact, Pepco's filings do not identify any specific neighborhood reliability improvement projects.[776]

458. OPC witness Binz argues that accelerated cost recovery mechanisms like the RIM "tend to dull the incentives for efficiency that cost of service regulation provides to utilities." Where accelerated cost recovery mechanisms have been used, he contends,

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772 OPC Br. 182-186.

773 Over the 5 year period from 2011 through 2015, OPC states, Pepco plans to spend $566.7 million (revised upward from an earlier estimate of $385.6 million) in "reliability-driven capital expenditures," ranging yearly from $91.8 million in 2011 to $71.0 million in 2014. This $566.7 million figure represents a 227% increase over the $173.4 million that Pepco spent over the earlier 5-year period from 2006 through 2010. OPC (G) at 12-13 (Dismukes).

774 OPC (E) at 11 (Mara); *accord:* OPC Br. 186-194.

775 OPC Br. 203; OPC (E) at 10-11, 80 (Mara).

776 OPC R.Br. 87-88.

the justifications usually relate to regulatory efficiency and the financial health of the regulated companies, despite the negative impact on incentives. He also argues that cost adjustment mechanisms usually are applied only to costs that trend upward over time, and that they change the balance of equities embodied in traditional cost of service regulation.[777]

459. OPC concludes that traditional ratemaking regulation is adequate to ensure reliable electric service. A special "investment recovery mechanism" is not needed to accomplish the restoration of reliability in the District of Columbia.[778]

460. **AARP.** Traditional ratemaking is favored by AARP, which opposes surcharges and riders that seek cost recovery outside of traditional base rate cases. "A utility is obligated to provide reasonable service and to invest in modernization and maintenance of its distribution system as a normal duty."[779] AARP argues that Pepco has failed to show that a RIM surcharge is needed for it to deliver reasonably reliable service. A surcharge would inappropriately reward Pepco by allowing rate recovery prior to the demonstration of value and prudence. Moreover, AARP complains that Pepco's proposed RIM fails to contain any specific performance standards to measure whether RIM investments result in the promised improvements in reliability in service.[780]

461. Turning to the laundry list of accelerated cost recovery mechanisms, discussed by Pepco witness Lowry, AARP argues that they are distinguishable from Pepco's RIM proposal. Most of those capex mechanisms are not for reliability investments, the few related to reliability investments have significantly different features than Pepco's proposal, and a number of the mechanisms were adopted in response to legislative action.[781] Moreover, AARP argues, the fact that other states have used capex trackers does not mean that their use is consistent with the public good. AARP points out

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[777] OPC (A) at 16 (Binz).

[778] OPC (A) at 17.

[779] AARP (A) 21 (Alexander).

[780] AARP (A) 21, 28.

[781] AARP Br. 9-10; AARP (A) 22 (Alexander) (distinguishing Pepco's proposed RIM from capex mechanisms for: (1) natural gas utilities whose usage per customer was steadily declining for many years and who sought a capex surcharge to replace older cast iron pipeline systems; (2) electric utilities with surcharge recovery for AMI costs; (3) utilities with multi-year rate plans with penalties for noncompliance with quality improvement standards; and (4) surcharges tied to performance criteria, or tied to a lower Return on Equity).

that a 2009 survey on cost trackers by the National Regulatory Research Institute concludes that "[c]ost trackers can, in various ways, result in higher utility costs."[782]

462. AARP submits that Pepco failed to present any evidence to support the Company's claim that the RIM will benefit ratepayers by reducing the cost of obtaining funds in the capital markets. Instead, the RIM shifts risk to ratepayers by providing "a fast-track mechanism for cost recovery which assumes the expenditures are prudent and properly designed, properly attributed to reliability, properly accounted for and actually incurred." Further AARP argues that Pepco did not show that the RIM will reduce the frequency and costs of rate cases.[783] The proposed RIM review process places costs and burdens on intervenors to participate in a meaningful way, and "would essentially lead to ineffective regulation of these projects."[784] AARP concludes that the proposed RIM is both bad public policy and unreasonably costly.[785]

463. AARP avers that the Commission should consider the harsh economic impact that a RIM surcharge would have on the District's residential customers.[786] While energy prices are high, financial assistance for the poor is being reduced dramatically, and low income customers are having difficulty paying their home energy bills.[787]

464. AARP sharply criticizes the arbitrary nature of the project categories (and costs) that Pepco says will be covered by the RIM.[788] According to AARP, the RIM should cover only those project categories that relate to reliability and improvement in the distribution system's performance and that are linked to the Company's Comprehensive Reliability Improvement Plan. Other reliability related costs, such as vegetation management (an O&M cost) and improvements in customer care and call center performance should be excluded from the RIM.[789]

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782 AARP Br. 10. *Accord:* AARP (A) 22 ("the best practices that protect both the utility and the ratepayer are not reflected in Pepco's proposal.") (Alexander).

783 "The Company is unable to commit to filling fewer rate cases in the future and, as with the costs of capital, it has not performed a numerical analysis of these potential savings." AARP Br. 6-7.

784 AARP R.Br. 4; Tr. 1147 (Alexander).

785 AARP Br. 7-8, citing OPC (G) at 7-60 (Dismukes) on the problems associated with the RIM.

786 AARP Br. 4; AARP (A) 5-6 (Alexander).

787 AARP (A) 6-7 (Alexander).

788 AARP (A) 19-20 (Alexander).

789 AARP (A) 20.

465. A central problem with the RIM, AARP argues, is that Pepco has not shown that its proposed RIM projects will actually achieve the Commission's reliability goals.[790] Other than the new District-wide EQSS standards, Pepco has not suggested any specific performance standards for judging the effectiveness of RIM projects. There are many aspects of Pepco's operations that impact upon the Company's overall reliability besides RIM projects such as AMI meters, and O&M projects such as tree trimming. The Company made no showing that its proposed RIM projects, as distinct from other aspects of its operations, will actually improve reliability in the District.[791]

466. **AOBA.** Opposing any kind of RIM, AOBA contends that (among other faults) Pepco's RIM proposal fails to distinguish between projects that are only marginally related to reliability improvement and projects which have a clear and distinct impact on distribution system reliability in the District.[792]

467. AOBA criticizes Pepco's claim that the Commission's rising reliability standards are significantly increasing the level of expenditures required to improve reliability. According to AOBA, the Commission has not raised its reliability standards, rather it has simply been forced by Pepco's actions, or lack thereof, to quantify standards to reflect the District of Columbia's on-going need for improved service reliability. Moreover, AOBA argues that much of the increased expenditures to which Pepco refers should be viewed as "catch-up" expenditures that have been, or will be, incurred by the Company to recover from neglect of its operations in past periods. In Maryland, the PSC not only penalized the Company for imprudent management of service reliability matters, it has also explicitly indicated that it does not expect to provide the Company rate recovery of expenditures that are incurred to compensate for past omissions or neglect (*i.e.*, catch-up expenditures). AOBA believes that this Commission should consider adopting a similar stance.[793]

468. AOBA argues that a RIM is unnecessary and inappropriate. AOBA recognizes that Pepco's service reliability problems are not likely to be resolved in the absence of increased expenditures.[794] However, Pepco's highly academic consideration of generic ratemaking and regulatory policy issues fails to make a "compelling case that regulatory lag is the key to addressing its problems. The only D.C.-specific data on

[790] AARP Br. 8-9.

[791] AARP Br. at 9.

[792] AOBA (A) at 7 (Oliver).

[793] AOBA R.Br. 22-23.

[794] AOBA R.Br. 3.

Company earnings that Pepco presents (in Pepco (F)-8) fails to note that Pepco operated under settlement agreements during the years 2002-2007 when it voluntarily capped its rates. [795] Similarly, Pepco's data for 2008 through 2010 (with the exception of 2008) reflect results that were not subject to litigation. While Pepco claims that, over the long run, regulatory lag has increased Pepco's costs, AOBA argues that Pepco's claim is supported by nothing more than the conceptual tenet that a company that is viewed as more risky will pay more for capital. There has been no showing that Pepco's D.C. operations are viewed as more risky than the operations of other distribution-only utilities.[796]

469. The critical problem facing Pepco, according to AOBA, is not "regulatory lag" but instead the disparities in class rates of return ("ROR") and the negative ROR from the largest component of the Residential class (the R and AE subclasses).[797] AOBA argues: neither the adoption of a RIM nor the introduction of other mechanisms focused on regulatory lag issues will resolve Pepco's need for additional revenue, if its losses on the provision of service to Residential customers continue to grow.[798]

470. Noting the huge size of Pepco's proposed multi-year (2011- 2015) construction budget, AOBA argues that Pepco's planned capital expenditures are unnecessarily inflated by unsubstantiated projections of unprecedented growth in the number of its residential customers.[799] AOBA also questions whether that budget contains appropriate priorities to ensure that the largest service reliability improvements at the lowest cost are the first to be pursued.[800] AOBA contends that the Commission should not approve Pepco's greatly expanded capital spending program without weighing the increased risk and return requirements for investors and the increased revenue requirements it imposes on D.C. ratepayers.[801]

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795 AOBA R.Br. 3-4, 17-18. AOBA also submits that "if Pepco's returns did not meet expectations during that period [2002 to 2007] any shortfall would be attributable to the Company's failure to achieve expected 'synergy savings' from its merger with Conectiv rather than the effects of regulatory lag." *Id.* at 4.

796 AOBA R.Br. 18.

797 AOBA Br. 2-3, 38-41; AOBA R.Br. 4, 21-22; AOBA (2A) at 13 (Oliver Rebuttal); AOBA (A) at 5-6, 16-18 (Oliver); Tr. 1070-1071 (AOBA witness Oliver).

798 AOBA Br. 44; AOBA (A) at 69. Moreover, AOBA objects to the RIM design proposed by Pepco. *See* AOBA Br. 40- 42; AOBA R.Br. 21-22; AOBA (A) at 8, 18-20 (Oliver).

799 According to AOBA, Pepco's planned capital expenditures are unnecessarily inflated by unsubstantiated projections of growth in the number of D.C. residential customers. AOBA (A) at 8 (Oliver). AOBA Br. 46.

800 AOBA Br.43; AOBA (A) at 6, 21.

801 AOBA (A) at 12 (Oliver); AOBA Br. 46-47.

471. **DCG**. DCG opposes Pepco's RIM as not just and reasonable for the same reasons as OPC. DCG objects that the RIM is a departure from traditional ratemaking practices, and essentially shifts the risk of cost-recovery from the Company to ratepayers.[802] Twenty different time-consuming steps would be involved in the annual RIM review, and DCG questions whether procedurally, the RIM may be more complex to implement than simply having another rate case.[803] DCG recommends that the RIM process should be simplified to be effective. Moreover, before it is implemented, Pepco should be required to present a cost/benefit study showing that the RIM would benefit ratepayers in the long run.[804] Objecting to Pepco's proposed "hybrid" method for assigning RIM revenue requirements to customer classes, DCG asks that the SL/TS class and the RAD class be exempt from any RIM charge.[805]

472. **GSA.** GSA opposes Pepco's RIM, which would create a mini rate case that would replace the general rate case as the primary forum for setting rates to recover a major portion of Pepco's distribution costs. As GSA understands Pepco's proposal, its 2013-2016 RIM budget is nearly $944 million, which is over 80% of its total forecast distribution construction budget.[806]

473. GSA raises several other objections to a RIM. First, the RIM eliminates Pepco's incentives caused by regulatory lag to lower costs and operate efficiently.[807]

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[802] DC Govt Br. 19-20.

[803] DCG (A) at 6, 35-38 (Petniunas); DC Govt Br. 20-21. *See* DCG (A) at 37-38 (listing procedures required by the proposed RIM).

[804] DCG (A) at 38.

[805] DC Govt Br. 21- 22. *See also* Tr. 1178- 1180 (DCG witness Petniunas); DCG (A) at 5-6, 38-41 (Petniunas) and DC Govt (2A) at 24 (Petniunas Rebuttal). Opposing AOBA's recommendation that RIM revenues be collected from each class based on its rate base, DCG's rebuttal states that "a demand billing process would be appropriate" in the short term, and that "as smart meters begin the billing process, the kWh method should be phased out." DC Govt (2A) at 22-23 (Petniunas Rebuttal).

