ORDER NO. 81518

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 CHANGES.	* * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9093

Before: Steven B. Larsen, Chairman
Harold D. Williams, Commissioner
Allen M. Freifeld, Commissioner
Susanne Brogan, Commissioner

Concurring Statement by Commissioner Williams
Separate Statement by Commissioner Brenner
Statement dissenting, in part, by Commissioner Freifeld

Issued: July 19, 2007

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EXECUTIVE SUMMARY

Delmarva Power & Light Company ("Delmarva" or "Company") has filed for a rate increase of $20,333,000, representing an approximate 3.4 percent increase in the typical monthly bill for a Standard Offer Service residential customer using 1,000 kWh per month. After consideration of the record in this case, we conclude that the Company may, as a temporary rate pursuant to Public Utility Companies Article § 4-205, increase rates by $14,882,000, which represents an approximate 2.15% increase in the typical monthly bill for a Standard Offer Service residential customer using 1,000 kWh per month.

For reasons we discuss below, we find that the Company has not submitted an "independent audit opinion" demonstrating compliance with its Cost Accounting Manual. We explain that the letter's qualifications – that the Company's accountants were not retained to perform an audit and cannot express an opinion regarding the Company's compliance – cannot be reconciled with the plainly stated requirements of Public Utility Companies Article § 4-208. We also find, pursuant to Public Utility Companies Article § 4-205, that the public interest is served by setting and allowing the Company to implement a temporary rate that reflects our resolution of all other issues. As a result of these findings, the Commission will hold a second phase of this proceeding for the limited purpose of: (a) determining the Company's compliance with Public Utility Companies Article § 4-208; (b) reviewing service company costs to determine whether costs allocable to Delmarva and its affiliates have declined or should decline as a result of the closing of certain subsidiary companies' operations; (c) determining the extent, if any, to which these temporary rates should be adjusted to account for service company operating costs; (d) determining the extent, if any, to which the service company costs allocated to the Company should be

reduced, and (e) determining whether, as a result of the delays in issuing this decision, we should permit the Company some flexibility in the timing and mechanics of implementing the increase we approve today and any increase we approve in a final rate order.

Our temporary rates, and the final rate we anticipate setting after Phase II, adopt a rate design intended to move the rates of various classes closer to the Pepco system average return. In our decision, we have accepted the Company's proposed Bill Stabilization Adjustment ("BSA") as part of the new rate design, although we find that it should operate on a monthly rather than quarterly basis. As we explain below, the BSA serves multiple public policies. First, the BSA reduces the risks faced by the Company, and thus allows us to reduce the return on equity by 50 basis points to 10 per cent and the overall return to 7.68 percent on its rate base. Second, the BSA disengages the Company's revenue from the sale of kilowatt hours of electricity, which removes a major disincentive to the Company's participation in programs designed to manage demand for electricity. Third, the BSA smoothes out billing variations induced by extremes in weather conditions. This program, which has served customers well in other contexts, promotes energy conservation and stabilizes the revenues per customer of the Company. We believe, however, that the BSA merits further discussion and analysis, and we will refine the details of the BSA in a further proceeding. We reject a separate proposed surcharge by the Company that would allow it to recover changes in Pension and Other Post Employment Benefits ("POPEB") costs.

Our Order also adopts a proposed new "Present Value" methodology for calculating the costs of removing depreciated property, a change from the prior Straight Line Method that results in a significant reduction in depreciation expense recovered in rates. We will continue the prior policy of allowing Construction Work in Progress ("CWIP") in rate base,

with an Allowance for Funds Used During Construction ("AFUDC") offset in operating income.

Also, we have rejected application of the Reserved Delivery Capacity Service Credit ("RDCS") to customers who currently receive redundant electric service, but have approved the tariff for future applications of such service. We have rejected proposed changes applicable to the Standby Service Rider and specifically direct the Company to address those issues in the Demand Response Distributed Generation Working Group.

APPEARANCES

Kirk J. Emge, Paul H. Harrington, Mindy L. Herman, Arthur Adelberg, Richard M. Lorenzo, and Francis X. Wright, for Delmarva Power & Light Company.

James W. Boone, Lloyd J. Spivak, Todd E. Givens, and Ambika Murali, for the Staff of the Public Service Commission of Maryland.

Theresa V. Czarski, Chana Wilkerson, and Gary L. Alexander, for the Maryland Office of People's Counsel.

Telemac N. Chryssikos and Kimberly J. August, for Washington Gas Energy Services, Inc.

Brian R. Greene, for Retail Energy Supply Association.

Michael J. Quinan, for Maryland Energy Users Group.

John C. Dodge, for Comcast of Delmarva, LLC.

D. Kirk Morgan, for CED Rock Springs.

I. BACKGROUND

On November 17, 2006, Delmarva Power & Light Company ("Delmarva" or "Company") filed pursuant to Sections 4-203 and 4-204 of the Public Utility Companies Article of the *Maryland Annotated Code* (the "PUC Article") an application for authority to increase its retail rates for distribution of electric energy in Maryland. The Applicant seeks a rate increase of $20,333,000 based on a test year ending September 30, 2006.[1]

Delmarva was last granted an increase in its base rates for electric service in Maryland in Commission Case No. 8492, *Re Delmarva Power and Light Company*, 84 Md. PSC 131 (1993). About six years thereafter, in connection with the Company's restructuring proceeding (Case No. 8795), rates for Delmarva's residential customers in Maryland were reduced by approximately 7.5 percent and frozen at that level for four years; non-residential customers were granted a three-year rate freeze. *Re Delmarva Power and Light Company*, 90 Md. PSC 115 (1999). As part of the settlement of the proceeding that approved Conectiv's merger with Potomac Electric Power Company, rates for non-residential customers were reduced on July 1, 2003, and caps on distribution rates were generally extended through December 31, 2006. *Re Potomac Electric Power Company*, 93 Md. PSC 134 (2002). Pursuant to a provision of the merger case settlement, the Company's rates were reviewed in 2004 in Case No. 8994; the settlement in that rate review proceeding left the Company's rates unchanged except that rates for non-residential customers were allowed

[1] This estimate is based upon a test year ending September 30, 2006, with six months of actual data and six months of projected data. The application was subsequently amended with 12 months of actual data that, if accepted in its entirety, would establish a potential rate entitlement of $24,560,000. However, the Company cannot be granted an increase above the amount requested in its initial application.

to increase to offset, in part, the July 1, 2003 decrease. *Re Delmarva Power and Light Company d/b/a Conectiv Power Delivery*, 95 Md. PSC 103 (2004).

Delmarva's request is based upon a need to provide it a reasonable opportunity to earn a fair rate of return from its Maryland operations during the rate-effective period. The Company also is requesting an authorized rate of return on its rate base of 8.17 percent, including a proposed 11.00[2] percent return on common equity.

This application came before the Commission at the regularly scheduled Administrative Meeting held on November 29, 2006 for the purpose of considering whether the Company's proposed effective date of December 17, 2006 should be suspended pursuant to § 4-204 of the PUC Article. The application was filed without an independent audit opinion of a Cost Allocation Manual ("CAM"), as required by Public Utilities Code § 4-208.

Delmarva argued that it was not required to comply with § 4-208. By Order No. 81147, issued on December 11, 2006, in both this case and Case No. 9092 regarding the rate application of Potomac Electric Power Company, the Commission suspended the rates for 150 days from December 17, 2006 and ordered the filing of an independent audit opinion on or before January 17, 2007. The Commission did so because the affiliate rules and § 4-208 provide important customer safeguards that are essential to maintaining a high level of integrity in competitive business practices and the establishment of just and reasonable rates. An additional suspension order was issued on May 11, 2007 in Order No. 81407.

A pre-hearing conference was held on January 3, 2007 at which the appearances of Delmarva, the Office of People's Counsel ("OPC"), and the Staff of the Public Service

[2] If granted its requested Bill Stabilization Adjustment ("BSA"), Delmarva's requested return on common equity is 10.75 percent.

Commission ("Staff") were noted. Petitions to intervene were granted as to Comcast of Delmarva, Inc. ("Comcast") and Washington Gas Energy Services ("WGES"). A procedural schedule was also set. Later, petitions to intervene were granted as to the Maryland Energy Users Group ("MEUG") and the Retail Energy Supply Association ("RESA").

Testimony was filed by various parties. Delmarva sponsored the testimony of Joseph M. Rigby, Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc. ("PHI"); Dr. Roger A. Morin, principal at Utility Research International; Steven Fetter, President of Regulation UnFettered; W. Michael VonSteuben, Manager of Revenue Requirements; Timothy J. White, Manager of Policy Coordination; Earl A. Robinson, President of Weber Fick & Wilson from AUG Consulting's Utility Service Group; Dr. Mark E. Browning, Director of Rates and Technical Services; Joseph F. Janocha, Regulatory Affairs Manager; Dr. John H. Chamberlin of Quantec, LLC; and Paul M. Normand, principal with Management Applications Consulting, Inc. Staff sponsored the testimony of Merwin R. Sands, Director of the Commission's Division of Economics and Policy Analysis; Gunter J. Elert, Gloria J. Prettiman, Daniel J. Hurley, Faina Kashtelyan, and Kevin D. Mosier, Regulatory Economists in the Division of Economics and Policy Analysis; and E. Matthew Faulhaber and Elizabeth Tuck, Public Utility Auditors in the Commission's Accounting Investigations Division. OPC filed the testimony of David J. Effron, a consultant specializing in utility regulation; Charles King, President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc.; and Jonathan F. Wallach, Vice President of Resource Insight, Inc. Comcast filed the testimony of Richard E.

Stinneford, a member of Cablesave, LLC; and MEUG filed the testimony of Bruce Patterson, Director of Facilities Management for Peninsula Regional Medical Center, and Stephen F. Wood, a consultant in the field of electric and gas utilities.

On March 23, 2007, a late-filed petition to intervene was granted as to CED Rock Springs, LLC ("Rock Springs").

Evidentiary hearings were held on April 5, 6 and 9, 2007, and hearings for public comment were held in the Company's service territory on May 15, 16 and 17, 2007.[3]

Pursuant to the procedural schedule established in this proceeding, initial briefs were filed on April 27, 2007, and reply briefs on May 9, 2007. On May 24, 2007, various other utilities filed an Amicus Brief regarding accounting for cost of removal in depreciation rates. Staff and OPC have filed Motions to Strike the Amicus Brief, which did not include a motion requesting its admission and was filed beyond the briefing dates set in this proceeding. As these utilities never sought intervention, never moved to file an Amicus Brief, and filed the Brief well beyond the deadline set in this proceeding for briefs by the parties, the Commission agrees with the arguments of Staff and OPC and grants their Motions to Strike.

II. THE CAM AUDIT AND TEMPORARY RATES

Despite extensive evidentiary and public hearings, we are unable to resolve one of the important issues in this case: whether and to what extent the Company's operating expenses should be adjusted to account for the management, financial and regulatory

[3] In future rate case filings, the Company must publish notices in newspapers in all counties in its service territory. The papers in which the notices were published in this case did not adequately cover the central part of Delmarva's service territory. This failing may have contributed to the poor public turn-out at the mid- and upper Eastern Shore public comment hearings.

services Delmarva receives from Pepco Holdings, Inc. ("PHI"), its parent company. We cannot resolve this issue because we find that the document the Company submitted for the purpose of satisfying Public Utility Companies Article § 4-208 does not qualify as the "independent audit opinion" demonstrating the Company's compliance with its Cost Accounting Manual ("CAM").

As a result, we invoke our authority under § 4-205 of the Public Utility Companies Article and, after the hearings held to date, we authorize the Company, as a temporary rate, to increase its rates in the manner and according to the rate design discussed below. As § 4-205 requires, we also order further proceedings – a Phase II of this case – during which (a) the Company may submit an "independent audit opinion" that satisfies § 4-208 and (b) we will determine whether and to what extent we should permit the Company to adjust its rates to account for parent company costs.

A. PHI Costs and the CAM Audit.

The Company initially filed this Application without an independent audit of its CAM, taking the position that it was not required to comply with Public Utility Companies Article § 4-208. After considering the Company's arguments, the Commission ordered the Company "to file with the Commission an independent audit opinion consistent with the statute on or before January 17, 2007," and directed the Company "to meet with Commission Staff to discuss the independent auditing firm, and the nature and scope of the audit opinion" in an effort to avoid "any subsequent disputes about the adequacy of the audit opinion."[4] Unfortunately, the document the Company submitted does not and cannot satisfy the Company's obligations under § 4-208. By its terms, the "Report of Independent

[4] Order No. 81147 (December 11, 2006), at 13. This Order applied both in this case and in Case No. 9092.

Accountants on Applying Agreed-Upon Procedures" is, by Ernst & Young's ("E&Y") own description not an "independent audit opinion" demonstrating the Company's compliance with its CAM:

> We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the Company's compliance with the CAM requirements. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.[5]

In our view, the governing statute is not ambiguous: a public service company that "files a request for a change in its rate base," as the Company has here, "shall file an independent audit opinion prepared by an entity approved by this Commission,"[6] and the independent auditor shall "examine . . . compliance by the [utility] with . . . the [utilities'] cost allocation manual" and the allocation and appropriateness of those costs. Our statute required the Company to retain appropriate professionals to conduct an audit and express an opinion that the Company stood in compliance with its CAM requirements. We cannot square E&Y's specific disclaimer that it had not been engaged to perform an audit, and its expressed inability to opine on the Company's compliance, with our statutory mandate to ensure that the opposite occurs, *i.e.*, that companies seeking changes in their base rates submit an "independent audit opinion" that satisfies § 4-208(b). To the extent that the Commission reached a different conclusion in a different proceeding, we respectfully disagree with that conclusion.[7] We do not believe that E&Y's disclaimers are substantively meaningless. To the contrary, we doubt that an accounting and auditing firm would take the

[5] Emphasis added.
[6] Public Utility Companies Art. § 4-208(b)(1)(ii)(1) (emphasis added).
[7] *See In the Matter of the Application of Baltimore Gas and Electric Company for Revisions in its Gas Base Rates*, Case No. 9036, Order No. 80080 (July 6, 2005).

care to distinguish its report from an audit if that distinction lacked substantive professional meaning. Put another way, cannot reconcile the statute's express and plainly stated requirement that the Company submit an "independent audit opinion" with the auditor's professional judgment that it has not been asked to perform one.

