ORDER NO. 81517

IN THE MATTER OF THE APPLICATION OF POTOMAC ELECTRIC POWER 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. 9092

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

The Potomac Electric Power Company ("Pepco" or "Company") has filed for a rate increase of $55.7 million, representing an approximate 3.9 percent increase in the typical monthly bill for a Standard Offer Service residential customer using 800 kWh per month. During the course of this case, Pepco reduced its request to $49.2 million. After consideration of the record in this case, we have concluded that the Company may, as a temporary rate set pursuant to Public Utility Companies Article § 4-205, increase rates by $10,606,000, which represents an approximate 0.56 % increase in the typical monthly bill for a Standard Offer Service residential customer using 800 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 Pepco 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, 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.

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. The Commission has rejected a separate proposed surcharge by the Company which would allow recovery of changes in Pension and Other Post Employment Benefits ("POPEB") costs.

The decision also adopts a proposed new "Present Value" methodology for calculation of costs of removing depreciated property. This change in depreciation policy from the prior Straight Line Method advocated by the Company results in a large reduction in depreciation expense recovered in rates. The Commission 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.

We are aware of the concerns stated by various customers with their own generation who are members of the Standby Service Class and reject the Company's proposed changes to such service at this time. However, we specifically direct that the Company raise any issues regarding changes in such service class in the Demand Response Distributed Generation Working Group.

APPEARANCES

Kirk J. Emge, Paul H. Harrington, Mindy L. Herman, Richard M. Lorenzo, Arthur W. Adelberg, and Francis X. Wright, for Potomac Electric Power Company.

Kirk Howard Betts, David E. Crawford, and Deborah S. Howard, for the University of Maryland-College Park.

Frann G. Francis and Lesa Noblitt Hoover, for the Apartment and Office Building Association of Metropolitan Washington.

Robert C. Smith, for the General Services Administration of the Federal Government.

Joseph J. Zimmerman, for the Washington Metropolitan Area Transit Authority.

Telemac N. Chryssikos, for Washington Gas Energy Services, Inc.

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

Theresa V. Czarski, Michael C. Flannery, and Pauline C. Onyemaechi, for the Maryland Office of People's Counsel.

James W. Boone, Annette B. Garofalo, and Todd E. Givens, for the Staff of the Public Service Commission of Maryland.

Brian Lederer, for the International Brotherhood of Electrical Workers, Local Union 1900.

Channing D. Strother, Jr., for the Montgomery Chapter of the Maryland Municipal League.

Brian R. Greene, for Retail Energy Supply Association.

Joelle K. Ogg, for the National Energy Marketers Association.

Gary R. Alexander and James K. McGee, for Consolidated Edison Solutions, Inc.

I. INTRODUCTION

On November 17, 2006, Potomac Electric Power Company ("Pepco," "Applicant" or "Company") filed with the Commission an application for an increase in its distribution rates of $55.7 million, representing an approximate 3.9 percent increase in the typical monthly bill for a Standard Offer Service ("SOS") residential customer using 1,000 kWh per month, according to the Company. The initial application was based on a test year period of the 12 months ending September 2006, with the application providing six months actual data and six months projected data. During the course of the proceeding, the Company updated its projected data with actual results of operations, and in its final position the Company seeks an increase of approximately $49.2 million. The application further notes that the Company's last authorized increase in base rates was granted in 1998, and since that time the Company has decreased its residential distribution rates by about seven percent for residential customers and four percent for non-residential customers pursuant to electric restructuring.[1] This case marks Pepco's first base rate increase as solely a distribution company, and Pepco asserts that costs have risen over the last several years so that an increase is necessary. The Company contends that its return from Maryland operations has declined over the past several years so that an increase is now warranted, claiming that it

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[1] The Company's electric restructuring rates were reached in Case No. 8796, which rates were capped at reduced levels until July 2004. *Re Pepco*, 90 Md. PSC 329 (1999); *Re Pepco*, 91 Md. PSC 170 (2000).

The rate cap was also extended for an additional 30 months as a result of settlements reached by the parties in the Pepco/Conectiv merger proceeding, Case No. 8890. *Re Pepco*, 93 Md. PSC 134 (2002). In accordance with the merger settlement, the Company's rates were also reviewed in 2004 in Case No. 8995, with no change directed from that proceeding. *Re Pepco*, 95 Md. PSC 136 (2004).

currently realizes a return of just 3.27 percent on common equity and that major credit rating agencies have downgraded the Company's credit ratings, which underscores the necessity of allowing Pepco the opportunity to earn a reasonable rate of return.

By Order No. 81147, entered on December 11, 2006, the Commission suspended the proposed rate increase and instituted proceedings as to the justness and reasonableness of the proposed rates. The suspension Order, which was also filed in Case No. 9093 regarding the rate application of Pepco's sister company, Delmarva Power and Light Company ("Delmarva"), also directed Pepco (as well as Delmarva) to file an independent audit opinion regarding the Company's Cost Allocation Manual ("CAM audit") required by Section 4-208 of the Public Utility Companies Article.[2] An additional suspension order was issued in the instant case on May 11, 2007 in Order No. 81408.

A pre-hearing conference in this matter was held on January 3, 2007, notice of which was published in newspapers of general circulation throughout the service territory of the Company. At the pre-hearing conference, the Commission accepted interventions by the Office of People's Counsel ("OPC" or "People's Counsel"), the Commission's Staff, the Apartment and Office Building Association of Metropolitan Washington ("AOBA"), the General Services Administration of the Federal Government ("GSA"), Comcast of Potomac, LLC ("Comcast"), University of Maryland-College Park ("UMCP"), Washington Gas Energy Services ("WGES"), and the Washington Metropolitan Area Transit Authority ("WMATA"). During the course of the proceeding, late interventions have also been granted to the National Energy Marketers Association ("NEMA"), the Retail Energy Supply Association ("RESA"), the International Brotherhood of Electrical Workers ("IBEW"),

[2] The independent audit opinion, prepared by Ernst & Young, LLP, was filed in a confidential report on January 18, 2007.

Consolidated Edison Solutions, Inc. ("ESI"), and the Montgomery Chapter of the Maryland Municipal League ("MCMML"). Pursuant to the schedule adopted following the pre-hearing conference, a procedural schedule was developed which provided for hearings held on April 12, 13, and 16, 2007 at the Commission's offices in Baltimore, Maryland, notice of which was advertised throughout the service area. Also, following the conclusion of the evidentiary hearings, evening hearings for the purpose of receiving public comment were advertised and held on May 22, 2007, in College Park, Maryland, and May 23, 2007, in Rockville, Maryland.

Pursuant to the procedural schedule established in this proceeding, initial briefs were filed on May 4, 2007, and reply briefs on May 15, 2007. On May 24, 2007, various other utilities filed an Amicus Brief with respect to the issue of accounting for cost of removal in depreciation rates. Staff and OPC have filed Motions to Strike the Amicus Brief, as the Amicus Brief did not include a motion requesting its admission and it 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. POSITIONS OF THE PARTIES

As noted above, this case concerns the application by Pepco for a rate increase, which is based on actual results for the test year ending September 30, 2006. Following updated figures and after adjustments accepted by the Company through the course of the proceeding, Pepco reduced its request and is seeking an increase of $49,215,000. This case constitutes Pepco's first distribution rate increase since the divestment of its generation plants, and would be the first increase in distribution rates for the Company since 1998. The Company seeks a return on equity of 11.0 percent, which utilizing its current capital structure results in an overall cost of capital of 8.47 percent. However, Pepco also proposes several unique tariff provisions regarding a Bill Stabilization Adjustment ("BSA"), as well as an innovative pension surcharge rider ("POPEB")[3] which if granted would reduce risk and volatility to the Company. Therefore, parties are in agreement that these adjustment trackers may result in a reduction to the return on equity, although the parties disagree as to what the appropriate reduction should be if these innovative tariff proposals are accepted.

Accordingly, the appropriate return and BSA and POPEB riders are major issues in this proceeding with certain parties opposing the Company's positions. Other significant issues concern the appropriate depreciation methodology, the policies regarding construction work in progress ("CWIP") inclusion in rate base, and the charges allocated to Pepco from its affiliated service company as Pepco is a subsidiary of Pepco Holdings, Inc. ("PHI") and receives services from the affiliated entity, PHI Service Company. Therefore, while Pepco contends a rate increase in excess of $49 million is warranted, OPC contends the requested increase should be rejected in its entirety, as in fact People's Counsel argues that the Company's rates should be reduced by $46,665,000, with the refund largely due to differences in depreciation methodology. The Commission Staff has also made a full evidentiary presentation in this case, and concludes that a rate increase of $10,905,000 has been justified. The other intervening parties in this case have come up with various recommendations and positions with respect to specific issues, with a prime concern of many intervenors being the rate design of the final rates determined in this proceeding. In

[3] "POPEB" refers to "Pension and Other Post-Employment Benefits."

this regard, the intervening parties who are customers of Pepco (AOBA, GSA, Comcast, MCMML, UMCP, and WMATA), while discussing certain specific ratemaking issues of interest in this proceeding, have generally expressed primary concern with respect to the rate design and impacts on their rate classes, including the apportionment of rates among the various rate classes as they seek to move class allocations closer to the system average return.

In this proceeding, Pepco has presented the testimony of ten witnesses in support of its application. Joseph M. Rigby, Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc., presented testimony regarding an overview of the application as well as the revenue impacts. Dr. Roger A. Morin, Professor of Finance and principal in the Utility Research International economic consulting firm, presented testimony regarding the Company's cost of capital in this proceeding, while Steven M. Fetter, President of the consulting firm Regulation UnFettered, presented testimony regarding risk facing Pepco as a distribution utility. Linda J. Hook, Regulatory Affairs Manager for PHI, presented testimony regarding the Company's lead lag study and cash working capital component of rate base. Frank J. Salatto, III, Manager-Tax Accounting for PHI, presented rebuttal testimony in this proceeding regarding the appropriate tax accounting for the Company as the appropriate tax calculation, especially regarding state income tax, has been raised by other parties. W. Michael VonSteuben, Manager-Revenue Requirements for PHI, presented testimony regarding operating income adjustments proposed by the Company as well as other adjustments proposed by other parties in this proceeding. Dr. Mark E. Browning, Director of Rates and Technical Services for PHI, presented testimony regarding cost allocations as well as the proposed BSA rider and sales adjustments sought by the Company in this proceeding. Dr. John H. Chamberlin, a consultant with Quantec, LLC, presented testimony on behalf of Pepco with respect to the BSA adjustment, especially with respect to the effect on risks of such an adjustment. J. Reed Bumgarner, Manager of Pricing and Regulatory Affairs for Pepco, presented testimony regarding appropriate rate design, including the proposed POPEB surcharge tariff requested by the Company. Earl M. Robinson, a principal and Director of AUS Consultants, testified on behalf of the Company with respect to the appropriate depreciation expense reserves, remaining lives, and salvage that should be utilized in this proceeding.

The Office of People's Counsel presented a comprehensive review of the Company's application presenting three witnesses during the course of the evidentiary hearings. Charles W. King, President of the economic consulting firm of Snavely King Majoros O'Connor and Lee, Inc., presented testimony regarding the rate of return and also depreciation and cost of removal, as he advocates a marked departure from past Commission precedent regarding depreciation, advocating use of a five-year average for depreciation expense rather than the use of the accrual method of accounting for future cost of removal included in depreciation rates. Jonathan F. Wallach, Vice President of Resource Insight, Inc., presented testimony on behalf of OPC with respect to the BSA, the cost allocations study, and the proposed residential rate design. David J. Effron, a consultant specializing in utility regulation, testified for OPC with respect to the appropriate rate base and operating income to be utilized in this proceeding and presented proposed adjustments on behalf of the residential customer class.

The Commission Staff also presented a comprehensive review of issues in this proceeding through testimony of witnesses. Merwin R. Sands, Director of the Economics and Policy Analysis Division of the Commission, provided testimony regarding a summary and overview of the Staff positions in this case. Timo Partanen, a Regulatory Economist in the Staff's Division of Economics and Policy Analysis, presented testimony with respect to the cost of service study and cost allocation methodologies utilized for rate design purposes. Donna H. Mullinax, Executive Vice President and Chief Financial Officer of Blue Ridge Consulting Services, Inc., testified on behalf of Staff with regard to accounting adjustments to determine the appropriate rate base and operating income to be used in this proceeding. William W. Dunkel, a consultant retained by Staff who is a principal with William Dunkel and Associates, presented Staff's recommendation with respect to depreciation, including recommending use of "present value" treatment for net salvage. Gunter J. Elert, Regulatory Economist in the Division of Economics and Policy Analysis, testified with respect to the appropriate cost of equity capital, overall rate of return, and capital structure for Pepco. Kevin D. Mosier, also a Staff Regulatory Economist, testified with regard to a review of the Company's proposed BSA, and about which Staff recommends approval. Daniel J. Hurley and Faina Kashtelyan, both Staff Regulatory Economists, appeared jointly as a panel with respect to proposed rate structures for Pepco and rate design, as well as providing testimony on certain specific tariffs and fees proposed in this proceeding.

As noted, the intervening parties in this proceeding presented testimony and recommendations with respect to the cost of service and revenue allocations that impact the rate design of their respective interests, while also presenting testimony and commentary on other specific ratemaking issues of interest. The University of Maryland presented two witnesses in this proceeding, David C. Parcell, Executive Vice-President and Senior Economist of Technical Associates, Inc., who presented testimony with respect to the rate of return as well as the appropriateness of the BSA proposal; and Robert C. Smith, Vice-President of GDS Associates, Inc., who presented testimony regarding rate design issues (including the Company's Standby Service), as well as certain selected revenue requirement issues. Dr. Dennis W. Goins, a consultant with Potomac Management Group, testified on behalf of GSA with respect to rate design and Standby Service. Bruce R. Oliver, President of Revilo Hill Associates, Inc., testified on behalf of AOBA, commenting on numerous aspects of the Company's proposal in this case, including opposition to the BSA as well as opposition to the Company's rate of return, certain operating income adjustments, and rate design proposed by the Company, with AOBA recommending no rate increase be granted as it believes the reasonableness of the Company's affiliated service company charges have not been adequately supported and require further review. Dr. William G. Foster, President of Foster Economic Research, testified on behalf of WMATA, with respect to the rate of return and proposed BSA and POPEB adjustment mechanisms. Paul H. Raab, an independent economic consultant, testified on behalf of Comcast with respect to Staff's proposed rate design and argued in favor of a rate decrease for certain classes of customers.

