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April 12, 2017

Brinda Westbrook-Sedgwick
Commission Secretary
Public Service Commission
of the District of Columbia
1325 G Street, NW
Suite 800
Washington, DC 20005

RE: Formal Case No. 1139 – In the Matter of the Application of Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service

Dear Mrs. Westbrook-Sedgwick:

Enclosed for filing please find an original and 15 copies of the Office of the People's Counsel for the District of Columbia's Initial Post-Hearing Brief (Public).

If there are any questions regarding this matter, please contact me at (202) 727-3071.

Sincerely,

Arick R. Sears
Assistant People's Counsel

Enclosure
cc: All parties of record

BEFORE THE
PUBLIC SERVICE COMMISSION
OF THE DISTRICT OF COLUMBIA

In the Matter of	§	
	§	
The Application of the	§	**Formal Case No. 1139**
Potomac Electric Power Company	§	
For Authority to Increase Existing	§	
Retail Rates and Changes for	§	
Electric Distribution Service	§	

INITIAL POST-HEARING BRIEF
OF
THE OFFICE OF THE PEOPLE'S COUNSEL
(PUBLIC VERSION)

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April 12, 2017

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INITIAL POST-HEARING BRIEF
OF
THE OFFICE OF THE PEOPLE'S COUNSEL

I. INTRODUCTION

Pursuant to Rule 137.1 of the Public Service Commission of the District of Columbia's ("Commission") Rules of Practice and Procedure,[1] the Office of the People's Counsel for the District of Columbia ("OPC or "the Office"), the statutory representative of District of Columbia utility consumers and ratepayers, respectfully files its *Initial Post-Hearing Brief* ("*Initial Brief*").

The Office has participated actively in this proceeding and assisted in the development of a substantial evidentiary record. Based on the record in this proceeding, which is reviewed in detail in this *Initial Brief*, Pepco has failed to meet its burden of proof and the Company's proposed $77,494,000 increase should be rejected. The evidence proffered by OPC in this proceeding demonstrates that Pepco's proposed increase is inflated, unjust, and unreasonable.

1 15 D.C.M.R. § 137.1 (2010).

For the reasons set forth in testimony, pursued at hearing, and reviewed in this *Initial Brief*, OPC recommends the Commission order that Pepco's base rate request be reduced by $52,355,000.

This case represents Pepco's first fully litigated rate review since its acquisition by Exelon last year. The fact that Pepco filed this application three months after the acquisition, coupled with the substantial rate increase sought, should concern the Commission and spark intense scrutiny of this request. This rate application is a test for the Commission, and as the inaugural post-merger base-rate proceeding, is the perfect opportunity for the Commission to establish the appropriate regulatory tone that will govern its relationship with Pepco now that it is an Exelon Company. Accordingly, it is imperative that both Exelon and Pepco be made to know at the outset—in this, Pepco's inaugural post-merger base-rate proceeding—that outrageous and inflated rate increases will not be tolerated.

Chief among the Office's concerns is Pepco's request to earn an 8.00% overall rate of return on its rate base, including a return on common equity of 10.6%. As outlined in this *Initial Brief*, the Company's request is flawed in that it fails to assign sufficient weight to the Commission's preferred estimation method and relies on overly optimistic and upwardly biased forecasts—all of which combine to make the Company's proposed cost of capital excessive, unjust, and unreasonable.

OPC also found Pepco's rate request to be bloated with unjust and unreasonable attempts to include post-test year plant additions in rates. As discussed in Issue 5 *infra*, the Office believes many of the projects for which Pepco seeks recovery are not compelling or unique enough to justify special rate treatment. Furthermore, a review of Pepco's Construction Program Report revealed that many of the project costs are not known and measurable or are too remote from the test year for inclusion under Commission precedent.

The Company's testimony in this proceeding also addressed, at the Commission's request, alternative ratemaking structures, which it chose to address in two parts: alternative recovery mechanisms and alternative rate designs. With respect to alternative recovery, Pepco proposed two mechanisms—a fully forecasted test year and a multi-year rate plan. As detailed in the discussion of Issue 19 *infra*, the Commission should decline to adopt either mechanism because Pepco failed to offer any details on how either one would be implemented and, most importantly, because this Commission's approach to traditional cost-of-service regulation has served the District well.

With respect to alternative rate design, OPC concurs with Pepco that a separate proceeding is necessary to address this issue, but the Office recommends the Commission ensure the scope of the proceeding is comprehensive and holistic. Given the swift pace of change in the electric industry generally and the unique factors affecting the District (e.g., substantial investment in reliability infrastructure, increased penetration of distributed energy resources, concerns regarding affordability of rates), a proceeding solely focused on the goal of ending negative class rates of returns would be unwise. Instead, the Office recommends the Commission investigate both the mechanical and policy goals to ensure rate policies are designed to not only assist our most vulnerable residents with discounts and subsidies, but also those on the second step—namely, the working poor and those on fixed incomes, who pay rates increased by the socialization and subsidization of other costs, including surcharges.

II. SUMMARY OF OPC'S POSITIONS

- **OPC recommends that the Commission decrease Pepco's revenue requirement by $52.355 million.**

This recommendation is based on the testimony of OPC Witness Ramas, which reflects and incorporates the testimony of all OPC witnesses, as detailed in Appendix A.

- **OPC recommends that the Commission establish a return on equity of 8.70% for Pepco or a return on equity of 8.60% if Pepco's Billing Stabilization Adjustment is continued**
- **OPC recommends revising Pepco's capital structure in order to include short-term debt.**
- **OPC recommends an overall rate of return or cost of capital for Pepco of 6.99% (or 6.94% if Pepco's Billing Stabilization Adjustment is continued.**

These recommendations are based on the testimony of Dr. J. Randall Woolridge, as discussed on pages 13-49 of this brief.

- **OPC recommends that the Commission leave the BSA unchanged at the current time and decide whether the BSA should be discontinued as part of the alternative rate design investigation that OPC and Pepco have asked the Commission to undertake shortly after the conclusion of this proceeding.**

This recommendation is based on the testimony of OPC Witness Dismukes, as discussed on pages 50-52 of this brief.

- **OPC recommends that Pepco to use the "Count of Contracts" data for BSA determinations going forward.**

This recommendation is based on the testimony of OPC Witness Ramas, as discussed on pages 50-52 of this brief.

- **OPC recommends Pepco's Ratemaking Adjustment 24 for post-test year reliability plant additions placed in service between April 2016 and December 2016 should be reduced by $5,197,000.**
- **OPC also recommends the Commission exclude Ratemaking Adjustments 25 and 26 from rate base as they are inconsistent with Commission precedent.**

These recommendations are based on the testimony of OPC Witness Mara, as discussed on pages 55-70 of this brief.

- **OPC recommends NOLC offset for ADIT associated with Ratemaking Adjustments 25 and 26 be removed from the test year.**
- **OPC recommends that the IRS Global Tax Settlement's impact be annualized and that the Commission direct Pepco to pursue, in consultation with the OPC, a Private Letter Ruling with the IRS. The final outcome of $33.5 million of the cash payment to Pepco associated with that IRS Global Tax Settlement should be dependent upon the IRS ruling.**

These recommendations are based on the testimony of OPC Witness Ramas, as discussed on pages 70-78 of this brief.

- **OPC recommends that, consistent with Order No. 17424, Pepco update its inflation-based discount rate using the Handy Whitman Indices and use the newly-revised discount rate as its SFAS 143 discount rate.**

These recommendations are based on the testimony of OPC Witness Smith, as discussed on pages 106-110 of this brief.

- **OPC recommends that the Commission approve Pepco's proposed revenue requirement allocation, but not prejudge the percentage increase in future rate cases**
- **OPC believes record evidence exists in this proceeding supporting Pepco's proposal to allocate the CBRC to the Residential and MMA customers.**
- **OPC recommends the Commission find that Pepco's plan for eliminating class rates of return is not reasonable.**

These recommendations are based on the testimony of OPC Witness Dismukes, as discussed on pages 119-131 of this brief.

- **OPC recommends the Commission condition approval of Pepco's Class Cost of Service Study on Pepco's acceptance of revisions to the allocators for secondary voltage facilities costs, subtransmission costs, and Commission assessment fees.**

These recommendations are based on the testimony of OPC Witness Dismukes, as discussed on pages 131-137 of this brief.

- **OPC recommends the Commission reject Pepco's Proposal to Increase Customer Charges for the R and AE classes and defer a decision on whether to consolidate the R and AE classes to a separate proceeding on alternative rate designs.**

These recommendations are based on the testimony of OPC Witness Dismukes, as discussed on pages 137-145 of this brief.

- **Pepco's Construction Program Report is in general compliance with Commission directives contained in Order Nos. 16930 and 17424; however, the Company should investigate and report back to the Commission on whether there are more cost-effective ways to improve reliability than through capital spending and it should exclude from rates all expenses**

associated with Remote Monitoring System and Conservation Voltage Reduction until the programs have been cost-justified through appropriate filings with the Commission.

- **Pepco's short-term and long-term load forecasts are not reasonable because they significantly overestimate actual demand and the Commission should institute a separate proceeding to investigate the Company's load forecasting methodology.**

These recommendations are based on the testimony of OPC Witness Mara, as discussed on pages 145-169 of this brief.

III. PROCEDURAL BACKGROUND

On June 30, 216, the Potomac Electric Power Company, ("Pepco") filed an application with the Public Service Commission of the District of Columbia ("Commission") requesting authority to increase exiting rates and charges for electric distribution service in the District.[2] The Apartment and Office Building Association of Metropolitan Washington ("AOBA") filed a *Notice of Appearance* and *Petition to Intervene* on July 1, 2016 and the General Services Administration ("GSA") filed its *Petition to Intervene and Notice of Appearances* on July 14, 2016.[3] The Baltimore Washington Construction and Public Employees Laborers' District Council filed a *Petition to Intervene* on July 21, 2016.[4] Additionally, the DC Water filed its *Petition for Leave to Intervene*, the DC Consumer Utility Board ("CUB") filed a *Petition to Intervene*, DC Solar United Neighborhoods ("DC SUN") and Public Citizen filed *a Petition to*

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2 *Formal Case No. 1139, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service ("Formal Case No. 1139"),* Application of the Potomac Electric Power Company, filed June 30, 2016.

3 *Formal Case No. 1139,* Petition to Intervene of the Apartment and Office Building Association of Metropolitan Washington, filed July 1, 2016. *Formal Case No. 1139*, Notice of Appearance of the Apartment and Office Building Association of Metropolitan Washington, filed July 1, 2016. *Formal Case No. 1139*, Petition to Intervene and Notice of Appearance, filed July 14, 2016.

4 *Formal Case No. 1139*, Petition to Intervene of the Baltimore Washington Laborers and Public Employees District Council, filed July 21, 2016.

Intervene and Notice of Appearance.[5] Finally, the District of Columbia Government ("DCG") filed its *Petition to Intervene and Notice of Appearance* on August 4, 2016.[6]

On August 26, 2016, Pepco filed the parties' *Consensus Proposed Procedural Schedule and Issues* consisting of 13 issues.[7] Additionally, Pepco, OPC, GSA, DCG and AOBA filed their list of non-consensus issues.[8] On September 9, 2016, the Commission convened a pre-hearing conference where it heard the parties' and intervenors' proposed issues and procedural schedules. The Commission also requested comment from the parties on issues it was considering including, stand-by rates, demand rates, performance-based ratemaking, distribution time of use rates and load forecasting. OPC, Pepco, AOBA, GSA, and DCG filed responsive comments on September 14, 2016.[9] Thereafter, the Commission issued an order designating nineteen issues for hearing and setting a procedural schedule.[10]

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5 *Formal Case No. 1139*, Petition of the District of Columbia Water and Sewer Authority for Leave to Intervene, filed July 22, 2016. *Formal Case No. 1139*, DC Consumer Utility Board's Petition to Intervene, filed July 22, 2016. *Formal Case No. 1139*, DC Solar United Neighborhoods' and Public Citizen's Petition to Intervene and Notice of Appearance, filed July 22, 2016.

6 *Formal Case No. 1139*, District of Columbia Government's Petition for Leave to Intervene, filed August 4, 2016.

7 *Formal Case No. 1139*, Potomac Electric Power Company's Submission of Consensus Proposed Procedural Schedule and Issues, filed August 22, 2016.

8 *Formal Case No. 1139*, Potomac Electric Power Company's Submission of Nonconsensus Proposed Issues, filed August 31, 2016. *Formal Case No. 1139*, Office of the People's Counsel's Prehearing Conference Comments and Proposed Non-Consensus Issues, filed August 31, 2016. *Formal Case No. 1139*, GSA's Statement of Issues, filed August 31, 2016. *Formal Case No. 1139*, Statement of Issues of the District of Columbia Government, filed August 31, 2016. *Formal Case No. 1139*, Statement of Issues of the Apartment and Office Building Association of Metropolitan Washington, filed August 26, 2016.

9 *Formal Case No. 1139*, Response of the Apartment and Office Building Association of Metropolitan Washington to the Commission September 9, 2016 Prehearing Request for Comments, filed September 14, 2016. *Formal Case No. 1139*, Comments of Potomac Electric Power Company Regarding Potential Commission Issues, filed September 14, 2016. *Formal Case No. 1139*, Office of the People's Counsel's Comments in Response to the Commission's Request for Comments Regarding Additional Rate Mechanisms Proposed by the Commission, filed September 14, 2016. *Formal Case No. 1139*, GSA's Response to the proposed Commission Issues, filed September 14, 2016. *Formal Case No. 1139*, Comments of the District of Columbia Government on Commission-Proposed Issues, filed September 14, 2016.

10 Order No. 18550, rel. September 22, 2016.

Pepco filed its Supplemental Direct Testimony on October 14, 2016.[11] OPC and the intervenors filed their Direct Testimony on December 14, 2016. The parties filed Rebuttal Testimony on February 1, 2017. Following the submission of testimony and exhibits, the Commission held an evidentiary hearing on Pepco's application on March 15-17, 2017 and March 20-24, 2017. The Office now submits its Initial Post-Hearing Brief in this proceeding.

IV. PEPCO'S BURDEN OF PROOF AND THE COMMISSION'S STATUTORY OBLIGATION IN UTILITY REGULATION PROCEEDINGS

As the Applicant in this proceeding, Pepco bears the burden of establishing by substantial evidence that its proposed distribution rates and charges are just and reasonable.[12] This burden is solely and exclusively Pepco's. The D.C. Court of Appeals has determined that the Company's burden includes "a responsibility to develop a record sufficiently complete to support a Commission order in their favor on any contested issue."[13] By contrast, OPC's obligation is to present convincing evidence and/or argument on contested issues. The Office submits it has met this legal standard in this proceeding.[14] As demonstrated in the record and reviewed in this brief, Pepco has failed to meet its evidentiary burden with respect to many of the contested issues. In each instance where Pepco has failed to satisfy its burden, the Company's requested rate adjustment should be rejected.

More broadly, the Commission has the responsibility to ensure that utility service in the District of Columbia is safe, adequate, and reliable and that the rates and charges for utility

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11 *Formal Case No. 1139*, Supplemental Direct Testimony of Potomac Electric Power Company, filed October 14, 2016.

12 D.C. Code § 2-509(b); *see also*, *Washington Public Interest Org. v. Public Service Comm'n*, 393 A.2d at 75, supplemental opinion and dissent, 404 A.2d 541 (D.C. 1979), cert. denied, sub nom *Potomac Electric Power Co. v. Public Service Comm'n*, 444 U.S. 926 (1979).