Accordingly, we find that the two caveats contained in the E&Y report - that the firm was "not engaged to and did not conduct an audit" and that that the firm did not "express an opinion" regarding the Company's compliance with its CAM requirements – preclude this Report from satisfying the Company's obligation to obtain and submit an "independent audit opinion that satisfies its obligations under § 4-208(b)."

B. Findings Regarding Temporary Rates.

Under the circumstances, we find that the public interest is served by setting a temporary rate, pursuant to our authority under Public Utility Companies Article § 4-205, that reflects our decisions on all of the issues raised by this Application except for any adjustments relating to the amount and allocation of PHI's costs to the Company. A temporary rate is warranted here because the rate currently in force – the rate structure in place since 1998 – no longer qualifies as a just and reasonable rate. As set forth below, the Company is entitled to an increase in its base rates, if perhaps not the full increase it sought. This Application represents the Company's distribution rate increase since the restructuring of the electricity markets in this State, and our decision implements important changes and reforms to rate analysis and design that, in our view, should be implemented without any further delay. We find that the importance of the Company's compliance with § 4-208 and the potential impact of the parent company cost allocations on the base rates requires enough additional study that a temporary rate serves the interests of justice – both justice to the

Company, which can implement an increased rate sooner subject to true-up after Phase II, and justice to ratepayers, who will benefit from our careful analysis of the Company's compliance with § 4-208 and adjustments to the Company's rates that may ensue. We find that the interests of justice are affirmatively disserved by delaying new rates, shortcutting our obligations to enforce compliance with § 4-208, or by reaching what could be an arbitrary final rate by rushing to judgment on the parent company cost allocation issue.

Accordingly, and pursuant to Public Utility Companies Article § 4-205, we will establish the rate set forth in the ordering paragraphs of this Order as a temporary rate, which will remain in effect for an initial period of nine months from the date of this Order unless extended under § 4-205(e)(2). We also will order the Company to obtain and submit an independent audit opinion, after which we will hold further proceedings for the limited purpose of determining whether the Company's document satisfies Public Utility Companies Article § 4-208 and, as set forth in the Ordering Paragraphs, to determine whether and to what extent we should adjust the Company's rates to account for the amount and allocation of parent company operating costs. We ask that the Company advise us within 14 days of entry of this Order when it expects it can obtain and submit an independent audit opinion so that we can schedule Phase II of this proceeding, which will encompass testimony, briefing and a hearing on these issues.

III. DISCUSSION AND FINDINGS

A. Rate Base

Rate base constitutes the investment of the Company in plant and other material used and useful in providing service, on which it is legally entitled the opportunity to recover a reasonable return. For purposes of determining just and reasonable rates, all parties have

utilized the 12-month test year that ended September 30, 2006, which includes the Company's most recent actual operating results. We accept this test year for purposes of reviewing the Company's rate base, revenues and expenses for determining rates in this proceeding.

The parties appear to agree to an adjusted rate base of $268,606,000, which includes a number of uncontested adjustments. The parties disagree, however, about the proper treatment of depreciation methodology and the Staff proposal to remove Construction Work in Progress ("CWIP") from rate base (with a corresponding adjustment to remove the Allowance for Funds Used During Construction ("AFUDC") from operating income).

1. Construction Work in Progress ("CWIP")

Staff argues that we should amend the Commission's historic and traditional treatment of allowing electric companies to include construction costs in rate base under the CWIP/AFUDC convention in this case. Normally, CWIP is included in rate base, but an Allowance For Funds Used During Construction ("AFUDC") is credited to the benefit of the ratepayers in operating income calculations. Staff witness Faulhaber contends that the prior policy to include CWIP no longer is justified for electric distribution companies. Staff contends that Maryland's policy to include CWIP with the AFUDC offset arose during a time when electric utilities were fully integrated and spent substantial sums building generation plants and related facilities that did not become used and useful in providing service for long periods of time. These predicates no longer exist, Staff contends; electric distribution companies no longer shoulder the heavy construction burdens that created the risk justifying the return on construction dollars that the historic policy afforded to

integrated utilities. Staff's proposed exclusion would remove $12,323,000 from the Company's proposed rate base in this proceeding.

Delmarva opposes Staff's proposal, noting that we have rejected the same recommendation in prior proceedings.[8] Indeed, the Commission affirmed the historic practice just two years ago:

> the Commission's long-standing CWIP/AFUDC policy has worked well in helping protect companies against rate obsolescence, while promoting rate stability for customers by the inclusion of certain construction projects which reduce the need for construction-driven rate proceedings. It also promotes equity between current and future rate customers as the AFUDC offset reduces the rate impact. Therefore, we decline the Staff proposal to change our long-standing policy to include CWIP in the rate base with an AFUDC offset. 96 Md. PSC at 344.

Delmarva notes that Staff's argument that CWIP should no longer be included as the Company no longer owns its generation facilities is in contradiction to the recent affirmation in the above cases. Delmarva counters that its status as a distribution-only utility strengthens the argument for inclusion of CWIP in rate base because distribution company test year CWIP will become plant in service during, if not before, the rate effective period. In short, the Company contends there is no policy or equitable reason to depart from the Commission's prior policy of including CWIP in rate base, and urges continuation of such practice in this proceeding with the AFUDC offset.

We find no compelling reason to alter the long-standing policy as to treatment of CWIP in rate base with the corresponding treatment of the AFUDC offset. As a distribution-only entity, the status of the Company actually strengthens the policy

[8] *See, e.g.*, *Re Delmarva Power & Light Company*, 68 Md. PSC 566, 588 (1977); *Re Washington Gas Light Company*, 94 Md. PSC 329, 346-47 (2003).

underlying our CWIP treatment. The short-term duration and smaller size of the projects that the Company constructs as a distribution-only entity justify the inclusion of these projects in rate base, as many such projects will be used and useful during the rate effective period. The Commission therefore accepts these adjustments.

2. Depreciation Adjustment to Rate Base

Pursuant to the determinations made with respect to depreciation, discussed elsewhere in this Order, additional adjustments to rate base in the amount of $1,423,000 are necessary to reflect the depreciation rates determined herein.

3. Conectiv Merger Costs

We also adjust the rate base by $130,000 to reflect previously approved Conectiv merger costs.

4. Rate Base Findings

Upon consideration of the record in this proceeding, and after making the adjustments as noted above, the Commission finds that the fair value of Delmarva's property used and useful in providing service to the customers is $267,313,000.

B. Operating Income

Operating income reflects the difference between the revenues received by the Company and the appropriate costs the Company incurs in providing service to its customers. Various adjustments to the test year revenues and expenses are proposed by the parties and are either accepted, rejected, or modified by the Commission in order to determine operating income.

In this proceeding, the Company's uncontested operating income was $12,286,000 for the test year period, which includes uncontested adjustments upon which the parties agree. The parties dispute other operating income and expense adjustments, however, and we discuss and decide these below.

1. Customer Care Costs

Through the course of this proceeding, Staff and OPC have recommended elimination of certain Company costs with respect to Company service representatives and a toll-free 800 line involved in customer care. Delmarva agreed to remove the toll-free line's costs because the line was not deployed, but it opposes the adjustment proposed by Staff witness Tuck and OPC witness Effron to reduce the cost of the Company's service representatives. OPC and Staff contend the record does not indicate that additional jobs have been filled by the Company. OPC also opposes the adjustment for temporary call center employees as speculative as to need and not proven as a known and measurable amount. In this regard, Company witness VonSteuben testified that new employees were hired for the call center in both March and April 2007, after OPC's testimony was filed.

The Commission finds that these costs are known and measurable. They are reasonable in amount and fulfill a purpose beneficial to ratepayers. We find that the Company has presented sufficient evidence of the employee number and costs for their inclusion in operating income. The hirings are not speculative. Mr. VonSteuben has presented clear documentation of the hirings for these positions which has satisfied the stated concerns. The Commission therefore accepts the Company's proposed adjustment.

2. Vehicle Costs

Staff and OPC challenge the vehicle costs claimed by the Company, arguing that the Company has overstated gasoline costs by assuming a cost of $3.00 per gallon for all fuels. In this regard, Staff witness Tuck admits that fuel costs may increase, but concludes that the average of prices for the last three years is a more accurate predictor of future costs in the rate effective period.

The Company's proposed adjustment also includes the costs of vehicle leases reflecting the planned replacement of ten percent of Delmarva's vehicle fleet each year. OPC disputes the Company's testimony that, as of 2007, leases on diesel vehicles have increased by $7,000 each as a result of new environmental standards, and asks us to eliminate the entire level of the Company's forecasted vehicle expense increases.

The Commission is keenly aware of the volatility in gasoline costs and notes that at the time testimony was prepared in this proceeding a cost of $3.00 per gallon may have appeared excessive. However, the Company's testimony with respect to vehicle replacement, as well as the recent price climate for fuels, leads us to conclude that the Company's adjustment is reasonable and it will therefore be accepted as better reflecting the likely conditions during the rate effective period.

3. PHI Service Company Costs

As noted above, Delmarva is a subsidiary of Pepco Holdings, Inc. ("PHI"), which provides management, financial, and regulatory services to its subsidiary operations. In this proceeding, Delmarva seeks to increase the share of costs allocated from PHI to Delmarva. The Company argues that this allocation is appropriate because PHI has closed three subsidiary companies, which reduces the number of affiliates that can bear these costs by

increasing the corresponding share that Delmarva must shoulder.[9] Staff accepted the Company's proposed adjustment of $305,000, while OPC opposed the reallocation of the holding company costs to Delmarva on the ground that Delmarva failed to show the reasonableness of such costs. OPC witness Effron offered a modified calculation based on actual test period expenses that yielded an adjustment to operating income of $94,000.

Delmarva responded that its share of service company costs during the test period should be adjusted to the level of overall allocable costs (and other post-employment benefit costs) expected in the rate effective period. The Company notes that three entities that formerly received services from this service company no longer receive them, and that these service company costs must now be allocated over the fewer remaining entities. The Company argues that its proposal reflects the level of costs incurred in the test period, increased only by the amount reflecting the cost differential attributed to divestiture of the facilities. That is, Delmarva claims the total of the common costs are not actually increased other than through a reallocation, although some costs that were previously capitalized are now being expensed.

For the reasons set forth in Section II above, we cannot resolve these issues at this time, and will do so in Phase II of this proceeding. The parties need not repeat their prior testimony during Phase II, but we will permit them to update and supplement their testimony and arguments as appropriate once we have received and reviewed the Company's CAM audit. For present purposes, we will calculate the applicable temporary rate without making adjustments to account for the proper amount and allocation of service company charges. In

[9] Keystone/Conemaugh closed September 1, 2006, Delaware City Facilities agreement terminated November 1, 2006, and B. L. England Facility closed February 8, 2007, and it is these closures which form the factual basis of the Company's reallocation.

Phase II, we will review the reasonableness of the service company charges, especially in light of the closing of three PHI subsidiaries, will review whether these closings have `resulted or should result in lower overall service company costs, and the proper amount and allocation of service company charges.

4. Revenue Days Adjustment

The Company proposed an adjustment to synchronize the number of expense days and revenue days in the test year. According to the Company, the test year reflected 365 days of revenue and 365.7 days of expense. People's Counsel opposed the adjustment noting that the rate effective year will actually have 366 days.

This issue is mooted by the Commission's acceptance of the Company's proposed Bill Stabilization Adjustment.

5. Rate Case Expenses

During the course of this proceeding, Staff has raised questions concerning Delmarva's regulatory costs as well as rate case expense related to this proceeding. In their final positions on brief, it appears that Staff and the Company are in general agreement that the Company's costs directly associated with this proceeding should be added to Delmarva's regulatory expense. The record reflects the costs were $158,000 through February 2007, with much of the rate case work (rebuttal testimony, the hearings, briefing) yet to be undertaken. The Company requests rate case expense of $318,000, which it claims will be the final total cost. Staff also proposed that a five-year amortization period is appropriate for these costs while Delmarva requests a three-year amortization timeframe.

The Commission accepts Delmarva's $318,000 rate case expense and finds that a five-year amortization of this amount shall be used. This timeframe is the more reasonable one in reference to the likely timeframe for the next rate case filing.

6. Interest Synchronization

The parties agree that an interest synchronization adjustment is necessary to reflect the tax effect of pro forma interest. This calculation is uncontested as to methodology, and the amounts differ only due to different levels of rate base. Using a capital structure including 51.37 percent debt and a cost of debt of 5.48 percent, as determined herein, we find an adjustment of $599,000 to operating income is appropriate.

7. Environmental Remediation Costs

In its filing, the Company originally requested recovery of the total estimated cost of environmental remediation of a site formerly used for gas manufacturing operations in Cambridge, Maryland. On rebuttal, the Company proposed amortization of only the actual costs through February 2007 amortized over three years ($14,000 per year). The Staff argued against recovery of the costs, noting that the site was not used for electric operations. People's Counsel witness Effron proposed that the Company be allowed to recover in this case the amount of remediation costs incurred to date amortized over a period of 10 years.

We adopt the Staff's position in this proceeding, as the evidence indicates that the property was not used for the provision of electric service to Delmarva's customers. We note, however, that the issue may be revisited in the future if the Company can present a more compelling case for cost recovery.

8. Conectiv Merger Costs

The Company has included costs associated with the Delmarva/Atlantic City Electric merger consistent with prior Commission orders, which prescribe a 10-year amortization period, expiring March 2008. OPC suggested that certain merger-related costs remaining as of April 1, 2007 should be amortized for an additional three years, the period over which the rates established in this case are expected to remain in effect. People's Counsel notes that if the rates established herein remain in effect for three years, the Company will continue to recover an amortization expense that no longer exists after the first year.

Having considered the evidence with respect to this matter, the Commission adopts the ratemaking treatment proposed by People's Counsel. This treatment assures that the Company will recover previously approved merger costs but will not over-recover them by embedding in its rates an expense item that will cease after the first year the rates are effective.

9. Depreciation Adjustment

In this proceeding, the Commission adopts the Present Value Method for recovery of removal costs. Additionally, the Commission accepts the plant-only depreciation rates recommended by the Company. These decisions result in an adjustment to operating income of $549,000.

10. Price Elasticity

We reject the elasticity adjustment proposed by the Company. This adjustment is mooted by our acceptance of the Bill Stabilization Adjustment.