[806] GSA Br. 2; GSA R.Br. 3-4.

[807] GSA Br. 2-4; GSA R.Br. 5-6; GSA (A) at 7 (Goins). GSA states that "regulatory lag has long been recognized as an incentive for utilities to control costs and operate efficiently." As economist Alfred Kahn has stated, regulatory lag is "to be regarded not as a deplorable imperfection of regulation but as a positive advantage. Freezing rates for the period of the lag imposes penalties for inefficiency, excessive conservatism, and wrong guesses, and offers rewards for their opposites: companies can for a time keep the higher profits they reap from a superior performance and have to suffer the losses from a poor one." GSA (A) at 11-12 (Goins). GSA's post-hearing reply brief vigorously denies that GSA witness Goins ever "acknowledged that Pepco had not earned more than 73% of its authorized ROE for any year in the last decade." Overlooked by this Pepco statement, GSA states, is the fact that during much of the last decade,

Instead, a RIM conveys a bonus to Pepco that the Company has not earned by shifting financial risk from Pepco's shareholders to its ratepayers, despite Pepco's recent track record of poor service quality and reliability in the District of Columbia. Second, the RIM would only add to the alleged inefficient, time consuming, and expensive rate setting process that Pepco is seeking to replace.[808] Were the RIM to be adopted, it would require stakeholders to participate both in Pepco's general rate cases and in Pepco's annual mini-rate cases on the RIM.[809] The short 60-day RIM annual approval process would unreasonably limit prudence reviews of Pepco's project expenditures. Moreover, the Commission's approval of Pepco's annual RIM budget might well operate, in effect, to limit review of Pepco's reliability expenditures to amounts spent in excess of the Commission-approved RIM budget.[810] Third, the proposed RIM ignores Pepco's overall financial position; instead, it constitutes single-issue ratemaking that targets selected investments for special ratemaking treatment, focusing on one element of cost of service without considering the utility's overall financial position."[811] It guarantees that Pepco's distribution rates will go up faster than they would under traditional ratemaking.[812] Fourth, GSA objects that Pepco's RIM will perpetuate (or exacerbate) existing interclass rate subsidies.[813]

474. **WMATA.** WMATA opposes Pepco's RIM. WMATA asserts that "[t]he RIM investments described in the Company's case are normal and customary investment and should not be the subject of a rider that shifts the burden of imprudent investments from the Company to the customer. The proposed RIM is a dramatic change from the ordinary course of business particularly to the extent that the customer's money is immediately provided to the Company before the Commission has an opportunity to review the prudence of the investment. In addition to shifting the timing of the expenditures, the proposed annual review of the RIM investments adds another layer and cost to the regulatory process without providing any protections or benefits to customers."[814] WMATA argues that Pepco's inability to earn its authorized rate of return

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Pepco was operating under a rate cap that Pepco itself agreed to. Moreover, GSA contends, a RIM entails a significant risk of allowing Pepco to collect over-earnings. GSA R.Br. 4-5.

808 GSA Br. 2, 4-6.

809 GSA Br. 4; GSA (A) at 6-9 (Goins).

810 GSA Br. 5; GSA (A) at 10-11.

811 GSA Br. 9. *Accord:* Tr. 1207-1209 (GSA witness Goins).

812 GSA Br. 6.

813 GSA Br. 6-7; GSA (A) at 7, 12-14, 16 (Goins).

814 WMATA notes that nearly 40% of the Company's expenditures to improve reliability took place in 2011 and should be "known and measurable." To the extent that these investments have already taken place, and are "used and useful," WMATA states that they should receive rate base treatment. WMATA Br. 1, 8-9; WMATA (A) at 15-16 (Foster).

is not the result of "regulatory lag" (as Pepco claims) but instead a result of the distortion in the Company's rate structure.[815] WMATA recommends a downward adjustment of 10 basis points in Pepco' authorized ROE if the Commission allows the RIM rider.[816]

DECISION

475. The Commission has decided to reject Pepco's proposed RIM surcharge. There are many flaws in Pepco's RIM proposal, and as a matter of regulatory policy we have concluded that it is inappropriate for the District of Columbia.

476. We find that traditional utility ratemaking is appropriate for the District of Columbia and that it should be continued as something decidedly superior to Pepco's proposed RIM surcharge. First, we observe that Pepco's proposed RIM surcharge covers many more projects than just reliability projects. The Company's RIM proposal is unsupported by any meaningful cost-benefit analysis that identifies which investments would give the greatest "bang for the buck" in improving D.C. reliability. Instead, Pepco's current proposal throws basically most capex costs into the RIM. Second, we find that traditional ratemaking's regulatory lag can serve positive functions. Among them is the fact that it leaves with the Company the risk of making prudent investment decisions before recovering costs from ratepayers. Third, traditional rate cases provide an opportunity to look at a public utility's entire financial outlook, and to determine whether to increase or decrease its overall ROE depending upon what is a just and reasonable rate for ratepayers. Fourth, the RIM as proposed by the Company would not reduce the burdens of the parties from a traditional rate case. Instead, it would add a mini-rate case each year to traditional rate cases -- which would continue unabated, if perhaps less frequently. The proposed RIM review processes would require extensive work, but only for the limited purpose of determining how much more money the Company would receive earlier through this mechanism. Overall, we are not persuaded that Pepco's RIM surcharge mechanism is necessary or appropriate. To the contrary, we are persuaded that the Company can do the work it needs to do and have a reasonable opportunity to earn its approved return without any nontraditional recovery mechanisms.[817]

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815 WMATA (A) at 14-15 (Foster); WMATA Br. 9.

816 WMATA (A) at 16 (Foster).

817 *Accord:* Maryland Public Service Commission *Case No.9826, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service,* Order No. 85028 at 143-147 (July 20, 2012).

477. In the Commission's view, traditional utility ratemaking is more than adequate to address the Company's ability to earn its allowed rate of return and proved reliable service as compared to the brave new world represented by Pepco's proposed RIM surcharge. Nor has Pepco demonstrated that this view is unreasonable. This issue is for the sound discretionary judgment of the Commission. The choice between traditional ratemaking and the approach taken by Pepco's proposed RIM surcharge is an important policy decision. Our decision to maintain the traditional ratemaking process is a discretionary policy judgment that is amply supported by the record in this case.

478. We also agree with the criticisms of Pepco's proposed RIM voiced by OPC, AARP, AOBA, DCG, and GSA. The surcharge proposed by Pepco is insufficiently defined, particularly with respect to the "consumer protections" in the annual RIM review (*e.g.*, minimum requirements for the contents of Pepco's initial filing; the discovery rights of other parties; and dispute resolution mechanisms if there is disagreement over what projects should or should not be included in the RIM). We cannot agree with Pepco's sweeping claim that traditional ratemaking makes chronic under-earning inevitable for the Company during this time of accelerated construction to improve reliability in the District of Columbia. To the contrary, we think that OPC, the other parties, and the recent decisions of the Maryland PSC rejecting RIM surcharges for WGL and Pepco convincingly answer that sweeping claim by Pepco.

479. We also agree with OPC, AARP, AOBA and the other parties that Pepco's RIM is overly broad insofar as it sweeps in non-reliability projects. Testimony by Pepco witnesses,[818] as well as Pepco's request for approval of its RIM "in principle," suggest that Pepco is looking to the Commission to refine its RIM proposal and to determine what construction costs are eligible for RIM recovery. We are not persuaded, however, that a capex RIM surcharge would be beneficial, on balance, for the District of Columbia.

480. The Commission recognizes Pepco's refinement, in rebuttal, that its annual RIM review would include a final "prudence" review of the RIM-eligible assets that became used and useful in the previous calendar year.[819] We are not convinced, however, that such a single-issue annual review system would be an improvement over traditional ratemaking given the history of complaints about Pepco's reliability in D.C.[820]

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818 *See* Tr. 220-221 (Pepco witness Lowry).

819 To some extent, this blunts OPC's criticism that Pepco's RIM "asymmetrically" shifts risk to ratepayers for sizable investments, with only a delayed review for prudence and reasonableness in Pepco's next general rate case, while "Pepco enjoys the benefits of accelerated returns * * * in a manner that bypasses most of the safeguards provided by traditional cost-of-service ratemaking review." OPC (G) at 5-7, 18-19 (Dismukes).

820 *See, e.g., Formal Case Nos. 766, 982, 991, 1002*, Order No. 16427, ¶ 47 ("We also note that Pepco's recent poor performance has caused it to be the subject of severe criticism in the press, in

OPC's concern about a RIM lessening incentives for improved Pepco management and efficiency are not adequately addressed in our view by Pepco's general assurances and referenced studies. In combination with the BSA, the RIM might significantly erode incentives for efficient management, as other state commissions have recognized. Other criticisms of Pepco's amended RIM seem well-taken. They include the absence of a cap on RIM expenditures, the absence of a "stay out" provision restricting when Pepco could seek rate increases for reliability-related costs, and the absence of any limit restricting the use of RIM surcharge-recovered amounts to projects that improve D.C. reliability.[821]

481. In conclusion, the Commission rejects Pepco's proposed RIM surcharge, for all of the reasons set forth above. We decline to approve a RIM "in principle." Nor will we approve the proposed structure or subparts of Pepco's RIM proposal such as the categories of projects to be recovered through the RIM, RIM reporting requirements, Pepco's proposed annual March RIM fillings, or its proposed tariff parameters for a RIM surcharge.

482. Our decision is that, as a matter of regulatory policy, a capex RIM surcharge as proposed in this case is not appropriate for the District of Columbia. Our policy conclusion is amply supported by the record in this case. Pepco has not demonstrated that the RIM is needed. It has not fully and reasonably described how its proposed RIM would be implemented. Nor has Pepco adequately justified its proposed RIM as a cost recovery mechanism that would address concerns about improving Pepco's service quality and reliability in the District.

483. The Commission is particularly concerned that the proposed RIM would dramatically weaken Commission oversight of Pepco's massive D.C. reliability-improvement construction program at a time when "serious doubts" have been raised about the cost-effectiveness of that program. We believe Pepco's proposed massive construction program to improve D.C. reliability should be guided by a practical, upfront cost-benefit analysis of categories of projects to prioritize investments and to try to achieve the biggest "bang for the buck," *(i.e.*, value for the money spent or effort expended).

484. While Pepco provided a great deal of information about its capital expenditure program during the course of this proceeding, the presentation was lacking. The data was provided inconsistently, in piecemeal fashion and untimely. As result, the

legislative circles, and in comments throughout the D.C._Metropolitan Area."); Tr. 134 (Pepco witness Lowry) (acknowledging that Pepco has "significant reliability problems").

821 Pepco stated that monies it received through the RIM surcharge could be used for any purpose by the Company, including raising employee salaries. *See* Tr. 1860-1862 (Pepco witness Gausman).

information was less useful than it could have been, both to the parties and to the Commission.

485. Accordingly, the Commission directs Pepco to file more precise information describing its massive distribution construction program, including its District of Columbia reliability-improvement construction projects, at least three (3) months before it files its next base rate case. The information should be provided to the Commission in clear, complete, and well-organized form, with an index, separately-labeled sections that correspond to the categories shown immediately below. The clarity and completeness of these submissions are important to allow the Commission to maintain effective oversight over Pepco's construction program and its exploding capital budget forecasts to improve reliability in the District.

> **Executive Summary**. The summary, referencing the individual parts of Pepco's submission, should adequately justify the level of costs that Pepco proposes to successfully meet the District's new reliability standards, demonstrate that the expenditures in totality are reasonable, and show by reference to a practical cost-benefit analysis that all costs are being prudently and cost-effectively incurred so that the District's reliability standards are achieved at the lowest feasible cost.
>
> **Overview of Projects**. The overview should describe the construction projects in terms of their purpose; geographical location(s); expected useful life; and justification for how and why each project best meets the identified needs. The project numbering system must be unique to the geographical location of the construction project. The Company must provide a thorough explanation of any project numbering system (such as WBS) and use the same system in the subsequent base rate filing (or explain any deviation).
>
> **Past Loadings**. This calls for historical data on summer peak, winter peak and annual energy loadings in MVA on relevant Company facilities expected to be impacted by the proposed projects.
>
> **Forecast Loadings.** Projected summer peak, winter peak and annual energy loadings should be provided in MVA for the current year and the next nine years thereafter.[822]
>
> **Identified Need.** Pepco's submission should identify (a) whether the proposed project is to address a reliability criteria violation, and if so, a

[822] The past loadings and forecast loadings information will be necessary for projects involving load growth, such as a new substation.

description of the violation; and (b) whether the need is generated by a regulatory/statutory mandate, and if so, a description of the mandate.

