1053-E-361

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

OPINION AND ORDER

January 30, 2008

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, Order No. 14712

Before the Commission:

Agnes Alexander Yates, Chairperson
Richard E. Morgan, Commissioner
Betty Ann Kane, Commissioner

Appearances:

Kirk J. Emge, Deborah M. Royster, Anthony C. Wilson, Keith Townsend, Richard M. Lorenzo and Arthur W. Adelberg, for Potomac Electric Power Company; Elizabeth A. Noël, Sandra Mattavous-Frye, Karen R. Sistrunk, Barbara L. Burton, Laurence C. Daniels, Lopa B. Parikh, Brian O. Edmonds, John Michael Adragna, Barry Cohen, Joanne Doddy Fort, David Pomper and Scott Strauss, for Office of People's Counsel; Frann G. Francis, W. Shaun Pharr and Nicola Y. Whiteman for the Apartment and Office Building Association of Metropolitan Washington; Linda Singer, Bennett Rushkoff and Brian R. Caldwell for the District of Columbia Government; Robert C. Smith and David A. Leib for the General Services Administration; Marc E. Biondi for Washington Metropolitan Area Transit Authority; Avis Marie Russell, Robert I. White and Nancy A. White for the District of Columbia Water and Sewer Authority; John C. Dodge for Comcast of the District, LLC.

Table of Contents

BACKGROUND

1. On December 12, 2006, the Potomac Electric Power Company ("PEPCO" or "Company"), a subsidiary of Potomac Holdings, Inc. ("PHI"), filed an Application with the Public Service Commission of the District of Columbia ("Commission") to increase current distribution service rates and electric service charges in the District of Columbia by $50.5 million, representing a 14.74 percent increase in PEPCO's distribution revenues. PEPCO states that the requested rates are designed to collect $392.8 million in total revenues.[1] PEPCO seeks authority to earn an overall rate of return of 8.42 percent, including an 11.00 percent return on common equity.[2] Pepco divested its generation assets in late 2000, and this matter represents PEPCO's first rate case since divestiture.[3]

2. PEPCO's cost of service calculation relies on a partially forecasted test year, of which six (6) months are actual and six (6) months are projected. PEPCO proposes a Bill Stabilization Adjustment ("BSA") as a means of accounting for variations in electricity consumption from test year levels. PEPCO proposes that the BSA will automatically increase or decrease distribution service rates depending on whether actual revenues per customer are below or above the Commission-approved level. PEPCO asserts that, if the Commission were to approve the BSA proposal, the Company's recommended return on common equity would be lowered to 10.75 percent.[4] PEPCO further proposes a sales (repression) adjustment, reducing test-year base distribution revenues by $2.3 million. In addition, PEPCO proposes a surcharge mechanism to reflect the yearly increases and decreases in its Pension and Other Post-Employment Benefits ("OPEB") costs. PEPCO's request also includes cost recovery for its new Northeast Substation that was placed in service on August 25, 2007. To this end, PEPCO includes a ratemaking adjustment to its test-year cost of service to reflect the known and measurable costs associated with this project that were incurred before its in-service date.[5]

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[1] *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*, filed December 12, 2006 ('Formal Case No. 1053") ("PEPCO's Application"). 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 initial brief as "PEPCO Br."; and its post-hearing reply brief as "PEPCO R. Br."

[2] PEPCO's Application at 6. While PEPCO initially sought a revenue requirement of $50.454 million on an 11.0% ROE (PEPCO C-1 at 28), by the end of the hearings it had adjusted the revenue requirement to $47.880 million without the Bill Stabilization Adjustment ("BSA"), and $43.450 million with the BSA (PEPCO Br., Appendix B). On the other hand, OPC originally proffered a revenue requirement figure of $31.090 million (OPC C-3 at 1); then by the end of the hearings, OPC adjusted this to $30.849 million (OPC Br. Exh. C-3 at 1; and OPC R. Br. at Appendix B, at a 7.43% rate of return without the BSA).

[3] *See Formal Case No. 945, In the Matter of the Investigation Into Electric Service Market Competition and Regulatory Practices*, Order No. 11576 (December 30, 1999).

[4] *Id.* at 7-9.

[5] *See Formal Case No. 1053*, Letter from Keith Townsend, PEPCO Assistant General Counsel, to Dorothy Wideman, Commission Secretary, filed August 27, 2007.

3. PEPCO did not base its proposed rate design on its marginal cost study filing which the Company argues is no longer necessary. In fact, PEPCO requests elimination of the requirement to provide a marginal cost study in future rate cases.[6] Further, PEPCO proposes: (1) revisions to its Standby Rider; (2) a cost-based increase to its Reconnection Fee from $35.00 to $100.00; (3) elimination of experimental riders for residential electric vehicle service; (4) elimination of Residential Time Metered Experimental Service; and (5) certain additional minor tariff revisions.[7]

4. The Commission held a pre-hearing conference on February 7, 2007, to identify and clarify the proposed issues and to address substantive, procedural, and scheduling matters relating to PEPCO's Application. On March 8, 2007, the Commission issued Order No. 14232,[8] designating the issues, establishing a procedural schedule,[9] and granting the petitions to intervene of, among others, the Apartment and Office Building Association of Metropolitan Washington ("AOBA"); the District of Columbia Government ("District Government"); the District of Columbia Water and Sewer Authority ("WASA"); Washington Metropolitan Area Transit Authority ("WMATA"); and the General Services Administration ("GSA").[10] The Office of the People's Counsel of the District of Columbia ("OPC") is a party of right.[11]

5. In accordance with the adopted procedural schedule, PEPCO submitted supplemental testimony on March 22, 2007. In response to PEPCO's Application and direct and supplemental testimony, the following parties submitted testimony on May 14, 25, and 31, 2007: WMATA, OPC, AOBA, the District Government, GSA, and Comcast of the District, LLC ("Comcast"). Rebuttal testimony was filed by PEPCO, OPC, the District Government, and GSA on

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6 *Id.* at 12.

7 *Id.* at 13.

8 Order No. 14232 (March 8, 2007). The Commission's orders in this proceeding (Formal Case No. 1053) are hereinafter referred to as "Order No. __ at (page)." Orders in other Commission proceedings shall be cited in the following format: "*[Case Name].*, Formal Case No. _______, Order No. _____ (Date), ___ DCPSC ___ ( )." Court decisions shall be cited as follows: "*[Case Name].*," ___ A.2d ____, ____ (D.C. ____)."

9 The procedural schedule was periodically amended to enlarge the briefing periods in light of developments in this proceeding. *See, e.g.*, Order No. 14285 ¶8 and 17 (May 4, 2007).

10 Order No. 14232 at ¶ 6-7, allowing the intervention of Washington Gas Light Company ("WGL"); Comcast of the District, LLC ("Comcast"); the District of Columbia Commission on Aging; the International Brotherhood of Electrical Workers Local Union No. 1900 ("IBEW"); Brookland Neighborhood Civic Association the Federation of Citizens Associations; Shaw Main Streets, Inc.; H Street Main Street Inc.; Kingman Park Civic Association; Main Street Anacostia, Inc.; and Robert L. Church, Resident of Ward 5. The Commission also subsequently granted the late intervention request of the City of Alexandria, Virginia ("City of Alexandria") and allowed limited intervention of the Politics and Prose Climate Action Project ("Politics and Prose"). Order No. 14285 at ¶ 7.

11 D.C. Code, § 2001 Ed. 34-804 (2007) ("The Office shall be a party, as of right, in any investigation, valuation, revaluation, or proceeding of any nature by the Public Service Commission of or concerning any public utility operating in the District of Columbia"). OPC's Direct Testimony is hereinafter referred to 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 shall be identified by party and hereinafter referred to as "Intervenor __"; its rebuttal testimony, as "Intervenor (2__)"; its post-hearing initial brief as "Intervenor Br."; and its post-hearing reply brief as "Intervenor R. Br."

June 18, 2007. The Commission held evidentiary hearings on June 26, 27, 28, and 29, 2007. In response to questions from the Commission and other parties during the hearing, and as directed by the Commission, post-hearing exhibits and data responses were submitted by PEPCO on July 11, 2007.[12] The Commission convened community hearings on June 12, and 16, and July 12, 2007. Post-hearing initial briefs were filed by PEPCO, OPC, AOBA, Comcast, District Government, GSA, WASA, and WMATA on July 25, 2007; and reply briefs were submitted by AOBA, District Government, OPC, PEPCO, and WASA on August 3 and 10, 2007. A Community Brief was filed by the Consumer Utility Board ("CUB") on August 3, 2007, and additional letters and e-mail communications were submitted to the Commission by members of the community at various points in the proceeding.[13]

6. The Commission is vested with authority to set rates that are "just and reasonable."[14] Although there is no formula for determining what constitutes a reasonable rate, courts have defined the lower boundary of the zone of reasonableness as one which is not confiscatory in the constitutional sense (*i.e.*, it must allow the company to earn a fair rate of return on its investment) and the upper boundary as one which is not exorbitant.[15]

I. TEST PERIOD (Issue No. 1)[16]

7. The process of ratemaking 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

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12 PEPCO's post-hearing subsmissions consisted of the following: (1) an order from the Public Service Commission of Maryland; (2) a list of accounts recovered through customer costs; (3) a PowerPoint summary regarding energy efficiency programs in California; (4) PowerPoint summary regarding funding and savings of California Energy Programs; (5) a chart of average billing days by month for 2004-2007; (6) confirmation of the correct District of Columbia billed distribution base revenue that had been mislabeled; (7) total amount of Allowance for Funds Used During Construction ("AFUDC") for the Northeast Substation; (8) additional response regarding the Executive Incentive Compensation Plan; (9) statement that PEPCO's deferred compensation plan is funded and how it is reflected in PEPCO's balance sheet; (10) calculation of the annual savings for the average residential customer as a result of a 25 basis point return on equity ("ROE") adjustment for the implementation of the BSA; (11) redlined changes to specific elements of PEPCO's rates; and (12) chart detailing the proposed changes and percentage increase of several rate classes.

13 The community's comments are summarized in Section XXI.A of this Order.

14 D.C. Code 2001 Ed. § 34-911.

15 *See Office of the People's Counsel v. Public Service Commission*, 797 A.2d. 719 (Rates must fall within zone of reasonableness safeguarding interests of both investors and consumers).

16 Designated Issue No. 1 asks: "Is PEPCO's proposed partially projected test year ended September 30, 2006, the appropriate test year?"

base which were established in the test year will continue into the near future, when the prescribed rates will be in effect.[17]

8. **PEPCO.** Witnesses Joseph M. Rigby and W. Michael VonSteuben testify that the Company's Application is based on a partially projected test year ended September 30, 2006, consisting of six months of actual data (October 2005 to March 2006) and six months of projected data (April 2006 to September 2006).[18] According to VonSteuben, the use of such a partially projected test year reflects the conditions expected to prevail during the period when the proposed rates are likely to be in effect.[19] He explains that the Company's reliance on a partially projected test year is based on Commission Rule 200.4,[20] which allows the use of forecasted data not exceeding six months, as well as on Commission precedent, including Order No. 10646 in Formal Case No. 939, which approved a similar test year.[21]

9. Witness VonSteuben identifies the following key assumptions underlying the portion of the test period that is based on projected results:

- Megawatt-Hour ("MWh") Sales (District of Columbia billed distribution) – six months actual of 5,609,369 MWh and six months projected of 6,111,689 MWh;

- Sales of Electricity (District of Columbia billed distribution) – six months actual of $161,204,000 and six months projected of $183,970,000;

- Other Operation & Maintenance Expense (System Distribution-related) – six months actual of $116,694,000 and six months projected of $100,965,000; and

- Construction Expenditures (System Distribution-related) – six months actual of $94,000,000 and six months projected of $121,000,000.[22]

10. VonSteuben asserts that the six months of projected data are based on the Company's 2006 budgeted data. He also states that the projected data are combined with six months of actual data, and are directly assigned and/or allocated first to PEPCO's distribution business, and then to the District of Columbia jurisdiction.[23] Witness VonSteuben testifies that PEPCO Exhibit (C)-1 sets forth the necessary financial and accounting data for the test period ending September 30, 2006, to support the proposed increase in annual revenues.[24] He adds that PEPCO

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17 *See PEPCO v. Public Service Commission,* 380 A.2d 126 (1977).

18 PEPCO (A) at 5:3-6 (Rigby Direct); PEPCO (C) at 2:9-12, 22-23, and 3:1-4 (VonSteuben Direct).

19 PEPCO (C) at 3:11-17 (VonSteuben Direct).

20 15 DCMR § 200.4.

21 PEPCO (A) at 5:7-10 (Rigby Direct); PEPCO (C) at 4:3-9 (VonSteuben Direct); and PEPCO (2C) at 2:2-6. *See also* Formal Case No. 939, *In the Matter of Potomac Elec. Power Co.*, Order No. 10646 at 5 (June 30, 1995).

22 PEPCO (C) at 4:13-5:5 (VonSteuben Direct).

23 *Id.* at 5:8-13.

24 *Id.* at 5:14-7:7.

Exhibit (C)-4 provides an analysis of changes in the jurisdictional rate base, expenses, and operating income between the historical and proposed test years, as required by Commission Rule 200.5(d).[25]

11. **OPC.** Witness Nancy B. Bright states that OPC adopted PEPCO's partially projected test year ended September 30, 2006, because it is the only information PEPCO made available.[26] Although OPC did not move to strike the data, Bright expresses concern that the Company has not updated the projected test-year data in this proceeding with actual data, whereas in a parallel Maryland Public Service Commission ("Maryland PSC") rate case, which is also based on a partially projected test year, PEPCO submitted, on February 9, 2007, updates to its testimony and exhibits that provided actual data for the year ending September 30, 2006.[24] Bright notes PEPCO's reliance on Commission Rule 213.2,[27] which provides for the submission of actual results 180 days after completion of a rate case using a projected test period,[28] but asserts that such a submission would be too late to enable OPC to determine the accuracy of the Company's partially projected test period.[29] In its brief, OPC requests that the Commission "reconsider" Rule 213.2.[30] OPC also urges the Commission to substitute actual data for the projections when they are different, as the Commission allegedly did with regard to projected wage and employment benefit expenses in Formal Case No. 905.[31]

12. **PEPCO Rebuttal.** Witness VonSteuben states that, during discovery, PEPCO provided to OPC system-level actual results for 12 months ending September 2006 and made available for OPC's inspection the complete workpapers for the 12 months of actual data filed in the Maryland PSC proceeding. Additionally, VonSteuben notes that the actual results in the Maryland PSC proceeding showed very little variance from the partially projected results therein, and that there is no reason why a different result should follow from updating the actual data in the instant case.[32]

DECISION

13. Commission Rule 213.2 clearly permits PEPCO to use up to six months of forecasted test-year data. OPC has requested that we amend the rule. Even if we were to conclude that a rule of general applicability can be properly amended in an adjudicatory proceeding, OPC has not argued, nor is it apparent, how the amended rule could be lawfully applied retroactively to PEPCO. For the foregoing reasons, we determine that PEPCO's proposed test year is appropriate.

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25 *Id.* at 24:20-25:4.

26 OPC (C) at 5:16-18 (Bright Direct).

27 15 DCMR § 213.2.

28 OPC (C) at 6: 16-7:6 (Bright Direct).

29 *Id.* at 7:4-6.

30 OPC Br. at 25-26 (mentioning PEPCO's submission of actual data in Maryland Public Service Commission, Case No. 9092).

31 Formal Case No. 905, Order No. 9868 at 4, 12 D.C.P.S.C. 651, 661 (October 23, 1991); OPC Br. at 24-25.

32 PEPCO (3C) at 2:16-3:6 (VonSteuben Rebuttal).

II. RATE OF RETURN/COST OF CAPITAL (Issue No. 2)[33]

14. **PEPCO.** The Company proposes that, if the BSA is not approved, PEPCO's overall rate of return should be 8.42 percent, and its rate of return on common equity should be 11.00 percent. The overall return is based on the following calculation:[34]

Capitalization	Ratio	Cost	Return
Long-term Debt	53.45%	6.17%	3.30%
Common Equity	46.55	11.00	5.12
	100.00%		8.42%

If the Commission approves the proposed BSA, the Company seeks an 8.30 percent overall rate of return, and a 10.75 percent return on common equity.[35]

15. **OPC.** OPC proposes that, without the BSA, the Company's cost of capital be set at 7.43 percent, and its cost of common equity should be 9.25 percent,[36] calculated as follows:

Capitalization	Ratio	Cost	Return
Long-term Debt	53.87%	6.17%	3.32%
Short-term Debt	4.07	5.25	.21
Common Equity	42.06	9.25	3.89
	100.00%		7.43%[37]

If the BSA is approved, OPC proposes a 374 basis point downward adjustment to the cost of common equity to 5.51 percent based on the yield on AA-rated bonds, reflecting PEPCO's reduced risk as the result of the BSA. OPC proposes an overall cost of capital of 5.85 percent.[38] Alternatively, if the Commission is "uncomfortable with such an unprecedented low cost of equity," OPC offers as a compromise a 187 basis point reduction that averages its two recommendations (*i.e.*, 9.25 percent and 5.51 percent), yielding an average return on common equity of 7.38 percent.[39]

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33 Designated Issue No. 2 generally asks: "What is a reasonable rate of return (including capital costs and capital structure) for PEPCO?" Issue No. 2 includes sub-issues that shall also be discussed herein in sequence.

34 PEPCO (B)-10 at 1.

35 *Id.*

36 OPC (B) at 46:5-11 (Rothschild Direct); OPC (B)-1.

37 OPC (B)-1 (total reflects rounding).

38 OPC (B)-15; OPC (B) at 43:19-44:23, 47:5-21(Rothschild Direct).

39 OPC (B) at 47:21-48:7 (Rothschild Direct).

A. Cost of Common Equity[40]

16. **PEPCO.** Witness Morin recommends that PEPCO be allowed to earn a return on equity ("ROE") of 11.0 percent.[41] Witness Rigby explains that this return is necessary to enable PEPCO to attract capital on reasonable terms, and to maintain its financial integrity.[42]

17. Relying on several United States Supreme Court cases and lower court decisions, Witness Morin concludes that a public utility such as PEPCO should be allowed the opportunity to earn an ROE that is: (1) commensurate with returns on investments in other firms having corresponding risks; (2) sufficient to assure confidence in the company's financial integrity; and (3) sufficient to maintain the company's creditworthiness and ability to attract capital on reasonable terms.[43]

18. Morin believes that, in estimating the cost of common equity and associated investor expectations, it is inappropriate to rely exclusively or predominantly on a single methodology due to the possibility of measurement difficulties and vagaries in the data of individual companies.[44] Accordingly, Morin uses three methods to determine PEPCO's cost of equity: the Capital Asset Pricing Model ("CAPM"); the Risk Premium method; and the Discounted Cash Flow ("DCF") model. Morin summarizes these models as follows:

- The CAPM is a form of risk premium analysis that is based on the principle that investors require higher returns for risky stock investments than for risk-free investments such as government bonds. The CAPM uses a volatility measure ("beta") to quantify such additional return.[45] In addition, Morin uses an empirical approximation of the CAPM ("ECAPM") as part of his analysis. According to Morin, the ECAPM is a variant of the CAPM that was developed to correct the CAPM's tendency to underestimate the cost of equity for low-beta securities and to overestimate the cost of equity required from high-beta securities.[46]

- The Risk Premium method, as applied by Morin, is based on the historical relationship between earned or allowed returns on equity and returns on long-term

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40 Designated Issue No. 2.a asks: "What cost of common equity should PEPCO be allowed to earn?"

41 PEPCO (B) at 90:18-23 (Morin Direct); PEPCO Br. at 8 (citing PEPCO (B) at 5:16-20 (Morin Direct)).

42 PEPCO (A) at 4:19-24, 10:16-13:7 (Rigby Direct).

43 PEPCO (B) at 13:2-15:1 (citing *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973); *Permian Basin Rate Cases*, 390 U.S. 747 (1968); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989)).

44 *Id.* at 18:23-19:24, 20:18-23:25.

45 *Id.* at 36:17-21, 37:18-38:20.

46 *Id.* at 52:1-54:16.

government bonds.[47] Morin provides risk premium analyses of the electric utility industry and the natural gas industry, and the allowed returns for utilities.[48]

- The DCF model is based on the proposition that the value of any security to an investor is the expected discounted value of the future stream of dividends or other benefits.[49] Morin states that it is appropriate to use this model in conjunction with other approaches, but he notes the need for caution in interpreting the results of the DCF model. Morin contends that the application of the standard version of the DCF model to utility stocks understates the investor's expected return when the stock's market-to-book ratio exceeds unity, a situation that, according to Morin, has existed in the utility industry for more than two decades.[50] Noting that some regulatory authorities principally rely on the DCF method, Morin describes what he believes to be the potential problems with relying solely on that method.

Morin further argues that flotation costs are real and measurable, and that they must be recognized on an ongoing basis for investors to have the opportunity to earn the ROE set by the Commission.[51]

19. Morin states that the average result of his application of the above three methods of estimating PEPCO's cost of equity is 11.0 percent,[52] which he recommends for adoption by the Commission if PEPCO's proposed BSA is not adopted.[53] Morin explains that he arrived at this recommendation by performing four different risk premium analyses. He states that two risk premium studies applied the CAPM and ECAPM models based on current market data, while the other two were based on historical and allowed risk premium data from electric distribution industry aggregate data.[54] Morin also states that he performed DCF analyses on two proxy groups for PEPCO: a group of investment-grade electricity distribution utilities and a group representative of the natural gas distribution utility industry.[55] According to Morin, the average results from the three principal methodologies are as follows:[56]

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47 PEPCO Br. at 10.

48 PEPCO (B) at 56:13-69:17 (Morin Direct).

49 *Id.* at 69:19-24.

50 *Id.* at 25:21-26:3, 29:16-31:3; 34:17-35:11;PEPCO Br. at 8.

51 PEPCO (B) at 83:9-88:23 (Morin Direct); PEPCO (B), App. B; PEPCO Br. at 11.

52 PEPCO (B) at 89:3-90:1 (Morin Direct).

53 *Id.* at 90:18-23.

54 Morin also states that he examined the historical risk premium inherent in the natural gas utility industry. PEPCO (B) at 57:11-58:22 (Morin Direct).

55 PEPCO (B) at 89:3-22; PEPCO (B)-2 at 1-2.

56 PEPCO (B) at 89:14-22 (Morin Direct).

CAPM	11.9%
Risk Premium	11.1%
DCF	10.2%
Average	11.0%

20. **OPC.** Witness Rothschild proposes a cost of common equity of 9.25 percent if the BSA is not adopted.[57] Rothschild states that he derived his proposed 9.25 percent cost of equity from DCF results between 8.95 percent and 9.16 percent, which he confirmed by a Risk Premium/CAPM result of 9.14 percent.[58] In its brief, OPC urges primary reliance on the DCF method, upon which the Commission has long relied.[59] OPC argues that it would be unnecessary, inaccurate, counterproductive, and inequitable to abandon or deemphasize the DCF approach.[60] Rothschild states that he applied the DCF method to a proxy electric group based on that used by Morin. However, Rothschild removed Texas Utilities ("TXU") from Morin's proxy electric group because TXU's valuation could be distorted by expectations of an acquisition premium arising from public knowledge of its being a target of a leveraged buyout and by a $4.2 billion write-off of overseas investments that reduced TXU's book value from $15 per share in 2001 to $1.01 per share in 2006.[61] Rothschild did not rely on Morin's natural gas proxy group because PEPCO is not in the gas distribution business.[62]

21. Rothschild describes the components of his DCF calculation – dividend yield, growth estimate, future return on book equity, retention rate, and adjustment for sale of new common stock. He explains that he calculates the dividend yield (dividend divided by price) for two different time periods.[63] He calculates the growth component as the future expected return on book equity multiplied by the retention rate, and he adds an allowance for growth caused by the sale of new common stock above book value. OPC refers to this method of calculating expected growth as the "standard, 'sustainable growth' version of the standard annual DCF methodology," also known as the "retention growth" or "reinvestment growth" method.[64] Rothschild points out that he did not include a flotation cost adjustment because he believes it to be a violation of the Commission's policy against making an allowance for financing costs not actually incurred in the test year.[65]

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57 OPC (B) at 2:20-3:14 (Rothschild Direct); *see also* OPC (A) at 22:8-15, (Smiley-Smith Direct) where Smiley-Smith instead mentions Rothschild's calculated cost of capital of 5.85% if the BSA is adopted.

58 OPC (B) at 2:23-3:2 (Rothschild Direct); OPC (B)-2.

59 OPC Br. at 26-33.

60 *Id.* at 33.

61 OPC (B) at 25:18-26:10 (Rothschild Direct)..

62 *Id.* at 4:7-14.

63 OPC Br. at 26-28.

64 *Id.* at 36.

65 OPC (B) at 67:12-14 (Rothschild Direct), *et seq.*

22. The results of Rothschild's analyses, which do not include flotation costs, are summarized below:

Primary Analysis[66]

DCF – Electric – (Morin Group less 1 Company) (Spot Dividend Yield)	8.95%
DCF – Electric – (Morin Group less 1 Company) (Annual Dividend Yield)	9.16%
CAPM Electric Group – (ROE for Market Adjusted for Electric Industry Beta and Inflation)	9.14%
Recommended Return	**9.25%**

23. Rothschild also provides an alternative proxy group sensitivity study.[67] In this analysis, he excludes ten of the companies in his primary group of sixteen electric companies because they have substantial earnings from unregulated generation.[68] Rothschild's sensitivity analyses, which do not include flotation costs, are summarized below:

Sensitivity Analysis (to confirm cost of equity conclusion)[69]

DCF – Electric – (Six of the electrics in the Morin Group) (Spot Dividend Yield)	8.52%
DCF – Electric – (Six of the electrics in the Morin Group) (Annual Dividend Yield)	8.86%
CAPM Electric Group	8.64%
Recommended Return	**9.10%**

24. Rothschild disagrees with Morin's inclusion of TXU and natural gas companies in the proxy groups and criticizes several other aspects of Morin's rate of return analysis.[70] First, he asserts that Morin should not have used analysts' five-year growth projections to estimate the growth component of the DCF model, and instead should have employed the "sustainable growth" approach.[71] Second, he contends that Morin should have used dividend growth, rather than earnings

66 OPC (B)-2.

67 OPC (B) at 49:17-50:9 (Rothschild Direct).

68 OPC Br. at 41-43.

69 OPC (B)-10 to (B)-14; OPC (B) at 5:20-6:8 (Rothschild Direct).

70 OPC (B) at 6:13-8:11 (Rothschild Direct).

71 Morin states that, under the "sustainable growth" or "retention growth" method, a company's "future growth is estimated by multiplying the fraction of earnings expected to be retained by the company … by the expected return on book equity." PEPCO (B) at 74:18-75:6 (Morin Direct); PEPCO (3B) at 22:20-23 (Morin Rebuttal). Rothschild does not provide a direct description of the "sustainable growth" concept, but he also discusses sustainable growth in terms of retention rates. OPC (B) at 23:1-23 (Rothschild Direct).

growth, in the DCF model. Third, he faults Morin's reliance on the thirty-year Treasury bonds as the risk-free rate in the CAPM analysis. Fourth, he questions Morin's use of the arithmetic, rather than the geometric, mean in his interest premium analysis.[72] Fifth, he argues that Morin's CAPM analysis is not valid because it relies on an allegedly flawed DCF study.[73]

25. **AOBA.** Witness Oliver submits a combination of DCF, CAPM, and Risk Premium analyses that support a cost of common equity for PEPCO not exceeding 9.3 percent.[74] Oliver states that Standard & Poor's ("S&P") average business risk profile score for the electric distribution utility holding companies he uses as proxies is 2.6.[75] According to Oliver, the average business risk profile score for his natural gas distribution utility proxy group is 2.7.[76] Oliver uses groups that are subsets of Morin's proxy groups and, according to Oliver, reflect average risk profile scores "roughly comparable to those assigned to PEPCO."[77] Oliver states that the business risk profile assigned to PEPCO is 3.0.[78] With no flotation cost allowance, the average of Oliver's DCF results is 9.04 percent; and, with flotation costs, the average is 9.26 percent. The average result of Oliver's Risk Premium and CAPM analyses is 8.96 percent, without flotation costs.[79] When a flotation cost allowance is included, the average of Witness Oliver's estimates is 9.27 percent.[80]

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72 OPC contends that the history of financial investments is a long and volatile series of past results, and that for such a series, the long-term return will fall below the average of the various annual returns. Quoting Wharton Professor Jeremy Siegetl, OPC contends that investors can be expected to realize geometric returns over long periods of time. OPC Br. at 61.

73 *Id.* at 6:13-8:11.

74 AOBA (A) at 64:11-14 (Oliver Direct); AOBA Br. at 8.

75 S&P uses risk profile scores with a range of 1 (excellent) through 10 (vulnerable). AOBA (A), Attachment C at 1 (Oliver Direct).

76 AOBA (A) at 61:8-14 (Oliver Direct); AOBA (A)-2 at 3; AOBA Br. at 8.

77 AOBA (A) at 61:8-10 (Oliver Direct).

78 *Id.* at 59:1-4.

79 *Id.* at 62:5-6 ; AOBA Br. at 8.

80 AOBA (A) at 62:5-10 (Oliver Direct).

26. In sum, the results of Oliver's analyses are as follows:[81]

		Without Flotation Costs (%)	With Flotation Costs (%)
DCF	Subset of Morin Group – Electric Companies with S&P Risk Profile Similar to PEPCO's	9.13	9.38
DCF	Gas Companies with S&P Profile Similar to PEPCO's	8.94	9.15
Interest Premium – Revised Morin Historical Risk Premium Study		9.75	10.03
CAPM – Adjusted Morin Study Using Data For Utilities		8.20	8.50
Recommended Return		**9.00**	**9.30**

27. Oliver notes that PEPCO's group of "electric distribution utilities" includes the parent companies of distribution companies.[82] Many of these parent companies have substantial investment in generation assets, and, as such, face much greater risk than companies with mere distribution operations such as PEPCO. He points out that the difference in risk is indicated by the S&P business risk profile scores for distribution utilities and their parent companies.[83] Oliver generally concurs with Morin that electric distribution businesses are similar in risk to natural gas distribution businesses.[84] Oliver questions the use of a 7.2 percent risk premium in Morin's CAPM analysis. Oliver notes that the 7.2 percent risk premium is close to the 7.19 percent mean DCF risk premium shown in Morin's table of 39 industries,[85] but the table itself reflects a lower 4.19 percent risk premium for utilities, and an Adjusted Industry Beta for utilities of 0.71.[86] Substituting these figures in the CAPM analysis for the values Morin uses, Oliver produces the returns on equity shown in the table above.

28. **WMATA.** Witness Foster believes that PEPCO's distribution operations face less business risk than the companies Morin labels "distribution electric utilities," particularly in light of the divestiture of its generation assets.[87] Foster also contends that PEPCO's customer profile

81 *Id.* at 89:14-90:2; AOBA (A)-3 at 1-2.

82 AOBA (A) at 41:13-20 (Oliver Direct).

83 *Id.* at 42: 5-7.

84 *Id.* at 46:13-47:3.

85 PEPCO (B) Appendix A-1 at 11.

86 AOBA (A) at 59:19-60:9 (Oliver Direct).

87 WMATA (A) at 6:12-25 (Foster Direct).

and service territory reflect relatively less risk as compared to other jurisdictions.[88] Foster states that he reviewed twenty-seven rate cases of natural gas and electric utilities in 2005-2006, and found their average rate of return allowed during that period to be 10.32 percent, as shown in his summary, WMATA (A)-2.[89] Foster asserts that PEPCO does not face more risk than the twenty-seven natural gas and electric utilities whose returns are reflected in that average.[90]

29. **PEPCO Rebuttal.** PEPCO states that the cost of equity estimates of OPC Witness Rothschild and AOBA Witness Oliver suffer from numerous analytical flaws, and their testimony does not support a lower allowed ROE than the Company's witness proposed.[91] PEPCO asserts that Rothschild has a long history of recommending unreasonably low allowed rates of return for utilities and that his cost of equity estimate of 9.25 percent in this case is below the allowed ROE for every one of the sixteen utilities in Rothschild's comparable group, and well below the group's average 10.7 percent return.[92] According to Morin, the low cost of equity of OPC Witness Rothschild is driven primarily by the latter's flawed reliance on the "sustainable growth method."[93] PEPCO states that Rothschild's approach has been challenged on the basis of circularity in the past and that, due to this circularity, the Commission rejected Rothschild's cost of equity recommendation for PEPCO in Formal Case No. 905.[94]

30. PEPCO also states that there are many errors in OPC Witness Rothschild's application of the DCF method. For example, PEPCO argues that Rothschild's dividend yield calculation multiplied the spot dividend yield by one plus half the expected growth rate, whereas the correct factor is one plus the growth rate.[95] PEPCO also argues that Rothschild ignored the fact that dividends are paid quarterly rather than annually;[96] that he erroneously ignored flotation costs associated with continuous external stock issuances;[97] and that he used incorrect return on equity forecasts based on end-of-period equity rather than average book equity.[98] Morin states that, although Rothschild offered a CAPM analysis as a "check" on his DCF cost of equity estimate, Rothschild's application of the CAPM is flawed principally due to his use of the geometric mean rather than the arithmetic mean of historic returns to estimate the market risk premium.[99] Morin explains that the arithmetic mean reflects volatility, whereas the geometric mean ignores volatility,

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88 *Id.* at 7:1-9:21.

89 *Id.* at 10:4-9; WMATA (A)-2.

90 *Id.* at 10:6-9.

91 PEPCO Br. at 11-12.

92 PEPCO (3B) at 13:2-14:5 (Morin Rebuttal); PEPCO Br. at 12.

93 PEPCO (3B) at 22:20-25.5 (Morin Rebuttal).

94 Tr. at 496:12-497:2, 498:10-14 (Rothschild Cross); Formal Case No. 905, Order No. 9868 (October 23, 1991), 12 D.C.P.S.C. 651, 673; PEPCO Br. at 13.

95 PEPCO (3B) at 16:11-17:19 (Morin Rebuttal).

96 *Id.* at 17:22-18:21.

97 *Id.* at 19:3-21:12.

98 *Id.* at 27:22-28:22.

99 *Id.* at 44:15-54:12; PEPCO (3B)-1.

and therefore it is more appropriate to use the arithmetic mean to estimate the market risk premium for investors, who typically require a higher expected return from a company whose earnings are volatile than from one with stable earnings.[100]

31. Morin states that Oliver's analysis likewise is flawed because Oliver's cost of equity recommendation is unreasonably low, as Oliver relies exclusively on the DCF approach. According to Morin, the application of the standard DCF model to utility stocks understates the investor's expected return when the market-to-book ratio exceeds unity, as is currently the case for utility stocks. Morin further contends that Oliver's 9.3 percent recommended return is well outside the zone of currently allowed rates of return for Oliver's two sample groups of companies (*i.e.*, 10.79 percent and 11.16 percent, respectively).[101] In addition, Morin takes issue with Oliver's reliance on the S&P Business Risk Scores because, he contends, they measure only business risk, not total investment risk. He states that "[s]ome electric utilities with high (low) business risk have lower (higher) financial risk." Others face higher regulatory risk, warranting a "thicker" common equity ratio.[102]

DECISION

32. In its decisions, the Commission has relied primarily on the DCF method to determine a utility's appropriate cost of common equity because the Commission consistently has found that the DCF method produces results more reasonable than those of other calculation methods.[103] Nevertheless, the Commission's preference for the DCF model does not preclude consideration of other methods for calculating cost of equity in some instances. In fact, in PEPCO's last rate case, the Commission clarified that its reliance on the DCF method did not foreclose the parties from advocating the use of other methods in future rate proceedings.[104] 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.[105]

33. In the present case, the Commission continues to favor the DCF model because it most reliably focuses the analysis on comparable companies or proxy groups. However, the

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[100] PEPCO (3B) at 46:21-48:13 (Morin Rebuttal), including an appendix, PEPCO (3B)-1, purporting to be a detailed explanation of the advantages of the arithmetic mean over the geometric mean for purposes of estimating a utility's cost of equity, as distinguished from its historical performance.

[101] *Id.* at 73:19-85:14.

[102] *Id.* at 89:16-90:11.

[103] *See, e.g.*, Formal Case No. 939, Order No. 10646 at 38 and n.16 (June 30, 1995) (citing Formal Case Nos. 929, 912, 905, 889, and 869); Formal Case No. 929, Order No. 10387 at 38-41 (July 26, 1992); 150 P.U.R. 4th 528, 1994 WL 109204, at 29-30; Formal Case No. 912, Order No. 10044 (June 26, 1992), 13 D.C.P.S.C. 512, 544 (June 26, 1992).

[104] Formal Case No. 939, Order No. 10646 at 38, rel. June 30, 1995.

[105] *E.g.*, Formal Case No. 1016, Order No. 12986, ¶¶ 57-64, 229 P.U.R.4th 177, (Nov. 10, 2003) (the Commission also considered other record evidence when determining whether adjustments to DCF calculations should be made); *D.C. Telephone Answering Service Committee v. Public Service Commission*, 476 A.2d 1113, 1124 (D.C. 1984) ("the law required only that the approved rate fall within a 'zone of reasonableness'").

Commission has concerns about some of the DCF results reached by the parties. As further discussed below, PEPCO's DCF results (9.2 percent to 10.6 percent, without flotation costs)[106] are flawed because PEPCO used proxy groups with risk profiles not comparable to that of PEPCO's distribution operations. Similarly, the DCF results (also without flotation costs) reached by OPC (8.95 percent to 9.16 percent)[107] and AOBA (8.94 percent to 9.13 percent)[108] are also unreliable because they are substantially lower than recently allowed returns of utilities.[109]

34. For its DCF analysis, PEPCO relies on proxy groups that include electric distribution companies' corporate parents.[110] The Commission agrees with AOBA Witness Oliver and others that such companies have more business risk from their generation and unregulated businesses than PEPCO has from its distribution operations.[111] PEPCO's argument that some electric utility holding companies with high business risk have lower financial risk is not adequately supported by the record. In addition, PEPCO has made no showing that the total investment risk for Witness Morin's proxy group of electric companies is comparable to that of PEPCO's distribution operations. The Commission concludes that PEPCO's ROE results for the electric proxy group overstate PEPCO's required return on its distribution operations due to the inclusion of companies that have risk profiles different from that of PEPCO.

35. OPC Witness Rothschild's primary DCF results, 8.95 percent and 9.16 percent, essentially are based on Dr. Morin's electric proxy group, which Mr. Rothschild criticizes as producing overstated results. In his alternative proxy group sensitivity analysis, Mr. Rothschild excludes companies from the electric group that have substantial unregulated generation.[112] OPC's alternative costs of common equity are approximately 8.5 percent and 8.9 percent, and are based on an admittedly small group of electric distribution companies.[113] The usefulness of Witness Rothchild's DCF approach has been questioned previously by the Commission,[114] and we believe that the results it produces in this proceeding are below a reasonable level. In particular, the record in this proceeding establishes that, in 2005-2006, allowed returns for electric and gas companies averaged 10.32 percent.[115]

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106 PEPCO (B) at 79:11-82:17 (Morin Direct).

107 OPC (B) at 28:2-5 (Rothschild Direct).

108 AOBA (A)-2 at 1.

109 WMATA (A) at 10:4-9 (Foster Direct); WMATA (A)-2 (indicating 10.32 percent average return of 27 utilities in 2005-2006). The Commission considers recently allowed returns more relevant than existing returns, which may have been allowed years ago.

110 PEPCO (B) at 81:1-82:1 (Morin Direct); PEPCO (B)-1 at 1-2.

111 AOBA at 41:10-46:11 (Oliver Direct); WMATA (A) at 7:1- 9:21 (Foster Direct).

112 OPC (B) at 25:14-26:10, 49:16-50:21 (Rothschild Direct).

113 OPC (B) at 28:12-22, 49:17-50:9 (Rothschild Direct).

114 Formal Case No. 905, Order No. 9868 at 25 (October 23, 1991); Formal Case No. 850, Order No. 9927 at 31 (January 27, 1992) cited at Tr. 488: 5-17.

115 *Id.* We note, however , that no weight has been given to the allowed returns presented by Dr. Morin in his rebuttal testimony at page 14, because the dates these returns were allowed were not provided.

36. AOBA's analysis yields DCF estimates of 8.94 to 9.13 percent, without flotation costs.[116] The Commission notes that, as is the case with OPC, AOBA's results are significantly lower than recently allowed returns on common equity of other companies.[117]

37. Given the wide variance of DCF results proposed by PEPCO and the other parties, the Commission finds that, while substantial weight should be given to the DCF method, exclusive reliance on that method would not be appropriate. Accordingly, the Commission will give weight to the alternate approaches presented in this proceeding.

38. PEPCO has submitted three interest premium studies that produce an estimated ROE of approximately 10.9 percent.[118] The first is a historical study based on Moody's Electric Utility Index for 1932 to 2001; the second, a historical study based on Moody's Gas Utility Index for 1955 to 2001; and the third is based on the difference between allowed returns on equity (*i.e.*, those allowed by regulators) for electric utility companies and long-term Treasury yields over the period 1997 to 2006. The specific results of PEPCO Witness Morin's interest premium studies are as follows:

Moody's Electrics –	10.85%
Moody's Natural Gas Companies –	10.95%
Allowed Returns –	10.90%

39. AOBA Witness Oliver criticizes PEPCO Witness Morin's risk premium analyses for (1) failing to differentiate between the risk of electric distribution utilities and other electric companies that often have substantial investment in generation assets and face greater risk;[119] (2) exhibiting wide dispersion of results for the electric and gas groups, as the standard deviations associated with the annual equity risk premium estimates are roughly three times the magnitude of the computed average equity risk premium for both gas and electric utility stocks;[120] and (3) failing to take into account significant downward trends in risk premiums.[121] Oliver recalculated Morin's risk premium results for his electric and gas groups for the most recent thirty-year period for which data were provided, with the following results:

> Moody's Electrics – 10.2% without flotation costs (10.5% with flotation costs)
> Moody's Natural Gas Companies – 9.75% without flotation costs (10.03% with flotation costs)[122]

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116 AOBA (A)-2 at 1.

117 No party disputed WMATA's statement that the average allowed return of 27 electric utilities during 2005-2006 was 10.32 percent. WMATA (A)-2.

118 PEPCO (B) at 59:18-60:11 (Morin Direct).

119 AOBA (A) at 53:6-14, 57:6-11 (Oliver Direct).

120 *Id.* at 55:3-8.

121 *Id.* at 55:11-18; AOBA (A)-3.

122 *Id.* at 55:11-57:4.

40. CAPM studies were submitted by PEPCO, OPC, and AOBA. The results of these studies, without flotation costs, are as follows:

PEPCO	– 11.4% (ECAPM – 11.7%)[123]
OPC	– 9.14%[124]
AOBA	– 8.20%[125]

41. The primary difference between PEPCO's and OPC's CAPM results is related to the debate over whether historical risk premiums should be measured in terms of geometric or arithmetic averages, when it is not clear that investors rely exclusively on either. This factor alone can make a substantial difference in the cost of equity, as much as 180 basis points according to PEPCO,[126] or 200 basis points according to OPC.[127] AOBA's CAPM calculation produces an ROE that the Commission considers outside the range of reasonableness because it is substantially lower than other results and industry benchmarks.[128]

42. Based on the record in this proceeding, the Commission finds that the cost of common equity for PEPCO's distribution operations, assuming no BSA adjustment, is within a range of reasonableness of 9.75 percent to 10.25 percent. The Commission sets the cost of common equity, with no BSA adjustment, at 10.00 percent. This determination is generally supported by the DCF results at the lower end, and by the Interest Premium results at the upper end. The record evidence on the 10.32 percent average of recently allowed returns for electric and gas utilities[129] also suggests that this is a reasonable result, given that the return established here is for PEPCO's distribution operations. The cost of common equity does not include any flotation cost adjustment, as PEPCO has not indicated that flotation costs were incurred during the test year,[130] and such costs traditionally have been treated as an expense in the District of Columbia.[131]

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123 PEPCO (B) at 51:23-54:16 (Morin Direct).

124 OPC (B) at 37:17-18 (Rothschild Direct).

125 AOBA (A) at 60:6-9 (Oliver Direct).

126 PEPCO (3B) at 6:1-13 (Morin Rebuttal).

127 OPC Br. at 64.

128 Formal Case No. 989, *Washington Gas Light Co.*, Order No. 12589 at ¶ 61-62 (Oct. 29, 2002), (Commission gave little weight to two risk premium calculations that produced cost of equity found to be too high and too low, respectively).

129 WMATA (A) at 10:4-9 (Foster Direct); WMATA (A)-2.

130 OPC (D) at 4:1-8 (Gumer Direct).

131 Formal Case No. 889, Order No. 9509 at 47 (July 24, 1990), 11 D.C.P.S.C. 302, 326, 1990 WL 509797, at *47.

B. Cost of Debt[132]

43. **PEPCO.** The Company computes its weighted-average cost of long-term debt as 6.17 percent.[133] PEPCO Witness Morin states that the proposed cost of long-term debt is ascertained by examining Company-specific associated contractual interest payments. He asserts that the calculation methods he relies on are consistent with methods approved in PEPCO's previous rate of return filings in the District of Columbia.[134]

44. **OPC.** Witness Rothschild uses the 6.17 percent cost of long-term debt employed by PEPCO.[135] The cost of short-term debt used by Rothschild is PHI's commercial paper rate of 5.25 percent, as reported to the Securities and Exchange Commission ("SEC").[136]

DECISION

45. No party objects to PEPCO's use of its actual June 30, 2006, cost of long-term debt of 6.17 percent. The Commission finds this long-term debt rate reasonable and accordingly accepts it. There is no need to address the cost of short-term debt because, as discussed below, the Commission has decided to adopt a capital structure that excludes short-term debt.

C. Capital Structure[137]

46. **PEPCO.** Morin states that his overall rate of return recommendation is based on PEPCO's actual June 30, 2006 capital structure, with 53.45 percent long-term debt and 46.55 percent common equity.[138] Morin states that he considers this capital structure reasonable and appropriate because; (1) it is based on company-specific information; (2) the methods used to compute it are consistent with Commission precedent; and (3) the proposed common equity ratio is reasonable compared to the average common equity ratio of the electric distribution companies with parent companies in his Electric Group.[139]

47. **OPC.** Witness Rothschild bases his proposed capital structure for PEPCO on PHI's December 31, 2006 capital structure, which contains a smaller percentage of common equity than PEPCO's capital structure.[140] Rothschild reasons that, because PEPCO's risk is less than that

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132 Designated Issue No. 2.b asks: "Has PEPCO properly determined its cost of debt?"

133 PEPCO (B)-10 at 1-4.

134 PEPCO (2B) at 2:10-23 (Morin Supp. Direct).

135 OPC (B) at 13:3-7 (Rothschild Direct).

136 *Id.* at 13:6-7.

137 Designated Issue No. 2.c asks: "Is the capital structure that PEPCO uses to develop its overall cost of capital reasonable and appropriate?"

138 PEPCO (B) at 91:3-11 (Morin Direct); PEPCO (B)-10 at 1.

139 PEPCO (2B) at 3:4-20 (Morin Supp. Direct).

140 OPC (B)-1; OPC (B)-8.

of PHI,[141] PEPCO's common equity ratio should be no higher than PHI's common equity ratio.[142] He also asserts that "the only place within these companies that common equity is sold to the public is at the PEPCO Holdings level."[143] Rothschild claims that part of what PEPCO describes as common equity is actually debt because the combined level of equity of PHI's subsidiaries apparently exceeds that of PHI itself.[144] The capital structure Rothschild calculated for PHI includes short-term debt and excludes securitization debt issued by PHI's Atlantic City Electric subsidiary, which, according to Rothschild, does not "behave" as debt.[145] In its brief, OPC argues that the capital structure should be adjusted to weight long-term debt more heavily, as it is weighted in PHI's consolidated capital structure.[146] Alternatively, according to OPC, if PEPCO's recommended capital structure is adopted, then, absent the BSA, the equity return allowance should be reduced to 9.10 percent, and the return on total capital should be 7.23 percent.[147] OPC's alternative adjustment seeks to reduce PEPCO's return on common equity based on a claim that there is a 4 basis point change in the cost of equity for each 1 percent move from the 42.06 percent common equity ratio proposed by OPC to PEPCO's 46.55 percent reported equity ratio. In particular, OPC claims the 4.5 percent difference between 42.06 percent and 46.55 percent warrants a 15 basis point decrease in the equity return allowance.[148]

48. **PEPCO Rebuttal.** PEPCO argues that OPC Witness Rothschild conceded during the hearings that he had misread the Company's financial statements, which according to PEPCO show no disparity between the amount of equity reported by the subsidiaries and the parent company.[149] According to PEPCO, in attempting to compute total subsidiary equity, Rothschild mistakenly added columns showing subsidiary equity to a column that already included those sums, resulting in double-counting.[150]

49. Morin states that Rothschild's recommended capital structure, with a common equity ratio of 42.06 (including short-term debt) to 43.85 percent (excluding short-term debt), reflects common equity ratios far below those found to be reasonable in recent regulatory decisions.[151] Morin also asserts that Rothschild's recommended use of PHI's capital structure rather than PEPCO's ignores the fact that the former includes debt obligations exceeding one billion dollars of affiliates such as Atlantic City Electric and Delmarva Power and Light.[152] Morin further argues

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141 OPC (B) at 11:11-17 (Rothschild Direct).

142 *Id.* at 11:1-10.

143 *Id.* at 8:18-22.

144 *Id.* at 9:16-10:13.

145 *Id.* at 11:18-12:5.

146 OPC Br. at 12-13.

147 *Id.*

148 OPC R. Br. at 71.

149 Tr. at 546:14-549:1; OPC (B)-8; PEPCO Br. at 18.

150 Tr. at 549:2-18; PEPCO Br. at 18-19.

151 PEPCO (3B) at 66:13-67:12 (Morin Rebuttal); PEPCO Br. at 19.

152 PEPCO (3B) at 67:20-24, 68:6-8 (Morin Rebuttal); PEPCO Br. at 19.

that the appropriate capital structure concerns the use of funds, not their sources. He explains that the capital structure is dictated by investment risk, not by mode of financing. He concludes that there is no merit to OPC's use of PHI's capital structure in this rate case.[153] He points out that PEPCO's capital structure is similar to that of other electric utilities. In support, he cites a Regulatory Research Associates January 30, 2007 Regulatory Focus report showing that the average common equity ratio authorized during the entire year of 2006 was 48.67 percent. In addition, Morin observes that the same report states that the average common equity ratio authorized during the fourth quarter of 2006 was 50.59 percent. Accordingly, Morin asserts that PEPCO's proposed common equity ratio of 46.55 percent is more in line with other recent electricity decisions than OPC's proposed common equity ratio of 42.06 percent.[154]

DECISION

50. The Commission adopts PEPCO's proposed capital structure to calculate the overall return in this proceeding. We note, in particular, that the proposed common equity ratio is similar to that approved by the Commission in Formal Case No. 939.[155] We also agree with the Company that PEPCO's proposed capital structure is generally in line with those of other electric utilities.

51. The Commission finds unpersuasive OPC's argument that, since PEPCO's distribution business is less risky than the overall operations of PHI, the equity ratio of PHI should be used to calculate PEPCO's ROE. OPC fails to substantiate its claim that PEPCO's equity ratio is unreliable or otherwise inappropriate for purposes of this proceeding. Witness Rothschild conceded at the hearing that he committed a computation error when he initially indicated that some of what appears as equity in PEPCO's books was in fact financed with debt.[156] While OPC's post-hearing brief alludes to the potential for a parent company's manipulation of its subsidiary's capital structure, as described in a *Chesapeake and Potomac Telephone Co.* ("C&P") case,[157] OPC fails to offer any evidence of such manipulation between PHI and PEPCO. OPC points to the difference (which it describes as a "discrepancy") between the parent-level and PEPCO-level equity ratios, but OPC has not established that this difference was due to improper manipulation by PHI. For example, OPC's post-hearing brief and reply brief do not cite any testimony affirmatively accusing PHI of manipulating PEPCO's capital structure. Thus, unlike the C&P case in which "the evidence show[ed] that such manipulation exists,"[158] the Commission finds that OPC has not provided evidence of manipulation between PHI and PEPCO.