None of the other intervening parties have presented testimony in this matter, although Washington Gas Energy Services has participated in the hearing through cross-examination of witnesses and also filed a brief in this matter raising questions regarding the functionalization of Pepco's SOS costs and possible inclusion of such costs in distribution rates, as WGES asserts such costs have not been completely removed from distribution rates.

At the evening hearings held in this matter for receipt of public comment, two persons attended the College Park evening hearing and commented in opposition to the

Company's proposed increases in the Standby Service rates applicable to those customers with their own electric generation who are participants in the Pepco Standby Service class. No customers appeared at the Rockville evening hearing.

All of the testimony and evidence on the record, as well as the comments of the public and the arguments of the parties on brief, have been carefully reviewed and considered in rendering a decision in this matter.

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

> <u>We were not engaged to and did not conduct an audit</u>, the objective of which would be the expression of an opinion on the Company's compliance with the CAM requirements. <u>Accordingly, we do not express such an opinion</u>. 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, "<u>shall</u> file an <u>independent audit opinion</u> prepared by an entity approved by this Commission,"[6] and the

[4] Order No. 81147 (December 11, 2006), at 13. This Order applied both in this case and in Case No. 9093.
[5] Emphasis added.
[6] Public Utility Companies Art. § 4-208(b)(1)(ii)(1) (emphasis added).

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 care to distinguish its report from an audit if that distinction lacked substantive professional meaning. Put another way, we 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)."

[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).

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, 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.

IV. DEPRECIATION

A. Background

Depreciation is the method companies use to recover the original cost of their investment 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. As in this case, net salvage is negative if 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 more than $60 million in contested revenues. While there is some disagreement regarding the appropriate plant-only depreciation rates, there is a significant controversy regarding the proper method to recover removal costs. Pepco 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 proposes to recover removal expenses using a historical average of actual costs. Staff recommends using the Present Value Method to calculate removal costs, which represents an amount between the Company's and OPC's proposals. Additionally, OPC proposes returning the current removal cost reserve to ratepayers, which the Company and Staff oppose. For the reasons explained herein, the Commission adopts the Present Value Method, which reduces the Company's current annual depreciation expense.

Pepco presented the testimony of Earl M. Robinson, Principal and Director of AUS Consultants and Dr. Mark Browning, PHI's Director of Rates & Technical Services. The Maryland Office of People's Counsel offered the testimony of Charles W. King, President of the economic consulting firm Snavely King Majoros O'Connor & Lee, Inc. Staff filed the testimony of William W. Dunkel of William Dunkel and Associates.

Mr. Robinson notes that Pepco'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 uses the Straight Line Method to recover depreciation expenses because it is widely understood and utilized almost exclusively for depreciating utility property. Net salvage is based upon historical experience and future estimates of the cost of removal and gross salvage amounts. More weight is given to recent experience with a gradualism toward forecast net salvage.

Pepco's current annualized depreciation expense is $90,331,083 when applied to its year-end 2005 Distribution and General Plant. Mr. Robinson proposes decreasing this amount by $9,356,997 to $80,974,090 annually. Pepco's current composite (plant and salvage) depreciation rate, based on 12-31-05 plant, is 4.55 percent. Mr. Robinson's proposals reduce this rate to 4.07 percent. According to Mr. Robinson, the Company's current depreciation rates are based on a study using plant investment as of December 31, 1990 for Pepco-Maryland.

Staff offers two alternative depreciation recommendations, based on whether the Commission adopts the Company's or OPC's average service lives ("ASLs") and plant-only rates for the various individual plant accounts. Based upon Pepco's plant-only rates and ASLs and Staff's cost of removal recommendation, Staff proposes an annual depreciation accrual of $59,636,231, which results in a 3.00 percent rate. If OPC's plant-only rates and service lives are used, Staff's recommendation is $49,844,461, which results in a 2.51 percent rate including Staff's cost of removal rates.

Mr. King states that his recommended depreciation and removal cost rates yield a total annual accrual of $44.6 million, based on year-end 2005 plant. This results in a composite depreciation and removal cost rate for Pepco's Maryland plant of 2.37 percent. Additionally, Mr. King recommends the amortization of Pepco's current removal cost reserve balance of $36.2 million over five years, which would result in an annual credit to ratepayers of $7.24 million.

B. Plant-Only Rates

Mr. King conducted a life analysis of Pepco's Distribution and General Plant accounts. He concludes that of approximately 25 accounts all but five of Mr. Robinson's proposed service lives are supported by the data and accepts Mr. Robinson's proposals for the remaining accounts. Mr. King disagrees with Mr. Robinson's proposed service lives for

Accounts 364 (Poles, Towers & Fixtures), 366 (Underground Conduit), 367 (Underground Conductors & Devices), 370 (Meters), and 391.3 (Information Systems).

Both OPC and Pepco conducted an actuarial analysis of the various plant accounts. They concur that the average service lives for Accounts 364 and 367 should be increased, which results in a decrease in proposed depreciation rates for these accounts. However, Mr. King proposes larger increases in the ASLs and criticizes Mr. Robinson for not adhering to the results of the actuarial analysis. Mr. Robinson responds that his recommendations incorporate an analysis of industry data and Company-specific information in addition to the actuarial results.

Pepco proposes reductions in the ASLs for Accounts 366, 370, and 391.3 that would increase the proposed depreciation rates. OPC recommends no change in the ASLs for these three accounts. Mr. Robinson asserts that historical data in many cases is significantly limited and does not produce reasonable ASLs that can be anticipated in the future. He points to Account 391.3 (Information Systems) to support his viewpoint. According to Mr. Robinson, computer equipment typically experiences a useful service life of approximately five years. However, Mr. King's actuarial analysis indicates that a 20 year service life can be expected. Mr. Robinson argues that such a result simply proves that this historical data is not representative of the real use of this equipment. Mr. Robinson concludes that all factors anticipated to affect a property group must be considered when estimating a useful average service life rather than performing a simple arithmetic analysis of the overall historical data.

Mr. King concludes that his plant-only depreciation rate for Distribution Plant is 1.86 percent, while Pepco's is 2.13 percent. His plant-only depreciation rate for General Plant is

4.81 percent, while Mr. Robinson's rate is 4.96 percent. When applied to year-end 2005 plant, Mr. King's recommended plant-only depreciation rates generate $5.2 million less in annual accruals than Mr. Robinson's proposed rates.

C. Removal Cost Rates

According to Mr. Robinson, Pepco's current cost of removal reserve of $36.2 million is substantially less than the $326.2 million theoretical reserve he has calculated is necessary to make Pepco 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 $234 million cost of removal deficit based on a theoretical reserve of $269.8 million. Moreover, Mr. Robinson points out that the cost of removal is rising rapidly, being $9.0 million in 2005 alone. 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. According to Dr. Browning, the Company's traditional removal cost methodology accrues an equal amount each year in nominal dollars so that at the time of retirement there is a sufficient amount in the depreciation reserve to cover the expense of removal of the assets. Based upon the Straight Line Method of recovery, Mr. Robinson proposes $37.2 million in annual removal cost accruals.

OPC witness King strongly disagrees with the Company's regulatory approach to removal costs. Mr. King states that according to Mr. Robinson's workpapers, Pepco's average removal cost between 2001 and 2005 was only $5.37 million. Mr. King proposes using this historical average to calculate the appropriate removal cost component of depreciation rather than the Straight Line Method, which Mr. King characterizes as the "Traditional Inflated Future Cost Approach ("TIFCA")."

Mr. King cites three problems with applying the traditional depreciation approach to mass property accounts: It extrapolates past inflation rates into the future; even when adjusted for future inflation, the TIFCA method charges present ratepayers the undiscounted cost of future removal activities; and it results in a permanent and growing loan from ratepayers to the utility. According to Mr. King, this permanent and growing loan from ratepayers results because there is always a greater inflow of new plant generating higher removal cost charges than there is an outflow of old plant that has accumulated removal cost reserve. Thus, the dollar value of Pepco's plant is always expanding. Mr. King states that even if Pepco's plant was not growing, inflation will cause the dollars added each year to exceed the dollars retired. As a result, Mr. King concludes that "[r]atepayers never catch up."[8]

According to Mr. King, the traditional net salvage procedure employed by Mr. Robinson extrapolates past inflation into the future because it is based on the implicit assumption that the change in the value of the dollar in the future will match that in the past. Stated another way, the traditional approach assumes that the same relationship between the original cost of retired plant and the current cost of removing that plant will exist in the future as it has in recent years. However, Mr. King points out that inflation is forecasted to increase at a 2.2 percent rate through 2016, which is less than half the 4.5 percent rate in the past. Thus, Mr. King concludes that Mr. Robinson has overstated future removal costs.

Mr. King also argues that the 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 20 years from now is worth far less than a dollar collected today. Not only will inflation erode

[8] King Direct at 33.

the future value of a dollar, but the holder of that dollar has the benefit of its earning (or spending) value in the mean time. Mr. King concludes that the traditional approach incorrectly assumes a dollar collected now has the same value as a dollar spent 20 years from now.

Mr. King says the solution to the 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. This is the procedure recently adopted by the Delaware Public Service Commission. Mr. King asserts that the rolling average approach preserves the practice of accruing removal costs reserves by means of rates applied to plant balances, but effectively halts any further increase in the reserve already accumulated. Mr. King has calculated OPC's proposed rates and accruals for Pepco's plant using the five year average approach, which results in an annual accrual of $5,374,932 based on year-end 2005 plant in service. He recommends this approach because it eliminates all of the infirmities of the traditional approach.

Mr. Robinson argues that Mr. King's historical removal cost proposal is "backward looking" and bears little relationship to the future removal costs Pepco will incur. Furthermore, it gives no consideration to removal costs for consumption of the still surviving plant in service. Mr. Robinson notes that the level of retired property that is the basis of Mr. King's proposal is quite small (approximately 2.1 percent) in relation to the remaining plant in service, which some day must be retired. He emphasizes that because future costs of removal will increase dramatically, Mr. King's recommendation grossly understates the reserves necessary to pay those future costs. Mr. Robinson concludes that an analysis of removal costs requires an objective assessment of what those costs will be.

According to Mr. Robinson, Mr. King's assertion that his cost of removal recovery method moves in "lockstep" with plant-in-service additions, is irrelevant to a determination of the proper cost of removal recovery. Cost of removal and replacement plant additions are accounted for differently on the Company's books. Mr. Robinson states that if Mr. King's approach is adopted, cost of removal recovery for the prior generation plant that is no longer in service would be deferred and recovered from the customers being served by the replacement property. Consequently, these customers would pay for property from which they are not receiving service. Mr. Robinson concludes that if Mr. King's proposal is accepted, the Company "would always be in the hole."[9]

According to Mr. Robinson, because Mr. King chose to analyze an account with one of the longest retirement ages, Mr. King overstated the historical inflation rate in the Company's analysis. Pepco's average age of retirements for plant in service is 17 years. Mr. Robinson states that during the most recent 15 and 20 year periods, annual inflation has ranged between 2.72 percent and 3.03 percent, not the 4.5 percent benchmark Mr. King suggests. Moreover, Mr. Robinson notes that inflation has recently (2005 and 2006) averaged 3.38 percent and 3.23 percent. Consequently, Mr. Robinson concludes it is reasonable to expect that the inflationary trends covering the average age of the plant retirements that generated the Company's net salvage experience will continue into the foreseeable future. Moreover, Mr. Robinson emphasizes that to date Company assets have been retired at ages less than the ASL of the property groups. If property groups experience their ASLs in the future, removal costs will increase for these longer life assets.

Staff did not conduct a life analysis of the plant in service. Consequently, Staff presented two alternative removal cost proposals. Using Pepco's proposed service lives and

[9] Robinson Rejoinder at 7.

the same cost of removal percents as proposed by Pepco (which means using the same future inflation and future removal costs), Mr. Dunkel calculates an annual accrual of $15,858,014 for future removal costs. As a result, the only real difference between this Staff proposal and Pepco's removal cost calculation is that Mr. Dunkel is "present valuing" those future removal cost amounts, but Pepco is not. Based upon the same inputs, but using OPC's proposed service lives results in an annual accrual of $10,647,224.

According to Mr. Dunkel, the major problem regarding removal costs is that customers may pay the utility decades before the utility has to remove the facilities. This prepayment creates significant analysis issues. Additionally, Mr. Dunkel notes that the decline in the purchasing power of the dollar over decades must be properly addressed.

Mr. Dunkel states that under the traditional straight-line depreciation method current customers are charged future inflation. He argues that the dollars customers are currently paying are improperly treated as if they have the lower purchasing power that future dollars will have, which means that more of these current dollars are collected from current customers to allow for future inflation. The main disadvantage to this approach is that customers overpay with the highest premium for customer payments that are paid the farthest in advance of the removal date.

Mr. Dunkel admits that customers that use the facilities during its service life pay for the future cost of removing that facility under the traditional net salvage approach. In addition, utility commissions are familiar with this methodology. However, he argues that there is not a strong theoretical foundation for the traditional method when net salvage is negative. When net salvage is positive, it is used to pay back investor provided funds. However, Mr. Dunkel states that negative net salvage results in customers paying in advance for the net cost of removal. No account in this case has positive net salvage. Mr. Dunkel concludes that the theory on which the traditional method is based was not designed to handle prepayments by customers properly.

Mr. Dunkel notes that some have argued that the traditional salvage approach provides certain benefits such as favorable treatment by investors, reducing the amount of money the Company must borrow and providing future deductions from rate base. However, he argues that these are not valid reasons to collect excessive amounts for depreciation expenses. Mr. Dunkel concludes that depreciation should be calculated properly. Therefore, he does not recommend the traditional approach, used by Pepco.

Mr. Dunkel supports using the Present Value Method (PV Method) for removal costs. This method is based on charging current customers the “present value” of the future removal costs. As an additional part of the calculation, customers also pay the “interest” so that all money in the depreciation reserve is from customers. Mr. Dunkel states that this is consistent with the present value treatment that Pepco and other utilities currently use for “legally” required asset retirement obligations (“AROs”). Moreover, removal costs are recovered over the life of the investment and customers do not overpay for removal. Since the PV Method also results in customers paying reasonable rates, Mr. Dunkel recommends this methodology for removal cost recovery.