Justification. The Company should explain: (a) how and why the specifically proposed project best meets the identified needs; (b) the timing of and planned in-service date of this proposed project; and (3) each project's role in the Reliability Enhancement Plan.[823]

Total Original Cost. The most recent total estimated original cost includes (1) capital investment, (2) net salvage value, (3) O&M expenses associated with the proposed capital project, (4) incremental A&G, (5) interest during construction, and (6) allowance for contingencies.

Work Schedule. The most recent detailed project milestone and implementation schedule should be provided.

Status. The current status of the proposed project in terms of its scheduled milestones and expenditures and operational status of ongoing projects.

Life-Cycle Costs. The total estimated annual incremental costs to the ratepayers.

Benefit-Cost Ratio. The proposed project's estimated benefit/cost ratio, if this can be estimated. Where possible, the Company should provide estimated anticipated SAIDI/SAIFI (District of Columbia-wide) improvement/benefits for each category of projects.

Alternatives. Explain why the proposed project is the best to meet project objectives. The alternative solution can include: (1) a brief description; (2) total costs; (3) life-cycle costs; and (4) reasons why the alternative is not as good as the one chosen.

Priorities. List Pepco's priorities in implementation and explain whether projects that were most cost effective and/or expected to be most effective in improving reliability were assigned higher priority for implementation.

Source of Funds. Where the source of funds is any government agency or any customer, explain the financial treatment of all funds and credits.

Related Government Action. Where any project is motivated by government agency action, provide the following: (a) citation of government agency action (applicable regulation, approved plan or

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823 Item (3) only applies to the reliability improvement projects.

inspection report); (b) Government agency approval status; and (c) Attestation that any fines or penalties are excluded.

The construction program submission described above should be updated and filed together with any new Pepco request for a rate increase in the District of Columbia.

XX. OTHER MATTERS

A. Community Comments

486. The Commission held eight community hearings in this Pepco rate case, one in each Ward of the City.[824] Thirty community witnesses testified at the community hearings, and hundreds more submitted written comments. Their comments were directed at Pepco's reliability and service, consumer education on smart meters and smart grid technology, Pepco's executive salaries, the ratemaking treatment of old meters, solar energy, Pepco's proposed RIM, and a variety of other miscellaneous issues, as well as Pepco's proposed rate increase. These community comments are part of the evidentiary record,[825] and the Commission has carefully considered them.[826]

1. Objections to Higher Pepco Rates

487. The Community Brief[827] states that "D.C consumers are distressed by Pepco's poor quality of service and outraged by the Company's Application requesting a rate increase of $42.1 million. Outlining the harsh real life impact that a rate increase would have on consumers, the Brief supports OPC's description of current economic

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824 Transcripts of these community hearings are cited as "Community Hearing, Ward _, Tr.____ (date)." As previously noted, transcripts of the Evidentiary Hearings are cited simply as "Tr.__ (date)."

825 *See* Tr. 23 (January 30, 2012) (granting OPC's motion to include community comments in the record).

826 Traditionally, in addition to hearing testimony at formal evidentiary hearings, the Commission holds community hearings in utility rate cases to solicit comments from the public at large, including Advisory Neighborhood Commissions (ANCs) and individual ANC Commissioners. The Commission is ***not*** required to give "great weight" (or any special weight) to the advice it receives from ANCs. *See, e.g., Office of People's Counsel v. Public Serv. Comm'n*, 630 A.2d 692, 698 (D.C. 1993); *Potomac Electric Power Company, Formal Case No.1076*, Order No.15710, ¶433, n.838 (March 2, 2010), 280 PUR4th 381, 2010 WL 886951. We listen carefully, however, to all the community comments. The Commission has taken note of the "outpouring of sentiment from the public" (AARP Br. 5) concerning Pepco's rate increase request. We have carefully considered all the comments from community witnesses, which are summarized in this section of the Opinion and Order, in determining Pepco's rate application.

827 The Community Brief was signed by four ANC Commissioners; the Chairman, former Acting Chair and a Board member of the D.C. Consumer Utility Board; and 16 other people who are D.C. residents and members of community groups in the District of Columbia (*e.g.*, DC Tenant's Coalition, AARP, H Street Main Street, Manor Park Citizens Association, Dupont Park Civic Association).

conditions in the District.[828] and states that "[i]n some unfortunate instances, the consumer must choose between whether to pay the electric bill or buy medicine * * * [or] forgo the use of electric service during the summer," creating serious health and safety issues for seniors or house-bound consumers with limited cooling options. The Commission has a duty to consider the economy, the Community Brief states, and to ensure that Pepco's rates are just and reasonable. Throughout this Pepco rate case, community members in unprecedented numbers have voiced their displeasure and opposition to Pepco's rate requests. The Community Brief asks the Commission to:

1) deny a rate increase for Pepco's reliability programs;
2) reject Pepco's proposed Reliability Investment Recovery Mechanism ("RIM");
3) be extremely vigilant about requiring Pepco to prove that consumers are actually benefiting from the Company's smart grid program; and
4) require Pepco to provide consumers a credit of $2 million for the poor level of service provided over the past several years.

According to the Community Brief, thousands of letters and postcards have been submitted to the Commission opposing Pepco's request for a rate increase:

Party's Affiliation	# of Consumers in Opposition to Pepco Rate Increase: Formal Case No. 1087
ANC [829]	2
AARP	4,765
Citizens	1,007
Total	5,774

Over the past three years, the Community Brief complains, Pepco has received $48.1 million from two rate cases and used the money to pay its shareholders consistent dividends while providing its customers poor and unreliable service. What consumers are questioning, the Community Brief states, is whether the Company has focused its efforts on paying high salaries to its officers and executives, avoided paying taxes or used the money to lobby politicians while at the same time ignoring the needs of its customers.[830]

[828] The Community Brief at 6 quotes OPC's statements that Pepco's request for a rate increase occurs; 1) during a severe economic downturn; 2) when there is record high unemployment in certain Wards of DC; 3) Pepco has yet to establish an effective plan to improve its poor quality of service and customer service; 4) Pepco appears to be a financially healthy company, and 5) this is Pepco's *third* request for a rate increase in four years.

[829] The Community Brief claims at 3 that, "[a]s a matter of law, the Commission must give great weight to the testimony of Advisory Neighborhood Commissioners (ANCs)," citing D.C. Code § 1-309.10(3)(A).

[830] Community Brief at 1-6, 16. The Community Brief reviews the written comments and testimony submitted by D.C. consumers, which the Commission has independently reviewed, including comments

488. Well over 600 consumers sent the Commission a standard-form preprinted postcard stating (in both English and Spanish) their opposition to Pepco's proposed $42.5 million rate increase. The postcard states that:

> [r]esidents throughout the city are still suffering from poor reliability and unexplained outages. This is the third rate request in 3 years, a 34% increase in distribution rates. Customer bills have doubled since 2005. Given current economic conditions, the PSC should deny Pepco's request for a 10.75% profit margin. It is unfair to allow Pepco to get richer while consumers are struggling financially. Pepco's proposed surcharge to automatically recover reliability costs would allow Pepco to receive funds without sufficient PSC or public scrutiny.[831]

489. The Commission received many other comments stating that D.C. ratepayers simply cannot afford another Pepco rate increase.[832] These are difficult economic times. Our country is still in a recession, community witnesses stated, with high unemployment in the District of Columbia, and rising costs for food, medicine and housing. They pointed out that a Pepco rate increase would be particularly difficult for seniors (who are especially vulnerable to the effects of inadequate heating and cooling), as well as fixed-income retirees, low-income residents, and people with disabilities.[833] At

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from; Dr. E. Faye Williams, Esq. (Chair of the National Congress of Black Women, and former White House Liaison to the US Department of Energy); Gigi Ransom (ANC 5C Commissioner), Mary Cuthbert (Ward 8 resident and ANC 8C Chair), Robert Robinson (Ward 1 resident and member of the Mount Pleasant Solar Co-op); Dr. Lawrence Thurston (Ward 5 member and former OPC economist); Michael Sindram; Ms. Joyce Robinson-Paul (for ANC Commissioner and Consumer Utility Board member), A. Bernard Jones (Ward 7 resident and former acting chair of the Consumer Utility Board); Ms. Karrye Braxton (Ward 4 resident); Ms. DeAnn Lavan (Ward 3 resident); Kathy Henderson (former ANC Commissioner); Anwar Saleem (Executive Director of H Street Main Street); Greg Rhett (President of the Eastland Gardens Civic Association); and Ms.Willette Seaward (Chairperson of ANC 7D). Community Brief at 6-12.

[831] All these standard form postcards were placed in the record in *Formal Case No. 1087*.

[832] *See, e.g.*, Community Hearing, Ward 8, Tr.6-10 (Mary Cuthbert, Chair ANC 8C) (November 8, 2011); Community Hearing, Ward 3, Tr.12-13 (Carol Gill) (November 18, 2011) ("I'm retired and it's very difficult to afford the increase of $5, the amount for which is proposed. That's a big charge for me and that would certainly provide a good deal of money for Pepco."), Tr.38 (Joan Hustad) (November 18, 2011); Community Hearing, Ward 7, Tr.15-17 (Rita Brown-Hall) ("I can't afford the increases. I need to pay for education for my children."), Tr.19-21 (Cheryl Gilliam), Tr.23 (Christine Tolson) ("I've been retired 13 years and $5 is like $50,000 when you have other things to do."), and Tr.28-29 (ANC 7B05 Commissioner Jean McVea) (senior citizens and retirees on fixed incomes in our community "will not be able to afford it") (November 19, 2011); handwritten note from Mattie B.Butts (December 6, 2011); Email from AARP member Linda Anderson, received by the Commission February 18, 2012 ("living on a fixed income I cannot afford another penny to Pepco!").

[833] *See, e.g.*, Community Hearing, Ward 5, Tr.26-28 (Kathy Henderson, ANC 5B10) and Tr. 31-33, 37 (Joyce Robinson-Paul) (November 21, 2011); Community Hearing, Ward 3, Tr.36-38 (Joan Husted) and Tr. 13-19 (Laurie Scalli) (November 18, 2011); Community Hearing, Ward 7, Tr.6-7 (Dorthea Hector),

the same time, several community witnesses noted that Pepco has paid very substantial dividends to its shareholders in recent years;[834] that Pepco or Pepco Holdings is "the top highest yielding utility stock" listed by Standard and Poors;[835] and that Pepco's rates are already "one of the highest in the northwest region."[836]

490. Two dozen or more consumers submitted a one-page, standard-form memoranda (sometimes more than once), addressed to the Commission, expressing concern about Pepco's requested $42 million rate increase. The memorandum states that "Pepco's service is poor." Despite the Company's advertisements saying it is improving service, "many people throughout the city are still suffering unexplained outages—even on days when the weather is good." The memorandum questions whether Pepco "made good use of the money" it received in past years and argues that Pepco should "shoulder some of the burden" for improving its service now. The memorandum states that:

> a lot of people are suffering in this rough economy * * * Many of us are seniors on fixed incomes * * * It is unfair to allow Pepco to get richer while consumers are struggling just to make ends meet.[837]

Tr.7-9 (Reverend Clarence Turner), Tr.12 (A. Bernard Jones, former acting Chairman of the DC Consumer Utilities Board), Tr.30 (Gregg Rhett, President of Eastland Gardens Civic Association) and Tr.33 (David Belt) ("This is a bad time during this economy to be making this kind of request on the consumers.") (November 19, 2011); Community Hearing, Ward 6, Tr.7 (Dr. E. Faye Williams, Chair of the National Congress of Black Women, Inc.), Tr.10-12 (James McSpadden, AARP) (November 22, 2011); written statement of Dr. E. Faye Williams (filed November 22, 2011); Vivian Walker, handwritten note to Commission, filed November 10, 2011; SILC letter from Darnise Henry Bush to Commission filed December 6, 2011; Email from Dr. Edwin J. Nichols to Commission filed December 14, 2011.