13 *Id.*

14 *Id.*

service are reasonable, just, and nondiscriminatory.[15] In addition, the PSC must consider the economic and environmental impact of its decisions.[16] The D.C. Court of Appeals has found, "[a] utility rate cannot be deemed 'reasonable' simply because an expert agency says it is. . . . the Commission . . . has the burden of showing fully and clearly why it has taken the particular ratemaking action. Absent such comprehensive explanation, judicial review of the Commission's substantive decisions cannot be completed and the rate order finally approved -- or set aside."[17] As the D.C. Court of Appeals held in deciding how to allocate the financial gain from the sale of land by a public utility:

> The Commission, as decision-maker, must evaluate all the presentations and then fashion the most just and reasonable order, including a determination of the land-gains issue. The Commission, however, cannot validly do so without furnishing detailed findings of fact and conclusions of law sufficient to demonstrate that the overall rate determination is "in accordance with the reliable, probative, and substantial evidence."[18]

The law requires that the Commission's factual findings be based upon substantial record evidence.[19] As the Court has held, "This 'substantial evidence' test is not directed solely at the quantity of evidentiary support for an administrative determination. Equally important is the preceding language of [§ 2-509(e)], '*in accordance with* . . . .' [Emphasis added.] There 'must be a *demonstration* in the findings of a 'rational connection between facts found and the choice made' [citation omitted]." Thus, as applied to ratemaking, there must be enough evidence,

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15 D.C. Code § 1-204.93 (2010).

16 D.C. Code § 34-808.02 (2010).

17 *Washington Public Interest Org. v. Public Service Comm'n*, 393 A.2d at 75; *accord, e.g., D.C. Telephone Answering Service Committee v. Public Service Comm'n*, 476 A.2d 1113, 1119 (D.C. 1984); *see* D.C. Code § 2-509 (e).

18 *Washington Public Interest Org. v. Public Service Comm'n*, 393 A.2d at 77; D.C. Code § 2-509(e); *Chesapeake & Potomac Tel. Co. v. Public Service Comm'n*, 339 A.2d 710, 714.

19 *Office of People's Counsel v. Public Service Comm'n*, 571 A.2d 206, 209 (D.C. 1990) (quoting *Atlantic Tel. Co. v. Public Service Comm'n*, 390 A.2d 439, 441 (D.C. 1978)).

rationally related to the rate order (through clearly articulated criteria), to justify the Commission's decision."[20] When describing the quantity of evidentiary support requirement, the Court has held that "'substantial evidence' is 'more than a mere scintilla'; it is 'such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.'"[21]

In addition, "the Commission must indicate 'fully and carefully the methods by which, and the purposes for which, it has chosen to act. . . .'"[22] To satisfy this requirement, the Commission must state on the record the criteria governing its decision and must explain how its particular decision applies these criteria to the facts of the case.[23] In describing the criteria governing a rate determination, the Commission must balance both consumer and shareholder interests. The Supreme Court has stated, "[the] consumer interest cannot be disregarded in determining what a 'just and reasonable' rate . . . . is and the rate itself cannot be 'exorbitant.' Equitable factors from the ratepayer perspective, therefore, are equally a part of the just and reasonable rate calculus."[24] Consideration of the economy and its impact on ratepayers is required pursuant to the PSC's statutory mandate.[25]

Regarding the Commission's duty to explain clearly how its criteria are satisfied by the rate order -- how it arrived at the particular result, the Supreme Court has noted, "Judicial review of the Commission's orders will . . . function accurately and efficaciously only if the

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20 *Washington Public Interest Org. v. Public Service Comm'n*, 393 A.2d at 77 (citations omitted).

21 *Id.* at n. 6 (citation omitted).

22 *Washington Gas Light Co. v. Public Service Comm'n*, 450 A.2d 1187, 1193 (D.C. 1982) (quoting *In Re Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968)).

23 *Washington Public Interest Org. v. Public Service Comm'n*, 393 A.2d at 75, supplemental opinion and dissent, 404 A.2d 541 (D.C. 1979).

24 *Id.* at 76 (citations omitted).

25 D.C. Code § 34-908.02 (2010).

Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act . . . ."[26] "The methodology must be disclosed for the bearing it may have on that overall judgment. Absent precise explanation of methodology as applied to the facts of the case, there is no way for a court to tell whether the Commission, however expert, has been arbitrary or unreasonable."[27] The Commission's findings of fact cannot be upheld on appellate review if they are "unreasonable, arbitrary, or capricious."[28]

As the Court indicated in *Washington Public Interest Org.*, the Supreme Court's requirement that the Commission create reasonably precise ratemaking criteria and explain with clarity how the facts relate to each in support of the overall rate order, "is inherent in the Commission's responsibilities under the District of Columbia Administrative Procedure Act, by which a rate order also must be tested."[29]

V. <u>DISCUSSION</u>

ISSUE No. 1 IS PEPCO'S PROPOSED $85,477,000 INCREASE IN BASE DISTRIBUTION RATES JUST AND REASONABLE?

Through supplemental and rebuttal testimony, Pepco reduced its requested increase in base rates from $85,477,000 to $77,494,000. While OPC supports many of Pepco's proposed revisions to its initial application, Pepco's revised base rate request is still not just and reasonable. As discussed herein, OPC recommends an increase in base distribution rates of $25,139,000 based on a recommended distribution rate base of $1,602,964,000. This recommendation includes OPC's recommended adjusted net distribution operating income of

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26 *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968).

27 *Washington Public Interest Org. v. Public Service Comm'n*, 393 A.2d at 76-77.

28 D.C. Code § 34-606 (2010).

29 *Washington Public Interest Org. v. Public Service Comm'n*, 393 A.2d at 77 (citations omitted).

$111,246,000, and recommended rate of return of 6.94%, which is itself based on a recommended return on equity ("ROE") of 8.60%.

ISSUE No. 2 IS PEPCO'S PROPOSED TEST YEAR ENDING MARCH 31, 2016, CONSISTING OF TWELVE (12) MONTHS OF ACTUAL RESULTS REASONABLE?

Pepco proposed to use an actual, historic test year consisting of the twelve-month period ending March 31, 2016. The timeframe is somewhat problematic. As OPC Witness Ramas explained, because the merger closed a mere eight days before the end of the test period, "the proposed test year consisting of the period April 1, 2015 through March 31, 2016 is not an ideal timeframe for determining fair and reasonable base distribution rates on a going-forward basis."[30] Among other things, the timing leads to the inflation of certain operating expenses beyond the amount reflected in normal operations.[31] That said, OPC Witness Ramas further clarified that so "long as appropriate adjustments are made, Pepco's proposed test year ending March 31, 2016 can be reasonable and appropriate for setting rates."[32]

ISSUE No. 2(a) Are the proposed adjustments to the test year data for known and measurable changes reasonable?

While Pepco's application included adjustments to the test year, certain of them are unreasonable and they are collectively insufficient to make the test year reasonable and appropriate for setting rates. OPC proposed revisions to those adjustments, as well as additional known and measurable adjustments to the test year data. OPC's recommended revisions to

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30 Exhibit OPC (B) (Ramas) at 6.

31 *Id.* at 31; *see* Designated Issue No. 7.

32 *Id.* at 7-8.

Pepco's proposed adjustments and OPC's additional recommended adjustments are discussed under the remaining designated issues below.[33]

ISSUE No. 3 ARE PEPCO'S REQUESTED COST OF CAPITAL AND CAPITAL STRUCTURE JUST AND REASONABLE?

(a) What cost of common equity should Pepco be authorized to earn?
(b) Has Pepco properly determined its cost of debt?
(c) Is the capital structure that Pepco uses to develop its overall cost of capital just and reasonable?
(d) Should Pepco's authorized return on equity ("ROE") be adjusted for the Bill Stabilization Adjustment and, if so, by how many basis points?[34]

OPC contends that Pepco's requested costs of capital and proposed capital structure are not just and reasonable. Pepco Witness Robert B. Hevert provides the Company's proposed capital structure and estimates a return on equity for Pepco. The Company's currently authorized ROE, with the 10 basis point reduction for the Bill Stabilization Adjustment ("BSA"), is 9.40%.[35] Witness Hevert concludes in his testimony in this proceeding that an ROE of 10.60%, within a range of 10.00% to 10.65%, represents the cost of equity for Pepco.[36] Witness Hevert finds that the Company's capital structure, consisting of 49.14% common equity and

33 To the extent OPC's brief does not address a particular Pepco-proposed adjustment, OPC takes no position at this time on that adjustment.

34 *See Formal Case No. 1139, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, Order No. 18550 at p. 4, ¶ 7 (Order and Report on Prehearing Conference issued Sep. 22, 2016).

35 *See Formal Case No. 1103, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, Order No. 17424 at ¶¶ 284, 326 (Mar. 26, 2014).

36 *See* Exhibit PEPCO (D) at p. 2-3; *see also* Exhibit PEPCO (3D) at p. 2-3.

50.86% long-term debt, is reasonable.[37] Pepco Witness Kevin M. McGowan estimates Pepco's overall rate of return at 8.00% for its distribution rate base in the District of Columbia.[38]

OPC Witness Dr. J. Randall Woolridge estimates the cost of capital for Pepco. OPC Witness Woolridge contends that Witness Hevert's recommended return on equity is excessive, unjust, and unreasonable. OPC Witness Woolridge recommends that the proper equity cost rate or ROE for Pepco is 8.70%.[39] If Pepco receives authority from the Commission to continue its BSA, Witness Woolridge recommends an 8.60% ROE for Pepco.[40] OPC Witness Woolridge used the Company's actual capital structure in his analysis, but unlike Pepco, recommends including short-term debt.[41] Witness Woolridge's capital structure for Pepco includes **[BEGIN CONFIDENTIAL]**

[END CONFIDENTIAL] Dr. Woolridge recommends an overall rate of return for Pepco at 6.94%.[43]

Dr. Woolridge's recommendations align with those of other non-Pepco witnesses. AOBA Witness Bruce R. Oliver in his Direct Testimony recommends that the Commission should reject the Company's requested 10.60% ROE "as not reflective of returns having risk comparable to that for Pepco's distribution utility operations".[44] Witness Oliver recommends an

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37 *See* Exhibit PEPCO (D) at p. 9; *see also* Exhibit PEPCO (3D) at p. 3.

38 Exhibit Pepco (B) at p. 22, Exhibit Pepco (B)-5 at p. 1 of 4.

39 Exhibit OPC (C) at 4-5.

40 Exhibit OPC (C) at 5.

41 Exhibit OPC (C) at 4.

42 Exhibit OPC (C) at 4.

43 Exhibit OPC (C) at 5.

44 Exhibit AOBA (A) at p. 18.

ROE of 9.25% for Pepco with an overall return no greater than 7.31%.[45] Witness Oliver recommends that the Commission should monitor Pepco's authorized rate of return and Exelon's rate of return.[46] Witness Oliver does not challenge Pepco's proposed capital structure in this proceeding.[47]

DC Water Witness Michael P. Gorman recommends a 9.10% ROE, within a range of 8.80% to 9.30%.[48] Witness Gorman recommends an overall rate of return of 7.26% for Pepco.[49] Witness Gorman does not take issue with Pepco's proposed capital structure.[50]

HCNCA Witness Kevin W. O'Donnell, who contends that Witness Hevert's recommended ROE "is excessive, unreasonable, and lacks basic evidentiary support", recommends an ROE of 8.75%.[51] Witness O'Donnell does not propose changes to Pepco's proposed capital structure or use of embedded cost of long-term debt.[52] Witness O'Donnell recommends an overall rate of return of 7.09% for Pepco.[53] Witness O'Donnell does not challenge Pepco's proposed capital structure in this proceeding.[54]

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45 Exhibit AOBA (A) at p. 19, 35-36.

46 Exhibit AOBA (A) at p. 18.

47 Exhibit AOBA (A) at p. 26.

48 Exhibit No. DC Water (A) at p. 3.

49 Exhibit No. DC Water (A) at p. 3, Exhibit No. DC Water (A)-1.

50 *See* Exhibit DC Water (A) at p. 18-19.

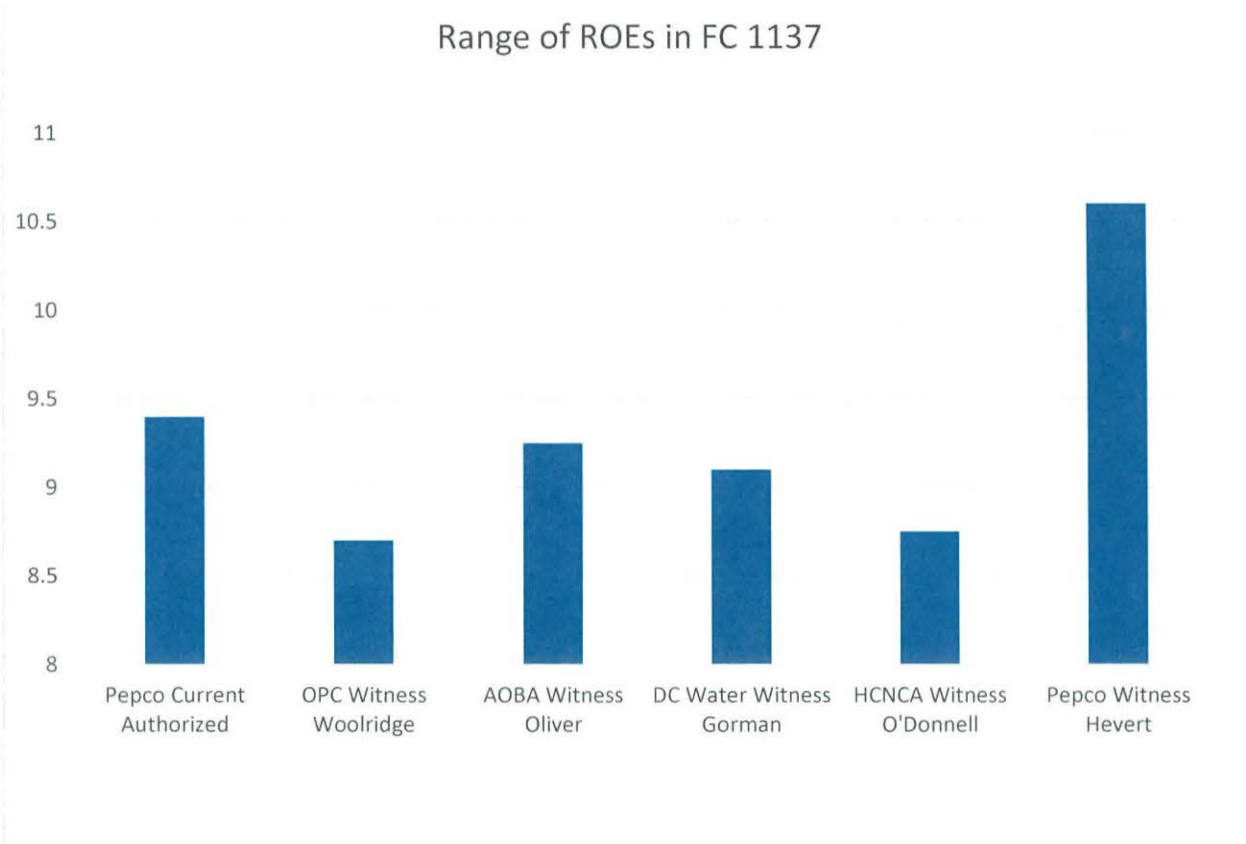
51 Exhibit HCNCA (A) at p. 6.

52 Exhibit HCNCA (A) at p. 6-7.

53 Exhibit HCNCA (A) at p. 6-7.

54 Exhibit HCNCA (A) at p. 41.

The chart below summarizes each witness' ROE recommendation relative to Pepco's current authorized ROE of 9.40%.