Mr. Dunkel states that the most accurate present value calculations are done by vintage. This means that the calculation is done separately for each year of installation. It also recognizes that the current “present value” calculations are different for investments installed in different years.

Mr. Robinson states that the principal defect of the Present Value approach is that it does not recover future removal costs from customers over the period in which they consume the property. Additionally, the Present Value Method is severely backloaded and it fails to ratably recover costs over the life of the property being consumed. As a result it is a methodology that will burden future generations. Moreover, Mr. Dunkel's argument that removal costs can be deferred because new plant additions (with lower initial present-value-based depreciation rates) will keep rates levelized inappropriately defers the collection of removal costs resulting in future customers paying a disproportionately large percentage of the removal costs on current property.

Dr. Browning notes that Mr. Dunkel is concerned that inflation is distorting the payments for removal costs. However, when Mr. Dunkel attempts to solve the inflation issue he makes an unexplained jump to using a discount rate. Adjusting for inflation, presumably using an inflation index and adjusting for present value using a cost of money discount rate are significantly different concepts, according to Dr. Browning. Further, Dr. Browning states that the effect of these two different concepts is significant, causing a drastic shift in cost responsibility to future customers over time. Dr. Browning concludes that Mr. Dunkel's proposal results in current customers significantly underpaying.

Dr. Browning states that the Present Value Method requires annual additional accruals to provide for the change in the present value of the retirement cost and ensure that there are sufficient funds to cover these costs at the end of the useful life of the assets. If the Commission fixes cost of removal rates at the amounts recommended by Mr. Dunkel, then according to Dr. Browning. The Company would have to initiate annual rate cases or the intergenerational inequities (backloading problem) caused by Mr. Dunkel's proposal would get worse. A possible solution would be for the Commission to establish a depreciation rider that would increase the cost of removal depreciation component of rates each year. Dr. Browning concludes that Mr. Dunkel's proposal should be rejected because it is flawed and future customers pay more for removal costs (in nominal dollars).

The Company has claimed that if the Present Value Method is adopted annual increases in depreciation rates would be required or that annual rate cases would be necessary. Mr. Dunkel says these claims are not valid. He notes that Staff's proposed cost of removal rates incorporate the plant remaining lives in the calculations. Mr. Dunkel states that removal rates would increase each year only if the average remaining lives ("ARL") for the accounts were declining each year, which is not a reasonable assumption.

Staff asserts that the average remaining life for an account is impacted by the addition of new investments, plant retirements and the fact that existing investments that are not retired get older each year. Some of these changes tend to increase the ARL of an account while others decrease it. Consequently, the ARL for accounts can increase, decrease, or stay the same from year to year. Since Pepco's assumption that the ARL will decline every year (causing the depreciation rate to increase each year) is not reasonable, there is no valid basis for the claim that Staff's Present Value proposal requires annual depreciation rate increases. Pepco uses the average remaining life in their plant only depreciation calculations and it has not proposed a rider for these depreciation rates, which Mr. Dunkel argues indicates Pepco does not expect the ARL to decrease every year. Mr. Dunkel does not recommend recalculating depreciation rates every year.

According to Mr. Robinson, Mr. Dunkel's analysis and recovery methodology fails to consider all of the factors affecting the cost of removal recovery and the effect on rate base. He states that Mr. Dunkel's proposal combines a straight line recovery method for the plant component with a sinking fund type of recovery method for the cost of removal depreciation component which results in an inappropriate mixture of calculations and unnecessary complexity. Mr. Robinson also asserts that Mr. Dunkel completely dismisses the significance of the rate base offset and lower return component paid by customers under Pepco's cost of removal recovery method.

According to Mr. Robinson, the Present Value Method is a discounting approach that incorrectly calculates the current liability using the Credit Adjusted Risk Free Rate. Mr. Robinson asserts that the liability is dependent 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. Additionally, if the Present Value Method is used, the discounting application needs to start with the true future end of life costs of each of the asset property groups rather than the very conservative level of estimated removal costs incorporated into the Company's proposed depreciation rates. Moreover, since the future costs of removal results in a negative (versus positive) cash flow the discount rate that is used should be adjusted to reflect this fact.

Mr. Robinson emphasizes that the Company's estimate of future net salvage is quite conservative compared to what will likely occur because the historical experience used included retirements that occurred at ages far lower than the average service life estimated for each of the property groups. Mr. Robinson argues that Mr. Dunkel should have used the higher forecasted negative net salvage levels in his Present Value calculations rather than the historical negative net salvage percentages. Additionally, Mr. Robinson states that

Mr. Dunkel erroneously proposes to use Staff's overall cost of money as the discount rate. He states that a far lower discount rate should be used because of the increased risk and uncertainty surrounding the cost of removal and the resulting negative cash flow necessary to fund that obligation. Mr. Robinson states that Pepco's proposed net salvage factors include an implicit zero percent discount rate.

Mr. Dunkel addressed objections to the PV Method raised by the Company. According to Mr. Dunkel, the fact that Mr. Robinson disagrees with a particular rate of return used in a present value analysis is not a valid objection to the methodology itself. As Mr. Dunkel points out, the rate of return determined by the Commission can easily be incorporated into the present value calculations. Additionally, uncertainty about the amount of future removal costs will have an impact on any chosen methodology, the traditional approach as well as the PV Method. Mr. Dunkel states that he input the same future net salvage ratios as Pepco used. Consequently, Mr. Dunkel's future removal cost estimates in his calculations are effectively the same as in Pepco's proposal.

Dr. Browning states that under all of the methods proposed by the parties, the issue is one of who pays or intergenerational equity. Dr. Browning notes that the traditional method collects money earlier in the period than the other methods; however, all of the money goes into the depreciation reserve and is a deduction from rate base.

Mr. Dunkel states that there is no depreciation reserve deficiency despite Mr. Robinson's claim that customers have not paid the full amount that they should have paid to cover the cost of removal component. He states that the Company's data shows that the actual amount in the depreciation reserve exceeds the theoretical reserve calculated by Pepco. Using Pepco's proposed service lives and net salvages, the theoretical depreciation reserve should be $982,001,886 while the actual reserve is $1,044,209,000. Mr. Dunkel says Mr. Robinson's claim is a result of the way Pepco split the reserve amounts between the "plant only" and "removal" categories. Finally, Mr. Dunkel does not propose any amortization of any alleged reserve "surplus" or "deficiency."

Mr. Robinson addressed Mr. Dunkel's assertion that there is no depreciation reserve deficiency. He states that Mr. Dunkel's proposed average service life produces a composite ASL of 44.2 years for Pepco's current (12-31-05) plant in service. Multiplying Mr. Dunkel's recommended annual recovery of $15.9 million by the 44.2 ASL results in a total cost of removal of $703 million, which is $233 million less than Mr. Dunkel's estimated cost of removal of $936 million. Therefore, Mr. Robinson concludes that Mr. Dunkel's annual cost of removal allowance will not allow Pepco to recover its required cost of removal. Even though Mr. Dunkel has implied that a portion of Pepco's book depreciation reserve could be used to pay for removal costs, Mr. Robinson states cross subsidization of reserve components is not possible because the Company separates its book depreciation reserves into various components.

D. Amortization of Removal Cost Reserve

Mr. King argues the rolling five-year average method should supply sufficient funds on a current basis to cover all removal costs. Therefore, he states that 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 $36,207,603 as of year-end 2005, a five year amortization would result in an annual credit to ratepayers of $7,241,521. Mr. King devoted much of his testimony to the proposition that the removal cost reserve should be classified as a regulatory liability. 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 Pepco 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.

Mr. Robinson strongly opposes OPC's proposal to return the current (under-funded) removal cost reserve to ratepayers. 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 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

Pepco'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, 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.

Mr. Dunkel does not support Mr. King's proposal to amortize the $36 million removal cost reserve. Mr. Dunkel states that if Mr. King's proposal is adopted, ratepayers would pay nothing toward removal costs for the next five years and would actually receive a net credit if combined with Mr. King's five-year rolling average proposal. Furthermore, the alleged reserve surplus (OPC) or deficiency (Pepco) may no longer exist if different factors or parameters are used in a future depreciation study.

E. Commission Decision

Pepco and OPC are in substantial agreement on the plant-only depreciation rates that should be adopted in this proceeding, disagreeing on only five Distribution and General Plant accounts. Pepco proposes increasing the average service lives for Accounts 364 and 367 while OPC recommends larger increases in these ASLs. For Accounts 366, 370 and 391.3, Pepco has proposed reducing the ASLs while OPC recommends no change in the current average service lives. Staff did not analyze the ASLs proposed by Pepco and OPC and consequently is not recommending which service lives should be adopted.

The differences between Pepco and OPC result from Mr. Robinson incorporating industry and Company specific factors into his depreciation recommendation while OPC relied upon the results of the historical analysis. This is particularly evident for Account 391.3, Information Systems, where Mr. Robinson points out that historical data is not particularly representative of the real use of computer equipment. Based upon this record, the Commission finds the industry and Company specific information relevant in developing the plant-only depreciation rates. Therefore, the Commission approves Pepco's proposed plant-only rates.

The parties strongly disagree about the appropriate cost of removal methodology and the rates that should be adopted. Mr. Robinson proposes using the traditional Straight Line Method of recovery, which results in an annual accrual of $37,163,195 for removal costs. Mr. King proposes using the Company's five-year historic average (2001-2005) for removal costs, which is $5,374,932. Between these two proposals, Staff offered two alternatives based upon the Present Value Method of accrual. According to Mr. Dunkel, if Pepco's proposed service lives are used, the annual removal cost accrual is $15,858,014. If OPC's proposed lives are adopted, the figure is $10,647,224. Mr. King also recommends amortizing the current removal cost reserve balance of $36.2 million over five years, which would result in an annual credit to ratepayers of $7.24 million.

The Commission has carefully reviewed the record and finds that the Present Value Method should be adopted for the recovery of removal costs. 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. Consequently, today's ratepayers would pay more in "real" dollars under the Straight Line Method for the recovery costs of the plant they consume than would future ratepayers when net salvage is negative, as everyone projects.

Conversely, Mr. King's proposal to use the historical five-year average 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, Pepco's actual removal costs were $9.0 million in 2005 compared to the five year average of $5.37 million. Use of a historical average would only exacerbate the apparent under-funded removal cost reserve and it would not reflect anticipated future expenses. Moreover, as noted by Mr. Dunkel, the removal cost of investments would not be recovered over their service lives under the historical methodology.

We will apply the Present Value Method to Pepco's proposed service lives. The Present Value Method strikes a balance between the straight line and historical 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. In our opinion, the Present Value Method strikes an appropriate balance between the interests of current and future ratepayers. It is an approach that avoids the infirmities inherent in the proposals of OPC and the Company.

The Commission rejects Mr. King's proposal to return to ratepayers the current removal cost reserve. Mr. Robinson's analysis indicates that the reserve is currently under funded. Moreover, as Staff has pointed out, adoption of Mr. King's amortization proposal effectively eliminates any removal costs from rates for several years when combined with OPC's historic removal cost proposal, which would clearly be an unreasonable result. The accruals to date reflect plant consumption in earlier years that has actually occurred. OPC's amortization proposal would simply saddle future ratepayers with an even larger burden. Therefore, the Commission will not adopt Mr. King's amortization proposal. Finally, while the Commission will not adopt Mr. King's proposal to label the removal cost reserve a "regulatory liability," the Commission directs Pepco to continue to segregate removal costs from plant-only depreciation expenses.

Our findings regarding depreciation result in an increase in rate base of $15,492,000 and a $20,254,000[10] increase in net operating income.

V. 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 that will result from this proceeding, all parties have utilized the test year of the 12 months ended September 30, 2006, which period includes updated figures of the most recent results of actual operations presented by the Company. Accordingly, this test year will be accepted for purposes of reviewing the Company's rate base, revenues and expenses for determining the rates in this proceeding.

With respect to the appropriate rate base for which rates will be determined, the parties start with the unadjusted rate base of $876,330,000 to which uncontested adjustments regarding Annualization of the Deductible Mixed Service Cost tax methodology ($8,243,000) will be added, with an uncontested adjustment with respect to Cash Working Capital ($4,591,000) then deducted.

[10] $90,331,000 (Pepco's "per books" depreciation expense) minus $56,636,000 (Dunkel depreciation expense calculation (WWD-8)) equals $30,695,000. This delta, when adjusted for taxes, equals the adjustment to net operating income.

The biggest difference between the parties with respect to rate base concerns treatment of depreciation and depreciation methodology discussed above, and also the Staff proposal to remove CWIP from rate base (with a corresponding adjustment to remove the Allowance for Funds Used During Construction ("AFUDC") from operating income). Other contested issues with respect to rate base concern Staff's proposal to reflect the average balance of materials and supplies in rate base rather than the Company's proposed termination balance, and treatment of severance costs discussed below in operating income also affects the rate base determination. In addition, UMCP contests the Company's inclusion of pre-paid pension and other post-employment benefit liabilities in rate base, claiming such expenses are over-funded and do not involve solely investor funds. These contested issues will now be discussed.

A. Construction Work in Progress ("CWIP")

In this proceeding, Staff has proposed a change from the Commission's historic and traditional treatment of allowing electric companies to include construction costs in rate base under the CWIP/AFUDC convention, whereby CWIP is included in rate base but an Allowance for Funds Used During Construction ("AFUDC") is then credited to the benefit of the ratepayers in operating income calculations. Staff witnesses Sands and Mullinax contend that the prior policy to include CWIP is no longer justified for electric distribution companies, and state the proposed policy to exclude CWIP from rate base has also been adopted by the District of Columbia where Pepco also operates. In its final arguments in this case, 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. Staff contends that crucial tests used by the Commission in including CWIP included whether an electric utility would be irreparably harmed by the failure to include CWIP in the rate base. However, Staff contends that due to short duration and the relatively small size of construction projects undertaken by an electric distribution company, there is no need to include CWIP in rate base. Staff argues that an electric distribution company in general does not need to shoulder the heavy construction burden that a fully integrated utility once did, and therefore there is no reason or need to earn a return on construction dollars where there is no danger of irreparable harm. Staff acknowledges that if the assets under consideration will become used and useful during the rate effective period, the Company could make such showing, and therefore inter-generational equity is no longer a concern if construction projects are completed quickly. Staff concludes that CWIP should now be excluded from rate base as it represents assets that are not used and useful in providing utility service to Maryland ratepayers. Such exclusion would remove $71.3 million from the Company's proposed rate base in this proceeding.