834 Community Hearing, Ward 4, Tr. 6 (Calvin Gurley, President of the Takoma Civic Association) (November 9, 2011); Community Hearing, Ward 3, Tr. 24-26 (Calvin Gurley) (November 18, 2011); Community Hearing, Ward 7, Tr. 29 (Greg Rhett, President of Eastland Gardens Civic Association in Ward 7), Tr. 31 (Christine Tolson) and Tr. 32-33 (Willette Seaward, Chairperson of ANC 7D) (November 19, 2011).

835 Community Hearing, Ward 7, Tr. 32-33 (Willette Seaward, Chairperson of ANC 7D) (November 19, 2011); Ward 3, Tr. 23-24 (Calvin Gurley, President of the Takoma Civic Association) (November 18, 2011).

836 Community Hearing, Ward 5, Tr. 15 (Michael Sindram) (November 21, 2011).

837 Written statement, titled "Opposition to Pepco's request for $42.1 Million," signed by Sterlin Johnson, Barbara S. Hair, Vernel Waters, Geraldine Harris, Betty L. Cochran, Lois Johnson, Victoria Fitzgerald, Phyllis O. Hooker, Amenta H. Kennedy, Edddie Kelsey, Richard Washington, Daniel White, Linda Walton, Gloria Nelson, Estelle Littlejohn, James Jackson, Alvin Stewart, Charles Grayton, Laura Goggans, Florestine Jones, and Carroll Dupen (received at the Commission December 2, 2011). The same comments, word-for-word, were made in later letters submitted by Amenta H. Kennedy, Eddie Kelsey, Richard Washington, Daniel White, Linda Walton, Gloria Nelson, Estelle L. Littlejohn, James E. Jackson, Alvin Stewart, Charles Grayton, Laura Coggans, Florestine Jones, Cattoll Dyson, Sterlin Johnson, Barbara Hair, Vernel Waters, Geraldine Harris, Betty L. Cochran, Lois Johnson, Victoria I. Fitzgerald, and Phyllis Hooker (November 15 through 17, 2012).

491. Testimony by several D.C. ratepayers expressed particular frustration at being asked to pay higher Pepco rates, immediately after or during a period of high outages and other shortcomings in Pepco's electric service.[838] Joyce Robinson-Paul and others asked why ratepayers should have to pay increased rates to obtain basic reliability in electric service. "When you get a black out, we should be getting a rebate from Pepco rather than being sent a rate increase."[839] Similarly, Robert Robinson complained that "Pepco has consistently neglected maintenance and capital improvements in the grid infrastructure, and customer service staff, while paying generous dividends to investors." The Commission, he said, should "stop rewarding Pepco for its bad behavior in neglecting the grid's infrastructure and stiff arming its ratepayers."[840] A similar argument was presented by A. Bernard Jones, former acting Chairman of the D.C. Consumer Utility Board. Over the years, he said, Pepco made a business decision and failed to invest adequately in improving its infrastructure to ensure reliability. Mr. Jones argued that, because Pepco's reliability project "should have been dealt with years ago," the Company now should pay 80% of the increase it seeks to improve infrastructure.[841]

492. Two ANC Commissioners argued that improvements in Pepco's service and reliability should come first, before the Commission grants a rate increase to pay for them. Representing 2,000 constituents in ANC 5C12, Commissioner Albretta Gigi Ransom opposed Pepco's proposed rate increase, because the Company has not documented any measurable improvements in its reliability and service.[842] Though

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838 *See, e.g.,* Community Hearing, Ward 6, Tr. 13-14 (James McFadden, AARP) (reporting comment from an AARP member, at a recent community conversation that AARP hosted in Ward 3, that "She was frustrated that she could not depend on the power to stay on and frustrated that she was paying for reliability improvements that were not being realized for her.") (November 22, 2011); email from Donna Davis to Commission, received January 9, 2012 ("Residents throughout the city are still suffering from poor reliability and unexplained outages. My own electricity was shut off twice on CHRISTMAS EVE 2011. * * * This is the 3rd rate request in 3 years, a 34% increase in distribution rates.")

839 Community Hearing, Ward 5, Tr.33, 36, 37 (Joyce Robinson-Paul) (November 21, 2011).

840 Community Hearing, Ward 1, Tr. 4-5 (Robert Robinson) (November 21, 2011) and written testimony of Robert Robinson and Sherrill Berger filed November 21, 2011. Similarly, an email from Van W. Chambers, received by the Commission on January 29, 2012, complained: "Over the past 5 years, Pepco rates have doubled as the quality of their service has decreased. Pepco should not be allowed to raise their rates until the service that they provide now, gives the customers their money's worth. They want us to pay for upgrades that should have been phased in over a 10 year period, after they've collect[ed] profits over that period, they want the customers to pay now for the upgrades. NO."

841 Community Hearing, Ward 7, Tr.12-14 (A. Bernard Jones) (November 19, 2011). Ms. Nina Dodge raised the related point that "to the extent the prior rate increases were approved in order to cover some system maintenance and upgrades, I want to make sure that we're not being double-billed for those system maintenance and upgrades that were promised in prior years and presented by Pepco in prior requests for rate increases." Community Hearing, Ward 3, Tr.12 (Nina Dodge) (November 18, 2011).

842 Community Hearing, Ward 5, Tr.7-10 (ANC 5C12 Commissioner Albretta Gigi Ransom) (November 21, 2011).

Pepco has improved its customer relations, Ms. Ransom stated that blackouts still occur in her neighborhood. The Smart Grid program is not fully operational, she noted, so ratepayers have no way of assessing whether it actually delivers its promised benefits. The Commission should insist on measurable improvements in Pepco's performance, not just words, she said. Kathy Henderson representing ANC 5B10 similarly commented that the Commission should make Pepco perform – by improving service and reliability (by tree trimming and maintaining power lines) – and make Pepco present some "quantifiable showing" that its service reliability has improved, before awarding Pepco a rate increase.[843] ANC Commissioner India A. Henderson (ANC 5B10) later submitted a letter, attaching post cards from 105 D.C. residents, commenting that "financial hardship caused by the $42.5 million dollar increase will devastate my community, which is comprised of mostly senior citizens on fixed budgets. Additionally, several residents in the ANC 5B10 community have not been able to pay for electric service and have subsequently been without any electricity for extended periods. Citizens should not have to choose between paying the mortgage or rent, buying food and paying for electric service."[844]

493. Nearly 400 standard-form postcards, expressing the same sentiments, have been to the Commission by AARP members who live in the District of Columbia. They argue that Pepco's $42.5 million electric rate increase is "unfair," in light of "our struggling economy." "I should not be required to pay more for unreliable service and to increase Pepco's profits. Hold Pepco accountable by demanding that it demonstrate reliability before you consider giving them a raise. Deny Pepco's $42.5 million rate increase."[845]

494. "We should not be required to pay for something we have not received and may never receive," wrote one D.C. customer plagued by multiple Pepco outages this year. He suggested that, if Pepco receives higher rates, the Company should be required to refund the rate increase to customers who lose power for longer than 24 hours during a 12-month period.[846] Another customer emailed the Commission stating: "What I have heard about Pepco's 'value' is that it is the wealthiest electrical company in the country, while at the same time delivering the worst service in the country. Rather than being rewarded for appalling service by being granted a distribution rate increase at this time, Pepco should invest its own earnings to improve its service significantly. Once it has shown this improvement, then an increase could be considered."[847]

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843 *See* Community Hearing, Ward 5, Tr.28-29 (ANC 5B10 Commissioner Kathy Henderson) (November 21, 2011).

844 ANC Commissioner India A. Henderson, 5B10, letter to Commission (January 20, 2012).

845 Over a dozen AARP members living in D.C. sent in emails to the Commission saying the same thing as the standard-form postcards quoted above.

846 Wm. Mark Scott letter to Commission (November 25, 2011).

847 Judy Brace email to the Commission (November 21, 2011).

495. OPC's former chief economist, Lawrence Thurston, commented at a community hearing that the Commission should reject a significant portion of Pepco's requested $42.1 million rate increase, because it is seeking advanced recovery of Pepco's investment costs to improve reliability, mismatching benefits and costs contrary to long-established Commission precedent. There is no warrant, he said, for D.C. customers to pay upfront now for Pepco to correct its past neglect of its own distribution system. The Company's ROR is excessive, in his view, particularly because Pepco (the sole electric distributor in the District) has zero risk of losing its captive D.C. customers.[848]

496. Other citizens complained that "the rate hike is unwarranted due to [Pepco] having 880 million in profits and paying no taxes."[849] The Commission received over four hundred (400) emails from D.C. consumers complaining that: "I should not be required to pay more for unreliable service to increase Pepco's profits. Hold the Company accountable, by demanding that it demonstrate reliability before you approve a raise."[850]

DECISION

497. The Commission's decision balances the interests of ratepayers (including low and fixed income ratepayers) and the interests of Pepco shareholders. The Company's initial request for a $42.1 million rate increase was decreased by $17.7 million in this case. The Commission also rejected Pepco's request for a RIM surcharge.

498. With respect to the plight of low-income Pepco customers, the Commission pointed out at the community hearings that the District of Columbia has long had a special low-rate RAD rate class for low-income Pepco customers.[851] The Commission is examining how to improve RAD enrollment in Formal Case No. 813/945. The web site of the Commission will be updated to provide a clear, easy to understand explanation of the RAD rate and the RAD discount.

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[848] Community Hearing, Ward 5, Tr.19-24 (Lawrence Thurston) (November 21, 2011) and Lawrence Thurston's email to the Commission (November 22, 2011).

[849] Email from Phillip Love (June 11, 2012).

[850] *See, e.g.*, Emails to the Commission from Shirley Schwarz, Prudence Shaw, Doretta Gilliam, Carolyn Thompson and Lonnel Moore (June 6 through 8, 2012); Email from Phillip Love (June 11, 2012); identically-worded Emails from Elizabeth Moran, David Peebles, Leonard Fink and more than three hundred other consumers (June 27, 2012); identical Emails from Darlene Robinson, Florencetine Presston and more than twenty other people (June 30 through July 5, 2012), identically-worded Emails from Phyllis Moore, Dr. Leslie Richards and sixteen other D.C. consumers including Darryl Cowherd (also complaining about power surges) (July 6, 2012).

[851] Community Hearing, Ward 5, Tr. 39 (Chairman Kane) (November 21, 2011).

2. Quality of Pepco's Services

499. Testimony and comments from many D.C. residents criticized Pepco's reliability and service quality.[852] The Community Brief demands that "Pepco be held financially accountable and made to deliver reliable, quality service." "A company rated in the lowest quartile of performance when compared against its peers should not be rewarded with yet another rate increase when it has failed to present a viable plan to improve its service." The Community Brief states that D.C. community leaders representing broad constituencies want to know "that this Commission will stand up to Pepco and hold it accountable for its poor performance by requiring a fine or penalty of at least $2 million which should be credited to consumers and require Pepco to do what is necessary to ensure its poor performance will not continue in this city."[853]

500. Telephone polling of over 2,000 AARP members shows that 89% believes that there would be no improvement in Pepco's services if the Company receives its requested rate increase.[854] There were particular complaints about electricity outages, Pepco's consumer complaint services, and Pepco's efforts (or lack of them) to educate consumers about Smart Meters and Smart Grid technologies.

a. Outages

501. A comment from a citizens group complained that "the average Pepco customer experienced 70% more outages than customers of other big-city utilities, with outages lasting more than twice as long."[855] Another comment stated that power utility companies in Baltimore and Virginia "restored power to a higher percentage of their customers" than Pepco. "We all might recall that the earlier Washington Post article about Pepco noted that the utility had a far higher number of outages than our neighboring utilities do – and many that are not storm related. So don't buy into Pepco's statements about our trees being the problem."[856]

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852 *See, e.g.*, Community Hearing, Ward 1, Tr. 4-5 (Robert Robinson) (November 21, 2011) and written testimony of Robert Robinson and Sherrill Berger (filed November 21, 2011); Community Hearing, Ward 5, Tr.10-14 (Tiema Mills) (November 21, 2011); Community Hearing, Ward 3, Tr.39-41 (DeAnn Lavan) (November 18, 2011); Community Hearing, Ward 4, Tr. 12 (Karrye Braxton) (November 9, 2011). *See also* handwritten note to the Commission from Andrea and John Hughes, filed December 5, 2011.