A. LEGAL FOUNDATION FOR ASSESSING COST OF CAPITAL

A reasonable rate of return requires an examination of the utility's cost of capital, cost of debt, and projected capital structure.[55] This Commission has adopted the standards derived from United States Supreme Court opinions in *Bluefield Waterworks v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944). In *Hope Natural Gas*, the Court held that the return to equity owners (or shareholders) of a regulated public utility should be "commensurate" to returns on investments in other enterprises with corresponding risks.[56]

The Commission determines a public utility's authorized overall rate of return by the "cost of capital" method. The rate of return expresses "the amount of money a utility earns, over and above operating expenses, depreciation expense, and taxes expressed as a percentage of the legally established net valuation of utility property, the rate base."[57] The cost of capital method thus seeks to determine the return that the utility must offer its investors in order to attract capital investment (in stocks and bonds) necessary to finance its operations and construction projects.[58] When properly and competently computed, the cost of capital is "practically the equivalent of a fair rate of return."[59]

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55 *Formal Case No. 1103, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, Order No. 17424 at p. 82-83, ¶ 226 (Mar. 26, 2014).

56 320 U.S. at 603 (explaining that "the return should be sufficient to assure confidence in the financial integrity of the enterprise" to allow it to maintain credit and attract capital).

57 *Formal Case No. 1103*, Order No. 17424 at p. 82-83, ¶ 226 (quoting Formal Case No. 685, Order No. 6096, p. 6, rel. June 14, 1979).

58 *Formal Case No. 1103*, Order No. 17424 at p. 83, ¶ 226.

59 *Formal Case No. 1103*, Order No. 17424 at p. 83, ¶ 226.

Public utility rates must be just, reasonable, and nondiscriminatory.[60] While the Commission maintains broad statutory authority to formulate its own standards and to exercise its ratemaking function free from judicial interference, it must ensure that "the rates fall within a zone of reasonableness which assures that the Commission is safeguarding the public interest" for both investors and consumers.[61] Accordingly, the Commission enjoys the statutory authority to set just, reasonable, and nondiscriminatory rates by establishing a rate of return on common equity at any point within that zone of reasonableness.[62]

B. <u>RETURN ON EQUITY AND COMMON EQUITY COST RATE</u>

A key issue in setting rates that are just and reasonable is determining the allowed return on equity ("ROE"). The allowed ROE is the amount that the utility's common stockholders earn on the capital they invest in the utility when they buy its stock. If the Commission sets the ROE too low, the stockholders will not have the opportunity to earn a fair return; if the Commission sets the ROE too high, the customers will pay too much, and the resulting rates will be unjust and unreasonable.[63]

In this case, several parties sponsored expert witnesses who testified concerning the appropriate ROE for use in setting PEPCO's rates. OPC Witness Dr. Woolridge primarily evaluates Pepco's cost of capital through a detailed Discounted Cash Flow ("DCF") analysis. Witness Woolridge also evaluates Pepco's cost of capital under a Capital Asset Pricing Model

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60 *Formal Case No. 1103*, Order No. 17424 at p. 101, ¶ 272 (citing *Metropolitan Board of Trade v. Public Service Commission of the District of Columbia*, 432 A.2d 343, 350 (D.C. 1981)).

61 *Formal Case No. 1103*, Order No. 17424 at p. 102, ¶ 272 (quoting *Metropolitan Board of Trade v. Public Service Commission of the District of Columbia*, 432 A.2d 343, 350 (D.C. 1981)).

62 *Formal Case No. 1103*, Order No. 17424 at ¶ 272; D.C. Code § 34-1101.

63 *See* Exhibit OPC (C) at 43-44.

("CAPM") approach.[64] AOBA Witness Oliver conducts DCF and CAPM analyses to assess Pepco's cost of capital.[65] DC Water Witness Gorman used several methods to estimate Pepco's cost of capital, including (1) a constant growth DCF model using consensus analysts' growth rate projections, (2) a constant growth DCF model using sustainable growth rate estimates, (3) a multi-stage growth DCF model, (4) a Risk Premium ("RP") model, and (5) a CAPM approach.[66] HCNCA Witness O'Donnell evaluates Pepco's cost of capital using a DCF analysis and a CAPM analysis.[67] Pepco Witness Hevert evaluates Pepco's cost of capital under a mixture of methods and approaches, including the use of constant growth and multi-stage DCF analyses, the CAPM approach, and the Bond Yield Plus Risk Premium method.[68]

A. Witness Woolridge's DCF Approach

The DCF model is a widely used method for estimating an investor's required return on a utility's common equity. The Commission has explained that it "primarily relies on the DCF method to determine a utility's appropriate cost of common equity because the Commission consistently has found that the DCF method produces results more reasonable than those of other calculation methods."[69] No party in this proceeding has presented evidence that warrants a sharp turn away from the Commission's historical reliance on the DCF model.

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64 *See* OPC Exhibit (C) at p. 47-78.

65 *See* AOBA Exhibit (A) at p. 35-37, Exhibit AOBA (A)-1.

66 *See* Exhibit No. DC Water (A) at p. 20, 23-48.

67 *See* Exhibit HCNCA (A) at p. 15-35.

68 *See* Exhibit PEPCO (D) at p. 2-3, 15-34.

69 *Formal Case No. 1103*, Order No. 17424 at p. 102, ¶ 273.

According to the DCF model, the current stock price is equal to the discounted value of all future dividends that investors expect to receive from investment in the company. As such, stockholders' returns ultimately result from current as well as future dividends. As owners of a corporation, common stockholders are entitled to a *pro rata* share of the company's earnings. The DCF model presumes that earnings that are not paid out in the form of dividends are reinvested in the company so as to provide for future growth in earnings and dividends. The rate at which investors discount future dividends, which reflects the timing and riskiness of the expected cash flows, is interpreted as the market's expected or required return on the common stock. Therefore, this discount rate represents the cost of common equity. Algebraically, the DCF model can be expressed as:

$$P = \frac{D_1}{(1+k)^1} + \frac{D_2}{(1+k)^2} + \cdots \frac{D_n}{(1+k)^n}$$

where P is the current stock price, D_n is the dividend in year n, and k is the cost of common equity.[70]

Under certain assumptions, including a constant and infinite expected growth rate and constant dividend/earnings and price/earnings ratios, the DCF model can be simplified:

$$P = \frac{D_1}{k - g}$$

where D_1 represents the expected dividend over the coming year and g is the expected growth rate of dividends. This is known as the constant-growth version of the DCF model. To use the

70 *See* Exhibit OPC (C) at p. 47-48.

constant-growth DCF model to estimate a utility's cost of equity, one solves for k in the above algebraic formula as follows:

$$k = \frac{D_1}{P} + g$$

Thus, the equity cost rate (k) is the sum of the dividend yield and expected growth.[71]

Under current investment and market conditions, the average stock investor will calculate the amount of funds he/she will receive relative to the initial investment, which is defined as the current dividend yield and the amount of funds that the investor can expect in the future from the growth in the dividend. Calculating the combination of the current dividend yield and the future growth in dividends is the central tenet of the DCF model. Despite an apparent complicated formula, the DCF approach is rather straightforward. Unlike models such as the CAPM, which are more theoretical and academic, the DCF method encompasses the same practical approaches and principles used by money managers, financial analysts, and individual investors.

As discussed in his Direct Testimony, Dr. Woolridge primarily relies on the DCF method to estimate a utility's cost of capital in light of the Commission's preference and precedent, due to the relative stability of the utility business, and because most investment firms use some form of the DCF model as a valuation technique.[72] Dr. Woolridge presents the three-stage DCF or dividend discount model ("DDM") in his testimony and exhibits.[73] The DDM model presumes that a company's dividend payout progresses initially through a growth stage, then proceeds

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71 *See* Exhibit OPC (C) at p. 49-50.

72 *See* Exhibit OPC (C) at p. 45-48.

73 Exhibit OPC (C) at p. 48-49, Exhibit OPC (C)-9.

through a transition stage, and finally assumes a maturity (or steady-state) stage.[74] Under this approach, dividends are projected into the future using different growth rates in the different stages. The equity cost rate is the discount rate that equates the present value of the future dividends to the current stock price.[75] Dr. Woolridge explains that the utility business is in the steady-state (*i.e.,* constant-growth stage) of the three-stage DCF due to the stability of the utility industry, the mature demand for utility services, and the regulatory oversight of utilities.[76]

In employing the DCF method, OPC Witness Woolridge explains the importance of accounting for the DCF model's assumptions regarding the estimate of the dividend yield and the expected growth rate.[77] Accordingly, it is critical to consider recent utility financial performance alongside current economic conditions and forecasts to produce accurate estimates of investor expectations regarding future performance.[78]

Dr. Woolridge calculated the dividend yields for the companies in his proxy group ("the Electric Proxy Group") using the current annual dividend and the 30-day, 90-day, and 180-day average stock prices.[79] Because the median dividend yields using the 30-day, 90-day, and 180-day average stock prices range from 3.4% to 3.5%, Witness Woolridge decided to use 3.45%, the

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74 Exhibit OPC (C) at p. 48 (further explaining that the dividend-payment stage of a company depends on the profitability of its internal investments, which is largely a function of the life cycle of the product or service).

75 Exhibit OPC (C) at p. 49.

76 Exhibit OPC (C) at p. 50.

77 Exhibit OPC (C) at p. 50-51.

78 *See* Exhibit OPC (C) at p. 51.

79 Exhibit OPC (C) at p. 51, Exhibit OPC (C)-10. Witness Woolridge explains the selection criteria for the Electric Proxy Group on pages 34-35 of his Direct Testimony in Exhibit OPC (C).

average of the medians, as the dividend yield for the Electric Proxy Group.[80] Witness Woolridge used 3.50%, the average of the medians for the dividend yield ranges as the dividend yield for Pepco Witness Hevert's proxy group ("Hevert Proxy Group").[81]

Dr. Woolridge explains that it is common for analysts to adjust the dividend yield by some fraction of the long-term expected growth rate.[82] Accordingly, Witness Woolridge adjusted the dividend yield by one-half (1/2) of the expected growth so as to reflect growth over the coming year. The DCF equity cost rate ("K") is computed as:

$$K = [\ (D/P) * (1 + 0.5g)\ ] + g$$ [83]

As to the growth rate component of the DCF Model, investors use some combination of historical and/or projected growth rates for earnings and dividends per share and for internal or book-value growth to assess long-term potential.[84] Dr. Woolridge analyzed various measures of growth for companies in the Electric Proxy Group, including a review of *Value Line Investment Survey's* ("*Value Line*") historical and projected growth rate estimates for earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS"). Witness Woolridge also incorporated into his analysis the average EPS growth rate forecasts provided by Yahoo, Reuters, and Zacks.[85] Dr. Woolridge explains that while historical growth rates for EPS, DPS, and BVPS are factors in forming expectations of future growth, one must exercise caution as

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80 Exhibit OPC (C) at p. 51.

81 Exhibit OPC (C) at p. 51. Dr. Woolridge compares the Electric Proxy Group to the Hevert Proxy Group on pages 35-37 of his Direct Testimony in OPC (C).

82 Exhibit OPC (C) at p. 52.

83 Exhibit OPC (C) at p. 52.

84 Exhibit OPC (C) at p. 53.

85 Exhibit OPC (C) at p. 53.

historical growth is not necessarily a failsafe indicate of future growth potential.[86] An analyst employing the conventional DCF model should account for the context in applying a particular growth rate and must examine long-term growth rate expectations.[87]

In developing an equity cost rate using the DCF model, Dr. Woolridge recommends using a DCF growth rate that is comprised of the long-term projected growth rate in EPS, DPS, and BVPS.[88] Dr. Woolridge does not rely exclusively on EPS growth rate forecasts of Wall Street analysts as DCF growth rates because the appropriate growth rate in the DCF model is the dividend growth rate, not the earnings growth rate.[89] However, an analyst should still consider other indicators of growth, including prospective dividend growth, internal growth, and projected earnings growth. Studies have also indicated that analysts' long-term earnings growth rate forecasts should be used with caution as inputs for valuation and cost of capital purposes.[90] Because the long-term EPS growth rate forecasts of Wall Street securities analysts tend to be overly optimistic and upwardly biased, Dr. Woolridge concludes that using these growth rates as a DCF growth rate will provide an overstated equity cost rate.[91] Given that stock prices reflect that upward bias and thus affect the dividend yield, Dr. Woolridge emphasizes that the DCF

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86 Exhibit OPC (C) at p. 53-54.

87 Exhibit OPC (C) at p. 54.

88 Exhibit OPC (C) at p. 57.

89 Exhibit OPC (C) at p. 57; Formal Case No. 1086, Order No. 16930, ¶ 154.

90 Exhibit OPC (C) at p. 57-58, fn. 27 (citing M. Lacina, B. Lee & Z. Xu, *Advances in Business and Management Forecasting (Vol. 8),* Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101 (2011)).

91 Exhibit OPC (C) at p. 57-58, fn. 28 (citing various sources), fn. 29 (citing Peter D. Easton & Gregory A. Sommers, *Effect of Analysts' Optimism on Estimates of the Expected Rate of Return Implied by Earnings Forecasts,* 45 J. ACCT. RES. 983–1015 (2007)).

growth rate needs to be adjusted downward from the projected EPS growth rate to offset that upward bias in EPS growth rate forecasts.[92]

In applying the growth rates for purposes of his DCF analysis, Witness Woolridge evaluated the historical growth rates as published in *Value Line* for the companies in the proxy groups. The median historical growth measures for EPS, DPS, and BVPS for the Electric Proxy Group ranged from 3.5% to 5.5%, with an average of the medians of 4.2%.[93] Those median historical growth measures for the Hevert Proxy Group ranged from 3.3% to 6.3%, with an average of the medians of 4.4%.[94] As to *Value Line's* projected growth rates for the companies in the proxy groups, the medians range from 4.0% to 5.5%, with an average of the medians of 4.9%, for the Electric Proxy Group.[95] The medians ranged from 4.0 % to 5.5%, with an average of the medians of 4.8%, for the Hevert Proxy Group.[96] In light of sustainable growth as a significant and "primary driver of long-run earnings growth", Dr. Woolridge determined sustainable growth rates for the companies in the two proxy groups as measured by *Value Line*'s average projected retention rate and return on shareholders' equity.[97] For the Electric and Hevert Proxy Groups, the median prospective sustainable growth rates were 3.7% and 3.6%, respectively.[98]

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92 Exhibit OPC (C) at 58.

93 Exhibit OPC (C) at 59, Exhibit OPC (C)-10.

94 Exhibit OPC (C) at 59, Exhibit OPC (C)-10.

95 Exhibit OPC (C) at 59, Exhibit OPC (C)-10.

96 Exhibit OPC (C) at 59, Exhibit OPC (C)-10.

97 Exhibit OPC (C) at 60, lines 4-5, Exhibit OPC (C)-10.

98 Exhibit OPC (C) at 60, Exhibit OPC (C)-10.

OPC Witness Woolridge also assessed growth for the proxy groups by measuring analysts' forecasts of expected 5-year EPS growth rates. Dr. Woolridge determined that the mean/median of analysts' projected EPS growth rates for the Electric and Hevert Proxy Groups were 4.4%/5.3% and 4.9%/5.6%, respectively.[99] In giving primary weight to the projected EPS growth rate of Wall Street analysts, Dr. Woolridge concluded that the appropriate projected growth rate range for the Electric Proxy Group is 5.0% and for the Hevert Proxy Group is 5.25%.[100]

In light of the foregoing DCF method and analysis, Witness Woolridge derived the following cost rates for the Electric Proxy Group and the Hevert Proxy Group.