Pepco, through witness VonSteuben, advocates continuation of CWIP in rate base with the related AFUDC in operating income. Pepco notes the Commission has authorized CWIP in rate base for well over half a century in setting Pepco's rates, noting that since 1948 Pepco has been authorized to include all CWIP in rate base. Pepco further notes the argument that CWIP should be excluded from rate base as it represents property which is not used and useful in rendering service to the public has been rejected by the Commission in prior proceedings,[11] including recent rejections of the proposed recommendation against inclusion of CWIP in a 2003 Washington Gas Light Company ("WGL") case and the 2005

[11] *E.g., Re Delmarva Power & Light Company*, 68 Md. PSC 566, 588 (1977).

Baltimore Gas and Electric Company ("BGE") case.[12] In the BGE case, the Commission stated:

> 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.

Pepco 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, as both the WGL and BGE gas rate cases involve natural gas distribution companies. Pepco counters that such status as a distribution-only utility in fact strengthens the argument for continued inclusion of CWIP in rate base, as any concerns regarding equitable inter-generational treatment of customers should be reduced or eliminated by the removal of long-duration generation-related construction projects from the Company's CWIP balance. In further support of its position, the Company contends that for Pepco, the vast majority of the assets in the Company's CWIP balances are in fact in service rather than presently under construction, in part due to the nature of shorter duration of distribution projects as well as the Company's internal procedure of waiting approximately 120 days for final vouchers related to the construction of the assets. In short, the Company contends there is no policy or equitable reason to depart from the Commission's prior policy of

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[12] *Re Washington Gas Light Company*, 94 Md. PSC 329, 346-347 (2003); *Re Baltimore Gas and Electric Company*, 96 Md. PSC 334, 344 (2005).

including CWIP in rate base, and urges continuation of such practice in this proceeding with the AFUDC offset.

Upon consideration of the evidence and arguments of the parties, the Commission is not convinced to abandon our long-standing practice to include CWIP in rate base with an AFUDC offset. As we have said on other occasions, the long-standing policy has worked well in protecting companies against rate obsolescence, while promoting equity between current and future rate customers. We do not believe the Staff's arguments as to the change in structure to a distribution-only company justifies a change in this well accepted policy regarding acceptance of CWIP/AFUDC. In fact, the status of the Company as a distribution-only entity actually strengthens the policy underlying our CWIP treatment, as the short-term duration and smaller size of construction justifies the inclusion in rate base. We therefore reject Staff's proposal to remove CWIP from rate base.

B. Materials and Supplies in Rate Base

In this proceeding, the Company has included the end-of-period balance for the materials and supplies component of rate base, as witness VonSteuben contends such balance is more representative of the balances that will be utilized in the rate-effective period and is also based on precedent authorizing such end-of-period balance.

Staff recommends an adjustment to this component of rate base regarding inventory of spare parts, as Staff proposes use of a 13-month average balance rather than the end-of-period balance. As noted by Staff witness Mullinax, use of a 13-month average will annualize seasonal variations and costs. Staff further notes the Commission has used average balances, terminal balances or an imputed adjusted balance with the key determination concerning which valuation is considered more representative of the conditions that will prevail during the rate effective period. In this case, Staff notes the monthly balances have ranged from a low of approximately $37 million in December 2005 to a high of over $42 million in July 2006, while the materials and supplies dollars included in accounts payable have also varied from less than $500,000 to over $2 million during the same period. Staff contends such large swings represent seasonal variations which are best accommodated by the use of a 13-month average, and the Staff proposal would reduce the Company's rate base by $1,257,000.

In rebuttal to Staff's proposed reduction, the Company presented testimony by Mr. VonSteuben indicating that Pepco's materials and supplies inventory has consistently trended upward through 2006 and early 2007, due largely to the increasing cost of materials. The record reflects Pepco's total plant monthly materials and supplies balance increased from approximately $36.2 million to $39.3 million between September 2005 and September 2006, and during the five months immediately following the test year, the total plant balance only once dipped slightly below the terminal test year level (of $39,287,307) to $39.2 million in December 2006. Furthermore, in each of the other post-test year months, the total Company balance exceeded the September 2006 level, with the February 2007 balance $43.7 million. In addition, the Company contends there has been a clear and significant upward trend in the cost of a number of items of equipment that are critical to the Company's operation, and therefore the Company contends an end-of-period balance should be utilized as more reflective of the rate effective period.

As noted, the Commission has utilized both average or terminal values for materials and supplies as a rate base element, with the Commission specifically noting the decision is based upon which balance was more likely to be representative of the rate effective period.[13] Based upon the evidence presented, the Commission will utilize a terminal balance as proposed by the Company, as the evidence shows the balances in the post-test year period have exceeded the terminal balance on a fairly consistent basis, so that such terminal balance is a better indicator, and in fact may even be lower, than the monthly balances that will result during the rate effective period. While Staff's argument that using a 13-month average annualizes seasonal variations and costs, we find the evidence persuasive that the balances have increased since the test year so that the terminal balance is more representative in this instance and will be utilized.

C. Pre-Paid Pension Asset

Pepco has included in its rate base pre-paid pension assets, which Staff and UMCP question in their initial testimonies as both these parties question whether such funds are solely investor-supplied funds for which a return should be paid, with UMCP further contending such expenses are over-funded. During the course of these proceedings, Pepco witness VonSteuben has provided additional information regarding the asset, noting Pepco's pre-paid pension asset is equal to the amount of funding made to the plan in excess of the Financial Accounting Standards Board ("FASB")-determined expense. Accordingly, Pepco contends that to the extent the pension plan required funding in excess of the FASB-determined expense amount, Pepco funded such asset with the use of investor-supplied cash distributions, not customer funds, as there were no customer funds available for such purpose. Based on this information, Staff has withdrawn its recommendation to reduce rate base by the pre-paid pension contributions, while UMCP still maintains that these expenses

[13] *Re Pepco*, 82 Md. PSC 172, 179-180 (1991).

are over-funded. Also, UMCP disagrees that solely investor funds were used as Pepco profits generated from customer payments are utilized as the funding source, according to UMCP witness Smith. In its final position on brief, UMCP recommends removal of $60.9 million from the rate base related to the pre-paid pension balances, which proposed exclusion is vigorously contested by Pepco.

Upon review of the record, the Commission finds that Pepco has presented sufficient documentation that Pepco funded the disputed assets without using ratepayer funds, and therefore we agree with Pepco's and Staff's final position that no exclusion is warranted for the pre-paid pension balances. We also note that an exclusion as proposed now only by UMCP would require a larger expenditure of funds for pension expense,[14] and we find no adjustment to exclude the pre-paid pension assets is justified or warranted.

D. Depreciation and Severance Costs Adjustments to Rate Base

Pursuant to the determinations made with respect to depreciation and severance costs, discussed elsewhere in this Order, additional adjustments in the amount of $15,492,000 are necessary to rate base to reflect the depreciation rates determined herein, and $565,000 for our decision with respect to severance costs.

E. 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 Pepco's property used and useful in providing service to the Company is $895,503,000, as noted in Appendix I attached hereto.

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[14] UMCP's proposed removal of pre-paid pension assets from rate base would decrease revenue requirement by less than $5 million, but the Company's annual pension expense would then increase by $6.7 million without the pre-paid pension asset, according to Mr. VonSteuben.

VI. OPERATING INCOME

Operating income reflects the difference between the revenues and appropriate costs of the Company in providing service to the customers, with various adjustments to the test year revenues and expenses proposed by the parties and either accepted, rejected, or modified by the Commission as a key element in our determination of the rates that will be allowed for the Company.

In this proceeding, all parties start with the unadjusted operating income of $46,548,000 for the test year period, to which various uncontested adjustments are agreed upon by the parties.[15] Operating income and expense adjustments contested by the parties are discussed below.

A. Severance Costs

The record reflects the Company has included in its test year figures expenses related to 2004 severance costs paid to employees at that time in an effort to downsize Company personnel. The Company utilized a three-year amortization of such costs, which the Company considers consistent with past amortization treatment for severance programs. According to witness VonSteuben, the adjustment included by the Company reflects amortization of the termination payments of $2.1 million over a three-year period, which period the Company considers to be reasonable for the amount of such costs. Pepco also

[15] Uncontested adjustments concern inclusion of interest expense on average customer deposits, exclusion of institutional and promotional advertising expenses, removal of Mirant bankruptcy-related costs, annualization of changes in employee health and welfare costs, annualization of 2006 postal rate increase, inclusion of costs associated with current proceeding (although certain regulatory expenses are disputed by Staff with respect to costs of this case), exclusion of merger-related costs, reflection of a coal credit, an additional adjustment to correct tax treatment of software, and an additional adjustment to increase test period revenues for billing.

argues that such inclusion is in accordance with prior Commission precedent with regard to BGE's 1995 Voluntary Severance Program.[16]

Staff and UMCP oppose inclusion of the severance costs in the test year expenses, noting that such costs precede the test year and inclusion would continue in rates well beyond their amortization. OPC has opposed inclusion, but in its final position on brief recognizes that any severance costs remaining after April 1, 2007 be amortized for an additional three years, which is comparable to Staff's alternative position that should such costs be allowed, the amortization period should be no less than five years pursuant to Commission precedent. Furthermore, Staff argues that the costs should be disallowed as the Company neither sought nor obtained approval as a regulatory asset for these costs. In its arguments against inclusion of the severance costs, UMCP also notes that Pepco's rates have been capped since 1999, with the severances in question effective in December 2004 thereby decreasing Pepco's expenses related to such employees. Therefore, UMCP contends Pepco has already benefited from the reduced costs by the income received after December 2004.

Upon review of this issue, the Commission notes that Pepco's proposed amortization involves an adjustment to net operating income of $269,000, with a corresponding adjustment to rate base of $565,000. The Commission notes that costs for severance programs have historically been allowed as a necessary and proper expense, as such programs usually benefit ratepayers in the long run by the reduction in employee costs that traditionally result from the terminations. However, as the severance programs are not an ordinary event, amortization of such costs is appropriate, with a five-year amortization used

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[16] *Re BGE*, 88 Md. PSC 42, 64 (1997). In that case, however, which authorized a merger between BGE and Pepco, which merger was never completed, a five-year period for severance program costs was utilized for the 259 employees involved.

for the BGE severance program cited by Pepco, which period we believe is more appropriate in this instance than the Company's proposed three-year amortization. Accordingly, we also reject the positions of those parties who would totally exclude the costs which were incurred in December 2004, and we believe the position of OPC witness Effron is the most reasonable and is consistent with the longer amortization period that is appropriate for such costs. Accordingly, we accept OPC's adjustment to continue amortization, resulting in a $565,000 addition to rate base and a $67,000 reduction to operating income (rather than $269,000 proposed by the Company).

B. Labor Expense – Annualization of Wage Increase and Normalization of Employee Levels

In this proceeding, OPC has proposed a reduction to the number of employees to reflect the year-end total which number is less than that utilized by the Company. In support of this recommendation, OPC witness Effron notes that there have been reductions in employee numbers in 2005 and 2006 and beyond, and therefore the total on September 30, 2006 (the end of the test year) is a more accurate reflection than the Company's number of employees. The adjustment proposed by OPC results in a reduction to labor expense of $1.2 million.

The Company opposes the use of the year-end level of employees, as its filing reflects the average number of employees for the test year as a better match with the test year concept as well as a reasonable estimate of Pepco's employee level during the rate effective period. Mr. VonSteuben notes the Company is not staffed up to its authorized complement, and is actively recruiting personnel to increase the number of employees to that level. The Company considers use of the terminal level of employees as non-reflective of the costs the Company will experience during the rate effective period.

Staff has not commented on this issue, but includes a wage and salary adjustment that is slightly higher than the Company's in recognition of actual increase to exempt salaries of 3.61 percent during the test year as opposed to the projected increase of 3.5 percent. This Staff adjustment has apparently not been contested by any other party and is an apparent slight correction based on actual figures and will be accepted, reducing operating income by $13,000 more than the Company's wage adjustment.

With respect to the number of employees, the Commission finds that the OPC year-end total should be accepted. The record reflects that, although Pepco may have plans to increase personnel, such staffing is speculative in contrast to the detailed information provided regarding call center employees discussed later in this Order. Accordingly, we accept the OPC adjustment to employee levels, increasing operating income by $820,000.

C. Deferred Compensation

Both OPC and Staff oppose Pepco's treatment including certain costs for adjustments to deferred compensation, as OPC witness Effron contends such adjustments are a one-time, non-recurring expense, noting no similar adjustments in 2002 through 2004. Staff witness Mullinax contends the deferred compensation is based on shareholder benefits and is characterized as an incentive plan. In addition, while Pepco has argued the plan is not an incentive plan but part of overall executive compensation, Staff notes the compensation committee is responsible for setting the performance criteria by which the incentive compensation is rewarded, and cites excerpts from Company materials regarding an Incentive Compensation Plan. Furthermore, the 2006 goals established by the compensation committee are closely tied to stock price and shareholder value, according to Staff. Staff therefore recommends that this deferred compensation, which is based on the earnings performance of PHI and paid to some persons who are not even employees (*i.e.*, non-employee directors), be excluded from Pepco's revenue requirements, contending that Pepco has failed to meet its burden of proof regarding clear benefit to ratepayers and necessity of the compensation to bring the covered employees and directors' compensation to market rates.

Pepco contests the proposed Staff and OPC exclusion of deferred compensation expense, disputing OPC's contention that such adjustments were a one-time event (as OPC witness Effron noted there were no similar adjustments in the years 2002, 2003 and 2004). Pepco witness VonSteuben states a change in accounting policy that was effective December 2005 now provides that deferred compensation adjustments are recurring and continuing as the accounting policy now requires adjustment so that the liability is recognized as compensation in the period in which it is deferred and represents the total amount of projected benefits discounted back to present value. With respect to Ms. Mullinax's contentions that the deferred compensation should be excluded as it is tied to executive performance benefiting shareholders rather than customers, Mr. VonSteuben states "the ability to defer a portion of compensation is an integral element of the overall executive compensation program, and is not contingent on meeting shareholder, customer, or any other goals." (Pepco Exh. No. 14, VonSteuben Reb., p. 28.) Furthermore, Pepco contends that the incentive program cited by Staff is totally separate and distinct from the deferred compensation program whose costs are at issue in this case. On brief, Pepco states the cited goals of the incentive plan noted by Staff refers to the Company's "Long-Term Incentive Compensation Program" and not to the Company's "Deferred Compensation

Program" which two programs are distinct with the Company requesting recovery of costs associated with the latter but not the former.