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153 PEPCO (3B) at 64:19-65:5 (Morin Rebuttal).

154 *Id.* at 67:4-12.

155 Formal Case No 939, Order No. 10646 at 15 (June 30, 1995).

156 Tr. at 534:21-542:3.

157 OPC Br. at 69-70 citing Formal Case No. 850, *Chesapeake and Potomac Telephone Co*, Order No. 9927, 13 D.C.P.S.C. 67, 79 (Jan. 27, 1992).

158 Formal case No. 850, Order No. 9927 (Jan. 27, 1992), 13 D.C.P.S.C. 67 at 79.

52. The Commission is not persuaded by OPC's alternative proposal to reduce PEPCO's return on common equity by 15 basis points based on OPC's further claim that there should be a 4 basis point change in the cost of equity for each 1 percent difference between the 42.06 percent equity ratio proposed by OPC and the 46.55 percent equity ratio reported by PEPCO.[159] OPC failed to explain and support its basis for reducing PEPCO's ROE based on the capital structure of its parent, PHI. The Commission, therefore, rejects both of OPC's capital structure alternatives.

D. BSA Adjustments[160]

53. **PEPCO** Witness Morin states that the reduced risk from the BSA warrants a downward adjustment of PEPCO's rate of return on common equity by no more than 25 basis points.[161] **OPC** Witness Rothschild states that, if the BSA is adopted, PEPCO's authorized rate of return should be reduced by 374 basis points because the BSA will virtually eliminate all non-diversifiable risk.[162] **AOBA** Witness Oliver states that PEPCO's ROE should be adjusted downward by at least 50 basis points if the BSA is adopted.[163] **WMATA** states that it recognizes that the BSA may have certain advantages to the Company and the ratepayer, such as reducing risk by guaranteeing that revenue requirements are met. WMATA believes this reduced risk must be reflected in an appropriate 50 basis point reduction in PEPCO's cost of equity capital.[164]

DECISION

54. As discussed under Issue No. 13, the Commission agrees in principle with the BSA concept. This assumes (without deciding) that the BSA can be implemented under D.C. law, an issue that we have asked the parties to address in Phase II of this proceeding. The basis for our decision establishing a Phase II proceeding on the BSA is more fully explained in Section XIII, below.

E. Other Risk Adjustment Factors[165]

55. **PEPCO.** Witness Morin states that no other adjustments to PEPCO's equity cost rate are required. He explains that the risks faced by PEPCO (*i.e.*, interest rate, business,

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159 OPC R. Br. at 71.

160 Designated Issue No. 2.d asks: "Should PEPCO's authorized rate of return on common equity be adjusted downward to reflect reduced risk resulting from the Company's proposed implementation of a Bill Stabilization Adjustment and, if so, by how many basis points?"

161 Tr. at 149:10-151:19; PEPCO (2B) at 4:13-5:13 (Morin Supp. Direct); PEPCO Br. at 20.

162 OPC (B) at 41:16-49:14 (Rothschild Direct); OPC Br. at 65.

163 AOBA at 64:1-14 (Oliver Direct).

164 WMATA Br. at 6.

165 Designated Issue No. 2.e asks: "Are there other factors, besides the Bill Stabilization Adjustment, that would reduce or increase risk to PEPCO? If so, what adjustment, if any, should be made to PEPCO's rate of return on common equity to account for the increased or reduced risk?"

regulatory, financial, and construction risks) in operating its electric distribution system in the District of Columbia reasonably approximate the risks faced by the operating distribution utilities whose parent companies are included in his proxy groups.[166]

56. **OPC.** OPC argues that, if PEPCO's proposed capital structure is adopted, capital obtained as debt will earn an equity return, which will reduce risk. OPC states that in this event the equity return allowance should be 9.10 percent without the proposed BSA, or 7.23 percent if the BSA is approved.[167]

57. **AOBA.** Witness Oliver states that PEPCO's provision of Standard Offer Service ("SOS") includes an administrative charge that compensates the Company for the risk of rendering such service. However, he does not recommend an adjustment to ROE based on the SOS charge; instead, he proposes that the margins PEPCO receives for providing SOS be recognized as additions to Other Revenue.[168] In addition, AOBA argues that, although it does not favor the approval of the Pension/OPEB Rider, if one is adopted, the approved ROE for PEPCO should be closer to the lower end of the range of options considered in this proceeding.[169]

DECISION

58. The Commission finds that no adjustment to the allowed return on equity is warranted. AOBA does not seek a reduction to PEPCO's ROE based on the SOS administrative charge. Further, as discussed below, the Commission does not adopt PEPCO's proposed Pension/OPEB Rider. The Commission, therefore, need not discuss such factors in connection with the issue of ROE reduction.

59. The Commission does not find as OPC suggests that PEPCO's ROE should be reduced by 15 basis points if PEPCO's capital structure is adopted. As the Commission notes in the discussion of Issue No. 2c, OPC fails to justify the use of PHI's capital structure instead of PEPCO's for purposes of determining the appropriate cost of capital for PEPCO. OPC also fails to adequately explain or support its alternative of a 15 basis point reduction in PEPCO's ROE based on the adoption of PEPCO's capital structure for ratemaking purposes.

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166 PEPCO (2B) at 5:14-6:9 (Morin Supp. Direct); PEPCO Br. at 23.

167 OPC Br. at 13:68-71.

168 AOBA (A) at 62:15-63:18 (Oliver Direct); AOBA R. Br. at 7-8.

169 AOBA R. Br. at 7.

OVERALL COST OF CAPITAL

60. Based on our findings, above, we determine that the following reflects a fair and reasonable overall cost of capital for PEPCO:

Capitalization	Ratio	Cost	Return
Long-term Debt	53.45%	6.17%	3.30%
Common Equity	46.55	10.00	4.66
	100.00%		7.96%

Such a return falls within the zone of reasonableness discussed above. It will allow PEPCO to maintain its financial integrity, attract capital on reasonable terms, and earn a return commensurate with those of other investments of corresponding risk. Finally, in order to be able to monitor PEPCO's earnings on an ongoing basis, the Commission directs the Company to file quarterly reports on its jurisdictional earnings on both a ratemaking (including weather normalization) and "per books" basis. These reports shall provide PEPCO's earnings on average total capital and earnings on average common equity for the year ending in the quarter of the filing. In addition, the capital structure used to calculate earnings on total capital shall be provided. The reports are to be filed with the Commission within 60 days following the end of each quarter. Along with each report, workpapers shall be provided.

III. RATE BASE
(Issue No. 3)[170]

61. **PEPCO.** Witness VonSteuben asserts that PEPCO's proposed 13-month average rate base is reasonable, properly computed, and conforms to the Commission's past ratemaking determinations.[171] PEPCO states that the Commission has indicated its preference for a 13-month average rate base in Formal Case No. 748[172] and in ensuing cases.[173] PEPCO also states that no parties have challenged its use of a 13-month average rate base, as distinguished from challenges to specific adjustments to the test year rate base.[174] The rate base originally proposed by PEPCO is $980,636,000.[175]

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170 Designated Issue No. 3 generally asks: "Has PEPCO properly computed its proposed rate base?" Issue No. 3 includes sub-issues that shall be discussed in sequence.

171 PEPCO (2C) at 2:7-15 (VonSteuben Supp. Direct); PEPCO (C) at 7:12-8:1 (VonSteuben Direct).

172 PEPCO Br. at 23, citing Order No. 7457, 2 D.C.P.S.C. 401, at 17 (1981).

173 *Id.* at 23 n.105.

174 *Id.* at 23-24, noting that the Company's proposed rate base includes "plant materials and operating supplies, net of related accounts payable." The rate base also includes the net average balance of the Company's prepaid

DECISION

62. The Commission approves PEPCO's use of a 13-month average rate base as being consistent with Commission precedent.[176] However, while no party has objected to the use of a 13-month average rate base, what is to be included in the rate base and the proper amounts thereof, have been challenged by OPC. We discuss and resolve those issues below.

A. Construction Work in Progress ("CWIP")[177]

63. **PEPCO.** The Company states that Ratemaking Adjustment ("RMA") No. 23 ("Inclusion of Projects Completed and In Service")[178] seeks to include in rate base the average balance on several District of Columbia distribution projects totaling \$16.923 million (\$16.617 million after depreciation and accumulated deferred income taxes) that the Company believes to be complete, in service, meeting customer needs, and meeting the known and measurable standard. Witnesses VonSteuben and Gausman explain that these projects have not been transferred from CWIP to Electric Plant In Service ("EPIS") in the financial records of the Company because they are either (1) projects awaiting final accounting treatment to EPIS, or (2) projects for which PEPCO is holding open the project work orders to allow sufficient time for all project costs to be properly recorded.[179]

64. **OPC.** Witness Bright asserts that all the items in RMA No. 23 should be reversed because they are not analogous to situations in which the Commission has allowed the rate base to include projects in service before the end of the test year, but not recorded as test year plant in service due to bookkeeping delays. Bright claims the CWIP amounts in PEPCO's workpapers are not related to the specific projects identified by PEPCO Witness Gausman in PEPCO (E)-5, but

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pension asset/OPEB liability net of associated accumulated deferred income taxes (PEPCO (C) at 7:19-8:1) (VonSteuben Direct).

175 PEPCO (C) -1, page 1.

176 See, for e.g., Formal Case No. 939, *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. 10646 at 54 (June 30, 1995).

177 Designated Issue No. 3.a asks: "Is the Construction Work in Progress PEPCO has included in rate base reasonable and consistent with Commission precedent?"

178 PEPCO (C)-1 at 26.

179 PEPCO (C) at 22:23-23:19 (VonSteuben Direct); PEPCO (E) at 2:13-23, 27:17-28:7, 29:1-13 (Gausman Direct); PEPCO Br. at 25. Witness Gausman states that projects under the second category are termed "buffer" projects, which are allowed to accumulate any late or delayed direct charges and invoices. PEPCO (E) at 29:1-13 (Gausman Direct). Witness VonSteuben states that the buffer period also involves accounting controls, many of which relate to compliance with Sarbanes-Oxley requirements. Tr. at 174:8 to 175:3; PEPCO Br. at 25-26.

instead represent amounts actually in CWIP and accruing an Allowance for Funds Used During Construction ("AFUDC").[180]

65. Bright recommends that the Commission disallow the inclusion of the $16,617,000 of CWIP in rate base[181] because: (1) allowing CWIP in rate base does not follow the relevant precedent (such as Formal Case No. 1016);[182] (2) allowing this balance in the rate base would mean simultaneously earning a current return on CWIP and earning AFUDC[183] because projects earn AFUDC before their inclusion in plant in service; and (3) allowing the CWIP in RMA No. 23 in rate base is a "slippery slope"[184] to the extent that CWIP is included in rate base, but the revenues generated by the CWIP are excluded and thus the matching of revenues and costs may be distorted and could result in an unfairly high rate of return on assets serving customers.[185]

66. **PEPCO Rebuttal.** Witness VonSteuben asserts that, contrary to Bright's claims, there is a direct correlation between the specific projects listed on PEPCO (E)-5 and the CWIP balances in RMA No. 23. VonSteuben further points out that the projects listed under RMA No. 23 either were never or are no longer eligible to accrue AFUDC based on PEPCO's policy. He concludes that RMA No. 23 appropriately affords PEPCO an opportunity to earn a return on assets currently serving customers in a manner analogous to the treatment the Commission approved for Washington Gas Light in Formal Case No. 1016.[186]

67. VonSteuben further states that PEPCO's response to Staff Data Request No. 2-28 outlined its policy providing that AFUDC does not accrue on (1) work completed and in service but waiting for "unitization" to the Company's plant records and (2) routine projects of short duration.[187] He adds that OPC's data requests did not ask if the construction projects reflected in RMA No. 23 were now accruing, or had ever accrued, AFUDC.[188] At the hearing, Bright conceded that, given VonSteuben's description of the items in RMA No. 23, they would not accrue AFUDC.[189]

DECISION

68. Under Commission precedent, the rate base of a utility can properly include the cost of a construction project that is in service during the test period and, in appropriate

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180 OPC (C) at 10:3-20 (Bright Direct); PEPCO Br. at 27.

181 OPC (C) 12:14-15 (Bright Direct).

182 *Id.* at 11:1-11.

183 *Id.* at 11:26-12:6.

184 *Id.* at 11:18-12:12.

185 *Id.* at 12:9-12.

186 PEPCO (3C) at 4:14-7:3 (VonSteuben Rebuttal); PEPCO Br. at 28-29.

187 PEPCO (3C) at 5:21-6:12 (VonSteuben Rebuttal).

188 *Id.* at 6:9-12.

189 Tr. at 628:3-629:9.

circumstances, a project completed outside the test period, as long as its in-service date is not too remote in time from the test period.[190] In this case, the evidence reflects that the projects covered by RMA No. 23 were complete and in-service during the test year and were not included in the Company's EPIS records because they were awaiting either final accounting treatment to EPIS or the proper recording of all project costs.[191] In other words, the projects were not merely being constructed, but rather were already in service and meeting customer needs during the test year.[192]

69. In such circumstances, allowing the proposed adjustments to the rate base is consistent with our ruling in Formal Case No. 1016, where we stated that "it is reasonable to allow the costs of construction projects to be included in rate base when projects are in fact placed in service before the end of the test year, but are not recorded as being test year plant in service because of delays in bookkeeping."[193] OPC's claim that RMA No. 23 is unrelated to the projects for which the Company seeks rate base treatment (as listed in PEPCO (E)-5), but instead pertains to CWIP items accruing AFUDC,[194] has been refuted by PEPCO. Witness VonSteuben has demonstrated to our satisfaction that there is a direct correlation between RMA No. 23 and the projects listed in PEPCO (E)-5[195] and that the project balances in RMA No. 23 are not eligible to accrue AFUDC under PEPCO's policy concerning work awaiting "unitization" to plant records and certain short-duration projects.[196] Bright conceded at the hearing that, based on VonSteuben's description of the items in RMA No. 23, such items would not accrue AFUDC.[197]

70. The Commission also does not share OPC's concern resulting from PEPCO's use of an average level of CWIP costs. An averaging convention is used to smooth out variability in the spending pattern of the dollars from month to month, and is typical in most rate base determinations.[198] The Commission observes that the Company's spending during the nine months used to arrive at the Company's proposal varied from $12.5 million to $23.8 million. The proposed averaging method smoothes out the variation. Accordingly, the Commission allows RMA No. 23 to

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190 Formal Case No. 870, Order No. 9146, 9 D.C.P.S.C. 452, 483-85, 500 (1988); Formal Case No. 905, Order No. 9868, 12 D.C.P.S.C. 651, 682-83 (1991); *see also*, Formal Case No. 912, Order No. 10044, 13 D.C.P.S.C. 512, 569 (1992).

191 PEPCO (C) at 22:23-23:19 (VonSteuben Direct); PEPCO (E) at 2:13-23, 27:17-28:7, 29:1-13 (Gausman Direct); PEPCO Br. at 25; Tr. at 174:8-175:3; PEPCO Br. at 25-26.

192 PEPCO (E)-5; PEPCO (3C) at 4:14-7:3 (VonSteuben Rebuttal); PEPCO (E) at 27:17-30:10 (Gausman Direct).

193 Formal Case No. 1016, Order No. 12986 at ¶ 187 (Nov. 10, 2003), 229 P.U.R. 4th 177 at ¶ 187.

194 OPC (C) at 10:3-20 (Bright Direct); PEPCO Br. at 27.

195 PEPCO (3C) at 4:14-7:3 (VonSteuben Rebuttal); PEPCO Br. at 28-29.

196 PEPCO (3C) at 5:18-6:9 (VonSteuben Rebuttal).

197 Tr. at 628:3-629:9.

198 Formal Case No. 929, Order No. 10387 (Mar. 4, 1994), 150 P.U.R. 4th, 1994 WL 109204 at *69; Formal Case No. 912, Order No. 10044 (June 26, 1992), 13 D.C.P.S.C. 512, 583.

increase the rate base by $16,923,000, with the corresponding adjustment to depreciation increasing the pre-tax Operating and Maintenance ("O&M") expenses by $443,000.[199]

B. Northeast Substation Project's Prudence[200]

71. **PEPCO.** Witness Gausman states that because the Northeast Substation is necessary to maintain reliability, it is appropriate to include its cost (*i.e.*, $51.9 million comprising the District's portion of $73.7 million of "planned expenditures" for the Northeast Substation) in the rate base.[201] Gausman asserts that the Commission should allow costs of the Northeast Substation to be included in rate base because the Commission has in the past allowed rate base treatment for construction projects that would be in service at the time the rates adjudicated are in effect.[202] He states that the Substation and network system will be placed in service, and serving customers, before the beginning of the rate effective period.[203] At the hearing, Gausman also indicated that, although the Northeast Substation was not yet in service, it was "undergoing testing", and was "making very good progress" towards an August 2007 start.[204] Subsequent to the hearing, PEPCO notified the Commission that the substation was energized on August 22, 2007 and began serving customers on August 25, 2007.[205]

72. Witness Gausman explains that PEPCO's N-1 design criteria have been used by the Company in the District for 50 years, and are typical among electric utilities.[206] Under the N-1 criteria, a network feeder system is designed in such a way that the loss of a single network feeder will not result in the loss of load and force a customer outage.[207] To maintain this level of reliability, PEPCO employs three types of solutions: (1) transferring load; (2) installing new substation transformers; and (3) constructing a new substation, the latter being the last resort.[208] PEPCO's system planning process was instrumental in determining the need and location for the new Substation in order to effectively meet future loads that could not be served reliably by the existing substations.

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199 PEPCO (C)-1 at 26:3.66.

200 Designated Issue No. 3.b asks: "Is the cost of $94 million for the Northeast substation project prudent? Is the assignment of $73.7 million to PEPCO's rate base reasonable? Is the allocation of $51.9 million of the $73.7 to the District reasonable?"

201 PEPCO (E) at 5:6-15 (Gausman Direct); PEPCO (C)-3 at 25.

202 *Id.* at 26:21-28:7.

203 *Id.* at 26:21-27:6.

204 Tr. at 1200:18-1201:13; PEPCO Br. at 30.

205 Tr. at 1201:2-5. On August 28, 2007, PEPCO made a filing to indicate that the Substation was energized on August 22, 2007 and started serving customers on August 25, 2007. Since this filing was made pursuant to the Commission's request, the Commission will *sua sponte* reopen the record to include this filing.

206 PEPCO (E) at 10:1-11:22 (Gausman Direct).

207 *Id.* at 10:4-15.

208 *Id.* at 5:32-7:20;12:9-14:3.

73. Witness Gausman supports the prudence of the Northeast Substation's total projected $94 million construction cost. He identifies the major activities and undertakings that had to be accomplished for the Northeast Substation to adequately meet its design requirements[209] and provides the timeline for the overall project, including site selection, site work, and substation and network construction milestones.[210] He also presents drawings and illustrations of the Northeast Substation and equipment[211] and describes the configuration of the substation and network feeder systems in terms of voltage levels, conductor and conduit sizing, and right-of-way lengths for the feeder and distribution cables.[212] He outlines the annual estimated costs of the components of the Northeast Substation over the period 2003 through 2008, and arrives at a total cost of $93,875,000 or $94 million.[213] Gausman states that the project was awarded through a competitive bid process and provides information on the engineering and construction firms, which include a number of minority contractors that worked on the Substation.[214] He testifies that the work was successfully and professionally completed.[215] Gausman identifies the permits granted for construction of the project[216] and points out that, while it was not necessary to obtain a Certificate of Public Convenience and Necessity from the Commission, the Company kept the Commission informed of the Substation plans.[217] He also states that a design revision by PEPCO involving the duct bank route from Benning Substation to the Northeast Substation saved some $15 million to $20 million in total project costs.[218] In addition, Gausman claims that, because PEPCO undertook the project when it did, conflicts were avoided with the District's Benning Road and H Street redevelopment program.[219]

74. In light of the foregoing, Gausman states that the Northeast Substation's $94 million cost is reasonable. He further states that the $51.9 million that was assigned to PEPCO's District rate base represents only the costs of the Northeast Substation that will be in service and useful to customers of the District of Columbia slightly prior to the beginning of the rate effective period.[220] This includes the cost of the Substation and equipment, subtransmission system, and a portion of the feeder system and land.[221] PEPCO's Witness Browning further explains that this

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209 *Id.* at 18, Table 2.

210 PEPCO (E)-2.

211 PEPCO (E)-3.

212 PEPCO (E) at 20:15-23:15 (Gausman Direct).

213 *Id.* at 24, Tables 4 and 5.

214 PEPCO (2E) at 9, Table 7 (Gausman Supp. Direct).

215 *Id.* at 8:1-9:8.

216 *Id.* at 10, Table 8.

217 PEPCO (2E) at 10:9-11:7 (Gausman Supp. Direct). *See* Section 2.2 of PEPCO's 2004, 2005 and 2006 Annual Consolidated Reports.

218 *Id.* at 12:22-13:9.

219 *Id.* at 13:10-14:2.

220 PEPCO (E) at 4:20-5:22, 17:15-23:15 (Gausman Direct); PEPCO (2E) at 2:10-14:2 (Gausman Supp. Direct); PEPCO (2E)-1; PEPCO (E) at 5:6-20 (Gausman Direct); Tr. at 1200:18 to 1201:1; PEPCO Br. at 29-30.

221 PEPCO (E) at 17:15-19:7, 23:16-24:3 (Gausman Direct); PEPCO Br. at 30.

allocation of plant costs is consistent with Commission precedent allocating subtransmission costs to jurisdictions based on the Commission-approved Average and Excess Demand Non-Coincident Peak ("AED-NCP") allocation ratio, with the rest of the plant costs (*i.e.*, those not related to subtransmission) being allocated to District of Columbia customers served by the Substation.[222] Witness VonSteuben also avers that RMA No. 22, "Inclusion of Northeast Substation System", adjusted the rate base and operating expenses to include investment in the Northeast Substation project, and, if this adjustment is not adopted in this proceeding, then the rates authorized by the Commission will not fully reflect the costs that PEPCO will incur during the rate effective period.[223]

75. **OPC.** Witness Pavlovic acknowledges that there is no reasonable alternative to the Northeast Substation to maintain reliability and to meet load growth.[224] He also concedes that the Northeast Substation costs are reasonable.[225] However, based on Gausman's statement that the Northeast Substation increases PEPCO's ability to serve new load growth, Pavlovic argues that there will be new sales revenue of about $7 million associated with new load during the rate effective period. Pavlovic describes as a "distinction without a difference" Gausman's comparison between the transferring of loads to the Northeast Substation and the availability of capacity to serve new load because of the new substation.[226] His revenue to cost analysis purports to show that the rates of return requested by PEPCO, when applied to new load during the rate effective period, will enable PEPCO to recover the Northeast Substation costs.[227] In response to PEPCO's rebuttal argument (discussed below) that the Commission did not grant a sales adjustment for the Chalk Point Combustion Turbines in Formal Case No. 905, OPC argues that the Commission so ruled because those units were found to be peaking units, whereas the Northeast Substation is not a peaking facility.[228]

76. OPC Witness Jones claims that PEPCO has not adequately considered and remedied the environmental impact of the Substation.[229] Jones addresses the following three environmental issues: (1) the acquisition of the land; (2) the Substation's construction phase; and (3) the environmental impacts of the Substation's operation.[230] With regard to property acquisition, Jones believes PEPCO did not adequately address the environmental condition of the property before acquiring it.[231] Regarding construction, Jones notes that the Substation is nearing completion,

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222 PEPCO (2F) at 2:11-21 (Browning Supp. Direct); PEPCO Br. at 31 (citing Formal Case No. 929, Order No. 10387 (Mar. 4, 1994), 150 P.U.R. 4th 528, 1994 WL 109204 at *187-188; Formal Case No. 905, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651 at 758).

223 PEPCO (C) at 20:22-21:5 (VonSteuben Direct); PEPCO Br. at 31.

224 OPC (E) at 10:10-12 (Pavlovic Direct).

225 *Id.* at 10:12.

226 *Id.* at 7:17-8:15.

227 *Id.* at 8:16-10:1.

228 OPC R. Br. at 22-23.

229 OPC (J) at 2:21-22.

230 *Id.* at 2:23-26.

231 *Id.* at 2:26-27.

that construction permits were obtained from the appropriate District government agencies, and that "there is an assumption that the construction permit requirements were followed or, if not, DC inspectors required implementation of corrective actions prior to continuation of the construction activity."[232] Further, Jones claims the project's building permit expired on November 2, 2006, and that PEPCO has not supplied documentation showing that the permit was extended.[233] With regard to the operational phase, he states that the environmental issues relate to the effects of exposure to electromagnetic fields ("EMF") on pedestrians, bike path users, nearby residents, and workers.[234] Jones believes PEPCO has not adequately addressed the impact of claimed elevated EMF exposure, and refers to epidemiologic studies purporting to show that EMF exposure above certain levels may be a risk factor for childhood leukemia.[235] Jones acknowledges that he is "not an expert in this area of study" and that he was "only reporting what [he] had read in the EPRI [Electric Power Research Institute] literature."[236] Jones also questions whether PEPCO undertook sufficient investigations of soil and ground-water sampling and analyses, and fluid containment systems for electrical transformer and capacitor bank equipment.[237] He states that the adequacy of PEPCO's investigations is in doubt because the final report regarding this project is not complete.[238]

77. OPC Witness Bright argues that, because the Northeast Substation plant will not be in service until "nine months after the end of the projected test period" it should be excluded from rate base.[239] She claims that the Northeast Substation does not meet the "unique or compelling" circumstances standard under Commission case law for including CWIP in rate base.[240] Like Witness Pavlovic, Bright asserts that the Commission's allowance in rate base of the costs associated with the four Chalk Point Combustion Turbines (Formal Case No. 905) is not an applicable precedent for allowing the Northeast Substation costs in PEPCO's rate base.[241] Bright argues that the Chalk Point Combustion Turbines were generation facilities while the Northeast Substation facilities are not. Bright further claims that the exclusion of the Northeast Substation's revenues generated from new loads served will create a mismatch if costs are included.[242] Bright's proposed exclusion of the Northeast Substation investment from rate base, if accepted by the Commission, would reduce the revenue requirement by $6,911,217, assuming OPC's proposed 9.25 percent ROE.[243]

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[232] *Id.* at 2:28-3:2.

[233] *Id.* at 8:14-16.

[234] *Id.* at 3:2-7, 9:12 - 10:23.

[235] *Id.* at 3:4-5, 9:21-10:4.

[236] *Id.* at 10:4-5.

[237] *Id.* at 4: 9-23.

[238] *Id.* at 8:14-20.

[239] OPC (C) at 12:21-13:1 (Bright Direct).

[240] *Id.*at 12:19-13:32; OPC Br. at 85-97.

[241] *Id.* at 14:2-5.

[242] *Id.* at 14:8-19.

[243] *Id.* at 10:1-19; OPC (C)-3 at 1.

78. **PEPCO Rebuttal.** Witness Gausman states that there is "uncontradicted testimony in this case [that] demonstrates that PEPCO has acted prudently in its overall assessment of the need to install new electric distribution capacity in the District and has done so at the appropriate time and at a reasonable cost."[244] Accordingly, he argues that PEPCO should be allowed the "opportunity to begin recovering its reasonable and prudently incurred costs for this project," because it is necessary and appropriate to meet the reliability needs of customers in the District.[245] Furthermore, at the hearing, Gausman stated that the Northeast Substation was then energized, undergoing testing, and expected to be in-service in August 2007.[246]

79. Witness Gausman disputes Witness Pavlovic's arguments for denial of rate base treatment of the Northeast Substation.[247] Gausman explains that the Substation's costs are consistent with PEPCO's overall obligation to provide electric services to all of its customers in a reliable manner today and in the future.[248] He asserts that Pavlovic has "a fundamental misunderstanding of the manner in which new facilities are built and brought into service."[249] With respect to Pavlovic's (as well as OPC Witness Bright's) revenue-cost arguments against cost recovery, Gausman opines that such a view misunderstands an electric utility's obligation to reliably and cost-effectively plan, design, and construct its electric system.[250] He states that an electric company "does not incrementally expand its system just to meet each increase in customer demand."[251] According to Gausman, it would be imprudent, costly, and largely impossible to construct new facilities just in time to meet today's customer needs and that such an approach, even if achievable, would likely result in the loss of economies of scale and higher rates for customers.[252]

80. Witness Gausman also states that it has never been the Commission's practice to place a power plant in rate base gradually while the load growth was increasing over time. He explains that placing an entire facility in service at once is necessary so as not to lose the economies of scale and to serve long-term load growth. He believes the same is true for transmission and distribution plant and equipment.[253] Gausman asserts that Witness Pavlovic's acceptance of the need, prudence, and reasonableness of the Northeast Substation's costs is inconsistent with OPC's arguments in favor of a disallowance of the opportunity to recover the costs of the Northeast

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244 PEPCO (3E) at 2:23-3:4 (Gausman Rebuttal).

245 *Id.* at 3:8-14.

246 *Id.* at 3:17-4:15.

247 *Id.* at 4-6.

248 *Id.*

249 *Id.* at 5:1-3.

250 *Id.* at 5:14-9:20.

251 *Id.* at 5:19-20.

252 *Id.* at 5:23-6:1.

253 *Id.* at 6:2-13.

Substation at this time.[254] Under such circumstances, future customers would bear the totality of the costs while current customers would derive the benefits and not bear the costs.[255]

81. Witness Gausman argues that the Commission's decision regarding the Chalk Point Combustion Turbines in Formal Case No. 905 is relevant to this case.[256] His testimony includes a table that summarizes what he believes are the similarities between Formal Case No. 905 and PEPCO's request in this proceeding.[257] Gausman further argues that rate base treatment was given to the Chalk Point Combustion Turbines in Formal Case No. 905 because they were needed to provide a reasonable generating reserve to maintain reliability.[258] To Gausman the same rationale applies in the instant case because the Northeast Substation is aiding reliability by "increasing electric distribution capacity within the District."[259]

82. Witness Gausman also addresses OPC Witness Jones' claims regarding environmental impacts of the Northeast Substation. He responds that contrary to Jones' assertions, PEPCO performed complete and adequate due diligence before purchasing the Northeast site, and PEPCO is not seeking any future "unknown costs stemming from concealed or unknown site conditions."[260] Contrary to Witness Jones' claim that only draft reports about the project were available, Gausman points out that PEPCO did provide final reports on the project in PEPCO's updated response to OPC Data Request No. 4-155.[261] He states that the required reports, which Jones previously claimed were not filed, [262] were submitted prior to the issuance of the building permit. Gausman also argues that the Northeast Substation Building permit did not expire on November 2, 2006.[263] According to Gausman, there should be no question about PEPCO's ability to successfully operate the Northeast Substation, since it has successfully operated "more than 200 electric substations on the PEPCO system."[264] He states that EMF concerns have been adequately addressed by PEPCO, including the implementation of "various EMF mitigation strategies."[265] He adds that EMF and other environmental issues were examined by the District Office of Planning and other agencies, and PEPCO complied with all applicable standards.[266] Gausman similarly notes that

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254 *Id.* at 6:24-7:13.

255 *Id.* at 7:18-8:5.

256 *Id.* at 11:8-15.

257 *Id.* at 12.

258 *Id.* at 11:8-15.

259 *Id.* at 12:10-11.

260 *Id.* at 15:1-2.

261 *Id.* at 17:7-11 (with attached reports).

262 *Id.* at 15:6-11.

263 *Id.* at 13:23-24, 14:1-14.

264 *Id.* at 16:21-22.

265 *Id.* at 18:12.

266 *Id.* at 18:21-24.

community involvement was also a part of the review process.[267] He concludes that, because of the "uncontradicted need" for the Northeast Substation, and the District authorities' acceptance of PEPCO's environmental compliance efforts, the Commission should not give any weight to Jones' testimony.[268]

83. In response to OPC Witness Bright's request that the Commission exclude the costs of the Northeast Substation from rate base, Witness VonSteuben states that the inclusion of the Northeast Substation's costs in rate base is "entirely appropriate and in conformance" with Commission precedent regarding such facility additions in Formal Case Nos. 870, 905, and 912.[269] With regard to the Commission decisions cited by Bright in support of her exclusion recommendation, VonSteuben states that such decisions actually support PEPCO's position.[270] According to VonSteuben, the Commission's decisions on this subject originally allowed CWIP to be included in rate base in recognition of the need to support the construction of power plants.[271] He states that the Commission subsequently became concerned with issues of intergenerational equity to the extent that the inclusion of CWIP in rate base sometimes resulted in customers beginning to pay for power plants well before they were placed in service.[272] VonSteuben explains that the Commission modified its policy by allowing accrued interest on plant construction while postponing rate recovery until plants were placed in service.[273] He notes, however, that the Commission "has allowed current cost recovery before construction was completed" where issues of intergenerational equity were "insubstantial," as was the case with the Chalk Point and Station H Combustion Turbines.[274] VonSteuben argues that this is also the case with respect to the Northeast Substation, which he describes as "clearly needed for reliable service … within budget and nearly complete."[275]

84. Witness Browning addresses OPC Witness Pavlovic's claims about the revenues generated by the Northeast Substation project. Browning explains that the Commission has not made sales adjustments associated with new capacity placed in service. He further states that, if an adjustment were to be made, Pavlovic's sales adjustment "seriously overstates" revenues by a factor of about two.[276] Browning also states that Pavlovic has not considered "any additional expenses" due to the increase in load that Pavlovic claims generates the additional revenues.[277] PEPCO notes

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267 *Id.* at 19:17-20.

268 *Id.* at 19:23-20:4.

269 PEPCO (3C) at 7:4-12 (VonSteuben Rebuttal).

270 *Id.* at 7:19-20.

271 *Id.* at 7:21-8:2.

272 *Id.* at 8:2-7.

273 *Id.* at 8:8-12.

274 *Id.* at 8:12-19.

275 *Id.* at 8:19-9:4.

276 PEPCO (3F) at 8:3-9:12 (Browning Rebuttal).

277 *Id.* at 9:3-12.

in its brief that the Commission declined to make such a sales adjustment with regard to the Chalk Point combustion turbine in Formal Case No. 905.[278]

C. Reasonable Need for Northeast Substation Project[279]

85. PEPCO Witness Gausman describes the process that PEPCO used to determine the need for the Northeast Substation.[280] According to Gausman, the Northeast Substation was planned in accordance with PEPCO's N-1 design criteria for electrical reliability. He explains that before pursuing the Northeast Substation project, PEPCO first exhausted its options to transfer loads and to install additional transformers at existing substations.[281] He describes the Northeast Substation as a long-term solution to provide reliable electric service to the District.[282] Gausman adds that, from an environmental perspective, the Northeast Substation adds value to the District, blends in architecturally with the surrounding community, and provides no view of the electrical equipment within the Substation.[283] He notes that back-up station service is provided by batteries rather than by diesel generators and on-site storage of fuel oil.[284]

1. Reliability Level and Timing[285]

86. Witness Gausman states that the Northeast Substation project will provide electric capacity for existing load through the installation of the first two (of four) station transformers and the first two (of four) 69 kV supply circuits and the first three 13 kV network feeders.[286] PEPCO states that by transferring the existing load to the Northeast Substation, no substation service area is

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278 Formal Case No. 905, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651 at 683-84; PEPCO Br. at 35.

279 Designated Issue No. 3.c asks: "Has PEPCO demonstrated a reasonable need for the Northeast project?" In addition, Issue No. 3.c includes the following sub-issues:

> i. Are the level of reliability sought by PEPCO and the timing of the request for the new substation reasonable?
>
> ii. Has PEPCO adequately considered the functionality of the distribution plant and equipment facilities that it claims will be used and useful in the service of District customers?
>
> iii. Has PEPCO adequately considered alternatives to the construction of the Northeast Substation?
>
> iv. Has PEPCO adequately considered the environmental impact of the substation and provided adequate remedial actions for such impacts?

280 PEPCO (E) at 14:8 to 28:16 (Gausman Direct).

281 *Id.* at 10:4-11:20.

282 *Id.* at 11:7-12:8.

283 *Id.* at 19:9-20:12. Environmental compliance also involves aesthetic factors. *See e.g.*, the Code's definition of "Environment," which includes "aesthetic significance." D.C. Code, 2001 Ed. § 34-2602(2).

284 PEPCO (2E) at 27:16-20 (Gausman Supp. Direct).

285 Designated Issue No. 3.c.i asks: "Are the level of reliability sought by PEPCO and the timing of the request for the new substation reasonable?"

286 PEPCO Br. at 40.

projected to be operating above 100 percent of capacity in 2008 and the installation of the Northeast Substation project will allow PEPCO to continue to meet the N-1 design criteria and preserve a high level of reliability.[287] PEPCO points out in its brief that OPC Witness Pavlovic does not dispute that the Northeast Substation project is necessary and that its cost is reasonable.[288]

2. Functionality of Plant and Facilities[289]

87. PEPCO states that it has carefully considered the functions required of the Substation project. PEPCO also states that the Northeast Substation's design supports the N-1 design criteria and that the functionality of the Substation is enhanced by being fully enclosed and in harmony with its surroundings.[290]

3. Consideration of Alternatives[291]

88. Witness Gausman states that PEPCO adequately considered alternatives to constructing the Substation project. He explains that there are three ways PEPCO seeks to add electric capacity: (1) load transfer from existing stations; (2) installation of new transformers; and (3) addition of a new substation when other methods of economically providing capacity have failed.[292] Before installing the Northeast Substation, PEPCO pursued six alternative capacity measures: June 1992 - installation of a third transformer in Substation 10; June 1993 - load transfers through installation of underground network feeder cutovers; June 1995 - reconstruction of overhead lines to transfer load between two substations; June 2005 - underground network load transfers through installation of cutovers to transfer load between two other substations; June 2002 - reconstruction of overhead lines to transfer load between two substations; and June 2004 - installation of underground network feeders to transfer load between another pair of substations.[293] Between 2000 and 2003, however, the Company's annual system planning updates indicated that load transfers and transformer installation options would be fully used by 2007.[294] The Company also projected that, if there were no new substations in 2007, two existing substations and two network feeder groups would be overloaded, posing reliability risks.[295] The Company began

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287 PEPCO (E) at 8:17-9:15 (Gausman Direct); PEPCO (E-1); PEPCO Br. at 40.

288 OPC (E) at 10:10-12 (Pavlovic Direct); Tr. at 723:3-6; PEPCO Br. at 40-41.

289 Designated Issue No. 3.c.ii asks: "Has PEPCO adequately considered the functionality of the distribution plant and equipment facilities that it claims will be used and useful in the service of District customers?"

290 PEPCO (E) at 19:9-15 (Gausman Direct); PEPCO (2E) at 21:10-14 (Gausman Supp. Direct); PEPCO Br. at 41-42.

291 Designated Issue No. 3.c.iii asks: "Has PEPCO adequately considered alternatives to the construction of the Northeast Substation?"

292 PEPCO (E) at 6:3-12:8 (Gausman Direct); PEPCO Br. at 42-43.

293 PEPCO (E) at 12:22-13:19 (Gausman Direct); PEPCO Br. at 42.

294 PEPCO (E) at 15:3-10 (Gausman Direct).

295 *Id.* at 16:5-17:14.

assessing real estate options for a new substation in 2000, and an industrial zoned site was chosen and purchased in 2003.[296]

4. Environmental Impact[297]

89. The parties raise the same arguments and responses on environmental issues as described above with regard to the prudence of the Northeast Substation project.

DECISION

90. As discussed further below, the Commission has decided to allow the District of Columbia portion of the costs of the Northeast Substation to be included in the Company's rate base, because the Northeast Substation meets the applicable prudence and need requirements and because it was placed in service on August 25, 2007, within 12 months following the end of the test year. Accordingly, the Commission finds that the Northeast Substation satisfies the requirement that the basis of the proposed out-of-test-period adjustment be known, certain, and measurable.[298]

5. Need for Northeast Substation

91. The Commission finds that there is a reasonable need for the Northeast Substation project proposed by PEPCO. That need is undisputed. PEPCO Witness Gausman testifies the Company has not constructed a substation in the District since 1992,[299] has exhausted its ability to transfer loads among existing substations, and cannot add transformers to its existing substations.[300] OPC Witness Pavlovic has conceded that there is "no reasonable alternative to the Northeast Substation."[301] Based on these facts and other evidence of relevant planning, preparations and permitting activities, the Commission finds that the Company has established the reasonableness of the Northeast Substation.

6. Prudence of Northeast Substation's Cost

92. The Commission finds prudent and reasonable the total $73.7 million planned expenditure, and the allocated District portion of $51.9 million, for the Northeast Substation. As explained by PEPCO, the distribution-related portion of Northeast Substation costs is allocated 100 percent to the District, and the subtransmission-related portion is allocated 40.79 percent to the District, based on the AED-NCP Allocator.[302] The AED-NCP allocation approach has been

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296 *Id.* at 15:11-18.

297 Designated Issue No. 3.c.iv asks: "Has PEPCO adequately considered the environmental impact of the substation and provided adequate remedial actions for such impacts?"

298 Formal Case No. 922, Order No. 10307 (October 8, 1993), 146 P.U.R. 4th 429, WL 565426, at *39; Formal Case No. 905, Order No. 9868, 12 D.C.P.S.C. 651, 664 (1991).

299 PEPCO (2E) at 4:6-8 (Gausman Supp. Direct).

300 PEPCO (E) at 12:17-17:14 (Gausman Direct).

301 OPC (E) at 10:10-11 (Pavlovic Direct).

302 PEPCO (F) at 2:4-21 (Browning Direct); PEPCO (C)-1 at 25.

authorized by the Commission for PEPCO cost of service purposes for many years over many proceedings.[303] No party takes issue with the total or the District's portion of such costs. In fact, OPC Witness Pavlovic specifically acknowledges in his Direct Testimony that the costs of the Northeast substation are reasonable.[304] As PEPCO correctly points out, current customers need to begin to pay for current facilities that provide electric services, and in this instance the Northeast Substation will be in-service throughout the rate effective period.[305]

93. OPC claims that there is a need to recognize additional revenues if the Northeast Substation project is included in rate base. This argument suggests that the Commission should evaluate each new distribution-related plant and equipment item or system placed in service to determine whether there are loads being served that otherwise would not be served, and the resulting revenue impact. With respect to distribution-related plant and equipment that serves a localized area, this argument is without merit. It is true that OPC Cross Examination Exhibit No. 14 shows increases in megavolt amperes load over the period 2006-2009 on certain substations.[306] During the same period, however, other substations show decreases in megavolt amperes loads,[307] yet there is no negative adjustment of the revenue for such substations. Moreover, as PEPCO Witness Gausman points out, the Company plans, constructs, and places in service distribution-related plant facilities to meet the total needs in the area over time, not to meet "incremental loads."[308] As Gausman notes, the Commission has approved additions of plant and equipment that reflect the economies of scale inherent in the facilities to not only meet the current needs, but to meet the changing needs over time.[309] In our opinion, the same considerations apply to transmission and distribution facilities,[310] including the Northeast Substation.

94. The Commission notes, however, that PEPCO's testimony regarding the Commission's prior treatment of sales adjustment issues is misleading. In particular, Witness Browning indicates that the Commission has not made sales adjustments associated with new capacity placed in service. Contrary to PEPCO's argument, Order No. 9868 indicates that the Commission is not, in principle, averse to the concept of a sales adjustment. Rather, the Commission found the need for such an adjustment unsubstantiated in Formal Case No. 905.[311] Moreover, as cited by the Commission *in* Formal Case No. 905, the Commission actually granted such a sales adjustment in Formal Case No. 889.[312] In addition, the Commission granted a sales

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303 Formal Case No. 939, Order No. 10646 at 198-99 (June 30, 1995); Formal Case No. 929, Order No. 10387 at 263-65 (Mar. 4, 1994), 150 P.U.R. 4th 528, 1994 WL 109204, at *185-86; Formal Case No. 912, Order No. 10044 (June 26, 1992), 13 D.C.P.S.C. 512 at 654-55; Formal Case No. 905, Order No. 9868, 12 D.C.P.S.C. at 756-58.

304 OPC (E) at 10:10-12 (Pavlovic Direct).

305 PEPCO (3E) at 7:14 to 8:5 (Gausman Rebuttal).

306 OPC Exh. 14.

307 *Id.*

308 PEPCO (3E) at 5:14-6:1 (Gausman Rebuttal).

309 *Id.* at 6:2-12.

310 *Id.* at 6:12-13.

311 Formal Case No. 905, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. at 683-84.

312 Formal Case No. 889, Order No. 9509 (July 24, 1990) (in connection with an Ohio Edison capacity

adjustment in Formal Case No. 912,[313] no matter how small, to the extent it was substantiated by evidence submitted by PEPCO itself. In the present case, the Commission declines to grant a sales adjustment for the Northeast Substation because OPC has not adequately substantiated the need for the proposed adjustment, and not because such adjustments are not allowed under Commission precedent.

7. Timeliness of Northeast Substation in Relation to the Test Period and Rate Effective Period

95. On a case-by-case basis, the Commission has allowed the rate base to include the cost of construction work completed outside the test period in certain "unique and compelling" circumstances, including situations where (1) the project's completion date is not too remote in time from the test period; (2) the cost of the project is reasonable; and (3) the project will clearly be beneficial (*i.e.*, "used and useful") to ratepayers during the entire rate effective period.[314] In this case, the Commission finds that these three factors are present in the Northeast Substation project, collectively constituting "unique and compelling" circumstances warranting inclusion of its cost in rate base.[315]

96. The Northeast Substation began serving customers on August 25, 2007.[316] That in-service date is not too remote from the test year ended September 30, 2006. The Commission has previously allowed the cost of facilities placed in service after the test period to be included in the rate base, as in the case of the Chalk Point Combustion Turbines in Formal Case No. 905 (six months after the test period)[317] and the pipeline facility in Formal Case No. 870 (one year after the test period).[318]

97. The Commission considers unpersuasive OPC's attempt to distinguish the Northeast Substation from the Chalk Point Combustion Turbines in terms of peaking characteristics, relation to load growth, or type of facility.[319] PEPCO Witness Gausman testified that, similar to the Chalk Point Combustion Turbines, it is peak load that drives the service date of the Northeast

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purchase).

313 Formal Case No. 912, Order No. 10044 (June 26, 1992), 13 D.C.P.S.C. 512 at 574 (in connection with the "Station H" CT).

314 Formal Case No. 870, Order No. 9146, 9 D.C.P.S.C. 452, 483-85, (1988); Formal Case No. 905, Order No. 9868, 12 D.C.P.S.C. 651, 682-83 (Oct. 23, 1991); *see also*, Formal Case No. 912, Order No. 10044, 13 D.C.P.S.C. 512, 569 (Jun. 26, 1992).

315 Formal Case No. 1016, Order No. 12986 at ¶ 186 (Nov. 10, 2003), 229 P.U.R. 4th 177 at ¶ 186.

316 Letter dated August 28, 2007 from PEPCO to the Commission, reporting that the Northeast Substation was energized on August 22, 2007, and started serving customers on August 25, 2007.

317 Formal Case No. 905, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651 at 682-83.

318 Formal Case No. 870, Order No. 9146 (Oct. 28, 1988), 9 D.C.P.S.C. 452 at 473, 483.

319 OPC (C) at 12:19-14:19 (Bright Direct).

Substation, which is intended to serve peak load as well as other load characteristics.[320] OPC did not rebut this testimony.

98. OPC indicates that the principal difference between the Chalk Point CTs and the Northeast Substation is that the purpose of the Chalk Point CTs was to "increase PEPCO's generation reserve margin (which was severely deficient at 7.6% prior to their being placed in service), not to serve load growth, while the purpose of the Northeast Substation System is precisely to serve load growth."[321] Thus, the need for Chalk Point CTs resulted from insufficient capacity. OPC further states that the planning data provided by PEPCO indicate that there will be insufficient capacity available to serve load in the area of the District currently served by Substations 52 and 133 if the Northeast Substation System is not placed in service.[322] Thus, OPC agrees that the need for the Northeast Substation resulted from insufficient capacity. Accordingly, the Commission finds that there is no material difference between the two projects with regard to the propriety of including their costs in the rate base. They both involve efforts to resolve the problem of insufficient capacity, whether characterized in terms of reserve margin or load growth.

99. Moreover, in Formal Case No. 905, the Commission focused on the cost and benefits of the Chalk Point Combustion Turbines, and relied on Formal Case No. 870 to justify the inclusion of the cost in rate base despite the out-of-test-period context. In both Formal Case Nos. 905 and 870, the Commission weighed the "known," "certain," and "measurable" costs and benefits of the facilities involved. The Commission concludes that such precedent applies to the Northeast Substation because it was placed in service within eleven months after the test period.

100. The Northeast Substation project also will benefit ratepayers during the entire rate effective period. In Formal Case No. 905, the Commission allowed PEPCO to earn a return on the full value of its investment in the Chalk Point Combustion Turbines because they were "in-service and ratepayers [were] currently benefiting from the units."[323] Similarly, in Formal Case No. 870, the Commission recognized price benefits expected from the pipeline facility involved therein.[324]

101. In the present case, the evidence establishes that the Northeast Substation is necessary for reliability and that its cost is reasonable. No such facility has been built by PEPCO in the District for more than a decade.[325] PEPCO has exhausted other alternatives for adding capacity.[326] No party disputes the need for the Substation to maintain the reliable supply of power; even comments of some members of the community confirm the need for such an improvement to

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320 PEPCO (3E) at 11:4-7 (Gausman Rebuttal).

321 *See* Commission Exhibit 1. This Exhibit is a data response from OPC to Commission Staff.

322 Commission Exhibit 2.

323 Formal Case No. 905, *In re Potomac Elec. Power Co.*, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651, 683.

324 Formal Case No. 870, Order No. 9146 (Oct. 28, 1988), 9 D.C.P.S.C. 452, 485.

325 PEPCO (2E) at 4:6-8 (Gausman Supp. Direct); PEPCO (E) at 7:15-16 (Gausman Direct).

326 PEPCO (E) at 6:3-17:14 (Gausman Direct).

PEPCO's provision of electricity.[327] The Northeast Substation is already in service and is expected to continue providing reliability benefits to the District's ratepayers for the entire rate effective period. The Commission finds these circumstances to be sufficiently "unique and compelling" to render it appropriate to include in the Company's rate base, the cost of the Northeast Substation although it was placed in service eleven months after the test period. Based on the foregoing, the Commission finds that including the project's cost in the rate base is reasonable.

D. Net Prepaid Pension and Other Post-Employment Benefits ("OPEB")[328]

102. **PEPCO.** Witness VonSteuben testifies that the Company proposes to include $23.3 million in its rate base for Prepaid Pension/OPEB Liability net of taxes.[329] He states that typically PEPCO has funded its pension plan with the use of investor-supplied capital to the level of its Accumulated Benefit Obligation ("ABO").[330] VonSteuben explains that the ABO reflects the Company's future liability for employees who are currently serving customers.[331] He argues that, because PEPCO has funded the amount with the use of investor-supplied cash contributions, it should be afforded the opportunity to earn the authorized rate of return on this asset, similar to other assets that are used and useful in providing electric service.[332] He contends that the funds generate earnings, which serve to reduce the annual pension expense as determined by the actuary.[333] VonSteuben states that PEPCO's proposal is consistent with prior Commission rulings. He further states that, in addressing the implementation of Statement of Financial Accounting Standards ("SFAS") 106 and the external funding of OPEB costs in Formal Case No. 926, the Commission ruled that C&P was required to continue its current policy, which was to place an amount equal to the SFAS accrual into an external funding mechanism.[334]

103. PEPCO explains that the OPEB liability is created when the OPEB expense calculated by an actuary under SFAS 106 exceeds the annual cash contribution. According to PEPCO, its policy is to fund OPEB only to the extent that the cash contributions are deductible for income tax purposes. Therefore, no excess funding is accumulated. This liability, net of tax, reduces the rate base.[335]

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[327] *See, e.g.*, Tr at 13-17, 47-50 (June 12, 2007).

[328] Designated Issue No. 3.d asks: "Is PEPCO's inclusion of the net prepaid Pension/OPEB Asset in rate base reasonable?"

[329] The pension asset is created when cash contributions exceed the annual expense calculated by an independent actuary under Financial Accounting Standards 87.

[330] PEPCO (3C) at 9:20-10:2, 13:28-17:11(VonSteuben Rebuttal).