11. Operating Income Findings

After considering the adjustments noted above, the Commission finds that during the test year ended September 30, 2006, as adjusted herein, the Company's operating income for ratemaking purposes is $11,728,000, as detailed in Appendix I.

C. Depreciation

1. Background

Depreciation is the method companies use to recover the original cost of their investment based on the service lives of the plant as well as any net salvage. Net salvage is the difference between the remaining market value of an asset at retirement and its cost of removal. In this case net salvage is negative as removal costs are forecasted to exceed any remaining value of the assets at the time of retirement. Annual depreciation rates are developed based upon the remaining book value of the assets placed in service, amounts received as gross salvage and expenses incurred for the cost of removal.

Depreciation is an important issue in this case because it represents approximately $8 million of the Company's requested $20 million revenue increase. While there is some disagreement regarding the appropriate rate at which plant is depreciated, there is significant controversy regarding the proper method to recover removal costs. Delmarva proposes to recover anticipated removal expenses using the traditional Straight Line Method. This method recovers the same nominal amount from customers ratably over the life of the asset. OPC proposed that the Company recover removal expenses using an historical average of actual costs, which would reduce current depreciation expenses. OPC also proffered an alternative method of recovery known as the Present Value Method. Additionally, OPC proposes returning the current removal cost reserve to ratepayers, which the Company

opposes. For the reasons explained herein, the Commission adopts the Present Value Method, which reduces the Company's current annual depreciation expense.

The Company's witness, Mr. Robinson, testified that Delmarva's proposed depreciation rates reflect four principal factors: (1) the plant in service by vintage; (2) the book depreciation reserve; (3) the future net salvage; and (4) the composite remaining life for the property group. Service lives are based on the average age, realized life and the survival characteristics of the property. The Company states that it uses the Straight Line Method of depreciation because, in its view, it is widely understood and has been utilized almost exclusively for depreciating utility property. Finally, in the Company's proposal, net salvage is based upon historical experience and future estimates of the cost of removal and gross salvage amounts.

Mr. Robinson proposes annualized depreciation expense of $21,347,454 when applied to the Company's year-end 2005 Distribution and General Plant. This results in a composite (plant and salvage) depreciation rate proposal of 4.23 percent. Delmarva's current annualized depreciation expense is $16,641,021, which results in a current rate of 3.30 percent applied to year-end 2005 plant. According to Mr. Robinson, the Company's current depreciation rates are based on a study using plant investment as of December 31, 1988.

OPC's witness, Mr. King, recommended depreciation and removal cost rates yielding a total annual accrual of $14.4 million of depreciation expense based on year-end 2005 plant. This results in a composite depreciation and removal cost rate for Delmarva's Maryland plant of 2.86 percent. Additionally, Mr. King recommends the amortization of

Delmarva's current removal cost reserve balance of $41.9 million over five years, which would result in an annual credit to ratepayers of $8,370,217.

Mr. Robinson and Mr. King agree on the appropriate General Plant depreciation rate of 3.39 percent. They differ on the rates recommended for two distribution plant-only accounts and the treatment of removal costs.

2. Plant-Only Rates

Delmarva proposes increasing the current average service life ("ASL") for Distribution Plant Account 362 (Station Equipment) from 47 years to 50 years, which reduces the depreciation rate and annual expenses. Mr. King argues that the ASL should be 58 years based upon OPC's actuarial analysis. Mr. Robinson counters that Mr. King has ignored industry data and Company-specific activity while relying solely on Delmarva's historical data to develop depreciation recommendations. According to Mr. Robinson, industry data supports a 37-year ASL. In addition, the Company anticipates an increase in the level of component failures in the future. Mr. King responds noting that retirements have been immaterial and that utilities routinely remove and rebuild equipment to maintain their systems.

The parties also contest the proper ASL for Distribution Plant Account 365 (Overhead Conductors and Devices). The current ASL is 44 years, and Mr. Robinson proposes an increase to 55 years. Mr. Robinson notes that the industry mean average service life is 36 years for this account. He concludes that an accurate ASL recommendation requires an assessment of both current and anticipated future events, including the impact of past retirements, future growth, plant change-outs, and upgrades. Because Delmarva's

affiliate has experienced dramatic growth for this account, Mr. Robinson concludes that Delmarva expects similar growth, which will affect the overall ASL of this property class.

In response to the Company's growth argument, in this regard, Mr. King notes that the Company admits that there are no specific current programs for widespread voltage upgrades on Delmarva's system. He recommends a 75-year ASL, noting that the best-fit of his actuarial analysis is 78 years

According to Mr. King, his overall plant-only depreciation rate for Distribution Plant is 2.41 percent while Mr. Robinson's overall rate is 2.51 percent. When applied to year-end 2005 Distribution Plant, Mr. King's proposed rates generate $505,000 less in annual expense accruals than Delmarva's proposed rates.

3. Removal Costs

OPC witness King strongly disagrees with the Company's regulatory approach to removal costs, which are components of net salvage. Mr. Robinson has proposed $8.5 million in annual removal cost accruals. According to Mr. King, this results in a ratio of total removal cost to the total original cost of the associated plant of approximately 58 percent. Mr. Robinson's approach is based upon the Straight Line Method, which charges ratepayers the same amount for depreciation each year over the life of an asset. Mr. King characterizes this methodology as the "Traditional Inflated Future Cost Approach ("TIFCA")."

Mr. King states that the traditional approach to depreciation results in a permanent and growing loan from ratepayers to the utility. This is because the inflow of newly installed plant always exceeds the outflow of retired plant and there is always more new plant than old plant. Thus, the dollar value of Delmarva's plant is always expanding.

Mr. King states that even if Delmarva's plant was not growing, inflation will cause the dollars added each year to exceed the dollars retired. As a result, there is always more new plant generating higher removal cost charges than old plant that has accumulated removal cost reserve. Therefore, Mr. King concludes that "[r]atepayers never catch up."[10] Consequently, there is an ever-growing loan from ratepayers to the utility.

Mr. King's recommended solution to his perceived ever-growing loan problem is to use an average of the last five year's actual removal costs as the basis for quantifying annual removal cost allowances, a procedure recently adopted by the Delaware Public Service Commission. Mr. King asserts that the rolling average approach preserves the practice of accruing removal cost reserves by means of rates applied to plant balances, but effectively halts any further increase in the reserve already accumulated. Mr. King calculated OPC's proposed rates and accruals for Delmarva's plant using the five-year average approach, and his calculations result in an annual accrual of $2,066,618 based on year-end 2005 plant in service. He argues that this approach eliminates all of the infirmities of the Straight Line Method and would be consistent with Delmarva's accounting in Delaware.

Mr. King also offered as an alternative a "present value" removal cost proposal.[11] Mr. King argues that the Company's traditional approach fails to recognize the present value of future removal costs because it charges ratepayers now for the projected cost of removal that will be incurred when equipment is retired. Mr. King emphasizes that a dollar spent 40 years from now is worth far less than a dollar collected today. Not only will inflation erode the future value of a dollar, but the holder of that dollar has the benefit of its earning (or

[10] King Direct at 33.
[11] Mr. King also discussed an "inflation corrected" removal cost proposal, which OPC recommends as a last resort and the Company opposed.

spending) value in the mean time. Mr. King concludes that the Straight Line Method incorrectly assumes a dollar collected now has the same value as a dollar spent 40 years from now.

According to Mr. King, this principle of discounting future removal costs, which is embedded in Statement of Financial Accounting Standards ("SFAS") 143, can be applied to the traditional salvage approach. This would avoid charging ratepayers with undiscounted future costs. Based upon a discounted value of 7.05 percent, the rate of return Mr. King recommends in this proceeding, total annual removal cost accruals under the Present Value Method are $2,883,405, based on year-end 2005 plant. If the Commission determines that Delmarva should continue to recover removal costs over the life of the plant, Mr. King concludes that the modified SFAS 143 procedure, or Present Value Method, should be adopted.

Staff recommends that the Commission adopt the Present Value Method for accruing removal costs. Staff notes that the Straight Line Method, which the Company uses, was adopted at a time when it was believed that plant would have some residual value (positive salvage) at the time it is retired. However, this predicate does not exist as plant today tends to have negative net salvage.

According to Staff, the Present Value Method is used to calculate annual accrual rates in the same manner as the Straight Line Method. Consequently, it seeks to match the recovery of removal costs with the use of the asset over the appropriate service life. The difference between the two methods is that the Straight Line Method charges present ratepayers the undiscounted cost of removal. It charges ratepayers the same amount in nominal dollars for each year of an asset's useful life. Consequently, the Straight Line

Method fails to account for the fact that a dollar is worth less in the future than it is today. Staff states that the Present Value Method remedies this defect by discounting the estimated future removal costs.

Staff argues that the Straight Line Method creates intergeneration inequity by its failure to recognize the effect of inflation. In other words, the Straight Line Method causes current ratepayers to actually pay more than future ratepayers to retire a group of assets because of the declining value of the dollar over time. Thus, the Straight Line Method is front loaded, charging current customers as if their current dollars have already lost value because of future inflation, when in truth current dollars are worth more than future dollars. Staff concludes that the Present Value Method creates a more just and reasonable result. Finally, Staff cautions that the Commission should be wary of permitting Delmarva to accrue large sums of money today in the name of removing retired plant in the future based upon cost projections that are difficult to estimate.

Mr. Robinson challenges Mr. King's removal cost proposals. He points out that the cost of removal is rising rapidly, being $2.8 million in 2004 and $2.4 million in 2005 compared to the five-year average of $2.1 million proposed by Mr. King. He argues that with the occurrence of end-of-life costs and related inflation, plus stricter environmental regulations, future removal costs will far exceed historical levels. Consequently, Mr. Robinson argues Mr. King's reliance on a historical (five-year) average will under-recover future costs.

Mr. Robinson also disagrees with the Present Value or SFAS 143 Methodology. He says this discounting approach incorrectly calculates the current liability using the Credit Adjusted Risk Free Rate. Mr. Robinson asserts that the liability depends on the level of risk

associated with the Company. Therefore, the more risky the company, the higher the discount rate and the lower the level of the liability. Mr. Robinson concludes that this does not constitute sound ratemaking. More importantly, Mr. Robinson argues that the Present Value Method does not appropriately recover future costs of removal from those customers over the period in which they consume the property.

4. Amortization of Reserve

Mr. King argues that OPC's proposed rolling five-year average method should supply sufficient funds on a current basis to cover all removal costs. Therefore, he argues the removal cost reserve will never be used to offset removal costs. Consequently, Mr. King recommends returning the current reserve to ratepayers. Based upon a reserve of $41,851,087 as of year-end 2005, a five year amortization would result in an annual refund to ratepayers of $8,370,217.

Mr. King devoted much of his testimony to the proposition that the removal cost reserve should be classified as a regulatory liability.[12] He bases this opinion on recent pronouncements of the Financial Accounting Standards Board ("FASB"), the Federal Energy Regulatory Commission ("FERC") and the Securities and Exchange Commission ("SEC"). Mr. King asserts that the SEC has issued directives that all rate-regulated utilities must report as "regulatory liabilities" reserve accruals against future removal costs. Since Delmarva is already required to separate removal costs from depreciation, Mr. King concludes that this will enhance the ability of the Commission to monitor these accruals, and if the money collected from customers is not spent, it can be refunded.

[12] Classifying removal cost accruals as a liability appears to be a predicate to the amortization of the reserve recommended by Mr. King.

Mr. Robinson strongly opposes OPC's proposal to return the current (under-funded) removal cost reserve to ratepayers. He argues that Mr. King's recommendations grossly understate the reserves necessary to pay future removal costs and would give away to customers the inadequate reserves accumulated to date. Mr. Robinson states Delmarva's current depreciation reserve is not sufficient to fully fund the cost of removal and that customers have not paid the full amount they should have paid to cover the cost of removal component of net salvage.

According to Mr. Robinson, Delmarva's current cost of removal reserve of $41.9 million is substantially less than the $89.6 million theoretical reserve he has calculated is necessary to make Delmarva whole at the end of the useful service life of the current plant in service. Even using Mr. King's proposed average service lives results in a $44 million cost of removal deficit based on a theoretical reserve of $85.5 million. Mr. Robinson notes that the removal cost reserve was collected through depreciation rates approved by this Commission. Furthermore, returning the funds to current customers would give them a windfall, leave the Company without the necessary funds to properly remove and dispose of facilities, and saddle future customers, who received no benefit from these assets, with the full cost of their removal. Mr. Robinson concludes that Mr. King's recommendation is improper. Moreover, Mr. Robinson argues it is illogical and contrary to standard depreciation principles to give away removal reserves simply because they have not been spent. As he has noted, there is no excess in the cost of removal depreciation reserve to give away. Finally, Mr. Robinson argues that because only a small portion of the total end-of-life net salvage has occurred so far, the determination of the cost of removal is extremely dependent on an analysis of future events.

Mr. Robinson also addressed the regulatory liability issue. He states that Mr. King's proposal to treat the removal cost reserve as a liability is improper because the reserve represents payments by customers for the ratable portions of end-of-life costs associated with the property they have consumed in the receipt of service. Moreover, the timing of Delmarva's payment of various cost components does not affect the total cost of the property serving the Company's customers. In addition, the Average Remaining Life depreciation technique, which Mr. Robinson employed and Mr. King supports, allows the Company to constantly true-up recovery amounts. Consequently, Mr. Robinson concludes that customers will be charged through depreciation rates for the proportionate consumption of assets incurred in the provision of utility service. Therefore, Mr. Robinson concludes that Mr. King's proposal to return the reserve to ratepayers is without merit.

5. Commission Decision

The parties are in substantial agreement on the plant-only depreciation rates that should be adopted in this case. For General Plant, the parties concur that the appropriate rate should be 3.39 percent. For Distribution Plant, OPC recommends a 2.41 percent rate while the Company recommends a 2.51 percent rate. The difference is based upon the fact that OPC would increase the current service lives for Accounts 362 and 365 by a larger amount than the Company proposes. However, Mr. Robinson's proposals for the two disputed accounts incorporate industry and Company-specific factors, in addition to the historical analysis relied upon by Mr. King. We find this information relevant and therefore approve Delmarva's proposed plant-only depreciation rates.