853 Community Brief at 4, 6, 12. The Community Brief states that the "decision made in this case will have an immediate and lasting effect on consumers and will define the character of this Commission." Community Brief at 12.

854 *See* Community Hearing, Ward 6, Tr.12 (James McSpadden, AARP) (November 22, 2011); Community Hearing, Ward 3, Tr.16-17 (Laurie Scalli) (November 18, 2011).

855 Penn Branch Citizens-Civic Association letter to Commission (January 5, 2012).

856 Email from Stephen Chapman, dated January 28, 2011, received by the Commission February 3, 2012 as an attachment to an email from Deborah Kavruck. Mr. Chapman disputed the earlier email from

502. Witnesses testified about the impact of outages – causing equipment damage to household computers, dishwashers, TVs and other electronic equipment, as well as spoiled food, accidents in the dark, and lost heating or air conditioning for several days—with particularly harsh consequences for seniors.[857] William Mark Scott, wrote that he and his neighbors are without electricity multiple times each year. After the snowstorm this year, he wrote, "we were without power for more than 4 days due to a downed tree. After the hurricane, it was 5 days for the same reason. In both instances, we lost all of our perishable food. And, in each of these cases, I contacted Pepco on several occasions and was told that the problem had been fixed before my electricity was back on."[858]

503. Testimony from Pedro Alphonso said that local businesses had met with Pepco and that "in subsequent months, the power reliability issue improved and eventually was mitigated by the concentrated infrastructure work performed by Pepco."[859] Laurie Scalli also acknowledged that Pepco "has done a very good job in the last few months, as far as not having black-outs."[860] Raymond Bailey stated: "I have noticed the improvements in the service that Pepco has provided over the years," including recent tree-trimming in Sheppard Park to improve reliability.[861] One customer sent in an email stating that "Pepco has made substantial headway in repairing dangerous power lines."[862] Ms. Francesca Skelton commented that Pepco's "reliability has improved lately" – in response to "the human cry and outrage of the residents" of D.C. – but that it is Pepco's job to provide reliable electric service, so she did not feel that the Company should get the reward of an increase for simply doing their job.[863]

Kevin B. Twine (dated January 28, 2011, also attached to Ms. Kavruck's February 3, 2012 email) stating that "Pepco has made substantial headway in repairing dangerous power lines."

[857] *See, e.g.*, Community Hearing, Ward 5, Tr. 12-13 (Tiema Mills), Tr. 36-37 (Joyce Robinson-Paul) and Tr. 38 (Lester Hinton) (November 21, 2011); Community Hearing, Ward 1, Tr. 8-10 (Joel Harder) (November 21, 2011); Community Hearing, Ward 7, Tr. 19-20 (Cheryl Gilliam) (November 19, 2011); Community Hearing, Ward 8,Tr. 8 (Mary Cuthbert, Chair ANC 8C) (November 8, 2011); Community Hearing, Ward 6, Tr.13 (James McSpadden, AARP) (November 22, 2011); Joel Harder email filed November 21, 2011.

[858] Wm. Mark Scott letter to the Commission (November 25, 2011).

[859] Community Hearing, Ward 4, Tr.8-9 (Pedro Alphonso, President of Dynamic Concepts, Inc.) (November 9, 2011).

[860] Community Hearings, Ward 3, Tr.18 (Laurie Scalli) (November 18, 2011).

[861] Community Hearing, Ward 4, Tr. 16-17 (Raymond Bailey) (November 9, 2011) ("I have seen an improvement.").

[862] Email from Kevin B. Twine (dated January 28, 2011, attached to Deborah Kavruck's email to the Commission (February 3, 2012).

[863] Community Hearing, Ward 3, Tr. 46 (Francesca Skelton) (November 18, 2011).

504. The Commission received dozens of emails from AARP members urging us to "[h]old the company accountable, by demanding that it demonstrate reliability before you approve a raise."[864] "Pepco must be held accountable for meeting stronger standards of reliability and customer service in D.C. before rate increases are considered."[865] Herbert Harris, Jr., Chairman of the D.C. Utility Board, criticized Pepco for favoring its shareholders while "ignoring infrastructure upgrades and local operation staff growth to ensure good service."[866] Another comment asked the Commission "to hold Pepco accountable," stating that "preventive maintenance is a key element of Pepco's public service responsibilities that it apparently has been shirking to tend to its bottom line. Pepco should not be granted a further rate increase until it delivers a reasonable level of service and quite shortchanging its customers."[867] Another comment was that "upgrades, maintenance projects, and repairs to their system are all part of the required upkeep that Pepco should be performing regularly as part of their duties. * * * They have already been paid to do their jobs correctly. Instead they diverted money to profits, ignoring the projects that needed to be done, resulting in their increased financial burden now. It should come from their profits."[868]

505. The Commission received a memorandum dated January 25, 2012, from the Burleith Citizens Association (BCA) to OPC, stating that "notwithstanding its well-publicized efforts to improve its reliability, the electrical service Pepco provides to Burleith is unsatisfactory. Without dissent, a motion was passed asking Pepco to provide the Association with a report of the number of power outages each year for the last 5 years (i.e., starting in January 2007). We asked that these reports include the date and time when the power outage occurred, the date and time power was restored, the duration of the outage, the cause of the outage, and the Company's plan for remediation/prevention of future power outages."[869]

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864 *See, e.g.*, separate emails from AARP members Marshall Opie, Candas Parker, Lynne Person, Leroy Dillard, Albert Anderson, Maurice Toler, Heike G. Wells, Jean Johnson, Karl Marshall, Carole Clem, Yolanda Lee, Evonne McDaniel, Marilyn Stackhouse, Carolyn Saunders, Craig Tregillus, Verdell Minick, Joan Schifferdecker, Deborah Kavruck, Irvin Sheppard, Jane Sargus, and dozens of other AARP members, received by the Commission in February and March 2012.

865 Email from AARP member Gary Schellehamer, received to the Commission (March 2, 2012).

866 Email from Herbert Harris, Jr., Chairman of the D.C. Utility Board, to the Commission (March 6, 2012).

867 Penn Branch Citizens-Civic Association letter to Commission (January 5, 2012).

868 Email from Arianne Bennett to Commission (January 10, 2012).

869 Memorandum from BCA to D.C. Office of People's Counsel (January 25, 2012).

DECISION

506. The Commission's rulings today are designed to ensure improved Pepco service and reliability in the District, as well as improving Pepco's accountability to its D.C. customers. Our new EQSS SAIDI/SAIFI reliability standards are enforceable by the Commission through appropriate means, including civil penalties. We are opening a separate proceeding to examine whether Pepco's executive salaries should be tied to the achievement of our new, more demanding reliability standards. The Commission is also ordering Pepco to provide more analysis and information to allow cost-benefit oversight of the Company's massive D.C. reliability-improvement construction program.

507. The Commission observes that the Burleith Citizens Association's inquiries are the kind of inquiries that might yield evidence relevant to establishing Pepco's civil liability under D.C. Code § 34-1508, § 34-1506(b) for violation of the D.C. reliability standard requiring "complete service restoration within 24 hours following a non-major service outage."[870] When Pepco consumers in the District suffer "blue sky outages," and their service is not restored within 24 hours, they have remedies including the remedy of seeking civil penalties from the Company.

b. Quality of Pepco's Customer Complaint Services

508. Two witnesses complained that they had received flippant, dismissive comments from Pepco's call center, when questioning their bills or calling for information.[871] Other consumers writing about their personal experience with Pepco's service made generalized comments ranging from "bad" to "poor," "not good," "fair," "satisfactory," "good but not great," "pretty good" to "very very good."[872] Dr. E. Faye Williams wrote in her statement "I live in SW D.C., and I assume it's a blessed area because I have never been without power, nor have I ever had a problem with Pepco."[873] Other community witnesses complained about delays in Pepco returning security deposits, issuing information, or resolving disputes about overcharges.[874]

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870 *See* 15 DCMR § 3603.7.

871 *See* Community Hearing, Ward 5, Tr. 10-14 (Tiema Mills) (November 21, 2011); Community Hearing, Ward 7, Tr. 16-17 (Rita Brown-Hall) (November 19, 2011).

872 *See* written statement submitted by twenty-one consumers, titled "Opposition to Pepco's request for $42.1 Million," to the Commission (December 2, 2011).

873 Written statement of Dr. E. Faye Williams, Esq., Chair of the National Congress of Black Women, Inc. (filed November 22, 2011).

874 *See, e.g.,* Community Hearing, Ward 5, Tr.17-18 (Michael Sindram) (November 21, 2011); Community Hearing, Ward 1, Tr. 10-14 (Michael Sindram) (November 21, 2011); written comments from Michael Sindram, filed with the Commission on November 21 and 30, 2011; Community Hearing, Ward 7, Tr. 21`(Cheryl Gilliam) (November 19, 2011).

DECISION

509. OPC and the Commission staff, as well as Pepco's complaint center, are open to receive consumers' complaints about inappropriate comments from Pepco's call center personnel or other substandard service.

c. Community Outreach Generally

510. The Commission heard public comments complimenting Pepco for holding community meetings throughout the city, to discuss outages and reliability issues with its Blue Ribbon Panel for Reliability.[875] Some residents said that Pepco's community outreach generally had diminished.[876] Other public comments said, however, that within the last 12 months Pepco's service and reliability had improved somewhat.[877]

d. Smart Meters and Consumer Education on Smart Grid Technology

511. Testimony by several community witnesses complained that Pepco had not shown that its new Smart Meters bring significant ratepayer savings or consumer benefits.[878] One witness asserted that Smart Meters do "not reduce rates" or produce any increased efficiency in the distribution of electricity. Calvin Gurley argued that ratepayers should not pay for Smart Meters, which primarily benefit the Company and its shareholders by allowing Pepco to cut costs by reducing its workforce for meter reading, while also allowing Pepco to charge more for consumers' peak usage.[879] Bernard Jones argued that Pepco should present studies showing that consumers benefit from Smart Meters before the Company receives a rate increase for them.[880] Irene C. Kellogg opposed Pepco's cost recovery for smart meters and service.[881]

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[875] *See* Community Hearing, Ward 8, Tr. 16-19 (Eugene Kinlow) (November 8, 2011); Community Hearing, Ward 6, Tr.8 (Dr. E. Faye Williams, National Chair of the National Congress of Black Women) (November 22, 2011).

[876] *See* Community Hearing, Ward 8, Tr.10 (Mary Cuthbert, Chair ANC 8C) (November 8, 2011).

[877] *See* Community Hearing, Ward 5, Tr.6-7 (ANC 5C12 Commissioner Albrette Gigi Ransom) (November 21, 2011); Community Hearing, Ward 8, Tr.11-13, 15-16 (ANC 8C Commissioner William Ellis) (November 8, 2011); Community Hearing, Ward 4, Tr.13-14 (Judy Jones, ANC 4B07 Commissioner) (November 9, 2011).

[878] Community Hearing, Ward 5, Tr. 22 (Lawrence Thurston), Tr. 25 (Jeremy Siegel), and Tr. 33-34 (Joyce Robinson-Paul) (November 21, 2011); Community Hearing, Ward 7, Tr.12-13,15 (A.Bernard Jones) (at this time "residents have not seen any real benefits" from Smart Meters) (November 19, 2011).

[879] *See* Community Hearings, Ward 3, Tr. 26-30 (Calvin Gurley) (November 18, 2011).

[880] Community Hearing, Ward 7, Tr. 37-38 (Bernard Jones) (November 19, 2011), written testimony of Robert Robinson and Sherrill Berger, filed November 21, 2011.

[881] Letter to Commission dated April 23, 2012 from Irene C. Kellogg.