Table 1
DCF-derived Equity Cost Rate/ROE

	Dividend Yield	1 + ½ Growth Adjustment	DCF Growth Rate	Equity Cost Rate
Electric Proxy Group	**3.45%**	**1.02500**	**5.00%**	**8.55%**
Hevert Proxy Group	**3.50%**	**1.025625**	**5.25%**	**8.85%**

As demonstrated in the above chart and the exhibits to Dr. Woolridge's Direct Testimony, the result for the Electric Proxy Group was the 3.45% dividend yield times the one and one-half growth adjustment of 1.025 plus the DCF growth rate of 5.0%, which results in an equity cost rate of 8.55%.[101] The result for the Hevert Proxy Group is an equity cost rate of 8.85%, which

99 Exhibit OPC (C) at 60, Exhibit OPC (C)-10 at p. 5.

100 Exhibit OPC (C) at 61-62.

101 Exhibit OPC (C) at 62, Exhibit OPC (C)-10

includes a 3.50% dividend yield, a growth adjustment factor of 1.025625, and a DCF growth rate of 5.25%.[102]

B. Witness Woolridge's Capital Asset Pricing Model Analysis

While the Commission relies primarily on the results of the application of the DCF model, the Commission may also consider application of other methodologies such as CAPM to calculate the cost of equity.[103] The Commission's preference for the DCF method thus does not necessarily foreclose parties from advocating the use of other methods.[104]

The CAPM is a risk premium approach used to gauge a utility's cost of equity capital. Under the risk premium approach, the cost of equity (k) is the sum of the interest rate on a risk-free bond (R_f) and a risk premium (RP)[105]:

$$k = R_f + RP$$

A. The yield on long-term United States Treasury securities is usually described as R_f. Risk premiums are measured in different ways. The CAPM approach is a theory of the risk and expected returns of common stocks. In the CAPM, two types of risk are associated with a stock: firm-specific risk or unsystematic risk, and market or systematic risk, which is measured by a company's beta. The only risk that investors receive a return for bearing is systematic risk.[106] Under the CAPM approach, the expected return on a company's stock (*i.e.,* the equity cost rate (K)), is equal to:

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102 Exhibit OPC (C) at 62, Exhibit OPC (C)-10.

103 Formal Case No. 1103, Order No. 17424 at p. 102, ¶ 273.

104 Formal Case No. 1103, Order No. 17424 at p. 102, ¶ 273.

105 Exhibit OPC (C) at 63.

106 Exhibit OPC (C) at 63.

$$K = (R_f) + ß * [E(R_m) - (R_f)]$$

Where:

- K represents the estimated rate of return on the stock;
- $E(R_m)$ represents the expected return on the overall stock market. Frequently, the 'market' refers to the S&P 500;
- (R_f) represents the risk-free rate of interest;
- $[E(R_m) - (R_f)]$ represents the expected equity or market risk premium—the excess return that an investor expects to receive above the risk-free rate for investing in risky stocks; and
- *Beta*—(ß) is a measure of the systematic risk of an asset.[107]

To estimate the required return or cost of equity using the CAPM requires three inputs: the risk-free rate of interest (R_f), the beta (ß), and the expected equity or market risk premium $[E(R_m) - (R_f)]$. The R_f is the easiest input to measure because it is represented by the yield on long-term U.S. Treasury bonds. The ß, the measure of systematic risk, is a little more difficult to measure in light of the range of opinions from analysts regarding what adjustments, if any, should be made to historical betas due to their tendency to regress to 1.0 over time. An even more difficult input to measure is the expected equity or market risk premium $(E(R_m) - (R_f))$.[108]

The yield on long-term (*i.e,* 30-year) U.S. Treasury bonds is usually viewed as the risk-free rate of interest in the CAPM. In his analysis, Witness Woolridge employs 4.0% as the risk-free interest rate, or R_f, in his CAPM.[109] While the yield in 30-year U.S. Treasury bonds ranged from 2.5% to 4.0% over the 2013-2014 time period, Dr. Woolridge selected 4.0% at the higher end of the range in light of the likelihood for higher interest rates.[110] As Witness Hevert

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107 Exhibit OPC (C) at 63.

108 Exhibit OPC (C) at 63-64.

109 Exhibit OPC (C) at 64.

110 Exhibit OPC (C) at 64, Exhibit OPC (C)-11.

acknowledged, the yield in 30-year U.S. Treasury bonds decreased to 3.05% during the evidentiary hearings in this proceeding.[111]

As indicated in the CAPM formula, *Beta*—(ß) is a measure of the systematic risk of an asset, such as a stock. Witness Woolridge explained in his Direct Testimony that the market, as reflected in Standard & Poor's iconic S&P 500 index, has a beta of 1.0.[112] The beta of a stock with the same price movement as the market also has a beta of 1.0. A stock whose price movement is greater than that of the market, such as a technology stock, is riskier than the market and has a beta greater than 1.0. A stock with below average price movement, such as a regulated public utility, is less risky than the market and has a beta less than 1.0. Estimating a stock's beta involves running a linear regression of a stock's return on the market return.[113] Witness Woolridge used betas for the companies in the proxy groups as provided in *Value Line*. The median betas for the companies in the Electric Proxy Group and the Hevert Proxy Group were both 0.70.[114]

Dr. Woolridge "synchronizes" his 4.0% risk-free rate with the market risk premium ("MRP").[115] The MRP is equal to the expected return on the stock market (*i.e.*, the S&P 500 or the $E(R_m)$) minus the risk-free rate of interest (R_f). The MRP is the difference in the expected total return between investing in equities and investing in "safe" fixed-income assets, such as

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111 *See* March 22, 2017 Transcript at p. 1496, lines 11-13.

112 Exhibit OPC (C) at 65.

113 Exhibit OPC (C) at 65. *See* Exhibit OPC (C)-11. As explained in Dr. Woolridge's Direct Testimony, the slope of the regression line is the stock's ß. A steeper line indicates that the stock is more sensitive to the return on the overall market. This means that the stock has a higher ß and greater-than-average market risk. A less steep line indicates a lower ß and less market risk. Exhibit OPC (C) at 65-66.

114 Exhibit OPC (C) at 66.

115 Exhibit OPC (C) at 65.

long-term government bonds. Although the MRP is easy to define conceptually, it is difficult to measure because it requires an estimate of the expected return on the market, $E(R_m)$.[116] In his Direct Testimony, OPC Witness Woolridge explains the various approaches to estimating the MRP.[117] The traditional "Ibbotson approach", a historical evaluation of stock and bond returns, usually suggests an equity risk premium range of 5% to 7% above the rate on long-term U.S. Treasury bonds.[118] Numerous studies have criticized this use of historical returns as indicia of market expectations in this traditional approach because the large equity risk premium discovered in historical stock and bond returns cannot be justified by the fundamental underlying financial data. Importantly, Dr. Woolridge explained these issues in his Direct Testimony:

> (1) *ex post* returns are not the same as *ex ante* expectations; (2) market risk premiums can change over time, increasing when investors become more risk-averse and decreasing when investors become less risk-averse; and (3) market conditions can change such that *ex post* historical returns are poor estimates of *ex ante* expectations.[119]

For his CAPM, Dr. Woolridge determined a median MRP of 4.63% after analyzing the results of various studies of the historical risk premium; *ex ante* MRP studies; MRP surveys of CFOs, financial forecasters, analysts, companies, and academics; and the Building Blocks approach to the MRP.[120] *Ex ante* MRP studies compute *ex ante* expected returns using market data to arrive at an expected equity risk premium. The Building Blocks approach is a hybrid approach that employs elements from both historical and *ex ante* models. In order to mitigate the

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116 Exhibit OPC (C) at 66 (explaining that the $E(R_m)$ is "one of the great mysteries in finance").

117 *See* Exhibit OPC (C) at 67-71.

118 Exhibit OPC (C) at 67.

119 Exhibit OPC (C) at 67-68.

120 Exhibit OPC (C) at 70, Exhibit OPC (C)-11 (summarizing the results of the studies reviewed by Dr. Woolridge).

effects of using studies published during market peaks in the early 2000s before the 2008 financial crisis, Dr. Woolridge removed studies dated before January 2, 2010 to arrive at an MRP median (for that subset of studies) at 4.95%.[121] Because the data indicated that the market risk premium ranges from 4.0% to 6.0% and because many studies suggest an increase in the market risk premium, Dr. Woolridge selected 5.5% - near the upper end of the range - as the MRP for his CAPM.[122] Financial advisors, such as Duff & Phelps, also recommended using a 5.5% MRP.[123]

The results of OPC Witness Woolridge's CAPM analysis are provided in the table below:

Table 2
CAPM-derived Equity Cost Rate/ROE
$K = (R_f) + \beta * [E(R_m) - (R_f)]$

	Risk-Free Rate	Beta	Equity Risk Premium	Equity Cost Rate
Electric Proxy Group	**4.0%**	**0.70**	**5.5%**	**7.9%**
Hevert Proxy Group	**4.0%**	**0.70**	**5.5%**	**7.9%**

As indicated above, for the Electric Proxy Group, the risk-free rate of 4.0% plus the product of the beta of 0.70 times the equity risk premium of 5.5% results in a 7.9% equity cost rate. For the Hevert Proxy Group, the risk-free rate of 4.0% plus the product of the beta of 0.70 times the equity risk premium of 5.5% results in a 7.9% equity cost rate.[124]

C. OPC's Return on Equity Recommendation

121 Exhibit OPC (C) at 70, Exhibit OPC (C)-11 at p. 6.

122 Exhibit OPC (C) at 71, Exhibit OPC (C)-11.

123 Exhibit OPC (C) at 72 (citing http://www.duffandphelps.com/insights/publications/cost-of-capital/index).

124 Exhibit OPC (C) at 73.

1. OPC Witness Woolridge's Analysis

As explained in his Direct Testimony, Witness Woolridge places primary weight on the results of the DCF model, the pre-eminent methodology used by rate of return analysts and utility commissions when setting ROEs for public utilities.[125] Dr. Woolridge's DCF analyses for the Electric and Hevert Proxy Groups indicate equity cost rates of 8.55% and 8.85%, respectively. As just explained, the CAPM equity cost rate for both the Electric and Hevert Proxy Groups is 7.90%.[126]

Table 3
ROEs Derived from DCF and CAPM Models

	DCF	CAPM
Electric Proxy Group	**8.55%**	**7.90%**
Hevert Proxy Group	**8.85%**	**7.90%**

The above results indicate that the appropriate equity cost rate for companies in the Electric and Hevert Proxy Groups is in the 7.90% to 8.85% range. Given Dr. Woolridge's and the Commission's preference for the DCF method, OPC Witness Woolridge concludes that the appropriate equity cost rate range is 8.55% to 8.85%. Recognizing the recent increase in interest rates after the 2016 presidential election, Dr. Woolridge concludes that an ROE or equity cost rate of 8.70% is appropriate.[127]

As to the appropriateness and fairness of an 8.70% ROE for Pepco, OPC Witness Woolridge explained the context for consideration of this rate case as compared to Pepco's last rate case in 2013-2014 in Formal Case No. 1103 where the Commission authorized a 9.40%

125 *See Formal Case No. 1103*, Order No. 17424 at p. 102, ¶ 273 (explaining the Commission's preference for the DCF approach).

126 Exhibit OPC (C) at 73.

127 Exhibit OPC (C) at 74.

ROE for Pepco.[128] As to regulatory trends in the public utility industry, authorized ROEs for electric utilities have declined from 10.01% in 2012, to 9.8% in 2013, to 9.76% in 2014, 9.58% in 2015, and 9.64% in the first three quarters of 2016.[129] The average authorized ROE for all electric utilities in 2016, vertically integrated and distribution only, and excluding the Virginia rider cases with ROE adders, was 9.66%.[130] The average authorized ROEs for distribution-only electric utilities is about 20 basis points below those averages.[131] The average authorized ROE for the ten distribution-only cases in 2016 was 9.45%.[132] Authorized ROEs have lagged behind capital market cost rates and thus have been slow to reflect low capital market cost rates.[133] The financial community has recognized that authorized ROEs for electric and gas utilities are declining due to lower interest rates.[134] Recently, many state utility commissions have been reluctant to authorize ROEs above 10% during this trend toward lower ROEs.[135] In November 2016, the Maryland Public Service Commission authorized a 9.50% ROE for Pepco.[136] The

[128] Exhibit OPC (C) at 74-76; Formal Case No. 1103, Order No. 17424 at ¶¶ 284, 326.

[129] Exhibit OPC (C) at 75-76, fn. 40 (citing *Regulatory Focus*, Regulatory Research Associates, January, 2016) (explaining that electric utility authorized ROEs exclude the authorized ROEs in Virginia which include generation adders and thus are inflated and inappropriate for making comparisons).

[130] March 22, 2017 Transcript at p. 1516, lines 1-7.

[131] Exhibit OPC (C) at 75-76.

[132] AOBA Hearing Exhibit AOBA-70.

[133] Exhibit OPC (C) at 75-76.

[134] Exhibit OPC (C) at 76-77, fn. 41 (citing Moody's Investors Service, "Lower Authorized Equity Returns Will Not Hurt Near-Term Credit Profiles," Mar. 10, 2015).

[135] Exhibit OPC (C) at 75-76, 78.

[136] March 22, 2017 Transcript at p. 1574, line 9 – p. 1575, line 14; *see also* AOBA Hearing Exhibit AOBA-63 (Pepco's Response to AOBA Data Request 12-2 regarding nationwide ROE data).

Maryland Public Service Commission also recently authorized a 9.6% ROE for Delmarva Power & Light, an Exelon subsidiary.[137]

As to the macro-economic context, the two key drivers affecting long-term interest rates are 1) economic growth and 2) inflation.[138] Given low inflationary expectations and slow global economic growth,[139] interest rates are likely to remain relatively low into the future.[140] Former Federal Reserve Chairman Benjamin Bernanke has recently explained that "[l]ow interest rates are not a short-term aberration, but part of a long-term trend."[141] In light of low interest rates, capital costs for utilities, as reflected in the long-term bond yields and the risk-free 30-Year U.S. Treasury yields,[142] remain at historically low levels.[143] As measured by beta (ß) in the CAPM, the electric utility industry is among the lowest risk industries in the United States. Therefore, the cost of equity capital for the electric industry is among the lowest in the United States.[144]

Reducing Pepco's currently authorized ROE of 9.40% to 8.70% is also fair because Dr. Woolridge employed a capital structure for Pepco that has a slightly higher common equity ratio

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137 *See* March 22, 2017 Transcript at p. 1574, line 9 – p. 1575, line 14. Mr. Hevert was Exelon's witness in that proceeding.

138 *See* Exhibit OPC (C)-14.

139 Dr. Woolridge explains in his Direct Testimony that economic growth will remain slow because "the world has more wealth chasing fewer opportunities for investment rewards." Exhibit OPC (C) at 29.

140 Exhibit OPC (C) at p. 21-34, 75-76; *see* Exhibit OPC(C)-2, Exhibit OPC(C)-14.

141 Exhibit OPC (C)-2 at 31 (quoting Ben S. Bernanke, "Why are Interest Rates So Low," Weekly Blog, Brookings, March 30, 2015. *Available at* http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/30-why-interest-rates-so-low).

142 Exhibit OPC (C)-2, Panel B, shows the differences in yields between ten-year U.S. Treasuries and Moody's Baa-rated bonds since the year 2000. Exhibit OPC (C)-3, Panel A, provides the yields on A-rated public utility bonds. Exhibit OPC (C)-3, Panel B, provides the yield spreads between long-term A-rated public utility bonds relative to the yields on 20-year U.S. Treasury bonds.