[331] PEPCO (C) at 8:21-9:10 (VonSteuben Direct); PEPCO Br. at 50.

[332] *Id.*

[333] PEPCO (C) at 8:7-10:1 (VonSteuben Direct); PEPCO (C)-1 at 1; Compliance Filing, 1053-E-4, at 1-4.

[334] PEPCO (C) at 8:4-10:1 (VonSteuben Direct); PEPCO (2C) at 3:6-19 (VonSteuben Supp. Direct); PEPCO (3C) at 9:5-17:11 (VonSteuben Rebuttal); PEPCO Br. at 49.

[335] PEPCO (C) at 8:21-10:1 (VonSteuben Direct).

104. According to PEPCO, the Pension/OPEB amounts are based on the average of the beginning balance on September 30, 2005, and quarterly balances for December 31, 2005, March 31, 2006, June 30, 2006, and September 30, 2006.[336] The derivation of PEPCO's proposed $23.294 million addition to rate base is as follows:

Average Prepaid Pension Asset	$81,811,087
Average OPEB Liability	(20,088,675)
System Total	61,722,412
DC Allocator	0.3774
Amount	$23,294,038

105. The Company justifies the proposed inclusion of Prepaid Pension Asset/OPEB Liability based on Commission precedent in Formal Case No. 926, where the Commission ruled that Bell Atlantic Washington DC ("BA-DC") was required to continue its current policy of placing an amount equal to the SFAS accrual into an external funding mechanism, with any accruals in excess of that amount applied as a reduction to rate base. Pepco states that in Formal Case No. 929, the Commission issued a similar ruling that "it is appropriate that PEPCO account for any amounts not externally funded . . . as a reduction to the rate base."[337]

106. **OPC.** Witness Bright recommends that the Commission reject the inclusion of $30,875,504 related to the Company's Accrued Pension Asset in rate base.[338] According to Witness Bright, shareholders, not ratepayers, have been the beneficiary of the reduction in pension expenses due to the additional expected return on fund assets. Bright also states that the amount of cash contribution and pension expense is influenced by the assumptions that PHI makes in calculating the pension expense components. She further argues that ratepayers should not be forced to pay a return on this asset simply because PEPCO was required to over-fund its pension plan in accordance with PHI's policy. Bright contends that, for every dollar that PEPCO has invested in these excess contributions, PEPCO is asking the ratepayers to pay funds in excess of 11.4 percent (based on OPC's recommended capital structure and rate of return) even though PEPCO's expected return on the pension assets is only 8.5 percent. Bright claims that ratepayers should not be expected to pay any return on these funds.[339]

107. Witness Bright states that PEPCO has accrued a liability because the amount of its OPEB expense has been larger than the amount that PEPCO has funded. She claims PEPCO began collecting the accrued cost of OPEB in Formal Case No. 929. At that time, according to Bright, the Commission determined that any amount collected but not externally funded would be

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336 Compliance Filing 1053-E-4, Pension/OPEB Asset at 1-4.

337 Formal Case No. 929, Order No. 10387 (Mar. 4, 1994), 150 P.U.R. 4th 528, 1994 WL 109204, at *102 (citing Formal Case No. 926, Order No. 10353 at 58); PEPCO (C) at 8:5-20 (VonSteuben Direct).

338 OPC (C) at 15:8-11 (Bright Direct). When the average accrued OPEB liability of $7,581,466 is deducted, the resulting amount of $23,294,038 is the amount PEPCO is requesting to be included in the rate base.

339 OPC (C) at 15:12-23:23 (Bright Direct).

deducted from rate base. Bright also states that PEPCO reduced the rate base by an average accrued liability for the four quarters ending September 30, 2006. The average accrued liability allocated to the District, as calculated by Witness VonSteuben, is $7,581,466.[340] Bright claims that, in a response to a data request, PEPCO indicates that it made a $22,663,605 adjustment to the accrued liability in December 2006. OPC recalculates the average to be used as the rate base deduction to take into account the December adjustment, resulting in an increase to the average OPEB Liability of $900,560.[341]

108. **PEPCO Rebuttal.** PEPCO contests OPC Witness Bright's arguments.[342] PEPCO argues that its actions were prudent and that it had been PEPCO's policy to fund the pension plan long before the formation of PHI.[343]

109. Witness VonSteuben further states that cash contributions financed by the Company's investors have resulted in a prepaid pension asset that has reduced pension expenses for customers.[344] He asserts that OPC Witness Bright is incorrect in her assertion that the Company's shareholders, rather than its customers, receive the benefit associated with the reduced pension expense resulting from having a prepaid pension asset. According to VonSteuben, absent the prepaid pension asset, the net periodic benefit cost in this proceeding would be approximately $4.4 million higher.[345] He explains that, due to divestiture and the subsequent unbundled rates set in Formal Case No. 945, as well as the rate reductions resulting from the merger with Conectiv, it is not possible to identify the level of pension expenses embedded in the Company's effective distribution rates.[346] VonSteuben states that rates have not been reset since Formal Case No. 939 and, therefore, any reductions in pension expenses could well have offset other cost increases for which PEPCO may have had to seek recovery, absent the pension savings.[347] VonSteuben points out that the Company has not earned the return on rate base authorized in Formal Case No. 939 since that filing. Thus, he disagrees with OPC Witness Bright's assertion that shareholders were thereby enriched.[348] He also disputes Bright's claim that the Company's pension fund is "over-funded."[349] VonSteuben explains that the pension fund is funded to the level of the ABO, based upon future obligations that have been earned to date by employees currently serving customers.[350] He states that OPEB has

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340 *Id.* at 23:4-24:18; PEPCO Br. at 55.

341 OPC (C) at 23:7-25:6 (Bright Direct); OPC (C)-2.

342 PEPCO Br. at 54.

343 OPC (C) at 22:20-22 (Bright Direct); PEPCO Br. at 54.

344 PEPCO (3C) at 12:2-5 (VonSteuben Rebuttal).

345 *Id.* at 9:15-19; PEPCO Br. at 51.

346 PEPCO (3C) at 10:19-11:2 (VonSteuben Rebuttal).

347 *Id.* at 11:3-10.

348 *Id.* at 11:10-12:10.

349 *Id.* at 13:28 -14:5.

350 *Id.* at 14:4-15.

different and less stringent accounting thresholds regarding funding levels and PEPCO funds OPEB only to the level at which there is a tax advantage.[351]

110. Witness VonSteuben asserts that investor-supplied cash contributions have benefited customers by reducing pension expenses and lowering Pension Benefit Guarantee Corporation fees.[352] He concludes that it is entirely appropriate for customers to pay a return on this asset.[353] He notes that both the Prepaid Pension Asset and the OPEB Liability are a result of the difference between the Company's obligation regarding future benefits owed to current employees and the level of those benefits PEPCO funds currently.[354]

111. VonSteuben asserts that it would be inconsistent to include the liability as a reduction to rate base, but deny inclusion of the prepaid asset.[355] VonSteuben also states that, contrary to Witness Bright's claim, the OPEB Liability should not be adjusted to reflect the December 31, 2006 balance. He points out that this adjustment has not yet been reflected in the actuarial studies from which annual expenses are derived, and so there would be a mismatch of cost of service elements if the adjustment were included in rate base without considering the impact on expenses.[356]

DECISION

112. The Company's inclusion of Prepaid Pension Asset/OPEB Liability in the rate base is consistent with Commission precedent. In an earlier case concerning BA-DC, the Commission found that BA-DC was required to continue its policy of placing an amount equal to the SFAS accrual into an external funding mechanism to the extent that tax advantaged vehicles exist, with any accruals in excess of that amount applied as a reduction to rate base.[357] In a subsequent case involving PEPCO, the Commission similarly found that "as in the BA-DC case, it is appropriate that PEPCO account for any amounts not externally funded … as a reduction to the rate base."[358]

113. The Commission finds that investor-supplied cash contributions have resulted in an asset from which PEPCO's customers receive a tangible benefit in the form of reduced pension expenses. Therefore, investors are entitled to earn a return on the capital they provided. If the Prepaid Pension Asset is included in rate base, the related OPEB Liability should also be included as a reduction. Both the asset and the liability result from the existence of a differential between the

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351 *Id.* at 16:12-19.

352 *Id.* at 14:16-15:20 (fees are determined based on the level of pension plan funding).

353 *Id.* at 15:20-21.

354 *Id.* at 16:5-20.

355 *Id.* at 16:20 - 17:1.

356 *Id.* at 17:2-10.

357 Formal Case No. 926, Order No. 10353 at 58 (Dec. 21, 1993), 148 P.U.R. 4th 113, 1993 WL 563075, at *65.

358 Formal Case No. 929, Order No. 10387 (Mar. 4, 1994), 150 P.U.R. 4th 528, 1994 WL109204 at *102.

Company's obligation regarding future benefits owed to current employees and the level of those benefits the Company funds currently. The Prepaid Pension Asset and the OPEB Liability are closely related and it would be inconsistent to include one and not the other. OPC argues that the liability should be updated to reflect the average accrued OPEB liability through December 31, 2006, rather than the four quarters ended September 30, 2006, thereby further reducing the net Prepaid Pension Asset/OPEB Liability. However, the Commission finds that it is inconsistent to adjust the rate base without a corresponding adjustment to the Company's revenue requirements for the expense portion. OPC's proposed adjustment to the OPEB Liability was not reflected in the actuarial studies from which the annual pension expense is derived. Inconsistent treatment would create a mismatch of cost of service elements. The OPEB Liability should not be adjusted to reflect the December 31, 2006, balance, as the impact to annual expenses from this adjustment has not been determined. Accordingly, the Commission retains the Prepaid Pension Asset/OPEB Liability included in rate base, as proposed by the Company, and rejects OPC's requested adjustment.

E. Cash Working Capital Requirements[359]/Ratemaking Adjustment No. 19 – Annualization of Software Amortization/Ratemaking Adjustment No. 21 – Annualization of Deductible Mixed Service Cost Tax Method

114. **PEPCO.** The Company seeks to include $11.075 million[360] in rate base for cash working capital to reflect a net lag of 15.56 days.[361] According to the Company, this amount represents the investor-supplied capital funds needed for day-to-day operations and reflects the difference between when the Company receives payment for service and when its expenses are paid.[362] The Company makes two adjustments to its study before arriving at its final number. Witness Hook states that the Company removed $87,937 of allocated withholding taxes for the District of Columbia from the calculation and included $230,206 for the allocated imprest funds requirement.[363] According to Hook, the Company's proposed cash working capital adjustment is based on its 2005 Cash Working Capital (lead/lag) study.[364] Hook further states that revenues were evaluated based on revenue collection data for the twelve months ended September 2005,[365] while expenses were evaluated based on payment data from calendar year 2005.[366] No party objects to this adjustment.

115. With regard to Adjustment No. 19, Annualization of Software Amortization, Witness VonSteuben states that the Company increased the rate base by $1,232,000 (the net of

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[359] Designated Issue No. 3.e asks: "Has PEPCO properly computed its cash working capital requirements based on its lag study?"

[360] PEPCO (D) at 8-9 (Hook Direct).

[361] *Id.* at 3:16-20.

[362] *Id.* at 2:11-13; PEPCO Br. at 56-57.

[363] PEPCO (D) at 3:21-4:9 (Hook Direct).

[364] *Id.* at 2:1-4 .

[365] *Id.* at 5:17-20.

[366] PEPCO (D)-2 at 3.

Electric Plant in Service of $1,209,000 and accumulated amortization of $2,441,000) and reduced the amortization expense by $197,000. According to VonSteuben, the adjustment reflects known and certain changes to software amortization in the rate effective period. He adds that software projects that became fully amortized within the test period, as well as software projects which will become fully amortized within one year of the end of the test period, were removed from the cost of service. VonSteuben points out that a similar adjustment was uncontested in Formal Case No. 939 and accepted by the Commission as "proper, accurate, and consistent with Commission precedent."[367] He states that the cost of service also includes the rate base and amortization expense impacts of projects placed in service by September 30, 2006, but which had not been included in the six months of projected data.[368] No party objects to this adjustment.

116. Regarding Adjustment No. 21, Annualization of Deductible Mixed Service Cost Tax Method, VonSteuben testifies that the Company increased its rate base by $7,489,000 to adjust its average accumulated deferred income tax balance to reflect the deductible mixed service cost method. He states that in 2001, the Company adopted a tax accounting method for capitalized overhead items that allowed for the current deduction of certain overhead costs that had previously been capitalized into the cost of self-constructed assets and depreciated over a twenty-year life for tax purposes. VonSteuben explains that the Company generated tax benefits based on this new method on its 2001 through 2004 tax returns. According to VonSteuben, for book purposes, these costs are capitalized and depreciated on a straight-line basis over a longer period of time. He points out that the book versus tax timing difference resulted in an increase in deferred taxes.[369] VonSteuben states that, in August 2005, the Company adopted the Treasury Department's proposed and temporary regulation that eliminated the Company's use of this tax treatment.[370] He explains that the Company changed its method of accounting for these overhead costs and must repay the difference in the tax computed under the new method as compared to what was deductible under the prior method over a two-year period beginning in tax year 2005.[371] He notes that the Company's adjustment removes the average accumulated deferred income tax balance for the amount of taxes the Company is required to repay.[372] No party objects to this adjustment.

DECISION

117. We have reviewed the Company's working cash requirements as well as Adjustments Nos. 19 and 21. Inasmuch as no party has objected to the Company's cash

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367 Formal Case No. 939, *In re Potomac Elec. Power Co.*, Order No. 10646 at 89 (June 30, 1995).

368 PEPCO (C) at 17:11-18:2 (VonSteuben Direct); PEPCO (C)-1 at 3; PEPCO (C)-1 at 22; PEPCO (2C) at 4:12-17 (VonSteuben Supp. Direct); Compliance Filing, 1053-E-4 at 90-97.

369 PEPCO (C) at 18:19-20:5 (VonSteuben Direct); PEPCO (C)-1 at 3; PEPCO (C)-1 at 24; PEPCO (2C) at 4:12-17 (VonSteuben Supp. Direct); Compliance Filing, 1053-E-4 at 100-105.

370 PEPCO (C) at 19:14-20:5 (VonSteuben Direct).

371 *Id.* at 19:14-20:2.

372 *Id.* at 20:3-5.

requirements or these particular adjustments, and because we find them otherwise reasonable, we approve them.

F. Ratemaking Adjustment No. 20 – Amortization of Severance Costs

118. **PEPCO.** Witness VonSteuben states that, by this adjustment, the Company increased the rate base by $350,000 (net of program costs of $478,000 and accumulated deferred income taxes of $128,000) and increased O&M expenses by $273,000. He explains that this adjustment was made to amortize more than three years of costs associated with a Power Delivery severance program initiated in December 2004. According to PEPCO, the Company's three-year amortization period and the inclusion of the unamortized balance in rate base are consistent with ratemaking treatment approved in Formal Case No. 939.[373]

119. **OPC.** Witness Bright recommends that the severance costs not be included in rate base because in Formal Case No. 1002 it was agreed that PEPCO would not charge District ratepayers for costs related to the Company's merger with Conectiv.[374] Moreover, according to Bright, the scheduled amortization of these costs shows that the costs will be fully amortized by the end of December 2007, three or four months after the rates determined in this case go into effect. Including these costs in the current case would permit PEPCO to continue to recover these expenses until the Company makes the decision to seek another rate adjustment, which could be months or years after the costs have been fully recovered.[375]

120. **PEPCO Rebuttal.** The Company asserts that OPC disregarded[376] the section in Order No. 12395 in Formal Case No. 1002 which states that merger transition costs (*e.g.*, severance payments) incurred two or more years after the closing of the merger will be presumed not to be merger transition costs.[377] PEPCO argues that, at a bare minimum, the Company should be allowed recovery for the four months of amortization remaining during the rate effective period. The Company stated that the combined annual wages/salaries of personnel who left PEPCO because of this severance program totaled $1.5 million, before consideration of associated reductions in benefits and payroll taxes. PEPCO contends that District ratepayers are receiving the benefit of these reduced wages and salaries, and it is only fair and appropriate that they share in the costs that resulted in those savings in accordance with past Commission practice. As an alternative, the Company provides a bare minimum adjustment to expenses of $91,000 (as opposed to the originally proposed $273,000).[378]

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373 *Id.* at 18:3-18; PEPCO (C)-1 at 2; PEPCO (C)-1 at 23; PEPCO (2C) at 4:12-17; Compliance Filing, 1053-E-4 at 98-99.

374 OPC (C) at 32:1-5 (Bright Direct) ; Formal Case No. 1002, Order No. 12986 (November 10, 2003).

375 OPC (C) at 32:6-11 (Bright Direct).

376 OPC (E) at 32:20-32:11 (Pavlovic Direct).

377 PEPCO (3C) at 26:8-27:18 (VonSteuben Rebuttal).

378 *Id.* at 28;1-12; PEPCO (3C)-1.

DECISION

121. The Commission rejects the Company's RMA No. 20 – Amortization of Severance Costs. As OPC has convincingly demonstrated, the scheduled amortization of these costs confirms that they were to be fully amortized by the end of December 2007.[379] We agree that including these costs in the current case would permit PEPCO to continue to recover them throughout the rate effective period, which could span years after the costs have been fully recovered. Therefore, the Company's rate base associated with the unamortized severance program costs will be reduced by $478,000, accumulated deferred income taxes will be increased by $128,000, and operating expenses will be reduced by $273,000.

IV. DEPRECIATION
(Issue No. 4)[380]

A. Current Filing

122. **PEPCO.** The Company states that its depreciation reserves and expenses are consistent with the Commission's decision in Formal Case No. 869, the last case in which PEPCO's depreciation rates were examined, and that the Commission did not require PEPCO to file an updated depreciation study as part of this proceeding.[381] PEPCO makes two *pro forma* adjustments to the accumulated reserve for depreciation and related depreciation expenses to reflect the inclusion of capital projects not reflected in electric plant in service during the test year: (1) RMA No. 22 – Northeast Substation and (2) RMA 23 – Inclusion of Projects Completed and In Service.[382] Witness VonSteuben states that the Company's depreciation expenses for the test year are based on rates approved by the Commission in Formal Case No. 869 and reflect the thirteen-month average balance calculation method approved in Formal Case No. 939.[383]

123. **OPC.** OPC asserts that PEPCO's depreciation reserves and expenses are not reasonable because they are inconsistent with the Commission's policy of requiring that depreciation rates be based on current data.[384] Specifically, OPC asserts that the Commission established the current depreciation rates in Formal Case No. 869 in 1989 and that PEPCO should be required to conduct a new depreciation study. OPC suggests that a new study would likely result in lower depreciation rates.[385]

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379 OPC (C) at 31:1-32:11 (Bright Direct).

380 Designated Issue No. 4 asks: "Are PEPCO's depreciation reserves and expenses reasonable and consistent with Commission policy?"

381 PEPCO (3A) at 51:19-21 (Rigby Rebuttal); PEPCO. Br. at 58.

382 PEPCO (C)-1 at 25-26.

383 PEPCO (2C) at 4:2-11 (VonSteuben Supp. Direct).

384 OPC (F) at 3:1-3, 9:3-8 (King Direct).

385 *Id.* at 9:3-5; 12:20-22; 13:1-2.

DECISION

124. The Commission approves PEPCO's pro forma adjustments to the accumulated reserve for depreciation and related expenses which reflect the inclusion of capital projects not reflected in Electric Plant In Service during the test year: (1) RMA No. 22 – Northeast Substation and (2) RMA No. 23 – Inclusion of Projects Completed and In Service. The approval of RMA No. 22 stems from the fact that the Commission has resolved to allow the District of Columbia portion of the costs of the Northeast Substation to be included in the Company's rate base for the reasons described above (Issue No. 3). The Commission approves RMA No. 22 because it adjusts the Company's depreciation reserves and expenses to reflect the inclusion of the Northeast Substation in the rate base.

125. Likewise, the approval of RMA No. 23 reflects the Commission's finding in this case that the projects covered by RMA No. 23 are properly included in rate base (Issue No. 3). The Commission approves RMA No. 23 because it adjusts the Company's depreciation reserves and expenses to reflect the inclusion of the completed projects in the rate base.

126. The Commission finds that PEPCO's depreciation reserves and expenses are reasonable for purposes of this proceeding.[386] The Commission did not require a new depreciation study in this rate case.[387] Thus, there is no record support for modifying PEPCO's depreciation rates at this time, and RMA Nos. 22 and 23 are based on the last Commission approved PEPCO depreciation study.

B. Future Rate Case

127. **OPC**. OPC asserts that PEPCO should be required to file a new depreciation study on or before it files its next rate case and that in that study the Company should account for certain depreciation rates and reserves differently. First, OPC recommends that PEPCO show "plant only" and "removal cost" depreciation rates and reserves separately for the following reasons: (a) separate accounting for "plant only" and "removal cost" depreciation already occurs in accordance with SFAS 143, Federal Energy Regulatory Commission ("FERC") Order No. 631, and SEC directives; (b) the separation would provide transparency of PEPCO's accounting reports; (c) the separation would enhance the Commission's ability to monitor the accruals; and (d) the function of the "plant only" rate to recover the costs already incurred is very different from the function of the "removal cost" rate to recover future estimated costs.[388] Second, OPC proposes that, even for "non-legal" Asset Retirement Obligations, the removal cost reserves should be considered a

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386 *See* D.C. Code, 2001 Ed. § 34-603 (all rates fixed by the Commission remain in force and presumed reasonable until found otherwise).

387 *See Formal Case No. 1053*, Order No. 14232 at 6 (March 8, 2007).

388 OPC (F) at 24:12-25:19 (King Direct).

"regulatory liability."[389] OPC Witness Charles King states that SFAS 143 applies to "non-legal asset retirement obligations if the costs of those obligations are being recovered in rates" based on paragraph B73 of the "Background Information and Basis for Conclusions."[390] Finally, OPC states that PEPCO does not keep a record of the amount in the District of Columbia reserve by plant account, and instead keeps these reserves using "blended" District of Columbia, Maryland, and FERC depreciation rates. OPC (F)-3 shows a complex four-step method PEPCO uses to determine what portion of the "blended" reserve is the reserve for each jurisdiction. According to OPC, PEPCO should develop a more transparent and straightforward method for recording District of Columbia depreciation expenses and reserves.[391]

128. **PEPCO.** PEPCO does not object to most of OPC's recommendations. However, PEPCO claims that OPC Witness King's proposal to treat the cost of removal as a regulatory liability seeks dramatic changes to the Commission's policy regarding depreciation and net salvage. PEPCO argues that the Commission rejected similar requests from OPC Witness King in Order No. 12986 (Formal Case No. 1016) and should likewise reject such requests in this proceeding.[392]

DECISION

129. The Commission agrees with OPC that the current depreciation rates should be updated before PEPCO files its next rate case. 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.

130. In addition, the Commission directs PEPCO to place into service by March 1, 2008, a system that will maintain depreciation expense, accumulated depreciation reserve, cost of removal, and salvage information separated by jurisdiction and by FERC account each month. The Commission directs PEPCO to report to the Commission and the parties to this case, no later than March 31, 2008, when that system is placed into service. The Commission notes that, in a discovery response, PEPCO states that it was working on such a new system, which was expected to be in service in October 2007.[393] Such a system is necessary for the more efficient management of depreciation data. In this case, as OPC observes, PEPCO currently does not keep a record of the amount in the District of Columbia reserve by plant account, and instead keeps these reserves using "blended" District of Columbia, Maryland, and FERC depreciation rates. In fact, PEPCO states that, because of problems determining what was in the reserve for each jurisdiction in the

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[389] *Id.* at 3:14-20, 23:39-24:2.

[390] *Id.* at 18:27-28.

[391] *Id.* at 3:10-12, 26:11-27:8.

[392] PEPCO (3A) at 53:5-10 (Rigby Rebuttal); *see* Formal Case No. 1016, *In re Wash. Gas Light Co.*, Order No. 12986 (Nov. 10, 2003), 229 P.U.R. 4th 177, 2003 D.C. PUC LEXIS, 50-57; PEPCO Br. at 59.

[393] PEPCO response to Staff follow-up request to Staff DR 2-39. Commission Exhibit No. 17 (Tr. at 1229:16 to 1230:13).

PEPCO Maryland PSC Case No. 9092, PEPCO's direct testimony concerning the depreciation calculation omitted over $130 million from the Maryland reserve.[394]

131. The Commission also directs PEPCO to separate the "plant only" and "net removal cost" depreciation rates and reserves starting with the next filed depreciation study. The Commission notes that, according to PEPCO, in the Maryland rate case, the Company proposed separate "plant only" and "net removal cost" depreciation rates and reserves. This does not change the total depreciation rate for an account; it simply shows the "plant only" portion separately from the "removal cost" portion which provides additional information. FERC has modified the Uniform System of Accounts to require that the "removal cost" depreciation accruals and reserves be shown separately from the "plant only" depreciation accruals and reserves.[395]

132. However, the Commission declines to declare the non-legal removal cost reserve as a "regulatory liability."[396] For utility regulatory purposes, the Commission has adopted the FERC Uniform System of Accounts,[397] which does not treat the non-legal Asset Retirement Obligations as a "regulatory liability." The Commission notes that, in response to discovery, OPC Witness King states "the difference between a separate removal cost regulatory liability and a separate removal cost depreciation reserve is arguably only a matter of semantics."[398] Thus, we are not persuaded that there would be any benefit from declaring the non-legal removal cost reserve a "regulatory liability.

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394 PEPCO response to Staff follow-up request to Staff DR 2-35. Commission Exhibit No. 16 (Tr. at 1229:2-15).

395 18 C.F.R. Part 101 (2007).

396 Statement of Financial Accounting Standards No. 143 (SFAS 143) *Accounting for Asset Retirement Obligation*, defines ***legal obligations*** (e.g. legal removal cost reserve) as an obligation resulting from: (a) a government action, such as a law, statute, or ordinance; (b) an agreement between entities, such as a written or oral contract; or (c) a promise conveyed to a third party that imposes a reasonable expectation of performance upon the promisor under the "doctrine of promissory estoppel." A ***non-legal obligation*** (e.g. non-legal removal cost reserve) is interpreted as obligations that are not legal. SFAS 143 applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset. SFAS 143 requires that regulated companies that meet certain requirements under SFAS 71, *Accounting for the Effects of Certain Types of Regulation*, classify legal obligations as "regulatory liabilities" in their financial statements; it does not require that non-legal obligations be classified as "regulatory liabilities" in financial statements.

397 18 C.F.R. Part 101 (2007).

398 OPC Response to Staff Request 1-24 (c) and similar in (b). Commission Exhibit No. 5 (Tr. at 814:4-14 and 811:3—812:9).

V. ADJUSTMENTS TO TEST YEAR REVENUES (Issue No. 5)[399]

A. Weather Normalization and Annualization of Revenues [400]

133. **PEPCO.** Witness Browning states that the Company's proposed adjustments to test year revenue are reasonable and the annualized revenues to reflect 365 days of billing are appropriate because the number of days of revenue in the test period are matched to the number of days of costs in the test period.[401] Browning indicates that the Company has weather-adjusted its test year revenues in accordance with Order No. 10646 in Formal Case No. 939. He contends that the Company performed a regression by daily degree-days using a thirty-year historic period and daily sales to develop weather coefficients.[402] Further, the weather coefficients are developed for each class of business and the weather coefficients are applied to the actual months in the test year (October 2005 through March 2006) to develop actual and weather-corrected monthly sales. Finally, the revenue calculation is based upon average monthly realization (cents/kWH) for each class of business.[403]

134. PEPCO states that RMA No. 1, weather Normalization and Annualization Revenues, annualizes test year billing month revenue to reflect 365 billing days and annualizes the revenue to the rates in effect during the entire test period, as the six month projected data reflected an anticipated adjustment to distribution rates as a result of a concurrent change in transmission rates, which has not occurred.[404] In total, the weather normalization adjustment reduces test-year revenues by $4,469,000 (before taxes) -- $315,000 to weather normalize bill distribution revenue, $454,000 for the billing days adjustment, and $3,700,000 to annualize District revenues to current rates.[405]

135. RMA No. 1 also adjusts District of Columbia expenses to include the original generation-only Residential Aid Discount ("RAD") subsidy in distribution rates.[406] This results in an additional revenue reduction of $550,000 (before taxes).

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399 Designated Issue No. 5 generally asks: "Are PEPCO's proposed adjustments to test-year revenues appropriate?" Issue No. 5 includes sub-issues that shall be discussed in sequence.

400 Designated Issue No. 5.a asks: "Has PEPCO properly weather-normalized and annualized its sales and revenue?"

401 PEPCO (2F) at 6:13-7:2 (Browning Supp. Direct); PEPCO (C) at 10:8-19 (VonSteuben Direct); PEPCO Br. at 60.

402 PEPCO (F)-5.

403 The details of the adjustment are explained by Witness Browning, PEPCO (F) at 13:20-19:23 (Browning Direct). The results of this calculation are shown in PEPCO (F)-5 and PEPCO (F)-6.

404 PEPCO (C) at 10:13-19 (VonSteuben Direct); PEPCO Br. at 62.

405 OPC (C)-1 at 4.

406 PEPCO (C) at 10:19-21 (VonSteuben Direct).

136. **OPC.** Although the Company states that PEPCO has properly analyzed and weather normalized its sales and revenues, OPC Witness Pavlovic claims that the billing days adjustment is not reasonable in this case because it has not been shown to be appropriate and may understate test-period revenues relative to the costs.[407] He argues that the proposed billing days adjustment should be rejected if PEPCO did not accurately match test year revenue and expenses to those existing during the rate effective period.[408] OPC argues further that PEPCO has provided no evidence supporting its assumption that its cycle billing will not produce the same discrepancy during the rate-effective period as occurred during the test period.[409] Pavlovic testifies that the Company's calculation for its billing days adjustment is 0.72 billing days.[410] The basis of this adjustment is that the length of the Company's billing cycles varies from month to month and, when aggregated for an entire year, will, depending on the year, produce more or fewer billable days and will not equal a 365-day calendar.[411] Pavlovic submits that PEPCO's adjustment would be necessary only if the Company could demonstrate that the "adjustment would be appropriate on a showing that it will produce a more accurate test year."[412] Pavlovic argues that the Company has not met that burden and presents no evidence that supports the need for this adjustment.[413] Witness Pavlovic points out that this is the first time PEPCO has proposed such an adjustment.[414]

137. **PEPCO Rebuttal.** Witness Browning states that PEPCO must show that its billing days adjustment will match 365 days of revenues with 365 days of expenses, which PEPCO has done.[415]

1. Heating and Cooling Seasons[416]

138. **PEPCO.** PEPCO classifies the months of October 2005 through March 2006 as heating months.[417] PEPCO also submits that October should be classified as both a heating and cooling month for the purpose of the weather correction.[418] The Company's degree-day analysis covers only the winter season because the summer season of the test year is forecasted.[419] The

407 OPC (E) at 10:21-12:8 (Pavlovic Direct); OPC Br. at 105.

408 OPC (E) at 10:15-12:11 (Pavlovic Direct); PEPCO Br. at 60.

409 OPC (E) at 12:5-11 (Pavlovic Direct); OPC Br at 106.

410 OPC (E)-1 at 11:8-9 (Pavlovic Direct).

411 *Id.* at 11:3-9; PEPCO (C)-1.

412 OPC (E) at 11:18-19 (Pavlovic Direct).

413 *Id.* at 12:2-11.

414 *Id.* at 12:8-11.

415 PEPCO (3F) at 9:16-18 (Browning Rebuttal).

416 Designated Issue No. 5.a.i asks: "Are the heating and cooling seasons designated in F.C. No. 939 still appropriate?"

417 PEPCO (2F) at 4:1-3 (Browing Supp. Direct); PEPCO Br. at 63.

418 PEPCO (2F) at 4:3-5 (Browning Supp. Direct); PEPCO (F)-4; PEPCO Br. at 63.

419 PEPCO (F)-4.

Company indicates that it has weather adjusted its test year revenues based on the heating and cooling seasons defined in Order No. 10646.[420] PEPCO also states that OPC Witness Pavlovic agreed that PEPCO used appropriate heating and cooling seasons.[421]

DECISION

139. We have reviewed the Company's adjustment regarding weather normalization and annualization of revenues. Inasmuch as no party has objected to this particular adjustment, and because we find it otherwise reasonable, we approve it.

140. However, the Commission rejects the portion of the Company's RMA No. 1 related to average billing days. The Commission notes that the Company's presentation and analysis are unsubstantiated in the record and unsupported by precedent. First, the Company simply states that its expenses are based on 365 days. The Company has not provided an analysis of the expenses and a demonstration that all of those expenses represent 365 days. PEPCO Witness Browning asserts that the test year has 365 days, while revenue is based on twelve billing months that total 365.72 days; however, he offers no analysis to support his assertion.[422]

141. Further, in reply to a data request from the Commission, PEPCO submitted its monthly billing days for 2004 through June 2007.[423] These data show that the billing days were as follows:

PEPCO (3C)-4	2004	2005	2006	2007
Annual Billing Days	365.49	365.66	364.36	364.89

142. The Company's proposed adjustment is based on 365.72 days, which is the sum of the billing days for the test period, October 1, 2005, through September 30, 2006. This number is higher than the annual billing days for the years shown above, indicating that the 365.72 figure is an outlier. Because the Company fails to demonstrate the reasonableness of its proposed adjustment for average billing days, the Commission rejects the proposal. Accordingly, the Commission rejects PEPCO's proposed revenue reduction of $454,000.

143. The Commission finds that the Company's heating and cooling seasons are reasonably designated and are consistent with season designations established in Order No. 10646.

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420 PEPCO (2F) at 4:1-3 (Browning Supp. Direct); Formal Case No. 939, *In re Potomac Elec. Power Co.*, Order No. 10646 at 73 (Jun. 30, 1995).

421 OPC (E) at 10:18-20 (Pavlovic Direct).

422 PEPCO (3F) at 9:13 - 10:3 (Browning Rebuttal).

423 PEPCO (3C)-4.

Finally, the $550,000 of original RAD subsidy included in RMA No. 1 is removed from RMA No.1 and is discussed under Issue No. 19.

B. Sales Repression[424]

144. **PEPCO.** The Company states that if the Commission decides not to approve the BSA, the proposed $2.263 million decrease in base distribution revenues to reflect reduced sales levels is reasonable and appropriate.[425] PEPCO states that if PEPCO is to have an opportunity to earn a reasonable rate of return on its investment, then the rates in this case should be based on an adjustment to test year revenues to reflect customers' reactions to these higher prices.[426]

145. Witness Browning states that on June 1, 2006, Standard Offer Service ("SOS") supply prices increased, reflecting the increase in purchased power expenses caused by increases in fuel prices. However, the higher SOS prices are not reflected in the projected sales volumes in the test year, since the forecast did not incorporate any price effects from supply price changes. In the rate effective period, these price increases will be in effect and customers will react to these higher prices by reducing usage. PEPCO proposes to set rates based on an adjustment to test year revenues to reflect customers' reactions to these higher prices. Browning indicates that a "conservative" estimate is provided of the sales effects of the price changes based on previous studies of the demand for electricity and proposes to use -0.05 as the estimate of the price elasticity of demand. This means that for a 10 percent increase in price, electricity sales will decrease by 0.5 percent. Browning also develops an estimated change in base distribution revenues using the 0.5 percent price elasticity in PEPCO (F)-7. He estimates that by accounting for the effects of the supply price increase, base distribution revenues decline by $2.3 million.

146. According to Browning, there is historical evidence that customers will reduce usage in response to a sharp price increase. In 1974, average prices for PEPCO's District of Columbia customers increased by 54 percent (39 percent adjusted for overall inflation), while sales in 1974 decreased by 9.7 percent. This was in contrast to the sales growth in the preceding four years that averaged 7.9 percent per year.[427]

147. **AOBA.** Witness Oliver states that PEPCO's computation of a price elasticity adjustment is crude in concept and flawed in application[428] particularly because: (1) PEPCO has not provided a systematic assessment of the actual percentage changes in electricity costs that different customer classes have experienced; and (2) PEPCO inappropriately applies its elasticity adjustment to the total distribution revenue and incorrectly assumes a proportionate adjustment when customers

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424 Designated Issue No. 5.b asks: "Is the Company's proposed adjustment to reflect *sales repression* as a result of price increases reasonable and appropriate?"

425 PEPCO (F) at 20:9-22:8; PEPCO (F) at 7; PEPCO (2F) at 5:5-6:10; the sales adjustment is Ratemaking Adjustment No. 18; PEPCO (C)-1 at 21 of 29; PEPCO Br. at 63.

426 PEPCO Br. at 64; PEPCO (F) at 20:4-22.

427 PEPCO (F) at 22:12-16 (Browning Direct); PEPCO (2F) at 6:8-10 (Browning Supp. Direct).

428 AOBA at 67:13-15 (Oliver Direct).

alter their energy usage in response to price changes.[429] Oliver concludes that the "conservative" nature of the price elasticity estimate does not compensate for the misapplication of the data.[430]

148. **OPC.** Witness Kapur argues that the Commission should deny PEPCO's proposed repression adjustment because PEPCO failed to meet the burden of providing the legally required information to support the proposed repression adjustment.[431] She states that in the Chesapeake and Potomac Telephone Company case, Order No. 7323, the Commission identified three criteria for an adequate demonstration of a valid proposed repression adjustment: (1) show that the economic models used to develop the repression adjustment are free of statistical problems; (2) disaggregate by service categories to estimate the price elasticity of demand; and (3) provide the methodology and calculate the dollar amounts of the repression adjustment by class.[432]

149. OPC contends that PEPCO has not provided any record evidence to establish that the Company has met the three required criteria to support its repression adjustment in this case.[433] OPC indicates that PEPCO has not explained the method used to calculate the repression factor or the price elasticity of demand. In addition, PEPCO has not developed its own model to estimate the price elasticity of demand and based its -0.05 elasticity of demand estimate on studies and analyses prepared by outside experts. Moreover, OPC asserts that the Company has not disaggregated service categories for determining the price elasticity of demand. Lastly, OPC agues that the Company has not shown the methodology or estimated the dollar amounts of repression adjustments by customer class.

150. **WMATA.** Witness Foster states that the repression adjustment is unnecessary and that PEPCO should accept the actual test year sales volumes as reported to the Commission. He points out that PEPCO is attempting to make up for future lost sales due to a decrease in usage, arguing its revenues will decrease if customers react to higher rates that reflect an increase in supply prices and cut usage. However, Foster maintains that PEPCO's assertion is "pure conjecture" since the "period in question is beyond the test year, and factors that could affect sales may result in either an increase or a decrease in revenues. In fact, he contends that PEPCO may have an increase in sales if the winter is severe, if there is growth in the customer base, or if the summer months are unusually hot."[434] Foster suggests that "the sales adjustment is a 'straw man' proposed by PEPCO in order to make the BSA more appealing.

151. **WASA.** WASA argues that PEPCO's price repression adjustment is objectionable on several grounds. WASA claims that PEPCO's proposal does not comport with the Commission standards for price repression adjustments.[435] WASA states that Witness Browning makes no

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429 *Id.* at 67:16 to 68:2.

430 *Id.* at 72:19 to 73:6.

431 PEPCO Br. at 65 (citing Exh. OPC (G) at 3:19-20 (Kapur Direct)); PEPCO (C)-1 at 21; OPC Br. at 106.

432 OPC (G) at 6:4-9 (Kapur Direct).

433 OPC Br. at 106-107.

434 WMATA at 11:15-19 (Foster Direct).

435 WASA Br. at 16 (citing OPC (G) at 3-11).

attempt to draw any correlation between the price elasticity studies that he relied on and his own proposal.[436] WASA goes on to cite WMATA's observation that PEPCO's price repression adjustment appears to be nothing more than a "straw man" proposal in order to make the BSA more appealing.[437] WASA's final objection to the price repression adjustment goes to PEPCO's use of this mechanism to adjust its overall revenue requirement.[438]

152. **PEPCO Rebuttal.** Witness Browning states that OPC Witness Kapur does not claim that sales will be unaffected by the price increases or offer an alternative adjustment that would be lower than PEPCO's proposal. Browning also maintains that, unlike the Chesapeake and Potomac Telephone Company case, PEPCO is not asking for an adjustment to sales due to the outcome of this case, but is seeking an adjustment due to supply price increases that occurred during the test year.[439] Similarly, Browning points out that AOBA Witness Oliver does not deny that higher prices will lower sales; does not claim that the sales adjustment is over-stated; and did not substantiate Oliver's claims regarding the impact on commercial customers.[440]

DECISION

153. The Commission denies the repression adjustment because the Company has failed to meet the Commission's standards for obtaining a repression adjustment, as identified in Order No. 7323 (May 28, 1981), and reiterated in Order No. 12986 (November 10, 2003). First, as OPC indicates, PEPCO has not attempted to estimate the price elasticity using District-specific data and does not demonstrate that any economic models used to develop the repression adjustment are free of any significant statistical problems.[441] Second, PEPCO has not shown that its elasticity estimate of -0.05 is applicable to all its customer classes, as PEPCO did not submit elasticity studies or analyses for each customer class. Third, PEPCO does not describe the dollar amount of the proposed adjustment by customer class nor provide the methodology used by service category. Accordingly, PEPCO has failed to meet its burden in justifying the sales repression adjustment. This decision will increase PEPCO's revenue by $2.3 million.

436 *Id.* at 16.

437 *Id.* at 16-17 (citing WMATA (A) at 11).

438 *Id.* at 17 (citing AOBA (A) at 71).

439 PEPCO (3F) at 13:6-20 (Browning Rebuttal).

440 *Id.* at 14:1-21.

441 OPC (G) at 6:4-15, 7:16-21, 10:19-22 (Kapur Direct).

VI. ADJUSTMENTS TO TEST YEAR OPERATING EXPENSES (Issue No. 6)[442]

A. Expenses for Transactions between PEPCO and Other PHI Affiliates[443]

154. **PEPCO.** The Company is proposing to allocate roughly $37 million of PHI Service Company costs to District of Columbia rates.[444] These costs are reflected in PEPCO's various expense adjustments. Witness VonSteuben states that allocation of PHI affiliate costs is in accordance with the Company's Cost Allocation Manual.[445]

155. **OPC.** OPC Witness Bright testifies that PHI affiliate costs are unreasonable.[446] At the outset, Bright identifies a discrepancy in two cost ratios, *i.e.*, in the Employee Cost Ratio and the Blended Ratio for 2005 and 2006. She states that her review of the numerator and denominator of these ratios, which are based on employee head counts, revealed that the number of PEPCO employees included in the numerator was overstated.[447] As a result, PEPCO received an overstated amount of Service Company costs where these ratios were being applied to determine PEPCO's allocation. Bright also presents exhibits[448] showing that a 2005 audit by the SEC found that the Company had not audited the raw data and had not confirmed the accuracy of the numerator or denominator of these ratios using employee head counts.[449] Bright's second concern involves the potential inability of the regular audit process to find the types of discrepancies discovered in the two cost ratios,[450] and a discrepancy of rental space square footage data.[451]

156. Witness Bright is also concerned with the rental expenses associated with PEPCO's use of Edison Place. Bright describes the circumstances surrounding the sale and lease of Edison by PHI and PEPCO to a PHI affiliate and then to Wachovia Development Corp.[452] According to Bright, when the PHI affiliate, Edison Place, LLC, sold Edison Place to Wachovia Development Corp., PHI realized a $68 million profit that went to shareholders.[453] In connection

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442 Designated Issue No. 6 generally asks: "Is each of PEPCO's proposed adjustments to test-year operating expenses reasonable?" Issue No. 6 includes sub-issues that shall be discussed in sequence.

443 Designated Issue No. 6.a asks: "Are the allocated expenses from transactions between PEPCO and other PHI affiliates reasonable?"

444 Commission Exhibit 19 (2006 Service Company costs); PEPCO (C)-3, at 20 (allocators). The exact amount of the Service Company costs for the test year was not provided.

445 PEPCO (2C) at 4:18-5:2 (VonSteuben Supp. Direct).

446 OPC (C) at 34:17-35:3 (Bright Direct).

447 *Id.* at 36:3-16.

448 DR OPC 2-24.

449 OPC (C) at 35:19-36:3 (Bright Direct).

450 *Id.* at 35:19-37:5.

451 *Id.* at 37:17-20 (Confidential).

452 *Id.* at 41:24-42.21.

453 *Id.* at 42:18-21.

with that sale, the Service Company, through its affiliate, Edison Place LLC, agreed to a lease with Wachovia Development Corp. that resulted in an increased lease payment of $1.8 million per year over the amount that was agreed to in the lease arrangement prior to the sale.[454]

157. In Bright's view, "ratepayers should be protected from incurring unnecessary costs that are the result of non-arms length transactions."[455] She recommends reducing the rate base by $6,075,146[456] and the Company's proposed expenses by $276,143 to reflect her estimate of excess lease costs associated with Edison Place.[457] Witness Bright proposes an alternative adjustment to reflect the difference in the lease arrangements when PEPCO signed the Second Amendment Deed of Office lease in January 2003 and when Edison Place, LLC sold the building to Wachovia in September 2003 for an increased annual payment of $1.8 million.

158. **AOBA.** Witness Oliver similarly maintains that PEPCO has failed to demonstrate that the Service Company charges it included in its revenue requirement are reasonable and justified.[458] In particular, Oliver objects to PEPCO's assertions that the costs of the services obtained through its Service Company are "less than or equal to those the company would incur if it either provided those services itself or obtained the same services from an independent third party"[459] and consistent with those of other electric utilities.[460] AOBA contends that "costs billed to PEPCO by the Service Company must be held to the same prudence standards that are applied to other utility expenditures."[461] AOBA also asserts that sharing of costs does not necessitate or justify a conclusion that those charges are less than the costs of alternatives for the acquisition of comparable services; that the Commission did not require PHI to form a Service Company; and that the Company's use of its pre-established cost allocation methodology does not inherently render the costs reasonable.[462] Oliver states that the only support that the Company offered was in the context of the need to reallocate the Service Company costs associated with the support of several generation stations in RMA No. 14, and that the Company merely makes an "unsupported assertion" that pooling of costs benefits customers.[463]

159. Witness Oliver also takes exception with the claim that the Company's Cost Allocation Manual is the "basis for all intra-company transactions."[464] He opines that the Manual

454 *Id.* at 43:5-10.

455 *Id.* at 44:9-10.

456 OPC (C)-2, Schedule 7 at 7.

457 *Id.* Schedule 7 at 8.

458 AOBA at 76:13-77:4 (Oliver Direct).

459 *Id.* at 76:18-21.

460 *Id.* at 76:21-77:3.

461 AOBA Br. at 16.

462 *Id.* at 17.

463 AOBA at 77:4-15 (Oliver Direct).

464 *Id.* at 77:18-23.

addresses only how costs are allocated, not the reasonableness of those costs.[465] Oliver further states that, in order to avoid abuses in the affiliate relationship, PEPCO should be held to a more rigorous standard when demonstrating the prudence of the costs charged from the Service Company.[466]AOBA echoes OPC and asks the Commission to reject RMA No. 14 – Reallocation of Service Company costs, as well as RMA No. 9 – Employee Health and Welfare Costs, until the Company quantifies the magnitude of savings from using the Service Company and establishes the appropriateness and reasonableness of those charges through industry benchmarks and/or competitive market data.[467]

160. **PEPCO Rebuttal.** Witnesses Rigby, VonSteuben, and White, address OPC's and AOBA's criticisms and concerns regarding Service Company costs and allocations to PEPCO. Rigby cites the pooling of resources and elimination of duplicate functions, such as legal, financial, accounting, and information technology, as means through which PEPCO and the other utility companies can share costs. He provides the specific example of the treasury and accounting staffs in which PEPCO pays only a portion of the costs, thus demonstrating, he says, that the Service Company approach "provides economies of scope and scale that could not be achieved on a stand-alone basis."[468] Rigby suggests that there is no need for the Company to perform "additional examinations, audits or benchmarking" in connection with its efforts to move duplicated functions to the Service Company, which also renders services to other utilities and affiliates.

161. Witness VonSteuben addresses OPC Witness Bright's concerns about whether the Company is receiving a fair price (as defined by the lower of cost or market)[469] when leasing office space from the Service Company. He states that the lease cost of $28 per square foot in the test year is less than market cost of $40-45 per square foot for similar space in the Penn Quarter Section of the District.[470] VonSteuben argues that, even with the lease escalators in the current lease agreement, the Service Company will not pay today's market rate (*i.e.*, the $40-$45 per square foot) until 2017.[471]

162. With regard to OPC's recommendation to remove $6,076,146 from rate base for the gain on the sale of the Edison Place building from PHI (Edison Place LLC) to Wachovia, VonSteuben states that OPC Witness Bright provides no support for contending that a gain on a sale of property of an unregulated affiliate should affect the rate base of the regulated affiliate that does not have the facility in its rate base. VonSteuben points out that, in Order No. 14285, the Commission ruled that under "established Commission precedent, the gains and losses on the sale of

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465 *Id.* 78:1-3.

466 *Id.* 78:16-18.

467 AOBA Br. at 21.

468 PEPCO (3A) at 39:21-23 (Rigby Rebuttal).

469 This is a foundation concept of asymmetrical pricing.

470 PEPCO (3C) at 28:23-29:4 (VonSteuben Rebuttal).

471 *Id.* at 29:4-8.

land accrue to PEPCO's shareholders."[472]

163. Witness VonSteuben also states that OPC's alternative lease cost proposal, which reduces expenses by $256,282,[473] is based on Bright's inaccurate calculation of the difference in lease costs before and after the sale of Edison Place to Wachovia Development Corporation. VonSteuben asserts that the comparison of the pre-Wachovia Purchase Lease (executed in January 2003) and the post-Wachovia Purchase Lease (executed in September 2003) is flawed because the post Wachovia Purchase Lease includes costs for additional space and items that were not included in previous agreements (*e.g.*, storage, locker rooms, ATM, and the first floor retail space from which PHI derives revenue).[474] Accordingly, VonSteuben submits that OPC's proposed treatment should be rejected.[475]

164. Witness VonSteuben then points out that OPC's concern that the lease payments in 2003 do not match the lease agreement in effect at the time[476] is due simply to the difference associated with including the "tenants' share of operating expenses and real estate taxes." He submits that the difference between the payments provided in response to OPC Data Request No. 2-35 and OPC's calculation can be explained by these two factors.[477] VonSteuben maintains that the basis of OPC Witness Bright's adjustment is in error, and that PHI pays below market costs for the space and, as a result, Bright's adjustments are "misguided and should be disregarded by the Commission."[478]

165. Witness White states that, since the merger with Atlantic City Electric Company and Delmarva Power and Light, the Service Company has been audited by many agencies and external audit firms, including the SEC, as well as the Public Utility Holding Company Act Staff of the SEC, Deloitte and Touche, PricewaterhouseCoopers ("PwC"), and the New Jersey Board of Public Utilities.[479] White adds that, in every examination, the Service Company charges "have been found to be reasonable," and none of the auditors found "any material and substantive issues with the calculation of the Service Company allocations."[480] White further states that, in addition to these external reviews, PEPCO is audited by its own external auditor, PwC, which conducted sample transaction tests on certain figures (known as "statistical key figures" or "SKFs") which are used to allocate Service Company charges to PEPCO. According to White, PwC has never proposed any changes to the allocators as a result of these tests.[481]

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472 *Id.* at 30:18-21.

473 OPC (C) at 45:10-14 (Bright Direct).

474 PEPCO (3C) at 32:5-22 (VonSteuben Rebuttal).

475 *Id.* at 32:22-33:1.

476 Second amendment in effect January 2003.

477 PEPCO (3C) at 33: 9-16 (VonSteuben Rebuttal).

478 *Id.* at 34:4-11.

479 PEPCO (I) at 3:1-7 (White Rebuttal).

480 *Id.* at 3:11-16.

481 *Id.* at 3:20-23, 4:1-2.