The parties disagree strongly, however, about the appropriate cost of removal methodologies and rates that should be approved. Since the parties concur that gross

salvage rates are expected essentially to be zero, the net salvage proposals mirror the cost of removal proposals.

Mr. Robinson proposes using the Straight Line Method of recovery, which results in an annual accrual of $8.5 million for removal costs. Mr. King proposes using the five-year Company average, which results in an annual accrual of $2.1 million. Mr. King also recommends amortizing the current reserve, which would result in a customer credit of $8.4 million per year over the next five years. As an alternative, Mr. King offers a Present Value proposal that results in a $2.9 million annual accrual. Mr. King argues that if the Commission determines that Delmarva should continue to recover removal costs over the life of the plant, the Present Value Method should be adopted. Staff also supports the Present Value Method in this proceeding.

We adopt the Present Value Method for the recovery of removal costs in this case. The Straight Line Method recovers the same annual cost in nominal dollars from ratepayers today as it does at the time plant is removed from service. However, a dollar is worth substantially more today than it will be 20 to 40 years from now. When net salvage is negative, as everyone projects, today's ratepayers would pay more in "real" dollars for the recovery costs of the plant they consume if the Straight Line Method is adopted than would future ratepayers.

Conversely, Mr. King's proposal to use the historical five-year average of $2.1 million is backward-looking. No party seriously disputes that removal costs (negative net salvage) are increasing due to inflationary pressures and environmental requirements. As Mr. Robinson points out, Delmarva's removal costs were $2.8 million in 2004 and $2.4 million in 2005. Therefore, use of an historical average would only exacerbate the

apparent under-funded removal cost reserve and it would not reflect anticipated future expenses.

The Present Value Method strikes a balance between the straight line and historical cost recovery proposals. It is a forward looking approach like the Straight Line Method and recovers projected costs over the life of the plant. However, because future costs are discounted to a "present value," today's ratepayers will pay only their fair share of recovery costs in "real" dollars rather than the inflated amounts under the Straight Line Method. Consequently, we conclude that the Present Value Method more appropriately balances the interests of current and future ratepayers.

We also reject Mr. King's proposal to return the current removal cost reserve to ratepayers. Mr. Robinson's analysis indicates that the current reserve is under funded. Moreover, adoption of Mr. King's removal cost and amortization proposals would effectively eliminate any removal costs from rates for several years, clearly an unreasonable result. The accruals to date reflect plant consumption in earlier years, which has actually occurred. The proposed credit would saddle future ratepayers with an even larger burden. Therefore, we will not adopt Mr. King's amortization proposal. Although we decline to adopt Mr. King's recommendation to label the removal cost reserve as a regulatory liability, we will, however, require Delmarva to continue to segregate removal costs from plant-only depreciation.

Our findings regarding depreciation result in a reduction of rate base of $1,423,000, and a $549,000 increase in net operating income.

D. Cost of Capital

The cost of capital consists of two components: return on equity capital ("ROE"), *i.e.*, the Company's stock, and a return on debt capital, *i.e.*, the company's bonds. Weighted according to the percentages of equity and debt in the utility's capital structure, the sum of the weighted returns on equity and debt equals the utility's overall weighted cost of capital. Calculation of a utility's return on common equity is usually the most significant and controversial component in calculation of the overall rate of return.

1. The Company's Position

Delmarva's rate of return witness, Dr. Morin, proposes a return on common equity of 11.00 percent without the BSA and 10.75 percent with the BSA,[13] and an overall cost of capital of 8.05 percent. Dr. Morin used the Company's existing capital structure of 51.37 percent long-term debt and 48.63 percent common equity.

Dr. Morin employed standard methodologies in calculating Delmarva's return on equity. He performed four Risk Premium analyses, including two versions of the Capital Asset Pricing Model ("CAPM"), plus the Discounted Cash Flow ("DCF") methodology. In performing their analyses, Dr. Morin and other witnesses employed various "comparable" companies having similarities to Delmarva in size, structure and type of business. The use of comparable companies as proxies for Delmarva is necessary in part because Delmarva does not issue its own stock.

[13] Dr. Morin lowered his recommended return on equity from 11.25 percent to 11.00 percent at the beginning of his cross-examination on April 5, 2007. He based his adjustment on lowered Treasury bond (risk free) rates at the time of the hearing. Dr. Morin acknowledges that acceptance of the BSA reduces the risk to the Company. He therefore reduces his recommended ROE by 25 basis points if the BSA is adopted, resulting in a 13 basis point reduction in the overall rate of return ("ROR").

Dr. Morin noted that the CAPM method quantifies the additional return, or Risk Premium, that investors in riskier securities require over and above the return on risk-free investments. The CAPM formula is ($K = R_f + B(R_m – R_f)$).[14] Delmarva's witness assumed a 5.25 percent CAPM risk-free return.[15] For his market Risk Premium, Dr. Morin used 7.2 percent, based on forward looking and historical studies of long-term Risk Premiums. CAPM also requires a Beta, which measures a stock's variability or volatility compared to the overall volatility of a specific market. A Beta of one shows that a stock has the same variability as the overall market. Dr. Morin employed a Beta of .86, based on the Beta of a large group of natural gas and electric distribution stocks "comparable" to Delmarva. The Beta of .86 indicates a variability less than that of the overall market. In the

CAPM formula the Beta is applied to the market risk premium, which is the difference between the return of an overall market index and a risk-free return.

Dr. Morin's CAPM calculation resulted in a cost of common equity for Delmarva of 11.4 percent, increased to 11.7 percent by a flotation cost adjustment of 30 basis points. Flotation costs are recovered through rates of return to compensate companies for the administrative and legal costs of issuing stock, and for possible declines in a stock's price due to the presence of more stock on the market.

Dr. Morin also performed an "empirical" version of the CAPM. The empirical CAPM ("ECAPM") is intended to account for the observations that low Beta securities earn returns somewhat higher than the standard CAPM would predict, while high Beta (high

[14] Where K is the required return on equity, R_f is the risk-free return, B is Beta, a measure of a stock's relative volatility, and R_m is the return in the market as a whole.
[15] In his oral testimony, Dr. Morin revised his risk-free return down to 4.8 percent. Recommendations in Dr. Morin's direct testimony are based on the higher 5.25 percent return.

variability) securities earn less than predicted. As Delmarva is considered a less risky investment than the market as a whole, Dr. Morin concluded that the traditional CAPM understates its return on equity. Dr. Morin's ECAPM calculation yielded a return on equity of 11.7 percent, or 12 percent with flotation costs. Dr. Morin then averaged and rounded up the CAPM and ECAPM results to achieve an ROE estimate of 11.9 percent.

Dr. Morin then performed an historical Risk Premium analysis on the electric industry as a whole. The Risk Premium is that amount above a risk-free rate of return (usually the return on a government bond) that investors require to purchase riskier securities, such as stocks and corporate bonds. Dr. Morin computed the actual return on equity for electric companies from Moody's Electric Utility Index and Moody's Natural Gas Utility Index for the period 1932 to 2001,[16] then subtracted the long-term government bond return for each year, obtaining an average difference of 5.6 percent. Adding together the risk-free rate of 5.25 percent and the average Risk Premium from 1932 to 2001 of 5.6 percent, Dr. Morin obtained an implied ROE for electric utilities of 11.2 percent and 11.3 percent for natural gas utilities, including flotation costs.

As a check, Dr. Morin performed a Risk Premium analysis of rates of return in the natural gas industry for the period 1955 to 2001. He determined that for the 1955 to 2001 period the rate of return on equity for gas companies was 11.3 percent, including flotation costs.

As a further aid in determining Delmarva's cost of common equity, Dr. Morin examined the historical allowed Risk Premiums implied in the return on equity allowed by regulatory commissions for electric delivery utilities over the last decade. Dr. Morin

[16] Information necessary for these analyses ceased to be available in 2001.

concluded that for the utility of average risk the Risk Premium should be 5.6 percent, which, when added to the long-term Treasury rate of 5.25 percent, yields a return on equity of 10.9 percent, rounded. Also, as these are allowed returns on equity, no flotation cost adjustment is necessary.

The Discounted Cash Flow ("DCF") method of calculating return on equity assumes that the value of any security to an investor is the expected discounted present value of the future stream of dividends and other benefits, such as the expected growth rate, accruing to shareholders. In this case, however, Dr. Morin did not use the dividend growth rate in calculating his DCF return, as he expects utility dividend growth to decline in the future. He employed only the earnings growth rate.

Discounted Cash Flow rates of return are traditionally performed on a group of "comparable" companies similar to the subject company – here Delmarva. While the DCF methodology is the primary method used by many regulatory commissions, Dr. Morin opines that the DCF model understates investors' expected return for utility stocks in the current market environment when stock prices exceed book value.

To perform his DCF calculation, Dr. Morin needed to select a group of comparable companies, and to obtain future growth estimates for those companies. Dr. Morin used both electric and gas distribution companies as proxies for Delmarva. Dr. Morin applied the DCF formula to two groups of proxy companies: widely traded dividend-paying electric distribution utilities, and investment grade dividend-paying natural gas utilities. After further refining his list of 20 electric utilities, Dr. Morin chose 17 companies that are parents of investment grade electric distribution companies. To reach this number, he eliminated companies with returns that were exceptionally high or low, or for which no data was

available. Included in the 17 were Constellation Energy, Consolidated Edison, Pepco Holdings, and Northeast Utilities.

Dr. Morin concluded that certain natural gas utilities possess economic characteristics similar to those of electricity distribution utilities. Dr. Morin chose to use approximately a dozen such gas companies in his DCF analysis, including Laclede Group and WGL Holdings, Inc.

Dr. Morin then obtained future growth estimates from both Value Line and Zack's research services. The average return on equity for Delmarva under the DCF method was 10.2 percent, according to Dr. Morin, which he believes is understated for utilities such as Delmarva, as noted above.

After performing his various return on equity calculations, Dr. Morin initially concluded that without the BSA, the Company's return on equity should be 11.00 percent, the same conclusion reached by the Commission's Staff. Dr. Morin then added 25 basis points for flotation costs, resulting in a recommendation of 11.25 percent. Dr. Morin later lowered this overall estimate to 11.00 percent due to updated information on interest rate declines. Delmarva states that its cost of long-term debt is 5.48 percent, which no party has challenged.[17] Dr. Morin therefore recommends an overall cost of capital of 8.05 percent.

2. People's Counsel's Position

The Office of People's Counsel's witness King recommends a 9.78 percent return on Delmarva's equity capital, resulting in an after-tax weighted cost of capital of 7.05 percent. Mr. King, however, would significantly reduce the return if either the BSA or POPEB mechanism is adopted, as each of these proposed adjustment trackers would greatly reduce

[17] Delmarva Initial Brief at 8.

the Company's investment risk. People's Counsel would reduce those returns to an 8.97 percent return on equity and a 6.80 percent overall return if the Commission adopts the BSA, as OPC recommends, with an additional reduction added if the POPEB tracker is also adopted.[18] Mr. King's proposed returns are based on the Company's capital structure as of September 30, 2006, but with attribution of Pepco Holding Company debt to Delmarva, as noted below.

OPC also proposes that we utilize a capital structure for ratemaking purposes that is significantly different than Delmarva's capital structure of approximately 48 percent equity and the remainder long-term debt. Mr. King recommends a "double leverage" adjustment to the Delmarva capital structure as he contends the "equity" component is not real equity, as Delmarva equity earnings are effectively increased when passed through to the parent, PHI. Therefore, OPC argues an adjustment is necessary so as to avoid an improper windfall flowing to PHI shareholders. Mr. King therefore concluded that Delmarva's capital structure should be comprised of 31.44 percent equity, 59.39 percent long-term debt, and 9.17 percent short-term debt (with short-term debt based on the average amount outstanding during the September 2006 test year).

Mr. King relied primarily on the DCF methodology. His criteria for selecting comparable companies for his DCF analysis included their having a Value Line financial strength rating of B+ or better, not being engaged in mergers, and receiving at least 60 percent of their revenue from regulated services. Based on these criteria, and after

[18] Mr. King recommends a reduction of 81 basis points to the return on equity for each of the BSA or POPEB tracker, for a total reduction of 162 basis points if both are adopted.

removing PHI from his list, Mr. King chose 26 electric utility companies as his comparable group. Included among them are Consolidated Edison, Entergy Corp, and Hawaiian Electric. Mr. King first calculated a DCF growth rate of 6.14 percent, employing the formula K = d/p + g.[19] Mr. King used a forecasted dividend yield rather than one increased by a growth factor. He avoided making any adjustment for the compounding of dividends, as the compounding "occurs outside of the dividend issuing company," by recipients of the dividends. Mr. King then added the 6.14 percent growth rate to the average 3.79 percent current dividend yield of the 26 companies to obtain an average 9.93 percent DCF return for the comparable group.

In addition to the "classic" DCF formula, Mr. King employed a newer, two-step formula, developed at FERC, that corrects for the classic formula's assumption that dividend growth will continue indefinitely at a company's short-term rate of growth. The "two step" formula assumes that dividend growth will ultimately match the rate of growth in the gross domestic product, and assigns one-third weight to that growth forecast. To obtain his recommended return on equity of 9.78 percent, Mr. King averaged the classic DCF result of 9.93 percent with the FERC two-step result of 9.51 percent, achieving his recommended 9.72 percent return on equity. He then added six basis points for flotation costs, resulting in a return on equity of 9.78 percent.

Mr. King did not rely significantly on the other cost of equity pricing models commonly employed by cost of capital analysts, such as CAPM and Risk Premium, for calculating a return on equity. Instead, he used those methods primarily as a "check" on his

[19] Where K = required rate of return; d = dividend in the immediate period; p = market price; and g = expected growth rate in dividends.

results. While Mr. King believes that the CAPM "has value in assessing the relative risk of different stocks and portfolios ..."[20] he criticizes the CAPM method for its reliance on subjective components, such as Beta and the risk-free rate of return. Mr. King points out that Value Line and Thompson Financial, both respected sources of Beta calculations, often provide inconsistent results. Mr. King also contends that choosing the risk-free rate of return from various types of government bonds involves significant subjective judgment.

Mr. King obtained a CAPM return on equity of 8.29 percent. Mr. King gave conflicting statements on cross-examination about whether he intended to rely on his CAPM findings to support his DCF findings. Delmarva points out that Mr. King's ultimate recommendation of 9.78 percent return on equity differs markedly from his lower CAPM estimate.