143 Exhibit OPC (C) at 8-10, 21-34, 75.

144 Exhibit OPC (C) at 75.

and therefore slightly lower financial risk than the capital structures of the Electric Proxy Group and the Hevert Proxy Group. Furthermore, Pepco's investment risk, as reflected in the Company's S&P and Moody's issuer credit ratings of BBB+ and Baa1, is in line with the average issuer credit ratings of the Electric Proxy Group and the Hevert Proxy Group.[145] Simply put, this lower risk warrants a lower required return. Importantly, lower authorized ROEs for utilities have not impaired their credit profiles, have not hampered their ability to attract capital, and have not deterred utilities from raising significant amounts of capital.[146] The increasing and widespread availability of regulatory cost recovery mechanisms further ensures a low business-risk profile for utilities.[147]

The required return for Pepco is also low (and no higher than 9.40%) in light of the recent corporate acquisition of Pepco's parent company, Pepco Holdings, by the Exelon Corporation on March 23, 2016.[148] Exelon in seeking to invest in and acquire additional assets through the purchase of Pepco Holdings relied on Pepco's currently authorized ROE of 9.50% (9.40% with the BSA). Thus, it is reasonable to infer that Exelon, in its merger commitments and planned acquisitions, relied on Pepco's authorized 9.50%/9.40% ROE.[149] It would have been unreasonable for Exelon to rely on a higher authorized ROE, such as the 10.60% ROE that Witness Hevert proposes for the Company in this proceeding. There was no reasonable basis for such reliance by Exelon. During hearings in this proceeding, Witness Hevert acknowledged that

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145 Exhibit OPC (C) at 75-76.

146 Exhibit OPC (C) at 76-77.

147 Exhibit OPC (C) at 76-77.

148 *See* Exhibit OPC (C) at 8.

149 *See* March 22, 2017 Transcript at p. 1563-1583.

Pepco's authorized ROE was 9.5% during the time that Exelon made the investment in Pepco Holdings.[150]

2. Reducing the Allowed ROE If the Commission Approves WGL's Requested Bill Stabilization Adjustment ("BSA")

In Formal Case No. 1103, the Commission explained that Pepco's Bill Stabilization Adjustment, as a means to eliminate any disincentives to utility-driven energy efficiency programs, should ensure that Pepco has a reasonable opportunity to earn a fair rate of return so long as customers are still charged fair and reasonable rates.[151] Mindful of Pepco's infrastructure replacement program and the significant depreciation expenses and capital costs associated with that program, the Commission approved the BSA in order to help mitigate any earnings erosion.[152] In Formal Case No. 1103, the Commission found that a 10 basis point downward adjustment for Pepco's ROE was appropriate.[153]

In this proceeding, AOBA Witness Oliver contends that Pepco's BSA primarily functions as a Revenue Assurance Mechanism and is not critical to Pepco's ability to maintain the financial health of its District of Columbia operations.[154] In light of various problems with the BSA and given Pepco's frequent rate filings, AOBA recommends discontinuing the BSA.[155]

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150 *See* March 22, 2017 Transcript at p. 1563, line 20 – p. 1564, line 4; *see also* p. 1579, lines 16-20.

151 *Formal Case No. 1103*, Order No. 17424 at ¶ 326.

152 *Formal Case No. 1103*, Order No. 17424 at ¶ 326.

153 *Formal Case No. 1103*, Order No. 17424 at ¶ 326.

154 Exhibit AOBA (A) at p. 40-41.

155 Exhibit AOBA (A) at p. 60. AOBA Witness Oliver identified five key problem areas for Pepco's current BSA: 1) the lack of consistency between BSA calculations and Pepco's development of its rate designs and BSA revenue per customer targets; 2) need to improve forecasts of kWh used to compute monthly BSA rate adjustments; 3) need to better account for the influence of weather in determining base rate revenue requirements by class; 4) need to establish separate rate class for MMA customers; and 5) need for a detailed audit of Pepco's crediting of revenues by rate class. *Id.* at p. 41-59.

Because Pepco has little incentive to refine its BSA process to improve the equity and accuracy of monthly BSA rate adjustments, AOBA contends that "any continuation of Pepco's BSA mechanism should require that Pepco assume greater responsibility for the reasonableness and accuracy of monthly rate adjustment calculations."[156]

If the Commission adopts the BSA again, then Dr. Woolridge recommends a downward adjustment from his 8.70% ROE recommendation to an 8.60% ROE per the 10 basis point adjustment that the Commission made for Pepco's ROE in Formal Case No. 1103.[157] HCNCA Witness O'Donnell similarly advocates a 10 basis point downward adjustment to his ROE recommendation if the Commission continues Pepco's BSA.[158]

Accordingly, if the Commission continues Pepco's BSA, OPC recommends a 10 basis point downward adjustment from its 8.70% ROE recommendation to an 8.60% ROE recommendation.

E. Errors in PEPCO Witness Hevert's Return on Equity Testimony

Pepco Witness Hevert estimates Pepco's cost of capital under a mixture of methods and approaches, including the use of constant growth and multi-stage DCF analyses, the CAPM approach, and the Bond Yield Plus Risk Premium method. Witness Hevert errs in the use of these methods to estimate Pepco's ROE. Unlike OPC Witness Woolridge, Witness Hevert's ROE recommendation is supported by speculative projections of higher interest rates and capital costs and does not account for the downward trend in authorized ROEs by public utility regulatory commissions. Witness Hevert further errs through his marginalization of his constant-

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156 Exhibit AOBA (A) at 61.

157 Exhibit OPC (C) at 74.

158 Exhibit HCNCA (A) at 54.

growth DCF results and through his projected interest rates and expected market returns to compute market risk premiums.

A review of Witness Hevert's prior testimonies reveals inconsistencies in Witness Hevert's methodological approaches and demonstrates that Witness Hevert's recommended ROEs are higher than those of other witnesses in rate proceedings the vast majority of the time, based on his careful selection of methodologies and his nuanced application of those methodologies to inflate ROE outcomes. The following chart highlighting the last three Pepco rate cases (Formal Case Nos. 1087, 1103, and 1139) reveals Witness Hevert's self-supplied flexibility to invoke his "reasoned judgment"[159] to use a variety of handcrafted methodological approaches in order to fit the circumstances of the case.

	FC 1087	**FC 1103**	**FC 1139**
Primary Reliance on DCF	Yes	Yes	No
Testimony Includes Table with Mean Low DCF Results	Yes	Yes	No
Hevert ROE Recommendation Ignores Mean Low DCF Results	No	Yes	Yes
Use of Subjective or Selective Criteria Inflates DCF Results[160]	Yes	Yes	Yes
Downplays CAPM Results[161]	Yes	Yes	No
Primary Reliance on CAPM	No	No	Yes
Hevert ROE Recommendation[162]	10.75%	10.25%	10.60%
Commission ROE Decision[163]	9.5%	9.5%	N/A

159 *See* Exhibit Pepco (3D) at p. 3, lines 19-22 (explaining that determining the cost of equity "requires the application of reasoned judgment in vetting the models and assumptions used by various analysts and in assessing the reasonableness of their recommendations").

160 In *Formal Case No. 1087*, the Commission reviewed Witness Hevert's approach and determined that "projected EPS growth rates are overstated and should not be exclusively relied upon". *Formal Case No. 1087*, Order No. 16930, ¶ 154. During hearings, Witness Hevert explained in Formal Case 1103 he used a multi-stage DCF model in his Rebuttal Testimony, but not in his Direct Testimony. *See* March 22, 2017 Transcript at p. 1502.

161 See OPC Hearing Exhibit Nos. 47 and 48 (Witness Hevert's Direct Testimonies in FC 1087 and FC 1103).

162 *Formal Case No. 1087*, Order No. 16930, ¶ 127; *Formal Case No. 1103*, Order No. 17424, ¶ 227.

		(9.4% with BSA)	

1. Errors in Witness Hevert's DCF Approach

Witness Hevert errs in his DCF analysis and approach by, among other things, (1) not affording sufficient weight to his constant-growth DCF results; (2) exclusively using the overly optimistic and upwardly biased EPS growth rate forecasts of Wall Street analysts and *Value Line*; and (3) by using an inflated terminal growth rate of 5.28% in his multi-stage DCF model that is not reflective of prospective economic growth in the U.S. and is more than 100 basis points above the projected long-term GDP growth.[164]

A review of Witness Hevert's testimony on behalf of Pepco in the last three Pepco rate cases (Formal Case Nos. 1087, 1103, and 1139) before this Commission reveals clear inconsistencies and case-selective approaches regarding Witness Hevert's application of the DCF model. During hearings in this proceeding, Witness Hevert acknowledged that the Commission in Formal Cases 1087 and 1103 indicated that it primarily relies upon the DCF method to determine a public utility's cost of capital.[165] Witness Hevert acknowledged that in Formal Case No. 1087, in 2011, he afforded more weight to his DCF results, which helped form his ROE recommendation.[166] Witness Hevert acknowledged that in Formal Case No. 1103 he utilized in his Direct Testimony a table that included mean low, mean, and mean high DCF results.[167] Witness Hevert also acknowledged that the Commission in Order No. 17424 in Formal Case No.

[163] *Formal Case No. 1087*, Order No. 16930, ¶ 156; *Formal Case No. 1103*, Order No. 17424, ¶¶ 284, 326.

[164] Exhibit OPC (C) at p. 74.

[165] March 22, 2017 Transcript at p. 1497, lines 16-20; p. 1508, lines 15-22.

[166] March 22, 2017 Transcript at p. 1495, lines 10-20; *see* OPC Hearing Exhibit 47.

[167] *See* March 22, 2017 Transcript at p. 1501, lines 5-10; *see* OPC Hearing Exhibit 48.

1103 eliminated Witness Hevert's recommended ROE because Witness Hevert "ignored [his] mean low DCF estimates".[168] In this proceeding in Formal Case No. 1139, Witness Hevert acknowledged that he did not include a chart in his testimony demonstrating the mean low DCF results and did not emphasize those results in this proceeding because they were "very low".[169]

In this proceeding in Formal Case No. 1139, Witness Hevert has given very little, if any, weight to his DCF results in arriving at an equity cost rate for Pepco.[170] Dr. Woolridge explains that the average of Witness Hevert's mean constant-growth stage DCF equity cost rates is only 9.0%.[171] If Witness Hevert had attributed any weight to those results, he would have been reasonably obligated to arrive at a much lower equity cost rate recommendation.[172] Witness Hevert attempts to avoid the weightier application of his constant-growth DCF results by expressing concerns that relatively high utility valuations contributed to those lower DCF results.[173] However, Dr. Woolridge points out that the "lower risk of utilities has led to higher valuation levels".[174]

In his DCF analysis in this proceeding, Witness Hevert also errs by exclusively relying on overly optimistic and upwardly biased EPS growth rate forecasts of Wall Street analysts and *Value Line*. OPC Witness Woolridge emphasizes that the appropriate growth rate in the DCF model is the dividend growth rate, not the earnings growth rate.[175] A sound DCF analysis

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168 March 22, 2017 Transcript at p. 1509, lines 13-14; *see* p. 1509, lines 11-20.

169 March 22, 2017 Transcript at p. 1511, line 20; *see* p. 1511, lines 7-20. In the table on page 21 of his Direct Testimony, Witness Hevert does not include his mean low DCF results. *See* Exhibit Pepco (D) at p. 21.

170 Exhibit OPC (C) at p. 82.

171 Exhibit OPC (C) at p. 82.

172 Exhibit OPC (C) at p. 82-83.

173 Exhibit OPC (C) at p. 82-83 (citing Exhibit Pepco (D) at p. 22).

174 Exhibit OPC (C) at p. 83.

considers historical prospective dividend growth, internal growth, and projected earnings growth.[176] Primary reliance on only the EPS growth rate forecasts produces an overstated equity cost rate.[177] The Commission has determined that "projected EPS growth rates are overstated and should not be exclusively relied upon".[178]

In his multi-stage DCF analysis, Pepco Witness Hevert commits two key errors: 1) his first-stage DCF growth rate is the average projected EPS growth rate and 2) his long-term GDP growth rate is based on historical GDP growth and is about 100 basis points above long-term projections of GDP growth. As discussed above, because EPS growth rate forecasts are overly optimistic and upwardly biased, EPS growth rate forecasts produce an overstated equity cost rate. Additionally, Witness Hevert has not provided sufficient theoretical or empirical support for his conclusion that a long-term GDP growth rate is a reasonable proxy for the expected growth rate of the companies in his proxy group. [179] Nonetheless, Witness Hevert's projected long-term GDP growth rate of 5.28% is 100 basis points higher than five-year and ten-year historic measures of growth for earnings and dividends for electric utility companies.[180]

In his Direct Testimony, OPC Witness Woolridge conducts a thorough analysis of GDP growth rates from 1961 to 2015.[181] While GDP had significantly grown since 1960, inflation and high prices from the 1960s to the 1980s influenced much of that growth. Of critical note, economic

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175 Exhibit OPC (C) at p. 84.

176 Exhibit OPC (C) at p. 84.

177 Exhibit OPC (C) at p. 84-85.

178 Formal Case No. 1086, Order No. 16930, ¶ 154.

179 Exhibit OPC (C) at p. 86.

180 Exhibit OPC (C) at p. 86, Exhibit OPC(C)-10. *See also* Exhibit OPC(C)-14.

181 Exhibit OPC (C) at p. 86-90, Exhibit OPC(C)-14.

growth in the United States has significantly slowed in recent decades.[182] A review of historic GDP growth rates demonstrates that Witness Hevert's long-term GDP growth rate of 5.28% is inflated.

Historic GDP Growth Rates[183]

10-Year Average - 2006-2015	**3.28%**
20-Year Average - 1996-2015	**4.36%**
30-Year Average - 1986-2015	**4.87%**
40-Year Average - 1976-2015	**6.19%**
50-Year Average - 1966-2015	**6.65%**

Unlike Witness Hevert's projected long-term GDP growth rate of 5.28%, current forecasts and projections of GDP rates range from 4.1% to 4.5%.[184] Witness Hevert erred by relying solely on long-term EPS growth rates and not considering historic EPS, DPS, and BVPS data.[185]

Witness Hevert also erred with respect to the use of his proxy group in his Constant Growth DCF analysis. During hearings in this proceeding, Witness Hevert acknowledged that he included FirstEnergy Corp. in his proxy group even though two out of three sources (*i.e.,* Zacks Earnings Growth and First Call) that Witness Hevert used reported negative earnings growth rate estimates and projections for FirstEnergy.[186] As to Witness Hevert's Exhibit Pepco (3D)-1, Witness Hevert agreed with counsel from AOBA that he included an "NA" in the relevant columns in the table with respect to Zacks' and First Call's analysis of FirstEnergy because the "data was either not reported or the estimate was negative".[187] Therefore, Witness

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182 Exhibit OPC (C) at p. 86-90.

183 Exhibit OPC (C) at p. 88.

184 Exhibit OPC (C) at p. 88-89.

185 Exhibit OPC (C) at p. 89.

186 *See* March 22, 2017 Transcript at p. 1540-1543; *see* Exhibit Pepco (3D)-1.

187 March 22, 2017 Transcript at p. 1543, lines 3-6.

Hevert only used *Value Line's* earnings growth estimate for FirstEnergy because it was the "only positive growth rate".[188] Due to the inclusion of FirstEnergy and Witness Hevert's omission of negative growth rates and use of only one positive growth rate estimate, Witness Hevert's Constant Growth DCF analysis produced higher, inflated mean ROE values for FirstEnergy (which are significantly higher than most of the mean ROE values for the other companies in the proxy group).[189] Simply put, Witness Hevert's adjustments upwardly skewed the DCF results.

2. Errors in Witness Hevert's CAPM Approach

As to his assessment of market conditions, Witness Hevert errs in his speculative projections of higher interest rates and capital costs. Witness Hevert errs by using a projected long-term Treasury yield of 4.65%, which was more than 150 basis points above the current yield on long-term Treasury bonds of 3.0%.[190] On March 22, 2017, Witness Hevert agreed that the Treasury yield was still at about 3%, specifically at 3.05%.[191] Similar to the errors in Witness Hevert's DCF approach, Witness Hevert errs in his CAPM approach by employing market premiums of 10.63% and 10.98%, which are based on the upwardly-biased long-term EPS growth rate estimates of Wall Street analysts.[192] As a result of those errors, Witness Hevert's CAPM approach produces an overstated expected market return and equity risk premium.[193] Dr. Woolridge explains in his Direct Testimony that, contrary to Witness Hevert's growth rate

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188 March 22, 2017 Transcript at p. 1548, lines 8-9.