166. Witness White dismisses Bright's concerns with the results of an SEC audit as unfounded,[482] stating that, contrary to Bright's testimony, there "are no errors in the raw data" submitted to the SEC.[483] White asserts that Bright selectively used an incomplete quotation from the SEC audit provided to OPC in response to data request OPC 2-24. She states that the SEC found that "[o]verall, PHI Service Company has an adequate process in place to allocate PHI Service Company costs to the operating companies.[484] White further explains that Ernst and Young ("E&Y") also conducted an agreed-upon procedures audit of the Company's Cost Allocation Manual for the test year,[485] and that E&Y tested the calculation of several of the allocators and did not find any errors.[486]

167. Witness White contends that equally without merit is OPC's allegation that the Service Company allocations inflated employee numbers and resulted in an inaccurate employee cost ratio.[487] According to White, although the employee numbers appear inconsistent, Service Company employees that support facilities, security, storeroom, and special billing functions that solely serve PEPCO were not included in employee headcounts supplied to OPC.[488]

168. With regard to Bright's testimony that there is a significant difference between the "square foot ratio" denominator of 244,000 square feet and the 340,275 square feet which appears in the lease agreement with Wachovia Development Corporation, Witness White states that the latter figure includes common space which was included after the Company implemented a "facilities management integration" which used computer-based software to track square footage in the building. She maintains that the Company is "allocating the cost of the facility to users based upon the space that they occupy in the building."[489]

DECISION

169. The Commission is persuaded that the Service Company charges reduce Company costs through economies of scale and, ultimately, reduce costs to ratepayers. PEPCO's inter-company cost allocations are not inconsistent with any Commission regulation or policy nor have they been found violative of federal law or standard auditing practices. Additionally, the

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482 *Id.* at 4:3-7.

483 *Id.* at 4:13-14.

484 *Id.* at 4:20-22.

485 Twelve months ended September 30, 2006.

486 PEPCO (I) at 5:13-14 (White Rebuttal).

487 *Id.* at 5:20-22.

488 *Id.* at 6:9-14.

489 *Id.* at 6:21–7:8.

Company has adequately explained the apparent lease cost discrepancies[490] and lease payment disparities[491] that Witness Bright identified.[492] Although we find some of the Service Company charges allocated to PEPCO difficult to track, this is an issue for a cost allocation proceeding and not a basis for denying the adjustment. Therefore, the Commission approves the Service Company charges, except where specifically excluded or modified elsewhere in this Order.

170. In order to minimize the adverse impacts on ratepayers in future cases, PEPCO shall procure the services of a contractor, subject to the Commission's approval of the RFP and the Commission's selection of a contractor, to conduct an independent audit of the costs of PHI's Service Company allocated to PEPCO in the District. The costs of the contract audit is to be paid for by PEPCO. The Commission also directs PEPCO to file, as part of its next base rate proceeding, a benchmark or industry study of the Service Company costs to support their reasonableness, itemized in sufficient detail to enable all parties to review and understand the individual component costs for those services.

B. Employee-Related Costs and Annualization of Wage Increases[493]

171. PEPCO. The Company has proposed two adjustments to Operations and Maintenance "O&M" expenses to pertaining employee-related costs and the annualization of wage increases:

> (a) ***Annualization of Wage Increases:*** RMA No. 8 increases O&M expenses by $1,357,000 to annualize employee salary and wage increases which occurred in the test year (March 1, 2006, for exempt employees and June 1, 2006, for union/bargaining unit employees). Additionally, according to PEPCO, the adjustment reflects reasonably known and certain increases for the rate effective period.[494] The Company's adjustment is based on a 3.31 percent increase for exempt employees during the test year and a 3.5 percent increase during the rate effective period. The adjustment for bargaining unit employees is

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[490] Witness VonSteuben explains that after the Wachovia purchase, the cost of the lease increased due to the inclusion of additional space and items, not because of non-arms length dealing. PEPCO (3C) at 32:15-33:1.

[491] Witness VonSteuben points out that the tenants' share of operating expenses and real estate taxes could explain why the 2003 lease payments seem higher than the contract price. PEPCO (3C) at 33:9-16.

[492] We also agree with PEPCO that Commission precedent does not support OPC's request to remove the gain from the Edison Place sale from the rate base. *See, for e.g.,* Order No. 14285 at ¶ 14 (May 4, 2007) (referring to "established Commission precedent that gains and losses on the sale of land (whether or not it has ever been part of the rate base) accrue to the benefit or detriment of utility shareholders"); Formal Case No. 939, Order No. 10646 at 164-66 (June 30, 1995) (referring to "long-standing precedent of this Commission that gains or losses on the sale of land formerly in rate base accrue to the utility's shareholders").

[493] Designated Issue No. 6.b asks: "Has PEPCO properly calculated employee-related costs and the annualization of wage increases?"

[494] PEPCO (C) at 12:19-13:1 (VonSteuben Direct).

based on a 3.0 percent increase for both the test period and the rate effective period.[495]

(b) ***Employee-Related Costs:*** RMA No. 9 increased O&M expenses by $343,000 to reflect changes in employee health and welfare costs in the rate effective period. Changes to medical, dental, and vision plans reflect anticipated percent increases developed by the Human Resource department. Increases in pension and benefits are based on information from the Company's actuarial firm. Increases have been offset by savings as a result of implementation of new plan designs.[496]

172. **OPC.** OPC recommends several adjustments to PEPCO's wage and salary expenses. Specifically, OPC proposes to remove the cost of certain executive compensation plans. OPC contends that although the Company removed the expense portion of the costs of the Executive Performance Supplemental Retirement Plans, consistent with the Commission's previous ruling in an earlier case, the Company is still attempting to charge District ratepayers with expenses associated with incentive compensation plans which are related to corporate financial goals by recovering costs associated with the Annual Incentive Plan, Executive Incentive Compensation Plan, and the Long Term Incentive Plan. PEPCO's expenses for these incentive plans during the projected test period total $8,629,284. OPC recommends a reduction of $1,591,156 to the District of Columbia distribution expense, a $1,308,995 reduction in plant-in-service, a $32,725 reduction in depreciation expense, and a $16,362 increase in accumulated depreciation applicable to the removal of the costs of the incentive plans from the test year.[497]

173. In addition, OPC proposes to eliminate gainsharing exempt salaries and wages, as the Commission did in Formal Case No. 939. OPC estimates capitalized gainsharing since Formal Case No. 939 of $692,000, depreciation expense of $27,000, and accumulated depreciation of $215,000. OPC also seeks to remove salaries and wages related to fifty-six employees that were transferred to the Service Company in December 2006. According to OPC, PEPCO did not clearly explain how the transfer of these employees to the Service Company would affect PEPCO's projected test-period salaries, wages, and employee benefits, or how the change in the employee number at PEPCO and the Service Company would affect the Service Company allocation factors, which are dependent on the number of employees working at the Service Company and the various affiliates or the costs associated thereto for the test period. OPC recommends removing 100 percent of the costs of the transferred employees from the projected test period and allocating an estimated 40 percent of those costs from the Service Company back to PEPCO. The recommended adjustment is $1,367,491.[498]

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495 PEPCO (C)-1 at 11.

496 PEPCO (C) at 13:2-14:2 (VonSteuben Direct); PEPCO (C)-1 at 2; PEPCO (C)-1 at 12; PEPCO (2C) at 4:12-17 (VonSteuben Supp. Direct); Compliance Filing, 1053-E-4 at 47-53.

497 OPC (C) at 47:13 51:11(Bright Direct).

498 *Id.* at 53:15-54:35.

174. OPC further proposes a reduction of the Company's projected wage and salary increases based on the difference between the projected level of employees included by PEPCO in projected test-period expenses and the actual number of employees at PEPCO and the Service Company during the test period. The Company calculated its projected test-year salaries and wages based on the actual number of employees in the first six months of the test year and on the budgeted number of employees for PEPCO and the Service Company during the projected six months of April 2006 through September 2006. According to Witness Bright, the budgeted number of employees used by PEPCO in its calculation of test-period wages and wage increases is substantially in excess of the actual number of employees at PEPCO and the Service Company during the projected six months ended September 30, 2006. On average, PEPCO's budget for the six months of the projection includes 160 more PEPCO employees and 112.6 more Service Company employees than the actual number of employees as of September 30, 2006. OPC proposes an adjustment of $860,059 to wages and salaries and $61,178 to Federal Insurance Contributions Act ("FICA") taxes to reflect the reduction in the actual number of PEPCO and Service Company employees in the projected test period.[499]

175. Finally, OPC notes that PEPCO includes a projected wage increase that is more than seventeen months after the end of the test period and that this increase is neither known nor certain as it relates to management employees not under a union contract. OPC explains that its adjustment removes the 2008 wage increase.[500]

176. **AOBA.** AOBA asserts that the Commission should disallow PEPCO's RMA No. 9 for Employee Health and Welfare Benefits, which increases O&M costs by allocating certain pension and OPEB costs from the Service Company to PEPCO. According to AOBA, a large proportion of the increased pension and OPEB costs included in PEPCO's RMA No. 9 appears to reflect reallocation of pension and OPEB costs as a result of the sale or shutdown of generating station facilities by an unregulated PHI subsidiary. AOBA's recommended adjustment is $940,000, with a net tax effect of $551,000.[501]

177. **PEPCO Rebuttal.** In response to OPC's proposed adjustments related to employee costs, VonSteuben asserts that the Company's incentive plans are important and necessary components of the Company's overall compensation structure. However, if the plans are unacceptable to the Commission, PEPCO alternatively proposes that the Commission consider averaging the costs over three years rather than adjusting them out of the proposed test-year expenses.[502]

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499 *Id.* at 55:19-57:8.

500 *Id.* at 58:20-59:5.

501 AOBA (A) at 86:12-88:13 (Oliver Direct). AOBA's numbers are from PEPCO (C)-3 at 12, covering the twelve months ended March 31, 2006. The Company's adjustment is $343,000, with a net of tax effect of $201,000 from PEPCO (C)-1 at 12, representing the proposed test year of six months actual and six months projected.

502 PEPCO (3C) at 34:19-35:15 (VonSteuben Rebuttal).

178. In regard to OPC's proposed adjustment related to gainsharing, VonSteuben recognizes that the Commission has consistently declined to include gainsharing in the rate base. If the Commission does not wish to depart from that view, the Company has revised both estimated depreciation through September 30, 2006, and allocation factors as follows:[503]

	OPC	**Pepco Revised**
Capitalized gainsharing since Formal Case No. 939	($692,000)	($706,000)
Depreciation expense	($27,000)	($27,000)
Accumulated depreciation	$215,000	$293,000

179. Witness VonSteuben states that the OPC adjustment relating to the December 2006 transfer of employees to the Service Company is inappropriate because it considers only employees transferring from PEPCO to the Service Company while ignoring employees transferring from the Service Company to PEPCO or from other PHI entities to the Service Company. He asserts that this adjustment attempts to bring into the test year the impact of one isolated situation without assessing the impact of other such transfers.[504] VonSteuben maintains that OPC's proposed adjustment, involving actual wages for the twelve months ended September 30, 2006, is similarly flawed because it considers only actual expenses that were lower than budgeted while ignoring expenses that were higher than budgeted. In PEPCO's view, OPC's approach constitutes piecemeal ratemaking and should be rejected.[505]

180. With regard to AOBA's proposed elimination of RMA No. 9, PEPCO asserts that the adjustment is not a reallocation of pension and OPEB costs as a result of the sale or shutdown of generating station facilities by an unregulated PHI subsidiary. Instead, PEPCO explains that the pension and OPEB costs used in the partially projected test year were based on preliminary numbers from the Company's actuary that did not reflect the elimination of the B. L. England, Keystone Conemaugh, and Delaware City facilities. PEPCO also states that AOBA erred in using the values from the historical test year ended March 2006, rather than the partially projected test year that is the basis for the Company's test year.[506]

DECISION

181. The Commission accepts OPC's recommendation to remove certain executive compensation plans, which the Commission finds should not be included in the rate base for the reasons stated in Formal Case No. 939 for excluding gainshairing plans from the rate base. This

503 *Id.* at 35:21-36:9; PEPCO (3C)-2.

504 PEPCO (3C) at 37:21-38:11 (VonSteuben Rebuttal).

505 *Id.* at 38:16-39:19.

506 *Id.* at 25:8-26:7.

adjustment results in a $1,591,000 reduction to District of Columbia distribution expense; a $1,309,000 reduction in plant-in-service; a $33,000 reduction to depreciation expense; and a $16,000 increase in accumulated depreciation.[507] The Commission rejects the Company's proposal to average these costs over three years. The Company has failed to demonstrate the variability associated with these costs and explain why they should be averaged instead of adjusted out of the Company's proposed test-year expenses.

182. The Commission also accepts OPC's proposed adjustment related to gainshairing, as revised by the Company. The Company acknowledges that the Commission has previously ruled in favor of such an adjustment.[508] Indeed, the Commission has consistently rejected PEPCO's requests to include gainsharing costs in the rate base.[509] While PEPCO concedes that the adjustment is proper, the Company has updated OPC's amounts to reflect both estimated depreciation through September 30, 2006, and allocation factors applicable to this proceeding.[510] The effect is to reduce capitalized gainsharing from Electric Plant In Service by $706,000, reduce depreciation expense by $27,000, and increase accumulated depreciation by $293,000.

183. The Commission rejects OPC's proposed adjustment related to the reduction of PEPCO's salary and benefit expenses to reflect the December 2006 transfer of 56 employees to the Service Company.[511] While the Commission recognizes that these 56 employees were transferred, the Commission finds that it would constitute piecemeal ratemaking if it were to make such an adjustment based on the transfer of employees from PEPCO to the Service Company without considering the impact of the 16 employees PEPCO testifies were transferred from the Service Company to PEPCO in the same month.[512]

184. However, the Commission accepts, with modification, OPC's proposed adjustment to reflect actual wages for the 12-months ended September 30, 2006, to recognize the significant reduction in workforce during and beyond the test year.[513] Based on evidence presented, there have been significant reductions in the number of PEPCO employees from the beginning of the test year to the end of the six months of projected test year results and beyond. PEPCO has not considered such reductions in its RMA No. 8 to annualize wage increases. As shown in OPC (C)-5, the Company significantly reduced its exempt and non-exempt employees from the start of the test year through the end of the test year and beyond. The reductions were as follows:

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507 OPC (C) at 50:22-51:11 (Bright Direct).

508 PEPCO Br. at 35.

509 Formal Case No. 939, *In re Potomac Elec. Co.,* Order No. 10646 at 125-27 (June 30, 1995) (cost of financial incentives with "triggers" tied to shareholder-oriented financial goals should not be funded by ratepayers); Formal Case No. 929, *In re Potomac Elec. Co.,* Order No. 10387 at 93 (Mar. 4, 1994), 150 P.U.R. 528, 1994 WL109204 at *67.

510 PEPCO (3C) at 35:21-36:9; PEPCO (3C)-2.

511 OPC (C) at 53:15-19 (Bright Direct).

512 PEPCO (3C) at 37:21-38:11 (VonSteuben Rebuttal).

513 OPC (C) at 55:17-57:8 (Bright Direct).

	Exempt	Non-Exempt
Sep-05	389	1,148
Oct-05	388	1,146
Nov-05	390	1,149
Dec-05	381	1,143
Jan-06	376	1,144
Feb-06	375	1,136
Mar-06	**372**	**1,132**
Apr-06	371	1,130
May-06	375	1,123
Jun-06	380	1,114
Jul-06	348	1,129
Aug-06	347	1,122
Sep-06	345	1,114
Oct-06	346	1,113
Nov-06	346	1,113
Dec-06	314	1,103
Jan-07	**315**	**1,081**
Net Change from Sep-05 through Jan-07	(74)	(67)
Net Change Mar-06 through Jan-07	(57)	(51)[514]

The Commission modifies the Company's RMA No. 8 to address this significant reduction in the workforce that is known and measurable. Specifically, the Commission directs that the adjustment to the rate effective period wage increase will be 84.68 percent of that used in PEPCO RMA No. 8 (January 2007/March 2006 or 315/372) for exempt employees. The corresponding adjustment for the non-exempt employees' rate effective period wage increase is 95.49 percent, calculated as follows: January 2007/March 2006 or 1,081/1132 or 95.49 percent. Accordingly, RMA No. 8 is reduced by $1,874,000 (reduction in number of employees and exclusion of March 2008 salary increase) for exempt wage expense and $689,000 for non-exempt wage expense (reduction in number of employees).

185. The Commission accepts OPC's proposed adjustment to eliminate the March 2008 salary increase.[515] The Commission agrees with OPC that a salary increase for non-exempt

514 OPC (C)-5 at 2.

515 OPC (C) at 58:19-59:5 (Bright Direct).

employees that is projected to take place March 1, 2008, more than 17 months after the test period, is neither known nor measurable. This adjustment is included in RMA No. 8.

186. The Commission rejects AOBA's request to eliminate PEPCO's RMA No. 9 for the annualization of employee health and welfare costs. The Commission finds that, contrary to AOBA's contention, the proposed adjustment for health and welfare costs does not constitute a reallocation of pension and OPEB costs as a result of the sale or shutdown of generating station facilities by an unregulated PHI subsidiary. Instead, PEPCO's partial projection of such costs is based on its actuary's preliminary numbers that did not reflect the elimination of such facilities.

C. Other Ratemaking Adjustments

1. Ratemaking Adjustment No. 2 – Exclusion of Supplemental Executive Retirement Plans

187. **PEPCO.** The Company has reduced O&M expenses by $349,000 for the removal of the costs associated with the non-qualified supplemental executive retirement plans consistent with the Commission's prior decision in Formal Case No. 939.[516]

188. **OPC.** OPC states that in Formal Case No. 939 (Order No. 10646), the Commission disallowed all costs associated with PEPCO's Supplemental Executive Retirement Plan ("SERP") and Executive Protection Plan. OPC contends that the Company excluded only the expense portion of the SERP, which is 54.7 percent, and not the entire SERP amount. OPC reports that, in a data request response, the Company stated that the capitalized portion was not removed from rate base because its accounting system does not trace specific cost elements.[517] OPC recommends an adjustment of $289,000[518] to adjust the rate base for the portion of SERP capitalized during the test period. OPC also recommends that all SERP costs capitalized since Formal Case no. 939 should be excluded, but contends that it has not been provided the information necessary to make such an adjustment.[519]

189. **PEPCO Rebuttal.** PEPCO argues that OPC's proposed adjustment to remove the capitalized portion of all SERP costs included in rate base since Formal Case No. 939 is inconsistent with Commission precedent and is tantamount to retroactive ratemaking. The Company states that it has treated SERP costs in the exact manner as proposed by OPC and accepted by the Commission in Formal Case No. 939.[520]

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516 Formal Case No. 939, Order No. 10646 at 128 (June 30, 1995); PEPCO (C) at 10:22-11:2 (VonSteuben Direct); PEPCO (C)-1 at 2; and PEPCO (C)-1 at 5; Compliance Filing, 1053-E-4 at 7-13.

517 OPC (D) 8:3-6

518 OPC Br. At 75.

519 OPC (D) at 8:13-18 (Gumer Direct).

520 PEPCO (3C) at 36:19 – 37:15 (VonSteuben Rebuttal).

DECISION

190. The Commission will remove the entire amount of SERP, not just the amount expensed. The Commission has previously explained its rationale for disallowing all costs associated with PEPCO's SERP and Executive Benefit Protection Plan. In Order No. 10646, the Commission ruled that "if PEPCO wishes to compensate its executives over and above its qualified pension plan, then this cost is properly borne by the shareholders, not the ratepayers.[521] Accordingly, we disallow all costs associated with PEPCO's SERP and Executive Benefit Protection Plan." Although PEPCO argues that it has not made a rate base adjustment in the past, *i.e.*, it has only removed the amount of SERP costs expensed, our reasoning in Order No. 10646 clearly applies to all SERP costs, and PEPCO has not provided a compelling argument to the contrary. As a result, PEPCO's proposed rate base will be reduced by $289,000. The Commission rejects OPC's proposal to exclude the capitalized portion of the SERP allowed since Formal Case No. 939, as this would amount to retroactive ratemaking.

2. Ratemaking Adjustment Nos. 3, 4, 5, 7, 10, 11, 15, and 16[522]

191. Under Adjustment No. 3, Exclusion of Industry Contributions, the Company removed $365,000 from O&M expenses for those costs associated with industry memberships and contributions. With regard to costs associated with the American National Standards Institute ("ANSI"), PEPCO included them based on the Commission's decision in Order No. 9509.[523]

192. Under Adjustment No. 4, Exclusion of Institutional and Promotional Advertisement, the Company removed $183,000 of Institutional and Promotional Advertising operating expense costs from the test year in accordance with Commission precedent. The Company included informational advertising expenditures because they are part of cost of service.[524]

193. Under Adjustment No. 5, Inclusion of Interest on Customer Deposits, the Company added $62,000 to Interest Expense for Customer Deposits. The amount is the difference between the 2006 interest rate applied to a 13-month (September 2005 through September 2006) average balance of Customer Deposits and the 2005 interest expense. PEPCO explains that treating interest on Customer Deposits as an operational expense is based on the Commission's removal of Customer Deposits from the rate base in Order No. 7457.[525]

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[521] Formal Case No. 939, *In re Potomac Elec. Co.*, Order No. 10646 at 128 (June 30, 1995).

[522] Adjustment Issues No. 8, Annualization of Wages, and No. 9, Annualization of Employee Health and Welfare Costs, are addressed under Issue No. 6(b).

[523] Formal Case No. 889, Order No. 9509, 11 D.C.P.S.C. 302, 368 (1990) (since American National Standards Institute and two other groups "demonstrably benefit ratepayers relative to the provision of electric service … contributions to these groups are reasonably charged to ratepayers"); PEPCO (C) at 11:3-8 (VonSteuben Direct); PEPCO (C)-1 at 6; Compliance Filing 1053-E-4 at 485-486.

[524] PEPCO (C) at 11:9-19 (VonSteuben Direct); PEPCO (C)-1 at 7; Compliance Filing, 1053-E-4 at 487-493.

[525] Formal Case No. 748, Order No. 7457, 2 D.C.P.S.C. 401 at 422-423 (Dec. 30, 1981).

194. Under Adjustment No. 7, Exclusion of Merger Costs, PEPCO Witness VonSteuben states that, in accordance with the terms of the Agreement and Stipulation in Formal Case No. 1002,[526] the Company removed the cost of merger related integration success initiatives from its proposed cost of service.[527] This adjustment reduces O&M expenses by $12,000.

195. Under Adjustment No. 10, Three-Year Average Storm Costs, the Company proposes to normalize storm-related expenses to their three-year average.[528] This adjustment seeks to increase O&M expenses by $90,000.[529]

196. Under Adjustment No. 11, Removal of Mirant Bankruptcy Costs, PEPCO proposes removing the legal costs associated with the Mirant bankruptcy from its cost of service. This proposed adjustment reduces test-year administrative and general expenses by $599,000.[530]

197. Under Adjustment No. 15, Postal Increase, the Company is requesting to increase O&M expenses by $12,000 to annualize the most recent postal increase in January 2006.[531] PEPCO claims that this adjustment is consistent with "longstanding Commission precedent regarding known and certain changes."[532]

198. Under Adjustment No. 16, Costs of Current Proceeding, the Company is requesting to increase O&M expenses by $255,000 to include the costs associated with Formal Case No. 1053.[533] These expenses include the costs for its cost of capital witness and outside counsel. The costs would be amortized over a three-year period. Test year O&M expenses would increase by $85,000 ($255,000/3).

DECISION

199. Parties either support the above adjustments or do not oppose them. Inasmuch as no party has opposed these adjustments and because we find them otherwise reasonable, we approve them.

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526 PEPCO (C) at 12:14-18 (VonSteuben Direct).

527 *Id.* at 12:14-18.

528 *Id.* at 14:3-5.

529 PEPCO (C)-1 at 13:8-10.

530 *Id.* at 14.

531 *Id.* at 18.

532 PEPCO (C) at 16:7-11 (VonSteuben Direct).

533 PEPCO (C)-1 at 19:3.

3. Ratemaking Adjustment No. 6 – 3 Year Average of Regulatory Expenses

200. **PEPCO.** The Company includes an additional $445,000 in regulatory expenses (assessment for formal cases) for the difference between a three-year average and test year regulatory expenses. PEPCO explains that this addition is based on Commission rulings in Formal Case Nos. 905, 912, 929, and 939. The Company includes years 2004, 2005, and the test year in its three-year average.[534]

201. **OPC.** Initially, OPC asserted that PEPCO should subtract $843,988 in refunds that the Company received from OPC in March 2007.[535] However, OPC later changed its position and agreed that PEPCO's proposed $445,000 adjustment should be accepted by the Commission.[536]

DECISION

202. After reviewing the proposed adjustment, the Commission is of the opinion that the Company should have normalized the regulatory expenses for non-recurring, one time expenses. The Company's January 3, 2007, compliance filing indicates that $1.1 million of expenses in 2005 were related to the Mirant bankruptcy.[537] This amount covered case expense assessments for OPC and the Commission in the amounts of $950,000 and $150,000, respectively, all allocated to distribution. These expenses should be removed from the Company's calculation of the three-year average because they constitute a non-recurring expense. The Commission, therefore, will approve a regulatory expense based on an adjusted 2005 regulatory expense of $1,277,925, calculated as follows:

	Amount
Regulatory expenses:	
2004	1,512,359
2005	1,277,925
Test year	1,276,569
DC 3-year Total	$4,066,853
DC 3-year Average	$1,355,618
Regulatory expense for Test Year: 12 months ending 9/30/06	$1,276,569
Increase to O&M	$79,049

203. Thus, the Commission will allow a $79,049 increase in regulatory expense for operating expenses, rather than the $445,000 increase requested by the Company, and the adjustment to PEPCO's O&M expenses is $366,000 (the difference between $445,000 and $79,000).

534 PEPCO (C) at 12:10-13 (VonSteuben Direct); PEPCO (C)-1 at 9; PEPCO (C)-5 at 1-4.

535 OPC (D) at 8:8-18 (Gumer Direct); Exhibit OPC (D)-12.

536 OPC Br. at 116.

537 Compliance Filing, 1053-E-4 at 30.

4. Ratemaking Adjustment No. 12 – Customer Care Enhancements

204. **PEPCO.** The Company is proposing to adjust test-year O&M expenses to include annual recurring costs associated with its enhanced customer care initiatives. This adjustment increases the Company's total O&M expenses by $1,953,358, which is comprised of $953,358 for 12.5 new hires to the call centers and $1,000,000 for peak period resources outsourcing.[538] The Company is seeking to recover $737,000 from ratepayers in the District.[539] Witness VonSteuben states that the Company is in the process of hiring 15 new customer care representatives and will expand its use of seasonal outsourced customer care representatives.[540]

205. **OPC.** OPC opposes the Company's adjustment on the grounds that it is an out-of-period adjustment. Witness Bright states that both components of the Company's adjustment, $953,358 for twelve new employees scheduled to be hired during 2007 and $1,000,000 for additional outsourcing during peak periods, should be rejected as speculative and not meeting the known and measurable standard.[541]

206. **PEPCO Rebuttal.** Witness VonSteuben states that removal of the costs associated with this customer care initiative would be "inappropriate."[542] He points out that the Company plans to have its number of customer service representatives at 110 full time equivalent employees ("FTEs") for the rate effective period and that, as of April 2007, the Company had 105 call center FTEs.[543] VonSteuben further states that the Company is actively seeking to hire the additional customer service representatives to "meet the target of 110."[544]

207. With respect to the $1,000,000 for the outsourced temporary employees, Witness VonSteuben states that these resources are needed to respond to seasonal demands driven by the higher levels of outages from "fast hitting storms, increased disconnects and reconnects, and full-time customer care employees taking vacation in the summer months."[545] He states that these outsourced resources would be ready to take calls in June 2007. VonSteuben concludes that these costs are appropriate because the Company is on track with its customer care initiative and because of the focus on the Company's ability to "meet customer service expectations in the post-Hurricane

538 Compliance Filing, 1053-E-4 at 66.

539 PEPCO (C)-1 at 15.

540 PEPCO (C) at 14:14-15:2 (VonSteuben Direct). The Commission notes that PEPCO relied on a figure of 12.5 new hires in its calculation of this adjustment, but referred to 15 new customer care representatives in its testimony.

541 OPC (C) at 27:3-11 (Bright Direct).

542 PEPCO (3C) at 18:2-4 (VonSteuben Rebuttal).

543 *Id.* at 18:7-10.

544 *Id.* at 18:12-13.

545 *Id.* at 18:18-22.

Isabel era."[546] For these reasons, VonSteuben concludes that OPC Witness Bright's proposed elimination of the customer care initiative costs should be rejected.[547]

DECISION

208. The requested adjustment is beyond the test period. In Formal Case No. 869, the Commission determined that it would be appropriate to permit adjustments to the test year if the adjustments were known, certain, and measurable, and not too remote from the test year.[548] In this instance, the Commission accepts PEPCO's adjustment in part. The number of customer care FTEs PEPCO included in the test year is 97.54. PEPCO proposes an adjustment that would add 12.5 more FTEs, for a total of 110 new customer care employees. The 97.54 figure is based on the actual number of FTEs for the first six months of the test year and a budgeted figure of 98 FTEs for each of the last six months of the test year.[549] The Company's response to data request OPC No. 4-70 shows that the Company's level of full time employees ("FTEs") was at 89 at the end of the test year.[550] As shown in the following table, the actual number of FTEs over the succeeding six months increased by four FTEs.

Month/Year	Number of FTEs
September 2006	89
October	87
November	88
December	89
January 2007	94
February	93
March	93

209. Further, PEPCO Witness VonSteuben testifies that, in April 2007, the number of active call center customer service representatives, expressed as FTEs, increased to 105.[551] As this testimony was not rebutted by any other party, we conclude that an increase of 7.5 FTEs (105-97.5)

546 *Id.* at 19:3-8.

547 *Id.* at 19:8-10.

548 *See,* Formal Case No. 869, *Potomac Electric Power Co.,* Order No. 9216, 10 D.C.P.S.C. 22, 110 (1989). Out-of-test year adjustments are allowed by the Commission only where the full impact on revenues, expenses, and rate base of a specific change in a utility's operation is known, certain, and measurable with precision. *See* Formal Case No. 989, Order No. 12589, ¶ 72.

549 Compliance Filing, 1053-E-4 at 67-69.

550 OPC Cross Exhibit No. 47.

551 PEPCO (3C) at 18:2-19:10 (VonSteuben Rebuttal).

is known and measurable.[552] We will therefore allow PEPCO's requested adjustment in part, to be calculated on the basis of 105 FTEs, rather than the Company's target number of 110, as there is no evidence indicating that this estimated target number was ever reached. Additionally, there is no evidence in the record to support PEPCO's requested adjustment for the outsourced temporary call center employees. Because there is no evidence or testimony that this estimated out-of-period adjustment is known and measurable, the Commission rejects the Company's proposed outsourcing adjustment. The Commission accordingly reduces the Company's proposed expense adjustment by $522,000.

5. Ratemaking Adjustment No. 13 – Increase in Commission and OPC Assessments

210. **PEPCO.** The Company adds $1,592,000 to Other Tax Expense representing the difference between the Fiscal Year 2006 Commission and Office of the People's Counsel's operating budget assessments and those of the test year. The addition is based on Commission Order Nos. 14051 and 14047,[553] which provide the FY 2006 amounts.[554]

211. **OPC.** Witness Gumer mentions regulatory expenses only in regard to formal cases and not to the appropriated budgets as referenced in this adjustment.[555] No party contests this proposed adjustment.

DECISION

212. Although no party has objected to this adjustment, we find that the proposed adjustment is too high. PEPCO's adjustment is based on actual data from FY 2006, when the assessments for the Commission's and OPC's operating budgets were disproportionately greater than in prior years because only three utilities were assessed in that year. Except for fiscal year 2006, the competitive energy and telecommunications providers in the District were, and will be assessed.[556] The Commission considered several options to allow PEPCO to recover the fiscal year 2006 assessments, including accepting the Company's proposed adjustment, using a three-year average similar to our decision in RMA No. 6, or basing the test year assessment on the actual FY 2007 assessment. The Commission has determined, however, that the most equitable method is to allow the Company to recover the relatively high fiscal year 2006 assessment costs through an amortization mechanism. Because these assessment costs generally are increasing, the Commission calculates PEPCO's test year assessment expense for this adjustment as follows:

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552 The Company's adjustment of 12.5 FTEs is derived by comparing the average number of FTEs in its test year adjustment, 97.54, and its target number of FTEs, 110, and rounding the difference to 12.5 FTEs. Correspondingly, the Commission rounds its adjustment to 7.5 FTEs.

553 Formal Case No. 748, Order No. 7457, 2 D.C.P.S.C. 401 at 422-23 (Dec. 30, 1981) (customer deposits are to be deducted from rate base and interest thereon reflected in an adjustment to operating expense).

554 PEPCO (C) at 15:3-6 (VonSteuben Direct); PEPCO (C)-1 at 16; Compliance Filing, 1053-E-4, at 542-545; PEPCO (2C) at 4:12-17 (VonSteuben Supp. Direct).

555 OPC (D) at 8:8-18 (Gumer Direct).

556 *See* D.C. Code, 2001 Ed. § 34-912 (b)(1).

FY 2005	$5,078,000
FY 2004	-4,439,000
Increase	$ 639,000
Percentage increase from 2004 to 2005	14.40%
Base Year Est. (FY 2005 + 14.40 % increase)	$5,809,000
FY 2006 Assessed Amounts	6,922,000
Difference	$1,113,000
1/3 of Difference	$ 371,000
New Base Year (Base Year + 1/3 Diff)	$6,180,000
Test Year Assessment Amounts	5,330,000
Adjusted Amount	**$ 850,000**

213. This option allows PEPCO to recover its excess assessment in 2006 over three years. The amortization will be trued up in the Company's next base rate request and any excess returned to customers. Thus, we will allow an $850,000 increase in the Commission's and OPC's budget assessments for operating expenses, rather than the $1,592,000 increase requested by the Company. The adjustment to PEPCO's O&M expenses is $742,000 (the difference between $1,592,000 and $850,000).

6. Ratemaking Adjustment No. 14 – Increased Allocation of Service Company Costs

214. **PEPCO.** The Company seeks to include $1.414 million of additional administrative and general expenses related to an increased allocation of the Service Company costs associated with the sale or closure of three PHI facilities: B.L. England, Keystone-Conemaugh, and Delaware City.[557] The Company claims that this reallocation of shared benefits and costs results from the sale or closing of these facilities.[558]

215. PEPCO states that customers benefit when affiliated companies efficiently pool resources and share costs in circumstances where the services and related costs would likely be higher if incurred by an individual entity.[559] Conversely, when an affiliate closes a facility or ceases its operation, a reallocation is necessary to redistribute the pool of costs associated with the business among the remaining affiliates.[560] PEPCO believes that District customers continue to receive

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557 PEPCO (C)-1 at 17 Column 5 (VonSteuben Direct).

558 PEPCO (C) at 15:7-11 (VonSteuben Direct).

559 *Id.* at 15:11-15.

560 *Id.* at 15:15-18.

benefits of "pooling of common resources within the holding company structure."[561] The Company believes that these costs need to be reallocated for the rate effective period and that, even with this adjustment, the costs of these services to PEPCO are less than PEPCO would incur on a stand-alone basis.[562]

216. **OPC.** Witness Bright recommends that the Commission eliminate the Company's proposed adjustment.[563] She states that the adjustment is not known and certain, and the Company changed its estimate of the impact without changing the revenue requirement in this case.[564] First, according to Bright, the calculation of part of the adjustment is based entirely on the difference in the Service Company's budgeted expenses for 2007.[565] Second, the benefit costs for 80 employees that are leaving PHI as the result of the sale of the B.L. England plant are generation-related and should not be borne by District ratepayers.[566] Next, Bright points out that in PEPCO's filing in Maryland PSC Case No. 9092, the Company removed these costs in its actual updated filing in that case. Finally, in the Maryland proceeding, PEPCO reduced the initial proceeding budgeted numbers associated with the before and after sale/shutdown of the PHI affiliates from a total of \$3.217 million to \$2.849 million—a reduction of \$368,000.[567] This change was not made in PEPCO's supplemental filing in this proceeding.

217. **AOBA.** Witness Oliver states that the Company has not demonstrated the appropriateness of this adjustment.[568] Specifically, he considers "troublesome" the fact that RMA No. 14 seeks to reallocate costs for service to generating facilities. He contends the fact that the key objective of restructuring was to ensure that distribution and generation costs were fully unbundled and that neither would subsidize the other. According to Oliver, this adjustment reallocates generation costs to PEPCO's distribution operations. He states that "minor transactional adjustments" might be acceptable, but the magnitude of dollars in this adjustment is too great (\$4.2 million in total, of which \$1.4 million is being allocated to District distribution operations).[569]

218. Oliver further asserts that the Company has not shown any additional benefits that PEPCO's customers will receive as a result of this reallocation.[570] Accordingly, he recommends that the Commission: (1) deny inclusion of RMA No. 14 – Reallocation of Service Company Cost;[571] and (2) deny any related rate increase until such time as the Company has demonstrated the

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561 *Id.* at 15:19-23.

562 *Id.* at 16:3-6.

563 OPC (C) at 30:16-17 (Bright Direct).

564 *Id.* at 30:17-20.

565 *Id.* at 29:4-8.

566 *Id.* at 29:22-24.

567 *Id.* at 30:7-13.

568 AOBA (A) at 79:1-7 (Oliver Direct).

569 *Id.* at 79:10-80:1.

570 *Id.* at 81:24-84:9.

571 Witness Oliver incorrectly cites adjustment 15 in his testimony at page 85, line 12.

savings ratepayers derive from PEPCO's use of an affiliated Service Company and has established the appropriateness and reasonableness of the Service Company charges through either a benchmark study or competitive market data.[572]

219. **PEPCO Rebuttal.** With regard to Witness Bright's assertion that the Company's update to actuals in its Maryland PSC filing in Case No. 9092 excluded this adjustment, Witness VonSteuben states that this is an inaccurate portrayal of what the Company did.[573] He states that, in the actual updates in the Maryland PSC filing, the Company incorporated its "Increased Allocation of Service Company Costs" in its updated projections for "Employee Health and Welfare Costs." VonSteuben asserts that it would have been "double-counting" to include both adjustments.[574] He concludes that "this demonstrates why it is inappropriate to cherry-pick certain isolated elements of a partially projected filing for updating to actual data."[575]

DECISION

220. Although the Commission has allowed out-of-period adjustments, the Commission has never allowed a fully forecasted test year adjustment, nor are we persuaded to do so now. The Commission rejects the proposed reallocation of these Service Company costs. The data that form the basis of the proposed adjustment consist of projected figures for 2007, not costs within the test period. Such forecasted data are uncertain and insufficient to show known and certain changes in measurable expenses.[576] The Company has therefore failed to meet its burden to prove the appropriateness of the proposed adjustment. As a result, the Company's proposed test year expenses are reduced by $1,414,000.

7. Ratemaking Adjustment No. 17 – Increase in Vehicle Use Costs

221. **PEPCO.** In this out-of-period adjustment, the Company is requesting to increase O&M expenses by $353,000 to include anticipated increases in costs related to its vehicle resources. This increase is based upon two primary factors: (1) an increase of $177,000 for higher fuel costs; and (2) an increase of $133,000 for higher vehicle lease expense.[577] PEPCO states that these costs relate to increased fuel costs, licensing costs, registration fees, and higher interest rates associated with the Company's leased fleet that are not reflected in the test year.[578]

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572 AOBA (A) at 85:9- 86:5 (Oliver Direct).

573 PEPCO (3C) at 23:5-7 (VonSteuben Rebuttal).

574 *Id.* at 23:7-13.

575 *Id.* at 23:16-19.

576 *Potomac Elec. Power Co. v. Pub. Serv. Commn,* 457 A.2d 776, 783 (D.C. 1983). PEPCO also has the burden of persuasion. *Potomac Elec. Power Co. v. Pub. Serv. Commn,* 661 A.2d 131, 140 (D.C. 1995).

577 PEPCO (3C) at 19:20-22 (VonSteuben Rebuttal).

578 PEPCO (C) at 17:2-6 (VonSteuben Direct).

222. **OPC.** Witness Bright recommends eliminating RMA No. 17 – Vehicle Resource Use Costs from the Company's test-period expenses.[579] She states that these expenses are not known and measurable. She also states that this type of budgeted expense for 2007 would be appropriate only if the Company were presenting a fully projected test year, which it is not. Bright states "a totally projected test period based on budgeted numbers has never been allowed and should never be allowed."[580]

223. **PEPCO Rebuttal.** Witness VonSteuben states that the Commission should reject OPC Witness Bright's proposal to eliminate RMA No. 17.[581] VonSteuben submits that the higher O&M vehicle use costs during the rate effective period are reasonably known and measurable and should be reflected in the cost of service.[582]

224. Witness VonSteuben also asserts that the adjustment was based, in part, on an estimate of fuel costs at $3.00 per gallon. He points out that prices in the D.C. area are "currently well over" that amount.[583] He adds that, as a result of new environmental regulations, the Company will begin using ultra-low-sulfur diesel fuel as its inventory of low-sulfur diesel fuel is depleted. This, combined with the Company's increased use of bio-diesel, an expensive but environmentally friendly fuel, and a trend in higher gas and diesel prices, supports the Company's proposed adjustment.[584]

225. With respect to lease costs, VonSteuben states that the Company's procurement plan calls for replacement of 10 percent of its vehicles annually. He explains that the Company is undertaking this replacement program to ensure that its fleet is safe, reliable, environmentally friendly,[585] and cost effective.[586]

DECISION

226. The Commission rejects the vehicle use cost adjustment. The Vehicle Resource Use Cost adjustment reflects, once again, the *forecasted* O&M costs the Company may incur during the rate effective period, including anticipated higher fuel costs, licensing and registration fees, and higher interest rates for the leased fleet not reflected in the test year. The Company's supporting

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579 OPC (C) at 28:6-15 (Bright Direct).

580 *Id.* at 28:14-15.

581 PEPCO (3C) at 21:22-22:1(VonSteuben Rebuttal).

582 *Id.* at 21:20-22.

583 *Id.* at 20:4-7.

584 *Id.* at 20:8-18.

585 Witness VonSteuben notes that diesel units produced after January 1, 2007, must meet stricter EPA emission standards which adds $7,000 to the cost to each diesel chassis. PEPCO (3C) at 21:12-16 (VonSteuben Rebuttal).

586 PEPCO (3C) at 21:16-20 (VonSteuben Rebuttal).

documentation[587] for these increases at the corporate level (*i.e.*, PHI and before affiliate, functional, and jurisdictional allocations) includes:

- $11,543,965 Vehicle Leases
- $2,460,000 Non-stock Materials (parts and tires)
- $1,100,000 Contractor
- $782,000 Licensing & Registration
- $1,463,000 Remaining Other[588]

227. The Company's Rule 206 Compliance Filing[589] indicates that these costs are only *anticipated* costs. These costs are too speculative for rate recovery. In addition, the Company has not included any lease cost credits for replaced vehicles that are returned and later sold by the lease company as specified in the leasing contract.

228. With respect to fuel costs, PEPCO's estimated costs are not known and measurable. The estimated costs are not considered to be substantive proof of the validity of the costs, and they are rejected. Accordingly, the Company's proposed test year expenses are reduced by $353,000.[590]

D. Other Ratemaking Adjustments Identified by Parties

1. Deferred Compensation

229. **OPC.** OPC recommends an adjustment to reduce deferred compensation. OPC points out that, in response to a data request (OPC Exhibit D-4 and D-5), PEPCO stated that it adjusted Account 923 – Outside Services by $1,160,548 (total company) to reflect the additional allocation to PEPCO from the Service Company of an update to the value of the deferred compensation balance and that only $132,000 of this adjustment is related to the test period. OPC argues that this adjustment is not a recurring item and that the appropriate amount for deferred compensation is $132,000 as recorded by the Company in the test year. OPC recommends allowing only the $132,000 related to the test year and proposes a reduction in District O&M expenses of $388,174 (($1,160,548-$132,000) times the D.C. allocator of 37.74 percent).[591] Following PEPCO's rebuttal, OPC, in its brief, revised this figure to $346,717 to reflect distribution-only expenses.[592]

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587 PEPCO Compliance Filing, 1053-E-4 at 83.

588 *Id.* at 83, column 6, sum of lines 4, 10, 12 and 18.

589 *Id.* at 83, column 6. *See* 15 DCMR § 206.

590 The following Ratemaking adjustments are discussed in Issues Nos. 3, 5, and 8: Ratemaking Adjustment No. 18, Revenue Sales Adjustment, Ratemaking Adjustment No. 19, Annualization of Software Amortization, Ratemaking Adjustment No. 20, Amortization of Severance Costs, Ratemaking Adjustment No. 21, Amortization of Mixed Service Costs, Ratemaking Adjustment No. 22, Northeast Substation, Ratemaking Adjustment No. 23, Inclusion of Projects Completed and In Service.

591 OPC (D) at 4:23-5:6 (Gumer Direct); OPC D-4.

592 OPC Br. at 131.

230. **PEPCO Rebuttal.** The Company states that, beginning in December 2005 and continuing through the test period and beyond, these adjustments are made pursuant to Company accounting policy. "As the deferred amounts change over time (via investment growth, market gain or loss, or guaranteed return), changes are recorded as adjustments to compensation expense and to the liability (obligation). The liability on PHI's ledger must at all times represent the total amount of projected benefit payments, discounted back to present value."[593] Prior to December 2005, the Company had not been adjusting the deferred compensation balance for these types of changes. The Company indicates that it will clearly continue to make this type of accounting adjustment in the future. Witness VonSteuben states that elimination of this expense on the grounds that it is non-recurring in nature is unfounded and should be rejected.[594] In addition, Witness VonSteuben testifies that OPC neglected to reduce its recommended adjustment by .1068 – the percent of FERC account 923 allocated to the transmission segment of the business. Finally the Company contends that OPC failed to include corresponding increases in taxes in its adjustment.[595]

DECISION

231. Consistent with our ruling in Formal Case No. 939, the Commission disallows the entire amount of the deferred compensation adjustment, including the amount identified as included in the test year by OPC. Further, OPC Exhibit D-4 shows that deferred compensation charges were allocated to PEPCO in the period January through September 2006, subsequent to the charge discussed by OPC, and we deduct the District's allocated portion of those costs as well. The additional amount charged to PEPCO totaled $553,945. (Account 923 - $26,513 and Account 920 - $527,432)[596] In PEPCO's base electric rate case before the Maryland PSC, PEPCO provided a document indicating that the deferred compensation represents incentive compensation for non-employee directors and a select group of management and or highly compensated employees. The document also indicates that these plans are unfunded.[597] The Company's Proxy Statement and 2005 Annual Report to Shareholders indicate that the executive incentive program's payouts are based on relative total shareholder return. In 2006, the Compensation Committee changed the performance criteria to earnings growth and free-cash flow because the Committee believed that these financial indicators are more closely tied to stock price and shareholder value.[598] These documents clearly demonstrate that this deferred compensation is contingent on meeting goals that are closely tied to stock price and shareholder value.

232. In Formal Case No. 939, the Commission found that "as a policy matter…it would be improper to approve for ratepayer funding the Company's supplemental retirement and

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593 PEPCO (3C) at 41:4-28 (VonSteuben Rebuttal).

594 *Id.* at 41:30-42:5.

595 *Id.* at 42:10-21.

596 OPC Exhibit D-5.

597 Commission Exhibit 9 (Response to Maryland PSC CN9092, Staff Data Request 12-10).

598 Commission Exhibit 10 (Pepco Holdings, Inc., Proxy Statement and 2005 Annual Report to Shareholders at 24).

incentive plans." The Commission ruled, "if PEPCO wishes to compensate its executives over and above its qualified pension plan, then this cost is properly borne by the shareholders, not the ratepayers."[599] The Commission, therefore, rejects PEPCO's currently proposed deferred compensation adjustment because it is the type of executive compensation plan that should not be funded by the ratepayers. The adjustment to the Company's proposed test year expense is $578,000.[600] This figure includes the entire amount of deferred compensation, including an adjustment to reflect the District's portion of the January through September 2006 deferred compensation charges.

2. Software Write-Off

233. **OPC.** OPC contends that in its Compliance Filing, the Company reported that in December 2005 it wrote off $3,997,880 when it replaced its material management software with an enterprise-wide application of software known as the Systems, Applications and Products in Data Processing ("SAP"). The software write-off is not a recurring expense that the Company will incur on an annual basis. Therefore, OPC recommends that the Commission remove this expense from Account 921 – Office Supplies and Expenses. The adjustment recommended by Witness Gumer is $1,294,807.[601]

234. **PEPCO Rebuttal.** Witness VonSteuben agrees that the one-time write-off should have been removed from cost of service. However, he does not agree with OPC's calculation of this adjustment. According to VonSteuben, PEPCO inadvertently gave OPC the wrong District of Columbia allocation factor. VonSteuben states that the correct calculation results in an adjustment to O&M expenses of $1,347,660.[602]

<u>DECISION</u>

235. PEPCO has agreed to remove this one-time write-off from the cost of service. In light of the testimony, we accept the adjustment as recalculated by PEPCO and adjust PEPCO's expenses by $1,348,000.

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599 Formal Case No. 939, Order No. 10646 at 128 (June 30, 1995).

600 ((($1,161,000 + $554,000) times .3774) times .8932).

601 OPC (D) at 5:18-6:22 (Gumer Direct).

602 PEPCO (3C) at 39:23-40:19 (VonSteuben Rebuttal).

VII. IMPACT OF D.C. AND FEDERAL TAXES (Issue No. 7)[603]

236. **PEPCO.** The Company requests an annual allowance of $7,863,000 for District of Columbia income taxes ("DCIT") and $31,261,000 for federal income taxes ("FIT").[604] PEPCO states that the proposed adjustments reduce the DCIT by $1,337,000, and FIT by $4,741,000.[605] According to PEPCO, it calculates its federal and District income tax liabilities on a stand-alone basis consistent with past Commission rulings.[606]

237. **OPC.** OPC argues that PEPCO's revenue requirement does not reflect the amount of taxes actually paid by PEPCO to the federal and District of Columbia governments and fails to recognize PEPCO's share of the savings resulting from its inclusion on the consolidated income tax returns filed by PHI on behalf of PEPCO and its other regulated and non-regulated companies.[607] PEPCO has requested annual allowances for FIT of $31,261,000, based on a rate of 35 percent, and for DCIT of $7,863,000, based on a rate of 9.975 percent.[608] OPC Witness Bright argues that the Commission should adopt an adjustment that recognizes PEPCO's share of the tax savings realized through its participation in the consolidated FIT and DCIT returns filed by its parent, PHI.[609] OPC states that PHI has filed a consolidated federal tax return on behalf of itself, all of its three regulated entities, and its non-regulated subsidiaries since the 2003 tax year. OPC's consolidated tax recommendation represents a substantial adjustment to the Company's proposed revenue requirement. OPC proposes an increase to net income related to federal tax consolidation of $22.4 million. The impact on revenue requirements is a reduction of over $34.5 million. The impact of the consolidation related to the District income taxes is a $1.8 million increase in operating income with a $2.8 million reduction to revenue requirements.

238. **PEPCO Rebuttal.** Witness VonSteuben states that the Company's District of Columbia franchise taxes and FIT, on an unadjusted basis and in individual ratemaking adjustments, are computed by the same method that was used in Formal Case No. 939.[610] Witness Rigby avers that PEPCO's use of the "stand-alone" method "ensures that utility customers are charged only the income tax costs and benefits based upon the revenues and expenses of PEPCO's utility operations."[611] Although PEPCO agreed under Commission questioning that virtually all of the

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603 Designated Issue No. 7 asks: "Does PEPCO's presentation of its revenue requirement properly reflect the impacts of District of Columbia and federal tax regulations?"

604 PEPCO (C)-1 at 1.

605 PEPCO (C) at 15:3-6 (VonSteuben Direct); PEPCO (C) at 1; *See also* Compliance Filing 206.9 Federal Income Taxes at 1-3, Compliance Filing 206.9 Other Taxes at 1-3, Compliance Filing 206.9 at 70-73.