Mr. King also has reservations about the Risk Premium method of calculating return on equity. He states that "no one has come up with an adequate way to identify the Risk Premium that equity investors require over measurable bond yields."[21] Mr. King therefore does not propound his own Risk Premium recommendation, but criticizes Dr. Morin's Risk Premium calculations as based on inflated assumptions.

In developing his recommended return on equity, Mr. King also reviewed the record of return on equity awards given to electric utilities by state utility commissions. Mr. King noted that the trend in returns on equity has been downward for 16 years, and "a rate of return award below 10 percent would not be inconsistent with recent equity return

[20] King Direct at 20.
[21] King Direct at 27.

allowances."[22] Mr. King does not specifically rely on that finding in reaching his own recommendation, however, due to concerns about possible circularity.

In calculating flotation costs, Mr. King used the stock of PHI as a proxy, as Delmarva itself does not issue stock. He concluded that PHI's stock issuances in 2002 and 2004 had generated $14,913,385 in flotation costs, which Mr. King deemed should be recovered over the seven-year life of PHI, or at the rate of $2,130,483 each year. That figure, being 0.059 percent of PHI's total common equity of $3.6 billion, supports a six basis point flotation cost, according to Mr. King.

If the Commission approves Delmarva's Bill Stabilization Adjustment and POPEB tracker, Mr. King concludes that "Delmarva will become one of the least risky electric utilities in the country."[23] Mr. King would therefore lower the Company's rate of return to a level he would consider consistent with the Company's lower level of risk. Thus, if the BSA is approved, People's Counsel recommends a return on equity set toward the lower end of the range of rates of return for electric utility companies with a reduction of 81 basis points to 8.97 percent and an overall return of 6.80 percent. If the Commission approves a pension and OPEB adjustment mechanism as well as a BSA, People's Counsel would propose a still lower 8.16 percent rate of return on equity with a correspondingly lower overall return.

Employing a return on equity of 9.78 percent, and including both short- and long-term debt in Delmarva's capital structure, which has been revised with his "double leverage" adjustment, witness King proposed a weighted cost of capital of 7.05 percent for the

[22] King Direct at 26.
[23] King Direct at 35.

Company. His recommended weighted cost of capital is 6.80 percent if the Bill Stabilization Adjustment is approved.

The Company and Staff criticized Mr. King's analyses and conclusions extensively. They claim Mr. King relied too heavily on the DCF formula, obtained widely varying results in his analyses, and ignored the effect of quarterly dividends. Delmarva was especially critical of the effect of Mr. King's basis point reduction in response to Commission approval of either the BSA, the Pension/OPEB tracker, or both. Delmarva claims Mr. King's reductions would result in a yield on the Company's bonds of 4.38 percent, an inappropriate return, as it would be less than the yield on essentially risk-free Treasury bonds.

3. Staff's Position

Staff witness Elert performed four types of standard analyses to arrive at his recommended return on equity: two Discounted Cash Flow analyses, a Risk Premium analysis (with two variations), and the Capital Asset Pricing Model.

Within the DCF category, Mr. Elert performed an Internal Rate of Return/Discounted Cash Flow ("IRR/DCF") analysis that focused on expected stock and dividend growth. Using the IRR/DCF, Mr. Elert arrived at an average cost of equity capital for his 18 proxy companies of 6.40 percent. Staff's 18 proxy electric companies were all publicly traded and located in the Mid-Atlantic and South. Most were from states that had undergone electric restructuring. Mr. Elert, in his March 7, 2007 direct testimony, decided to exclude the results generated by his IRR/DCF analysis. He concluded that the 6.40 percent cost of equity capital produced by the IRR/DCF calculations was too low to be appropriate or reasonable or credible, being lower than the prospective dividend yield of Baa-rated corporate bonds.

Mr. Elert also performed a traditional DCF calculation, averaging the revenue growth, cash flow growth, earnings growth and dividend growth for each proxy company. For his proxy group of electric utilities, Mr. Elert at first selected 20 firms with basic similarities to Delmarva. He then eliminated Pepco Holdings from this list, as well as Northeast Utilities, because of Northeast's very low rate of return of 4.52 percent. Thus, Mr. Elert was left with 18 companies in his comparable group. Mr. Elert averaged the resulting DCF growth rates for each company to develop an overall average traditional DCF return on equity of 9.8 percent. As a further check, Mr. Elert averaged the highest and lowest of the DCF values, obtaining a 10.7 percent return on equity. Mr. Elert concluded that the average of these averages of 9.8 percent and 10.7 percent would ultimately result in the more defensible DCF equity return of 10.25 percent.

Mr. Elert's Risk Premium analyses yielded a return on equity of 11.35 percent, the average of his two Risk Premium calculations. Here Mr. Elert used a corporate debt yield of 6.0 percent based on the projected return on AAA-rated corporate bonds for the years 2007-2010.

To obtain a Risk Premium value, Mr. Elert took the average difference between the expected yield on 30-year U.S. Treasury bonds for 2002-2006 and returns on equity granted to electric distribution utilities for the same period. As risk-free Treasury bonds return a lower yield than risk-free corporate bonds, the Risk Premium, based on Treasury yields, is 5.2 percent, about 80 basis points less than the projected safe corporate yield, according to Mr. Elert.

Using a 6.0 percent risk-free rate and a 5.2 percent Risk Premium, Mr. Elert performed an arithmetical and a geometric Risk Premium calculation, yielding a return on

equity of 11.20 percent and 11.50 percent, respectively. The average of these two figures is 11.35 percent, Mr. Elert's ultimate Risk Premium cost of equity.

The fourth method employed by Mr. Elert was the Capital Asset Pricing Model. The components of the CAPM formula are the risk-free and market risk elements, as well as Beta. For his Beta, Mr. Elert adopted Value Line's Beta calculations for December 2006, and he chose as the risk-free rate the forecasted interest rate for 30-year Treasury bonds for the period 2007-2010. For his CAPM Risk Premium rate Mr. Elert employed the same value as in his Risk Premium analysis, adjusted for use of long-term government as opposed to corporate bonds. Using the Risk Premium value of 6.0 percent in the CAPM formula, witness Elert found a return on equity for Delmarva of 10.61 percent.

Mr. Elert supports use of Delmarva's actual capital structure, as consistent with Commission precedent. He also found the effect on rates of including short-term debt in the capital structure to be *de minimis*. Therefore, Mr. Elert agrees with Delmarva that Delmarva's capital structure need not include short-term debt.

Using the agreed upon 5.48 percent cost of long-term debt, Mr. Elert recommends that Delmarva's return on equity be 11.00 percent, including a 25 basis point adjustment for flotation costs, and its overall rate of return be set at 8.16 percent. In its final position on brief, Staff recommends a 50 basis point reduction in the ROE if the BSA is adopted.

4. Discussion and Findings

We conclude that Delmarva's return on equity for the rate effective period should be set at 10.50 percent, including a six basis point flotation cost adjustment. Due to approval of the BSA mechanism, however, the 10.50 percent return on equity will be reduced by 50 basis points to 10.00 percent.

In reaching its decision, the Commission has in most instances given more weight to the findings of Delmarva and Staff than to those of People's Counsel. Both Staff and Delmarva employ a wide range of rate of return methodologies, which increased our confidence that their recommendations are broadly justified and not isolated. Once Mr. Morin reduced his recommended ROE by 25 basis points due to declining bond yields, Delmarva's and Staff's recommendations became essentially identical.

Both Delmarva and Staff criticize People's Counsel's witness King not only for his methodology but for his results, including his recommending ROEs ranging from 6.08 percent to 7.05 percent in certain cases. Among other things, they object to Mr. King's almost exclusive reliance on the DCF formula, which is alleged to give results that are either unrealistically high or low, in specific circumstances, depending upon prevailing market-to-book ratios.

While both Staff and Delmarva recommend an 11 percent ROE (absent any other adjustment), the Commission concludes that such an ROE would be higher than current bond returns justify. The Commission also accepts several of Mr. King's criticisms of Staff witness Elert's analyses, which point toward a somewhat lower ROE for Delmarva than Mr. Elert recommended. Therefore, the Commission has reduced the 11 percent ROE proposed by Staff and Delmarva to 10.50 percent, inclusive of flotation costs.

The Commission accepts OPC witness King's flotation cost analysis. By valuing the cost of stock actually issued by PHI since its inception, Mr. King was able to provide a quantifiable foundation for his recommendation of a six basis point flotation cost adjustment. Flotation cost adjustments proposed by Delmarva and Staff are less specifically supported. We therefore adopt Mr. King's six basis point flotation cost adjustment.

The BSA, which the Commission has approved, will provide significant insurance that Delmarva will achieve its level of revenue approved in this case. Delmarva's position is much less risky with the BSA than without it. In response to this decline in risk, all parties recognize the appropriateness of reducing Delmarva's return on equity by some amount. The Commission rejects both the minimal reduction of basis points proposed by the Company and the larger reduction proposed by People's Counsel. Given that approval of the BSA will result in improved cost recovery by Delmarva, the Commission shall reduce Delmarva's ROE by 50 basis points, to 10 percent.[24]

5. Capital Structure

The Company and Staff propose a rate of return based upon the Company's actual September 30, 2006 capital structure, consisting of 51.37 percent long-term debt and 48.63 percent common equity. As noted above, People's Counsel proposed a significantly different rate structure containing only 31 percent equity based upon Dr. King's double leverage theory.

We adopt the Company's actual capital structure, consistent with our long-standing preference for use of actual capital structure absent evidence that the actual capital structure is unduly burdensome to ratepayers. We note that the Company's actual capital structure is consistent with that generally employed by utility companies and strikes an appropriate balance between safety and economy. We reject People's Counsel's proposed capital structure because it suffers from numerous flaws. First, it assumes that the rate of return depends on the source of capital rather than the risks faced by the capital. Second, a capital

[24] This decision is consistent with the Commission's determination in *Re Baltimore Gas and Electric Company*, 91 Md. PSC 240, 273 (2000).

structure containing only 31 percent common equity would impose significant risks and would require a considerably higher return on equity than that authorized herein. Third, a capital structure containing only 31 percent equity would be extremely risky and would impair the Company's financial integrity in violation of applicable legal standards. *See*, *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

Delmarva has chosen not to include short-term debt in its capital structure because it believes long-term assets should be financed with long-term capital. Staff adopted the Company's capital structure.

People's Counsel would include short-term debt in Delmarva's capital structure because OPC concludes that Delmarva does use short-term debt to purchase long-term assets. OPC also urges that the Company's rate base contains shorter- as well as longer-lived assets.

We find that Delmarva's actual capital structure provides the most appropriate basis for calculating the Company's rate of return. Short-term debt is a small part of that structure and may, in our view, be omitted here. We note, however, that this finding is specific to this proceeding, and we may include or omit short-term debt in other cases as the circumstances warrant.

Thus, based on a 10.00 percent ROE and a 5.48 percent cost of long-term debt, Delmarva's weighted total return on capital is 7.68 percent, as shown by the following calculation:

Type of Capital	Ratios		Cost Rate		Overall Rate of Return
Long-Term Debt	51.37%	X	5.48%	=	2.815%
Common Equity	48.63%	X	10.00%	=	4.863%
	100%				7.678%

E. Revenue Requirement

When applying the 7.68 percent overall rate of return to the adjusted rate base of $267,313,000, the income requirement is $20,530,000. As the Company's adjusted net operating income was $11,423,000, for the September 30, 2006 test year, we find the Company experienced a net operating income deficiency of $9,107,000, which becomes a gross revenue deficiency of $15,398,000, as detailed in Appendix I, which amount of increase will result in just and reasonable rates to the Company and its customers.

F. Bill Stabilization Adjustment

Delmarva has proposed a surcharge and credit mechanism in order to provide a levelized stream of revenue based on the test year revenue requirement. The proposal will enhance the Company's opportunity to earn the authorized rate of return on its operations by limiting exposure to changes in revenue caused by variations in the energy usage of its customers. Delmarva's proposal would use a quarterly adjustment to the distribution energy charges ($/kWh) called the Bill Stabilization Adjustment ("BSA") Rider. The BSA is a mechanism that decouples revenues from abnormal levels in kWh sales and/or changes in the number of customers from adjusted test-year levels. Primarily, the BSA is intended to account for unanticipated changes in usage due to severe weather, customer response to supply price increases or State-mandated energy-efficiency programs. With the BSA, the

Company's revenue risk is decreased and, therefore, the Company benefits from a reasonably steady revenue stream in line with the level of revenues approved in this proceeding.

For each rate class, and for each billing month in the current quarter, the Company will multiply average (normalized) monthly revenue per customer (at rates approved in the latest base rate proceeding) by the actual number of customers for each of the three billing months. "Normalized quarterly test year revenue" is the sum of this product over the three billing months in the current quarter. The BSA would then be computed at the end of the current quarter by dividing the difference between actual quarterly revenue and the normalized quarterly test year revenue, plus any applicable true-up amount from previous quarters, by the forecasted kWh sales applicable to the service classification for the second succeeding quarter.

If, in the current quarter, actual kWh sales exceed normalized levels (*e.g.*, due to an abnormally hot summer), actual quarterly revenues will exceed the normalized test-year expected amount. As a result, the BSA will lead to a downward adjustment in base distribution energy charges, and this credit to customers will be applied in the second succeeding billing quarter (*e.g.*, the winter quarter). On the other hand, if actual kWh sales, in the current quarter, are lower than normalized levels (*e.g.*, due to an abnormally cool summer) then actual quarterly revenues will fall below the normalized test-year expected amount. As a result, the BSA will lead to an upward adjustment in base distribution energy charges, applied in the winter quarter.

The Company has also proposed to cap the BSA credit or surcharge at 10 percent of the test-year average base rate for the current quarter. If, at the end of a particular quarter,

the BSA credit or surcharge exceeds the 10 percent cap, then the difference is added to a cumulated "carry-over" account, which is recovered in future quarters for which the BSA is less than the cap.[25] The Company proposes this cap in order to avoid unduly large swings in the BSA.

The Company notes that the majority of short-term distribution costs are fixed (*i.e.*, are classified as being either demand-related costs or customer-related costs). There are no energy-related distribution costs and the supply costs of the electricity itself are passed through to the customer.[26] However, the customer and demand charges are not set at levels sufficient to cover all the fixed distribution costs. A significant amount of the distribution company revenues are collected through a volumetric energy charge.