189 March 22, 2017 Transcript at p. 1543-1548; Exhibit Pepco (3D)-1; *see also* Exhibit Pepco (3D)-1 at p. 1.

190 Exhibit OPC (C) at p. 91.

191 March 22, 2017 Transcript at p. 1496, lines 8-13.

192 Exhibit OPC (C) at p. 91.

193 Exhibit OPC (C) at p. 92.

assertions, the long-term economic, earnings, and dividend growth rate in the U.S. has only been in the 5% to 7% range, as demonstrated by a review of Nominal GDP, S&P 500 Stock Price, S&P 500 EPS, and S&P 500 DPS.[194]

GDP, S&P 500 Stock Price, EPS, and DPS Growth
1960-Present

Nominal GDP	**6.58%**
S&P 500 Stock Price	**6.69%**
S&P 500 EPS	**6.64%**
S&P 500 DPS	**5.76%**
Average	**6.42%**

Dr. Woolridge explains that because GDP growth is slowing to a rate of 4.0% to 5.0%, Witness Hevert's long-term growth rate projections are vastly overstated.[195] The current inflation rate of 2% to 3% and the real stock return rate in the 4% to 5% range imply nominal expected stock market returns in the 6% to 8% range.[196] Accordingly, Witness Hevert's projected earnings growth rates and implied expected stock market returns and equity risk premiums are not realistic indicators of the stock market and economic conditions.[197] Therefore, Witness Hevert's expected CAPM equity cost rate is significantly overstated. Under a more realistic equity or market risk premium, OPC contends that the appropriate equity cost rate for a public utility should be in the 8.0% to 9.0% range and not in the 10.0% to 11.0% range.[198]

A review of Witness Hevert's testimony on behalf of Pepco in the last three District of Columbia Pepco rate cases (Formal Case Nos. 1087, 1103, and 1139) reveals clear

194 Exhibit OPC (C) at p. 93; *see also* Exhibit OPC (C)-14.

195 Exhibit OPC (C) at p. 93-94.

196 *See* Exhibit OPC (C) at p. 94-95.

197 Exhibit OPC (C) at p. 95.

198 Exhibit OPC (C) at p. 96.

inconsistencies regarding Witness Hevert's application of the CAPM. In 2011 in Formal Case No. 1087, Witness Hevert used current and projected 30-year U.S. Treasury rates of 4.35% and 4.88% and gave more weight to his DCF results.[199] In 2013 in Formal Case No. 1103, Witness Hevert used current and projected 30-year U.S. Treasury rates of 2.97% and 3.15%.[200] Witness Hevert acknowledged that he did not give much weight to his CAPM results in Formal Case No. 1103 because they were "low" and "not reasonable by reference to authorized returns".[201] In this proceeding in Formal Case No. 1139, Witness Hevert strives to give more weight to his CAPM results and Risk Premium-based methods because "they are more likely than the Constant Growth DCF method to provide reliable estimates of the Cost of Equity during periods of market instability".[202] During hearings in this proceeding, Witness Hevert acknowledged the Commission's preference for the DCF method, but proffered that "we can find that DCF model results are quite unstable".[203] The record shows, however, that Witness Hevert handcrafts his methodologies and selectively emphasizes the weight he applies to each methodology in order to maximize ROE given the circumstances of each case.

3. Errors in Witness Hevert's Risk Premium Approach

Witness Hevert also employs the Risk Premium ("RP") model to estimate Pepco's equity cost rate, using three different thirty-year Treasury yields for a current yield of 2.62%, a near-term projected yield of 3.15%, and a long-term projected yield of 4.65% to establish equity cost rates

199 March 22, 2017 Transcript at p. 1496, lines 3-7; *see* OPC Hearing Exhibit 47.

200 March 22, 2017 Transcript at p. 1506, lines 5-10; *see* OPC Hearing Exhibit 48.

201 March 22, 2017 Transcript at p. 1507, lines 4-5, *see* p. 1506, lines 16 – p. 1507, line 7.

202 Exhibit Pepco (D) at p. 3, lines 11-12.

203 March 22, 2017 Transcript at p. 1498, lines 17-18. Witness Hevert further explained that the Commission's "preference for the DCF does not preclude consideration of other methods, like the CAPM and RPM…in some circumstances". March 22, 2017 Transcript at p. 1508, line 20 – p. 1509, line 4.

ranging from 10.04% to 10.47%.[204] Because current 30-year U.S. Treasury bonds yield at approximately 3.0%, Witness Hevert's projected 4.65% Treasury yield is unreasonably high.[205] Dr. Woolridge explains that such a drastic increase of yields by 150 basis points in the next few years "would result in significant capital losses for investors buying bonds today at current market yields".[206] Witness Hevert's RP method thus produces an inflated measure of the risk premium.

Pepco Witness Hevert's RP method improperly gauges regulatory commission behavior instead of investor behavior. OPC Witness Woolridge further explains that capital costs are determined in the market place wherein the financial decisions of investors are reflected in the following fundamental factors: dividend yields, expected growth rates, interest rates, and investors' assessment of the risk and expected return of different investments. In contrast, regulatory commissions evaluate capital market data in setting authorized ROEs, but also take into account other utility-specific and rate case-specific information in setting ROEs. Accordingly, Witness Hevert's approach and results improperly reflect these other regulatory commission factors, such as capital structure, credit ratings and other risk measures, service territory, capital expenditures, energy supply issues, and rate design.[207] Dr. Woolridge also explains that Witness Hevert's RP method produces an inflated investor-required rate of return above the ROE that Pepco investors would require.[208]

4. Witness Hevert's Failure to Account for Current Regulatory Commission Trend Authorizing Lower ROEs

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204 *See* Exhibit OPC (C) at p. 97, Exhibit OPC (C)-13.

205 Exhibit OPC (C) at p. 97.

206 Exhibit OPC (C) at p. 97, lines 16-17.

207 Exhibit OPC (C) at p. 98.

208 Exhibit OPC (C) at p. 98-99.

Authorized ROEs for electric utilities have declined from 10.01% in 2012, to 9.8% in 2013, to 9.76% in 2014, 9.58% in 2015, and 9.64% in the first three quarters of 2016.[209] The average authorized ROE for all electric utilities in 2016, vertically integrated and distribution only, and excluding the Virginia rider cases with ROE adders, was 9.66%.[210] The average authorized ROEs for distribution-only electric utilities was about 20 basis points below those averages.[211] The average authorized ROE for the ten distribution-only cases in 2016 was 9.45%.[212]

During hearings in this proceeding, Pepco Witness Hevert acknowledged the current trend of regulatory commissions authorizing ROEs under 10.0%.[213] Witness Hevert also acknowledged that no electric distribution company has received an ROE higher than 9.9% since 2012.[214] Witness Hevert acknowledged that the average ROE for electric distribution utilities in 2016 was 9.45%.[215] Witness Hevert also acknowledged that in the last three years from 2014-2016, there was not a single case for any type of electric utility (distribution, transmission, or vertically integrated) with an authorized ROE that is equal to or greater than Witness Hevert's proposed

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209 Exhibit OPC (C) at 75-76, fn. 40 (citing *Regulatory Focus*, Regulatory Research Associates, January, 2016) (explaining that electric utility authorized ROEs exclude the authorized ROEs in Virginia which include generation adders and thus are inflated and inappropriate for making comparisons).

210 March 22, 2017 Transcript at p. 1516, lines 1-7.

211 Exhibit OPC (C) at 75-76.

212 AOBA Hearing Exhibit AOBA-70.

213 March 22, 2017 Transcript at pp. 1514-1516 (referring to Regulatory Research Associates at the source for nationwide ROE data); *see* Exhibit OPC (C) at 75-76, 78.

214 March 22, 2017 Transcript at pp. 1535-1536; *see* AOBA Hearing Exhibit AOBA-63, AOBA Hearing Exhibit AOBA-70.

215 March 22, 2017 Transcript at pp. 1537-1538.

10.60% ROE for Pepco in this proceeding.[216] Despite these trends and despite Pepco's current 9.40% authorized ROE[217] for its District of Columbia operations and its recently authorized 9.50% ROE for its Maryland operations,[218] Witness Hevert insists on recommending a 10.60% ROE for Pepco in this proceeding. Witness Hevert's proposed 10.60% ROE for Pepco is unreasonable and should be rejected.

I. Capital Structure

Capital structure refers to the relative percentage of debt, equity, and other financial components utilized to finance a company's investments.[219] A well-balanced capital structure and debt-to-equity ratio are important aspects of the public utility ratemaking objective to balance the needs of the capital markets (including stockholders) with the needs of ratepayers.

Pepco has proposed a capital structure of 50.86% long-term debt and 49.14% common equity.[220] Pepco recommends a long-term debt cost rate of 5.48%.[221] OPC Witness Woolridge recommends using Pepco's 2015 year-end capital structure. Witness Woolridge recommends the inclusion of short-term debt in a capital structure that consists of **[BEGIN CONFIDENTIAL]**

. **[END CONFIDENTIAL]**[222] Dr. Woolridge recommends using Pepco's indicated short-term and

216 March 22, 2017 Transcript at pp. 1538-1539.

217 The authorized ROE is 9.50% not accounting for the BSA.

218 March 22, 2017 Transcript at p. 1575, lines 2-7; *see also* AOBA Hearing Exhibit AOBA-63 (Pepco's Response to AOBA Data Request 12-2 re nationwide ROE data).

219 Exhibit HCNCA (A) at 35-36.

220 Exhibit OPC (C)-5; *see* Pepco Exhibit (3D) at p. 126, Pepco Exhibit (B)-5.

221 Exhibit OPC (C)-5; *see* Pepco Exhibit (B)-5.

222 Exhibit OPC (C) at p. 37-38.

long-term debt cost rates as of December 31, 2015, which are **[BEGIN CONFIDENTIAL]**

[END CONFIDENTIAL] and 5.48% for long-term debt.[223]

OPC Witness Woolridge recommends the inclusion of short-term debt in Pepco's capital structure because the capital structure for Pepco's parent, PHI, has a lower common equity ratio than the two proxy groups (*i.e.*, Electric and Hevert Proxy Groups) and Pepco.[224] Dr. Woolridge explains that PHI's capitalization is a significant driver in the credit ratings and capital costs for Pepco because PHI, as the parent company, is the ultimate source of capital for Pepco.[225] Pepco's proposed capitalization has slightly more equity and less financial risk than the average current capitalizations of electric utility companies.[226] As demonstrated in Exhibit OPC (C)-4, the median common equity ratios of the Electric and Hevert Proxy Groups are 47.1% and 47.8%, respectively.[227] Finally, given the low interest rate environment, Witness Woolridge explains that not reflecting the historically low short-term debt cost rates in rates is not fair to consumers.[228]

In light of Witness Woolridge's foregoing analysis, OPC recommends the inclusion of short-term debt in Pepco's capital structure using Pepco's 2015 year-end capital structure.

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223 Exhibit OPC (C) at p. 38.

224 Exhibit OPC (C) at p. 38 (citing Pepco Response to OPC DR No. 16-12 (Confidential)).

225 Exhibit OPC (C) at p. 38.

226 Exhibit OPC (C) at p. 38, 80 (explaining that the 2015 capital structure has a slightly higher equity ratio and slightly less financial risk than the proxy companies).

227 Exhibit OPC (C) at p. 38.

228 Exhibit OPC (C) at p. 38 (adding that the low interest rates that Pepco is paying for short-term debt should be reflected in customer rates).

ISSUE No. 4 SHOULD PEPCO'S BSA MECHANISM BE CONTINUED AND, IF SO, WHAT CHANGES TO THE MECHANISM, IF ANY, ARE NECESSARY AND APPROPRIATE?

OPC would like to see the BSA discontinued. However, OPC recognizes that the BSA is but one component of the multitude of issues that must be considered in ensuring that Pepco's distribution rates are just and reasonable. As discussed herein,[229] these issues include, but are not limited to: (1) affordability of rates for low-income customers, the working poor, and the middle class; (2) the Commission's desire to place a greater emphasis on customer charges and demand rates and less emphasis on volumetric charges; (3) the Commission's desire to eliminate negative class rates of return; (4) the extent to which different customer classes benefit from reliability investments;[230] (5) the opportunity to use AMI data to inform decisions on rate design and the potential restructuring of Pepco's rate classes;[231] and (6) the Commission's interest in alternative ratemaking structures. OPC must balance these complicated and interrelated issues with its desire to discontinue the BSA.

In consideration of OPC's comprehensive rate design proposal, OPC recommends that the Commission: (1) leave the BSA unchanged at the current time; but (2) decide whether the BSA should be discontinued as part of the alternative rate design investigation that OPC and Pepco have asked the Commission to undertake shortly after the conclusion of this proceeding.[232]

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229 *See* the discussion regarding Issues 13, 15, and 19, *infra*.

230 As explained below, the record supports a finding that reliability investments provide greater benefits to commercial and industrial customers in terms of economic value than those same investments provide to residential and low-income customers. Tr. at 1809:2-8 (Stipulation). To withstand judicial revision, any decision on rate design and the allocation of the proposed revenue increase must account for those differences. OPC asserts that the strict adherence to the policy of eliminating negative class rates of return does not account for those differences.

231 Tr. at 1062:6 to 1063:12, 1065:9-11, 1065:19 to 1066:8 (Dismukes).

232 Exhibit OPC (A) at 95:5-16.

ISSUE No. 4(a) Has Pepco reasonably and appropriately developed the revenues per customer that will be used in BSA determinations subsequent to the conclusion of this proceeding?

Pepco proposed to calculate the BSA revenue per customer calculation after the Commission makes it determinations of the Company's revenue requirement, revenue allocation and rate design.[233] Pepco also stated that it plans to file the BSA revenue per customer levels based on test year billing determinants and customer counts that are themselves based on "Count of Contracts" data.[234] OPC agrees that Pepco's proposals are appropriate. OPC Witness Ramas explained that the "count of contracts" data is "used in the rate design calculations," and is "based on the number of customers and not on the number of billing occurrences."[235] Consequently, "[u]se of these data will ensure that the BSA and rate design calculations are consistent."[236]

ISSUE No. 4(b) If the BSA is continued, what forecasts of kWh per rate class should be used in the monetary computation of monthly rate adjustment ($/kWh)?

OPC does not take a position on Issue 4(b) at this time.

ISSUE No. 4(c) Are Pepco's test year numbers of customers and revenues developed in a manner consistent with the actual data presented in its BSA filings?

As discussed in subpart (a) of this designated issue, the test year customer numbers are based on the Count of Contracts Report, which is based on the number of customer contract accounts. The BSA filings, however, are based on different data: the number of billing

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233 *See* Exhibit Pepco (2G) (Janocha) at 2.

234 *Id.*

235 Exhibit OPC (B) at 9.

236 *Id.*

occurrences obtained from the Company's Active Billed Reports.[237] As OPC Witness Ramas explained,

> Based on a review of documents filed in Docket No. PEPBSAR-2016-01, it appears that the Company began using the number of bill occurrences in its BSA filings after the implementation of its SolutionOne billing and management system in January 2015. Thus, the actual data presented in the BSA filings submitted post-SolutionOne implementation, which includes the time period covered by the test year, were based on the Active Billed Reports rather than the number of customers on which the test year revenues in this case are based. The number of bills to customers (i.e., the Active Billed Reports) differs from the monthly number of customers partially as a result of the timing of the Company's billing cycle.[238]

Notwithstanding the data mismatch between Pepco's test year numbers of customers and revenues and data presented in its BSA filings, the Company has confirmed, through data responses and at hearing, that it recommends using the Count of Contracts for BSA determinations going forward.[239] OPC agrees it is appropriate to use this data for purposes of calculating the revenues per customer used for BSA determinations during the effective period.[240]

ISSUE No. 4(d) How would the BSA mechanism be adjusted if MMA customer count changes from number of dwelling units to the number of buildings?