606 PEPCO (3A) at 13:19-23 (Rigby Rebuttal); PEPCO Br. At 84.

607 PEPCO (3C) at 41:4-42:7 (Bright Direct); OPC Br. at 132.

608 OPC (C) at 59:11-13, 70:1-3 (Bright Direct); OPC Br. at 132.

609 OPC (C) at 59:17-20, 70:6-9; OPC. Br. at 133.

610 PEPCO (2C) at 5:10-6:4 (VonSteuben Supp. Direct).

611 PEPCO (3A) at 13:19-23 (Rigby Rebuttal); PEPCO Br. at 84.

Company's federal and District tax expenses were not paid to those respective governments,[612] PEPCO urged us not to depart from past policy because it "protects utility customers from tax costs which may be unrelated to PEPCO's utility operations but are incurred because the utility may be part of a consolidated federal income tax return."[613]

DECISION

239. At the outset, we note that the stand-alone method is not perfect, especially when it attributes tax costs to PEPCO that are not actually paid to the government. However, we are unpersuaded by the record in this case to reverse our long-standing position that a stand-alone approach is the most reasonable method of setting rates.[614] While a stand-alone method may have the disadvantage of saddling ratepayers with tax costs that are not actually paid to the government, it has the benefit of insulating ratepayers from the losses attributable to PHI's unregulated affiliates in a volatile market. Courts have held that adopting the stand-alone method is a matter within the discretion of the regulatory body.[615]

240. We recognize that other jurisdictions have adopted alternatives to the pure stand-alone approach that we uphold here. The other alternatives range from sharing mechanisms to a prorated consolidated return approach.[616] However, the advantages and disadvantages of those alternative methods have not been sufficiently explored in this proceeding to warrant the adoption of a new policy. If the parties wish to make more detailed arguments supporting an alternative method in the next base rate proceeding, the Commission will revisit its policy of pure stand-alone treatment. In view of the foregoing, the Commission continues to find the stand-alone method appropriate and rejects OPC's proposed adjustments.

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612 *See* Tr. at 989:4-11.

613 PEPCO (3A) at 13:19-23 (Rigby Rebuttal); PEPCO Br. at 84.

614 *See Office of the People's Counsel v. Public Service Commission*, 482 A2d. 404, 414 (1984) (when agency departs from a settled practice it has a special duty to explain the reasons for that departure); *see also Washington Gas Light v. Public Service Commission*, 483 A2d. 1164 (1984) (Commission not bound by single regulatory formula, and may modify policy choices so long as it explains the basis for the change).

615 *See, e.g., FPC v. United Gas Pipeline Co.*, 386 U.S. 237, 244-45 (1967) (although ratemaking is subject to the rule that income and expense from regulated and unregulated activities should be segregated, Supreme Court rejected argument that in every conceivable circumstance a company filing a consolidated return should be allowed a tax amount equal to what it would have paid had it filed a separate return, and should never share in tax savings inherent in a consolidated return); *see also Washington Gas Light Co., et al. v. Public Service Commission of the District of Columbia,* 450 A.2d 1187, 1233-1235 (1982) (Commission allowed sharing of consolidated tax benefits between shareholders and ratepayers).

616 In particular, we note New Jersey's rationale that where a utility's operations produce income that provides the opportunity for tax savings through offsetting annual losses of the other subsidiaries, the "ratepayers who produce the income that provides the tax benefits should share in those benefits." *Re Jersey Central Power and Light Co.*, 146 PUR4th 127, 135 (N.J.BRC, 1993*); In the Matter of Rockland Elec. Co.*, Docket Nos. ER 2080614 and ER02100724, Final Decision and Order 2004 N.J. PUC LEXIS 78, at 43 (March 3, 2004).

VIII. INTEREST SYNCHRONIZATION (Issue No. 8)[617]

241. **PEPCO.** The Company adjusts DCIT and FIT to reflect the synchronization of interest expense for income tax purposes with that inherent in the Company's return on rate base. PEPCO argues that its treatment of this issue is consistent with the Commission's decision in Formal Case No. 939 and prior cases.[618] The Company's adjustment is provided in RMA No. 24 – Interest Synchronization.

242. **OPC.** OPC recommends an adjustment to synchronize the interest expense used in determining the overall return with the interest expense used to calculate the income taxes based on the embedded cost of debt and capital structure recommended by OPC Witness Rothschild. The weighted cost of debt proposed by OPC is 3.53 percent.[619] The interest synchronization adjustment proposed by OPC increases FIT expenses by $1,324,071 based on OPC's proposed rate base adjustments totaling $107,168,842.[620]

DECISION

243. The Commission finds the Company's methodology for calculating interest synchronization to be consistent with our prior decisions.[621] Accordingly, we adopt the interest synchronization adjustment which is consistent with the cost of debt, capital structure and rate base approved elsewhere in this Order.

IX. COST CONTAINMENT PROGRAMS (Issue No. 9)[622]

244. **PEPCO.** PEPCO points out that the nature of the Company's business and its cost containment efforts have significantly changed since the last base rate proceeding. According to PEPCO, divestiture of generation and customer choice have contributed to the Company's

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617 Designated Issue No. 8 asks: "Are the test-year interest costs for PEPCO properly synchronized with the tax computations?"

618 PEPCO (C) at 23:20-24:2 (VonSteuben Direct); PEPCO (C)-1 at 3, 27; Compliance Filing, 1053-E-4 at 110.

619 OPC Br. at 143.

620 OPC (C) at 84:19-85:2 (Bright Direct); OPC (C)-2, Sch. 13, Line 5; OPC Br. at 143.

621 Formal Case No. 939, Order No. 10646 at 147 (June 30, 1995) (approving synchronization of interest in cost of service with interest in tax computations); Formal Case No. 869, Order No. 9216 (March 3, 1989), 10 D.C.P.S.C. 22 at 122 (1989) (preferring interest synchronization over actual interest cost approach); Formal Case No. 889, Order No. 9509 (July 24, 1990), 11 D.C.P.S.C. 302 at 377 (1990) (noting that Commission's decisions on rate base, capital structure and cost of debt may impact proposed interest expense); Formal Case No. 905, Order No. 9869 (October 23, 1991); Formal Case No. 912, Order No. 10044 (June 26, 1992); Formal Case No. 929, Order No. 10387 (July 26, 1992).

622 Designated Issue No. 9 asks: "Is PEPCO's cost containment program realistic, effective, and in the public interest?"

refocusing of its cost containment efforts on the cost of providing distribution services to its customers.[623]

245. The Company states that it has implemented a program to contain costs in a number of areas, including: the elimination of eligibility for subsidized retiree medical benefits for new employees hired after January 2005; the elimination of the medical indemnity plan and increased deductibles, hospital co-pays, and out-of-pocket maximums; caps on its retiree medical benefits that limit the Company's retiree medical costs; and cuts in its pension benefits.[624] PEPCO represents that it is engaged in an aggressive ongoing refinancing program to minimize capital costs, which reduced its cost of debt from 7.20 percent on December 31, 2001, to 6.18 percent on December 31, 2005. This has resulted in an annual savings of $26 million and a cumulative savings of over $54 million.[625] Additionally, Witness Rigby provides a summary of the containment mechanisms that PEPCO has implemented since 2001 in the areas of merger synergy savings, process improvements, and technological advancements.[626] PEPCO also notes that its efforts resulted in savings, which range from $3.1 million in 2001 to $107.0 million in 2005, and total $292 million over the five-year period from 2001 through 2005.[627] The most significant of these savings include $26.5 million for debt refinancing, $26.7 million for supply chain procurement savings, $23.9 million for merger synergy savings, and $16.75 million for restructuring and changes to benefits programs.[628]

246. **OPC.** OPC asserts that PEPCO has not demonstrated that its cost containment program has been aggressive or even effective. Witness Bright states that the Company's claim of having realized savings from its cost containment efforts is based on budgeted or planned savings as opposed to actual cost savings.[629]

DECISION

247. The Commission believes that, although PEPCO may be unable to demonstrate actual savings, the list of initiatives undertaken by the Company shows a reasonable and concerted effort to improve the operational performance of the Company. In our view, these efforts are beneficial to ratepayers.

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623 PEPCO (A) at 24:19-23 (Rigby Direct).

624 *Id.* at 18-21:23; Tr. at 947:3-948:7 (Rigby Cross); PEPCO Br. at 91.

625 PEPCO (A) at 22:9-19 (Rigby Direct); PEPCO Br. at 91.

626 PEPCO (A)-1; PEPCO Br. at 91.

627 PEPCO (A) at 22:7-9 (Rigby Direct); PEPCO (A)-1; PEPCO (2A) at 2:6-12 (Rigby Supp. Direct); PEPCO Br. at 91.

628 PEPCO (A)-1 at 2; PEPCO (A) at 20:18-23:6 (Rigby Direct).

629 OPC (C) at 85:16-19 (Bright Direct).

X. JURISDICTIONAL COST ALLOCATIONS (Issue No. 10)[630]

248. **PEPCO.** Witness Browning states that the Company has submitted a jurisdictional cost allocation study for distribution service (PEPCO (F)-1) covering the proposed test year, with six months of actual data and six months of projected data.[631] He explains that the study shows the allocation of distribution costs between the Company's District of Columbia customers and its remaining customers.[632] He describes the results of the study as showing an unadjusted test-year rate of return of 6.79 percent.[633]

249. According to Witness Browning, the study covers both distribution and transmission costs, most of which are inapplicable FERC accounts.[634] Browning further states that other costs, including General Plant and Administrative and General Expenses, are functionalized to identify their distribution portion.[635] He indicates that subtransmission costs were allocated using the average and excess noncoincident peak responsibility ("AED-NCP") allocation method.[636]

250. Browning also states that, in the study, the costs of facilities serving a local area were directly assigned to the jurisdiction served.[637] He notes that O&M expenses were also functionalized and allocated to the District of Columbia based on plant ratios.[638] He points out that customer accounts and sales expenses were assigned to classes based on a detailed 2004 study of customer accounts.[639] He states that deferred state income taxes were directly assigned to the taxing jurisdiction, while deferred federal income taxes were allocated, taking into account how they were affected by state income taxes.[640] Browning also explains that adjustments were made for the effect of different state depreciation rates on depreciation-related deferred federal taxes.[641] He adds that the test year base revenues were weather-corrected.[642] Browning asserts that the Company's

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630 Designated Issue No. 10 asks: "Are PEPCO's jurisdictional cost allocations reasonable? a. Is PEPCO's jurisdictional cost allocation study reasonable?; (i). Has PEPCO reasonably and accurately grouped rate base and operating expense items to functions?; (ii). Has PEPCO reasonably and accurately assigned and allocated rate base items and operating expenses to jurisdictions?"

631 PEPCO (F) at 4:14-20 (Browning Direct).

632 *Id.* at 4:21-24.

633 *Id.* at 5:1-3; PEPCO (F)-1 at 23.

634 *Id.* at 5:7-11.

635 *Id.* at 5:24-6:4.

636 *Id.*at 7:14-20.

637 *Id.* at 6:20-7:10.

638 *Id.* at 14:1-4.

639 *Id.* at 14:5-8.

640 *Id.* at 11:6-12:5; PEPCO (F)-1 at 10.

641 PEPCO (F) at 12:6-13:9 (Browning Direct).

642 *Id.* at 13:18-24, 18:6-19:23.

jurisdictional cost allocation study is consistent with previous Commission directives and is reasonable.[643]

251. **OPC.** Witness Pavlovic claims that PEPCO's cost allocation study is not reasonable because the Company allocates costs to functions based on allocation ratios from an earlier allocation study, rather than directly assigning such costs by function, and it allocates subtransmission costs to jurisdictions based on allocators that are unjust, unreasonable, and inconsistent with cost causation.[644] OPC argues that the flawed jurisdictional allocations are then carried into the class cost of service study ("CCOSS"), which is both the basis for the development of proposed class revenue requirements and rates, and the sole evidence of the purported subsidy of the residential class by the commercial class.[645]

252. Pavlovic recognizes that on several previous occasions, the Commission has directed PEPCO to use the AED-NCP method rather than the coincident peak method.[646] However, he asserts that the AED-NCP methodology is inconsistent with cost-causation factors on a distribution-only system such as PEPCO's, over-allocates costs to the District of Columbia, and should not be used.[647] He claims that use of non-coincident peak demand shifts subtransmission costs to the demand that does not peak at the system peak.[648] Pavlovic estimates that the allocation of test-year jurisdictional costs based on coincident-peak-only allocation would reduce the subtransmission rate base and operating expenses allocated to the District by $1,217,000 and $106,000, respectively.[649]

DECISION

253. The Commission finds PEPCO's jurisdictional cost allocation study reasonable and in accord with Commission precedent. With regard to distribution costs, PEPCO has clarified that such distribution costs are almost entirely directly assigned by jurisdiction based on their plant location.[650] Apart from meters,[651] the 2004 and 2003 allocation ratios were used to functionalize

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643 PEPCO (2F) at 7:13-20 (Browning Supp Direct); PEPCO (F) at 4:14-7:22, 10:12-18, 18:8-11 and 19-21 (Browning Direct); PEPCO Br. at 94.

644 OPC (E) at 12:20-13:21 (Pavlovic Direct); OPC Br. at 145-55.

645 OPC Br. at 146-47. OPC states that the CCOSS, in turn, has three flaws, in that it: (1) subfunctionalizes plant in service and other costs using allocators that in some instances are a decade or more old; (2) over-allocates the costs of secondary facilities through the use of allocators that do not reflect customer diversity in the use of those facilities; and (3) fails to attempt to allocate the cost of underground and network facilities to the customer classes that benefit the most from those facilities. OPC Br. at 146-147.

646 OPC (E) at 15:16-17 (Pavlovic Direct).

647 *Id.* at 14:1-15:16, 16:14-18:10; OPC Br. at 152.

648 OPC (E) at 17:18-19 (Pavlovic Direct).

649 *Id.* at 18:9-11 (citing OPC (E)-5).

650 PEPCO (3F) at 10:8-11 (Browning Rebuttal).

651 Meters (Account 370) are not recorded by jurisdiction because they do not remain specific to any jurisdiction, being constantly moved in and out of inventory. Meters were previously assigned to jurisdictions based

plant within, not between, jurisdictions.[652] As illustrated by PEPCO, a distribution plant would be directly assigned to a particular jurisdiction, and thereafter functionalized among primary, secondary, and customer functions – but the jurisdictional allocation itself is predicated on direct assignment.[653] The Commission considers this a reasonable and appropriate jurisdictional allocation of distribution costs.

254. With regard to subtransmission costs, PEPCO is correct that the Commission has previously approved and required the use of the AED-NCP method instead of the coincident peak method to allocate subtransmission items.[654] The AED-NCP allocation method is accepted by the National Association of Regulatory Utility Commissioners ("NARUC").[655] PEPCO's study follows generally accepted techniques for identifying and allocating jurisdictional distribution costs.[656] OPC concedes that the Commission's precedent requires the use of the AED-NCP method to allocate subtransmission costs,[657] though OPC claims the method is inconsistent with cost causation and with the way PEPCO's distribution-only business plans its facilities.[658]

255. In Formal Case No. 1016, the Commission considered the AED-NCP method the "*status quo* methodology . . . imbued with a heavy presumption of reasonableness."[659] OPC has not overcome that presumption. The Commission is not persuaded by OPC's argument that the AED-NCP method violates cost causation in a manner that would be exacerbated if applied to PEPCO's post-divestiture distribution business and that the method does not send the proper economic signals relating to consumption of energy resources. The Commission believes the AED-NCP approach appropriately combines an energy allocator with a non-coincident peak allocator because the design of the subtransmission and distribution system is properly based on both energy and demand characteristics. An energy allocation component is appropriate because as energy costs have risen, an electric utility should utilize cost effective methods to reduce energy losses in its substations, lines, and transformers. A non-coincident peak allocator is also appropriate because the maximum

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on the latest study available (2004). PEPCO (3F) at 10:12-20 (Browning Rebuttal).

652 PEPCO (3F) at 10:21-11:10 (Browning Rebuttal). For a study using six months of pro forma data for a one year period ending September 30, 2006, the Company's use of load data from 2005 is reasonable. The use of other supporting studies from 2003 (*i.e.*, the inventory analysis), while not optimum, is acceptable.

653 *Id.* at 11:3-10.

654 PEPCO (F) at 11:11-16; PEPCO Br. at 96 n.444, (citing Formal Case No. 939, *In re Potomac Elec. Power Co.*, Order No. 10646 at 198-99 (June 30, 1995); Formal Case No. 929, *In re Potomac Elec. Power Co.*, Order No. 10387 at 263-65 (Mar. 4, 1999), 150 P.U.R.4th 528, 1994 WL109204 at *198-99.; Formal Case No. 912, *In re Potomac Elec. Power Co.*, Order No. 10044 (June 26, 1992), 13 D.C.P.S.C. at 512, 654-55; Formal Case No. 905, *In re Potomac Elec. Power Co.*, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. at 756-58).

655 NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, COST ALLOCATION MANUAL 49 (1992) (discussing Average and Excess Method).

656 GSA at 5:6-11 (Goins Direct).

657 OPC (E) at 15:17-19 (Pavlovic Direct).

658 *Id.* at 14:1 to 18:10 (noting that PEPCO uses maximum peak demand for planning).

659 Formal Case No. 1016, *In re Washington Gas Light Co.*, Order No. 12986 at 262 (November 10, 2003), 229 P.U.R. 4th 177, 2003 D.C. PUC LEXIS 220 at 81-82.

demands on portions of the subtransmission and distribution system are non-coincident peak demands. The use of a non-coincident peak based methodology such as AED-NCP is reasonable to reflect demand-related system design and operation.[660]

256. With respect to PEPCO's post-divestiture period, the Commission notes that in Formal Case No. 939, it expressed some concern that PEPCO may become more of a distribution company and less of a generation company. The Commission determined that "under either scenario, jurisdictional cost allocation will be developed using the AED-NCP method," and the "jurisdictional cost allocation would be the same for District of Columbia ratepayers, notwithstanding the structural components of PEPCO."[661] The Commission sees no reason to deviate from its earlier finding that it would remain appropriate to apply the AED-NCP method even if PEPCO were to focus on the distribution business. Accordingly, the Commission approves the methodology and results of PEPCO's jurisdictional allocation of costs.

XI. CLASS COST OF SERVICE
(Issue No. 11)[662]

257. **PEPCO.** PEPCO submits that its proposal to allocate approximately one-third of the proposed rate increase, $16.8 million, to the residential classes, and the other two-thirds to commercial classes, is reasonable.[663] PEPCO states that the record contains a detailed explanation of the method it used to develop the proposed allocation.[664] PEPCO proposes to move the residential rate of return by 25 percent toward the overall rate of return of 8.42 percent that the Company is seeking in this case. PEPCO asserts that the proposed increase in the rate of return for residential customers moves that class from a negative rate of return to one close to the embedded cost of debt.[665] Each class of commercial customers will then be moved 50 percent toward the overall rate of return and then allocated the remaining increase based on a constant factor which allows PEPCO to reach the overall increase amount.[666] According to PEPCO, this method allows the classes to have more unity with respect to Unitized Rates of Return ("UROR").[667]

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660 The Commission also notes that there is only a 0.13% difference between the result of PEPCO's cost allocation study (PEPCO (F)-1 at 23) and that of OPC Witness Pavlovic's study (OPC (E)-5), representing a net change of about $1.22 million out of a total rate base of approximately $904 million.

661 Formal Case No. 939, *In re Potomac Elec. Power Co.*, Order No. 10646 at 198-99 (June 30, 1995).

662 Issue 11 asks: Is PEPCO's proposed distribution of its revenue requirement among rate classes reasonable? The Commission addresses the overall reasonableness of PEPCO's class cost of service in the discussion of the designated subissues below.

663 PEPCO (H) at 6:17-12 (Bumgarner Direct); Tr. at 320:16-19; *see* PEPCO Br. at 101.

664 PEPCO (H) at 4:9-7:6 (Bumgarner Direct); PEPCO Br. at 100.

665 PEPCO (H) at 6:17-25 (Bumgarner Direct); Tr. at 320:10-15 (Bumgarner Cross); PEPCO Br. at 101.

666 PEPCO (H) at 6:20-7:6 (Bumgarner Direct); PEPCO Exh. (H)-1; Tr. at 321:4-322:7 (Bumgarner Cross); PEPCO Br. at 101.

667 PEPCO (H) at 7:3-4 (Bumgarner Direct); Tr. at 322:8-15 (Bumgarner Cross); PEPCO Br. at 101.

258. **OPC.** OPC argues that PEPCO's proposal assumes that residential customers have been subsidizing commercial customers, but that PEPCO has failed to prove that assumption.[668]

259. **GSA.** Witness Goins states that PEPCO's jurisdictional separation study and a District of Columbia retail cost-of-service study for the test year ended September 30, 2006, follow "generally accepted techniques for identifying jurisdictional distribution costs and allocating these costs among District of Columbia retail customer classes."[669]

260. **Comcast.** Witness Raab uses PEPCO's data in his own class cost of service model and was able to duplicate Witness Browning's original study and verify PEPCO's calculations, subject to minor rounding errors.[670] However, Witness Raab asserts that PEPCO should be required to file "pro forma cost of service studies at existing and proposed rates" because "there is no way to verify the revenue figures or whether the class allocations would be the same if the class of business study were conducted with pro forma values."[671] He also agrees with PEPCO's proposed modification to PEPCO's rate schedule for Telecommunications Network Service ("TN") in principle, but disagrees with PEPCO's TN cost treatment.[672]

261. **AOBA.** AOBA supports the proposed rate increase as a "reasonable step" towards decreasing the level of subsidization that commercial classes have provided to residential classes.[673] AOBA states that to the extent the Commission approves a rate increase lower than that proposed, it should allocate one-third of the reduction among all classes and two-thirds among classes with greater than system average rates of return to further minimize subsidies.[674] AOBA Witness Oliver does not support PEPCO's proposed BSA mechanism, but suggests that if the Commission adopts the BSA mechanism, it should avoid the need for large increases in residential rates in future rate cases and adapt the BSA to continue to reduce the residential subsidy gradually.[675] AOBA also urges the Commission not to approve the full increase proposed for commercial rate schedules for General Service and Time Metered General Service ("GS and GT, respectively") in favor of a more gradual increase over three to four years.[676]

262. **District Government.** The District Government argues that the Commission's precedent requires that rate changes to the Street Lighting ("SL") and Traffic Signal

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668 OPC Br. at 156.

669 GSA (A) at 5:6-11 (Goins Direct).

670 Comcast (A) at 8:6-10 (Raab Direct).

671 *Id.* at 10:21-24.

672 *Id.* at 3:1-22.

673 AOBA (A) at 96:9-11 (Oliver Direct); AOBA Br. at 39.

674 AOBA (A) at 97:8-12 (Oliver Direct); AOBA Br. at 39-40.

675 AOBA (A) at 99:11-18(Oliver Direct); AOBA Br. at 40.

676 AOBA Br. at 41-42.

("TS") classes be based on a marginal cost analysis.[677] The District Government further argues that because PEPCO has not provided marginal cost studies, Commission policy requires an "across-the-board" approach to the rate increase.[678] The District Government states that PEPCO's proposed increase for the SL and TS classes is 780 percent[679] and urges the Commission to reject the increase based on principles of "gradualism, equity, and continuity."[680] The District Government disagrees with PEPCO's suggestion that the SL and TS rate increase is in line with other classes' increases if all of the rate components are taken into account.[681] Citing principles of "continuity, equity, and gradualism," the District Government argues against GSA's proposal for a distribution-only rate increase of 839 percent[682] for the SL and TS classes.[683]

263. **WMATA.** WMATA argues that PEPCO's proposal is insufficient to reduce the rate burden borne by the Rapid Transit Service ("Rate Schedule RT") class.[684] WMATA takes issue with PEPCO Witness Bumgarner's conclusion that a 25 percent increase for residential customers towards unity is appropriate. It argues for a 50 percent increase.[685] WMATA suggests that PEPCO start by increasing both the residential and commercial classes by 50 percent towards the desired rate of return and then increase the commercial rates to reach the target rate of return.[686] WMATA also suggests that the Commission require that PEPCO adjust its class rates over a three-year period to reach rates of return within a tolerance band of plus or minus 10 percent of its system average return.[687]

A. Class Cost Allocation Study[688]

264. **PEPCO.** PEPCO states that its Witness Browning establishes that the cost allocation study is just and reasonable[689] and consistent with Commission orders.[690] PEPCO submits

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677 Formal Case No. 869, *See Re Potomac Electric Power Company*, Order No. 9216, 10 D.C.P.S.C 22, 183 (Mar.3,1989); Formal Case No. 905, Order No 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651, 1991 WL 502017 at *212; DC Br. at 2.

678 Formal Case No. 905, Order No 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651, 1991 WL 502017 at *212.; DC Br. at 2.

679 Tr. at 446:1-3; DC Government (A)-1. The District Government notes that the average across-the-board increase for other classes is 22.15%. DC Government (A) at 26:25-26 (Petniunas Direct); DC Government Br. at 3.

680 Formal Case No. 869, Order No. 9216 (rel. March 3, 1989, 10 D.C.P.S.C. 22, 1149, DC Government Br. at 3.

681 PEPCO (3H) at 17:3-5 (Bumgarner Rebuttal); PEPCO (3H)-3; DC Government Br. at 4.

682 Tr. at 1046:16-17.

683 DC Government Br. at 4.

684 Tr. at 321:3-322:15; WMATA Br. at 3-4.

685 WMATA Br. at 4-5.

686 WMATA (A) at 18:15-21 (Foster Direct); WMATA Br. at 5.

687 WMATA Br. at 6.

688 Issue 11a asks: Is PEPCO's Class Allocation Study just and reasonable?

a class of business cost allocation for distribution service study ("CCOSS").[691] Browning explains the use of the study as follows:

> The class of business cost allocation study determines the amount of rate base, revenues, expenses, depreciation, amortization, taxes, and return for each of the major classes of business. The study provides a basis for comparing rates of return among classes and comparing class rates of return to the overall jurisdictional rate of return. In addition, the demand and customer components of cost are developed for each class.[692]

265. Witness Browning indicates that CCOSS covers the proposed test year period using six months of weather-corrected actual and six months of forecasted data,[693] and that the study allocates and assigns distribution costs between the major business classes served by PEPCO.[694] Further, Witness Browning contends that the study demonstrates that the test year rate of return is negative for residential and SL customers, while the general service customers significantly exceed the overall test year jurisdictional rate of return of 6.79 percent.[695]

266. Browning further explains that the allocation factors consist of demand, customer and revenue ratios[696] and that sub-transmission costs are allocated based on the AED-NCP.[697] Browning testifies that primary distribution facilities are allocated using the maximum annual NCP class demands;[698] secondary facilities are allocated using the summation of customer maximum annual demands;[699] line transformers are allocated on the average of the primary and secondary allocation demands;[700] and overhead and underground distribution services are allocated based on the summation of customer maximum annual demands.[701] Browning states that class customer ratios based on the average number of customers are used to allocate customer accounts and sales expenses,[702] and that revenues are taken from Company records and are weather-corrected.[703]

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689 PEPCO (F) at 15:20-18:23 (Browning Direct), PEPCO (F) 3, PEPCO (2F) at 8:19-10:3 (Browning Supp. Direct); PEPCO Br. at 106.

690 PEPCO (2F) at 9:23-10:3 (Browning Supp. Direct); PEPCO Br. at 107.

691 PEPCO (F)-3 (attached to Browning Direct).

692 PEPCO (F) at 15:20-16:3 (Browning Direct).

693 *Id.* at 15:12-17.

694 *Id.*

695 PEPCO (F)-3 (attached to Browning Direct).

696 PEPCO (F) at 16:15-16 (Browning Direct).

697 *Id.* at 17:9-12.

698 *Id.* at 17:14-15.

699 *Id.* at 17:16-18.

700 *Id.* at 17:18-24.

701 *Id.* at 17:21-24.

702 *Id.* at 18:3-5.

267. **OPC.** Witness Pavlovic contends that the study is inaccurate for five reasons:

> (1) the subfunctionalization of the test-year results is not based on a current analysis, but rather on ratios from earlier analyses, (2) secondary services are reclassified as customer services, (3) customer services rate base and expenses are demand-allocated rather than directly assigned, (4) significant differences in the costs and class usage of network and underground facilities versus radial and overhead facilities are not recognized in the study, and (5) the demand allocators used in the study do not properly reflect class cost causative characteristics.[704]

268. **District Government.** Witness Petniunas contends that PEPCO has not followed the Commission's historical ratemaking principles, particularly marginal cost pricing and elasticity considerations.[705] He testifies that PEPCO has not filed useful SL and TS marginal cost allocation studies for subtransmission, primary distribution, secondary distribution, and customer costs. Petniunas asserts that PEPCO also has not filed any elasticity studies for customer classes.[706]

269. Witness Petniunas further states that "Embedded Class Costs of Service" are only part of revenue reconciliation and rate design because, "these studies simply produce historical class rates of return, and do not reflect any aspects of costs at the margin, future costs, class growth, or other rate-making principles."[707] He contends that the Commission has used embedded costs of service studies only as a guide in revenue reconciliation and rate design and that marginal costs and class elasticities are the appropriate methods of revenue reconciliation and rate design.[708]

270. **GSA.** Witness Goins states that OPC Witness Pavlovic admits that he cannot quantify most of the alleged flaws in the class cost study and that, in Witness Goins's opinion, PEPCO should not need to redo the study.[709] Goins testifies that PEPCO's class cost of service study provides a reasonable basis to evaluate the class revenue requirements and revenue spreads because Pavlovic's concerns with the study are simply preferences. Further, he argues that Pavlovic has not shown that using his preferred methods would change the main result of the study, *i.e.*, that rates for PEPCO's residential customers are subsidized by other customer classes.[710] He further notes that even if Pavlovic's costing preferences were used in PEPCO's study, there would be little

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703 *Id.* at 18:8-23.

704 OPC (E) at 21:7-13 (Pavlovic Direct).

705 DC Government (A) at 9:3-10 (Petniunas Direct).

706 *Id.*

707 DC Government (A) at 11:25-12:10 (Petniunas Direct).

708 *Id.* Petniunas cites to Formal Case No. 758, Order No. 7614, 3 D.C.P.S.C. 300, 334-39 (1982); Formal Case No. 869, Order No. 9216, 10 D.C.P.S.C. 22, 143-49 (March 3, 1989); and Formal Case No. 905, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651, in his testimony on this issue. *See id.* at 13-20. *See* DC Government Br. at 2 (citing *Re Potomac Elec. Power Co.*, 10 D.C.P.S.C. 22, 183 (March 3, 1989); Formal Case No. 905, Order No. 9868, 12 D.C.P.S.C. at 179 (Oct. 23 1991); DC Government Br. at 5.

709 GSA (B) at 7:20-8:5 (Goins Rebuttal) (citing OPC (E) at 26:6-7 (Pavlovic Direct).

710 GSA (2A) at 9:9-25 (Goins Rebuttal).

chance that the estimated cost-of-service revenue requirement for residential customers would be significantly less than the assigned residential revenue requirement under PEPCO's (or GSA's) proposed revenue spread.[711]

271. **Comcast.** Comcast argues that PEPCO's class cost of service study is flawed with respect to TN customers. Comcast states that PEPCO's estimates for several allocators, such as embedded meter costs, for TN customers are inaccurate.[712] Comcast also states that PEPCO miscalculated rate schedule revenues for the TN class, which resulted in seemingly low returns for TN customers.[713] Comcast Witness Raab proposes a monthly charge of $15.16 per customer and a delivery charge of $0.02822 per kWh, assuming PEPCO's proposed rate levels are accepted.[714] Comcast states that no party, including PEPCO, has objected to Comcast's proposal due to its relative insignificance with respect to the overall rate increase.[715] Comcast argues that the Commission should accept Witness Raab's testimony and Comcast's proposed rate for the TN class because the study is superior to the one conducted by PEPCO, and the resulting new rates will have a small impact on the other parties.[716]

272. **PEPCO Rebuttal.** Witness Browning states that the ratios from 2003 and 2004 are used in the study only to functionalize plant within jurisdictions, not between jurisdictions. Accordingly, this method does not affect the jurisdictional allocation of plant or expenses; rather, it affects the split between functions, which is used in the class of business allocation study.[717] As an example, he notes the "functionalization of the distribution plant (which is directly assigned) between primary, secondary and customer functions is based on 2004 and 2003 studies[.]"[718]

DECISION

273. It is well-established that "[p]roperly designed rates should produce revenues from each class of customers which match, as closely as practicable, the costs to serve each class or individual customer."[719] In examining the allocation of costs among different classes of customers, the Commission is not limited to considering cost factors and may also consider non-cost factors in

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711 *Id.*

712 Comcast (A) at 9:12-10:16 (Raab Direct); Comcast (A)-2; Comcast Br. at 4.

713 Comcast (A) at 10:6-16 (Raab Direct); Comcast Br. at 4-5.

714 Comcast (A) at 12:22-24 (Raab Direct); Comcast Br. at 5.

715 Comcast Br. at 1, 5-6 (citing Comcast's "Motion to Excuse Its Witness from Appearing Before the Commission at a Schedule Hearing and Further Motion to Admit Testimony of Paul H. Raab into the Record" at 3-4).

716 Comcast Br. at 6.

717 PEPCO (3F) at 11:1-10 (Browning Rebuttal).

718 *Id.* at 11:3-6.

719 *Alabama Elec. Coop., Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982).

determining rates.[720] As we explain below, the Commission finds that PEPCO's CCOSS model is reasonable and consistent with precedent.

274. In Formal Case No. 939, Order No. 10646, the Commission described its criteria governing class cost allocation.[721] In particular, the Commission noted that it had relied on marginal cost and embedded costs as a guide and had approved "across the board" distributions of customer class revenue requirements in recent cases when marginal cost data was inadequate or when the use of marginal and embedded costs produced inappropriate results.[722]

275. In the instant case, District Government Witness Petniunas raises concerns that PEPCO is moving toward embedded costs rather than adhering to the Commission's policy of employing a marginal cost methodology.[723] However, while it is true that the Commission previously gave weight to PEPCO's embedded and marginal class cost-of-service studies, the Commission's more recent guidance shows a preference for embedded costs.[724] In particular, the Commission explained in the most recent PEPCO rate case, Formal Case No. 939 that it may rely on embedded costs to assign class cost responsibility and promote the goals of efficiency, conservation, and equity.[725] The Commission also emphasized "rate continuity and gradualism" as its guiding principles.[726] In this case, we are persuaded that the proper basis for the overall revenue allocation is PEPCO's embedded CCOSS.

276. Although OPC Witness Pavlovic has some concerns with PEPCO's calculations, other witnesses have been able to duplicate Witness Browning's original study and verify PEPCO's calculations, subject to minor rounding errors.[727] OPC Witness Pavlovic also contends that the study

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[720] *See* Office *of the People's Council v. Pub. Serv. Commn of the District of Columbia,* 797 A.2d. 719, 727-28 (D.C. 2002) (noting that the Commission may generally rely on cost and non-cost factors in rate design). "The term 'rate design' generally refers to both rate relationships among different classes of electric utility customers as well as differentials among customers within each class. The rate design, then, determines the specific rates different classes of customers should pay in order to generate the required revenues." *Metropolitan Washington Bd. of Trade v. Pub. Serv. Commn.*, 432 A.2d 343, 348 n.9 (D.C. 1981). The specific rates for customers are discussed in the sections below.

[721] Formal Case No. 939, *In the Matter of Potomac Electric Power Company for an Increase in Retail Rates for the Sale of Electric Energy,* Order No. 10646 at 230-31 (June 30, 1995) ("Order 10646").

[722] Order 10646 at 231 (citing Formal Case Nos. 905, 912, and 929).

[723] DC Government (A) at 11:6-30 (Petniunas Direct).

[724] *See* Formal Case No. 869, Order No. 9216, 10 D.C.P.S.C. 22 at 134 (1989) (citing Formal Case No. 758, Order No. 7614, 3 D.C.P.S.C. 300, 333 (1982) (finding that embedded costs must be used for determining PEPCO's jurisdictional revenue requirement)). In Formal Case No. 869, the Commission also utilized an "across the board" method to distribute a revenue decrease among rate classes. 10 D.C.P.S.C. 22 at 134.

[725] Formal Case No. 939, Order 10646 at 233 (June 30, 1995) (citing Formal Case No. 889, Order No. 9509 (July 24, 1990), 11 D.C.P.S.C. at 302, 406).

[726] Formal Case No. 889, Order No. 9509, 11 D.C.P.S.C. 302 at 408 (July 24, 1990). *See also Watergate East Inc. v. Public Service Commission*, 665 A2d. 943, 949 (1995), citing *Potomac Electric Power Co.,* 11 D.C.P.S.C. 302, 422 (1990) (Commission policy of gradualism in the setting of utility rates dictates that utility customers generally should not be subjected to dramatic fluctuations in their rate payments).

[727] Comcast (A) at 8:6-10 (Raab Direct).

is based on outdated figures. However, the fact that PEPCO relied on analysis from earlier periods does not, in and of itself, make the data "outdated" or render the study unreasonable.

277. This study provides a reasonable and accurate basis for measuring the existing situation, including historical cost relationships, based upon the relative rate of return attributed to each class. In particular, the primary example in this case, the SL and TS classes, which face a large increase under PEPCO's proposal, will now, and in the future, contribute to the cost of service based on embedded cost principles tempered by the Commission's principles of gradualism and rate continuity.

278. In the absence of a showing that the numbers in the study are inaccurate or that the results of the study cannot be replicated, the Commission sees no basis to reject the data or the study. Accordingly, the Commission finds that the study and the use of data from 2003 and 2004 is reasonable.

B. Assignment of Rate Base Items and Operating Expense to Classes and Functions[728]

279. **PEPCO.** Witness Browning describes in his testimony how rate base items and operating expenses are allocated to functions and classes.[729]

280. **District Government.** Witness Petniunas reiterates his view that PEPCO is improperly using embedded cost pricing for revenue distribution and rate design rather than a marginal cost methodology.[730] Petniunas concedes that it may be reasonable to include administrative and general costs, along with other operation and maintenance costs such as supervision and engineering, customer accounts costs, and taxes in PEPCO's Standard Offer Service.[731] However he believes that none of the allocated rate base functions should be included in the Standard Offer Service unless PEPCO provides marginal cost data for the SL and TS classes that shows the allocations are appropriate.[732] Without the marginal cost data, the District Government states that the SL and TS classes should be assigned the overall average increase assigned to all customer classes.[733]

281. **OPC.** As he did with the jurisdictional study, Witness Pavlovic asserts that this study relies on an outdated analysis. Pavlovic also claims that there are problems with the allocations in PEPCO's study based on the type of facilities used to serve residential customers. He explains:

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728 Issue 11b asks: Has PEPCO reasonably and accurately assigned and allocated rate base items and operating expenses to classes and functions?

729 PEPCO (F) at 15:20-16:24 (Browning Direct); PEPCO (2F) at 9:1-3 (Browning Supp. Direct); PEPCO Br. at 109-110.

730 DC Government (A) at 9:12-15 (Petniunas Direct).

731 *Id.* at 20:7-13; DC Government Br. at 5.

732 DC Government (A) at 20:13-16 (Petniunas Direct); DC Government Br. at 5.

733 DC Government Br. at 5.

> Sum of customer maximum demand allocators add to the non-coincident cost shift a further shift of costs to classes with relatively large numbers of customers with relatively small individual demands, such as the residential and small commercial classes. . . . The majority of residential customers are served by low cost overhead and radial design facilities, while the majority of commercial customers are served by high cost underground and network design facilities. While PEPCO accounts separately for the costs of overhead and underground facilities, in the cost study overhead and underground costs are combined before allocation to classes and, thus, this difference in cost is not reflected in the study. As a result, the study over allocates underground facilities costs to the residential classes and thus overstates the costs of serving residential customers and understates the cost of serving commercial customers.[734]

DECISION

282. With regard to OPC's assertion that the data is outdated, we reiterate that PEPCO's reliance on analysis from prior periods does not, in and of itself, make the data "outdated" or render the study unreasonable. The Commission finds that PEPCO's study reasonably allocates rate base items and operating expenses by class and function. This conclusion is amply supported by record evidence provided by PEPCO Witness Browning who describes how rate base and operating income items are determined based on historical data.[735] As explained below, the Commission further finds 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.

283. OPC Witness Pavlovic disagrees with the manner in which PEPCO assigns overhead and underground facilities, and argues that this choice over-allocates to the residential class; however, he does not provide a clear alternative to PEPCO's proposed allocation. In his testimony, PEPCO's Witness Browning explains that the overhead and underground distribution services are allocated based on the summation of customer maximum annual demands.[736] Pavlovic's assertion that some distinction in the use of these facilities may exist does not invalidate PEPCO's proposed allocation. The fact that more residential customers are served by lower-cost overhead lines, even if shown to be true, does not mean that all residential customers are served by lower-cost lines or that all of the cost of underground lines should necessarily be borne by other classes. OPC admits in its brief that it is concerned that only 39 percent of residential consumers receive service from more expensive underground lines (compared to 54 percent of commercial users) and that fewer residential customers (18 percent) receive service on network facilities than commercial users

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734 OPC (E) at 25:9-26:3 (Pavlovic Direct).

735 PEPCO (F) at 15:20-16:24 (Browning Direct); PEPCO (F)-2 providing a summary of the source of rate base items and operating expenses); PEPCO (2F) at 9:1-3 (Browning Supp. Direct); PEPCO Br. at 109-110.

736 PEPCO (F) at 17:21-24 (Browning Direct).

(35 percent). Even if what OPC asserts is true, it does not prove that any relative cost has been miscalculated by PEPCO.[737] Accordingly, the Commission does not find merit in OPC's argument.

284. District Government Witness Petniunas contends that, as a result of deregulation, the District now owns portions of the street light distribution plant and should not pay for any of this plant in PEPCO's cost of service, and this plant should not be allocated to rate base.[738] Witness Petniunas notes, however, that deregulation occurred in the 1980s. Because the oldest data used by PEPCO is from 1998, the Commission has no reason to believe that the study does not reflect the appropriate ownership after deregulation. Witness Petniunas has not provided any supporting information to substantiate his claims. Accordingly, the Commission accepts the assignment of rate base items and operating expenses based on PEPCO's study.

C. Demand Allocators for Subtransmission, Primary, and Secondary Facility Cost[739]

285. **PEPCO.** PEPCO argues that its class cost allocation study is reasonable, describing the allocation process it used.[740] PEPCO states that its allocation factors consist of demand, customer and revenue ratios.[741] Sub-transmission costs are allocated based on the AED-NCP methodology.[742] Primary distribution facilities are allocated using the maximum annual NCP class demands.[743] Secondary facilities are allocated using the summation of customer maximum annual demands.[744]

286. **OPC.** OPC argues that PEPCO has over-allocated costs to residential customers. With regard to primary distribution facilities, OPC argues that PEPCO's use of a non-coincident peak area demand allocator is inappropriate for residential customers because the residential peak is not coincident with the overall system peak.[745] OPC Witness Pavlovic explains that transmission facilities operate at voltages from 500 kV to 69 kV and are excluded from PEPCO's jurisdictional and class studies.[746] Subtransmission operates at 69 kV to 34.5 kV. Primary facilities carry power from subtransmission facilities to distribution substations.[747] Secondary facilities carry power from

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737 OPC (E) at 25:17-26:21 (Pavlovic Direct); OPC Br. at 164.

738 DC Government (A) at 19-20 (Petniunas Direct) (citing Formal Case No. 905, Order No. 9868 (Oct. 23, 1991), 12 D.C.P.S.C. 651, WL 502017 at 283).

739 Issue 11.c. asks: Are the demand allocators employed by PEPCO for subtransmission, primary and secondary facility costs reasonable?

740 PEPCO (F) at 17:3-24 (Browning Direct); PEPCO Br. at 111.

741 PEPCO (F) at 16:15-16 (Browning Direct).

742 *Id.* at 17:9-11.

743 *Id.* at 17:13-15.

744 *Id.* at 17:16-18.

745 OPC (E) at 25:1-6 (Pavlovic Direct); OPC Br. at 159-60.

746 OPC (E) at 21:22:1 (Pavlovic Direct).

747 *Id.* at 22:1-10.

distribution substations to PEPCO's connection to customer premises.[748] Pavlovic notes that PEPCO also functionalizes "customer" facilities as those which connect the customer premises to the secondary facilities and measure the customer's electric usage.[749]

287. Regarding secondary distribution facilities, OPC again argues that the use of a non-coincident peak area demand allocator is inappropriate for residential customers.[750] OPC states that use of a proper coincident peak allocator would reduce the rate base for residential customers by $51 million and reduce expenses allocated to residential customers by $3.5 million.[751] OPC also finds fault with PEPCO's use of the Sum of Customer Maximum Demands allocator because it fails to take into account diversity of load.[752]

288. **District Government.** The District Government does not find the demand cost allocators to be reasonable due to the fact that PEPCO has not conducted marginal cost studies. The District also objects to the 780 percent increase in distribution rates proposed for the SL and TS classes.[753]

DECISION

289. PEPCO's demand allocators for subtransmission, primary, and secondary facility cost, and specifically PEPCO's use of the average and excess non-coincident peak methodology, the AED-NCP allocation methodology, are reasonable.[754] The AED-NCP method has been used by the Commission for many years because it promotes rate stability and because it is an accepted allocation methodology.[755] In its brief, OPC even acknowledges that PEPCO Witness Browning's intent "to develop a rate structure which followed cost causation as indicated by the CCOSS"[756] is consistent with the "well-established ratemaking principle that cost recovery should track cost

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748 *Id.* at 22:11-15.

749 *Id.* at 22:16-18. "Customer" facilities are further divided into "services-customer," "meters," and "installations." *Id.* Here PEPCO allocates services based on the secondary serviced demand allocator and directly assigns meter and installation facilities. *Id.*

750 *Id.* at 25:10-14; OPC Br. at 160.

751 OPC (E) at 27:1-4 (Pavlovic Direct); OPC (E)-6); OPC Br. at 161.

752 Tr. 263:10-19; OPC Br. at 161-62.

753 DC Government Br. at 6.

754 OPC Witness Pavlovic explains that the AED-NCP method looks at (1) average demand (e.g., the amount of electricity transported in a year) and (2) excess demand – the measure of the peak demand on the facilities. OPC (E) at 14:10-18 (Pavlovic Direct). The discussion in Section 10 describes the Commission's use of the AED-NCP methodology.

755 Formal Case No. 939, Order 10646 at 195-99 (June 30, 1995) (noting that AED-NCP has been preferred by the Commission since the 1970s); Formal Case No. 869, Order No. 9216, 10 D.C.P.S.C. 22 at 137 (1989) (noting that the traditional AED-NCP method promotes rate stability); *See also* NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, COST ALLOCATION MANUAL 49 (1992) (discussing Average and Excess Method).

756 Tr. at 303:9-10.

causation."[757] As explained by Browning, "various facilities are sized to meet various loads, [therefore] three types of demand allocators are used [reflecting different parts of the distribution system]."[758]

290. OPC claims, however, that the allocators used by PEPCO do not meet the goal of matching cost allocation to how different facilities are planned and designed by PEPCO.[759] OPC asserts that PEPCO allocates primary distribution lines and expenses on the basis of the Non-Coincident Area Peak Demand Allocator ("NCAP") and that such allocation is inappropriate for a distribution-only system because the only cost–causative factor on the system is the collective class demand at the point of the system peak demand.[760] OPC's argument is that, since residential users' peak use occurs at a time other than system peak, PEPCO's method over-allocates to the residential class.[761]

291. As noted in Order No. 9868 in Formal Case No. 905, "[t]raditionally, PEPCO has used the AED-NCP method to make both jurisdictional cost allocations and customer class cost allocations. The AED-NCP method 'is a well established, reasonable method of jurisdictional cost allocation that this Commission has approved repeatedly, over many years.'"[762] We are not persuaded to abruptly abandon that methodology in this case.

292. While PEPCO has become a "wires-only" company, the purpose of the study has not changed. OPC Witness Pavlovic contends that PEPCO's costs are now driven by only customers and instantaneous load; however, he does not elaborate on why this distinction should alter the allocation of costs by AED-NCP. The design of the subtransmission system is properly based on both energy and demand characteristics. An energy component encourages PEPCO to use cost effective methods to reduce energy losses in its substations, lines, and transformers and is appropriately used here.

293. The subtransmission and distribution system is also designed based upon the maximum demands placed upon portions of the system, and these maximum demands are non-coincident demands. Accordingly, the Commission finds that the use of a non-coincident peak methodology is reasonable to reflect demand related system design and operation.

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757 OPC Br. at 159 (quoting *Public Service Co. of New Hampshire v. New Hampshire Elec. Coop., Inc., Northeast Util's Serv. Co.*, 83 FERC ¶ 61,223 at 61, 993 (1998)).

758 Tr. 264:4-6 (Browning Cross).

759 OPC (E) at 14:3-9 (Pavlovic Direct).

760 *Id.* at 14:21-15:7.

761 *Id.* at 15:3-7.

762 Formal Case No. 905, Order No. 9868, 12 D.C.P.S.C. 651, 757 (October 23, 1991) (quoting Formal Case No. 869, Order No. 9216, 10 D.C.P.S.C. 22, 137 (March 3, 1989)).

D. Cost Causation by Class[763]/ Identification of Customer, Demand, and Energy Costs by Class[764]/ Direct Assignment of the Northeast Substation Costs[765]

294. The objections here were minor and somewhat intertwined with the parties' positions above. OPC asserts that "[s]ubstituting coincident demand allocators [as PEPCO has done] reduces rate base and expenses allocated to the residential classes by, respectively, $51.0 million and $3.5 million."[766] OPC asserts that certain customer classes are served primarily by certain types of facilities; therefore it is important to take the costs of facilities into account.[767] However, as stated above, PEPCO's use of a non-coincident peak methodology is reasonable.[768] In our view, PEPCO's methodology accurately allocates costs by causation.

295. The District Government asserts that PEPCO's allocations to the SL and TS rate classes are not reasonable. According to the District Government, this rate class provides reliability at low risk and low cost to PEPCO,[769] and, as a result, the SL and TS rate classes should be allocated less of a percentage of the proposed rate increase.[770] Although we recognize that the level of risk is an important factor in costs, we believe this alignment of rates to costs should be gradual. Therefore, some misalignment of rates to costs at this time does not render the rates unreasonable.

296. With regard to "Identification of Customer, Demand, and Energy Costs by Class," OPC generally complains that PEPCO has not properly and accurately identified costs that are customer related, demand related, and energy related.[771] The District Government adds that PEPCO should have taken into account other factors such as value of service, ability to pay, historical rate patterns, the need to conserve energy resources, and "judgmental constraints."[772] However, after reviewing the evidence and testimony of PEPCO Witness Browning, we believe that the company has properly identified the relevant costs and accounted for them.

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763 Issue 11d asks: Do the allocation methods employed by the Company accurately attribute costs to classes based on causation?

764 Issue 11e asks: Has the Company properly and accurately identified for each class the costs that are customer related, demand related and energy related?

765 Issue 11.f. asks: Should any class(es) and/or customer(s) receive a direct assignment of a portion of the Northeast substation costs based on capacity or other factors?

766 OPC (E) at 27:3-4 (Pavlovic Direct) (OPC (E)-6).

767 OPC Br. at 164.

768 See discussion in Section 11.C.

769 *Id.* at 25:21-25 (Petniunas Direct); DC Government Br. at 6-7.

770 DC Government Br. at 7.

771 OPC Br. at 166. (See summary under Issue 11a.).

772 DC Government Br. at 7-8 (citing *Washington Gas Light Co. v. Pub. Serv. Comm'n*, 450 A.2d 1187, 1202-08 (D.C. 1982); Formal Case No. 905, *In re Potomac Power Co.*, Order 9868 at 175 (Oct. 28, 1991).

297. Finally, concerning the "Direct Assignment of the Northeast Substation Costs," PEPCO states that the Northeast substation costs should not be directly assigned.[773] No party takes issue with PEPCO's representation, nor do we.