Upon review of the evidence, the Commission finds that the adjustment to deferred compensation proposed by Staff should be accepted. Staff witness Mullinax has brought forth credible evidence, from the Company's own documents, indicating that incentive compensation programs are eligible for deferred compensation treatment, and while the Company notes the deferred compensation is separate from the incentive compensation program, it has brought forward no evidence indicating that amounts of deferred compensation do not include payments related to incentive compensation as in fact the record reflects incentive compensation is eligible for inclusion in deferred compensation. On brief, the Company asserts it seeks recovery of only deferred compensation and not incentive compensation, which latter program may involve rewards related to shareholder goals, but the Company has failed to provide sufficient evidence to assure us that no incentive compensation payments are included in the deferred compensation, and therefore we accept the Staff exclusion which increases operating income by $392,000.

D. Vacation Pay

Similar to its arguments with respect to exclusion of the deferred compensation as a non-recurring adjustment, OPC also seeks to exclude the Company's proposed increase to the balance of its accrued vacation pay account as a non-normal, non-recurring event. OPC witness Effron notes that the Company has made charges to true-up vacation pay liability in some years, including in 2005 which deficiency resulted in a true-up affecting the test year amount, but not in others, specifically a credit amount in 2004. He therefore does not accept the Company's true-up adjustment as a normal, recurring event that should be included in rates as representative of the rate effective period due primarily to the 2004 credit. The OPC elimination of the Company's adjustment would reduce Pepco's O&M expense by $1,772,000.[17]

In rebuttal testimony, Company witness VonSteuben has opposed OPC's elimination of the vacation pay true-up adjustment. Mr. VonSteuben claims the adjustment is based on the Company's accounting policy, wherein accrued vacation balances are reviewed periodically and adjusted based on balances in the current year entitlement, current year vacation carryover, and current year vacation used. He claims the amount included by the Company is based on the ongoing maintenance of financial records of the Company with the impact on the level of expense reflected in the test period appropriate as it reflects the actual costs of employee vacation expense in the test period. Furthermore, he states Mr. Effron's amount used in his ratemaking adjustment represents calendar year 2005 rather than the September 2006 test year, and therefore OPC's proposal should be rejected.

The Commission finds that no adjustment as advocated by OPC is warranted. We accept the statements of Mr. VonSteuben that the adjustment reflects the actual cost of employee vacation in the test year as properly adjusted for accrued vacation by the Company. The Company notes that the credit amount revealed by Mr. Effron in 2004 was impacted by the severance program that year, and therefore the credit for accrued vacation that year was an unusual event. Based on the record, we accept the Company's treatment, which reflects the actual costs of employee vacation during the test year period, without the adjustment proposed by OPC.

[17] The $1,772,000 calculation is the updated figure proposed by OPC rather than $2,053,000 originally proposed by Mr. Effron, which original figure was admittedly based on 2005 calendar year data.

E. Customer Care Costs

Through the course of this proceeding, Staff, OPC, and UMCP have all recommended elimination of certain Company costs with respect to customer service lines and Company service representatives involved in customer care. These parties have recommended elimination of the costs for a toll-free line, as the Company did not implement the customer service line as initially proposed. Pepco has agreed to remove such toll-free calling costs, but opposes the other adjustment proposed by Staff witness Mullinax and OPC witness Effron to reduce the cost of the Company's service representatives as OPC and Staff contend the record does not support such jobs have been filled by the Company. Upon further information provided by the Company, Staff witness Mullinax accepted the employee staffing levels for the customer call center, noting that the supplemental Company information indicates the additional customer care representative positions will be filled before the rate effective period and are therefore known and measurable. In this regard, Company witness VonSteuben testified during the hearings that 13 additional employees were intending to start in a week and a half, which would bring the number of such employees to 106 compared to the test year average of 97.5, whereupon a new training class of 12 to 14 would then start training. Accordingly, he contends that the Company will in fact have more than the 110 customer care employees included in the Company's rates at the beginning of the rate effective period.

In its final position on brief, OPC acknowledges the Company's testimony with respect to the process of hiring additional employees, but argues it is more likely the Company will be closer to its historic staffing levels of between 94 and 97 employees, which number reflects a more realistic known and measurable result than the 110 employees in the call center, which OPC considers to still be somewhat speculative. Furthermore, OPC contends the Company has failed to support the $1 million cost of "additional outsourcing." OPC contends the cost of outsourcing is not adequately supported as a legitimate known and measurable charge, and such costs should be rejected by the Commission. Elimination of these adjustments for employee staffing costs would reduce the Company's O&M expense by approximately $1.3 million, according to OPC.

The Commission finds that the issue with respect to known costs for the toll-free line of the customer call center have been withdrawn and are no longer at issue, with the only issue remaining concerning the appropriate staffing level costs for such customer service operations. Upon review of the record, we find that the Company has presented sufficient evidence of the additional employee costs for their inclusion in operating income, as the hirings are not speculative as the other employee staffing levels discussed and rejected above in this Order. Mr. VonSteuben has presented clear documentation of the timely hirings for these positions, which has satisfied Staff's concerns, and we are also satisfied that such costs are known and measurable and properly included. However, the Company has not met its burden to support the $1,000,000 expense for outsourcing customer care representatives. OPC witness Effron questioned the cost factors for this "additional outsourcing." Neither the Company's filed testimony nor its briefs nor any oral testimony provided any support for this expense. We determine that these costs are not known and measurable and therefore must be excluded. The net effect of accepting the customer care staffing enhancement and rejecting the additional outsourcing expense is an adjustment of $403,000 to operating income.

F. Vehicle Costs

Staff, OPC, and UMCP have raised issue with respect to the appropriate level of vehicle costs claimed by the Company in this proceeding. Witnesses Mullinax, Effron, and Smith all contend the Company has overstated gasoline costs used by vehicles as the Company utilized $3.00 per gallon for all fuels in its proposed adjustment. In this regard, Mr. Smith admits that it is difficult to predict the actual cost of fuel during the time that the rates will be effect, but suggests the compromise of using the average of prices for the 12-month period ending December 2006.

In addition to the dispute with respect to the cost of gasoline the Company utilized, the Company's adjustment also includes costs of vehicle leases reflecting the planned replacement of ten percent of Pepco's vehicle fleet each year, a practice followed by Pepco according to Mr. VonSteuben. As of 2007, Mr. VonSteuben indicates the leases on diesel vehicles have increased by $7,000 each as a result of technological changes with respect to new environmental standards. OPC has questioned the lease costs as overstated and speculative by the Company. OPC notes the Company analysis was based on expected cost increases reflected in the 2007 budget, which Mr. Effron considers to be a speculative increase not based on actual test year results. OPC recommends elimination of the entire level of the Company's forecasted vehicle expense increases which would reduce O&M expense by $377,000, with the other parties contesting that portion related to the cost of gasoline.

The Commission is keenly aware of the volatility in gasoline costs, and clearly at the time that testimony was prepared in this proceeding by various parties a cost of $3.00 per gallon may well have appeared excessive. However, the testimony of the Company as to vehicle costs, as well as the recent price climate for vehicle fuels, leads us to conclude the

Company's adjustment is reasonable and it will be accepted to better reflect the likely conditions during the rate effective period, as such increases are clearly known and measurable at this time. Therefore, we accept the Company's $230,000 adjustment.

G. MMIS Software Adjustment

In its initial filings, Pepco adjusted its software costs by writing off Material Management Information System ("MMIS") software. Staff, OPC, and UMCP opposed the software write-off as a one-time expense for property that is no longer used and useful. During the course of this proceeding, the Company indicates that the write-off was properly removed by witness VonSteuben when he filed rebuttal testimony, which the Company reiterates on brief stating the December 2005 software write-off was removed from the Company's updated actual figures.

H. PHI Costs

As noted above, Pepco is a subsidiary of Pepco Holdings, Inc. ("PHI"), which provides management, financial, and regulatory services to its subsidiary operations, including Pepco. In this proceeding, Pepco seeks to increase the share of costs allocated from PHI to Pepco. The Company argues that this allocation is appropriate because PHI has closed three subsidiary company operations,[18] thereby reducing the number of affiliates that can bear these costs and increasing the corresponding share Pepco must shoulder.

During the initial phase of this proceeding, several parties in this proceeding opposed the reallocation of the affiliated service company costs to Pepco. They claim that Pepco has failed to show the reasonableness of such costs, and contend that a lesser number of

[18] 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.

affiliates should in fact reduce the PHI costs that it allocates to its affiliates. UMCP witness Smith opposed the reallocation claiming Pepco has failed to prove such costs relating to the parent company will increase to Pepco, with AOBA witness Oliver also opposing the reasonableness of such costs but recommend a second case or Phase II to review the PHI changes. AOBA contends that Pepco has utterly failed to meet its burden of proof to substantiate the reasonableness of the service company charges made to Pepco in this proceeding, and contends the magnitude of such unsupported charges should result in the disallowance of any rate increase in this proceeding. OPC witness Effron also opposed the reallocation advocated by the Company, but suggest a modified calculation that he contends, would better reflect the actual test period level of expenses as the Pepco proposal is based on budgeted expenses which are not reflective of actual test period expenses. OPC contends that the Company provided no support for part of the adjustment related to the impact of 80 departing employees from a closed affiliate; Mr. Effron recalculated the allocation ratio to arrive at an adjustment to operating income of $627,000. Staff contended that the Company failed to match expenses with costs properly, as Pepco uses 2007 forecasted budgeted amounts against 2006 test year allocation relationships and therefore failed to meet the known and measurable standard for such costs.

Pepco responded that its share of service company costs in 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, including Pepco. The Company argues that its proposal reflects the level of such costs incurred in the test period, increased only by the amount reflecting the cost differential attributed to divestiture of the facilities. That is, Pepco claims the total of the common costs are not actually increased in reallocation although some costs that were previously capitalized are now being expensed. Pepco further disagrees that the service company can now do with a reduced workforce. Pepco claims that the reallocation reflects a smaller number of entities sharing common costs, not a reallocation of the operation costs of the divested entities. Pepco claims the rationale of the other parties' position, specifically AOBA's witness Oliver, would lead to the illogical conclusion that the Company could do with fewer than one comptroller, one treasurer, one general counsel, and a reduced IT department.

For the reasons set forth in Section III above, we cannot resolve these disputes at this time, but will do so in Phase II of this proceeding. The parties should 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 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 will review the proper amount and allocation of service company charges.

I. Gain on Sale of Property

OPC, through witness Effron, has proposed an adjustment related to the sale of the "Buzzard Point property." Mr. Effron notes the 1987 transfer to an affiliate was not reported to the Commission at the time, and the property was sold in 2005 to a third party. He proposes assigning the average gain per year since that time period (1987 through 2005), noting the property previously served as utility property and had been included in rate base for many years prior to the sale. He therefore contends ratepayers should share in any gain on the sale of the property, which he proposes to amortize over a three-year period resulting in a net gain of $4.2 million credited to utility operating income.

Pepco, through witness VonSteuben, opposes the OPC proposal. Pepco notes the property was transferred to an affiliate in 1987, which is the time that such amortization and any gain should properly start, although the property was transferred back to Pepco in 2002. However, the subject property, which is the Buzzard Point Generating Station located in the District of Columbia, was not included in rate base at any time when it was held by the affiliated entity (PCI) or after its return to Pepco, and therefore all revenues received from the sale, as well as all expenses incurred in the transfer, were excluded for ratemaking purposes. Furthermore, Pepco contends the Commission previously considered in Case No. 8315[19] in 1991 the issue of customer sharing and imputed gain from the transfer of the Buzzard Point property to PCI in 1987, whereby the Commission declined to make an adjustment to recognize any imputed gain from the transfer at that time as Company shareholders would ultimately be responsible for the costs of removal of the generating facilities located there. Furthermore, Pepco disagrees with Mr. Effron's proposed calculation of gain, stating Commission precedent finds that the fair market value at the time of transfer constitutes the appropriate measurement of gain. Pepco therefore disagrees with the amortization proposed by Mr. Effron commencing in 2007 as the property was sold to the third party in 2005.

[19] *Re Pepco*, 82 Md. PSC 172, 194 (1991).

The Commission notes that the property in question has not been included in rate base since 1987, and the imputed gain from the initial transfer at that time was previously rejected by the Commission. We find no grounds to seek inclusion of the sale proceeds in rates at this time, as such property has effectively been the property of the shareholders without cost to ratepayers since 1987. We therefore reject the proposed OPC adjustment.

J. Miscellaneous Revenue Adjustment

During the course of this proceeding, adjustments to revenue have been proposed by various parties. OPC proposes a revenue adjustment regarding the number of days in which Pepco will receive revenue in the rate effective period, to account for the leap year day. Also, UMCP has proposed a customer growth adjustment as witness Smith proposes increasing Pepco's test year revenues by $2 million to reflect additional revenues associated with new customers prior to and during the first six months of the rate effective period.

All of the above revenue adjustments are predicated upon parties' various concerns with respect to the appropriate revenue amount that will be realized by the Company during the rate effective period, with opposition to such charges based upon contentions that such revenue adjustments violate test year matching principles. However, the BSA tariff is also proposed by the Company, with support from various parties, that will adjust revenues if necessary during the rate effective period, acceptance of which makes the other revenue adjustments proposed effectively superfluous.

As the Commission has accepted the BSA adjustment as discussed later in this Order, no further revenue adjustment as discussed above appears necessary, and we decline the revenue adjustments proposed by OPC and UMCP in light of our acceptance of the BSA. With respect to UMCP's proposal, we further note that such a revenue adjustment for customer growth beyond the test period would also erode matching principles of the test year concept. Therefore, our only adjustment to revenues specifically noted in our calculation of Operating Income in Appendix II is the annualization of revenues calculated by the Company and Staff of $380,000, which appears to be an uncontested annualization that reduces the revenue requirement.