OPC does not take a position on Issue 4(d) at this time.

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237 *Id.* at 9-10 (citing Exhibit Pepco (2G) (Janocha) at 3).

238 *Id.* at 10.

239 Commission Cross-Examination Exhibit No. 72 ; Tr. at 1953, line 16 – p. 1954, line 10.

240 Exhibit OPC (B) (Ramas) at 10; *see also* Tr. at 1118, lines 2-14.

ISSUE No. 5 IS PEPCO'S PROPOSED RATE BASE, AS ADJUSTED, JUST AND REASONABLE?

Pepco has proposed a rate base, as modified by its rebuttal filings, of $1,714,834,000. OPC explained in its pre-filed testimony and demonstrated at hearing that the Company's proposed rate base and several of the proposed corresponding adjustments are unreasonable and/or are contrary to Commission precedent and should be rejected. OPC recommends a rate base of $1,602,964,000. The Office's recommended adjustments to the Company's rate base are set forth in Exhibit OPC (B)-2, and include:

$26,377,000	Revision to Post-Test Year ("PTY") Reliability Closing - April through December 2016 (including Net Operating Loss Carryforward ("NOLC") impact)
$39,723,000	Revision to PTY Reliability Closing - January through June 2017
$46,959,000	Revision to PTY Reliability Closing - April through Sept. 2017
$10,484,000	Annualization of December 2015 Cash Payment for Use of Pepco NOLC
$52,000	Removal of Amortization of Third Party Audit Costs
$324,000	Removal of SERP Expense and Associated Rate Base Impact
$4,316,000	Revised Merger Synergy/Costs to Achieve ("CTA") adjustment

These adjustments also impact the calculation of cash working capital. The bases for OPC's recommended adjustments are addressed below and under Designated Issue Nos. 7 and 10.

ISSUE No. 5(a) Is Pepco's lead-lag study and proposed cash working capital allowance reasonable?

Pepco's proposed cash working capital allowance, which Pepco calculates based on lead-lag study results presented by Witness Ziminsky, is not reasonable. OPC recommends several test year expense revisions—which are discussed below in subsections (c) and (d) and under Designated Issue No. 7—that result in a reduction to the adjusted test year cash working capital allowance. OPC also recommends excluding from the operation and maintenance expenses that are included in the cash working capital calculations the charges from PHI Service Company to Pepco for depreciation on PHI Service Company assets. Implementation of OPC's recommended adjustments results in a total cash working capital allowance of $ $12,001,234.[241]

Pepco has proposed to include both: (1) $39,152,000 in its adjusted rate base for Pepco's portion of PHI Service Company net plant in service[242]; and (2) $5,044,000 for depreciation expense associated with PHI Service Company assets in the cash working capital calculations.[243] OPC contends the Company should be precluded from including both the net assets in rate base and the depreciation expense associated with those assets as a component of cash working capital. As OPC Witness Ramas explained,

> [t]he unrecovered portion, or undepreciated portion, of the plant that is in service and used to serve customers is included as a component of rate base to which a return is applied, recognizing the investor supplied funding of those assets. It would not be appropriate to . . . include an additional return [by including the] depreciation expense as a component of cash working capital.[244]

The Company has not disputed that proper accounting calls for excluding depreciation expenses from cash working capital calculations when associated with assets that are included in rate base. Indeed, Pepco excluded the depreciation expense associated with Pepco owned assets from the cash working capital calculations. However, it did not do so with respect to PHI assets used to service Pepco customers. The Company claimed that the latter situation is different because it involves:[245]

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241 *See* Exhibit OPC (B)-4, Schedule 17 at 1-2.

242 *See* Exhibit OPC (B)-1 at 1, line 9

243 *See* Exhibit OPC (B)-7 at 4.

244 Exhibit OPC (B) (Ramas) at 15.

245 Exhibit Pepco (3E) (Ziminsky) at 39.

> investor funds temporarily required in order for Pepco to pay cash to the PHI Service Company for depreciation expense billed to Pepco. As such, Pepco is not seeking an "additional return" on its net service assets. It is seeking a return on the investor funds temporarily required for Pepco to pay its . . . PHI Service Company bill.

Pepco's contention that this transaction involves "two different returns"[246] is nothing more than a shell game. That the depreciation expense is levied through a "bill" does not change that "the service company assets [that are associated with that expense] are included in the rate base which [earns] a return on dollars."[247] Moreover, the "investor funds" on which Pepco seeks to earn a return, are "temporarily required" to pay a bill that is assessed by a company that shares the same investor pool as Pepco.[248] The Commission should not allow Pepco to circumvent appropriate ratemaking principles and earn two returns on the same assets.

ISSUE No. 5(b) Are the projects completed in the test period, which Pepco proposes to include in rate base, just and reasonable?

OPC takes no position as to Pepco's treatment in the adjusted test year of the capital projects that were completed in the test period.

ISSUE No. 5(c) Are Pepco's proposed post-test year additions just and reasonable?

A. Pepco's Proposed Post-Test Year Additions In RMAs 24, 25 And 26 Are Not Just And Reasonable. (Issue 5c)

Pepco has proposed a series of post-test year ratemaking adjustments (RMAs 24, 25, and 26) designed to include a collection of projects that Pepco has defined as "reliability projects"[249] in rate base that will not close to plant-in-service until, in some instances, over a year and half

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246 Tr. at 2062, lines 16-17.

247 Tr. at 2062, lines 14-16.

248 Tr. at 2061, line 5 – p. 2062, line 10.

249 *See* Exhibit PEPCO (E) (Ziminsky) at 19:5; Exhibit PEPCO (C) (Verner) at 16:12-13.

after the close of the test year in this proceeding.[250] The issue is not whether these projects should be performed, but whether they should be accorded extraordinary rate treatment; they should not. Pepco's proposed ratemaking adjustments have not been demonstrated to require special rate treatment, they distort the test year, are inconsistent with the Commission precedent, and should be rejected by the Commission.

The Commission has held that "the rate base of a utility can properly include the cost of a construction project that is in service during the test period and, in appropriate circumstances, a project completed outside the test period, as long as its in-service date is not too remote in time from the test period."[251] The Commission has also held that for post-test year projects to be placed in rate base, it must be shown that these post-test-year projects and their related costs are "known and certain changes that can be calculated with precision, that were needed, reasonable, and beneficial to ratepayers during the rate-effective period."[252] In applying this rule, the Commission has held that "it is reasonable to allow the costs of construction projects to be included in rate base when projects are in fact placed in service before the end of the test year, but are not recorded as being test year plant in service because of delays in bookkeeping."[253] With the exception of a subset of projects included in RMA 24, Pepco's proposed ratemaking adjustments fail this test and should be excluded from rate base in this proceeding.

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250 Pepco's proposed RMA 26 will not be fully closed to plant-in-service until September 2017. Exhibit PEPCO (C) (Verner) at 16 n.13.

251 *Formal Case No. 1053, In the Matter Of The Application Of The Potomac Electric Power Company For Authority To Increase Existing Retail Rates And Charges For Electric Distribution Service* ("*Formal Case No. 1053*"), Order No. 14712 at ¶ 68, rel. Jan. 30, 2008.

252 *Formal Case No. 1093, In The Matter Of The Investigation Into The Reasonableness Of Washington Gas Light Company's Existing Rates And Charges For Gas Service* ("*Formal Case No. 1093*"), Order No. 17132 at ¶ 72, rel. May 15, 2013.

253 *Formal Case No. 1053*, Order No. 14712 at ¶ 69.

i. Many Of The Projects Included In RMAs 24-26 Are Not The Types Of Projects For Which Post-Test Year Recovery Is Appropriate.

In *Formal Case No. 1093*, Washington Gas Light ("WGL") proposed a series of ratemaking adjustments for projects that still had CWIP balances at the end of the test year and that WGL claimed would be closed to plant-in-service in the test year.[254] In Order No. 17132, the Commission accepted ratemaking adjustments associated with several projects that were "placed in service before the end of the test year," but were not recorded in plant-in-service due to accounting delay.[255] The Commission, however, rejected the inclusion of six projects which involved "distribution main replacement activities" and had "no completion and in-service dates."[256] As the Commission concluded in Order No. 17132, "there is no basis to support the inclusion of these projects in rate base under our general rule."[257]

Application of that principle in the instant proceeding compels the rejection of many of the projects included in Pepco RMAs 24-26.[258] The Company has conceded in this proceeding that "many of the projects in Adjustments 24-26 are 'blanket' projects that encompass generic categories of work that continue year to year, but for which many individual jobs under unique work order numbers are created."[259] As such, these projects do not have specific "in-service"

254 Order No. 17132 at ¶ 68.

255 Order No. 17132 at ¶ 73.

256 *Id.*

257 *Id.*

258 Mr. Mara has identified a subset of projects included in RMA 24 that he considers replacement projects. Exhibit OPC (E) (Mara) at 18, Table OPC (E)-1 (Confidential).

259 OPC Cross Examination Exhibit 35 at 1.

dates, but instead are, in many cases, routine replacement work that the Company performs every year and can anticipate will be required on an annual basis.[260]

OPC witness Mara independently determined that many of the projects included in RMA 24 were "continuous, on-going replacement projects."[261] Mr. Mara distinguished these projects from large investments that are specifically targeted to improve reliability and which have clear benefits that are easy for the Commission, OPC, and interested parties to identify. For example, Mr. Mara notes that "[w]hen . . . a project is of significant size, such as the Waterfront Substation or a new generating facility, the benefit when placed in service is obvious to all parties."[262] In contrast, in the case of the continuous, on-going replacement projects that the Company has included in RMAs 24-26, it is "more difficult to determine if the portion completed rises to the level of providing ratepayer benefits."[263]

During cross examination, Pepco witness Verner conceded that, depending on the type of work being performed it is not clear when that work included in Pepco's "blanket" projects would be providing benefits to ratepayers. For example, Ms. Verner stated that if the Company was digging conduit as part of a blanket project, that work would not be providing benefits to consumers until some future point in time when cable was laid and energized by the Company.[264] Accordingly, as demonstrated below, where the Company is seeking recovery of blanket projects that extend, in many cases, for many years after the close of the test year, it is impossible for the Commission to determine when the blanket replacement project expenses included in the RMA

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260 Tr. at 878:14-879:12.

261 Exhibit OPC (E) (Mara) at 15:13-14.

262 *Id.* at 23:11-13.

263 *Id.* at 23:14-15.

264 Tr. at 904:16-20.

are actually providing benefits to ratepayers and qualify for inclusion in a ratemaking adjustment consistent with Commission precedent.

What is clear from the record evidence in this proceeding is that, like the post-test year projects that the Commission rejected in *Formal Case No. 1093*, many of the projects included in RMAs 24-26 are either: (i) on-going replacement projects that have no clearly defined in-service date; or (ii) long-term projects that have estimated in-service dates well beyond the test year and after the start of the rate effective period. For example, the Company has included in RMAs 24-26 a significant amount of post-test year expense related to the on-going conversion of the 4 kV system to 13 kV in Upper Shaw and Harvard/Columbia Heights area. According to the Company, that work involves upgrading conduit and cable and replacing transformers, supply feeders, and switchgear[265] for which Pepco has budgeted costs through 2019.[266] The Company has *estimated* that the work on that project will not be completed until May 20, 2020.[267] The Work Breakdown Structure ("WBS") for this 4 kV to 13 kV work makes no attempt to demonstrate when particular elements of the project will be in-service and providing benefits to ratepayers. Ratepayers are therefore being asked to fund a ratemaking adjustment in this proceeding based on an allegation of benefits during the rate effective period that has no support in the record. Such a result is not permitted under Commission precedent requiring that the proponent of a ratemaking adjustment demonstrate, among other things, that the proposed projects are beneficial to ratepayers during the rate-effective period.[268]

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265 Exhibit Pepco (C)-1, Attachment A at 295; Exhibit OPC (E) (Mara) at 21:4-6.

266 Exhibit Pepco (C)-1, Attachment A at 296.

267 *Id.* at 297.

268 Order No. 17132 at ¶ 72.

Similarly, the Company has included in its ratemaking adjustments a series of replacement projects such as Pepco's on-going pole replacement activity in the District. The in-service date for that project is listed on the Pepco WBS as "N/A."[269] Accordingly, there is no demonstration of when the work for which the Company seeks an adjustment will be complete and providing benefits to ratepayers during the rate-effective period. Furthermore, as with the distribution main replacement activity that the Commission rejected as a ratemaking adjustment in *Formal Case No. 1093*, this type of replacement activity that does not require special ratemaking treatment. The Company's WBS submitted to support this pole replacement shows that the Company routinely replaces a similar number of poles on an annual basis.[270] Accordingly, as Mr. Mara concluded, "[a] test year that captures annual replacements should fund continual replacement of the same magnitude into the future."[271] Stated differently, the proposed ratemaking adjustment does not provide any benefit to District ratepayers because the test year revenues already permit the Company to perform this level of replacement work on an annual basis. In contrast, permitting the special rate treatment that Pepco requests would distort the test year by permitting Pepco to recover two years worth of pole replacement activity against one year of revenue.[272]

The Office recognizes that in *Formal Case No. 1103* the Commission accepted a ratemaking adjustment associated with a collection of projects that were booked to plant by the

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269 Exhibit PEPCO (C)-1, Attachment A at 336.

270 Exhibit PEPCO (C)-1, Attachment A at 335.

271 Exhibit OPC (E) (Mara) at 19:20-20:2.

272 Exhibit OPC (E) (Mara) at 16:12-14.

Company within eight months of the end of the test year.[273] Consistent with that decision, the Office does not object to those actual reliability projects included in RMA 24—work on Priority Feeders, Distribution Automation, and increasing capacity for more flexibility in back feeding during N-1 contingencies[274]—that are known and certain expenses and will be closed within eight months of the test year.

The Office objects to the blanket replacement projects in RMA 24 on the grounds that those projects either do not have in-service dates or have not been demonstrated to provide benefits to ratepayers in the rate effective period. In *Formal Case No. 1103*, the Commission found that there was no evidence demonstrating that it was "unreasonable to rely on an entry of an asset into [Electric Plant in Service ("EPIS")] to establish the in-service dates of these projects for ratemaking purposes."[275] In contrast, there is such evidence in the record of this case because in Order No. 17424 the Commission ordered the Company "to make further refinements to the [Construction Program Report] so the overall costs and benefits of the various elements of the total construction portfolio can be better understood . . . ."[276] In response, the Company filed for the first time the project-specific information included in Attachment A to the Construction Program Report.

With the benefit of that additional, project-specific information in this proceeding, it is clear that it is not reasonable for the Commission to assume that the Company booking costs to EPIS means that the project is completed and providing benefits to ratepayers. As discussed

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273 Order No. 17424 at ¶ 112.

274 Mr. Mara identifies the reliability projects and costs included in RMA 24 by Project ID. Exhibit OPC (E) (Mara) at 20, Figure OPC (E)-2 (Confidential).

275 Order No. 17424 at ¶ 112.

276 *Id.* at ¶ 519.

above, many of the WBS breakdowns provided by the Company show that there is no in-service date for many of the projects included in the Company's RMAs despite the fact that the Company has booked a portion of those expenses to plant-in-service.

As the Commission has stated, the "burden of justifying an out-of-period adjustment is on the party seeking the adjustment."[277] On the basis of the record in this proceeding, the Company has failed to meet that burden. It is not enough under the Commission's standard for the Company to have incurred an expense and to have booked that expense to plant-in-service. Rather, the Company must demonstrate that all three prongs of the Commission test have been met, including the requirement that projects are in-service and providing benefits during the rate effective period. Unlike *Formal Case No. 1103*, the evidence of this record demonstrates that Pepco has failed to demonstrate when the "blanket projects" included in RMAs 24-26 will be in-service and providing benefits to ratepayers, and this failure compels rejection of those projects. The Commission should therefore order Pepco to make a compliance filing to remove from RMAs 24-26 all projects for which there is either no identified in-service date included in Attachment A to Exhibit C-1 or for which the estimated in-service date is beyond the start of the rate-effective period.

ii. Pepco's Claim That The RMAs Concern "Reliability Projects" Does Not Justify A Ratemaking Adjustment.