XII. DISTRIBUTION RATES BY CLASS (Issue No. 12)[774]

298. **PEPCO.** PEPCO submits that, due to unbundling, the rates developed in this proceeding are more reflective of costs than in previous proceedings.[775] PEPCO explains that in developing the rates, it focused on establishing rates of return for each class that were as close as possible to the overall required rate of return and on providing customers in each rate class with a rate that reflects the cost of providing service.[776] PEPCO provides a description of the method its witness used to develop class rates.[777]

299. Witness Bumgarner testifies that, at the request of Comcast, PEPCO modified Schedule TN by making it applicable to cable television power supplies and undertook a special class cost of service study to determine rates under Schedule TN.[778] The modifications to Schedule TN will account for the constant load characteristics of cable television power supplies and similar equipment that is currently served under Schedule GS ND.[779]

300. Bumgarner also testifies that the Company sees this proceeding as an opportunity to set its distribution rates on a stand-alone basis with a primary goal of reflecting cost of service.[780] He defines two major principles to guide the adjustment of distribution rates.[781] First, he attempts to minimize the amount by which the rate of return for any specific rate class differs from the overall required rate of return.[782] Bumgarner uses Unitized Rate of Return ("UROR") to detect whether certain classes are paying their appropriate share compared to PEPCO's overall rate of return, and he measures success by how close each rate class rate design is to a rate-class-specific UROR of unity.[783] His second goal is to provide accurate cost based price signals for each rate class for

773 PEPCO (2F) at 10:8-11:7 (Browning Supp. Direct).

774 Issue 12 asks: Are the class rates proposed by PEPCO just and reasonable for distribution-only service? The Commission addresses this overall issue in the discussions of the subissues described below.

775 PEPCO (H) at 3:12-4:10 (Bumgarner Direct); PEPCO Br. at 115-116.

776 PEPCO (H) at 5:1-6 (Bumgarner Direct); PEPCO Br. at 116.

777 PEPCO (H) at 5:9-7:6 (Bumgarner Direct); PEPCO Br. at 116-19.

778 PEPCO (H) at 11:20-12:10 (Bumgarner Direct); PEPCO Br. at 120.

779 PEPCO (H) at 11:20-12:10 (Bumgarner Direct).

780 *Id.* at 3:14-17.

781 *Id.* at 4:8-5:6.

782 *Id.* at 4:11-13.

783 *Id.* at 4:13-17. Bumgarner explains that the UROR is "the ratio of the return from each customer class to

customer, energy and, if applicable, demand rate components such that they reflect the costs in the CCOSS.[784]

301. PEPCO Exhibit H-1 details PEPCO's suggested revenue allocation.[785] The revenue allocation is designed to move the residential classes one quarter (25 percent) of the way toward PEPCO's requested overall rate of return.[786] The residential class would be allocated one third of the overall requested increase.[787] Each commercial class is adjusted halfway (50 percent) toward PEPCO's requested overall rate of return.[788] The revenue allocation still requires additional revenue, which is allocated by a constant factor on each commercial class.[789]

302. PEPCO points out that distribution rates are only a portion of the customer's bill.[790] PEPCO indicates that the average Residential Schedule R customer would see a 44.6 percent increase in distribution rates but only a 7.5 percent increase based on the total bill.[791] Similar figures for Schedule GS, LV, and ND result in an average distribution increase of 13.45 percent and an average increase in the total bill of only 3.2 percent.[792] These increases are based upon the Company receiving its full requested increase.

A. Reasonableness of Percentage Changes in Class Revenue Requirements[793]

303. **Comcast.** Witness Raab asserts that PEPCO has made a reasonable attempt to balance the competing objectives of class return parity and avoidance of "rate shock."[794]

304. **District Government.** Witness Petniunas testifies that "PEPCO's embedded cost proposal would increase the SL and TS rates by 35 times the proposed average increase for all customers."[795] He maintains that the amount of the increase to one customer class should be limited, particularly where, as here, usage for the SL and TS (energy schedules) has declined since the last rate case. He goes on to state:

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the overall return for the entire District of Columbia retail jurisdiction. A UROR greater than 1.0 means that the customer class is providing a greater than average return. A UROR less than 1.0 means that the customer class is providing less than the average return." *Id.* at 4:18-23.

784 *Id.* at 5:1-26.

785 PEPCO (H)-1 at 1.

786 PEPCO (H) at 6:10-17 (Bumgarner Direct). PEPCO requests an overall rate of return of 8.42%.

787 *Id.* at 6:19-20.

788 *Id.* at 6:19-22.

789 *Id.* at 6:22-25.

790 *Id.* at 7:9-23; PEPCO (H)-1 at 2.

791 PEPCO (H) at 7:13-20 (Bumgarner Direct).

792 *Id.* at 7:20-23.

793 Issue 12a asks: "Are the percentage changes in the class revenue requirements just and reasonable?"

794 Comcast (A) at 11:19-12:3 (Raab Direct).

795 DC Government (A) at 9:15-18 (Petniunas Direct).

> One possibility (among many) for taking into account rate continuity, revenue stability, and equity at this point in the reconciliation process would be to employ the following standards: (1) No customer or class should sustain a change in its revenue contribution that is 50 percent less or more than the overall percentage increase . . . .[796]

305. **GSA.** Witness Goins states that if the Commission allows a base revenue increase that is less than what PEPCO requested, the Commission should reduce the increase for each class while maintaining the relative increases shown under the GSA revenue spread."[797]

306. **OPC.** Witness Pavlovic reiterates his contention that "PEPCO's class cost study over-allocates costs to the residential classes, creating the appearance of a subsidy of the residential classes by the commercial classes in the current rates."[798]

307. **WMATA.** Witness Foster recommends that PEPCO adopt a tolerance band of +/- 10 percent of system average returns for each class with adjustments phased in over three years in order to avoid rate shock and maintain continuity.[799]

DECISION

308. At the outset, we note that the "allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science."[800] As part of its inquiry, the Commission considers cost and non-cost factors,[801] which may include the value of the service to the customer and the need for efficiency.[802] In this case, most of the parties recognize that PEPCO's CCOSS shows existing subsidies[803] and further recognize that the elimination of the existing subsidies cannot occur at one time. While these parties express their positions differently,

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796 *Id.* at 21:14-21 (quoting Formal Case No. 869, Order No. 9216 at 219).

797 GSA (A) at 14:12-18 (Goins Direct) (citing Schedule DWG-1 – Interclass Revenue Subsidies Under Proposed Revenue Spreads attached to GSA (A) (Goins Direct). Witness Goins notes as an example that if the allowed increase is half of PEPCO's 22.30 percent request, then the increase for Residential customers should be 29.77 percent (half of 59.54 percent) and the increase for GS customers would be around 5.34 percent (or half of 10.68 percent).

798 OPC (E) at 29:12-14 (Pavlovic Direct).

799 WMATA (A) at 20:11-13 (Foster Direct).

800 *Washington Gas Light Co. v. Pub. Serv. Commn. of D.C.*, 450 A.2d 1187, 1206 (D.C. 1982) (citations omitted). The Court of Appeals for the District of Columbia noted that under this standard a "lack of specificity does not alone imperil the validity of [a rate] order." *Id.* at 1206, 1209 (upholding a rate design even though no specific cost data were clearly provided).

801 *Id.*

802 *Id.* at 1202-04.

803 The subsidy issue is discussed in more detail in Part B below (discussing Issue 12.b.).

they all accept the concept of gradualism as used by the Commission to adjust rates over time.[804] AOBA and GSA argue that if PEPCO receives less than its full revenue request, the proposed increase to subsidized classes should not be reduced as significantly as other classes.[805]

309. In Formal Case No. 939, Order No. 10646, the Commission re-stated its principle of "gradualism" in moving towards cost-causation[806] and authorized a partial phase-out of a rate discount.[807] In accordance with this principle, the Commission will move rates towards cost-based amounts over a period of time. In this Order, the Commission has determined that the basis for cost of service, revenue allocation and rate design shall be a CCOSS performed on an embedded, not marginal, cost basis. The Commission has also determined that the Company's jurisdictional cost allocation study for distribution service[808] (Company Exhibit (F)-1) and the Company's CCOSS[809] (Company Exhibit (F)-3), both of which are for the period ending September 30, 2006, form a reasonable measure of the relative returns of the various classes.

310. The Commission notes that the rate of return for the residential classes (with the exception of R-TM) are well below that of the commercial classes, indicating that residential customers are being subsidized by commercial customers. The various parties to the case also recognize this subsidy and offer their suggestions for its elimination or reduction. OPC's contention that PEPCO's CCOSS creates only the appearance of a subsidy by overallocating costs to the residential class is based on OPC's disagreement with the methodologies used in PEPCO's CCOSS. The Commission has addressed these arguments in the preceding sections and found PEPCO's CCOSS reasonable.[810] Many parties recognize that a residential subsidy of approximately $50 million cannot be eliminated in one rate case due to its magnitude. They suggest that the Commission apply the principles of gradualism, which is a widely accepted rate design principle for avoiding rate shocks, to reduce or eliminate the subsidy.

311. The Company has proposed to reduce the subsidy and improve the rate of return of residential customers by closing the "gap" between the system rate of return and the residential rate of return by one quarter in this rate case.[811] To achieve that target, the Company has proposed that the residential distribution rates would increase 44.6 percent (equivalent to an average overall increase in the total bill for a residential customer under Rate Schedule R of 7.5 percent).[812]

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804 Formal Case No. 939, Order No. 10646 at 271 (June 30, 1995). *See* AOBA Br. at 42; OPC Br. at 219 (citing Formal Case No. 1016, Order No. 12986 at ¶ 382 (Nov. 10, 2003)); GSA (A) at 5:6-7:13 (Goins Direct); WMATA (A) at 20:1-7 (Foster Direct); PEPCO (3H) at 22:9-12 (Bumgarner Rebuttal).

805 AOBA (A) at 96:9-97:3 (Oliver Direct); GSA (A) at 14:12-18 (Goins Direct).

806 Formal Case No. 939, Order 10646 at 264 (Jun. 30, 1995).

807 *Id.* at 271 (citing Formal Case No. 889, Order No. 9509 (July 24, 1990), 11 D.C.P.S.C. 302 at 434 (phase-out must be consistent with gradualism)).

808 PEPCO (F)-1.

809 PEPCO (F)-3.

810 See Section 11 and subissues in Sections 11.A through 11.F, *supra.*

811 PEPCO (H) at 6:10-20 (Bumgarner Direct).

812 *Id.* at 7:10-22.

Similarly the average commercial customer served under Schedule GS, LV and ND, would see an increase in distribution rates of 13.4 percent (equivalent to an average overall increase in the total bill of 3.2 percent).[813] PEPCO proposes to move the residential rate of return by 25 percent toward the overall rate of return of 8.42 percent that the Company is seeking in this case. Each class of commercial customers will then be moved 50 percent toward the overall rate of return and then allocated the remaining increase based on a constant factor which allows PEPCO to reach the overall increase amount.[814]

312. The Commission is mindful of the recent increases in the SOS rates for generation. With the recognition of the SOS rate increase that occurred on June 1, 2007, the Commission cannot support such a disproportionate and large increase for any class at this time. After considering all relevant cost and non-cost factors, the Commission has determined that the revenue increase granted in this Order shall be allocated among the various customer classes in the following manner: each class will receive the same percentage increase in base distribution charge, with the exception that the residential classes will receive an additional 1 percent increase over the non-residential increase. In addition, as discussed below, the Street Light and Traffic Signal classes shall receive an increase equal to the maximum of all other classes, which equates to the same percentage increase as the residential classes. Thus, the percentage increase for the residential classes will be greater than the system average increase, and the percentage increase for the non-residential classes will be less than the system average increase. This revenue allocation methodology is similar to a method proposed by the Company in Formal Case No. 939, Order No. 10646.[815] In that case, the Commission modified PEPCO's request for a 1 percent increase in residential rates over commercial rates.[816] The Commission reduced the Company's recommended 1 percent increase to 0.42 percent while noting the importance of gradually moving the revenue requirement responsibility towards marginal cost as well as maintaining rate continuity and equity.[817]

313. In the instant case the disparity between the residential class rate of return and the overall rate of return has increased. Thus the Commission, while mindful of the impacts on both the residential and non-residential customers, has determined that the differential shall be the full amount of 1 percent.

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813 *Id.* at 7:16-23.

814 *Id.* at 6:20-7:6; PEPCO Exh. (H)-1; Tr. at 321:4-322:7 (Bumgarner Cross); PEPCO Br. at 101

815 Formal Case No. 939, Order No. 10646 at 231-32 (June 30, 1995).

816 *Id.* at 237.

817 *Id.* at 236-37. While the Commission discussed the movement of rates toward marginal cost in this proceeding, it also noted that the embedded cost study was appropriately considered. *Id.*

B. Inter-Class Subsidies in Proposed Rates[818]

314. **PEPCO.** PEPCO states that the proposed rates allow subsidies.[819] In PEPCO Exhibit (2H)-1, the company submitted a calculation, which shows the level of the subsidy between residential and non-residential classes to be $50,328,000 for a full rate of return at 8.42 percent.[820]

315. **AOBA.** Witness Oliver notes that while PEPCO earned an overall rate of return of 6.79 percent on its rate base investments for the 12 months ended September 2006, in some rate classifications, the earned returns are more than twice the system average.[821] PEPCO's CCOSS shows negative rates of return for customers under the Residential and RAD Rate Schedules.[822]

316. Oliver asserts that commercial customers have been heavily subsidizing PEPCO's costs of providing service to residential customers in the District of Columbia, despite the rate caps.[823] He contends that, "PEPCO's large and small commercial customers combined are providing the Company a return in excess of 12.7 percent prior to any rate increase, as contrasted with the average return for all residential service classes, amounting to – 3.28 percent."[824]

317. **District Government.** Witness Petniunas states that SL and TS services have produced negative rates of return in the past and have been priced at only marginal energy costs by the Commission.[825] He states that these negative rates of return result from "embedded cost allocation studies with marginal cost determined revenues based only on marginal energy costs."[826]

318. **WMATA.** Witness Foster asserts that there are gross distortions in the distribution of PEPCO's revenue requirements by rate class in the District of Columbia[827] and that "[a]s a result, the revenues attributed to the various rate classes do not reflect the cost of providing service to each class."[828] Foster asserts that the residential sector is subsidized by other classes because its class return is substantially lower than the returns of other classes.[829] Foster contends

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818 Issue 12b asks: "Do the proposed rates embody inter-class subsidies and, if so, what is the nature and level of the subsidies?"

819 PEPCO (2H) at 2:24-3:10 (Bumgarner Supp. Direct); PEPCO (2H)-1; PEPCO Br. at 127.

820 PEPCO (2H)-1, column 6, line 6.

821 AOBA (A) at 92:29-93:6 (Oliver Direct) (citing PEPCO (F)-3).

822 AOBA (A) at 93:36 (Oliver Direct).

823 *Id.* at 94:4-9.

824 *Id.*

825 DC Government (A) at 28:9-15 (Petniunas Direct). This pricing is based on several determinations that these services (SL and TS) have been considered a public good. *Id.*

826 *Id.* at 28:23-29:2.

827 WMATA (A) at 16:6-17:5 (Foster Direct).

828 *Id.* at 16:29-17:2 (Foster Direct).

829 *Id.* at 17:1-5.

that this is an unfair cross-subsidy and that it should be corrected.[830] Foster contends that class is also not being charged the true cost of the service it is using and, therefore, it has little incentive to conserve.[831]

319. **GSA.** Witness Goins states that PEPCO's proposed rates move each class closer to cost of service measured by movement in each class rate of return index ("RORI") toward unity.[832] While supporting the general effort of PEPCO to move rates closer to cost of service, Goins finds that PEPCO's proposed revenue spread maintains large interclass revenue subsidies.[833] In particular, he notes that the present rates for residential customers are about $49 million below PEPCO's cost of serving the class.[834] Goins notes that under-recovery of this amount is "shifted primarily to Commercial customers whose rates are above PEPCO's cost of service."[835] Goins recommends reducing the interclass revenue subsidies under PEPCO's proposed revenue spread by 10 percent. He states that the interclass subsidies can be reduced by modifying PEPCO's proposed revenue spread. In Goins's opinion, this modification would move PEPCO's distribution rates closer to cost of service without unacceptably high bill increases on any customer class.[836] Witness Goins also states that a cost of service index ("COSI") provides more information regarding how well rates track cost of service.[837]

320. Goins explains his alternative proposed revenue spread as follows:

> "[R]evenue spread only reduces the subsidies under PEPCO's proposed revenue spread by 10 percent. As shown in Table 2, Residential (including RTM) customers would still receive a subsidy of about $45 million, while general service Commercial customers would still pay slightly more than $45 million in revenue subsidies. . . . Under my recommended spread, Residential (excluding RTM customers) customers get a 59.54 percent distribution base rate increase compared with a 45.80 percent increase under PEPCO's proposed spread. (See Schedule DWG-1). Using a linear interpolation of the relationship between

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830 *Id.* at 17:4-5.

831 *Id.* at 17:8-10.

832 GSA (A) at 5:12-16 (Goins Direct). Goins explains that the closer that the RORI for a given class is to unity, the closer its rates come to recovering PEPCO's cost of service. *Id.* at 5:16-17. The RORI equals the class rate of return divided by retail system average rate of return. *Id.* at 5 n.3.

833 *Id.* at 5:14-17, 18-20.

834 *Id.* at 5:20-6:3.

835 *Id.* 6:1-3, 6:5-7.

836 *Id.* at 7:18-8:2.

837 *Id.* at 10:1-10. He explains the COSI's role as follows:

> "A COSI measures the degree to which a customer class' base revenue falls short of or exceeds its revenue requirement at the system average rate of return. Changes in a class' COSI not only indicate whether a revenue spread moves rates toward cost of service, but also indicates how effective proposed rate changes are in closing the difference between base rate revenues and assigned cost of service." GSA (A) at 10:2-10 (Goins Direct).

> distribution rate increases and total bill increases discussed in PEPCO's testimony, I estimate that my recommended revenue spread will increase the average Residential total bill for supply, transmission, and distribution services by around 10 percent. In my opinion, the distribution base rate increases under my proposed revenue spread are reasonable and necessary to move prices closer to cost of service and to mitigate the interclass subsidy problem."[838]

321. **OPC.** Witness Pavlovic restates his contention that PEPCO's class cost study is flawed and questions PEPCO's assertion that the residential class is being subsidized.[839]

322. **PEPCO Rebuttal.** In rebuttal, Witness Bumgarner states that his UROR measure of subsidy and Witness Goins's COSI are highly correlated and that GSA Witness Goins's proposal is reasonable, as is the company's own proposal.[840]

DECISION

323. The evidence of record shows that the residential class is being subsidized and that the amount of the subsidy is approximately $50 million.[841] Specifically, on this question, PEPCO has relied on the UROR. The UROR provides a means to measure the ratio of the return from each customer class to the overall return for the entire District of Columbia retail jurisdiction and provides a means to measure whether a customer class is providing a return that is greater or less than the average return.[842] The Commission notes that the UROR is used in other jurisdictions to measure subsidization.[843] PEPCO's analytical conclusion that a subsidy exists is supported by the analyses performed by AOBA, WMATA, and GSA.[844] In addition, GSA offers a supplemental measure of class contribution to cost of service—its cost of service index (COSI). While the UROR focuses on class return, the COSI focuses on the ratio of revenue to cost of service. Both of these methods are based on the distribution business class cost of service study, and both demonstrate that cross-class subsidizations have occurred, with some classes not even covering their cost of service.[845] In fact, even the revised study provided by OPC highlights that a subsidy exists between classes.[846]

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838 *Id.* at 13:4-14:8 .

839 OPC (E) at 27:18-21 (Pavlovic Direct).

840 PEPCO (3H) at 22:18-23:3 (Bumgarner Rebuttal).

841 PEPCO (2H)-1; GSA (A) at 11:12-16 (Goins Direct).

842 PEPCO (H) at 4:11-24 (Bumgarner Direct).

843 *See, e.g.,* Case No. 9092, *Re Potomac Electric Power Company,* Order No. 81517, 258 P.U.R. 4th 463 (Md. P.S.C. July 19, 2007).

844 WMATA (A) at 16:7-17:5 (Foster Direct); GSA (A) at 7:17-13:8 (Goins Direct), AOBA (A) at 93:5-6 (Oliver Direct).

845 PEPCO (H) at 3:14-7:6 (Bumgarner Direct); PEPCO (H)-1; GSA (A) at 10:1-13 (Goins Direct); Schedule DWG-1 (attached to Goins direct). Witness Bumgarner notes a negative return for Residential Schedules R and AE, the SL and TS classes, as well as for Schedule TN. PEPCO (H) at 5:21-6:2 (Bumgarner Direct).

846 OPC (E)-6.

Based on the foregoing, it appears that subsidies exist; the Commission will attempt to lessen the amount of the subsidies provided by particular classes in our rate design decisions herein.

C. Whether the Proposed Rate Elements Reflect Cost-Causation of Each Class[847]

324. **AOBA.** Witness Oliver states that the largest shifts in percentage terms are between commodity (kWh) and demand (kW) charges. He goes on to state:

> PEPCO's proposals lack reasonable and appropriate consideration of the principles of gradualism and continuity in ratemaking. . . . [T]he Commission should note that the objectives of the Company's proposed rate designs for Rate Schedule GS and Rate Schedule GT customers essentially **duplicate** those of the Company's BSA and the Company's price elasticity based revenue adjustment. . . . [T]he Commission must also recognize that a decision to approve the PEPCO's proposed BSA would essentially eliminate the need for the Company's proposed rate design changes for Rate Schedules GS and GT. Likewise, approval of the Company's proposed rate designs for Rate Schedules GS and GT would further undercut the need for, and appropriateness of, both PEPCO's proposed BSA and its price elasticity adjustment to its test year revenue.
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> . . . .
>
> Customers of all sizes rely on this Commission to ensue [*sic*] that rate changes are not abrupt and unpredictable, and many have made investment and/or operating decisions based on the presumption that the current structure of the Company's rates would not be radically altered. . . . Preferably, rate changes of the magnitude PEPCO has proposed for elements of its non-residential service schedules, to the extent that they are justifiable, should be phased-in over three or four cases."[848]

325. **OPC.** Witness Pavlovic reiterates his contention that PEPCO's class cost study does not properly assign costs to the rate classes and, therefore, should not be the basis for distribution of the revenue requirement to the classes or the design of rates.[849]

DECISION

326. As discussed above, PEPCO's use of an embedded cost of service study is appropriate and its CCOSS is reasonable.[850] The study also provides an appropriate basis for the rate

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847 Issue 12c asks: "Do the proposed rate elements for each class reflect the cost-causation characteristics of the class?"

848 AOBA (A) at 98:18-100:13 (Oliver Direct).

849 OPC (E) at 27:18-21 (Pavlovic Direct).

850 *See* Section XI and accompanying discussion.

elements (e.g., customer charges and demand rates) that make up the rate for each class.[851] After reviewing the study, the Commission is persuaded that the proposed rate elements for each class appropriately reflect the cost-causation characteristics of the class.

D. Appropriate Benchmarks to Measure Distribution of Revenue Requirement to Rate Classes[852]/

E. Appropriate Benchmarks for Distribution of Class Revenue Requirement to Rate Elements[853]

327. **PEPCO.** PEPCO believes that the CCOSS is an appropriate benchmark.

328. **District Government.** Witness Petniunas objects to PEPCO's benchmark based on his belief that PEPCO should have based its analysis on marginal costs rather than embedded costs, a view that we have already rejected.

329. **WMATA.** Witness Foster notes that while cost of service is the primary basis for establishing rates, it is not the only factor that a Commission should consider.[854] He notes other factors to consider, such as: continuity, market factors, rate shock, and social goals.[855]

330. **GSA.** Witness Goins discusses this issue in his rebuttal testimony and agrees with PEPCO's recommendation to set all rates for its distribution-only service on the basis of embedded costs.

331. **OPC.** Witness Pavlovic states that cost-causation is the appropriate benchmark but reiterates OPC's position that PEPCO's study is flawed.[856]

<u>DECISION</u>

332. For the reasons previously stated, we agree with PEPCO that the UROR from the CCOSS is an appropriate benchmark.

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851 PEPCO (F) at 15:20-25:7 (Browning Direct) (discussing cost allocation study); PEPCO (F)-1 through (F)-6 (supporting workpapers); PEPCO (H) at 2:11-23:14 (Bumgarner Direct) (discussing propose rate design); PEPCO (H)-1 through (H)-7 (supporting workpapers).

852 Issue 12d asks: "For ratemaking purposes, what are the appropriate benchmarks against which to measure the distribution of the revenue requirement to individual rate classes?"

853 Issue 12e asks: "For ratemaking purposes, what are the appropriate benchmarks against which to measure the distribution of class revenue requirement to rate elements?"

854 WMATA (A) at 19:2-4 (Foster Direct).

855 *Id.*

856 OPC (E) at 28:15-29:3 (Pavlovic Direct); OPC Br. at 171.

F. Whether Class Returns Should Vary Based on the Risk of Each Class[857]

333. **PEPCO.** Witness Browning states that an analysis based on risk would be burdensome and unlikely to produce any meaningful result, especially since each class will consider itself less risky than others.[858]

334. **District Government.** Witness Petniunas believes that certain classes, like the SL class, do not add to risk and should have lower rates because they contribute to reliability. Specifically, he states:

> Classes such as Street Lighting do not add risk to PEPCO's system since they do not contribute to peak demand, do not add to construction of substations or transmission lines, and do not add to the expansion of the distribution system. As such, because of their reliable contribution to PEPCO's revenues without added costs, their rates and rate increases should be lower than other classes of customers.[859]

The District Government is also concerned about the obvious public safety concerns such as crime and traffic accidents which weigh against reduction in consumption based on increased rates.[860]

335. **WMATA.** Witness Foster states that the residential sector has greater risks:

> The residential sector is probably more risky to serve because cost recovery is primarily based on volumetric rates rather than fixed charges. Cost recovery from volumetric rates is subject to uncertainties such as weather, and other demand related factors. In addition, residential customers tend to have a greater degree of turnover and a higher concentration of uncollectibles.[861]

336. **OPC.** OPC notes that, as to this narrow issue, further attempts to refine equity costs among class-specific risks would be burdensome and would likely produce little benefit.[862]

DECISION

337. The Commission finds that class returns may vary based on the risk to the Company because the level of risk is a valid non-cost factor to consider in rate design.[863] As an

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857 Issue 12f asks: Should class returns vary with the level of risk incurred by the Company?

858 PEPCO (2F) at 12:3-16 (Browning Supp. Direct).

859 DC Government (A) at 28:9-17 (Petniunas Direct).

860 *Id.* at 25:21-23; DC Government (A)-5; DC Government Br. at 19.

861 WMATA (A) at 19:9-13 (Foster Direct).

862 OPC Br. at 172.

863 *Washington Gas Light Co. v. Pub. Serv. Comm'n*, 450 A.2d 1187, 1200 (D.C. 1982) (noting that

example, District Government notes the unique nature of SL and TS service as low risk. While there are no specific means to quantify the value of the comparative low risk of the SL and TS classes to PEPCO on the record, the Commission will consider reduced risk, among other factors, in setting rates for the SL and TS classes. The Commission has also chosen to gradually implement the change and limit the initial impact of the rate increase on the District Government. Under PEPCO's initial proposal, the SL and TS classes face an increase of over 780 percent. The District Government notes that the rates for these services had been based on marginal cost, in part based on non-cost judgments as to the value of these services as a public good.[864] The Commission will follow the precedent in PEPCO's prior rate case, Formal Case No. 939, in which the Commission looked at the relative increases to different rate classes and applied principles of gradualism and rate continuity to adjust a rate increase.[865] Since each class shall receive nearly the same percentage increase in base distribution, with the exception that the residential classes shall receive an additional 1 percent increase, the increase for the SL and TS classes will be no greater than the maximum increase granted to any other class.[866]

338. While the District has made significant strides to introduce energy efficiency in traffic signals, additional opportunities remain in the SL class. Accordingly, the increase in SL revenue allocation will provide this class with a modest incentive to improve energy efficiency.

339. In succeeding rate cases, parties may introduce studies to provide the Commission with comparisons of class risk levels, which may impact the ultimate target UROR for each class. The Commission also notes that disadvantaged residential customers are somewhat protected by the capped RAD rates.

XIII. BILL STABILIZATION ADJUSTMENT ("BSA") (Issue No. 13)[867]

Overview of the BSA Proposal

340. **PEPCO.** PEPCO proposes a revenue decoupling adjustment, the Bill Stabilization Adjustment ("BSA"), which decouples revenues from variation in kWh sales per customer from adjusted test-year levels. Under PEPCO's initial proposal, the BSA is to be applied on a quarterly basis to the distribution charge for most customer classes.[868] As explained by Witness

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differences in class rate of return that derive from reasonable consideration of non-cost factors do not render rates invalid); *see* Sec. XI.D, *supra* (discussing consideration of risk).

864 DC Government (A) at 21:10-27 (Petniunas Direct) (DC A-1). Witness Petniunas notes that the nature of SL and TS service and their historic treatment as a public good priced at marginal energy cost explain the large percentage increase proposed here based on embedded cost. DC Government (A) at 28:9-29:4 (Petniunas Direct).

865 Formal Case No. 939, Order No. 10646 at 237 (June 30, 1995).

866 Under this method, the SL and TS classes shall receive an increase equal to the maximum of all other classes and thus should receive the same percentage increase as the residential classes. *See* discussion of Issue 12a, *supra*.

867 Issue 13 asks: "Is PEPCO's proposed Bill Stabilization Adjustment (BSA) reasonable?"

868 PEPCO (H) at 18:1-5 (Bumgarner Direct). In testimony, PEPCO indicated that a monthly analysis could be done as well. Tr. at 1000:10-1002:6 (Rigby Cross). In PEPCO (H)-2, PEPCO's proposed BSA is to be applied

Bumgarner, the BSA is designed to provide the Company with a stable revenue stream based on the test year revenue requirement.[869] For each rate class and for each billing month in a given quarter, "the approved test year revenue per customer for each service classification is applied to the number of customers in each billing month to arrive at target quarterly revenue for each service classification" and that "[t]he difference between the target revenue and the actual revenue forms the basis for the BSA for the following quarter."[870] The adjustment is billed on a per kWh basis, calculated quarterly for each service classification on a per customer basis, and applies a 10 percent cap on any adjustment. This cap will result in a charge or credit that will be carried over into a subsequent quarter's adjustment and a "true-up" that will account for over-collections or under-collections in the BSA in prior quarters. Further, PEPCO will add the balance from any over-collection or under-collection to the revenue differences to arrive at a "final BSA revenue target for each rate class for the current quarter."[871] This revenue is divided by the projected sales for the upcoming bill period and this rate will be "compared to 10 percent of the rate class test year average quarterly rate to determine the final BSA for the quarter."[872] The BSA, as proposed, does not apply to "stable" lighting and telecommunications customers.[873]

341. In describing the theory underlying the revenue "decoupling" in the BSA,[874] Witness Chamberlain asserts that, although distribution costs are "largely fixed and change little in the short run as usage levels change[,]" the distribution tariffs have a "significant volumetric component."[875] Additionally, changes in sales result from weather, price elasticity, building standards, expanded energy efficiency programs, and changes in appliance efficiency.[876] He further contends that "[t]he existing cost-of-service rate structure provides strong incentives for utilities to sell as much electricity or gas as possible."[877] Accordingly, the current rate recovery mechanism

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to customers on the following rate schedules listed by Rate Schedule abbreviation. Schedule "R" is Residential Service, Schedule "AE" is Residential All Electric Service, Schedule "R-TM" is Time Metered Residential Service, Schedule "GS-ND" is General Service – Non Demand, Schedule "GS-LV" is General Service – Low Voltage, Schedule "GS 3A" is General Service – Primary Service, Schedule "T" is Temporary or Supplementary Service, Schedule "GT LV" is Time Metered General Service – Low Voltage, Schedule "GT3A" is Time Metered General Service – Primary Service, Schedule "GT 3B" is Time Metered General Service – High Voltage, and Schedule "RT" is Rapid Transit Service.

869 PEPCO (H) at 18:8-19 (Bumgarner Direct). Witness Bumgarner also states that the BSA would prevent large billing spikes, particularly during periods of extreme weather, and would recognize that the costs of delivery are fixed. *Id.* at 14-21.

870 *Id.* at 19:6-12.

871 *Id.* at 19:12-25.

872 *Id.* at 20:3-5.

873 *Id.* at 18:5-11.

874 "Decoupling" breaks the link between the utility's commodity sales and its revenues. PEPCO (G) at 11:3-18 (Chamberlin Direct). Witness Chamberlin explains that decoupling removes a company's disincentive to encourage energy efficiency because the reduced sales from conservation will not reduce revenues. *Id.* at 5-16.

875 PEPCO (G) at 3:1-10 (Chamberlin Direct).

876 *Id.* at 8:1-22.

877 *Id.* at 7:1-7 (citing Rutgers University Center for Energy, Economic & Environmental Policy Decoupling White Paper #1).

does not encourage energy efficiency through demand side resources, because "[d]emand side resources reduce sales and, consequently, revenues and fixed cost recovery decline."[878] This creates a disincentive for the utility to consider demand side resources even when they are the lowest cost option.

342. At the hearing, PEPCO modified its proposal in response to comments raised by the parties about the time lag involved in the BSA and its effect on customer service. PEPCO indicates that it could provide monthly adjustments, rather than the quarterly adjustments proposed, in order to address concerns about the timing of the BSA adjustments.[879] In addition, in order to address the impact of the BSA on incentives to restore power following major storms, PEPCO also proposes "to exclude from the adjustment lost revenues associated with outages affecting 10,000 customers for over 24 hours."[880]

343. According to Witness Chamberlain, the BSA is beneficial because: (1) it will increase the stability for customer bills and reduce PEPCO's financial risk;[881] (2) it will provide PEPCO with a stable stream of revenue and prevent over-collection or under-collection if actual sales vary from the test year estimates due to weather conditions or other factors including improved energy efficiency;[882] (3) it would benefit ratepayers because it would result in approximately a 25 basis point reduction in PEPCO's cost of equity,[883] and it would eliminate the need for PEPCO's proposed $2.3 million adjustment to account for lower sales resulting from higher prices;[884] (4) it would eliminate the disincentive for the Company to promote energy efficiency by decoupling revenues from sales; [885] and (5) it helps ensure fixed-cost recovery.[886]

344. **OPC.** OPC argues that the Commission should reject the BSA because it would shift a significant amount of risk associated with the operation of PEPCO's distribution system from the stockholders to the ratepayers and would essentially guarantee PEPCO's recovery of its revenue requirement, including a return, regardless of the quality of service it provides.[887] Specifically, OPC asserts that the BSA is unlikely to stabilize customers' bills because multiple factors will be at issue, including: the current monthly adjustment to "normalize revenue" and over or under recovery of the

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878 *Id.* at 9:2-4.

879 PEPCO Br. at 134.

880 Tr. at 1000:10-1002:6 (Rigby Cross); PEPCO Initial Br. at 134.

881 PEPCO (F) at 23:18-23 (Browning Direct).

882 *Id.* at 24:4-23.

883 *Id.* at 23:20-24:1.

884 *Id.* at 24:1-3; PEPCO (2F) at 12:21-13:13(Browning Supp. Direct); PEPCO (A) at 14:20-15:4 (Rigby Direct).

885 Tr. at 1131 (Re-cross by OPC), 1133 (examination by the Commission); PEPCO (3G)-2; PEPCO Br. at 139-40.

886 PEPCO (H) at 19:6-12 (Bumgarner Direct).

887 OPC Br. at 8.

prior quarter's BSA and any possible carryover from prior months' excess over the cap.[888] OPC Witness Rothschild states that the BSA is a risk elimination measure, noting that the BSA virtually eliminates the "non-diversifiable" risks to PEPCO investors and provides a guaranteed revenue stream. While some non-diversifiable risks would remain, Rothschild asserts that the main risk, cost escalations due to general economic conditions, is an inflation risk that is "already factored into the cost of high-rated corporate debt, because such inflation would reduce the purchasing power of the stream of payments that debtors make to their lenders."[889] Rothschild concludes that "the cost of equity for PEPCO under the BSA would be the AA Bond cost rate of 5.51 percent."[890] He states that if the Commission adopts the BSA, he recommends "an overall cost of capital of 5.85 percent for PEPCO based upon a 5.51 percent cost of equity, 6.17 percent cost of long-term debt and a 5.25 percent cost of short-term debt."[891]

345. OPC Witness Larkin testifies that the BSA may partially circumvent individual customer actions since the BSA will decouple the delivery of kWh from the revenue generated from customers. He explains that if an individual customer desires to conserve energy and reduce his consumption, that reduction in consumption would be circumvented because, if PEPCO did not collect the average revenue per customer as calculated by PEPCO from the rate case, then the total customer group would have to make up that shortfall in revenue through the BSA.[892] Witness Larkin further states that, although the basic calculations for the BSA are verifiable, the inputs for those calculations are not.[893] He concludes that because there is no current demand-side management program that the Company is proposing to be implemented in conjunction with the BSA, there is no justification to implement the BSA at this time.[894]

346. **AOBA.** AOBA is generally opposed to PEPCO's BSA proposal since it is primarily intended to shift risk traditionally born by shareholders to its District of Columbia ratepayers.[895] AOBA Witness Oliver states that customers may not see the stability that PEPCO promotes as a benefit due to the lag in the application of adjustments under the BSA and the effect of other adjustments,[896] and that "under certain circumstances the Company's BSA proposal may have the effect of amplifying the volatility in PEPCO's billed charges for distribution service."[897] Witness Oliver further explains that the Rider BSA could increase volatility of billed distribution service charges because weather variations could cause past under-collection from decreased usage to

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888 OPC (H) at 10:4-14 (Larkin Direct).

889 OPC (B) at 43:16-18 (Rothschild Direct).

890 *Id.* at 47:20-21.

891 *Id.* at 49:12-14 (citing OPC (B)-15).

892 OPC (H) at 14:4-13 (Larkin Direct).

893 *Id.* at 5:20-6:7.

894 OPC Br. at 198.

895 AOBA Br. at 23.

896 AOBA (A) at 17:12-16 (Oliver Direct).

897 *Id.* at 17:17-19.

adversely impact customers at a future point.[898] While PEPCO contends that the BSA will eliminate the disincentive for the Company to promote energy efficiency by decoupling revenues from sales, Witness Oliver notes that several of PEPCO's proposed rate design changes are targeted at similar goals. As an example, AOBA cites PEPCO's proposed rate design changes for demand-metered non-residential rate classifications, which shift significant cost recovery from usage (kilowatt-hour) charges to demand charges. AOBA further notes that PEPCO does not actively promote increased use of electricity and has implemented demand side programs to improve efficiency in the past without the BSA. He asserts that this demonstrates that the BSA is not a necessary prerequisite for such programs.[899]

347. Witness Oliver recommends a downward adjustment of at least 50 basis points to the return on equity if the BSA is adopted. PEPCO has indicated that adoption of its proposed price elasticity based adjustment to test year revenue is unnecessary if the BSA is approved, therefore, Oliver argues, "it is reasonable to assume that the benefits of the proposed BSA less the value of the ROE adjustment should yield a net value that is equal to or greater than the dollar value of the Company's proposed test year revenue adjustment."[900] Oliver asserts that, in that case, "the total value of expected BSA benefits for PEPCO shareholders should be at least $4.15 million on an annual basis, and that equates to a 55 basis point adjustment to the Company's ROE."[901]

348. According to Oliver, PEPCO's level of commitment to demand-side resources and the importance of that level of commitment are yet to be determined. Oliver notes that PEPCO filed the Blueprint Plan, in which it proposed certain demand-side initiatives, but that Blueprint Plan is being addressed in a separate proceeding. Witness Oliver suggests that, given the unbundled nature of PEPCO's service in the District of Columbia, the appropriate role for the Company's demand-side initiatives, particularly for large commercial customers, is at best questionable.[902] AOBA concludes by recommending that the application of the BSA be limited to PEPCO's Residential and Small Commercial customer classes, and warns that the proposed application to classes with comparatively few customers and or more diverse annual kWh requirements and usage patterns could produce significant adverse impacts on individual customers within those classes, particularly for customers having requirement in terms of kWh per customers that are substantially above or substantially below the class average.[903]

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[898] Witness Oliver contends that "Assuming colder than normal winter weather or hotter than normal summer weather would yield increased per customer usage and more mild than normal weather would yield reduced usage, a warmer than normal winter quarter, followed two quarters later by a hotter than normal summer quarter, would have an adverse impact on customer bills for that subsequent summer quarter. . . . Thus, in this scenario, the volatility of billed distribution service charges would be amplified by the introduction of the Company's proposed Rider BSA." AOBA (A) at 18: 9-16, 19:2-4 (Oliver Direct).

[899] AOBA (A) at 21:20-22:18 (Oliver Direct).

[900] AOBA Br. at 8.

[901] AOBA (A) at 65:26-66:2 (Oliver Direct).

[902] *Id.* at 28:1-4.

[903] AOBA's Reply Brief at 18.

349. **WMATA.** WMATA believes that PEPCO can accomplish the decoupling of sales from revenues through rate design and that PEPCO's changes in rate design move toward decoupling because they "shift a substantial, portion of PEPCO's fixed costs to customer charges and demand charges, are reduced [therefore, w]ith higher fixed charges, revenue recovery is less a function of kWh sales which is a step toward decoupling."[904] Witness Foster states that the BSA is not needed for stability and, in fact, may result in wider fluctuations from quarter to quarter (now month to month).[905] He asserts that the Budget Billing Plan, already available to PEPCO's residential customers, allows customers to pay their yearly costs in equal monthly installments and, therefore, there is no benefit of bill stability from the BSA since PEPCO's customers may already choose to have a set monthly electric bill.[906] Finally, Foster asserts that the BSA is inappropriate for WMATA under Rate Schedule RT because WMATA is the only customer under this schedule and many of PEPCO's charges to WMATA are fixed already.[907]

DECISION

350. We agree with the BSA mechanism, in concept, particularly where a utility intends to rely on demand-side resources. The BSA decouples the Company's revenue from its sales, which has the potential to remove the disincentive for PEPCO's investment in energy efficiency and demand-side management programs. The experience of other states indicates that such energy efficiency can greatly reduce load growth and the potential for a significant reduction in load growth is a societal benefit.[908]

351. As the record reflects, the BSA also reduces the Company's risk. A reduction in risk reduces the Company's cost of capital which can ultimately benefit ratepayers. Ratepayers also benefit because the BSA insulates customers from the bill variations caused by weather extremes. However, any implementation of the BSA would have to be effected through a rulemaking, normally done in a separate proceeding. Implementation issues were not the subject of this proceeding. Therefore, issues relating to implementation were not identified and addressed by the parties. Nevertheless, any statutory or regulatory barrier to implementation is a matter that the Commission must consider before approving the BSA as proposed by PEPCO.

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904 WMATA (A) at 13:14-17 (Foster Direct).

905 *Id.* at 11:28-12:3.

906 *Id.* at 11:28-12:3.

907 *Id.* at 13:29-14:7. Witness Foster states that while the bill stabilization and decoupling benefits would not apply to WMATA, the BSA might be appropriate for other classes. *Id.* at 14:9-15.

908 Tr. at 1131-34; PEPCO 3(G)-2 (summarizing California's results). *See Idaho Power In the Matter of the Investigation of Financial Disincentives to Investment in Energy Efficiency by Idaho Power Company*, Case No. IPC-E-04-15, Order No. 30267, 256 P.U.R.4th 322 (Idaho PUC, Mar.12, 2007), *available at*http://www.puc.idaho.gov/internet/cases/elec/IPC/IPCE0415/ordnotc/20070312, Final Order No. 30267.PDF ("*Idaho Power*").

352. Although the Company has agreed to change the application of the BSA from a quarterly to a monthly basis,[909] there are specific requirements under D.C. law applicable to rate changes that make even a monthly adjustment problematic. Specifically, D.C. Code § 34-909(a) provides, in pertinent part, that:

> [n]otice of every rate application or *change in condition of service* proposed and filed with the Public Service Commission shall be given by the utility to each residential or commercial rate payer affected by the proposed rate application or change. . . . . The notice shall be sent in not later than the *next billing period following the filing*; no filing may be approved by the Commission without adequate time for rate payer response. Each notice shall be sufficiently accurate and detailed for the rate payer to understand the filing, including the rate payer's specified affected interest. *The notice shall provide the specific rate or service change affecting the rate payer, including the proposed percentage and dollar increase for the rate and rider category of the customer (emphasis added).*

353. Further, complaints about rate changes are governed by D.C. Code, 2001 Ed. § 34-908, which provides, in pertinent part, that:

> upon its own initiative or upon *reasonable complaint* made against any public utility that any of the rates, tolls, charges, or schedules or services...are in any respect unreasonable or unjustly, discriminatory...the Commission may, in its discretion, proceed, with or without notice, to make such investigation as it may deem necessary or convenient of any public utility. *But no order affecting said rates, tolls, charges, schedules, regulations, or act complained of shall be entered by the Commission without a formal hearing* (emphasis added).

354. Finally, § 34-910(a) of the D.C. Code requires that the utility be provided at least 10 days notice of any hearing on the complaint. Thus, it is unclear how the BSA can be implemented, especially on a monthly basis, in light of the relevant statutory requirements regarding utility rate changes. Moreover, the Commission believes that there are various regulatory implementation issues which must be addressed by the parties before we can determine how we might implement PEPCO's BSA proposal. Accordingly, in order to address these broad questions, we open a Phase II of this proceeding and direct the parties to address whether and how the BSA can be implemented consistent with law. Any comments should address the implementation of the process as well. For instance, are the Company's monthly calculations subject to comment each month? If so, what are the applicable time frames for commenting, holding hearings, and resolving disputes? Therefore, we defer ruling on the BSA issues until after the legal issues are addressed.[910] The Commission will issue a subsequent order initiating the Phase II proceeding.

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909 PEPCO Br. at 142; Tr. at 1001-18-1002:10 (examination of PEPCO's Witness Rigby by the Commission).

910 See Order No. 14232, Attachment A, Designated Issue 13.

XIV. PENSION/OTHER POST-EMPLOYMENT BENEFITS EXPENSE SURCHARGE (Issue No. 14)[911]

A. Reasonableness of Proposed Amount of OPEB Expense [912]

355. **PEPCO.** PEPCO Witness Rigby asserts that Pension/OPEB costs fluctuate by millions of dollars from year to year, not because of management decisions by the Company, but because of stock market prices, interest rate changes, retiree mortality rates, and health care costs which are beyond the Company's control.[913] Rigby states that due to this volatility, the expenses included in the test year cost of service may not be representative of actual expenses likely to be incurred in the rate effective period.[914] Rigby also lists the Company's efforts to contain Pension/OPEB costs, including: ineligibility of new employees hired after January 1, 2005, for subsidized retiree medical benefits; major medical plan design changes for all eligible current and future retirees that increase the costs to employees; caps on the annual average cost per participant that can be reached without requiring additional contributions from the entire group; increased contributions from retirees and active employees; and reduced pension benefits for new employees hired after January 1, 2005.[915] Rigby further states that while the test period expense can be determined with precision, such amount provides little guidance as to the amount that will occur in the rate effective period.[916]

356. **OPC.** OPC Witness Bright does not contest the test year OPEB amount PEPCO proposes but contends that if the proposed OPEB amount is included in the test year operating expenses, then it will give PEPCO a "fair opportunity to recover its ongoing costs of OPEB without starting a needless surcharge."[917] Witness Bright also disagrees with the Company's assessment that Pension/OPEB expenses vary considerably from year to year based on factors that are beyond PEPCO's direct control. She contends that PEPCO's OPEB expenses have been relatively stable over the last three (3) years and that the variance in OPEB expenses is not significant enough to mandate the imposition of a surcharge to recover any shortfall.[918] Bright notes that, despite the cost

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911 Issue 14 asks: "Is PEPCO's proposed Pension/Other Post-Employment Benefits Expense Surcharge reasonable and appropriate?"

912 Issue 14a asks: "Is the proposed amount of OPEB reasonable, and can that amount serve as a future point of comparison to actual OPEB costs?"

913 PEPCO (A) at 16:22-17:10 (Rigby Direct). As examples of fluctuating costs, PEPCO notes: interest rates, stock performance, retiree mortality rates, and the cost of health care as variable factors. *Id.* PEPCO also supplies a chart of its Pension/OPEB costs for 1996-2005 that reflects changes of $8-10 million in several years; PEPCO (A) at 18:1-2 (Rigby Direct); PEPCO Br. at 144.

914 PEPCO (A) at 17:6-10 (Rigby Direct).

915 *Id.* at 20:18-21:23 (Rigby Direct).

916 PEPCO (2A) at 5:2-5 (Rigby Supp. Direct).

917 OPC (C) at 92:1-2 (Bright Direct).

918 *Id.* at 88:9-14.

containment efforts cited by PEPCO, the $4.6 million OPEB amount included as the estimated expense for the rate effective period is the highest amount charged to the District in the last 12 years.[919]

357. **AOBA.** Witness Oliver testifies there is nothing that currently prevents PEPCO from seeking recovery of prudently incurred Pension/OPEB costs.[920] He notes that after the conclusion of the current rate cap period, PEPCO may file for changes in its distribution rates at any time.[921] Oliver further notes that without "a clearly-state[d] requirement that PEPCO affirmatively demonstrate the reasonableness of the pension and OPEB costs for which rate adjustments are requested, as well as the assurance of adequate time and resources to review such costs, the Commission will not be able to ensure that only prudently incurred costs are recovered through the proposed Rider OPEB."[922]

358. **PEPCO Rebuttal.** PEPCO Witness Rigby claims that the Pension/OPEB expense is unique in that the "primary drivers of the change from year to year are interest rates and the rate of return on Plan assets," which are beyond the control of the Company.[923] Rigby admits that PEPCO can pursue recovery of these costs through a rate case at the end of the current rate cap period. However, he contends that rate cases impose significant burdens on PEPCO, the Commission, and other parties.

DECISION

359. No party proposes an adjustment to PEPCO's OPEB expenses. The Commission agrees with OPC that PEPCO's OPEB expenses should be recovered as normal test year operating expenses, which should also provide PEPCO with an incentive to continue its cost containment efforts.

B. Reasonableness of the Mechanics of the Pension/OPEB Surcharge[924]

360. **PEPCO.** PEPCO Witness Rigby explains PEPCO's proposal to adopt a Pension/OPEB tracker to allow for the annual surcharges and credits to customer bills to reflect the differences between the test year Pension/OPEB cost levels and the actual outgoing costs.[925] He

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919 *Id.* at 91:16-20.

920 AOBA (A) at 29:30-2 (Oliver Direct).

921 *Id.* at 29:18-30:2.

922 *Id.* 31:5-19.

923 PEPCO (3A) at 31:9-11 (Rigby Rebuttal).

924 Issue 14b asks: Are the mechanics of the OPEB surcharge proposed by PEPCO reasonable?

925 PEPCO (A) 15:14-18:7 (Rigby Direct); PEPCO (2A) 4:1-15 (Rigby Supp. Direct); PEPCO (3A) 29:6-31:19 (Rigby Rebuttal); PEPCO (H) 20:14-19 (Bumgarner Direct); Tr. at 960:20-961:10 (Rigby Cross); PEPCO Br. at 144. The proposed Rider "POPEB" for the surcharge is provided as a proposed rate schedule. PEPCO (H)-2 at Original Page No. R-45.

contends that the annual surcharge is needed because the Pension/OPEB are large costs that vary by millions of dollars from year to year for reasons beyond PEPCO's control, including stock market prices, interest rate changes, and health care costs.[926] Rigby asserts that, without the proposed surcharge, there is no way to prevent over-recovery or under-recovery of these costs.

361. **OPC.** OPC Witness Smiley-Smith states that PEPCO's surcharge would undercut the ratemaking process if an opportunity to earn a fair rate of return is replaced with the surcharge's guarantee that a utility will recover all costs for that expense.[927] OPC Witness Bright also disagrees with PEPCO's assessment that Pension/OPEB expenses vary considerably from year to year as the result of factors that are beyond the direct control of the Company.[928] She asserts that OPC's analysis indicates that Pension/OPEB expenses, which vary less than $750,000, are not significant enough to mandate the imposition of a surcharge to recover any shortfall,[929] and that normal operating expenses should not be recovered through a surcharge [930]

362. **AOBA.** Witness Oliver testifies that PEPCO's request for a Pension/OPEB surcharge reflects inappropriate single-issue ratemaking and removes incentives for the Company to control such costs.[931] Oliver further states that while PEPCO indicated that it would provide the Commission with computations of the surcharge adjustment at least 90 days prior to the proposed inclusion on customer bills, such review time would likely be inadequate given the complexity of these programs.[932] He also explains that without a clear requirement that PEPCO affirmatively demonstrate the reasonableness of the Pension/OPEB costs for which rate adjustments are requested, the Commission will not be able to ensure that only prudently incurred costs are recovered through the proposed Pension/OPEB Rider.[933] He also notes a number of difficulties faced by the Commission in assessing prudence of PEPCO's pension and OPEB costs; particularly, he notes that the identification of actual expenditures and review of actuarial assessments of pension and OPEB costs do not necessarily address the prudence of those expenditures. [934]

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926 PEPCO (A) at 16:22-17:10 (Rigby Direct). As examples of fluctuating costs, PEPCO notes: interest rates, stock performance, retiree mortality rates, and the cost of health care as variable factors. *Id.* PEPCO also supplies a chart of its Pension/OPEB costs for 1996-2005 that reflects changes of $8-10 million in several years; PEPCO (A) at 18:1-2 (Rigby Direct); PEPCO Br. at 144.