512. The Community Brief asked the Commission to "establish a set of robust metrics to evaluate the smart grid program to ensure consumers are benefiting from the program." According to the Community Brief, the Maryland PSC has made it clear that Pepco's rates will be determined by whether the benefits of the smart grid program outweigh the costs. The Brief argues that D.C. consumers are entitled to the same protections that Maryland consumers are receiving.[882]

513. The Commission also heard related complaints that Pepco has "made few, if any, attempts to explain what Smart Meter or Smart Grid features benefit ratepayers, reduce consumption or promote efficiency."[883] The Commission noted at the community meetings that, even though there is a lot of information about Smart Meters in publicly-available Commission fact sheets and on the Commission's website, it was clear that greater public education was needed about Smart Meters.[884]

514. Tenants in master-metered apartments cannot directly control their energy costs, Dr. E. Faye Williams pointed out, "so landlords have to be held accountable to ensure that these buildings are as energy efficient as possible."[885] OPC's former chief economist, Lawrence Thurston, observed that it may be difficult for Smart Meter technology to benefit rental properties where the occupant does not own or control the meter. Moreover, some households lack internet access, which Mr. Thurston said may be necessary for some experimental rate designs.[886]

515. Ward 4 resident Nina Dodge, on the other hand, strongly supported "the installation of the various smart grid components that Pepco has received partial funding for from the Federal Government for both our present needs and for future growth. She commented that the new Smart Grid technologies, including the meters and all the systems that will make the system much more reliable, but also much more energy efficient, are extremely important. The efficiencies gained over the grid and operating the grid through these new systems will actually save Pepco some money – save us all some money.[887]

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882 Community Brief at 15.

883 Community Hearing, Ward 1, Tr. 5-6, 7 (Robert Robinson) (November 21, 2011). *Accord:* Community Hearing, Ward 7, Tr. 21-22 (Christine Tolson), Tr. 36-38 (A. Bernard Jones) (November 19, 2011).

884 *See* Community Hearing, Ward 3, Tr. 30, 33 (Chairman Kane) (November 18, 2011).

885 Community Hearing, Ward 6, Tr.7 (Dr. E. Faye Williams, National Chair of the National Congress of Black Women) (November 22, 2011).

886 Community Hearing, Ward 5, Tr. 22-23 (Lawrence Thurston) (November 21, 2011).

887 Community Hearing, Ward 3, Tr. 10-11 (Nina Dodge) (November 18, 2011).

516. Ms. Dodge stated that technical and financial experts around the country are still trying to quantify the savings from Smart Meters, which are important "so that we're not asked to pay more than we actually really need to as consumers."[888]

DECISION

517. The Commission explained during the community hearings that the D.C. Council has passed a law, in the wake of the District receiving significant federal funding for Smart Meters, requiring a Commission determination on whether the federal funds were sufficient. The Commission found that the federal funds were sufficient. Given that Commission finding, the District law now requires Pepco to install Smart Meters in the District of Columbia. There is no "opt out" provision for D.C. ratepayers who would prefer not to have a Smart Meter installed. That sort of change requires an amendment to the statute, which disgruntled consumers should seek from the D.C. Council.

518. Approximately $9 million out of Pepco's requested $42.1 million rate increase in this case is related to the Company's claim for recovery of Smart Meter costs. These costs are currently being held in a regulatory asset account, as required by District law, pending the Commission's determination of how much of Pepco's additional Smart Meter cost is prudent, and over what time period those costs should be recovered.[889] A case now before the Commission, in Phase II, is examining Pepco's educational program about Smart Meters and Smart Grid technology.[890] The impact of Smart Meters on apartment dwellers may be examined in that case.

3. Pepco's Employee Benefits and Executive Salaries

519. Testimony from some community witnesses complained about Pepco's employee benefits[891] and executive salaries, particularly the multi-million dollar salary being earned by the head of Pepco.[892] Several comments opposing Pepco's rate increase referred to an article in the *Washington Post*, "Pepco CEO got a fat raise before big fine."[893] The Community Forum letter reads in part:

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888 Community Hearing, Ward 3, Tr. 11 (Nina Dodge) (November 18, 2011).

889 *See* Community Hearing, Ward 3, Tr. 33-35 (comments of Commission Chairperson Kane) (November 18, 2011); *and see* Community Hearing, Ward 3, at Tr. 19-20 (Maryland has approved the installation of Smart Meters)

890 Community Hearing, Ward 3, Tr. 35 (comments of Commission Chairperson Kane) (November 18, 2011).

891 *See* Community Hearing, Ward 5, Tr. 7 (Albrette Gigi Ransom) (November 21, 2011).

892 *See* Community Hearing, Ward 5, Tr. 34 (Joyce Robinson-Paul).

893 Email from Justin Abad to Commission, received January 9, 2012, email from Rumba Café to Commission, received January 12, 2012, and January 21, 2012 letter to Commission from the Community

> the Pepco CEO and chairman was awarded a new 3-year compensation package worth nearly $6 million in salary and stock, plus bonuses. His annual pay rose from $880,000 in the previous contract to $985,000. Somehow, this does not sit well with those of us who are left in the cold and in the dark.

Other consumer comments sent to the Commission similarly complained that "[p]eople are fighting to keep their lights on while [Pepco's CEO] recently [was] awarded a three-year $6 million compensation package."[894]

DECISION

520. The Commission will examine, in a separate proceeding, whether Pepco's executive salaries should be tied to the achievement of the District's new more demanding reliability standards.

4. Ratemaking Treatment for Old Meters

521. Other witnesses at the community hearings wondered what ratemaking treatment would be given to the old meters that are being replaced by the new Smart Meters.[895] Testimony by community witness Lawrence Thurston, OPC's former senior economist, suggested that Pepco had not properly accounted for the salvage value of 80,000 old meters that were being replaced by new Smart Meters.[896]

DECISION

522. The Commission's decision today addresses salvage value and other ratemaking issues for Pepco's old meters that are being replaced by Smart Meters.

5. Solar Energy

523. Tariffs proposed by Pepco, according to one witness, would impede the development of distributed solar energy production in the District. Robert Robinson criticized Pepco's attempt to impose transmission and distribution fees upon solar

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Forum at Albright United Methodist Church (signed by 18 citizens in Ward 4), all referring to Washington Post, Metro (Section B) (Thursday, January 5, 2012) at B1 ("*Pepco CEO got a fat raise before big fine*").

894 Email from Herbert Harris, Jr., Chairman of the D.C. Utility Board, received by the Commission March 6, 2012.

895 *See* Community Hearing, Ward 1, Tr. 7 (Robert Robinson) (November 21, 2011).

896 Community Hearing, Ward 5, Tr. 24 (Lawrence Thurston) (November 21, 2011) and Lawrence Thurston's email to the Commission, received November 22, 2011.

producers, as well as Pepco's low rate of compensation for solar-generated electricity (.5 cents per kWh, as compared to the 1.50 cents per kWh that Pepco charges consumers for electricity from the grid), and the absence of more discussion about dynamic pricing for solar energy producers.[897] Another community witness said that Pepco needs to provide more information about how the installation of solar panels in residential homes might affect Pepco's bills.[898]

DECISION

524. The Commission's website contains information about solar energy generation issues, contact information for companies that install solar panels, and the certification process for renewable energy credits.

525. Tariffs governing solar power producers include Pepco's Net Energy Metering- Rider "NEM". Under that Tariff, whether a customer pays transmission and distribution charges (to Pepco, or to a competitive supplier) depends, in the first instance, on whether the customer's meter registers a net inflow of electricity (triggering charges) or a net outflow of electricity (triggering credits, subject to some restrictions).

526. Where a "net energy metering customer" is signed up with Pepco for Standard Offer Service (SOS), the Tariff provides the greatest incentives to small generators (100 kilowatts or less) by giving them a Transmission/Distribution credit that is not available to large generators (greater than 100 kilowatts). In the case where the customer's meter registers a net outflow of electricity, the small generator receives a credit for Transmission/Distribution service in an amount equal to the full retail rate for Transmission and Distribution service (excluding surcharges) times the net outflow. [899]

6. Objections to Pepco's Proposed RIM Surcharge

527. The Commission received comments from the community complaining that "Pepco's proposed surcharge to automatically recover reliability costs would allow Pepco to receive funds without sufficient PSC or public scrutiny."[900]

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897 Community Hearing, Ward 1, Tr.6-7 (Robert Robinson) (November 21, 2011).

898 *See* Community Hearing, Ward 4, Tr.14-15 (colloquy between ANC 4B07 Commissioner Judy Jones and Chairman Kane) (November 9, 2011).

899 *Formal Case No. 945, In the Matter of the Investigation into the Electric Service Market Competition and Regulatory Practices*, Order No. 15837, ¶ 8 (June 11, 2012); 15 DCMR § 903.5 (2010).

900 Email from Donna Davis to Commission, received January 9, 2012; standard-form preprinted emails to the Commission from various members of the public.

DECISION

528. The Commission has rejected Pepco's proposed RIM surcharge.

7. Other Comments

529. Other public comments raised concerns about environmental/pollution cleanup issues associated with the decommissioning of a Pepco plant in May 2012,[901] the plain English readability of Pepco's bills,[902] energy audits, obtaining accurate meter readings,[903] outage reporting issues, and how Smart Meters may affect apartment dwellers in master-metered apartments.[904] One comment objected to Pepco spending money collected from ratepayers on *Washington Post* advertising about its efforts to improve reliability.[905] Another comment stated, "wires should be put underground where they are not exposed to the elements and last much longer."[906]

530. Anwar Saleem, executive director of H Street-Main Street, Inc., a nonprofit organization seeking to revitalize business in the District of Columbia, complained that there were delays before Pepco updated its wires and infrastructure along the newly overhauled H Street corridor. "In the case of an affluent part of the city, Georgetown, this was done, and again, in the case of H Street, Northwest, it was not," he claimed.[907] Mr. Saleem criticized the Commission and Pepco for not conditioning the sale of Pepco's generating assets, during deregulation, on establishing an "escrow to replace or upgrade the infrastructure of old neighborhoods and commercial corridors throughout the city." The Commission, he said, should impose "strong reliability checks" on Pepco, to safeguard reliability, before granting any Pepco rate increase.

901 *See* Community Hearing, Ward 7, Tr. 30 (Gregg Rhett,) and Tr.32-33 (Willette Seaward, Chairperson of ANC 7D) (November 19, 2011). *See also* Email from AARP member Ervin Pinckney, received by the Commission March 2, 2012 ("I also want Pepco to give us back that property by the river and for Congress to deem it a Superfund site and make Pepco pay for the century of pollution it let flow into our drinking water!").

902 *See* Community Hearing, Ward 7, Tr. 22-24 (colloquy between Christine Tolson and Commissioner Lori Murphy Lee) (November 19, 2011).

903 *See* Community Hearing, Ward 7, Tr. 16-19 (colloquy between Rita Brown-Hall and Chairman Kane) (November 19, 2011).

904 *See* Community Hearing, Ward 3, Tr. 42-46 (colloquy between Wes Morrison and Chairman Kane) (November 18, 2011).

905 Email from James Burchill, to the Commission (February 15, 2012).

906 Email from AARP member Deborah Kavruck, to the Commission (February 17, 2012).

907 Community Hearing, Ward 6, Tr.18 (Anwar Saleem) (November 22, 2011).

Moreover, he urged the Commission to request that the Mayor and the D.C. Council "put in place a comprehensive energy policy that will create guidelines for all to follow."[908]

DECISION

531. Under the Commission's rulings, Pepco's educational advertising benefiting customers is reimbursable by ratepayers, but image advertising by Pepco is not.[909] The issue about pollution clean-up at a Pepco plant being decommissioned in May 2012 will be addressed in a future Commission proceeding. OPC and Commission staff are available to help consumers with most of the other miscellaneous issues raised by consumers, as the Commission stated at the community hearings.