Additionally, residential customers do not face demand charges, so even a larger share of revenues is generated through the energy charge. Consequently, there is a mismatch between the source of distribution costs and the rates intended to recover those costs, and fixed-cost recovery is dependent upon a potentially volatile revenue stream. Under this scenario, if customers decrease kWh usage then revenues decrease without a corresponding decrease in cost. As a result, the distribution company's fixed-cost recovery is thwarted. The Company also notes that demand-side management ("DSM") resources reduce sales and, consequently, revenues and fixed-cost recoveries decline. This creates a

[25] The term "future quarters" refers to quarters beyond the second succeeding quarter wherein the capped BSA is applied.

[26] For retail customers who actively switch to a specific alternative supplier of power, the supply price is set by that specific supplier. For customers who do not switch to a specific alternative supplier of power (*i.e.*, the "Standard Offer Service" customers), Delmarva procures wholesale power on behalf of, and passes the costs of this power through to, these customers. In Browning Rebuttal at 17(2 – 3), the witness states that "in September 2006, 94% of residential customers were SOS customers."

disincentive for the utility to consider demand side resources even when they are the lowest cost option.

According to Company witness Chamberlin, the BSA is beneficial because (1) it stabilizes customers' bills; (2) it aligns revenues with costs; (3) it provides for more efficient investment decisions by decreasing the disincentives towards investment in demand-side and energy-efficiency programs; and, (4) it helps ensure fixed-cost recovery.

OPC and Staff agree with Delmarva that the BSA should be approved, but each proposes modifications to the Company's BSA proposal. OPC argues that four modifications are necessary conditions for approval of the BSA: (1) the BSA should be tied to implementation of cost effective demand side management ("DSM") programs; (2) the timing of recovery of costs should be adjusted; (3) the BSA should be capped at five percent; and (4) the BSA should be subject to monitoring and reporting. Staff agrees with OPC that the BSA should be subject to monitoring and reporting, and recommends one other modification: the BSA proposal should be modified such that Delmarva's ROE is adjusted downward by 50 basis points instead of the 25 proposed by the Company.

The parties do not agree on whether the BSA over- or under-collection of revenue should be recovered in a subsequent quarter, month or over the year. Delmarva proposes a quarterly adjustment. OPC notes that the high bills in a cold winter would be paid primarily by space-heating customers, but could result in a BSA refund in the spring that flows predominately to non-heating customers. OPC asserts that this creates confusion and may result in the sending of inadvertently misleading price signals. OPC therefore recommends that the timing of BSA recovery should be modified by making the quarterly adjustments one year later, so that excess revenues from a cold winter are refunded to customers the

following winter, and excess revenues from a hot summer are refunded the following summer. Staff supports the quarterly implementation, but notes that such timing slows the stabilization effect. All parties agreed that a monthly implementation of the BSA might be advantageous.

Both Staff and OPC concur that the BSA should include additional monitoring and reporting. In its brief, Delmarva rejects that proposal as an unnecessary burden upon the Company, based in part, upon Dr. Browning's representation that the Company's proposal will provide ample information for the Staff to review.

The parties are in substantial agreement that the BSA should be adopted in this case, and we agree. The BSA serves multiple public policies. First, it reduces risk and, therefore, the Company's cost of capital. This reduction in the cost of capital redounds to the benefit of customers, as evident in the 50 basis point reduction in the rate of return we authorized above. Second, the BSA decouples the Company's revenue from sales of kilowatt hours. Thus, it removes a major disincentive to the Company's participation in the full deployment of demand-side management and energy efficiency programs. The enhanced deployment of such programs will facilitate customers in better controlling their electric bills. We consider the deployment of such programs to be a major policy undertaking that will substantially inure to the benefit of ratepayers in an environment of increasing cost of electric supply and growing reliability concerns. Third, the Bill Stabilization Adjustment will smooth out bill variations induced by weather extremes. This will aid customers in dealing with those months in which the weather is harsh and bills would be unusually high. Fourth, mechanisms similar to the BSA have been approved for all of Maryland's larger gas companies and have served customer interests well.

The Commission concludes that the BSA should be adopted as filed for all of these reasons. However, there are a number of implementation issues associated with the BSA which the Commission will explore in a separate proceeding. Specifically, the Commission seeks to refine operation of the BSA by exploring the issues listed below. The fundamental decision made herein to adopt the BSA and the rate of return adjustment adopted herein will not be revisited. The Commission will, however, seek opinion on the following questions:

- How can the Commission insure that service quality is maintained when revenue decoupling takes place?
- Should the BSA operate monthly, quarterly, or annually?
- Should the BSA apply to all customer classes or should certain classes be exempt from its operation?
- What ongoing monitoring and studies of the BSA should be ordered?

The parties disagree on the appropriate adjustment to the ROE based on the approval of the BSA in this proceeding, and the Commission addresses this matter in its discussion of the ROE section of this Order. The parties also disagree on the timing of the BSA. The parties disagree on whether the monitoring of the BSA's impact on customer bills is appropriate with Delmarva rejecting the conditions proposed by OPC and Staff as unnecessary.

We decline to adjust the BSA's recovery threshold at this time and accept the Company's proposal that the BSA adjustment be capped at 10 percent. The Commission finds that any amount over 10 percent of the test year revenue should be deferred in a separate account to offset future over- or under-collections by the Company. The Commission finds that limiting the amount of revenues that the Company will recover from customers in a given month is a reasonable accommodation of the competing concerns for

insulating the Company from revenue variability and insulating the customer from above average or below average usage due to forces beyond their control. We therefore approve a 10 percent cap on the BSA as proposed by the Company. However, the operation of the BSA will be reviewed, and the cap can be adjusted if an adjustment proves necessary.

The Commission will adopt a monthly operation of the BSA. However, the issue can be explored further in the separate BSA proceeding noted above.

The BSA, as proposed by Delmarva, will address lost sales. The BSA will not address all facets of a more comprehensive approach to energy efficiency activities by the Company. However, we have instituted a number of proceedings to consider energy efficiency and demand-side management efforts. Moreover, the Company has proposed a comprehensive set of energy efficiency activities. The approval of the BSA in this proceeding will complement those ongoing efforts to provide customers with greater conservation programs and activities.

We agree with Staff and OPC that additional monitoring and reporting on the performance and impact of the BSA is in the public interest. The monitoring and reporting of data on the BSA should meet the needs for data collection as defined by Staff. Therefore, we direct Delmarva to confer with Staff and OPC as to adoption and implementation of monitoring and reporting requirements recommended by Staff.

G. Pension and Other Post-Employment Benefits

Delmarva witness Rigby proposes a Pension and Other Post-Employment Benefits ("POPEB") rider. The POPEB rider is a surcharge that captures yearly differences between the pension and OPEB costs embedded in the Company's base rates and the actual expenses properly chargeable to the Company's distribution operating costs. According to the

Company, the POPEB costs fluctuate, not because of management decisions by the Company, but because of stock and bond performance, retiree mortality rates, health care costs and actuarial changes in assumptions which are beyond the Company's control.

The Company avers it would employ an "independent" actuary to identify the yearly differences between test year and actual POPEB costs. POPEB costs would be calculated on an annual basis and collected through a per kilowatt-hour surcharge. The actuary would inform the Company and the Company would adjust energy charges based on the over-collection or under-collection of POPEB costs in base rates. Thus, the POPEB proposal would shift the recovery of employee costs to a volumetric charge.

OPC opposes the POPEB rider. OPC witness Effron testified that "the proposed tracker mechanism would guarantee virtual dollar for dollar recovery of OPEB and pension costs and would reduce the incentive to control those benefits costs ...."[27] OPC argues that the POPEB "tracker will remove the risk to Delmarva that these employment-related costs will vary in ways unpredicted in the rate case but may arise due mostly to accounting changes which require these types of anticipated future expenditures to be currently recognized at their present discount value."[28]

OPC witness Effron asserts that the necessity of implementing a POPEB tracker mechanism has not been established:

> The Company has not explained why pension and OPEB costs should be treated differently from these other expenses that go into the determination of its base revenue requirement ... As a general matter, reconciliation mechanisms are contrary to sound ratemaking practice, as such mechanisms tend to either reduce or eliminate incentives to control costs. Such mechanisms should be reserved for expenses that are of such

[27] Effron Direct at 24.
[28] People's Counsel's Initial Brief at 38.

> exceptional magnitude and volatility that unexpected adverse fluctuations can cause irreparable financial harm .... While pension and OPEB costs are not immaterial, they clearly are not comparable in scale to purchased power costs and purchased gas costs.[29]

OPC also notes the inconsistent treatment of the POPEB and BSA in Delmarva's testimony: the BSA removes risk, and the Company is willing to reduce its proposed rate of return for the BSA, but the Company has not proposed a similar reduction `to its proposed ROE for the reduction in risk from approval of the POPEB surcharge. Therefore, OPC rejects the adoption of the POPEB tracker because POPEB costs are not like purchased gas or power costs. However, if the POPEB tracker is adopted, OPC asserts that an additional reduction in the return on common equity of 81 basis points is required.

Staff similarly opposes the POPEB mechanism, noting that the Company does control the structure of its benefits package. Staff also argues that OPEB expenses are not a major expenditure for the Company, and consequently do not expose the Company to undue financial harm. Finally, Staff is concerned that Delmarva's aging workforce would lead to the POPEB rider generally increasing customers' bills.

The Company responds that its management of the POPEB costs has not been challenged as imprudent and that volatility in POPEB costs[30] is a genuine problem that needs to be addressed, notwithstanding the Company's efforts to exercise control over the costs. Delmarva contends that the POPEB rider is necessary because annual fluctuations in the POPEB costs are beyond the Company's control.

[29] Effron Direct at 25.
[30] During the last ten years Delmarva has merged with ACE and Pepco during the period when it notes annual variations in POPEB costs have ranged from -$35.4 million to $14.4 million per year.

We reject the Company's request to implement OPEB and pension tracker mechanisms.[31] Tracker mechanisms that guarantee dollar-for-dollar recovery of OPEB and pension costs lessen the Company's financial incentive to control the benefits of costs of its retirement plans. The Company has not proven to us that the rider is just, reasonable and an appropriate mechanism for recovery of costs. We have approved riders for fuel, universal service and environmental surcharges, but the Company has not demonstrated that POPEB charges are sufficiently similar to these types of expenses to justify a Company surcharge based on revenue recovery of POPEB costs. Implementation of a tracker mechanism is an extraordinary form of ratemaking usually reserved for very large expense items that have the potential to impair seriously a utility's financial well-being, which is not the case here for OPEB and pension costs. We therefore deny the Company's request for a POPEB rider.

H. Cost Allocation

Delmarva presents a Class Cost of Service Study ("CCOSS") to support its proposals for allocating its costs of service among the various customer classes, as well as its proposals for revenue requirement recovery within customer classes. As part of the CCOSS, the Company assigned or allocated (using one of several allocation factors) each distribution cost item to specific jurisdictions and customer classes. Delmarva asserts that it allocated costs in a manner that sends appropriate price signals and reduces inter-class subsidizations.

Delmarva serves customers in Maryland, Virginia and Delaware. On a jurisdictional basis, for the 12 months ended September 30, 2006, Delmarva asserts that its overall rate of return across the three jurisdictions was 9.22 percent, whereas the rate of return on Maryland distribution rate base was 7.40 percent.

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[31] *See Re Washington Gas Light Company*, 94 MD PSC 329, 353 (2003) (Order No. 78757).

Twelve Months Ended September 30, 2006	Rate of Return	Rate Base	Electric Operating Revenues	Operating Expenses
System	9.22%	$701,630,943	$283,959,892	$219,439,714
Maryland	7.40%	$276,852,220	$103,060,113	$82,612,181

This compares to a 9.75 percent rate of return on Virginia operations and a 10.46 percent return on operations in Delaware.

As noted in the rate base section of this Order, Delmarva developed its proposed Maryland jurisdictional rate base by a combination of direct assignment to Delmarva-Maryland or a functional allocation to Delmarva-Maryland. Directly assigned costs, like distribution plant, were identified to produce the distribution related portion of the costs of service. Other costs, like general plant and administrative and general expenses, have been functionalized to produce the distribution related portion of these costs. As noted in the rate base section of the Order, the Commission determined Delmarva's Maryland jurisdictional rate base to be $267,313,000 for the test year.

Delmarva witness Normand provides the Maryland-only distribution class cost of service analyses. In developing his customer class rates of return, Mr. Normand specifically notes that:

> Costs can vary significantly between services and customer classes depending upon the nature of their demands, delivery voltage on the system and the facilities and services required. The purpose of an Allocated Cost of Service Study is to directly assign costs based on company records or allocate each relevant and identifiable component of cost on an appropriate basis in order to determine the proper cost to serve

> the Company's respective jurisdictions (Schedules 2 and 3) and customer classes (Schedules 4, 5 and 6) under study.[32]

Based upon allocations and direct assignment of costs, Mr. Normand provides the Company's rate of return analysis for each retail customer class based on the 12-month period ended September 30, 2006 (see table below).

After allocating and assigning costs, revenues and utility plant to the customer classes, the Company was able to develop class rates of return. This process allows determination of whether a particular customer class is subsidizing, or being subsidized by, any other class.

Delmarva develops an indicator, known as the index of return, to compare a customer class' rate of return to that provided by the system as a whole. To develop the index of return for the customer classes, Mr. Normand divides each class rate of return by the Maryland overall distribution rate of return (7.40 percent). Doing so produces a rate of return for the residential class of 8.42 percent (and an index of 1.14), while the residential space heating class rate of return is 6.34 percent (with an index for this subclass of 0.86). The general service secondary-small rate of return is 10.23, while the index for that class is 1.38. Mr. Normand asserts that the index of return can be used as a guide to establish reasonable revenue targets and class increases.

The following chart contains the unadjusted class rates of return and the class rates of return reflecting the Company's allocation of costs and proposed revenues that reduces the index of return of the residential class:

[32] Normand Direct at 5-6.