K. Rate Case and Regulatory Expenses

During the course of this proceeding, Staff has raised questions concerning Pepco'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 Pepco's regulatory expense based on a three-year amortized period. At the close of the briefing stage, the record reflects such costs are $270,000, although the Company requests the opportunity to reflect actual expense that would not be known until completion of the entire proceeding with the updated amount reflected through the compliance rates. In addition, there appears to be a slight difference with regard to other regulatory costs which total $229,000 for which Staff proposes utilization of a five-year average as such costs have significantly increased within the preceding five-year period. The Staff adjustment would increase operating income by $21,000 if the five-year average is utilized rather than the test year amount.

Upon consideration, we will accept the Staff's adjustment to these other regulatory costs through a normalization of regulatory expenses. In accepting the Staff adjustment as a reasonable one in this instance, a five-year average of other regulatory costs increases operating income by $21,000.

With regard to the expenses associated with this rate case proceeding, we agree with Staff and the Company that company costs directly associated with this proceeding should be included in Pepco's regulatory expenses. The Commission believes a longer period than the three-year amortization of rate case expense proposed by the Company is appropriate, however. A five-year amortization period shall be used, as this time frame more reasonably reflects the probable lapse of time before the next rate case filing. This adjustment results in a $32,000 reduction in operating income.

L. Taxes

In this proceeding, issues with regard to tax calculations have arisen. OPC witness Effron provides a different tax calculation which he states is related to the Maryland income taxes and recording deferred taxes on software amortization. He claims his method to calculate the Maryland income tax, using the seven percent statutory rate, conforms with other companies such as Washington Gas Light Company and Delmarva. Mr. Effron also provides a corrected software tax adjustment taking into account the Company's criticism of his original adjustment. OPC claims that calculation of the income tax liability is $1.1 million lower using the seven percent statutory rate for all adjustments.

Pepco witness Salatto testified with respect to the Company's income tax calculation. He states Maryland law requires the use of an apportionment formula for entities with multiple state operations even though the formula may not correlate to how revenues and other factors are allocated between jurisdictions for ratemaking purposes. Pepco utilizes the seven percent statutory tax for Maryland-only adjustments and the "three factor apportionment" formula[20] for Pepco system-wide amounts in calculation of Maryland

[20] The "three factor apportionment" formula involves sales, property, and payroll.

State income taxes. However, the Maryland tax only went into effect in 2000, which is why the computation of the State income tax effect on ratemaking adjustments was not used in prior Pepco proceedings. Mr. Salatto also states the OPC proposal with respect to software tax issues concerns different book and tax treatment for software, and if OPC's software proposal is adopted, it should only be implemented prospectively.

In its final position, Staff expresses support for the Pepco tax methodology inclusion of the three factor formula for computation of taxes, as Pepco utilizes a three-part apportioned tax rate for system adjustments and the statutory seven percent rate for adjustments germane to Maryland operations. Staff in fact supports application of the three-part formula to all income adjustments when deriving Maryland State income taxes.

Upon consideration of the record, we will accept the Company's tax treatments, including its calculation of the Maryland State Income tax. We note in this regard that the Company's calculation accurately reflects Maryland's tax laws, according to the Company. The alternative calculation presented by People's Counsel does not track with the statutory formula although it may reflect other appropriate regulatory considerations. We also note Staff supports the Company's incorporation of the three factor formula, and in fact Staff wants the formula applied to all adjustments. We find the weight of the evidence supports the appropriateness of the Company's methodology, which uses the seven percent rate only for "Maryland-only" adjustments and the three factor apportionment formula to system-wide related adjustments in accordance with the requirement to use the apportionment formula for entities with multi-state operations.

M. Interest Synchronization

Parties are in agreement that an interest synchronization adjustment is necessary to reflect the tax effect of pro forma interest. This calculation is uncontested as to methodology, with the amounts differing due to the determination of the levels of rate base. Using a capital structure including 52.31 percent debt and a cost of debt of 6.15 percent, as determined herein, we find an adjustment of $1,844,000 to operating income is appropriate.

N. Price Elasticity

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

O. Operating Income Findings

Accordingly, after consideration of the adjustments noted above including the present value depreciation adjustment as calculated by Staff, the Commission finds that during the test year ended September 30, 2006, as adjusted herein, the Company operating income for ratemaking purposes is $65,278,000, as detailed in Appendix II attached to this Order.

VII. RATE OF RETURN

A. Cost of Capital

The cost of capital consists of two components: return on equity capital ("ROE") – the company's stock – and a return on debt capital – 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

Pepco'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,[21] and an overall cost of capital of 8.47 percent (without the BSA) and to 8.34 percent with the BSA. Dr. Morin used the Company's existing capital structure of 52.31 percent long-term debt and 47.69 percent common equity.

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

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 ($K = R_f + B(R_m – R_f)$).[22] Pepco's witness assumed a 5.25 percent CAPM risk-free return.[23] 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

[21] Dr. Morin lowered his recommended return on equity from 11.25 percent to 11.00 percent at the April 12, 2007 hearing. 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, and therefore reduces his recommended ROE 25 basis points if the BSA is adopted, resulting in a 13 basis point reduction in the overall rate of return ("ROR").

[22] 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.

[23] 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.

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 Pepco. 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 Pepco 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 variability) securities earn less than predicted. Morin Direct at 37. As Pepco is considered a less risky investment than the market as a whole, Dr. Morin concluded that its return on equity is understated by the traditional CAPM. Dr. Morin's ECAPM calculation yielded a return on equity of 11.7 percent, or 12.0 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,[24] 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 when 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 for gas companies was 11.3 percent, including flotation costs.

As a further aid in determining Pepco'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 transmission utilities over the last decade. He determined that the average ROE spread over long-term Treasury bond yields was 5.5 percent for the 1997 to 2006 time period. Dr. Morin 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. Therefore, the DCF rate is comprised of two primary components, the expected dividend yield plus the long-term growth forecast. In this case, however,

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

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 Pepco. 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 where 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. In his DCF calculation, Dr. Morin used both electric and gas distribution companies as proxies for Pepco. 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. (Staff witness Elert has objected to Dr. Morin's inclusion of Pepco Holdings in the group of comparables designed to achieve the appropriate return for a Pepco Holdings subsidiary.)

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 Pepco under the DCF method was 10.2 percent, according to Dr. Morin, which he believes is understated for utilities such as Pepco, as noted above.

After performing his various return on equity calculations and weighing the various methodologies equally, 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 estimate to 11.00 percent due to updated information on interest rate declines. Pepco states that its cost of long-term debt is 6.15 percent, which no party has challenged. Dr. Morin therefore recommends an overall cost of capital of 8.47 percent (reduced to 8.35 percent with adoption of the BSA).

2. People's Counsel's Position

The Office of People's Counsel's witness King recommends a 9.78 percent return on Pepco's equity capital, resulting in an after tax weighted cost of capital of 7.17 percent. However, Mr. King would significantly reduce the return if either the BSA or POPEB mechanisms are adopted, as each of these proposed adjustment trackers greatly reduce the Company's investment risk. People's Counsel would reduce those numbers to an 8.97 percent return on equity and a 6.94 percent overall return if the Commission adopts the BSA, as OPC recommends, with an additional reduction added if the POPEB tracker is also adopted.[25] Mr. King's proposed returns are based on the Company's capital structure as of

[25] 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.

September 30, 2006, but with attribution of parent company PHI debt to Pepco, as noted below.

Also, in contrast to the Company's and Staff's acceptance of Pepco's capital structure, OPC proposes a significantly different capital structure be utilized by the Commission for ratemaking purposes than Pepco's structure of approximately 48 percent equity, and the remainder long-term debt. Mr. King recommends a "double leverage" adjustment to the Pepco capital structure as he contends the "equity" component is not real equity as Pepco equity earnings are effectively increased when passed through to the parent, PHI. Therefore, OPC argues an adjustment is necessary as otherwise an improper windfall results to PHI shareholders. Mr. King therefore concluded that Pepco's capital structure should be comprised of 28.55 percent equity, 68.87 percent long-term debt, and 2.58 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 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 calculated a DCF growth rate of 6.14 percent, employing the "classic" formula $K = d/p + g$.[26] 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,

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

as the compounding "occurs outside of the dividend issuing company," by recipients of the dividends. King Dir. T. at 15. 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, which 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, witness 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.

Witness King does not rely significantly on the other cost of equity pricing models commonly employed by cost of capital analysts, such as CAPM and Risk Premium which he uses primarily as a "check" on his results. While Mr. King believes that the CAPM "has value in assessing the relative risk of different stocks and portfolios ..."[27] 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

[27] King Dir. at 20.

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 8.26 percent.

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."[28] 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 "an award below 10 percent would not be inconsistent with recent equity return allowances."[29] 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 Pepco 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 Pepco's Bill Stabilization Adjustment and POPEB tracker, Mr. King concludes that "Pepco will become one of the least risky electric utilities

[28] *Id.*, at 26.
[29] *Id.*, at 26.

in the country."[30] 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. If the Commission approves a pension and OPEB 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 Pepco's capital structure, which has been revised with his "double leverage" adjustment, witness King achieved a weighted cost of capital of 7.17 percent for the Company. His recommended weighted cost of capital is 6.94 percent if the Bill Stabilization Adjustment is approved.

The Company and Staff extensively criticized Mr. King's analyses and conclusions. They claim Mr. King relied too much on the DCF formula, obtained widely varying results in his analyses, and ignored the effect of quarterly dividends. Pepco 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. Pepco 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.

[30] King Dir., at 34.

3. Staff's Position

Staff witness Elert performed four types of 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 witness Elert performed an Internal Rate of Return/Discounted Cash Flow ("IRR/DCF") analysis, which focused on expected stock and dividend growth. Using the IRR/DCF, witness Elert arrived at an average cost of equity capital for his proxy companies of 6.40 percent. Staff's 19 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 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, 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 Pepco. He then eliminated Pepco Holdings from this list, as well as Northeast Utilities, because of Northeast's very low rate of return. 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 19 DCF values, obtaining a 10.7 percent return on equity. Mr. Elert concluded that the average 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 analysis yielded a return on equity of 11.35 percent, the average of his two Risk Premium calculations. The Risk Premium methodology requires use of a risk-free corporate debt yield and a Risk Premium, which is the amount above the corporate debt yield rate that investors must earn to purchase risk-bearing securities. 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 his 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 achieved a return on equity for Pepco of 10.61 percent.

Mr. Elert supports use of Pepco'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.[31] Therefore, Mr. Elert agrees with the Company that Pepco's capital structure need not include short-term debt.

Using the agreed-upon 6.15 percent cost of long-term debt, Mr. Elert recommends that Pepco's return on equity be 11.00 percent, including a 25 basis point adjustment for flotation costs, resulting in an overall rate of return of 8.46 percent. Mr. Elert also concludes that an alternative treatment for adoption of the BSA would be to retain the 8.46 percent ROR without reduction, provided the Company is required to monetize the value of the BSA adjustment and use such funds in a conservation program. In its final position on brief, Staff recommends a 50 basis point reduction in the ROE if the BSA is adopted.

4. Intervenor Parties

In addition to recommendations regarding rate of return by the Company, OPC and Staff, intervenors AOBA, WMATA, and UMCP have also made recommendations in this proceeding. AOBA witness Oliver has recommended a return on equity of 8.95 percent, with a reduction of at least 50 basis points if the BSA is adopted, with AOBA severely criticizing the Company's analysis, especially with respect to the comparable risk profiles of comparison companies used by the Company. In this regard, AOBA contends that Pepco, as a distribution company, has a much stronger rating than PHI's more risky consolidated business risk profile, and the comparison groups used by Dr. Morin also have noticeably

[31] Elert Reb., p. 12.

higher risk than Pepco and undermine the weight of his analysis. WMATA witness Foster, who has reviewed prior Commission-determined return on equities, has presented a return on equity recommendation of 10.32 percent. UMCP witness Parcell has presented analyses utilizing DCF, CAPM, and comparable earnings, and concludes that Pepco's cost of equity capital is 9.75 percent, while also opposing any upward adjustment in the return on equity to reflect regulatory risk and opposing any flotation cost adjustments in this proceeding.

5. Commission Findings

Having carefully considered the positions of the parties, the Commission concludes that Pepco'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 Pepco and Staff than to those of People's Counsel. Both Staff and Pepco employed a wide range of rate of return methodologies, thus increasing confidence that their ultimate recommendations are broadly justified and not isolated. Once Company witness Morin reduced his recommended ROE by 25 basis points due to declining bond yields, Pepco's and Staff's recommendations became essentially identical.

Both Pepco and Staff criticize People's Counsel's witness King not only for his methodology but for his results, including his recommendation of 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 Pepco 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 Pepco than Mr. Elert recommended. Therefore, the Commission has reduced the 11 percent ROE proposed by Staff and Pepco 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 Pepco and Staff are less specifically supported. The Commission therefore adopts Mr. King's six basis point flotation cost adjustment.

The BSA, which the Commission has approved, will provide insurance that Pepco will achieve its level of revenue approved in this case. Thus, Pepco is less risky with the BSA than without it. In response to this decline in risk, all parties recognize the appropriateness of reducing Pepco's return on equity by some amount. The Commission rejects both the minimal reduction of basis points proposed by the Company, and the much larger reductions proposed by People's Counsel. Given that approval of the BSA will result in improved cost recovery by Pepco, the Commission shall reduce Pepco's ROE by 50 points, to 10 percent.[32]

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

B. Capital Structure

The Company and Staff propose a rate of return based upon the Company's actual September 30, 2006 capital structure, consisting of 52.31 percent long-term debt and 47.69 percent common equity. As noted above, People's Counsel proposed a significantly different rate structure containing under 29 percent equity based upon Dr. King's double leverage theory.

The Commission will 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 structure containing only 29 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 29 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 Co.*, 320 U.S. 591 (1944).

Pepco 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 Pepco's capital structure because OPC concludes that Pepco does use short-term debt to purchase long-term assets; further, OPC urges that the Company's rate base contains shorter- as well as longer-lived assets.

As noted above, the Commission finds that Pepco's actual capital structure is the most appropriate capital structure to adopt in calculating the Company's rate of return. Short-term debt is a small part of that structure, and the Commission concludes that it may be omitted without damage to the developing of an appropriate cost of capital, in this case. The Commission reserves the right to include or omit short-term debt in other cases as the record dictates.