8. Support for Pepco

532. Testimony from Ward 4 resident Paul Blair supported Pepco's requested rate increase as necessary to ensure a healthy Pepco (essential to the growth and health of this region) and a smarter system (to allow consumers to knowledgeably control what they use). Pepco employees have worked hard, he said, to implement the Company's reliability plan—involving "the extension of poles, wires, heavier wires, trimming of trees." The Company's reliability had improved recently, he said, "so I'm willing to pay $5 more a month to be protected as a consumer."[910] Another Ward 4 resident, Raymond Barley, also favored Pepco's rate increase, to acquire new technology and support continued improvement in the Company's service and reliability.[911] James Lively of Ward 3 also was supportive of Pepco's application.[912]

533. Local D.C. businessman Pedro Alphonso supported Pepco's continued investment in infrastructure to improve the reliability of electricity service. Noting the disruptive effect of outages and the importance of reliable electricity to the business community, he spoke for a group of eight affected businesses in Northeast that had met with Pepco to talk about improving reliability in their specific area. Mr. Alphonso said "we support a rate increase that goes into enhancing the power grid, reducing outages, and improving customer service."[913]

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908 Community Hearing, Ward 6, Tr. 18 and written testimony of Anwar Saleem (filed November 22, 2011).

909 The Company followed these principles here in Formal Case No. 1087. *See* Pepco Exhibit No. 89, p.1 (in response to Commissioner Lee's questions at Tr. 1639-1640, Pepco states that its cost of service recovers for informational advertising, but that institutional advertising is removed from its cost of service).

910 Community Hearing, Ward 3, Tr.7-10 (Paul Blair) (November 18, 2011).

911 Community Hearing, Ward 4, Tr. 15-18 (Raymond Bailey) (November 9, 2011).

912 Written comments of James Lively, filed with the Commission November 22, 2011.

913 Community Hearing, Ward 4, Tr. 8-10 (Pedro Alphonso) (November 9, 2011) and written testimony of Pedro Alfonso (November 9, 2011).

534. Ward 7 resident Shareda Smith commented that, while she has experienced prolonged outages in the past, the outages are now few and far between, that Pepco crews are trimming trees and replacing poles, and that she noticed faster restoration of her power when it went out. "It appears that they have finally begun to spend the money necessary to make the improvements that we, as citizens, have demanded for years. These improvements cost money and these tough economic times aren't making it any easier for many of us to have to shell out more for service, but is necessary if we want the quality service that we, the citizens of the District of Columbia, deserve. * * * I want Pepco to continue to improve and to hold them accountable for providing the services they say they will provide."[914]

535. Another consumer comment objected to AARP's position in this Pepco rate case stating, "Pepco is struggling to recover its reasonable costs to provide service and reliability. To deny them a recovery of adequate funds to meet their obligations is unfair and counterproductive. The distribution portion of the Pepco bill is only 25-30% of the total bill."[915]

DECISION

536. The Commission's decision in this case sets Pepco rates at levels that fairly balance the interests of both ratepaying consumers and Company investors.

B. Motions to Correct Transcript

537. To correct typographical errors, garbles, misspellings, and other errors, Pepco, OPC and the District Government filed motions to correct the transcript of the Commission hearings held from January 30 through February 3, 2012. The Commission finds that all of these requested corrections are non-substantive in nature, and will clarify the record of these proceedings. No party objects. Accordingly, the motions to correct the transcripts of Commission hearings held from January 30 through February 3, 2012 are GRANTED.[916]

538. The Commission also grants the June 18, 2012, motions of Pepco and OPC to correct the transcripts of the Commission hearings held on June 11 and June 12, 2012. These corrections are also non-substantive and ensure a more accurate record of the proceedings.

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[914] Community Hearing, Ward 7, Tr.10-11 (Shareda Smith) (November 19, 2011) and written comments of Shareda L. Smith, filed November 19, 2011.

[915] Email from Jack Sullivan to the Commission (March 2, 2012).

[916] *Accord:* Order No. 16721, ¶ 10 (March 2, 2012).

XXI. FINDINGS OF FACT AND CONCLUSIONS OF LAW

539. Based on the evidence in the record of this proceeding, the Commission makes the following findings of fact and conclusions of law:

a. That Pepco's proposed partially-projected test year ending September 30, 2011, is reasonable;

b. That Pepco's District of Columbia rate base for the test period is $1,151,822,000;

c. That a fair rate of return (including capital costs and capital structure) on Pepco's District of Columbia rate base is 8.03 percent;

d. That the Commission's earlier decision, approving a 50 basis point reduction in Pepco's return on equity as part of the approval of the Company's Bill Stabilization Adjustment ("BSA"), continues to be reasonable;

e. That Pepco shall be allowed to earn a cost of common equity, including the BSA adjustment of 50 points, of 9.50 percent;

f. That Pepco's cost of long-term debt is 6.60 percent;

g. That the capital structure proposed by Pepco to develop its overall cost of capital is appropriate for this proceeding;

h. That the return requirement when the 8.03 percent rate of return is applied to the adjusted rate base of $1,151,822,000 is $92,491,000;

i. That Pepco's adjusted District of Columbia net operating income of $78,227,000 for the test-year was deficient by the amount of $14,264,000;

j. That the adjustment which would increase Pepco's test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order is $24,376,000, which includes a proper allowance for taxes (*see* attached Schedules);

k. That the Commission approves as reasonable the following uncontested ratemaking adjustments (RMA) affecting Pepco's Rate Base, which were proposed by Pepco and either stipulated or accepted by the parties:

RMA No.1, Inclusion of Projected Completed and In Service;
RMA No. 2, Inclusion of Subtransmission Plant;

RMA No. 3, Recovery of Upgrade to Control Center Energy Management System;
RMA No. 10, Removal of Formal Case No. 939 Disallowed Gainsharing and Wages;
RMA No. 11, Removal of Supplemental Executive Retirement Plans ("SERP"); RMA No. 12, Removal of Exempt and Executive Incentive Plan Costs;
RMA No. 13, Annualization of Software Amortization;
RMA No. 14, Removal of 25 percent of 69kV Lines;
RMA No. 15, Reflection of Amortization- Formal Case No. 1053 Rate Case Costs;
RMA No. 16, Recovery of Formal Case No. 1076 Rate Case Costs;
RMA No. 17, Recovery of Formal Case No. 1087 Rate Case Costs;
RMA No. 18, Recovery of Deferred Customer Education Costs.

l. That, as Pepco and OPC agreed during the case, Pepco's projected plant additions during the forecasted part of the test year were overstated and that the average test year plant in service balance should be reduced as proposed by OPC witness Ramas (and accepted by Pepco) by $12,737,000 (RMA No. 47);

m. That Pepco's 2011 Pension and OPEB expense is reasonable (RMA No. 8);

n. That Pepco's depreciation rates are reasonable. Pepco is directed to conduct a new depreciation study which Pepco shall file, together with associated workpapers, at least 90 days prior to its next general rate case;

o. That Pepco's removal of the 2008 stock issuance flotation costs should be modified to remove all of the costs from the rate effective period;

p. That Pepco's cash working capital calculation, which reduces Federal Income Taxes to zero as agreed upon by the Company and OPC is reasonable. The Commission directs Pepco to prepare and file an updated lead-lag study based on at least one (1) year of AMI data by no later than July 31, 2013. However, if Pepco cannot meet the July 2013 filing deadline then Pepco should provide its reasons and proffer a filing deadline for the 2013 calendar year in its compliance filing;

q. That Pepco's test year sales and revenue and Pepco's weather-normalized sales and revenues are accepted for the purpose of this case. Pepco is directed to prepare and file a weather normalization study with its next rate application as outlined in this Order;

r. That Pepco's participation in the Credit Facility and the costs associated with its participation are reasonable and approved (RMA No. 21) subject to conditions of this Order. However, the interest earned by Pepco on funds invested in the Money Pool shall be credited to the ratepayers;

s. That Pepco's request to recover Organizational Review Project Severance Costs related to the sale of Conectiv Energy and the phasing-out of Pepco Energy Services (RMA No. 28) are denied;

t. That Pepco's recovery of 2012 stock issuance costs (RMA No. 39) are denied as unsupported;

u. That Pepco's costs associated with the installation of the third transformer at the Northeast Substation (RMA No. 43) is approved;

v. That the Commission approves as reasonable the following uncontested Company ratemaking adjustments (RMA) affecting Pepco's test year Operating Income and Expenses:

RMA No.25, Reflection of Three-Year Average Regulatory Expense;
RMA No.27, Reflection of Savings from Post-Contectiv Energy Divestiture ORP;
RMA No.31, Removal of Adjustments to Deferred Compensation Balances; RMA No 32, Removal of Employee Association Costs;
RMA No.33, Removal of Industry Contributions and Membership Fees;
RMA No.34, Removal of Institutional Advertising/Selling Expenses;
RMA No.36, Inclusion of Interest on Customer Deposits;
RMA No. 37, Reflection of Increased D.C. WASA rates;
RMA No.38, Reflection of D.C. Steel Plate Fees (withdrawn by Pepco);
RMA No.41 Reflection of Unitary Tax; and
RMA No.44, Removal of Non-Utility Property Tax.

w. That Pepco's annualization of wages and salaries increase (RMA No. 22) is reasonable and approved;

x. That Pepco's annualization of employee health and welfare costs (RMA No. 23) is reasonable and approved;

y. That Pepco's reflection of Hurricane Irene storm costs (RMA No. 42) is rejected;

z. That the three-year average storm costs (RMA No. 26) shall be modified by including the cost of Hurricane Irene in the three year average as explained in this Order;

aa. That Pepco's increase fuel costs adjustment (RMA No. 29) is reasonable and approved;

bb. That Pepco's vegetation management expense related to its tree trimming efforts (RMA No. 30) is approved, and Pepco is directed to file its annual plan and first quarterly report on its efforts no later than December 31, 2012, as outlined in this Order;

cc. That Pepco's PHI service costs are reasonable and approved;

dd. That Pepco's costs of deployment of AMI (RMA No. 4 and RMA No. 5) are reasonable and approved;

ee. That Pepco has properly reflected the cost and savings attributable to AMI in Pepco's operating and maintenance expense (RMA No. 7);

ff. Pepco is directed to report, beginning June 1, 2013, through June 1, 2015, on an annual basis the functionality of its AMI network;

gg. That Pepco's accounting treatment of old non-AMI meters (RMA No. 6) is reasonable and approved;

hh. That Pepco's recovery of deferred AMI costs incurred through December 31, 2008 (RMA No. 19) is reasonable and approved ;

ii. That Pepco's removal of the cost associated with the Benning environmental clean-up (RMA No. 35) is approved subject to terms of this Order;

jj. That OPC's adjustment to remove non-recurring meter expense and accepted by the Company (RMA No. 45) is approved;

kk. That OPC's adjustment to remove the accounts receivables write-off for employee reimbursement and accepted by the Company (RMA No. 46) is approved;

ll. That as stated in this Opinion and Order, Pepco has justified its increase in customer care costs for hiring new personnel (other than new Energy Advisors and Energy Engineers), infrastructure improvements (hardware and software improvements), test year storm readiness expenses, and (as revised by Pepco) customer education and research, which the Commission determines is reasonable; however, the Company did not justify the costs associated with recovery of the costs of its new Energy Advisors and Energy Engineers, and such costs are denied (RMA No. 24);

mm. That as stated in this Opinion and Order, Pepco shall provide some additional, more focused reporting on its customer care services provided to District customers;

nn. That Pepco is directed to have its Call Center give some reasonable priority to District of Columbia customer calls, and to report back to this Commission on how it is implementing this directive in its quarterly reports no later than December 31, 2012, to this Commission; that where Pepco provides shared services to both Maryland and the District of Columbia, as is true in the case of its Call Center, Pepco is directed to provide D.C. ratepayers with the fully loaded services that D.C. ratepayers are paying for under today's decision; and that the impact of any "hiring freeze" or cut-backs in Pepco personnel or Pepco service, because of decisions of the Maryland Public Service Commission, should be confined by Pepco so that it affects only Maryland, not the District of Columbia. Each quarter, Pepco shall provide information to the Commission showing monthly call volume and staffing levels in its Call Center, including both contract and direct employees. This quarterly report also shall include the monthly volume of escalated complaints, broken out by type of complaints, and including those related to major service outages;

oo. That Pepco's reliability improvement projects in the test year represent reasonable and prudent expenditures;

pp. That Pepco's proposed treatment of income taxes and other tax expenses is reasonable;

qq. That it is just and reasonable to amortize the additional taxes that Pepco incurs because of a change in Medicare Part D expenses over three years, with the unamortized balance included in rate base (RMA No. 9); however, in future rate cases, Pepco is directed to file testimony with the Commission that confirms that it has "trued up" (for ratemaking and accounting purposes) its initial estimates of this adjustment, which has been approved for taxes on Medicare Part D expenses;