Row	Customer Class	Delmarva Proposed Class Rates of Return Prior to the Proposed Revenue Increase		Unadjusted Rate of Return (Normand)		Adjusted Rate of Return (Janocha)	
		Rate of Return	Index of Return	Rate of Return	Index of Return	Rate of Return	Index of Return
1	Residential	8.42	1.14	7.29	0.99		
2	Residential Space Heating	6.34	0.86	7.29	0.99		
3	General Service Secondary – Small (SGS)	10.23	1.38	10.23	1.38		
4	Cable Service (TN)	14.19	1.92	14.19	1.92		
5	General Service Secondary – Large (LGS-S)	0.92	0.12	0.92	0.12		
6	General Service Primary (GS)	7.69	1.04	7.69	1.04		
7	Street Lighting (OL-ORL)	1.67	0.23	1.67	0.23		
8	Total Maryland Distribution	7.40	1.00	7.40	1.00		

Details of the Class Cost of Service Study were presented by Delmarva witness Janocha. He proposes the achievement of class specific unitized rates of return ("UROR") in a desired range, and uses the UROR results as a benchmark to determine appropriate shifts in class revenue requirements. The thrust of Delmarva's class revenue requirement proposals is that classes with the lowest UROR receive the highest percentage increase in proposed customer- and energy-related charges so as to move all classes towards a more equal rate of return.

In the Company's proposed allocation of the revenue increase across the customer classes: the GS and SGS classes received small increases; the residential class received slightly less than a system average increase; residential space heating received slightly more than a system average increase; and the LGS-S and Street Lighting classes received increases exceeding the average.

Staff witnesses Prettiman, Hurley and Kashtelyan's analysis of the Company's proposed jurisdictional cost of service study concentrated on the methodology and actual calculation of Delmarva's allocation factors. Staff found them to be reasonable and appropriate. Staff followed the method that Mr. Janocha used in developing the revenue increase for each customer class. However, Staff developed a slightly different inter-class allocation of the proposed revenue increase across the customer classes, allocating a greater portion of the increase to smaller commercial customers (a smaller portion to the larger commercial and street lighting classes). Staff's position represents its adherence to traditional Commission policy of implementing rate design changes gradually over time.

Staff notes that Delmarva's proposed demand allocation factors were based on load research "data from 1994, 1996, and 1998 to develop certain demand allocators for the 2006 cost of service study." Staff concludes that, "[U]sing old analysis and updating the dated results based upon current conditions is not completely unacceptable. However, . . . a more current load analysis and peak study would better serve both the Company and ratepayers."[33]

Staff accepts Delmarva's distribution class cost of service study, but is concerned that the Company does not perform periodic peak or load research studies. Therefore, Staff recommends that the Company be required to perform load and peak allocation studies on a biennial basis and submit a summary of the results to the Commission as a part of a formal report.

OPC argues that the Commission should not rely on Delmarva's CCOSS in determining the allocation of any rate increases for residential customers, based upon a

[33] Prettiman Direct at 15.

number of problems with the Company's CCOSS and allocation decisions. Specifically, OPC disagrees with:

1. The allocation of transformers based on a simple average of maximum coincident demand ("MCD") and non-coincident peak ("NCP");

2. The allocation of services based on MCD, which does not account for the sharing by many residential customers of a single service line to a multi-family building; and

3. The addition of heating and non-heating NCP to calculate the residential NCP rather than calculating a single NCP for the combination of the residential heating and non-heating customers.

OPC, like Staff, criticizes the availability of test year inputs to the allocation factors. OPC notes that Delmarva has not developed information on: (1) the average number of non-heating and heating residential customers; (2) the percentage of non-heating and heating residential customers that live in multifamily dwellings; and (3) the residential class as a whole (treating heating and non-heating customers as a single group).

OPC asserts that a substantial portion of housing in Delmarva's service territory is multi-family, noting that as of 2000, 18.3 percent of customers are in multi-family housing with 2 to 9 units and 11.4 percent are in multifamily units with more than 9 units. Thus, OPC concludes that the residential customers that are sharing DPL services are being over-allocated distribution costs, with a concomitant understatement of the residential class rate of return.

OPC contests the method that Delmarva uses to account for load diversity for the residential class in the derivation of certain allocation factors. OPC asserts that load diversity impacts the cost contribution for the class/group utilizing the equipment. OPC

argues that because all customers in a class do not incur peak loads simultaneously and coincident with the distribution facility's peak, a class group peak will always be less than the sum of each customer's maximum demand. OPC argues that Mr. Wallach's conclusions, `which were not disputed or rebutted by the Company, showed that the NCP for the residential class as a whole was 10 percent lower than the NCP calculated by Delmarva, which results in an increase from 0.86 to 1.05 in the relative rate of return for the residential space heating subclass. OPC therefore recommends an equal percentage across the board increase rather than the Company's proposed distribution of the revenue increase across customer classes.

The functionalization and allocation of costs to customer classes involves a significant level of judgment as to whether a particular cost should be allocated based on a maximum coincident demand ("MCD") or non-coincident peak ("NCP") allocator or a combination of both. As a general matter, we agree with witness Janocha that the distribution of the proposed increase should move the classes in an appropriate fashion towards equalized rates of return. However, we find that more gradualism is appropriate for developing class revenue requirements in this proceeding. We therefore will allocate the revenue increase in the manner proposed by Staff. We recognize that Staff's approach began with the Company's proposed allocation, which sought to move all classes closer to the system rate of return, but adopted a more gradual approach equalizing rates of return as a matter of policy.

We further direct the Company, in its next rate filing to provide (a) NCP calculations for the residential heating and non-heating customers as suggested by OPC; and (b) to submit more recent load and peak data, as suggested by Staff.

I. Rate Design

Following allocation of costs, revenues and expenses among the jurisdictions and customer classes, it is necessary to design rates for each customer class that will recover the assigned revenue requirement. The Company states that its proposed distribution rates are intended to provide to each rate class price signals that reflect cost causation, both between and within rate classes. The Company's goals are to: (1) minimize, to the extent possible, the amount that a particular customer class is paying above or below the system rate of return; and (2) provide price signals that accurately reflect the cost of providing service.

The Company made three significant generic changes to the design of its current rates. It generally proposes increases in the level of costs recovered through the customer charge, increases in the recovery of demand-related costs through the demand charge, and, for certain commercial customers, replacement of what it has termed "minimum charges" with cost-based customer charges.

The Company also tried to close the gap between the residential distribution energy charges in the initial and trailing blocks in the winter months as a first step to removing the seasonal differentiation. It further proposes two major modifications to its Standby Service Rider "S" ("Standby Rider"). The first change is to eliminate a 20 percent discount on demand and energy charges. The second change is to discontinue the practice of grandfathering, which in the past has exempted customers that would otherwise receive standby charges.

In addition to altering the Standby Service tariff, Delmarva proposes the addition of two entirely new riders to the Company's tariff. The first of these is the Telecommunications Network Service Rider. Delmarva also proposed a Reserved Delivery

Capacity Service ("RDCS") Rider to charge for the provision of a separate, additional Company-provided delivery source for those customers desiring redundant service, so as to give those customers enhanced reliability. Finally, Delmarva proposes changes to the premise collection and reconnection charges. The following discussion addresses each of these changes.

1. Residential Rate Design

Delmarva's present residential rate collects revenue from customers on a monthly basis through a fixed monthly customer charge of $3.64 and a charge for energy usage that varies both with the number of kilowatt-hours used ("volumetrically") and the season of the year. In the summer, current residential energy charges for distribution cost recovery are $0.02745 per kWh. In the winter, residential energy charges have a declining block rate design of $0.030965/kWh for the first 1,000 kWh used, declining to $0.019995/kWh for all remaining kWh used during the month.

Delmarva proposes to increase the residential customer charge by 121 percent from $3.64 to $8.04 per month, and to nearly cut in half the difference between the rate for the initial rate block and the rate for the "over 1,000 kWh per month rate block" that applies in the winter months.

The Company contends that its proposed changes strike a balance between moderating the size of the increase while meaningfully redressing the current subsidization of low-usage customers by high-usage customers that results from recovering much of the Company's fixed customer related costs through volumetric rates. Delmarva witness Janocha asserts that the movement to increase the recovery of customer costs in the customer charge reduces the need for a declining trailing block energy rate in the winter.

The net result of the Company's proposal is an initial increase of 3.4 percent for customers that use 1,000 kWh/month.

As noted above, OPC asserts that the Company's proposed modifications to the residential customer charges and winter energy rates are based on a flawed class cost of service study that over-allocated distribution plant to the residential class. OPC states that the Commission should reject the Company's proposal to increase the residential customer charge because residential customers are being saddled with an increase of 121 percent in the customer charge which disproportionately impacts customers with below average usage. OPC therefore recommends that customer and energy charges should be increased in proportion to the overall revenue increase allocated to the residential class.

Staff's rate design witnesses also objected to the Company's proposed 121 percent increase in the customer charge for the residential class. Staff recognized that Delmarva's goal was to increase the proportion of "customer-related" costs that are recovered through the customer charge, ". . . but staff does believe the Commission should continue its gradual approach to altering rate designs."[34] Therefore Staff argues for a 25 percent increase in the customer charge.

Delmarva's proposed residential rate design includes a 121 percent increase in the customer charge that will significantly impact small residential customers. Residential customers who use less than average amounts of electricity each month will receive a rate increase that is higher than the average increase for the residential class. Electric heating customers will be similarly impacted by the Company's proposed reduction in the winter tail block differential.

[34] Staff Initial Brief at 53.

We find that a more gradual approach is appropriate for setting the residential customer charge. After considering the positions of the parties and the record evidence, we conclude that a $6.00 residential customer charge, and an $8.50 customer charge for R-TOU customers, reflect the appropriate balance between gradualism and cost causation. We further direct Delmarva to recover the rest of the residential class distribution revenue requirement in the energy charge. The Company shall use the relative changes in block rates for the winter seasonal energy rate differential proposed in the Company's initial filing.

2. Commercial and Industrial Rate Design

The Company and Staff made rate design proposals for commercial and industrial customers. The Company proposed a reallocation of the revenue requirement within the commercial classes to more equalize class rates of return. Specifically, the Company proposed more of an increase to GSS-Large and Street Lighting and smaller increases to GSS-Small. The Company also proposed customer charge increases consistent with the level of fixed customer costs. Finally, the Company proposed to increase the recovery of demand-related costs through a demand charge and to eliminate the minimum charge for certain classes.

Staff largely supported of the Company's proposed rate design changes for commercial customers. However, Staff noted that moving all the way to the system average return for all classes would be inconsistent with the policy of gradual rate design shifts. Therefore, Staff proposed smaller rate increases for GSS-L and Street Lighting services than proposed by the Company. The Staff supported the proposed customer charges as being reflective of customer costs. Finally, the Staff also supported the Company's proposal to increase the recovery of demand-related costs through the demand charge.

Certain Delmarva customers qualify as standby service customers. They receive a discount on demand and energy charges pursuant to the Standby Service Rider. The Company proposes two major modifications to its Standby Service Rider "S": (1) eliminating the 20 percent discount on demand and energy charges; and (2) discontinuing the exemption for customers that would otherwise be responsible for additional charges for standby service.

Accompanying the changes to the Standby Service Rider is the introduction of a new rider for "Reserved Delivery Capacity Service" ("RDCS"). Finally, the Company proposes to extract the Telecommunications Network service customer billing determinants from the General Service Class and establish a new rate class for cable network facilities. This new customer class will receive a monthly bill containing a customer charge of $17.18 per month (for customers with a meter) or $14.98/month (if the meter is removed). This rate design change was made on a revenue-neutral basis, as the new customer class received no increase under the Company's proposal.

The Maryland Energy Users Group ("MEUG") opposes the proposed RDCS service. MEUG argues that Delmarva's proposed RDCS rider inappropriately focuses on an element of the cost of service for certain customer classes, and that Delmarva provides redundant capacity to other customers without additional charges. MEUG asserts the RDCS is duplicative of charges that Delmarva has already collected in Contributions in Aid of Construction that it has used to recover the costs for providing dual feed service. Finally, as a policy matter MEUG argues dual feed service to high priority customers should be considered standard service and not be made subject to a surcharge.

Staff proposes rates for General Services Secondary-Large and Street Lighting services that increase the returns for these two classes and cause them to move toward the system average rate of return, but not all of the way to unity. Staff notes that the standby service tariff was initiated in Case No. 8975 Phase II, by a settlement agreement. Staff does not support the removal of the current 20 percent discount applied to the Standby Service Schedule S tariff. This is so, in part, because customers would have to pay distribution rates for their entire load, including behind the meter generation. Citing the principle of gradualism and giving recognition to the value of demand response and distributed generation to the entire electric system, Staff suggests that the Demand Response Distributed Generation Working Group should take the lead in beginning to develop the rules for the implementation of Standby Service Tariffs. Finally, Staff did not oppose the Company's proposal to institute the RDCS Rider.

The Commission adopts Delmarva's proposed changes to the rate elements for all commercial classes except the Street Lighting and General Service Secondary Large class. The Commission further finds that the Staff's proposal is more appropriate for developing the rate elements for the Street Lighting class and General Service Secondary Large class.

The addition of a reserved delivery capacity service rate was strenuously opposed by MEUG. During the hearings, the numbers of customers affected by the change were disputed as well as the impact of the change on customers who have paid a contribution in aid of construction. Policy issues of whether public purpose customers, such as hospitals, should have to pay for heightened service reliability through system redundancy are also of concern to the Commission. Moreover, the record indicates that customers currently receiving redundant service may well have paid an upfront charge for that service through

contributions in aid of construction. Under the circumstances, the Commission directs the Company to identify all customers currently receiving redundant service and to exempt them from the RDCS. However, the RDCS is approved for application to customers seeking redundant service from this day forward.

In light of our policy of facilitating deployment of distributed generation, the Commission rejects the proposed changes to the Standby Service Rider. The issues raised by Staff's discussion of distributed generation is appropriately addressed in the Demand Response Distributed Generation Working Group. We direct Delmarva to address the issues of distributed generation and a revised Standby Charge in the Demand Response Distributed Generation Working Group.

3. Telecommunications Network Service Rider

With respect to the proposed service classification Telecommunications Network Service ("TN"), Comcast and Delmarva achieved a settlement on this service. At the hearing, the settlement was described as an agreement on the TN rate class revenue requirement and on the rate design for the TN classes. The Commission adopts the proposed settlement of the issues surrounding the Telecommunications Network service classification as consistent with the public interest. Delmarva shall file a copy of the settlement reached with Comcast with the Commission, identifying any particularized areas of agreement not reflected in the Company's filed tariff.