C. Pepco's Weighted Total Return on Capital and Revenue Deficiency

Thus, based on a 10.00 percent ROE and a 6.15 percent cost of long-term debt, Pepco's weighted total return on capital is 7.99 percent, as shown by the following calculation:

Type of Capital	Ratios		Cost Rate		Overall Rate of Return
Long-Term Debt	52.31%	X	6.15%	=	3.22%
Common Equity	47.69%	X	10.00%	=	4.77%
					7.99%

Accordingly, when applying the 7.99 percent overall ROR to the adjusted rate base of $895,503,000, we find the Company's net operating income requirement totals $71,551,000. As the Company's adjusted net operating income was $,65,468,000 for the September 30, 2006 test year, we find that the Company experienced a net operating income deficiency of $6,273,000, which becomes a gross revenue deficiency of $10,606,000.

Therefore, we find that a temporary rate increase of that amount, $10,606,000, will result in just and reasonable rates to Pepco and its customers, and the Company is authorized to file tariffs for such amount in accordance with the findings of this Order.

VIII. RATE DESIGN

A. Bill Stabilization Adjustment

Pepco 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 rate of return on its operations by limiting exposure to changes in revenue caused by variations in the energy usage of its customers. Pepco'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) then 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.[33] 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

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

through to the customer.[34] However, while distribution costs are fixed, a significant amount of the distribution company revenues are collected through the volumetric energy charge. Currently, the customer and demand charges are not set at levels sufficient to cover all the fixed distribution costs.

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 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 Pepco that the BSA should be approved; however, 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

[34] 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" customer), Pepco procures wholesale power on behalf of, and passes the costs of power through to, these customers.

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 Pepco's ROE is adjusted downward by 50 basis points instead of 25.

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. Pepco 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.

While the Company objects to waiting a year to apply refunds or credits (which is what OPC proposed annual lag would suggest), Pepco seems amenable to addressing OPC's concerns by calculating the BSA monthly. While the year lag is OPC's first choice, OPC also seems amenable to a month lag and believes that such a lag structure, while not perfect, would tend to be more in keeping with the idea of stabilizing the bill.

AOBA concludes that Pepco's proposed BSA is unnecessary, inappropriate, and duplicative of other ratemaking initiatives included in its filing in this proceeding. Consistent with the position held by OPC, AOBA claims that Company witness Morin's proposed 25 basis point reduction in the return on equity (ROE), should the BSA be adopted, understates the reduction in risk facing the Company.

AOBA also shares the same concerns with OPC over the proposed quarter lag. In addition, AOBA notes that Pepco customers already have a budget-billing option available, which is set up solely to stabilize monthly bills.

The Commission Staff generally supports the BSA as an appropriate decoupling mechanism which serves multiple policy purposes. Staff, however, shares OPC's and AOBA's concerns over: (1) the proposed quarter lag (but Staff is open to the aforementioned one-month lag alternative); (2) the perceived small downward adjustment in ROE of 25 basis points proposed by witness Morin in response to the lower revenue risk owed to the BSA; and (3) the need for annual studies on, and monitoring of, the progress of `the BSA implementation.

Staff agrees with AOBA that the ROE should be lowered by 50 basis points if the BSA is implemented. Finally, consistent with the Company's proposal, Staff recommends that the BSA be applied to all rate classes.

UMCP recommends that the Commission should not accept the BSA at this time. Rather, UMCP feels that the Commission should defer consideration of the BSA to the "Blueprint for the Future" proceeding in order to provide greater opportunity for in-depth investigation and solicitation of input from interested parties.

UMCP notes that the revenue stability produced by the BSA may lead to a longer lag between rate cases. While noting that this may be a benefit to ratepayers, UMCP also notes that this extended regulatory lag may create an incentive for the Company to cut costs by skimping on service quality.

UMCP also claims that the BSA does not cap Pepco's earnings at the Commission-authorized level. If Pepco keeps expenses at test year levels, Pepco's earnings could exceed the authorized amount. Finally, UMCP argues that if the Commission does not approve Pepco's proposed amendment to the Standby Tariff, but the Commission does approve the BSA, then it is possible that the BSA could produce variations in class revenue, depending on whether or not the UMCP's generating facilities are operating. For this reason, UMCP recommends that should the BSA be implemented, it should only be applied to classes such as the residential and small commercial rate classes or it should exclude large distributed generators from the class BSA calculations.

In response to interveners' direct testimonies, the Company's rebuttal primarily focuses on the claims by various interveners that: (1) the Company's ROE should be significantly reduced (*i.e.*, beyond the 25 basis points proposed by Dr. Morin) if the BSA is implemented; (2) there should be on-going studies and monitoring of the BSA implementation; (3) other rate initiatives in the Company's filing make adoption of the BSA redundant; and (4) if the BSA is implemented, it should only be applied to residential and small commercial rate classes.

Company witness Dr. Browning responds to the intervenors' claim that there is a need for additional and continuing studies on, and monitoring of, the BSA progress. Dr. Browning feels that such requirements would be unnecessary and redundant because the proposed tariff already requires that the Company provide on a quarterly basis a filing on the BSA, and that it provide the workpapers to the Staff. The Company will work with Staff to provide them the information that they require.

The Company claims that, even with the other rate initiatives in these proceedings, the BSA would not be redundant with other rate initiatives. The Company claims that its proposed changes to demand charges and customer charges, while recovering more of the fixed distribution costs, are still set to cover only 60 percent of the distribution base revenue; therefore, there remains a continual dependence on the energy charge for recovery of fixed costs. In response to the other concerns, the Company goes on to say that (as noted above) it would be willing to replace the quarter lag with a monthly lag. Finally, the Company claims that limiting the application of the BSA to residential and small commercial customers would deprive other customers of the stability benefits of the BSA.

Having considered the evidence with respect to this matter, the Commission concludes that the Bill Stabilization Adjustment mechanism should be approved. The BSA serves multiple public policies. First, it reduces risk and therefore reduces the Company's cost of capital. This reduction in the cost of capital redounds to the benefit of customers as is evident in the 50 basis point reduction in the return on equity authorized herein. 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 enable customers to better control their electric bills. 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.

We therefore consider the deployment of such cost-effective programs to be a policy undertaking that the Commission believes will substantially inure to benefit ratepayers amid increasing costs of electric supply and growing reliability concerns.

The Commission concludes that the BSA should be adopted as filed for all of these reasons, with the modification that it should operate on a monthly rather than quarterly basis at this time. 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 Commission declines to adjust the BSA's recovery threshold at this time and accepts 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 that 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. Thus the Commission approves 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 BSA as proposed by Pepco, will address lost sales. The BSA will not address all facets of a more comprehensive approach to energy efficiency activities by the Company. However, the Commission has 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.

The Commission agrees with Staff and OPC that additional monitoring and reporting on the performance of the BSA and the 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 the Commission directs Pepco to confer with Staff and OPC as to adoption and implementation of appropriate monitoring and reporting requirements outlined by Staff. The Company is directed to provide the first report within 90 days of this Order.

B. Pension and Other Post Employment Benefits

Pepco witness Rigby proposes a Pension and Other Post Employment Benefits ("POPEB") rider. The POPEB rider is a surcharge to capture 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- 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 states "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 ...."[35] OPC avers that the POPEB "tracker will remove the risk to Pepco 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 type of anticipated future expenditures to be currently recognized at their present discount value."[36]

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

> 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

[35] OPC witness Effron Direct at 24.
[36] OPC Initial Brief at 58; OPC Reply Brief at 1.

> sound ratemaking practice, as such mechanisms tend to either reduce or eliminate incentives to control costs. Such mechanisms should be reserved for expenses that are of such exceptional magnitude and volatility that unexpected adverse fluctuations can cause irreparable financial harm.... While pension and OPEB costs are not immaterial, they clearly are not comparable in scale to purchased power costs and purchased gas costs.[37]

OPC also notes the inconsistent treatment of the POPEB and BSA in Pepco's testimony, in that, 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 (ROE) of 81 basis points is required.

UMCP, AOBA and WMATA all oppose the proposed POPEB rider. UMCP argues that Pepco's POPEB rider is simply an attempt to formulize the recovery of costs for a normal operating expense when these costs do not require any different treatment than Pepco's other operating expenses, such as debt costs, health costs, labor costs and postal rates that are also influenced by factors outside Pepco's control. AOBA notes that nothing currently prevents Pepco from seeking recovery of prudently incurred pension and OPEB costs and notes that the language of the proposed rider's tariff does not protect customers from embedded costs that are in excess of actual costs. WMATA opposes the POPEB rider in part, because adoption of the POPEB surcharge mechanism would significantly shift economic risk from the Company to ratepayers.

[37] Effron Direct at p.22-25.

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

The Company argues in response to opposition from OPC and Staff, that its management of the POPEB costs has not been challenged as imprudent. Therefore, Pepco asserts it has demonstrated that volatility in POPEB costs[38] is a genuine problem that needs to be addressed, notwithstanding the Company's efforts to exercise control over the costs. Pepco concludes that the POPEB rider is necessary because annual fluctuations in the POPEB costs are beyond the Company's control.

The Company's request to implement OPEB and pension tracker mechanisms is not accepted.[39] The tracker mechanisms guarantee dollar for dollar recovery of OPEB and pension costs and thus would lessen the Company's financial incentive to control the benefits granted under its retirement plans and the costs thereof.[40] The Company has not sufficiently met its burden of proof that the rider is just, reasonable, and an appropriate expense for isolated recovery of costs. The Commission has approved riders for fuel, universal service and environmental surcharges. The Company has not demonstrated that POPEB charges are sufficiently similar to these types of expenses for the purpose of affording the Company surcharge based revenue recovery of POPEB costs. However, implementation of a tracker mechanism is an extraordinary form of rate-making which is

[38] During the last ten years Pepco merged with Delmarva during the period when it notes annual variations in POPEB costs have ranged from -$35.4 million to $14.4 million per year.
[39] *See Re Washington Gas Light Company*, 94 Md. PSC 329, 353 (2003) (Order No. 78757).
[40] *Id*.

usually reserved for very large expense items which have the potential to seriously impair a utility's financial well being.[41] Therefore the Commission denies the Company's request for a POPEB rider.

C. Cost Allocation and Rate Design Issues

1. Overview of the Company's Position

Pepco is proposing changes to its existing rate schedules consistent with its overall proposed increase in base revenue requirements. The Company argues that its proposed rate changes: (1) will lessen class-specific rate-of-return deviations from the overall company rate of return; and (2) will provide customers within each rate class with price signals that are more in line with the levels and types of costs associated with providing distribution services and that are indicated by the Company's class cost-of-service studies ("CCOSS"). In general, these rate changes yield less reliance on volumetric energy charges and yield less seasonal differentiation in rates (where such differentiation is not justified by cost).

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.[42] However, while distribution costs are fixed, a significant amount of the distribution company revenues are collected through the volumetric energy charge. Currently, customer and demand charges are not set at levels sufficient to cover all the fixed distribution costs. Additionally, residential customers do not face demand charges,

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[41] *See id*.

[42] 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), Pepco procures wholesale power on behalf of, and passes the costs of this power through to, these customers. In Dr. Browning's Rebuttal at 17(2 – 3), the witness states that "in September 2006, 94 percent of residential customers were SOS customers."

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.

Also current distribution rates yield a large variation in the class-specific rates of return. Starting from the formula for distribution revenue requirements, the overall rate of return can be expressed as net operating income divided by rate base. Net operating income is given as operating revenues minus operating expenses (including annual depreciation expenses and taxes) and is required by the Company to cover interest payments on debt as well as a fair profit. In a CCOSS, the expenses and rate base items are also allocated to each rate class. Therefore, once the proposed rates are set, and the expected revenue from each class is determined, the allocated costs and rate base items from the CCOSS also enable one to calculate "class-specific rates of return." The Unitized Rate of Return ("UROR") for a given rate class is equal to that class's rate of return divided by the overall return for the entire Maryland jurisdiction.

Ideally, based on cost causation, distribution rates should be set as to:

> minimize, to the extent possible, the level that any rate class specific rate of return is more or less than the overall required rate of return. The measure of success at achieving this goal is . . . [based on] the extent to which each rate class rate design results in a rate class specific UROR of unity [i.e., UROR equal to one].[43]

[43] Bumgarner Direct at 4 (5 – 11).

> Based on the Company's CCOSS, current distribution rates yield earned returns that vary widely by class.

At present rates, the Company contends that the standard (Schedule R) and time-of-use (Schedule R-TM) residential rate classes are at the low end of the range for class-specific rate of return values, with returns of 0.72 percent (UROR = 0.15) and -1.05 percent (UROR = – 0.22), respectively. The high end of the range contains the large commercial high-voltage (Schedule GT-3B) class at 31.96 percent (UROR = 6.63) and telecommunications network service (Schedule TN) at 53.85 percent (UROR = 11.17). Indeed, the Company's CCOSS shows that all of the medium to large commercial classes had class-specific return values at least twice as high as the Company's overall rate of return. In general, the residential classes currently provide virtually no earnings on distribution service while the commercial classes provide above average rates of return.

2. The Company's Proposed Residential Rates

The Company's proposed rate increases will more than triple the residential classes' UROR values, but these proposed rate increases are still roughly half of what would be required to yield UROR values equal to one. Expectedly, the interveners for commercial customers have significant concerns over the substantial erosion of the residential class rate of return which leaves that class, the Company's largest class of service, providing virtually no return on more than $500 million of rate base investment that Pepco has incurred to serve that class.

AOBA witness Oliver proposed that if a lesser overall increase is approved than requested, the majority of any such reduction should be distributed among rate classes in a manner that further reduces class rate of return differentials. The Commission Staff reaches a similar conclusion by stating that – while in an effort to further the Commission's policy of gradualism, it declines to recommend rate decreases for commercial customers – Staff does recommend that any increase in the instant case be absorbed by the residential classes, street lighting class, and small commercial user class (GS-LV).

In deriving its recommended residential rate design modifications, the Company states that its first step was to adjust the Customer Charge to half of the full level of customer-related cost. This resulted in proposed monthly Customer Charges of $8.29 for Schedule R and $14.21 for Schedule R-TM. For Schedule R, the Company reduced the summer energy charge by five percent and increased the winter block rates by an amount sufficient to produce the revenue target. As a result: (1) the resulting winter block rates are virtually the same (as compared to the current decreasing-block winter rates); (2) the current differential between the summer energy rate and the winter energy rate has been significantly reduced; and, (3) the structure of Schedule R is now more in line with the flat energy charge structure on Schedule R-TM.