rr. That Pepco's jurisdictional cost allocations (based on its established AED-NCP methodology) are reasonable;

ss. That Pepco's Class Cost Allocation Study (CCAS) is adequate as a guide to set class revenue requirements and class RORs in this case; however, in its next rate case, Pepco is directed to submit an improved CCAS that considers class loads, as well as the number of customers in a class, in allocating the costs of overhead and underground distribution facilities among customer classes; moreover, in its next rate case, Pepco is directed to submit a CCAS that breaks out MMAs as a separate customer class and accurately determines the cost of service for Pepco to serve MMAs;

tt. That Pepco's customer class revenue targets and rate designs shall be determined as directed in this Opinion and Order, making moderate progress toward eliminating negative class RORs, reducing interclass subsidies, and reducing the disparities that now exist in class rates of return;

uu. That the Residential Customer Charge shall be increased by $2.60, from $6.65 per month to $9.25 per month for the R, and R-AE, with no change to the energy components of the residential rate;

vv. That in the absence of a full record to support a separate MMA rate class, the historical treatment of MMAs as part of the residential class, as proposed by Pepco, shall be continued in this case;

ww. That the Customer Charge for the Residential Aid Discount (RAD) customer class shall be increased by $2.60, from $2.50 to $5.10 per month, while making no other changes to the other components of the RAD rate;

xx. That Pepco is directed to move with all deliberate speed to display the amount of the RAD discount (in dollars) on the face of each District of Columbia RAD Customer's bill;

yy. That Pepco's proposal to set a one percent (1%) class ROR for the Streetlight Service class, producing a $45,222 revenue increase from that class, is reasonable;

zz. That a $220,000 increase in the Streetlight (SL)/Traffic Signal (TS) class, which now earns a negative class ROR, is reasonable and appropriate and takes into account gradualism, as well as all the conservation, low risk, non-cost, public safety and other factors cited by the District Government in favor of keeping SL/TS class rates low;

aaa. That the Company's proposed methodology is reasonable for distributing among the commercial classes the remaining revenue burden of its revenue increase (*i.e.*, the overall \$24.376 million D.C. jurisdictional rate increase minus the \$11.030 million increase allotted to the residential classes minus the \$45,222 increase allotted to the Streetlight Service class minus the \$220,000 increase allotted to the SL/TS classes;

bbb. That Pepco is directed to propose a separate rate classification and schedule for MMAs in its next rate case, based upon more accurate MMA cost information;

ccc. That the Commission approves as reasonable Pepco's proposals for the rate designs for GS ND rates, GS LV and GS 3A rates, GT LV rates, GT 3A and GT 3B rates, and TN and T rates;

ddd. That the Commission approves Pepco's long-standing practice, consistent with the District of Columbia statutes, of collecting taxes and surcharges based on kWhs;

eee. That in its next rate case Pepco is to present a refined CCOSS that reallocates the "per lamp" charge in Pepco's tariffs between the SL and TS tariffs;

fff. That in the future Pepco's CCOSS should differentiate within SL/TS rates between the District Government's costs (unmetered) and the costs of the Federal Government (metered);

ggg. That the Commission approves of WMATA's proposed simplified billing system of twelve equal charges over the course of a year for the Metro-RT rate; that Pepco is directed to remove the BSA mechanism from the Metro-RT rate; and that the Commission may revisit this ruling (eliminating the BSA from the Metro-RT rate) if, in the future, another customer joins the Metro-RT customer class;

hhh. That the Commission accepts the DC Government's technical tariff change, in the SL/TS rate schedules, replacing the word "electricity" with the word "delivery," as reasonable language;

iii. That Pepco's proposed RIM is not just and reasonable; that Pepco has not demonstrated that a capex RIM surcharge is needed; that Pepco has not fully and reasonably described how its proposed RIM would be implemented; and that Pepco has not adequately justified its proposed RIM as a cost recovery mechanism that would address concerns about improving Pepco's service quality and reliability in the District of Columbia;

jjj. That as a matter of regulatory policy, a capex RIM surcharge is not appropriate for the District of Columbia; and that traditional ratemaking procedures are reaffirmed by the Commission;

kkk. That to fully evaluate Pepco's multi-year reliability improvement construction budget, the Commission directs Pepco to provide substantially more information (as detailed in this Opinion and Order) so that the Commission can exercise effective oversight over Pepco's D.C.-reliability-improvement construction program;

lll. That part of the information that Pepco is directed to file on its construction program (as detailed in this Opinion and Order) should adequately justify the level of costs that Pepco proposes to successfully meet D.C.'s new reliability standards, demonstrate that the expenditures in totality are reasonable, and show by reference to a practical cost-benefit analysis that all costs are being "prudently and cost-effectively incurred" so that District reliability standards are achieved "at the lowest feasible cost."

THEREFORE, IT IS ORDERED THAT:

540. On Pepco's District of Columbia rate base of $1,151,822,000 for the test year, a fair and reasonable rate of return (including capital costs and capital structure) is 8.03 percent;

541. The adjustment that would increase Pepco's test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order is $24,376,000, which includes a proper allowance for taxes;

542. The motions of Pepco, OPC, and the District Government to correct the transcripts are **GRANTED**; and

543. Pepco is directed to file revised rate schedules and supporting exhibits, consistent with this Opinion and Order, no later than October 12, 2012. Rates authorized by this Opinion and Order shall be effective on October 18, 2012, at 12:01 a.m., unless otherwise ordered by the Commission.

A TRUE COPY: **BY DIRECTION OF THE COMMISSION:**

CHIEF CLERK: **BRINDA WESTBROOK-SEDGWICK**
COMMISSION SECRETARY

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

Formal Case No. 1087
Schedule 1

Potomac Electric Power Company - District of Columbia Division
Twelve Months Ending September 30, 2011 (Six Months Actual, Six Months Projected)
Revenue Requirements

(in thousands)

Line	Description (A)	Pepco-DC Post Hearing Adjusted (B)	Adjustments (C)	Adjusted Totals (D)
1	**Rate Base**			
2	Electric Plant in Service	$ 2,384,419	$ -	$ 2,384,419
3	Less Accumulated Depreciation	(845,385)	-	(845,385)
4	Less Accumulated Amortization	(7,558)	-	(7,558)
5	Materials and Supplies	20,597	-	20,597
6	Cash Working Capital	14,109	-	14,109
7	Accumulated Deferred Income Taxes	(482,994)	-	(482,994)
8	Prepaid Pension/OPEB (net of tax)	49,626	-	49,626
9	Customer Deposits	(21,060)	-	(21,060)
10	Pepco Portion of Servco Assets	6,829	-	6,829
11	Regulatory Assets	36,758	(3,973)	32,785
12	Unamortized Credit Facility Costs	454	-	454
13	Total Rate Base	$ 1,155,796	$ (3,973)	$ 1,151,822
14	Rate of Return	8.64%		8.03%
15	Return Requirement	$ 99,861	$ (7,369)	$ 92,491
16	**Operating Revenues**			
17	Sale of Distribution Service	$ 410,911	-	$ 410,911
18	Other Operating	3,224	232	3,456
19	Total Operating Revenues	$ 414,135	$ 232	$ 414,367
20	**Operating Expenses**			
21	Operation and Maintenance	$ 105,355	$ 412	$ 105,767
22	Depreciation	59,382	-	59,382
23	Amortization	9,773	(3,084)	6,689
24	Other Taxes	141,560	-	141,560
25	D.C. Income Tax	3,561	301	3,862
26	Federal Income Tax	17,906	974	18,880
27	Total Operating Expenses	$ 337,537	$ (1,397)	$ 336,140
28	**Total Operating Income**	$ 76,598	$ 1,629	$ 78,227
29	**Income Deficiency**	$ 23,263	$ (8,999)	$ 14,264
30	Revenue Conversion Factor	1.70893	-	1.70893
31	**Revenue Deficiency**	$ 39,754	$ (15,378)	$ 24,376
32	Percent of Adjusted Request			61.32%

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

Formal Case No. 1087
Schedule 2

Potomac Electric Power Company - District of Columbia Division
Twelve Months Ending September 30, 2011 (Six Months Actual, Six Months Projected)
Rate of Return

Line	Description	Capital Structure (A)	Ratio (B)	Cost % (C)	Weighted Cost % (D)
1	Long-Term Debt	$ 1,491,158	50.77%	6.60%	3.35%
2	Short-Term Debt	-	0.00%	0.00%	0.00%
3	Common Equity	1,445,984	49.23%	10.00%	
4	Adjustment for BSA			-0.50%	
5	Adjusted Common Equity			9.50%	4.68%
6	Total	$ 2,937,142	100.00%		8.03%

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

Formal Case No. 1087
Schedule 3

Potomac Electric Power Company - District of Columbia Division
Twelve Months Ending September 30, 2011 (Six Months Actual, Six Months Projected)
Ratemaking Adjustments

(in thousands)

Line	Description	Pepco-DC Post Hearing Adjusted	Adjustment 1	Adjustment 2	Adjustment 3	Adjustment 4	Adjustment 5	Adjustment 6	Adjustment 7	Adjustment 8	Adjustment Subtotal	Adjusted Totals
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)	(L)
1	**Rate Base**											
2	Electric Plant in Service	$ 2,384,419									$ -	$ 2,384,419
3	Less Accumulated Depreciation	(845,385)									-	(845,385)
4	Less Accumulated Amortization	(7,558)									-	(7,558)
5	Materials and Supplies	20,597									-	20,597
6	Cash Working Capital	14,109									-	14,109
7	Accumulated Deferred Income Taxes	(482,994)									-	(482,994)
8	Prepaid Pension/OPEB (net of tax)	49,626									-	49,626
9	Customer Deposits	(21,060)									-	(21,060)
10	Pepco Portion of Servco Assets	6,829									-	6,829
11	Regulatory Assets	36,758	$ (1,207)			$ (68)	$ (355)		$ (2,343)		(3,973)	32,785
12	*Unamortized Credit Facility Costs*	454									-	454
13	Total Rate Base	$ 1,155,796	$ (1,207)	$ -	$ -	$ (68)	$ (355)	$ -	$ (2,343)	$ -	$ (3,973)	$ 1,151,822
14	**Operating Revenues**											
15	Sale of Distribution Service	$ 410,911									$ -	$ 410,911
16	Other Operating	3,224						232			232	3,456
17	Total Operating Revenues	$ 414,135	$ -	$ -	$ -	$ -	$ -	$ 232	$ -	$ -	$ 232	$ 414,367
18	**Operating Expenses**											
19	Operation and Maintenance	$ 105,355		$ 720	$ (308)						$ 412	$ 105,767
20	Depreciation	59,382									-	59,382
21	Amortization	9,773	$ (720)			$ (303)	$ (404)		(1,657)		(3,084)	6,689
22	Other Taxes	141,560									-	141,560
23	D.C. Income Tax	3,561	72	(71)	29	30	40	23	165	13	301	3,862
24	Federal Income Tax	17,906	227	(227)	98	95	127	89	523	42	974	18,880
25	Total Operating Expenses	$ 337,537	$ (421)	$ 422	$ (181)	$ (178)	$ (237)	$ 112	$ (969)	$ 55	$ (1,397)	$ 336,140
26	**Total Operating Income**	$ 76,598	$ 421	$ (422)	$ 181	$ 178	$ 237	$ 120	$ 969	$ (55)	$ 1,629	$ 78,227

Adjustment 1 Remove Hurricane Irene as a Separate Event (Pepco #42)
Adjustment 2 *Inclusion of Hurricane Irene Event in 3-Year Average Storm Costs (Pepco #26)*
Adjustment 3 Incremental Customer Care Expense (Pepco #24, OPC #9, AOBA #3)
Adjustment 4 Reflection of Ending Amortization - Flotation Costs (Pepco #20)
Adjustment 5 Remove 2012 Flotation Costs (Pepco #39, OPC #8)
Adjustment 6 Allocate Money Pool Interest Income to Ratepayers (AOBA)
Adjustment 7 Remove Organizational Review Project Severance (Pepco #28, OPC #16)
Adjustment 8 Interest Synchronization