4. Miscellaneous Fees

The Premise Collection Fee presently is $15.00. Delmarva charges customers for receiving a payment at the customer's premise, rather than through the internet or regular mail. The Reconnection Fee is the charge for restoration of service. The current fees for

reconnection are on a sliding scale from $30 to $90 depending on when the restoration is requested (work-day, weekend and holidays, after hours).

Delmarva proposes to increase the Premise Collection Fee to $38.00 and the Reconnection Fee to a sliding scale ranging from $75 to $125. Delmarva asserts that the proposed fee structure will bring these fees more in line with the costs associated with their related activities.

Staff has reviewed the costs provided by Delmarva and believes that the new fees for premise collection and reconnection of service reflect the cost of providing the services. Staff supports the increase in premise collection, reconnection and the other miscellaneous tariff changes, consistent with its proposed modifications within each rate class. OPC took no position on the Premise Collection Fee and Reconnection Fee increases.

The Commission approves Delmarva's proposed Premise Collection Fee increase as a means of making the fee for the service more reflective of the costs of providing the service. However, public policy compels us to reject the Company's proposed Reconnection Fee increase. This fee is imposed on customers whose service has been disconnected, primarily due to nonpayment of delinquent bills. We believe that the proposed increase in the Reconnection Fee will only add to the difficulty low-income customers' face in maintaining their electric service. Although we recognize that this decision shifts the cost of reconnecting specific customers to other customers, we believe this is the better policy choice.

The Company also filed language clarification and other tariff revisions in witness Janocha's Exhibit JFJ-9, which are uncontested. We approve these miscellaneous tariff revisions.

IV. CONCLUSION AND ORDERED PARAGRAPHS

In conclusion, upon review of the record, we find that the application for a rate increase of $20,333,000 filed by Delmarva on November 17, 2006 will not result in just and reasonable rates and is therefore rejected. Instead, we find that based on an adjusted test year of the 12 months ended September 30, 2006, the Company is authorized to file revised temporary rates and charges for an increase of $14,882,000.00, which amount will result in just and reasonable rates to the Company and its customers pending further proceedings and the issuance of a final rate order. These temporary rates shall be in effect for an initial period of nine months from the date of this Order. Accordingly, the Company may file revised tariffs for such increase in accordance with the rate design and decisions in this Order effective with service rendered on or after June 16, 2007, the termination of the full suspension period provided by law.

IT IS, THEREFORE, this 19th day of July, in the year Two Thousand Seven, by the Public Service Commission of Maryland,

ORDERED: (1) That the application of Delmarva Power & Light Company filed November 17, 2006, seeking to increase distribution rates for electric service by $20,333,000, is hereby denied;

(2) That Delmarva Power & Light Company is hereby authorized, pursuant to Public Utility Companies Article § 4-205, to file tariffs for distribution of electric service that will increase rates on a temporary basis by $ 14,882,000.00 for service on or after June 16, 2007 in accordance with the findings of this Order. These temporary rates shall be in effect for an initial period of nine months from the date of this Order;

(3) That such tariffs shall be subject to acceptance by the Commission;

(4) That the Company shall notify the Commission within fourteen days of this Order when its expects to submit an independent audit opinion pursuant to Public Utility Companies Article § 4-208, after which the Commission will establish a procedural schedule for a second phase of this proceeding in which the Commission will in which the Commission will (a) determine the Company's compliance with Public Utility Companies Article § 4-208; (b) review service company costs to determine whether costs allocable to the Company and its affiliates have declined or should decline as a result of the closing of three subsidiary companies' operations; (c) determine the extent, if any, to which these temporary rates should be adjusted to account for service company operating costs; (d) determine the extent, if any, to which the service company costs allocated to the Company should be reduced; and (e) determine whether, because of our approval of a temporary rate, we should permit the Company some flexibility in the timing and mechanics of implementing the increase we approve today and any increase we approve in a final rate order;

(5) That the Company shall adopt monitoring and reporting requirements with respect to the Bill Stabilization Adjustment as noted in this Order, and shall provide the first report within 90 days, with further review of the BSA occurring in a new proceeding;

(6) That the Company shall address issues of Distributed Generation and a revised Standby Charge in the Demand Response distributed generation Working Group; and

(7) That the Company shall file a copy of the settlement reached with Comcast identifying any particularized areas of agreement not reflected in the Company's filed tariff.

/s/ Steven B. Larsen

/s/ Harold D. Williams

/s/ Allen M. Freifeld

/s/ Susanne Brogan
Commissioners

APPENDIX I

DELMARVA POWER & LIGHT COMPANY
CASE NO. 9093

Revenue Requirement
($000's)

Rate Base	267,313
Rate of Return	7.68%
Required Income	20,530
Adjusted Income	11,728
Income Deficiency	8,802
Conversion Factor	1.6908
Revenue Requirement	14,882

Rate Base
($000's)

Uncontested Rate Base	268,606
Adjustments:	
Conectiv Merger Ratemaking	130
Reject Adjustment for CWIP	0
Reflect New Depreciation Rates	(1,423)
Adjusted Rate Base	267,313

Operating Income
($000's)

Uncontested Operating Income	12,286
Adjustments:	
Interest Synchronization	(599)
Cost of Base Rate Filing	(38)
Customer Care Costs	(179)
Vehicle Costs	(162)
PHI Service Company Costs	0
Reflect Conectiv Merger Ratemaking	(129)
Reject Price Elasticity Adjustment	0
Reject Adjustment to AFUDC	0
Reject Revenue Days Adjustment	0
Cambridge Environmental	0
New Depreciation Rates	549
Adjusted Operating Income	11,728

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 CHANGES.	* * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9093

CONCURRING STATEMENT OF COMMISSIONER WILLIAMS.

I join in the Commission's decision in this case. I acknowledge that I joined in the Commission's ruling in Order No. 80080, discussed at pp. 6-7 above. But after reconsidering carefully the "independent audit opinion" requirement in Public Utility Companies Article §4-208 in connection with these proceedings, I am persuaded that the Commission's analysis in Section II of this Order is correct, notwithstanding our prior decision.

/s/ Harold D. Williams
Harold D. Williams
Commissioner

Dated: July 19, 2007

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 CHANGES.	* * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9093

DISSENT OF COMMISSIONER ALLEN M. FREIFELD

I disagree with the decision declaring the rates authorized by the Commission today to be "temporary." The Company's proposed rates were filed nearly eight months ago; the statutory suspension period expired a month ago; the rate request has been investigated by the Commission and multiple parties through the pre–filing of testimony; extensive discovery; several weeks of hearings; and the filing of Briefs and Reply Briefs. To characterize the end result of this process as a 'temporary rate' seems wrong. The suspension, investigation and hearing process summarized should culminate in the Commission issuing a 'final' rate Order. To characterize the rates as temporary adds an unnecessary and unhealthy element of uncertainty to Maryland's regulatory process.[35]

The Commission has taken this action because of its concerns with respect to cost allocation between Pepco, Delmarva, and their parent company. The Commission should, of course, investigate these matters as thoroughly as necessary. However,

[35] The Commission's reliance upon § 4-205, Md. Ann. Code, Public Utility Companies Article, to set temporary rates is misplaced. A prerequisite to invocation of that section is that "a temporary rate is necessary in view of the length of time that must elapse before a final order may be entered." § 4-205 (b)(2) Given the nearly eight months that the rate application has already been pending, it cannot be fairly said that a temporary rate is necessary in view of the length of time that must elapse before a final order may be entered.

instituting a further investigation of this matter does not require the decision entered into herein to be 'temporary'. This is particularly so given the record in this proceeding. The Company has filed an Officer's affidavit affirming that the cost allocation principles contained in the Company's Cost Allocation Manual (CAM) comply with all applicable Commission rules and regulations, and an independent auditor (Ernst & Young) has performed the procedures agreed upon with the Commission Staff for review of the allocation of affiliate costs. This agreed-upon procedures engagement was conducted in compliance with the attestation standards of the American Institute of Certified Public Accountants. Ernst & Young's Report notes that every transaction it reviewed was consistent with the Company's Cost Allocation Manual. The CAM was filed by the Company consistent with the Commission's affiliate transaction rules and other Commission orders governing affiliate transactions. *See*, COMAR 20.40. Importantly, there is no evidence contradicting either the affidavit or the Ernst & Young Report.

In sum, the record developed in this proceeding establishes the reasonableness of the costs – and the rates authorized herein should be final. There is no factual basis upon which to declare this Order 'temporary'. The Commission can investigate this issue further, and a different record may compel a different conclusion, but the Commission is required to base its decisions on the record (Md. Ann. Code, Public Utility Companies Article, § 3-113), and the record developed in this proceeding offers no basis upon which to declare this Order 'temporary.'

The Commission is concerned that the cover page to the Ernst & Young Report contains this statement:

> We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the Company's compliance with the CAM requirements. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

Due to this passage, the Commission concludes that the Ernst & Young Report does not satisfy § 4-208, Public Utility Companies Article. The Commission relies on this passage and gives little weight to the rest of the Report or what Ernst & Young actually found.

The Ernst & Young Report indicates that Ernst & Young reviewed all portions of the CAM for compliance with COMAR 20.40, affiliate transactions. Specifically, Ernst & Young:

- Agreed the amounts reported by Pepco & Delmarva as affiliate transactions to the books of the Regulated Electric Companies without exception;
- Documented the Regulated Electric Companies' and the service affiliates' intercompany billing processes; and
- Found that the allocation of building use based on square footage by the companies is consistent with the CAM.

For costs allocated to the Regulated Electric Companies, Ernst & Young:

- Selected a random sample of 50 disbursements and noted that the cost center coding was consistent with the invoice support and was in agreement with the coding requirements of the intercompany billing procedures and the procedures outlined in the CAM;
- Randomly selected 25 service affiliate employees and 25 dates and reviewed their work description, time charged, and noted that the time reported complied with the procedures outlined in the "Time Reporting" section of the CAM;
- Obtained service affiliate total billings to all affiliates,

- Identified 12 cost centers that had direct charges greater than $2 million dollars;

- Obtained supporting documentation on the fully distributed hourly rates used to bill affiliates for service affiliate employee time;

- Recomputed 12 activity type hourly rates from the supporting documentation without exception and noted that the activity type price hourly rates were calculated in agreement with the CAM;

- Identified the 18 cost centers that allocated amounts greater than $2 million dollars and for these 18 cost centers;

- Documented the quarterly calculation of the allocation factors used to allocate service affiliate costs to the Regulated Electric Companies, and

- Recomputed the 18 allocation factors without exception and noted that the allocation factors were developed in agreement with the ratio descriptions included in the CAM and the service affiliate charging procedures included in the CAM.

For each of the cost centers, Ernst &Young tested the application of the activity type prices and allocation factors to the service affiliates' billings to the Regulated Electric Companies for the months of January, February, and July 2006. Ernst & Young noted that the 12 activity type price hourly rates and 18 allocation factors agreed to the hourly rates and the corresponding allocation factors without exception.

Public Utility Companies Article § 4-208 required Pepco and Delmarva to file an independent audit opinion with its request for a change in rates. The phrase "audit opinion" is not directly defined in the statute, but the Commission's decision reflects a determination that the Ernst & Young Report does not satisfy the statutory requirement.

While the phrase "audit opinion" is not directly defined in the statute, § 4-208(b)(2) does describe precisely what the independent auditor shall do:

> The independent auditor shall:
>
> (i) examine:
>
> 1. compliance by the public service company with policies and procedures of the public service company's cost allocation manual;
> 2. proper allocation of costs to an affiliate of the public service company in accordance with the manual; and
> 3. appropriate charging of costs and transactions relative to the manual to the public service company and its affiliates; and
>
> (ii) identify adjustments that should be made:
>
> 1. to the manual consistent with prior Commission rulings; and
> 2. to the public service company or to an affiliate of the public service company relative to the examination of the allocation of costs and charging of costs and transactions.

It seems to me that the Ernst & Young Report does exactly what is required by § 4-208. The Commission's reliance upon the passage noted above in spite of what Ernst & Young actually did is unreasonable. [36]

Of course, the Commission can require more information from the Company, but it should do so after appropriate notice and in a timely fashion. To wait until this date - issuance of the Order – to declare the Report inadequate is not appropriate, particularly given the fact that the scope of the Ernst & Young Report was negotiated with the

[36] The Commission addressed this same issue in Case No. 9036. The Commission affirmed the adequacy of a Report similar to that at issue here. The Commission accepted the contention that the statutory reference to an independent audit opinion must be understood in its ordinary meaning, not in a technical accounting sense, because in accounting jargon an audit refers to review of a Company's financial statements, and the CAM is not a financial statement. Moreover, the Commission noted that the report in that case (like the Report herein) did in fact express opinions regarding compliance with the CAM. (Case No. 9036, Order No. 80080, July 6, 2005)

Commission's Staff prior to the filing. In any event, requiring more information on a prospective basis does not render the Ernst & Young Report insufficient under the statute. Furthermore, requiring more information on a prospective basis should not render the decision issued today 'temporary'. For all these reasons, I would have preferred that the Commission issued a final rate order a month ago and docketed a further proceeding for prospective adjustments, if any are ultimately found necessary. Finally, if the Commission is going to reject the Ernst & Young Report as inadequate it would be helpful to provide some guidance as to what would be adequate.

/s/ Allen M. Freifeld
Allen M. Freifeld
Commissioner

July 19, 2007

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 CHANGES.	* * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND CASE NO. 9093

STATEMENT OF COMMISSIONER BRENNER

Because I was not a member of the Commission at the time the record in this case was submitted or at the time of the hearings, I did not participate in this proceeding and therefore cannot join the Commission's opinion. However, I write to note my agreement with the legal analysis contained in Section II of the Commission's opinion that, as a matter of law, the Ernst and Young report the Company submitted for the purpose of satisfying Public Utility Companies Article § 4-208 cannot satisfy the Company's obligation to submit an "independent audit opinion." I further agree that it is appropriate in these circumstances to set temporary rates pursuant to § 4-205. I will participate fully in Phase II of this proceeding.

/s/ Lawrence Brenner
Lawrence Brenner
Commissioner

DATED: July 19, 2007