The Company notes that if the customer charge was based on 100 percent of the full residential customer-related costs (as opposed to its proposed 50 percent value), then this charge would be $16.58 for Schedule R customers (as opposed to the proposed $8.29 amount) and $28.42 for Schedule R-TM customers (as opposed to the proposed $14.21 amount). The higher customer-related costs for Schedule R-TM customers is owed to the more expensive metering and billing associated with time-of-use pricing.

Staff, while acknowledging the need to move rates closer to cost, recommends that, in order to avoid rate shock, the proposed customer charge for the residential classes should be increased 25 percent, rather than the 50 percent proposed by the Company. Staff's recommendation would result in an increase in the residential customer charge to $6.93 (for Schedule R) and $14.21 (for Schedule R-TM).

OPC also shares Staff's concern over the potential rate shock associated with Pepco's proposed customer charge. OPC states that rather than achieving fair and equitable results, in this proceeding the Company is proposing to increase the customer charges for the residential class. Residential customers are being saddled with a proposed increase of 50 percent in the customer charge for the R class and 24 percent for the R-TM class."[44] OPC recommends that the customer and energy charges should be increased in proportion to the proposed overall revenue increase allocated in the residential class, and that the proposed customer charge increase runs counter to the Commission's prior holdings on rate shock. Since the customer charge has a disproportionate impact on customers with low usage, the Commission has generally limited the increase in the customer charge component of rates.

Pepco's proposed residential rate design includes a 50 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.

The Commission therefore determines that a more gradual approach is appropriate for setting the residential customer charge. After considering the positions of the parties and the record evidence, the Commission determines that a $6.65 residential customer charge,

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[44] OPC Initial Brief p. 66.

and a $13.76 customer charge for R-TM customers, reflects the appropriate balance between gradualism and cost causation.

3. The Company's Proposed Commercial Rates

The Company proposes to increase the revenue received from the commercial classes through demand charges and decrease the revenue received through the energy charges. The Company also proposes to eliminate the summer on-peak demand charge for the time-of-use metered commercial classes. The revenue formerly recovered by this charge has been included in the maximum demand charge and the seasonal differential has been reduced by lowering the summer demand charge and raising the corresponding winter demand charge.

The Company states that the seasonal differences in the demand charges was simply a vestige of the former fully bundled rate designs and does not reflect any seasonal cost causality for distribution service.

Neither Staff nor OPC contested the elimination of the summer on-peak demand charges. However, Staff recommends that only 25 percent of the demand-related costs should be collected through the maximum demand rate instead of the 50 percent level proposed by the Company. Staff makes this recommendation because it is concerned over the effect such a large increase would have on smaller commercial customers within a class and that the Company will attain greater revenue certainty through Staff's recommendation to accept the Bill Stabilization Rider.

While AOBA witness Oliver noted that Pepco's proposed elimination of summer on-peak demand charges for distribution service is reasonable and appropriate for low voltage customers in the GT and MGT rate classifications, he argued that the proposed shift of revenue from the energy charge to the demand charge should be moderate.

As mentioned above, all the commercial class interveners, AOBA, GSA, WMATA, and UMCP expressed dismay at the perceived subsidy from the commercial classes to the residential classes.

AOBA Witness Oliver notes that the distribution costs in a customer's bill represent between 20 percent and 30 percent. Thus, the exact matching of cost recovery to the elements of the customers' bill — namely customer demand and energy charges will necessarily violate competing concerns for gradualism when changing rate elements.

UMCP opposes Pepco's proposal to eliminate on-peak demand charges stating that it would have serious consequences because it would transfer costs away from those who impose the greatest cost on the distribution system. In addition UMCP showed that elimination of the on-peak charges would create inconsistencies among design, cost allocation and rate recovery and would reduce the effectiveness and economics of load control devices.

GSA, as one of Pepco's largest commercial ratepayers, similarly opposes the proposed energy to demand shift, and notes that no rate that tries to track costs using only two parameters — maximum kW demand and total kWh energy use — can or should be expected to recover the utility's exact cost of serving each customer. GSA argues that Pepco has provided no analysis to demonstrate that its proposed shift is necessary to track costs accurately, nor whether the intraclass billing impacts of its proposal are reasonable and acceptable. *Id.* at p. 14. Notwithstanding its concerns, GSA would, however, support limiting the energy to demand shift to no more than 25 percent of demand related costs.

Given the significantly smaller revenue increase authorized herein, relative to the Company's proposed revenue increase, the Commission will not adopt significant rate design or cost allocation changes. The Commission adopts the following rate design consistent with the principles enunciated by the Staff with respect to gradualism and the policy of moving all class rates of return towards parity: as previously noted, the residential customer charge should be increased by 20 percent to a level of $6.65; and the R-TM customer charge should be increased by 20 percent to $13.76. Customer charges for the small commercial customer classes should be increased by five percent. The customer charges for the large commercial customer classes should be increased by $10.00. The remaining revenue requirement shall be raised by across-the-board increases in energy charges for all classes.

4. Standby Service and Reserved Delivery Capacity Service

Certain Pepco customers qualify as standby service customers. They receive a discount from the general service rates pursuant to the Standby Service Rider in that the energy charge is not applicable to their self-generation. The Company proposes to replace the existing Facilities Charge and Usage Charges with a Monthly Rate. Under the new Monthly Rate section of Schedule S, standby customers will pay a distribution charge based on the electric usage and load of the premises including both the kilowatt-hours and kilowatts provided by the customer's on-site generation and the total kWhs provided by the Company or by an electricity supplier.

The Company also proposes the introduction of a new rider for Reserved Delivery Capacity Service ("RDCS"). The rider is designed for customers who seek an agreement with the Company for the reservation of capacity on an alternative delivery service on the

Company's electric system, and varies by the customer class and whether the facilities are new or existing. It is not available for standby or back-up service for generation operating in parallel with the Company's delivery system. The RDCS rider provides discounts to Commercial customers that vary from 12.95 percent for existing facilities of the Washington Metropolitan Area Transit Authority to 96.27 percent for customers who install new facilities on the MGT-LV tariff. No party opposed the Company's proposal to institute the RDCS rider. The rider is hereby approved.

UMCP is a large commercial (GT-3A) customer opposed to Pepco's proposed Standby Service Charge. UMCP argues it is paying more than its annual cost of service prior to the addition of Pepco's proposed Standby Service charge and therefore, that Pepco's proposed standby tariff amendments should be rejected. UMCP argues that since PEPCO is a distribution company rather than a generation, transmission and distribution company, Pepco's proposed rate for standby service is consumption based and it would be inappropriate to apply the rate to all load and energy on campus, irrespective of whether the University's generators supplied that power or not. UMCP therefore suggests that because Standby Service issues are very complex and require a careful balancing of interests, including the value of distributed generation, the Commission should institute a separate proceeding to address the issue and UMCP should be grandfathered under the existing Standby Service tariff.

Staff notes that the current Standby Service tariff was made effective in 1984 when it was approved by the Commission in Case No. 7714. Staff does not support the modifications 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.

The Commission rejects the proposed changes to the Standby Service Rider and determines to maintain the status quo at this time. Given the value that distributed generation provides to the system as a whole and our policy of facilitating deployment of distributed generation, the issues raised by Staff's discussion of distributed generation should be continued in the Demand Response Distributed Generation Working Group. The Commission directs that the issues of Distributed Generation and the proposed Standby Charge changes be addressed in the Demand Response Distributed Generation Working Group.

The Company proposes to extract the Telecommunications Network ("TN") service customer billing determinants from the General Service Class and establish a new rate class for cable network facilities. The TN tariff will be available for unmetered electric service to certain telecommunications network and power supply devices not exceeding 1.8 MW per device. At the customer's option, monthly kilowatt-hour consumption will be computed on the basis of either the manufacturer's average wattage ratings with no allowance for outages, or on the basis of statistically valid sampling techniques. TN customers will not pay a customer charge and will be charged 0.03292 per kWh summer and 0.01992 per kWh in the winter. Thus, the TN rate provides a savings over the rates proposed for the GS class which has a customer charge of $10.83 per month and a rate of 0.03357 per kWh in the summer and 0.02422 per kWh in the winter.

The Commission determines that the proposed rate design for TN customers is consistent with the appropriate balancing of competing rate design concerns including the initiation of a new rate class, and moving the TN class closer to a unitized rate of return.

5. The Company's Proposed Reconnection Fee

The Company proposes to increase the reconnection fee from its current level of $35 to its full-cost level of $100. It argues that the he proposed fee better reflects the full costs associated with this activity and thus should provide an incentive for customers to remain current on their electric bills. In addition, the Company has deducted reconnect fee revenue from the residential class revenue requirement in development of the proposed rates.

OPC opposes the proposed 186 percent increase in the reconnection fee. OPC feels that such a large increase "imposed upon those who already experience difficulty in making payments flies in the face of the doctrine of gradualism."[45] Moreover, OPC is skeptical regarding the Company's suggestion that increasing this fee will give customers a greater incentive to pay their bills on time. Rather, OPC states that "Pepco is totally in the dark as to the effect of this increase on a decrease in the number of terminations. Pepco cannot make any estimate concerning the number of terminations its increased fee will bring."[46]

The Company and OPC disagree on the appropriate percentage increase in the reconnection fee. OPC, appropriately, questions the nexus between an increase in the reconnection fee and an increase in a customer's ability to pay a delinquent bill.

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[45] OPC Initial Brief, pp. 61 – 62.
[46] *Ibid*.

Pursuant to Senate Bill 1,[47] the Commission has collected, in Case No. 9074, customer termination information for all utilities in the State. The Commission therefore is monitoring customer terminations on an on-going basis. Furthermore, consistent with activities in other proceedings, the Commission will work toward improvements in the assistance provided to those customers with challenges in paying their monthly electric bill. The proposed increase in the reconnection fee will simply add to the difficulty low-income customers have in maintaining their electric service. Therefore, the Commission will not accept the proposed increase in the fee. The Commission recognizes that this decision shifts the cost of reconnecting specific customers to other customers but does so as an appropriate public policy choice.

6. Elimination of Experimental Riders for Residential Electric Vehicle Service

Pepco proposes to eliminate the experimental riders for residential electric vehicle service (R-EV and RTM-EV). Pepco Witness Bumgarner Direct at p. 25. Pepco asserts that there have been 4 customers taking service on this experimental tariff over the six years of its existence. *Id.* He goes on to argue that because Pepco is now a distribution company, there is no basis in cost for the electric vehicle rider.

No party contests this proposal. Therefore, consistent with the Commission's review of the Company's conservation and energy efficiency issues in a separate proceeding, the Commission approves elimination and closure of this rider to new customers going forward, and the grandfathering of any existing customers until the earlier of the customer's decision to opt to leave the rider or the customer ceasing its use of electric vehicles.

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[47] Chapter 5, 2006 Laws of Maryland, 1st Sp. Session.

IX. CONCLUSION AND ORDERED PARAGRAPHS

In conclusion, upon review of the record, the Commission finds that the application for a rate increase of $55.7 million filed by Pepco on November 17, 2006 will not result in just and reasonable rates and is therefore rejected. Rather, the Commission finds 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 $10,606,000, which amount will result in just and reasonable rates to the Company and its customers pending further proceedings of 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. We also order that the Company file an independent audit opinion, as required by Public Utility Companies Article § 4-208, and we will schedule and convene a second phase in this case to consider parent company costs and to determine the appropriate final rate. 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 Potomac Electric Power Company filed November 17, 2006, seeking to increase distribution rates for electric service by $55.7 million, is hereby denied;

(2) That Potomac Electric Power 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 $10,606,000 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 (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; and

(6) That the Company shall address issues of Distributed Generation and a proposed Standby Charge in the Demand Response Distributed Generation Working Group.

/s/ Steven B. Larsen

/s/ Harold D. Williams

/s/ Allen M. Freifeld

/s/ Susanne Brogan
Commissioners

POTOMAC ELECTRIC POWER COMPANY - CASE NO. 9092
RATE BASE
(Test Year Ended 9/30/06)

1.	Unadjusted Rate Base	$876,330	
	Uncontested Adjustments		
2.	Annualize Deductible Mixed Service Cost Tax Method	8,243	
3.	Adjustments to Cash Working Capital	(4,591)	
		879,982	
	Contested Adjustments		
4.	Removal of Plant Related to M & S	(536)	
5.	Amortization of Severance Programs	565	
6.	Reflection of New Depreciation Rates	15,492	
	Adjusted Rate Base		895,503
	Overall Rate of Return		x 7.99%
	Net Operating Income Required		71,551
	Adjusted Net Operating Income (from Appendix II)		65,278
	Net Operating Income Deficiency x 1.6908 (Tax Factor)		6,273
	Gross Revenue Requirement		$10,606

POTOMAC ELECTRIC POWER COMPANY - CASE NO. 9092
OPERATING INCOME
(Test Year Ended 9/30/06)

1.	Unadjusted	$46,548
	Uncontested Adjustments	
2.	Interest expense on customer deposits	(547)
3.	Exclude institutional & promotional advertising	109
4.	Remove Mirant bankruptcy costs	877
5.	Annualize changes in employee health & welfare	(682)
6.	Annualize postal rate increase	(16)
7.	Exclude merger-related costs	12
8.	Reflection of coal credit	90
9.	Additional adjustment to correct tax treatment of software	698
10.	Additional adjustment to increase test period revenues for billing	210
11.	Interest synchronization	(1,844)
	Contested Adjustments	
12.	Amortization of severance programs	(67)
13.	Annualization of revenues	380
14.	Annualization of wage increase	(1,312)
15.	Customer service enhancement	(403)
16.	Increase in vehicle resource use costs	(230)
17.	Reallocation of PHI service company costs	0
18.	Reflect new depreciation rates	20,254
19.	Deferred Compensation Adjustment	392
20.	Regulatory Expense Adjustment	21
21.	Amortization of Rate Proceeding Costs	(32)
22.	Normalization of employee levels	820
	Adjusted Net Operating Income	$65,278

IN THE MATTER OF THE APPLICATION OF POTOMAC ELECTRIC POWER 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. 9092

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 page 11 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 III 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 POTOMAC ELECTRIC POWER 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. 9092

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.[48]

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,

[48] 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.[49]

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

[49] 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

Dated: July 19, 2007

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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 III 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