927 OPC (A) 8:18-9:7 (Smiley-Smith Direct); OPC Br. at 201.

928 OPC (C) at 88:7-18 (Bright Direct).

929 *Id.* at 88:11-18.

930 *Id.* at 88:21-89:6.

931 AOBA (A) at 28:18-38:12 (Oliver Direct).

932 *Id.* at 30:8-31:4.

933 *Id.* at 31:5-19. Oliver also notes that there must also be the assurance of adequate time and resources to review such costs. *Id.* PEPCO stated it would provide the Commission with computations of the surcharge adjustment at least 90 days prior to the proposed application on customer bills. *Id.* at 30:8-21 (citing PEPCO (H)-2, at 45).

934 *Id.* at 36:5-38:7.

363. **PEPCO Rebuttal.** PEPCO Witness Rigby admits that, although PEPCO is not aware of other jurisdictions that have adopted a surcharge mechanism similar to the one proposed, this commission and the Michigan Public Service Commission have approved tracker mechanisms for POPEB costs.[935] Witness Rigby quotes the Commission approval of a mechanism for Washington Gas Light Company in Formal Case No. 922 stating that an "exception to the rule against single issue ratemaking was proper because (1) it is our policy that ratepayers should be charged an accurate cost of service, which requires that all prudent costs be included in rates; and (2) without this mechanism, Washington Gas may not be able to record deferred amounts as a regulatory asset, which will significantly damage the Company's earnings."[936] He also states that the purpose of the proposed surcharge is to provide a more efficient recovery mechanism for this "volatile element" of PEPCO's costs, which can be negative as well as positive.[937]

364. Rigby concludes that the other parties, in recommending that the Commission deny the Pension/OPEB surcharge, are essentially recommending that PEPCO either over-recover or under-recover its Pension/OPEB costs.[938] Rigby contends that it is better ratemaking policy to approve the surcharge and remove the potential for under-recovery or over-recovery while assuring an appropriate match of revenue and expense during the rate effective period.[939]

DECISION

365. The Company has not met its burden of showing that the rider surcharge is an appropriate mechanism or that isolated recovery of Pension/OPEB costs is warranted. The rider would formalize the recovery of costs for a normal operating expense when those costs do not require any different treatment than PEPCO's other operating expenses. Further, the Commission previously advised PEPCO in Formal Case No. 939 that any large increases in OPEB costs would be scrutinized.[940] Based on the record in this proceeding, PEPCO's showing is insufficient to persuade us that PEPCO's proposed surcharge would be verifiable. Accordingly, we reject PEPCO's proposed Pension/OPEB Rider as a means to recover these costs through a surcharge.

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935 PEPCO (3A) at 35:17-22 (Rigby Direct).

936 *Id.* at 36:6-15 (quoting Formal Case No. 922, Order No. 10207, at 100, October 8, 1993).

937 *Id.* at 32:1-5.

938 *Id.* at 33:19-34:6.

939 *Id.* at 34:6-10.

940 Formal Case No. 939, Order No. 10646 at 145-46 (June 30, 1995).

XV. TARIFF CHANGES (Issue No. 15)[941]

366. **PEPCO.** PEPCO is proposing the following tariff changes: the elimination of the experimental riders for residential electric vehicles ("R-EV," "RTM-EV") and the Residential Time Metered Experimental Rate ("RTM-EX") because there is no need to incur the administrative burden of maintaining these rates since such a small number of customers are served;[942] the elimination of Rider SL-TN, and the twin-lamp discount on SSL-UG because no customers are taking those types of service;[943] and a change in Schedule SL to reflect that PEPCO no longer offers streetlight service.[944]

DECISION

367. No party has contested the elimination of rate schedules R-EV, RTM-EV and RTM-EX. Additionally, no customers take service under them. The Commission concludes that these schedules should be eliminated to avoid creating confusion or a situation in which a potential customer or intervenor believes that the service should be offered.

XVI. RATE DESIGN (Issue No. 16)[945]

A. Reasonableness of Non-Residential Class Rate Designs[946]

368. **PEPCO.** Witness Bumgarner testified that the rate design changes to the non-residential class rates are reasonable because the proposed revenues move the classes closer to a UROR of 1, the rate components reflect the CCOSS, and the dollar and percentage impacts are moderate.[947] This reasoning is based on the fact that PEPCO has focused its rate designs on following cost causation. PEPCO generated guidelines that start with movement towards cost for customer charges.[948] Secondarily, for rates which have demand components, PEPCO proposes to

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941 Issue 15 asks: Are the changes in the tariff language proposed by PEPCO reasonable?

942 PEPCO (H) at 21:26-22:9 (Bumgarner Direct); PEPCO Br. at 148.

943 PEPCO (H) at 22:10-14 (Bumgarner Direct). PEPCO proposes the deletion of the "Rider SL-TN" – Telecommunications Network Charge. The Rate Schedule "TN" – Telecommunication Network Service remains and is modified. PEPCO (H)-2 (proposed tariff sheets); PEPCO Br. at 148.

944 PEPCO (H) at 22:15-18 (Bumgarner Direct); PEPCO Br. at 148.

945 Issue 16 asks: Are PEPCO's proposed rate designs reasonable?

946 Issue 16a asks: Are the proposed rate design changes to the non-residential class rates just and reasonable?

947 PEPCO (2H) at 7:11-13 (Bumgarner Supp. Direct); PEPCO (H) at 7-9 (Bumgarner Direct). See Issue 12 discussion; PEPCO Br. at 149.

948 PEPCO (H) at 3-14-10:2 (Bumgarner Direct).

move significantly toward a demand cost basis.[949] Bumgarner states that while the CCOSS indicates that the costs are "either customer or demand related, with no energy-related cost, in the interest of mitigating intra-class rate impacts, [he] applies judgment on a class by class basis to shift the relationship between the demand and energy components such that recovery through the demand charge moves significantly closer to full cost recovery from current levels."[950]

DECISION

369. For non-residential customers, the Commission finds PEPCO's proposal to increase the demand and customer charge and reduce the energy charge reasonable. As discussed above, the rates, as modified by the Commission, reflect its principles of gradualism and rate continuity.[951] This change begins the process of reducing energy related charges for distribution rates. Based on the overall order, strict adherence to the customer charge increase as proposed may result in disproportionate intra-class impacts and PEPCO may need to scale the customer and demand charge in proportion to the overall revenue increase to each class. In the Compliance Filing, PEPCO should: (a) adhere to the 1 percent rate difference between the residential and commercial classes, and (b) consider gradualism in reducing energy charges and increasing customer and demand charges. While the Commission finds PEPCO's methodology for determining the rate design for the non-residential rate classes to be generally acceptable, we will discuss below the reasonableness of the proposed rate design as applied to those rate classes in which issues have been raised by the parties.

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949 *Id.* at 9:12-20.

950 *Id.* at 9:13-20.

951 *See* discussion of Issues 11.A and 12.A, *supra.*

1. Rate Schedule TN

370. **PEPCO.** Witness Bumgarner testifies that Rate Schedule TN will apply to customers directly connected to the distribution system with constant load characteristics (such as cable television power supplies).[952] The proposed rate is based on a special cost of service study with a full cost customer charge that offers a discount, if existing meters are removed, at customer expense.[953] Accordingly, the customer charge will not be a small fraction of the bill under Rate Schedule TN.[954]

371. **Comcast.** Witness Raab testifies that PEPCO did not perform a proper cost analysis upon which rates could be developed and asserts that PEPCO has greatly overstated the costs of providing service to the devices served by Schedule TN.[955] Raab explains that cable power supplies are interconnected with the local electric distribution system, often on the utility's poles and operate continuously (often with very high load factors, approaching 100 percent), except for outages.[956] According to Raab, utilities that serve cable power supplies under an unmetered tariff implicitly or explicitly acknowledge these operational characteristics since the lack of metering implies a constant load.[957] He further asserts that cable power supplies are thus ideal loads for an electric system. Not only are they a very high load factor, but the load is distributed across the entire distribution system, and not concentrated at one or two locations.[958] Comcast requested the modification of Schedule TN to make the rate available to larger devices, such as Comcast's power supplies.[959]

372. Although Raab was able to duplicate the mathematics in PEPCO's study, he disagrees with the results, stating:

> While the arithmetic is correct, many of the allocators used to split the TN customers from the remaining GS-LV customers are clearly not correct and will severely overstate the cost of serving TN customers.[960]

373. Raab contends that under the proposed rate levels, the correction of one of these errors changes the cost to serve Schedule TN customers by approximately $91,000, or 25 percent of

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952 PEPCO (H) at 11:22-12:1 (Bumgarner Direct).

953 *Id.*

954 *Id.* at 8:19-9:2, 11:17-12:10.

955 Comcast (A) at 3:8-12 (Raab Direct). Witness Raab agrees with PEPCO's modification to Schedule TN that will make the rate available to larger devices, such as Comcast's power supplies. *Id.* at 1-7. Comcast requested the modification of Schedule TN. *Id.*

956 *Id.* at 5:16-22.

957 *Id.* at 6:2-5, 5:17-20.

958 *Id.*

959 *Id.* at 3:1-7.

960 *Id.* at 8:12-14.

the estimated cost to serve these customers.[961] If the erroneous allocation of meter expenses is corrected, Raab believes that customer costs are reduced from the class cost of business study by \$4.51/customer/month.[962] Accordingly, Raab determines the resulting customer charge to be \$19.67 - \$4.51 = \$15.16.[963] In addition, Raab asserts that if PEPCO is granted revenues less than the full amount that it is requesting in this case, there should be a corresponding reduction in the rate levels associated with TN service.[964]

DECISION

374. As stated above, PEPCO is modifying its Schedule TN at Comcast's request in order to provide for its application to higher wattage devices.[965] Comcast agrees with the change in principle as altering Schedule TN to apply to Comcast's cable television power supplies.[966] The Commission also agrees with PEPCO's modification.

375. The Commission also agrees with Witness Raab that, as a result of an error in PEPCO's proposal, \$91,000 has been misallocated to customers served by Schedule TN. PEPCO did not refute Raab's calculation. Consequently, \$91,000 of revenue that PEPCO allocated to the TN class should be allocated, as appropriate, to the GS class.

2. Rate schedules GT3A and GT3B[967]

376. **PEPCO.** PEPCO recommends eliminating the time-of-day rating periods for Schedule GT3A and GT3B because there are no time-of-day features in any of the distribution rates.[968]

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961 *Id.* at 9:5-9. Raab notes that the results of correcting for this single error are summarized on his Exhibit Comcast (A)-2. *Id.* at 8-9.

962 *Id.* at 13:1-3.

963 *Id.* at 13:3-4.

964 *Id.* at 14:1-4.

965 PEPCO (H)-2 at (Third Revised Page Nos. R-14 and R-14.1) (proposed revisions to Schedule "TN"). Specifically, the coverage of Schedule TN is increased from 15 watts to 1,800 watts and new monthly charges are added. *Id.* As explained by Witness Raab, these changes make Schedule TN applicable to cable television power supplies which operate continuously at high load factors. Comcast (A) at 5:4-7:6 (Raab Direct).

966 Comcast (A) at 3:1-7, 3:6-7 (Raab Direct).

967 Issue 16a.i. asked: Is PEPCO's proposal to eliminate the time-of-day rating periods for Schedule GT3A and GT3B reasonable?

968 PEPCO Br. at 150.

DECISION

377. No party has raised any objections to PEPCO's proposed revision. After reviewing the proposed revisions, the Commission finds PEPCO's revisions are justified by the lack of time-of-day features in the distribution rates, and approves the revisions.

3. Rate schedules SL[969] and TS

378. **PEPCO.** PEPCO proposes increasing the per kilowatt-hour charge to the SL and TS classes in order to produce the proposed revenue requirement.[970] The rate of return for this class will increase from a negative 4.27 percent to a positive 2.69 percent. PEPCO goes on to note that these classes have moved from having a heavily subsidized rate of return to a return that almost recovers the cost of debt.[971] Witness Bumgarner states that PEPCO's proposed changes in the tariffs were necessary to produce the revenue requirements associated with these classes of services or to reflect the appropriate spread of the proposed increase across the fixed and O&M components of the rate.[972]

379. **District Government.** Witness Petniunas contends that PEPCO's proposed rates are excessive and represent rate hikes of around 780 percent, which violates the Commission's directives to price these services at a total rate equal to the marginal energy cost.[973] In cases where the Commission was not able to make reasonable decisions on revenue reconciliation and rate design because marginal cost studies were either flawed or defective, the Commission ordered revenue increases to be allocated to all customer classes and rate elements on an equal percentage basis, resulting in an across the board increase for all services.[974]

380. **PEPCO Rebuttal.** Witness Bumgarner asserts that in order to consider the proposed increase in the proper perspective, one must look at the increase in terms of the total bill, including Generation, Transmission and surcharges,[975] similar to the analyses presented for other

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969 Issue 16a.ii. provides Are PEPCO's proposed revisions to the Rate Schedule for Street Lighting (SL) reasonable?

970 PEPCO (2H) 8:16-9:11 (Bumgarner Supp. Direct); PEPCO (H)-1 at 1.b, 13. There is also a minor, uncontested charge to the SL tariff to reflect the fact that the Company no longer offers series streetlight service. PEPCO (H) at 22:15-18 (Bumgarner Direct); PEPCO Br. at 150.

971 PEPCO (3H) 17:6-15 (Bumgarner Rebuttal); PEPCO (H)-1 at 16; PEPCO (H) 3:12-7:6 (Bumgarner Direct); PEPCO Br. at 150.

972 PEPCO (2H) at 8:19-10:2 (Bumgarner Supp. Direct).

973 DC Government (A) 9:24-10:2 (Petniunas Direct); PEPCO Br. at 151.

974 DC Government (A) at 27:6-16 (Petniunas Direct) (citing Formal Case No. 905, Order No. 9868 (October 23, 1991), 12 D.C.P.S.C. 651, 1991 WL 502017, at *282).

975 PEPCO (3H) at 16:23-17:5:1-5 (Bumgarner Rebuttal) (citing PEPCO (H)-3).

classes in PEPCO (H)-3. When this is done, as with other classes, the percent increase on the total SL bill, including SOS and surcharges, is shown to be only 18 percent.[976]

DECISION

381. As discussed in Issue No. 12(A) above and Issue No. 16(B) below, the Commission has determined the rate design shall be based on PEPCO's CCOSS which was performed on an embedded cost basis and the Commission will move gradually to implement such rate increases and limit the initial impact on the District Government. The Commission finds that PEPCO's proposal for rate schedules SL and TS is not just and reasonable without modification. PEPCO's CCOSS demonstrates that the Street Lighting class receives a subsidy from other classes based on its negative UROR.[977] PEPCO's proposal would apply to the results of PEPCO's CCOSS and increase the distribution rates for the SL class by approximately 780% immediately.[978] The Commission recognizes the results of the CCOSS, but will increase rates more gradually.[979] Specifically, the increase to the SL and TS classes shall be no greater than the maximum increase granted to any other class, *i.e.*, the percentage increases for the SL and TS classes will be the same as the residential classes.

4. Rate Schedule for Street Light Maintenance[980]

382. **PEPCO.** PEPCO proposes revisions to the Rate Schedule for Street Light Maintenance in order to produce the revenue requirements associated with these classes of services or to reflect the appropriate spread of the proposed increase across the fixed and O&M components of the rate.[981]

DECISION

383. PEPCO has provided its calculations for the charges for servicing street lights served by both underground and overhead lines.[982] PEPCO's proposed rate schedules, "SSL-OH" for overhead lines and "SSL-UG" for underground lines, list the fixed and O&M charges for maintenance of street lights served by each type of line. As directed for the SL and TS classes, the

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976 *Id.* at 17:3-5.

977 PEPCO (H)-1 at 1-2.

978 *Id.* at 1b. Although PEPCO argues that the increase is only 18% of the overall bill, the Commission is focusing in this distribution rate case on the increase to the distribution rate only.

979 Formal Case No. 869 Order No 9216 (March 3, 1989), 10 D.C.P.S.C 22, 149 (noting principles of gradualism, continuity, and equity).

980 Issue 16a.iv. asks "Are PEPCO's proposed revisions to the Rate Schedule for Street Light Maintenance reasonable?"

981 PEPCO (2H) at 8:19-10:2 (Bumgarner Supp. Direct).

982 PEPCO (H)-1 at 15-16 (showing calculations); PEPCO (H)-2 at Proposed Third Revised Page Nos. R-12 through R-12.1 (proposed revisions to Schedule "SSL-OH" for overhead lines) & Proposed Fifth Revised Page Nos. R-13 through R-13.1 (proposed revisions to Schedule "SSL-UG" for underground lines).

Commission finds that the increase in revenue for the two SL service classes shall be no greater than the maximum increase granted to any other class.[983]

B. Reasonableness of Residential Rate Design[984]

384. **PEPCO.** Witness Bumgarner testifies that "[f]or the Residential non-TOU classes, the Minimum Charge for the first 30 kWh was increased 20 percent of the way toward the full Customer Cost of $18.75, starting from the present cost of $0.4[7] per monthly bill, resulting in a recommended charge of $4.11."[985] He explains that his rate design for residential rates (Rate Schedules R (Residential) and AE (Residential All-Electric) and their associated riders) was accomplished in three steps.[986] First, "the charge for the Next 370 kWh block for [Rate Schedules] R and AE was increased by 20 percent to a level of $0.01134/kWh, both summer and winter."[987] The minimum charge and "Next 370 kWh block" for Schedules RAD and RAD-AE were left at current levels.[988] Second, a "$0.000195/kWh adjustment was given to the winter Over 400 kWh block of AE to eliminate half of the current winter discount."[989] Finally, Bumgarner "adjusted the summer and winter Over 400 kWh blocks by an equal cents per kWh amount to produce the revenue target."[990] He also notes that while the winter Over 400 kWh blocks are shown as applying to Rider RAD for Schedules R and AE, in compliance with the Merger Settlement Agreement, PEPCO will

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983 Formal Case No. 869, Order No 9216 at 215 (March 3, 1989) (noting principles of gradualism, continuity, and equity). The Commission also considers the impact on public safety as well as demand response.

984 Issue 16b asked: Are the proposed changes to the residential class rates design just and reasonable?

985 PEPCO (H) at 8:11-15 (Bumgarner Direct); Tr. at 297:1-3 (correcting the $0.45 amount in PEPCO (H) at 8:14 (Bumgarner Direct)). The residential rate schedules are standard residential service ("Schedule R") and residential "all-electric" service ("Schedule AE"), that is available for individual residences or individually metered dwellings where electricity is the sole source of energy for space heating or the primary source for certain types of units. The proposed and redlined rate schedules are PEPCO (H)-2 (attached to Bumgarner Direct). Schedules R and AE reflect a $0.47 charge. PEPCO (H)-2 at proposed Fourth Revised Page Nos. R-3 and R-4.

986 PEPCO (H) at 10:16-11:6 (Bumgarner Direct). The residential rate design for non-TOU classes is shown in PEPCO (H)-1 at 3 (attached to Bumgarner direct). The proposed and redlined rate schedules are PEPCO (H)-2 (attached to Bumgarner Direct).

987 PEPCO (H) at 10:17-20 (Bumgarner Direct). Residential customers served by Schedules R and AE were adjusted to move the Minimum Charge 20% of the way to full customer related cost. This change resulted in the increase from $0.47 to $4.11 per month on the minimum charge in Rate Schedules R and AE. PEPCO (H)-1 at 3b (listing calculations for "Residential Rate Design Detail") (attached to Bumgarner Direct); PEPCO (H)-2 at proposed Fourth Revised Page Nos. R-3 and R-4.

988 PEPCO (H) at 10:20-21 (Bumgarner Direct); PEPCO (H)-2 at proposed Fourth Revised Page No. R-29 (Rate Schedule for Residential and Discount Rider "RAD"). This "Rider RAD" applies to Schedules R and AE for 18 months to provide lower cost service after a customer is certified by the Government of the District of Columbia as eligible under federal law for the Low Income Home Energy Assistance Program ("LIHEAP").

989 *Id.* at 10:23-11:3. Witness Bumgarner notes that this is in continuation of the process to phase out the AE discount pursuant to Formal Case No. 939, Order No. 10646 at 271.

990 *Id.* at 11:4-6; PEPCO (H)-2 at proposed Fourth Revised Page Nos. R-3 and R-4.

not apply any increase to RAD customers until the expiration of a RAD Distribution rate freeze in August 2009.[991]

385. Witness Bumgarner states that increasing the minimum monthly customer charge from $0.47 to $4.11 is reasonable and that it is only a 20 percent movement towards full customer costs of $18.75.[992] In addition, Bumgarner states that 16 percent of the customers would receive a modest increase of $4.37 per month of which $3.64 would be the result of the increase in the customer charge.[993] Bumgarner further states that the category of customers who would receive the highest percentage increase (more than 30 percent) represents about 5 percent of the total customers. He states that these are "empty residences" that have an average monthly usage of 90 kWh.[994]

386. **OPC.** Witness Pavlovic contends that PEPCO did not provide an accurate class cost study and asserts that "customer charge/demand charge rates constructed upon proper and accurate jurisdictional and class cost studies would be, in the words of Bonbright, 'optimal rates. . . provid[ing] clear, efficient, effective, informative, and cost effective market signals about the present and future costs of service to buyers and sellers.'"[995] Since PEPCO did not provide a study that he considered appropriate, Pavlovic provides "illustrative" rates indicating that Schedule Residential R should be restructured with a Minimum/Customer Charge of $5.30 and a Kilowatt Charge of $4.12 per kilowatt; $3.78 and $2.72, respectively, for RAD-Standard.[996] He states that the example is only an illustration and believes that a proper and accurate class cost study would result in reduced revenue requirement for the residential classes and would reduce the customer cost percentage of the residential classes' revenue requirements.[997]

387. OPC submits that the PEPCO "residential distribution service rate design consists of: an increase to the customer charge rate element, a decrease to the volumetric charge rate elements, and implementation of the BSA."[998] OPC argues that a rate structure that is aligned with distribution costs should consist solely of a customer charge and a demand or capacity charge. OPC also states that PEPCO's rate design does not track cost causation because it retains a volumetric component.[999]

388. **PEPCO Rebuttal.** In Bumgarner's opinion, Witness Pavlovic is suggesting that the Commission reject the Company's gradual changes to the current residential distribution rate

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991 *Id.* at 11:7-13; PEPCO (H)-2 at proposed Fourth Revised Page No. R-29.

992 PEPCO (2H) at 11:1-4 (Bumgarner Supp. Direct).

993 *Id.* at 11:8-15. In its brief, PEPCO notes that under Exhibit (H)-3, at p. 3, about 70% of Schedule R and 67% of Schedule AE customers would experience an annual increase of 10% or less. PEPCO Br. at 155.

994 PEPCO (2H) at 11:16-21 (Bumgarner Supp. Direct).

995 OPC (E) at 35:18-21 (Pavlovic Direct).

996 *Id.* at 36: 7-33.

997 *Id.* at 37: 7-10.

998 *See* OPC Br. at 207. PEPCO (G) 10:14-11:1 (Chamberlin).

999 OPC Br. at 208.

structure and replace it with a radically restructured scheme that not only would collapse the rate into one composed only of a customer charge and a flat non-seasonal monthly demand charge but also result in a customer charge that is 29 percent higher than the Company's proposal.[1000]

389. With regard to OPC's solution, Bumgarner states that it is unrealistic because: a) it would result in severe bill impacts; b) it would not reward customers for shifting their load to the off-peak periods; and c) implementation would be a major undertaking in such a short time frame.[1001]

DECISION

390. Generally, the Commission has "wide discretion in making rate design decisions" and may validly consider cost and non-cost factors.[1002] The Commission in the past has given weight to PEPCO's embedded and marginal class cost-of-service studies and to their showing of relative class rates of return. The Commission may also consider a variety of other non-cost factors in making rate design decisions.[1003] Among the valid considerations in rate design are "not only quantity but also 'the nature, time and pattern of use so as to achieve reasonable efficiency and economic operation'" and "'equitable considerations' such as 'value of service to the customer' and 'ability to pay,' historical rate patterns, 'the need to conserve energy resources,' and other 'market-place realities.'"[1004]

391. In accordance with the factors mentioned above, the rates allowed will approach a cost based level over a period of time. While no detailed analysis of risk is presented on this record, the Commission will in the future consider evidence of the various types of risk associated with a class. In succeeding cases, parties may introduce studies to provide the Commission with comparisons of class risk levels, which may impact the ultimate target UROR for each class. In this case, the Commission has determined that a distribution close to an across-the-board increase with a slight modification is just and reasonable. The Commission finds that this methodology accords with the Commission's principle of gradualism and is consistent with the Commission's approach in Formal Case 939.[1005]

1000 PEPCO (3H) at 5: 3-10, 16-19 (Bumgarner Rebuttal).

1001 *Id.* at 6:8-25; Tr. at 1109:17-1110:1, 1128:12-1129:20 (Chamberlin Cross); PEPCO Br. at 154.

1002 Formal Case No. 869, Order No. 9216, 10 D.C.P.S.C. 22 at 133 (March 3, 1989) (citing *Washington Gas Light Co. v. Pub. Serv. Commn*, 450 A.2d 1187 at 1199-1209 (D.C. 1982).

1003 *Washington Gas Light Co. v. Pub. Serv. Commn*, 450 A.2d 1187 at 1199-1209 (D.C. 1982); Formal Case No. 869, Order No. 9216, 10 D.C.P.S.C. 22 at 134 (March 3, 1989) (citing cases).

1004 Formal Case No. 869, Order No. 9216, 10 D.C.P.S.C. 22 at 134 (March 3, 1989) (citations omitted).

1005 Formal Case No. 939, Order No. 10646 at 237 (June 30, 1995).

1. Proposed increase in the minimum monthly customer charge from 47 cents to $4.11 for the Standard (R) and All-Electric (AE) residential classes[1006]

392. **PEPCO.** As noted above, Witness Bumgarner testifies that "[f]or the Residential non-TOU classes, the Minimum Charge for the first 30 kWh was increased 20 percent of the way toward the full Customer Cost of $18.75, starting from the present cost of $0.4[7] per monthly bill, resulting in a recommended charge of $4.11."[1007]

393. **OPC.** Witness Pavlovic contends that because PEPCO did not provide an accurate class cost study, the customer charge provided here cannot be accurate, and he proposes a customer charge/demand charge rate for the residential class.[1008]

DECISION

394. The Commission rejects the Company's proposed increase in the minimum monthly charge from $0.47 to $4.11 for the Standard (R) and All-Electric (AE) residential classes. Instead, as discussed below, the Commission approves a new customer charge.[1009] Such a charge will in part reduce the gap between customer-related cost and revenue.

C. Proposed Increase in Reconnection Fee[1010]

395. **PEPCO.** Witness Bumgarner states that PEPCO proposes to increase the reconnection fee from $35 to $100 to reflect the full costs associated with reconnecting customers. Bumgarner asserts that the increase in the reconnection fee from $35 to $100 dollars is necessary to align the fee with the cost of reconnection and to provide an incentive for customers to remain current on their bills.[1011] PEPCO submits that the real cost of having service reconnected is $106.25,

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1006 Issue 16b.i. asks: Is PEPCO's proposed increase in the minimum monthly customers charge from $.47 to $4.11 for the standard (R) and All-Electric (AE) residential classes reasonable?

1007 PEPCO (H) at 8:11-15 (Bumgarner Direct); Tr. at 297:1-3 (correcting $0.47 amount PEPCO (H) at 8:14 (Bumgarner Direct)). The residential rate schedules are standard residential service ("Schedule R") and residential "all-electric" service ("Schedule AE"), that is available for individual residences or individually metered dwellings where electricity is the sole source of energy for space heating or the primary source for certain types of units. The proposed and redlined rate schedules are PEPCO (H)-2 (attached to Bumgarner Direct). Schedules R and AE reflect a $0.47 charge. PEPCO (H)-2 at proposed Fourth Revised Page Nos. R-3 and R-4.

1008 OPC (E) at 35:18-36:1 (Pavlovic Direct).

1009 See discussion of Issue No. 16 G., *infra*.

1010 Issue 16c asks: Is PEPCO's proposed increase in the reconnection fee from $35 to $100 reasonable?

1011 PEPCO (H) at 21:15-24 (Bumgarner Direct) PEPCO H-(6); Tr. at 404:12-405:9 (Bumgarner Cross); PEPCO Br. at 156.

which includes the cost of a field collection visit, a reconnection visit, a call from the Call Center, and dispatch for both disconnect and reconnect.[1012]

396. **OPC.** Witness Lockley testifies that because the customer's electric service is still connected during the field collection visit, and may never be disconnected if the customer makes a payment during the field collection visit, the cost of $32.67 for the Field Collection Visit should not be included in the reconnection fee.[1013] OPC argues that: (1) the reconnection fee is not justified because the Field Collection Visit is not part of the reconnection process;[1014] (2) the cost of dispatch, the call center activity, and the reconnection visits are not separated out;[1015] and (3) the cost of reconnection was over-priced because it includes the labor of meter installers instead of less skilled workers who could do the job.[1016] OPC also argues that an increase of the fee to $100 would be too much of a financial burden on consumers who have a hard time paying for their electricity, and that if the Commission does approve an increase in the fees it should be staggered to mitigate price shock.[1017]

397. OPC maintains further that there is no evidence as to how the costs of the fee were derived,[1018] and without such evidence, PEPCO has failed to carry its burden of proving that the increase in the reconnection fee is reasonable.[1019]

398. **PEPCO Rebuttal.** PEPCO Witness Bumgarner explains the procedure for Field Collection Visits, which he asserts are prerequisites to a disconnection, and is, therefore, appropriate to include in the Reconnect Fee.[1020] PEPCO also argues that the task of reconnecting services is similar to installing a meter and, thus, a skill set of a meter installer is appropriate for the task.[1021]

DECISION

399. The Commission agrees with OPC and finds that an increase in the reconnection charge from $35 to $100 is not warranted on this record. As noted in the discussion of Issue 16 B. above, the Commission has wide discretion to consider cost and non-cost factors in rate design.[1022]

1012 PEPCO Exh. (H)-6); PEPCO Br. 156.

1013 OPC (K) at 3:6-5:8. Witness Lockley notes that if the customer pays the bill or the meter is inaccessible, the Field Connection Visit will not result in disconnection. *Id.* at 4. See OPC Br. at 219.

1014 OPC (K) at 4:9-22 (Lockley Direct); PEPCO Br. at 156.

1015 OPC (K) at 5:9-8:13 (Lockley Direct); PEPCO Br. at 157.

1016 OPC (K) at 8:14-9:2 (Lockley Direct); PEPCO Br. at 157.

1017 OPC Br. at 219.

1018 *Id.* at 218.

1019 *Id.* at 219.

1020 PEPCO (3H) at 12:14-14:11 (Bumgarner Rebuttal).

1021 *Id.* at 16:6-12.

1022 *Washington Gas Light Co. v. Public Service Commission,* 450 A.2d 1187 at 1193.

PEPCO failed to provide any support for its contention that an increased fee would lead to lower disconnections. PEPCO also has not demonstrated to the Commission's satisfaction that an increase in the reconnection fee will provide sufficient incentive to encourage customers to remain current on their bills. Although PEPCO has provided a breakdown of the $106.25 service reconnection cost,[1023] it has not substantiated or proved that these itemized costs are applicable to all reconnections. Based on the above factors, the Commission will reject PEPCO's request for an increase in the reconnection fee and direct that the Company maintain the charge at $35.

D. Whether PEPCO's Proposed Rates Provide More Accurate Price Signals[1024]

E. Effect of Rate Design on Incentive to Conserve[1025]

400. **PEPCO.** PEPCO states that it "moved each component of each rate schedule toward the level of underlying costs reflected in the CCOSS, using judgment as necessary to moderate the resulting bill impacts."[1026] Witness Bumgarner asserts that this approach gives customers a price signal which better reflects the cost of service.[1027] Bumgarner asserts that "[t]o the extent that Distribution service rates recover the cost of service, they do not distort the total price signal that the Customer receives in the monthly bill."[1028] The proposed rate design changes and the rates, "move each class's total revenue, as well as rate elements, closer to the full cost of service . . . the rates should promote economically efficient use of distribution resources."[1029]

401. **District Government.** The District Government states that PEPCO's proposed rate design could impede the District of Columbia's ability to conserve energy. This is so because the high energy costs could work as a disincentive to be more energy efficient by cutting into the District's plan to replace the incandescent lights with more efficient lights.[1030]

1023 PEPCO Exhibit (H)-6.

1024 Issue 16d asks: Do PEPCO's proposed rate design changes and rates provide more accurate price signals?

1025 Issue 16e asks: Do PEPCO's proposed rate design changes and rates reduce the incentives customers would otherwise have to conserve?

1026 PEPCO (2H) at 12:12-15 (Bumgarner Supp. Direct); *see* PEPCO (H) at 7:24-10:2 (Bumgarner Supp. Direct); PEPCO Br. at 158.

1027 PEPCO (H) at 9:20-21 (Bumgarner Direct).

1028 PEPCO (2H) 12:25-13:3 (Bumgarner Supp. Direct).

1029 *Id.* 12:19-12:25; PEPCO Br. at 158.

1030 DC Government Data Response to Commissioners Morgan and Kane at 5A, pages 4-5 (July 9, 2007), DC Government Br. at 20.

DECISION

402. To the extent that rates move towards cost, they provide improved price signals. For the reasons discussed above, the Commission finds that PEPCO's proposed rates, as modified by this order, would provide more accurate price signals.[1031]

403. As rates approach the full cost of service, the rates should also promote the economically efficient use of distribution resources.[1032] While the rates adopted in this order do not move towards the full cost of service as quickly as do PEPCO's proposed rates, the rates allowed herein gradually adjust rates towards costs, and thus provide an incentive to conserve.

F. Whether the Initial kWh Allowance in the Minimum Charge for Residential Customers Should be Changed[1033]

G. Whether a Customer Charge Should Replace the Minimum Charge[1034]

404. **PEPCO.** PEPCO states that it supports the elimination of the initial kWh allowance within the Minimum Charge, and converting that charge to a pure customer charge.[1035] PEPCO asserts that this could be accomplished if the Customer Charge was set at $3.83 per month, which is the proposed Minimum Charge net of the included energy at the price for the next 370 kWh. PEPCO states that this could initiate incentives to conserve because they will not distort the price signal to the customer.[1036] Bumgarner asserts that he used a minimum charge that included the first 30 kWh of monthly usage pursuant to Commission direction in prior cases; however, since the issue has been reopened, he would now replace the Minimum Charge for the first 30 kWh with a Customer Charge.[1037] He explains that a $3.83 per month charge could be easily accomplished with a bill insert and would be appropriate because it would have modest bill impacts while improving overall distribution price signals.[1038]

405. **OPC.** OPC supports PEPCO's proposal to replace the Minimum Charge with a Customer Charge because such a charge would move the existing rate structure towards one that is appropriate for a distribution only company.[1039] However, in OPC's view, the impact of the

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1031 See discussion of Issue 11.A., *supra*.

1032 PEPCO (2H) 12:16-13:3 (Bumgarner Supp. Direct); PEPCO Br. at 158.

1033 Issue 16f asks: Should the initial kWh allowance (within the minimum charge) for residential customers be changed?

1034 Issue 16g asks: Should the minimum charge be replaced by a customer charge? What would be the impact on customers, customer education required and conservation?

1035 PEPCO Br. at 158. PEPCO's existing Residential Rate Schedule contains a Minimum Charge including the first 30 kWh. PEPCO now proposes to change from a minimum charge to a customer charge based on usage.

1036 PEPCO (2H) at 12:16-13:3 (Bumgarner Supp. Direct).

1037 *Id.* at 13:15-20.

1038 *Id.* at 13:21-14:6.

1039 OPC Br. at 220.

Customer Charge would be an increase to the monthly bills of small customers and a decrease to the large customers, as shown in Exhibit OPC (E)-7. OPC also states that the Customer Charge will have little effect on conservation.[1040]

DECISION

406. The Commission finds that replacing the Minimum Charge with a Customer Charge in distribution rates is just and reasonable in this instance. No party has opposed PEPCO's proposal to change from a Minimum Charge to a Customer Charge. While some consumer education initiatives will be required, the use of a customer charge is more appropriate for a distribution-only company, such as PEPCO. It also will create a more transparent price signal and remove any misperception that the first block of electricity used by the consumer is free because it is included as part of the monthly minimum charge.[1041] The Commission also finds that an increased Customer Charge provides enhanced revenue stability for PEPCO and lowers the impact of weather on customers.[1042]

407. However, the Commission, consistent with the principle of gradualism, believes that the immediate $3.83 charge to customers is not a reasonable first step. Accordingly, PEPCO is directed to implement the residential Customer Charge at $2.00.[1043] The $2.00 amount is reasonable because it is sufficient to provide an appropriate price signal without causing an undue impact on low use customers. Placing the entire amount in the Customer Charge would generally reduce the energy charge and unduly burden low use customers. PEPCO's proposal was based upon its requested $50.5 million increase. Based on the approved revenue increase of approximately $28.286 million the Commission considered a similar percentage increase to the Customer Charge to be reasonable, or approximately $2.00. As the record reflects, the real cost is approximately $18.75, while the original minimum charge was only $0.47.[1044] The Commission considers the implementation of a $2.00 customer charge to be reasonable in this instance. PEPCO is therefore directed to implement the residential Customer Charge at $2.00. In addition, PEPCO shall develop, and file with the Commission for review, a customer information program to explain this change.

1040 *Id.* at 220.

1041 PEPCO (H)-2 at Proposed Fourth Revised Page Nos. R-3 and R-4 (listing Residential Schedules R and AE a "Minimum Charge (including the first 30 kilowatt-hours or fraction thereof of consumption").

1042 The Commission notes that the move to a customer charge shifts costs from consumption to fixed charges. This change protects disadvantaged consumers who use more energy to heat less efficient homes.

1043 It should be noted that this customer charge no longer includes the first 30 kWh consumption. All of the kWh consumption will be subject to the kWh charges in the applicable residential rates.

1044 PEPCO (H) at 8:11-15 (Bumgarner Direct); Tr. at 297:1-3 (correcting reference to $0.45 amount in PEPCO (H) at 8:14 (Bumgarner Direct)).

XVII. STANDBY SERVICE SCHEDULE (Issue No. 17)[1045]

A. Design of Standby Service Schedule "S"[1046]

408. **PEPCO.** Witness Bumgarner contends that the Standby rates are necessary because customers with behind-the-meter ("BTM") generation operating in parallel require PEPCO to maintain facilities capable of providing service for the total load, even though the customer's generation normally provides all or a portion of that load.[1047] The costs of providing this standby capacity, including both plant-related and operating- and maintenance-related costs, must be recovered through a separate standby charge, since those costs are not directly recovered through distribution rates from customers with BTM generation.[1048] The proposed Standby Service Schedule S will not be applicable to customers generating less than 100 kW.[1049] Nor will it apply to on-site generation used primarily for emergency purposes such as hospitals, water pumping stations, and telephone facilities that own and operate emergency on-site generation in excess of 100 kWs and do not operate in parallel with PEPCO's delivery system.[1050]

409. Witness Bumgarner explains that a customer's distribution cost recovery is based on the total load of the premises.[1051] Customers receiving PEPCO-supplied Generation and Transmission service will be billed on net usage.[1052] Any incremental Generation and Transmission costs caused by a customer's generation will be applied to the bill.[1053]

410. Bumgarner submits that a customer must have metering and communication equipment that allows the Company to monitor and meter the output of the customer's on-site generation.[1054] He points out that only one customer, GSA, currently meets this requirement.[1055] The estimated annual total standby revenue would be about $165,000 for this customer, revenue that

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1045 Issue 17 asks: Is PEPCO's proposed Standby Service Schedule S reasonable?

1046 Issue 17a asks: Is the schedule properly designed to reflect PEPCO's identified cost of providing standby delivery service?

1047 PEPCO (H) at 13:19-14:8 (Bumgarner Direct); PEPCO (H)-2 at Proposed Second Revised Page Nos. R-16 and R-16.1 (Rate Schedule for Standby Service Schedule "S").

1048 PEPCO (H) at 14:1-7 (Bumgarner Direct).

1049 *Id.* at 14:17-20.

1050 *Id.* at 16:7-10.

1051 *Id.* at 15:4-6).

1052 *Id.* at 15:7-10.

1053 *Id.* at 15:10-12.

1054 *Id.* at 1513-16.

1055 *Id.* at 15:20-23. *See also* GSA (A) at 15:12-16 (Goins Direct).

other customers on Schedule GT-3A will not have to bear.[1056] The appropriate adjustment has been made for the total GT-3A class in the rate design.

411. Witness Bumgarner further states that the facilities needed to serve customers when a customer is off-line are the same as those in place to serve a full requirements customer.[1057] Thus, he asserts, the attendant costs of owning and operating those facilities are the same as for a full requirements customer.[1058] Moreover, he argues, the customer causing the costs should pay for the costs associated with the standby services.[1059] Otherwise, other customers would be unfairly paying additional costs.[1060] According to Bumgarner, this fact explains why the Schedule S charges are applied to load supplied by both the customer's generation and PEPCO's supply.[1061]

412. Bumgarner proposes that PEPCO replace the current Facilities Charge with a monthly rate calculation based on actual metered usage of the Schedule S service.[1062] The current Facilities Charge is calculated for each prospective customer based on carrying costs of the plant that provides site specific standby service, which Bumgarner asserts is time-consuming and costly.[1063]

413. **GSA.** Witness Goins recommends rejection of PEPCO's proposed Standby Rider and suggests the existing Standby Rider continue to be used because PEPCO has not demonstrated that the new rate proposal is either necessary or justified.[1064]

414. GSA also suggests two modifications: (1) PEPCO should offer a separate maintenance standby service priced at a discount to backup standby service, and (2) PEPCO should not be allowed to assess volumetric standby charges (the charges increase with the number of kWh produced) on a customer's BTM generation,[1065] volumetric standby charges being limited to kWh PEPCO delivers to serve standby load.[1066]

415. GSA contends that although three types of standby service exists (backup, maintenance and supplemental, each with different cost and reliability impacts), PEPCO's proposed rate assumes a uniform standby service. Therefore, according to Witness Goins, PEPCO's proposal implicitly assumes: (i) no capacity savings for standby customers compared to standard customers; and (ii) no cost difference between scheduled (for example, maintenance) and on-demand (for

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1056 PEPCO (H) at 15:23-16:3 (Bumgarner Direct).

1057 *Id.* at 16:18-21.

1058 *Id.* at 16:24-17:2.

1059 *Id.* at 17:2-7.

1060 *Id.* at 17:2-5.

1061 *Id.* at 17:10-13.

1062 *Id.* at 17:17-20.

1063 *Id.* at 17:13-17.

1064 GSA (A) at 8:3-9 (Goins Direct).

1065 *Id.* at 8:17-9:6.

1066 *Id.* at 9:3-6.

example, backup and supplemental) standby services. Goins states that PEPCO charges the same under its proposed Schedule S regardless of whether the standby service is scheduled when excess distribution capacity is available or in peak periods when distribution capacity may be constrained. GSA believes that these types of standby service are characterized by different load patterns, frequency of occurrence, and the ability to schedule in different time periods (for example, maintenance service).[1067] These characteristics imply that PEPCO's cost of supplying each type of service should be different.[1068] GSA asserts that PEPCO has not provided any analysis or cost studies to support its assumption that the costs of serving standby customers are no different from its costs of serving non-standby loads.[1069]

416. **PEPCO Rebuttal.** Witness Bumgarner argues that:

> Before the installation of its generator, the customer took full requirements from the Company. The Company planned and installed distribution facilities to serve those full requirements. After the customer began operating its generation, the Company's distribution facilities were not altered in any way and the expenses of owning, operating and maintaining the facilities also remained unchanged. The customer still expects the facilities to serve its full load would be available when and if needed. Therefore, it is obvious that the distribution revenue requirement associated with those facilities should be the same as for the full requirements customer before the installation of generation.[1070]

417. As to the kWh charge, Bumgarner concludes that "it is appropriate and reasonable for the customer to pay the full Distribution Services rate for load served by PEPCO and by the customer's generation."[1071] He explains that such payment is appropriate because, thus far, there has been no showing to demonstrate that a customer generator would produce concrete, verifiable distribution system savings to PEPCO and its customers.[1072] Bumgarner further argues that:

> [i]n order to provide standby service to the currently eligible customer, PEPCO must have the same distribution facilities in place as for a full requirements customer. Therefore, there are no avoided distribution costs to justify distribution rate savings. The Company's standby proposal is consistent with this concept because the base distribution revenue collected by the Company would be the same regardless of whether or not the customer generates.[1073]

1067 *Id.* at 16:19-21.

1068 *Id.* at 16:19-22.

1069 *Id.* at 16:4-7.

1070 PEPCO (3H) at 24:21-15:9 (Bumgarner Rebuttal).

1071 *Id.* at 27:16-19.

1072 *Id.* at 27:23-28:4.

1073 *Id.* at 28:6-15.

DECISION

418. The Commission rejects PEPCO's proposed revisions to the Standby Rates in Schedule S because PEPCO has not met its burden of showing that the proposed rate is just and reasonable. PEPCO's current tariff includes: (1) the cost of facilities constructed specifically to serve the Standby Service customer; (2) a charge of $0.45 per kW of contract demand; and (3) full distribution rates to the extent a Standby customer actually takes delivery of power from PEPCO's system, as opposed to serving its load with internal generation.[1074] The proposed tariff would charge a Standby Service customer the *same* rates as a distribution service customer taking delivery of 100 percent of its power needs from PEPCO's system. Distribution charges to the Standby Service customer would be imposed on the customer's total load, including load served by the customer's own generation.[1075]

419. The Commission believes that the distribution energy charge should apply only when PEPCO is called upon to provide power to the Standby Service customers as set forth in the current tariff. In a circumstance where the customer generator is producing kWh, and PEPCO's energy is not delivered to the load, the Commission believes that the imposition of a kWh distribution charge is not justified. PEPCO has not provided evidence to demonstrate that the proposed rates have any relationship at all to the actual cost of providing Standby Service. PEPCO's proposal also fails to recognize distribution savings (both short-term and long-term) from distributed generation ("DG"). The case-by-case approach is not sufficient in recognizing these benefits, nor does PEPCO provide sufficient information with regard to the net cost of providing Standby Services. The Commission agrees with GSA that more information is needed with regard to different types of services and their associated costs. PEPCO's case-by-case approach may be a better approach compared to its original proposal, but the potential impact of creating a DG barrier still exists if Standby customers are treated the same as full-requirements customers.

420. When DG is fully planned and deployed, long-term distribution benefits should be taken into account, and a "discounted" standby rate should be calculated.[1076] PEPCO's current "no charge" policy to GSA does not make sense if PEPCO is truly concerned about the "intra-class subsidy." As PEPCO Witness Bumgarner admits, "if GSA is not charged an appropriate rate, the subsidy would be from the GT 3A customers." PEPCO's current policy of not charging GSA actually creates the need for a subsidy.

421. The Commission believes that the Standby tariff could have a significant impact on DG development. Since the District of Columbia is a transmission-constrained area, the future development of DG is crucial to electric reliability in the District of Columbia. In Formal Case No. 1050, the Commission is investigating the interconnection standards for on-site generators. While

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1074 PEPCO (H)-2 at First Revised Page No. R-16.

1075 *Id.*

1076 For example, Delmarva Power currently offers a 20 percent discount on stand-by service. *See, In the Matter of the Application of Delmarva Power and Light Company for Authority to Revise its Rates and Charges for Electric Service and for Certain Rate Design Charges,* (Maryland Public Service Commission) Case No. 9093, Order No. 81518 at 66 (July 19, 2007).

the interconnection standards also have an impact upon the development of DG in the District of Columbia, the Commission thinks it is appropriate to explore Standby Service rates in that proceeding as well. The Commission therefore rejects PEPCO's proposed Standby tariff changes in this proceeding and will pursue this issue further in Formal Case No. 1050.

XVIII. RAD AND RAD-AE GENERATION RATES (Issue No. 18)[1077]

422. **Background.** With respect to generation for low–income customers, PEPCO presently maintains two separate Residential Aid Discount ("RAD") rate schedules: 1) Schedule RAD serving non-all-electric customers; and 2) Schedule RAD-AE serving all-electric customers. Both rate schedules were in existence prior to the restructuring of the electric industry in the District of Columbia. Upon the implementation of restructuring in the District in 1999-2000, PEPCO's rates were unbundled, and a generation rate cap was put in place until February 8, 2005 for non-RAD customers, and February 8, 2007 for RAD customers.[1078]

423. The generation rate cap for non-RAD customers expired in February 2005. RAD customers did not experience a rate increase at that time, and have benefited from a rate cap on *all* kWh purchases since February 8, 2005. PEPCO, in its role as the SOS supplier, has borne the cost associated with the difference between capped RAD rates and market rates from February 8, 2005 to February 8, 2007. However, as of February 8, 2007, PEPCO no longer was required to sell power at capped rates to RAD customers.[1079] Thus, February 8, 2007, was the first time RAD customers have had a generation rate increase since 1995. In Formal Case No. 1017, Order No. 14139, the Commission decided to allow an across-the-board 7.5 percent increase in RAD customers' bills effective February 8, 2007. This was lower than the much higher market-based increase of approximately 40 to 50 percent.[1080] To achieve the 7.5 percent rather than the 40 to 50 percent rate increase, an additional subsidy of $2.986 million was created through the Reliable Energy Trust Fund (RETF).[1081]

424. A so-called RAD rate anomaly first appeared in the rates proposed to be effective February 8, 2007. While one would expect the RAD rates to be lower than R rates for all of the blocks, that was not the case as reflected in PEPCO's December 22, 2006, RAD compliance filing, made in response to Order No. 14139. In Order No. 14171, the Commission explained:

1077 Issue 18 asks: Certain portions of the RAD and RAD-AE generation rates, effective February 8, 2007, are higher than the corresponding standard residential and residential-all electric rates. (See Order No. 14171 at ¶ 10.) Should this be corrected? If so, how would it be funded?

1078 *Formal Case No. 1017, In The Matter of the Development and Designation of Standard Offer Service in the District of Columbia, and Formal Case No. 945, In The Matter of the Investigation into Electric Service Market Competition and Regulatory Practices*, Order No. 14139 at ¶ 22 (Dec. 13, 2006). District ratepayers also received a rate reduction at the start of the rate cap period. *See* Order No. 11576 (December 30, 1999).

1079 *Id.* ¶ 23.

1080 *Id.* ¶¶ 31 & 34.

1081 *Id.* ¶¶ 26 & 27.

> ". . . the proposed summer tailblock generation rate of $0.08581 per kWh applicable to both RAD and RAD-AE customers exceeds the current market-based rate of $0.07923 per kWh and $0.07986 per kWh paid by non-RAD residential and residential-AE customers, respectively. This outcome arises from the fact that the current RAD and RAD-AE summer tailblock rate of $0.07707 per kWh is not discounted and, as such, is very close to the current market-based rates paid by non-RAD residential customers. As a result, the application of the ATB [across the board] 7.5 percent increase to the tailblock rate causes the proposed generation rate to exceed current market-based levels. Notwithstanding this discrepancy, the Commission accepts PEPCO's December 22 Compliance Filing without modification, since the District's Standard Offer Service generation rates applicable to both RAD and non-RAD customers are expected to change for service rendered on or after June 1, 2007."[1082]

425. **PEPCO.** Witness Bumgarner suggests adjusting the RAD and RAD-AE Standard Offer Service ("SOS") rates for the summer over 400 kWh block ("tailblock") to parity with other residential rates R and AE, and that $0.00002/kWh be added to the Reliable Energy Trust Fund ("RETF") surcharge to achieve such parity. PEPCO submits that to correct this anomaly, $204,219 would be needed, which roughly translates to the $0.00002/kWh increase in the RETF surcharge. This amount was calculated based on PEPCO's December 22, 2006 filing of SOS rates and on the rates proposed to be effective February 8, 2007.[1083]

426. **OPC.** OPC agrees that the mismatch between regular residential and RAD rates, and that between All-Electric and RAD-AE rates, should be corrected.[1084] OPC requests the Commission to correct this mismatch on a going forward basis by adopting Witness Pavlovic's proposal to institute a non-bypassable RAD surcharge on all non-RAD customers.[1085]

DECISION

427. This issue concerns the use of the Reliable Energy Trust Fund ("RETF") to reduce the electricity rates of RAD and RAD-AE customers. The threshold issue is whether the Commission should correct this discrepancy and, if so, how any corrective measure should be funded. After considering the record provided in this proceeding, the Commission will permit PEPCO to propose and present a detailed calculation of the RETF adjustment to correct the tailblock anomaly for the rates effective June 1, 2007.

1082 Order No. 14171 at ¶ 10 (Jan. 18, 2007).

1083 PEPCO (2H) at 15:3-8 (Bumgarner Supp. Direct); PEPCO (2H)-2 (showing PEPCO's calculations); PEPCO Br. at 163.

1084 OPC Br. at 221.

1085 OPC (E) at 39:15-21.

428. The Commission finds that PEPCO's proposal addresses an earlier December 2006 filing rather than the question of how to address RAD rates going forward.

429. As referenced in the background above, the Commission did not require an RETF adjustment for the rates effective February 8, 2007. In Order No. 14171, the Commission accepted PEPCO's December 22 Compliance Filing without modification because the District's SOS generation rates applicable to both RAD and non-RAD customers were expected to change once more for service rendered on or after June 1, 2007.[1086] Thus, a more relevant filing on this issue is the SOS rate filing made on February 22, 2007 by PEPCO. In that filing, PEPCO proposed to eliminate this discrepancy, beginning June 1, 2007, by limiting the proposed increase to the summer tailblock rates to keep the rates from exceeding June 1, 2007 market levels.[1087]

430. However, PEPCO has not explicitly indicated how it would recover the cost associated with eliminating the anomaly. According to our calculation, the tailblock adjustment amounts to $197,875.[1088] This $197,875 translates to $0.000017/kWh. Absent a new source of funding, the Commission assumes the additional $197,875 subsidy would come from the RETF.[1089] Therefore, in the next RETF surcharge filing, PEPCO may request an RETF surcharge adjustment and present a detailed calculation of the RETF adjustment on the correction of the tailblock anomaly for the rates effective June 1, 2007.

XIX. FUTURE FUNDING OF RAD
(Issue No. 19)[1090]

431. **PEPCO Supplemental.** Witness Browning avers that PEPCO would support a change from the current recovery of a portion of the authorized RAD generation subsidy in the distribution rates, to full recovery from the RETF.[1091] If the Commission approves such a change,

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1086 *Formal Case No. 1017, In the Matter of Development and Designation of Standard Offer of Service in the District of Columbia*, Order No. 14171 at ¶ 10 (January 18, 2007).

1087 *Id.*, Retail Rates for Standard Offer Service, Attachment E, filed February 22, 2007.

1088 This calculation was based on the Feb. 22, 2007 filing, Attachment E. PEPCO's calculation ($204,219) is not applicable because it was based on the earlier December 22, 2006 filing instead of the February 22, 2007 filing.

1089 In other words, the additional RETF subsidy of $2.986 million approved in Order No. 14171 would increase to $3.18 million.

1090 Issue 19 asks: In Order No. 14139, the Commission evaluated several options before deciding on an appropriate level to increase RAD generation rates upon expiration of the RAD generation rate cap. The Commission's decision to limit overall RAD customer bill impacts to 7.5% necessitated an increase in the RETF Surcharge to provide an additional $2.986 million in RAD subsidies (*See* Order No. 14171 ¶ 6). However, the Commission also reiterated that one of its goals is to reduce, to the extent possible, the long-term reliance on the RETF for RAD generation subsidies. To that end, should the District recover a greater percentage of the authorized RAD generation subsidy in PEPCO's distribution rates? If so, how much? Could the RAD generation subsidy be included in base rates, or would it be necessary to utilize a distribution rider applicable to non-RAD customers?

1091 D.C. Code, 2001 Ed. § 34-1514 (2001) (describing RETF); *see* Order No. 11876 at ¶¶ 1-3 (discussing the RETF); Order No. 14139 at ¶ 25-27 (adopting a rate increase to annually fund the RETF). Exh. PEPCO (2F) at 13:21-14:17 (Browning supp.).

PEPCO would remove from its distribution base rate request the $550,000 included in PEPCO (C)-1 page 4 (Ratemaking Adjustment 1) for the generation subsidy, and instead propose that the $550,000 be collected through an increase in the RETF surcharge.[1092] PEPCO mentions that including all the funding in the RETF would simplify future changes in the funding level.

432. PEPCO also supports a phased-reduction of the RAD subsidy to gradually bring RAD generation rates to market levels.[1093] During the phase-in-period, PEPCO recommends that the RETF should be the source for any additional funding related to a revenue shortfall from RAD customers for electricity generation under SOS.[1094]

433. **OPC.** Witness Pavlovic explains that prior to rate unbundling, the RAD and RAD AE rate was 28 percent lower than R and AE rates. Thus, Pavlovic avers that RAD and RAD-AE rates (distribution, transmission and generation) should be revised to reflect a 28 percent discount from corresponding residential rates. He also states that the discounts should be funded by a non-bypassable surcharge on commercial and residential non-RAD customers.[1095]

434. Witness Pavlovic explains that the RAD funding is from two sources. The expanded RAD discounts are funded through the explicit RETF surcharge that is applied to all non-RAD rates. The original RAD discount, to which the expanded discount was added, was part of PEPCO's rate structure and was funded by an implicit surcharge embedded in the rates of other classes. Pavlovic avers that this funding was carried over when the rates were unbundled so that each component rate has a portion of the original discount embedded in it and there are corresponding implicit surcharges in the component rates for all other classes. Pavlovic states that, for the expanded discounts, PEPCO applies for reimbursement from the RETF fund. He explains for the original discounts, PEPCO reimburses itself from the revenues it collects from non-RAD classes.[1096]

435. Pavlovic contends that the implicit surcharges funding the original discounts should be removed from the non-RAD distribution and SOS transmission and generation component rates. He proposes that the implicit surcharges be replaced with a non-bypassable RAD surcharge on all non-RAD customers, to be collected by PEPCO. Under the current situation, the original RAD discounts are under-funded and paid disproportionately by the residential classes, where little or no supplier switching has occurred.[1097] He suggests removing funding of the expanded discounts from the RETF and placing it in the non-bypassable surcharge.[1098]

1092 Exh. PEPCO (2F) at 14 (Browning supp.).

1093 *Id.* at 14:12-14.

1094 *Id.* at 14:14-17.

1095 OPC (E) at 40 (Pavlovic direct).

1096 *Id.* at 38:20-39:1.

1097 *Id.* at 39:18-40:1.

1098 *Id.* at 40:1-3.

436. Pavlovic therefore suggests that a 28 percent discount should be applied to the residential distribution and SOS transmission and generation rates. PEPCO would be explicitly reimbursed from the surcharge for the distribution rate discount. Whoever supplied generation and transmission service to a RAD customer (PEPCO, alternative supplier or aggregation supplier) would be reimbursed for the generation and transmission discounts from the surcharge funds. OPC projects that by taking such action the Commission would have: (1) a transparent rate/discount structure that would encourage RAD customers to shop and allow alternative/aggregation suppliers to efficiently pursue such customers; (2) elimination of the possibility of under or over funding of the discounts; and (3) a clear public view of the costs of the RAD discount program.[1099]

437. **PEPCO Rebuttal.** Witness Bumgarner disagrees with OPC's current assessment of RAD.[1100] Bumgarner states that the RETF surcharge represents approximately 4 percent of the average total bill for distribution services.[1101] He also states that the percentage represented by such surcharges would increase if OPC's proposal is adopted.[1102] He concludes that OPC's proposal does not represent any tangible improvement over the current structure and funding of the RAD program and thus it should be rejected by the Commission.[1103]

DECISION

438. The first issue is whether the $550,000 generation subsidy should be included in base rates or in the surcharge. If the $550,000 is absorbed through base rates, then all of the customers would share this cost. But if it is in a surcharge, the non-RAD customers will shoulder the subsidy. So the advantage of including it in a surcharge is that it slightly reduces RAD bills. Since no parties suggest that the $550,000 should be included in base rates, the Commission approves PEPCO's suggestion to remove the $550,000 included in Ratemaking Adjustment 1 from its proposed distribution rates and instead recover this amount through a new RAD surcharge.[1104] PEPCO is allowed to include this amount in a new RAD surcharge in its compliance filing.

439. In addition, the Commission finds that OPC's method of a 28 percent discount has some merit. According to OPC's surcharge method, there will be a growing subsidy if generation rates increase further in the future. On the other hand, such a design eliminates the need for deciding appropriate RETF funding each time. Thus, RAD customers would continue to have rates at a 28 percent discount (or a different percentage to be determined) compared to regular R customers, and RAD-AE customers would continue to have rates at a 28 percent (or a different percentage) discount

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1099 *Id.* at 40:1-14.

1100 PEPCO (3H) at 7-8 (Bumgarner Rebuttal).

1101 *Id.* at 8.

1102 *Id.* at 8-9.

1103 *Id.* at 9.

1104 This method of recovery, *i.e.*, a RAD surcharge, differs from PEPCO's proposal that the recovery be through an RETF surcharge. *See* PEPCO 2(F) at 14.

compared to R-AE customers. The Commission finds that OPC's approach in terms of using a fixed percentage discount is consistent with the Commission's expectations.

440. From PEPCO's perspective, an RETF or a RAD surcharge would not make much difference. From the non-RAD customers' perspective, changing to a RAD surcharge would not affect their bottom line. The Commission believes that a RAD surcharge should be established. It is indeed more transparent than the current RAD structure and subsidies.

441. Witness Bumgarner indicates that PEPCO does not object to the overall concept of using a residential discount percentage. However, he does not know whether or not 28 percent is the right amount.[1105] He further describes his concern on customer impact with this new approach.[1106]

442. Since PEPCO does not object to this method, but is unclear as to the amount of the percentage, the Commission directs the Formal Case No. 945 Retail Choice Working Group to discuss OPC's proposal,[1107] suggest a percentage of discount for implementation, and file a report with the Commission. The report should include a discussion of the customer impact of the proposal and be filed with the Commission within 45 days from the issuance of this Order. If a consensus position is not reached, parties may file individual comments.[1108]

XX. STANDARD OFFER SERVICE AND RATE OF RETURN (Issue No. 20)[1109]

443. **PEPCO Supplemental.** Witness Browning contends that PEPCO's proposed rate of return on common equity will compensate the Company for its provision of distribution services in the District.[1110] Browning also argues that the Commission has determined

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1105 Tr. at 1277:12-15.

1106 Witness Bumgarner stated: "I think what we have to watch for is that since we got away from that straight 28 percent discount and started playing with different blockings in the rate, that if you change it right now, that you are going to have some customer impacts to look at. And so you want to be careful about doing that, I think, by looking at the impacts before you make a decision on what percentage discount should be applied." Tr. at 1277:16-1278:3.

1107 In Order No. 14139 (Formal Case Nos. 1017 and 945) issued on December 13, 2006, with respect to the announced increase for RAD and RAD-AE customers for a 7.5 percent rate increase, PEPCO filed a report with the Commission concerning the impact of the RAD increase on RAD and RAD-AE customer defaults, disconnections, arrearages and uncollectibles on December 12, 2007.

1108 The sources of the discount may include: (1) $2.986 million authorized to reduce the February 2007 rate increase; (2) $550,000 of generation subsidy; (3) $775,000 assigned to the RAD expansion program; and (4) $197,875 the tailblock anomaly fix as discussed in Issue 18. The second component of $550,000 will be recovered through a RAD surcharge in the future. The other three components will be recovered through the RETF as the Commission determined prior to this rate case. This decision is different from OPC's proposal. OPC suggests removing funding of the expanded discounts from the RETF and placing it in the non-bypassable surcharge.

1109 Issue 20 asks: Do PEPCO's Standard Offer Service and any associated surcharges and administrative fees insulate PEPCO from business and regulatory risk? If so, what adjustment, if any, should be made to PEPCO's rate of return on common equity?

1110 PEPCO (2F) at 15:1-13 (Browning Supp. Direct).

that compensation for the risks associated with providing SOS is appropriately recovered from customers in the charges for SOS.[1111] In addition, Browning notes that the provision of SOS, including its associated surcharges and administrative fees, does not insulate the Company from business and regulatory risk.[1112] Browning also notes that the Commission ruled in Order No. 13268 that it was "appropriate to include a margin in the Administrative Charge to fully compensate PEPCO for the risk, including lost opportunity costs, it is incurring as the SOS provider."[1113] According to Browning, no adjustment is required on PEPCO's rate of return on common equity in this case, as each component of PEPCO's business is separately compensated for the risks it incurs.[1114]

444. **AOBA.** Witness Oliver contends that the SOS impact does not need to be adjusted through the ROE, but the margins PEPCO receives from the SOS service should be treated as additions to Other Revenue.[1115] By doing so, AOBA believes that it will reduce the amount of revenue that PEPCO must recover through the charges for distribution service.[1116] AOBA states that a portion of PEPCO's margin is intended to compensate PEPCO for costs associated with SOS. AOBA avers, however, that there is also a portion of the margin revenue that, in the absence of a base rate proceeding, has simply flowed to PEPCO as additional profit. AOBA contends that a component of the margin on SOS sales is not cost based and does not represent a return on investment, yet, AOBA alleges that PEPCO receives such margin revenue as part of its role as the monopoly provider of electric *distribution* service in the District. AOBA argues that in the absence of such recognition of margin revenue, PEPCO customers will be required to pay through distribution rates for risk that this Commission specifically intended to be recovered through charges for SOS, and PEPCO will be compensated for SOS risk through both its distribution service ROE and the margins it receives from SOS service.

445. **OPC.** Witness Pavlovic addresses the issue from the context of business and regulatory risk. He indicates that PEPCO recovers all of the costs it incurs as SOS provider through the SOS retail rates.[1117] Pavlovic asserts that PEPCO has a "double-belted guaranteed recovery of all its costs."[1118] Therefore, OPC asserts, PEPCO's rate of return in this proceeding should be lowered to reflect its reduced risk exposure as the SOS provider.[1119]

1111 *Id.* at 15:7-10.

1112 *Id.* at 15:11-13.

1113 *Id.* at 15:15-18 (citing *Formal Case No. 1017, In the Matter of the Development and Designation of Standard Offer Service in the District of Columbia*, Order No. 13268 (August 19, 2004).

1114 *Id.* at 15:18-21.

1115 AOBA (A) at 63:10-14 (Oliver Direct).

1116 *Id.* at 63:16-18.

1117 OPC (E) at 42:6-11 (Pavlovic Direct).

1118 *Id.* at 43:3-8.

1119 OPC Br. At 224.

446. **PEPCO Rebuttal.** Witness Browning argues that AOBA Witness Oliver's proposal is inappropriate because it mixes the costs and risks of providing SOS with the costs and risks of providing distribution services.[1120] He contends that AOBA's proposal penalizes PEPCO's distribution business because PEPCO is providing SOS service.[1121]

DECISION

447. The Commission finds that this issue should be addressed as part of the administrative charge determination in Formal Case No. 1047, which is the Commission's most recent proceeding on SOS issues. The Commission issued Order No. 13268 on August 19, 2004, which establishes the administrative cost levels for various classes of customers. The order states:

> "PEPCO proposes a margin component be included in the Administrative Charge as proposed by PEPCO. The margin component will provide PEPCO with a return that is designed to compensate PEPCO for any regulatory and market risk it assumes as the administrator of SOS…
>
> . . . As PEPCO witness Browning explains, the margin proposed here by PEPCO is akin to the return on equity that utilities earn in traditional rate cases. Its purpose is to compensate PEPCO for the risks associated with serving as the SOS provider.
>
> . . . The Commission does agree that the Wholesale Rules are intended to eliminate many of the known risks associated with the provision of SOS service. However, the Commission finds the arguments advanced by PEPCO regarding additional risks associated with the provision of SOS service valid. For example, to the extent that legislative or regulatory fiat could change the Wholesale SOS Rules, PEPCO is at risk.
>
> . . . [A]s PEPCO witness Browning states, "if everything goes as planned,' meaning if PEPCO administers SOS prudently, then it will earn the margin it proposes. In short, the opportunity to earn this margin is by no means a guaranteed return. For these reasons, the Commission finds that it is appropriate to include a margin in the Administrative Charge to fully compensate PEPCO for the risk, including lost opportunity costs, it is incurring as the SOS provider."[1122]

448. Any compensation to PEPCO for providing SOS service has nothing to do with distribution services. Generation revenue should not be used to compensate for distribution services or vice versa. The distribution ROE should be based on the costs and risks associated with providing distribution services, not generation services. Each component (generation, transmission and

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[1120] PEPCO (3F) at 4:1-3 (Browning Rebuttal).

[1121] *Id.* at 4:23-5:3.

[1122] Formal Case No. 1047, Order No. 13268 ¶¶ 25, 63, 64, 65 (August 19, 2004).

distribution) should be handled separately to avoid cross-subsidization. In fact, the administrative cost issues raised by the parties here are currently being addressed in Formal Case No. 1047.[1123] In that proceeding, the components of the administrative charge, such as the level and the need of the margin and related issues may be further discussed.

449. As for AOBA Witness Oliver's suggestion to use SOS margin revenues to adjust "Other Revenue" for distribution, the Commission finds such a suggestion unpersuasive as well as contradictory to his own testimony. SOS margin is generation revenue, not distribution revenue. In his direct testimony, Oliver clearly states, "one of the key objectives of PEPCO's restructuring was to ensure the costs for distribution and generation services were fully unbundled, and that neither activity could be placed in the position of subsidizing the other."[1124] This statement indicates his belief that unbundling should not produce cross-subsidization among generation, transmission and distribution rates. Thus, on one hand, Oliver does not believe in co-mingling of unbundled components, but on the other hand, his suggested handling of the SOS margin would produce exactly that outcome, *i.e.*, cross-subsidization. For the reasons discussed above, the Commission rejects AOBA's suggestion to reduce distribution revenue requirements through the adjustment of "Other Revenue."

XXI. OTHER MATTERS

A. Community Comments[1125]

1. Quality of PEPCO's Service in the District of Columbia

450. Several Community witnesses[1126] testify that PEPCO has failed to deliver safe and reliable service. They claim that in 2007 alone, there have been five to six outages in some parts of the District,[1127] with some of the outages lasting over 12 hours in duration.[1128] District resident Dr. Thomas Chused asserts that he had recorded no fewer than 13 interruptions, averaging 2.1 hours for the calendar year 2006.[1129] This testimony indicates that PEPCO's network is

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1123 *See* Order No. 14271 (April 26, 2007), specifying issues related to administrative costs. For example, Issue 17 in that proceeding asks: "Should the Administrative Charge be modified to reflect the current residential market in the District?" Issue 17(b) asks: "Should the current fee paid to the franchisee be modified? Does the current fee appropriately compensate the franchisee for providing SOS Services?"

1124 AOBA (A) at 79:10-13 (Oliver Direct).

1125 The Commission has reviewed and considered the comments of the community witnesses in determining the issues in this rate case. A summary of the comments are set forth in this section of our Order.

1126 Mr. Michael Herman, Eun Mi Yu, Ms. Bettie Florence, Dr. Thomas Chused, Ms. Jackie Ward, and Kathleen Maxa Frank.

1127 Community Br. at 7; Tr. at 14:1-21 (June 12, 2007).

1128 Community Br. at 7-8, Tr. at 17:17-20 (June 12, 2007).

1129 Community Br. at 8; Tr. at 48, 1.5-49, 1.13 (June 12, 2007). Dr. Chused's letter to Mr. Dorothy Wideman, Commission Secretary, attached the June 12 Community Hearing transcript.

deteriorating rather than a network besieged by major storms.[1130] Ms. Bettie Ford also reported frequent and long outages that were accompanied by a "loud, frightening noise."[1131] Kathleen Maxa Frank also expressed her displeasure with the frequent outages and the increase in rates which will not guarantee improved service.[1132] Mrs. Irma D. Salley states that PEPCO has responded very slowly to power outages and that it takes multiple calls to get a response from PEPCO.[1133] Bella Dinh-Zarr claims that she has been the recipient of power outages and has received little communication regarding the outages.[1134] Dr. Joanne Capper noted in her letter that she did not want the changes in rates to effect or make worse the service standards (e.g., longer power outages after storms).[1135]

451. Some commenters contend that PEPCO's poor delivery of electric service is corroborated by PEPCO's Consolidated Report ("Report") filed with the Commission. The Report compares PEPCO's service quality against 23 North American utilities of various sizes and design characteristics.[1136] The Report indicates that PEPCO ranks near the bottom in the delivery of electric service when it is compared to the other utilities in North America. The commenters surmise that PEPCO's customers are receiving some of the worst quality electric service in the nation.[1137]

2. PEPCO's Customer Service and Response to Outages and Property Damage

452. Three community witnesses[1138] claim that PEPCO has been slow in responding to consumer complaints regarding repeated outages and that PEPCO does not respect its customers.[1139] Ms. Eun Mi Yu asserts that several of her neighbors attempted to reach PEPCO through e-mails, but the e-mails were returned as undeliverable.[1140] Dr. Thomas Chused states that, "PEPCO did very little to address our inadequate service until our clamor became intense, and they wanted a rate increase."[1141] Dr. Thomas Chused also claims that he has also had his property damaged due to power surges.[1142] Mr. William Taylor testified at a community hearing regarding PEPCO's

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1130 Community Br. at 8.

1131 *Id.*; Tr. at 30:3-7 (June 12, 2007).

1132 Community Br. at 8-9, *See* Letter from Kathleen Maxa Frank (June 12, 2007).

1133 Mrs. Irma D. Salley letter to Dorothy Wideman (June 13, 2007).

1134 Bella Dinh-Zarr e-mail letter to Dorothy Wideman (June 11, 2007).

1135 Dr. Joanne Capper e-mail to the Commission (July 27, 2007).

1136 Community Br. at 9.

1137 *Id.* at 9.

1138 Ms. Eun Mi Yu, Dr. Thomas Chused & Mr. William Toyer.

1139 Community Br. at 10.

1140 *Id.*; Tr. 20:5-9 (June 12, 2007).

1141 Community Br. at 10; Tr. 50:13-15 (June 12, 2007).

1142 Community Br. at 10.

inappropriate response the day after several people suffered property damages as a result of power surges:

> Now the next day, when many people called PEPCO about this [property damage from the power surge], they called the property line, the claim line, and the young lady . . . was somewhat rude to many of the people. She told the people that PEPCO was not to blame for this. PEPCO was not going to pay for this. You should contact your insurance company.[1143]

453. The testimonials contend that PEPCO is not focused on delivering quality service to its customers and that granting PEPCO's request would send the wrong message to PEPCO that delivering substandard service and disrespecting customers is tolerable.[1144]

3. PEPCO's Financial Viability and Need for a Rate Increase

454. Consumer Utility Board Chair Herbert Harris asserts that PEPCO is currently in good financial standing and that PEPCO has done very well in the deregulated market place. He goes on to state that any attempt for PEPCO to cry poor is ridiculous. He adds that all one needs to do is, "look at PEPCO's stock and standing among utility companies to determine that they are one of the more financially viable companies, if not in the United States, definitely in the eastern part of the Country."[1145] ANC Commissioner Leon Swain claims that PEPCO's BSA will be ineffective since PEPCO is just the "delivery boys." The ANC Commissioner goes on to assert that PEPCO collects millions of dollars from the citizens of the District of Columbia in the form of taxes and now PEPCO wants a $7.8 million dollar allowance request. However, through sleight of hand accounting practices, the money they are getting from the taxpayer is being filed elsewhere in the company and kept as profit.[1146] The ANC Commissioner concludes that the underlying motivation for PEPCO to raise rates is greed.

4. PEPCO's Rates Are Unreasonable

455. A number of residents of the District claim that they feel that PEPCO's proposed rate increase is excessive, unjustifiable and wrong.[1147] Many Advisory Neighborhood Commissions and Civic Associations also state that they support OPC's response to PEPCO's rate increase request.[1148]

[1143] Community Br. at 10; Tr. 50:16-22 (June 12, 2007). Later on, during the evidentiary hearing, PEPCO changed its position and agreed to provide some compensation to the affected consumers.

[1144] Community Br. at 11..

[1145] Community Br. at 14; Tr. at 57:8, 58:1 (July 12, 2007).

[1146] Community Br. at 15; Tr. at 41:2-16 (June 16, 2007) (emphasis added).

[1147] Commissioner of 5B, Single Member District 5B10 India A. Henderson, Kathy Henderson, Mrs. Irma D. Salley, Bella Dinh-Zarr, Dr. Joanne Capper, Cynthia Lee.

[1148] Tenleytown Neighbors Association, Northeast Boundary Civic Association, Advisory Neighborhood Commission 7A, The Ethiopian Community Center, Bread for the City, Advisory Neighborhood Commission 5C,

456. Mrs. Irma D. Salley asserts that the PEPCO rate increase is unnecessary because PEPCO seems to raise rates consistently.[1149] Some District residents[1150] are also concerned that the rates will affect senior citizens who are living on fixed incomes and working families with small children.[1151] Citizens living in Wards 5, 7 and 8 have the highest rates of unemployment, illiteracy, asthma and other health issues that make them the most vulnerable.[1152] Also, Commissioner of 5B, Single Member District 5B10, India A. Henderson, and former Commissioner Kathy Henderson state that a rate increase if approved would likely outpace the DC Energy Office's ability to provide utility subsidies to economically disadvantaged residents.[1153] District residents also do not want PEPCO to offer lower rates to those who use large amounts of electricity, and there should be no subsidizing of the cost of new power connections or the cost of increasing the power capacity of existing customers.[1154] Cynthia Lee is opposed to PEPCO's rate increase because, as she states, the rates are already too high. She suspects that PEPCO may be overcharging customers. As support, she explains that after her residence went through an energy audit, she made changes in response to all the recommendations, and she still saw a 100 percent increase in her bill from last year.[1155]

457. Two District residents also argue that there is no evidence that instituting a BSA has harmed low income residents in California.[1156] Ruth Greenspan Bell and Barbara Elkus state that if there are people affected then there should be easy policy fixes that can make sure the lowest income earners in the District are not disproportionately hit.[1157] John Macgregor of Politics and Prose Climate Action Project states that the Commission should consider the option of keeping low income households on existing RAD rates until they install energy efficiency improvements, but require them to do the installation within a reasonable time frame.[1158]

Advisory Neighborhood Commission 7D, Advisory Neighborhood Commission 8D, Advisory Neighborhood Commission 5A, Advisory Neighborhood Commission 8E.

1149 Mrs. Irma D. Salley letter to Dorothy Wideman (June 13, 2007).

1150 Mrs. Irma D. Salley, Commissioner India A. Henderson, Former Commissioner Kathy Henderson.

1151 Mrs. Irma D. Salley letter to Dorothy Wideman (June 13, 2007), Commissioner India A. Henderson & Former Commissioner Kathy Henderson letter to Dorothy Wideman (August 3, 2007).

1152 Commissioner of 5B, Single Member District 5B10 India A. Henderson & Former Commissioner Kathy Henderson letter to Dorothy Wideman (August 3, 2007).

1153 *Id.*

1154 Dr. Joanne Capper e-mail to the Commission (July 27, 2007), Mr. Jan L. Mueller e-mail to the Commission (August 9, 2007).

1155 Cynthia Lee, Letter to the Commission (August 12, 2007).

1156 Ruth Greenspan Bell Letter to the Commission (July 13, 2007) & Barbara Elkus Letter to the Commission (July 18, 2007).

1157 *Id.*

1158 John Macgregor of Politics and Prose Climate Action Project letter to the Commission (June 28, 2007).

458. Phyllis Etheridge Young claims that PEPCO stated over a year ago that her community (Ward 4) had one of the worst performing feeder lines in the District of Columbia and that the line is being affected by squirrels and tree limbs hanging over the wires.[1159]

5. Energy Efficiency and Renewable Energy

459. Barbara Elkus states that she is concerned about global warming and that she is a supporter of renewable energy. She also states that the District of Columbia Government should work with PEPCO to obtain a long-term fixed-price supply contract for a substantial amount of power from renewable sources.[1160] Many District residents[1161] assert that if PEPCO implements the BSA then it should implement programs to help consumers improve their energy efficiency.[1162] Larry Martin of Sustainable Community Initiatives ("SCI") states that PEPCO needs an incentive to promote efficiency and that the BSA could be structured to reward PEPCO for improved overall efficiency and conservation and penalize the utility for any decrease. Mr. Martin also asserts that PEPCO should have a strategy to assist low income rate payers, renters and landlords install energy efficiency improvements.[1163] Julie Locascio states that the BSA will allow PEPCO to charge a slightly higher rate for a small portion of its current service which will in turn permit PEPCO to encourage District residents to adopt energy efficiency improvements and to also consume less power.[1164]

460. Judy Kosovich of the Capital Sun Group claims that PEPCO has not demonstrated that it is a serious and a responsible partner regarding a cleaner, more efficient District of Columbia that relies increasingly on renewable energy technologies. Under the current PEPCO net metering tariff, solar system owners will be billed 2 cents per kilowatt hour for everything their solar system produces. This is more than 20 percent of PEPCO's energy charges. This charge reduces the incentive for District residents to go solar.[1165]

461. Judy Kosovich also argues that PEPCO's energy auditors will be biased toward electricity savings during periods of peak loads and the auditors may not do a thorough job, which would include taking into account the use of renewable technologies. Capital Sun Group is aware of PEPCO's lack of experience with solar technology because they have been requested to provide PEPCO with engineering support for project proposals being developed in their unregulated ESCO business.[1166]

1159 Phyllis Etheridge Young Letter (June 14, 2007).

1160 Barbara Elkus Letter to the Commission (July 18, 2007).

1161 Dr. Mary J. Feeherry, Mr. Jan L. Mueller, representing the Saratoga-Chesapeake Tenants Association.

1162 Dr. Mary J. Feeherry e-mail to the Commission (July 28, 2007), Mr. Jan L. Mueller, representing the Saratoga-Chesapeake Tenants Association letter to the Commission (August 9, 2007).

1163 Larry Martin, Chair, Sustainable Community Initiatives, Letter to the Commission (July 12, 2007).

1164 Julie Locascio e-mail to the Commission (August 9, 2007).

1165 *Id.*

1166 *Id.*

462. John Macgregor of Politics and Prose Climate Action Project states that the renewable portfolio standard should be made a benchmark for allocating RETF funds between renewables and other uses.[1167] Mr. Macgregor also proposes that PEPCO and the District Government work together to encourage renewable power producers with a proposal for a long-term fixed price supply contract to supply a substantial amount of power from renewable sources.[1168]

6. Demand Side Management ("DSM")

463. Larry Martin of SCI also states that DSM should be a program of PEPCO, but that it should not be considered as a monopoly to the exclusion of other players, such as DC DOE, or other third parties. He goes on to claim that PEPCO should also have to describe the DSM it envisions if it succeeds in gaining its BSA.[1169]

7. Advanced Metering Infrastructure

464. Mr. Martin also argues that the cost of PEPCO's Advanced Metering Infrastructure should be borne by investors rather than ratepayers since the innovation will serve primarily to improve profitability through better information management.[1170]

8. Support of Rate Increase because PEPCO Has Not Raised Rates Since 1995

465. John Brown states that he supports the PEPCO rate increase because there has not been an increase in rates in the District since 1995. On average the cost to the average citizen will be an extra $6.00 per month which is reasonable given the higher costs PEPCO is required to pay.[1171] John Brown went on to assert that PEPCO should be acknowledged for its efforts to reconsider losses by consumers due to power surges.[1172]

9. PEPCO as Internet Provider

466. Judy Kosovich of the Capital Sun Group stated in a letter that PEPCO's increase should not be used to give it a competitive advantage as an internet provider and that PEPCO should have oversight as an entity that could engage in potentially monopolistic or unfair practices.[1173]

[1167] John Macgregor of Politics and Prose Climate Action Project letter to the Commission (June 28, 2007).

[1168] *Id.*

[1169] Larry Martin, Chair, Sustainable Community Initiatives, Letter to the Commission (July 12, 2007).

[1170] *Id.*

[1171] John Brown, Written Testimony (July 12, 2007).

[1172] *Id.*

[1173] Judy Kosovich, of the Capital Sun Group, Letter to the Commission (August 2, 2007).

10. Tax Treatment

467. Abby Powell states that PEPCO's request for a $31 million annual allowance for FIT should be rejected because PEPCO has not paid the full tax amount to the IRS, but has instead included it in a consolidated tax return that reduces PEPCO's overall federal taxes paid.[1174] Bella Dinh-Zarr also states that she supports OPC's recommended reduction of PEPCO rates by $32.5 million.[1175] Abbey Powell notes that PEPCO's request for a $7.8 million annual allowance for DCIT should also be rejected because PEPCO has not paid the full amount to the District of Columbia Treasurer, but has included it in a consolidated tax return that reduces the overall DCIT paid.[1176]

B. Motions to Correct Transcript

468. On July 13, 2007, the following parties filed motions to correct the transcript of the hearings held from June 26-29, 2007: PEPCO, OPC, and the District Government. The motions would correct typographical errors, as well as inadvertent spelling and reference errors. No party opposes these proposed corrections. Accordingly, the Commission grants the motions of PEPCO, OPC, and the District Government to correct the transcript.

1174 Abbey Powell e-mail letter to the Commission (June 8, 2007).

1175 Bella Dinh-Zarr e-mail letter to the Commission (June 11, 2007).

1176 Abbey Powell e-mail letter to the Commission (June 8, 2007).

XXII. FINDINGS OF FACT AND CONCLUSIONS OF LAW

469. Based on the evidence of record in this proceeding, the Commission makes the following findings of fact and conclusions of law:

470. That the partially projected test-year ending September 30, 2006, consisting of six months of actual data and six months of projected data, is the appropriate test-period to determine PEPCO's revenue requirements during the period of time in which the authorized rates will be in effect;

471. That PEPCO's District of Columbia rate base for the test period is $978,291,000;

472. That a fair rate of return (including capital costs and capital structure) on PEPCO's District of Columbia rate base is 7.96 percent;

473. That the level of return required when the 7.96 percent rate of return is applied to the adjusted rate base of $978,291,000 is $77,872,000;

474. That PEPCO's adjusted District of Columbia net operating income of $61,320,000 for the test-year was deficient by the amount of $16,552,000;

475. That the adjustment which would increase test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order is $28,286,000, which includes the proper allowance for taxes (*See* attached Schedules);

476. That PEPCO shall be allowed to earn a cost of common equity of 10.00 percent;

477. That PEPCO's cost of long-term debt is 6.17 percent;

478. That the capital structure proposed by PEPCO to develop its overall cost of capital is reasonable and appropriate for this proceeding;

479. That the Construction Work in Progress ("CWIP") that PEPCO has included in the rate base, $16.9 million before accumulated depreciation and taxes, is reasonable and consistent with Commission precedent;

480. That PEPCO has demonstrated a reasonable need for and the prudence of the cost of the Northeast Substation Project, and that the allocated District portion of the cost is $51.9 million, before accumulated depreciation and taxes;

481. That the inclusion of the net prepaid Pension/OPEB Asset in the amount of $23,294,000 in the rate base is reasonable;

482. That PEPCO has properly computed its cash working capital requirements based on its lead/lag study;

483. That PEPCO's proposed depreciation reserves and expenses are reasonable and consistent with Commission policy, subject to the requirements that PEPCO shall:

a. File a new depreciation study and associated workpapers at least 90 days prior to its next general rate case filing. The new depreciation study shall separate the "plant only" and "net removal cost" depreciation rates and reserves; and new depreciation rates will go into effect following Commission approval in the next general rate case; and

b. Place into service by March 1, 2008, a system that will retain the depreciation expense, accumulated depreciation reserve, cost of removal, and salvage information by jurisdiction by FERC account each month. By March 31, 2008, PEPCO shall report to the Commission and the parties to this case when that system was placed into service;

484. That the adjustment for amortization of severance costs is rejected as unreasonable;

485. That the Company's adjustment regarding weather normalization and annualization of revenues is reasonable and consistent with Commission precedent, except that the proposed adjustment for average billing days is unsupported and unreasonable in this case;

486. That the sales repression adjustment is unreasonable and is rejected;

487. That the adjustment for transactions between PEPCO and other PHI affiliates are reasonable, except where specifically excluded or modified by this Opinion and Order. PEPCO is to:

a. Procure a contract, subject to the Commission's approval of an RFP and the Commission's selection of a contractor, for an independent audit of PHI's Service Company costs for the services it provides to PEPCO, with the costs of the audit to be paid for by PEPCO; and

b. File, as part of its next base rate proceeding, a benchmark or industry study of the Service Company costs to support their reasonableness, itemized in sufficient detail to enable all parties to review and understand the individual component costs for those services;

488. That OPC's recommendation to remove certain executive compensation plans resulting in a $1,591,000 reduction to District of Columbia distribution expense, a $1,309,000 reduction in plant in service, a $33,000 reduction to depreciation expense, and a $16,000 increase in accumulated depreciation is reasonable;

489. That OPC's proposed adjustment related to gainsharing, as revised by the Company, is reasonable. The effect is to reduce Electric Plant In Service by $706,000, reduce depreciation expense by $27,000, and increase accumulated depreciation by $293,000;

490. That OPC's proposed adjustment related to the reduction of PEPCO's salary and benefit expense to reflect the December 2006 transfer of 56 employees to the Service Company is rejected;

491. That OPC's proposed adjustment to eliminate the March 2008 salary increase is reasonable and therefore adopted;

492. That OPC's proposed adjustment to actual wages for the 12 months ended September 30, 2006, to recognize the significant reduction in workforce during and beyond the test year, as modified, is reasonable in this case;

493. That adjustments to remove the entire amount of SERP (not just the amount expensed) are appropriate and therefore adopted. However, OPC's proposal to remove the capitalized portion of SERP allowed since Formal Case No. 939 is unreasonable and is rejected;

494. That the adjustment for three-year average of regulatory expenses is reasonable, subject to normalization for non-recurring one-time expenses, resulting in an adjustment to regulatory expense of $366,000;

495. That the adjustment for exclusion of merger costs is reasonable in this case;

496. That the adjustment for annualization of wages is reasonable, but only as adjusted, as described in this Opinion and Order;

497. That the Company's adjustment for annualization of employee health and welfare costs is reasonable;

498. That the adjustment, as modified in this Opinion and Order, for customer care enhancement is reasonable, reducing the Company's proposed expense adjustment by $522,000;

499. That an adjustment to reflect the increase in Commission and OPC assessments is reasonable and will be amortized over three years, as modified in this Opinion and Order, subject to true-up in the Company's next base rate request and to the return of any excess to customers;

500. That the adjustment for increased allocation of Service Company costs associated with the sale or closure of certain PHI plants is unsupported and unreasonable;

501. That the adjustment for the postal increase is reasonable;

502. That the adjustment for industry contributions and membership fees is reasonable;

503. That the adjustment for institutional advertising and selling expenses is reasonable;

504. That the inclusion of interest expense on customer deposits is reasonable;

505. That the adjustment for three-year average storm costs is reasonable;

506. That the removal of Mirant Bankruptcy and other outside counsel fees is reasonable;

507. That the annualization of software amortization is reasonable;

508. That the annualization of deductible mixed service cost tax method is reasonable;

509. That the adjustment for the costs of the current proceeding is reasonable;

510. That the proposed vehicle use cost adjustments are rejected as being too speculative and not known and measurable;

511. That OPC's proposed adjustment for deferred compensation, as modified in this Opinion and Order, is reasonable and consistent with Commission precedent. The effect is to reduce O&M expenses by $578,000;

512. That the adjustment for software write-off, as proposed by OPC and modified by the Company's revised labor ratio and District of Columbia allocation factor, is reasonable;

513. That PEPCO's method of calculating income taxes for purposes of determining its revenue requirement is reasonable and consistent with Commission precedent;

514. That PEPCO's cost containment program is reasonable;

515. That PEPCO's jurisdictional cost allocation study is reasonable and in accord with Commission precedent;

516. That PEPCO's class cost of service study is reasonable and consistent with Commission precedent;

517. That PEPCO has reasonably and appropriately assigned and allocated rate base items and operating expenses to classes and functions;

518. That the proper basis for the overall revenue allocation in this case is PEPCO's embedded class cost of service study;

519. That the demand allocators employed by PEPCO for subtransmission, primary and secondary facility cost are reasonable;

520. That the allocation methods employed by PEPCO appropriately attribute costs to classes based on causation;

521. That PEPCO has properly and appropriately identified for each class the costs that are customer-related, demand-related, and energy-related;

522. That it would not be appropriate to directly assign a portion of the costs of the Northeast Substation to any classes or customers based on capacity or other factors;

523. That the class rates PEPCO has proposed are not just and reasonable for distribution-only service;

524. That a distribution approximating an "across the board" increase, as provided for in this Opinion and Order, is just and reasonable with each class receiving approximately the same percentage increase in base distribution, with the exception that the residential classes shall receive an additional 1 percentage point increase over non-residential increase (excluding the SL and TS classes);

525. That the Street Light and Traffic Signal classes shall receive a rate increase equal to the maximum increase of all other classes and, therefore, shall receive the same percentage increases as the residential class;

526. That the proposed rate elements for each class reflect the cost-causation characteristics of the class within the context of an embedded cost study;

527. That class returns may vary with the level of risk incurred by PEPCO and that, in succeeding rate cases, parties may introduce studies to provide the Commission with comparisons of class risk levels, which may impact the target unitized rates of return ("UROR") for each class;

528. That PEPCO's proposed Bill Stabilization Adjustment ("BSA") will be considered in a Phase II proceeding to address whether and how the BSA can be implemented consistent with law;

529. That PEPCO properly synchronized the interest included in its cost of service with the interest included in its tax computation.

530. That the Commission rejects PEPCO's proposed OPEB surcharge;

531. That PEPCO's proposed tariff amendments are reasonable;

532. That the basis for the rate design shall be a CCOSS performed on an embedded cost, and not on a marginal cost basis;

533. That the Commission rejects the proposed increase in the minimum monthly charge from $0.47 to $4.11 for the Standard (R) and All-Electric (AE) residential classes; the initial kWh allowance within the Minimum Charge for residential customers is eliminated and substituted with a Customer Charge of $2.00, which will create a more transparent price signal. In addition, PEPCO shall develop, subject to the Commission's approval, a customer information package explaining this change;

534. That in its compliance filing, PEPCO shall, for non-residential customers, adhere to the 1 percent rate difference between residential and commercial ratepayers, and consider gradualism in reducing energy charges and increasing customer charges and demand charges consistent with the findings in this Opinion and Order;

535. That PEPCO's proposed increase in the reconnection charge for residential customers is unreasonable;

536. That PEPCO has not met its burden to show that its proposed Standby Service Schedule S is reasonable.

537. That the Standby Service rate issues will be further investigated in Formal Case No. 1050 concerning the interconnection standards for on-site generators;

538. That PEPCO is allowed to propose and present a detailed calculation of the RETF adjustment which shall correct the tailblock anomaly for the rates effective June 1, 2007, in its next RETF surcharge filing;

539. That the Commission removes the $550,000 included in Ratemaking Adjustment 1 from PEPCO's proposed distribution rates. PEPCO is allowed to include this amount in a new RAD surcharge in its compliance filing;

540. That the Commission directs the Formal Case No. 945 Retail Choice Working Group to discuss OPC's proposal and to recommend an appropriate RAD percentage discount and report its findings (including customer impact) to the Commission within 45 days of the issuance of this order. PEPCO may include a RAD surcharge filing of $550,000 in its compliance filing; and

541. That the SOS margin and administrative cost issues shall be addressed in Formal Case No. 1047, the Commission's SOS proceeding.

THEREFORE, IT IS ORDERED THAT:

542. On a District of Columbia rate base of $978,291,000, the annual authorized revenue shows a fair and reasonable rate of return of 7.96 percent.

543. PEPCO is directed to file with the Commission quarterly reports of its weather normalized, jurisdictional earned returns on both a ratemaking and "per books" basis. The reports should cover PEPCO's most recent quarter and the year ending in that quarter and provide PEPCO's earnings on an average total capital and earnings on average common equity. The reports (including workpapers) are to be filed with the Commission within 60 days following the end of each of the quarters.

544. The motions of PEPCO and OPC to correct the transcript are hereby granted; and

545. PEPCO is directed to file, consistent with this Opinion and Order, revised rate schedules, together with supporting exhibits no later than February 13, 2008. Rates authorized in this Opinion and Order shall be effective on February 20, 2008, at 12:01 a.m., unless otherwise ordered by the Commission.

A TRUE COPY: **BY THE DIRECTION OF THE COMMISSION**

CHIEF CLERK: **DOROTHY WIDEMAN**
COMMISSION SECRETARY

DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION

Docket: FC-1053
Schedule 1

Potomac Electric Power Company - District of Columbia Division
Twelve Months Ending September 30, 2006
(Six Months Actual; Six Months Projected)
Revnenue Requirements

(in thousands)

Line	Description (A)	PEPCO-DC Adjusted (B)	Adjustments (C)	Adjusted Totals (D)
1	**Rate Base**			
2	Electric Plant in Service	$ 1,960,068	$ (2,304)	$ 1,957,764
3	Accumulated Depreciation	(646,783)	309	(646,474)
4	Accumulated Amortization	(10,521)		(10,521)
5	Additions:			
6	Materials and Supplies	15,639		15,639
7	Cash Working Capital	11,075		11,075
8	Prepaid Pension / OPEB Liability (net of tax)	23,294	-	23,294
9	Unamortized Severance Program Costs	478	(478)	-
10	Subtractions:			
11	Accumulated Deferred Income Taxes	(356,984)	128	(356,856)
12	Customer Deposits	(15,630)		(15,630)
13	Total Rate Base	$ 980,636	$ (2,345)	$ 978,291
14	Rate of Return	8.42%		7.96%
15	Return Requirement	$ 82,570	$ (4,698)	$ 77,872
16	**Operating Revenues**			
17	Sale of Electricity	$ 338,442	$ 3,267	$ 341,709
18	Other Revenues	3,914		3,914
19	Total Operating Revenues	$ 342,356	$ 3,267	$ 345,623
20	**Operating Expenses**			
21	O&M Expenses	$ 86,914	$ (9,750)	$ 77,164
22	Depreciation	50,934	(60)	50,874
23	Amortization	3,551		3,551
24	Taxes Other Than Income	129,717		129,717
25	Total Expenses	$ 271,116	$ (9,810)	$ 261,306
26	Net Operating Income Before Taxes	$ 71,240	$ 13,077	$ 84,317
27	DC Income Taxes	$ 2,830	1,037	3,867
28	Federal Income Taxes	15,364	3,766	19,130
29	Total Income Taxes	$ 18,194	$ 4,803	$ 22,997
30	Adjusted Net Operating Income	$ 53,046	$ 8,274	$ 61,320
32	**Operating Income for ROR Calculation**	$ 53,046	$ 8,274	$ 61,320
33	**Income Deficiency**	$ 29,524	$ (12,972)	$ 16,552
34	Revenue Multiplier	1.70893		1.70893
35	**Revenue Deficiency**	$ 50,454	$ (22,168)	$ 28,286
36	Revenue Deficiency Percent Change		-43.94%	56.06%

Note:
PEPCO'S initial application was for $50.5 million, but that request was subsequently revised to $47.9 million if the bill stabilization adjustment (BSA) is not approved, or $43.5 million if the BSA is approved.

DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION

Potomac Electric Power Company - District of Columbia Division
Twelve Months Ending September 30, 2006
(Six Months Actual; Six Months Projected)
Summary of Adjustments to Company's Proposed Test Year
Jurisdictional Rate Base

(in thousands)

			Authorized Cost of Capital	
Line	Description	Impact to Rate Base	Impact on Return Requirement	Revenue Requirement Impact
	(A)	(B)	(C)	(D)
	Electric Plant in Service			
1	Remove Executive Incentive Compensation	$ (1,309)	$ (104)	$ (178)
2	Exclude Capitalized Portion of Disallowed Costs	(706)	(56)	(96)
3	Exclusion of Capitalized SERP (RMA #2)	(289)	(23)	(39)
4		$ (2,304)	$ (183)	$ (313)
	Accumulated Depreciation			
5	Remove Executive Incentive Compensation	$ 16	$ 1	$ 2
6	Capitalized Disallowed Costs-Accumulated Depreciation	293	23	39
		$ 309	$ 24	$ 41
	Accumulated Deferred Income Taxes			
7	Severance Costs: Accumulated deferred taxes	$ 128	$ 10	$ 17
8		$ 128	$ 10	$ 17
	Unamortized Severance Program Costs			
9	Severance Costs: Program Costs	$ (478)	$ (38)	$ (65)
10		$ (478)	$ (38)	$ (65)
11	Total Change to Rate Base	$ (2,345)	$ (187)	$ (320)

Notes

Col C:	Computed using Authorized Rate of Return		7.96%	
Col D:	Computed using Revenue Multiplier (See Below)			1.70892701
	Revenue Requirement Gross-Up Factor	58.5163%		
	Revenue Multiplier	1.70892701	=1/0.585163	

DISTRICT OF COLUMBIA PUBLIC SERVICE COMMISSION

Docket: FC-1053
Schedule 2

Potomac Electric Power Company - District of Columbia Division
Twelve Months Ending September 30, 2006
(Six Months Actual; Six Months Projected)
Summary of Adjustments to Company's Proposed Test Year
Jurisdictional Operating Revenue and Expenses

(in thousands)

Line	Description (A)	O&M Adjustment (B)	DC Corp Income Tax (C)	Federal Income Tax (D)	NOI Adjustment (E)	Estimated Revenue Requirement Impact (F)
	Revenue					
1	Annualization of Revenues (RMA #1)	$ 1,004	$ 101	$ 316	$ 587	$ (1,003)
2	Remove Sale Adjustment (RMA #18)	2,263	85	762	1,416	(2,420)
3	Total Revenue	$ 3,267	$ 186	$ 1,078	$ 2,003	$ (3,423)
	Expenses					
4	Remove Software Written-Off	$ (1,348)	$ -	$ -	$ 1,348	$ (2,304)
5	Reduction in O&M for Executive Incentive Compensation	(1,591)	159	500	932	(1,593)
6	Remove Allocated Service Company Costs (RMA #14)	(1,414)	141	446	827	(1,413)
7	Customer Care Initiatives (RMA#12)	(522)	53	164	305	(521)
8	Deferred Executive Compensation	(578)	58	182	338	(578)
9	Vehicle Use Costs (RMA #17)	(353)	35	111	207	(354)
10	Regulatory Cost 3 Year Average (RMA #6)	(366)	36	115	215	(367)
11	Remove 2004 Severance Program Costs (PEPCO RMA #20)	(273)	27	86	160	(273)
12	Exempt Salary Reduction in Force and 2008 increase	(1,874)	187	590	1,097	(1,875)
13	Barganing Unit - Reduction in Workforce	(689)	68	217	404	(690)
14	PSC & OPC FY 2006 budget assessments (RMA #13)	(742)	74	234	434	(742)
15	Interest Synchronization		7	24	(31)	53
16	Total Expenses	$ (9,750)	$ 845	$ 2,669	$ 6,236	$ (10,657)
	Depreciation					
17	Remove Executive Incentive Compensation	$ (33)	$ 3	$ 11	$ 19	$ (32)
18	Exclude Capitalized Portion of Disallowed Costs	(27)	3	8	16	(27)
19	Total Depreciation	$ (60)	$ 6	$ 19	$ 35	$ (59)
20	**Tax totals**		$ 1,037	$ 3,766		

Notes

Col F:	Computed using Revenue Multiplier (See Below)			1.70892701
	Revenue Requirement Gross-Up Factor	58.5163%		
	Revenue Multiplier	1.70892701	=1/0.585163	