Pepco has taken the position in this proceeding that its proposed ratemaking adjustments are appropriate because they are a subset of investments that the Company classifies as "reliability investments."[278] While the Commission has, under certain circumstances, permitted

[277] *Office of People's Counsel v. D.C. Pub. Serv. Comm'n*, 989 A.2d 190, 194 (D.C. 2010) (quoting *Office of People's Counsel v. D.C. Pub. Serv. Comm'n*, 610 A.2d 240, 247 (D.C. 1992)).

[278] During cross examination, Pepco witness Verner stated that the term "reliability projects" is a term that the Company developed to classify projects in the Construction Program Report. Tr. at 871:3-7 (Verner).

projects that do not meet the general, three-prong test for a ratemaking adjustment to receive special rate treatment under "unique and compelling" circumstances,[279] the projects included in Pepco RMAs 24-26 do not merit any special rate treatment based on Pepco labeling them as reliability projects.

In *Formal Case No. 1093*, WGL argued that the ratemaking adjustments that were still in CWIP under the theory that the projects were "safety-related costs" associated with its distribution mains, services, and meters replacement programs.[280] OPC opposed those adjustments on the grounds that, among other things, the projects were "regular and routine replacement work that is neither unique nor unusually large."[281] The Commission agreed, finding:

> We agree with OPC. We were especially struck by the argument made by WGL's witness that every project that has a safety component should be considered within the "unique and compelling" exception. That interpretation would make the exception the rule since there is a safety component in a majority of a utility's CWIP. Our exception has never been that broadly construed, and we decline to change our policy now and give it the interpretation that WGL is advocating. We therefore hold that the safety-related additions that do not qualify under our general rule as discussed above will also be excluded from rate base under the "unique and compelling" exception.[282]

As with the argument that WGL made in *Formal Case 1093*, Pepco's argument that "reliability projects" deserve special rate treatment would make the exception the rule. Pepco witness Verner testified that Pepco defines reliability projects as projects "that are designed to

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[279] *See* Order No. 17424 at ¶ 75.

[280] Order No. 17132 at ¶ 68.

[281] *Id.* at ¶ 69.

[282] *Id.* at ¶ 75.

either maintain or enhance system reliability."[283] There is, however, an element of reliability in every project that the Company undertakes on the distribution system. And, as Mr. Mara explains, "the need for replacing aged equipment has existed in all rate cases"[284] and "the core competency of an electric utility is to replace its aging plant and this in and of itself does not rise to the level of a 'reliability project' which must have special consideration in terms of post-test year inclusion."[285] There is nothing "unique or compelling" about replacing aged equipment; that is the kind of work that Pepco is obligated by statute to perform,[286] and does perform, on a routine basis.

Furthermore, during the hearing in this proceeding, it became clear that Pepco's distinction between reliability projects and load projects is arbitrary. Pepco witness Verner testified that the concept of a "reliability project" (as opposed to a "load growth" project) was based on the Company's internal classification in the Construction Program Report.[287] Pepco witness Verner also conceded that load growth could be the driver of the decision to convert a 4 kV feeder to 13 kV[288] despite the fact that the Company has classified such projects as "reliability driven" in the Construction Program Report.[289] The evidence of record also

283 Exhibit PEPCO (2C) (Verner) at 5:19-20.

284 Exhibit OPC (E) (Mara) at 16:8.

285 Exhibit OPC (E) (Mara) at 19:6-9.

286 D.C. Code § 34-1101(a) ("Every public utility doing business within the District of Columbia is required to furnish service and facilities reasonably safe and adequate and in all respects just and reasonable.").

287 Tr. at 871:3-7.

288 *Id.* at 875:12-15.

289 *See* Exhibit PEPCO (C)-1, Attachment A at 295-296. The Company has chosen to classify the 4 kV to 13 kV conversion in the Upper Shaw and Harvard as "Reliability Driven" for budget purposes despite the fact that the Company has justified the project based on the fact that "[t]he load at the Harvard Sub. 13 (4kV) is predicted to exceed its transformer firm capacity by 4% . . . ."

demonstrates that other projects that the Company has chosen to classify as "reliability projects" could have been caused by increased load on the distribution facilities. For example, Pepco witness Verner conceded that the feeder and substation reliability concerns that the Company is seeking to address in the Construction Program Report could be driven by the impact of increased load on the distribution system.[290] Pepco's claim that the ratemaking adjustments are needed because the projects included in RMAs 24-26 are reliability projects for which the Company receives no additional revenue is therefore not supported by the evidence in this proceeding and should be rejected by the Commission.

iii. RMAs 25 And 26 Are Based On Budgeted, Not Actual, Costs And Therefore Are Not Known, Certain and Measurable.

RMA 25 contains CWIP for portions of projects that are expected to close bet^^ December 2016 and May 2017 and RMA 26 contains budgeted costs for associated projects that the Company anticipates will be in-service by June 2017 and closed to plant-in-service for accounting purposes by September 2017.[291] The Commission has ruled unequivocally that:

> The fact that RMA No. 34 [in *Formal Case No. 1103*] contains costs that are budgeted and remained budgeted at the close of the record is enough for the adjustment to fail the first-prong test. Budgeted amounts cannot be counted as "known, certain and measurable" expenses under our precedents unless we make an exception to our rule.[292]

There is no reason for the Commission to reconsider that decision in this case and, because both RMAs 25 and 26 are based on forecasted costs and anticipated in-service dates, those adjustments should be rejected in their entirety.

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290 Tr. at 875:21-877:6.

291 Exhibit PEPCO (C) (Verner) at 16 n. 13.

292 Order No. 17424 at ¶ 118.

The evidence of record is clear that the Company's forecasted costs estimates have been severely inaccurate in the past and that this imprecision has continued in the Company's proposed ratemaking adjustments in this case. When the Company filed its application in this proceeding, it sought to include $106,112,000 in rate base under RMA 24.[293] RMA 24 includes projects that were expected to close by April-November 2016,[294] *i.e.*, the closest in time to the date of Pepco's filing and therefore presumably the most accurate. Pepco witness Verner testified that those numbers were based on the Company's best estimates at the time it filed its application in this proceeding,[295] however, by the time the Company filed its supplemental direct testimony, that request had been reduced by approximately $26 million to $80,240,000.[296] The Company explained the decrease as the product of: (1) capital expenditures from April through August 2016 being lower than expected, and (2) the estimated in-service date for certain projects being pushed back beyond the time period covered by RMA 24.[297] Pepco witness Ziminsky provided a further update with his rebuttal testimony that reduced the total amount requested in RMA 24 to approximately $64 million.[298] In other words, based upon the most current data provided by Pepco, the company's original estimate of $106,112,000 for RMA 24 was overstated by approximately 40 percent.

During the hearing, witness Verner explained some of the reasons why the Company's estimates are inherently unreliable:

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293 Exhibit PEPCO (E) (Ziminsky) at 19:11.

294 Exhibit PEPCO (C) at 16 n.13.

295 Tr. at 889:9-14.

296 Exhibit PEPCO (2E)-1 (Ziminsky) at 29, line 1.

297 OPC Cross Examination Exhibit 33.

298 Exhibit PEPCO (3E)-1 (Ziminsky) at 29, line 1.

> [W]e don't have detailed engineering done when we do our initial estimates. We don't have the benefit of field investigations, soil tests, a number of items, permits that impact our construction.[299]

These are precisely the kinds of reasons why estimates cannot be used to establish just and reasonable rates.

A comparison of the Company's budgets for reliability construction for 2013-2015 provide further evidence that the Company's forecasted expenses are not reliable and therefore are not known and certain. The following figure compares the Company's forecasted data to the Company's actual expense based on data produced by the Company in this proceeding:

	2013	2014	2015
Budget[300] (in millions)	$115.9	$111.7	$111.1
Actuals[301] (in millions)	$93.6	$105.8	$83.8
Variance (in millions)	$18.3	$5.9	$27.3

Accordingly, in each year for which the Company provided data in this proceeding, the evidence of record demonstrates that the Company's forecasted reliability expenditures were substantially overstated and not known with any certainty at the time the Company made its forecasts.

The Company has updated some of its forecasted RMA data to actuals as this proceeding has unfolded. Mr. Ziminsky has filed a series of updates to his testimony on the RMAs. At the hearing in this proceeding, the Company sought to include a data response sponsored by Mr. Ziminsky in response to Staff Data Request 14-7 showing that a portion of the Company's

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299 Tr. at 889:21-890:3.

300 OPC Cross Examination Exhibit 34.

301 Exhibit PEPCO (C)-2 at 7.

forecasted amounts included in RMA 25 have now been closed to actuals on the Company's books.[302] While the Office does not object to the admission of that data request into evidence and does not dispute that a portion of RMA 25 is now based on actual data, it would be inconsistent with Commission precedent to permit any portion of RMA 25 into rate base. In *Formal Case No. 1103*, the Commission stated that it would not "break up" an RMA in order to permit partial recovery. As the Commission explained in Order No. 17424, the Company's updates to its RMA to include actuals "were presented too late in the proceeding to allow for adequate examination."[303] Such is the case here. The Company's update to RMA 25 to include actual expense for January and February 2017 was not produced until March 13, 2017, on the eve of the hearing in this proceeding which began on March 15, 2017. There was, therefore, no opportunity for the parties to conduct discovery or meaningful cross examination on the actuals reported by the Company for January and February 2017. Accordingly, the Commission should not permit any expense included in RMA 25 in rate base as that adjustment still includes estimated data for March through June 2017 and therefore is not known and certain under Commission precedent. Similarly, RMA 26, which is based on budgeted capital expenditures through June 2017, is not appropriate for recovery in rate base under the Commission's precedent as those forecasted expenses are not known and certain.

iv. RMAs 25 And 26 Are Too Remote From The End of the Test Year to Be Included In Rates.

In addition to including budgeted costs, RMAs 25 and 26 should also be disallowed based on the independent grounds that those adjustments are too remote from the test year to be

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302 Pepco Cross Examination Exhibit 23.

303 Order No. 14724 at ¶ 118.

permitted in rate base. In *Formal Case No. 1103*, the Commission permitted certain project completed within eight months of the end of the test year to be included in rate base.[304] The Office believes that this is a reasonable cut-off point for the actual reliability projects included in RMA 24, which will be closed to plant-in-service within eight months following the close of the test year and the benefits of which can be readily discerned. RMAs 25 and 26, however, are too remote in time to be included in rate base. As discussed above, RMA 25 contains CWIP that will not be fully closed to plant-in-service until May 2017 (14 months after the end of the test) and RMA 26 included capital expenditures that will not be fully closed to plant-in-service until September 2017 (18 months after the end of the test year). Both of those RMAs include forecasted expenses that extended well beyond the eight-month period approved in *Formal Case No. 1103* and include estimated data that will not be converted to actuals until after the close of the record in this proceeding, meaning that the Commission, OPC, and interested parties will be afforded no opportunity to review the actual expenses when they are booked to plant-in-service. Furthermore, permitting these remote adjustments would mean that the parties would have no opportunity to review whether the projects are, in fact, complete and providing benefits that the Company has identified as justifying the expense in the Construction Program Report. The Commission should therefore reject RMAs 25 and 26 in their entirety.

v. The Commission Should Require Changes To The Company's Proposed Revenue Requirement.

Based on the foregoing discussion, the Office recommends several changes to the Company's proposed revenue requirement. First, based on Mr. Mara recommendation to remove

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304 Order No. 17424 at ¶ 112.

the network RMS project,[305] Pepco's ratemaking Adjustment 24 for post-test year reliability plant additions placed in service between April 2016 and December 2016 should be reduced by $5,197,000. Based on the removal of the $5,197,000, the post-test year reliability plant additions are reduced to $53,849,000 and accumulated depreciation should be increased by $723,000. Additionally, after factoring in the 2.685% composite depreciation rate recommended by OPC Witness Smith, depreciation expense associated with ratemaking Adjustment 24 should be limited to $1,446,000, and the associated ADIT offset to rate base associated with the post-test year reliability plant additions through December 31, 2016 should be $5,032,000.[306] Furthermore, based on the evidence presented at hearing and discussed above, the Office recommends further the Commission require the Company to submit a compliance filing to remove from RMA 24 the costs of all blanket replacement projects for which there is either no identified in-service date included in Attachment A to Exhibit C-1 or for which the estimated in-service date is beyond the start of the rate-effective period. Finally, all costs associated with RMAs 25 and 26 should be excluded from rate base as those RMAs are inconsistent with Commission precedent and should be excluded from rates.

ISSUE No. 5(d) Has Pepco appropriately offset rate base for accumulated deferred income taxes and has Pepco appropriately reflected the impact of Net Operating Loss Carry-Forward ("NOLC") on accumulated deferred income tax?

As explained by OPC Witness Ramas, accumulated deferred income tax ("ADIT") is a source of cost-free capital that reduces rate base.[307] When Pepco is in a Net Operating Loss Carry-Forward ("NOLC") position for income tax purposes, a Net Operating Loss ("NOL")

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305 Mr. Mara's recommendation to remove RMS from RMA 24 is fully explained in connection with Issue 17.

306 Exhibit OPC (B)-4, Schedule 1

307 Exhibit OPC (B) (Ramas) at 23.

deferred income tax asset results. This asset reduces the amount of ADIT offset to rate base that occurs absent the NOLC position, thereby effectively increasing rate base.[308] By participating in a consolidated tax group, Pepco may receive cash for the use of its NOLC to pay for income taxes owed by others in the group. Such transactions reduce Pepco's NOL deferred income tax asset.[309]

Pepco Adjustments 23-26 address the annualization of test year plant additions and post-test year reliability additions over three different time periods. Witness Ramas explained that as initially proposed, these adjustments had sizeable impacts on the ADIT offset to rate base.[310] Pepco's original and supplemental filings assumed that its NOL deferred income tax assets would increase by an amount equal to the increase in the ADIT balance, and based on that assumption, Pepco included in Adjustments 23-26 an offset to its NOL deferred asset equivalent to the offset from the ADIT impact.[311] Witness Ramas pointed out in direct testimony that this assumption was not well founded—the Company's NOL deferred federal income tax asset has declined substantially both during and subsequent to the test year[312] and recommended removing

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308 *Id.*.

309 Exhibit OPC (B) (Ramas) at 25; Exhibit OPC (B)-10. Pepco received payments from PHI for federal income taxes of: $56,269,015 during 2014 for the 2013 tax year, $6,339,027 during 2015 for the 2014 tax year, $56 million during 2016 associated with the 2016 tax year, and $147,400,457 during January and February 2016 associated with an IRS Global Tax Settlement with the Internal Revenue Service involving tax years 2003 through 2011. Exhibit OPC (B) (Ramas) at 25 (citing Exhibit OPC (B)-9).

310 Exhibit OPC (B) (Ramas) at 20 (discussing that post-test year reliability plant additions would be eligible for the 50% bonus depreciations allowance for income tax purposes).

311 *Id.*; *see also* Exhibit Pepco (E)-1 at 28-31; Exhibit Pepco (2E)-1 at 28-31.

312 Exhibit OPC (B) (Ramas) at 20-21 (citing Compliance Filing Section 206.9, Attachment B at 150; Exhibit OPC (B)-8) (explaining that during the test year Pepco's per book NOL deferred federal income tax asset declined from $216,145,693 in April 2015 to $107,836,270 as of March 2016, and declined even further to $82,701,780 as of September 30, 2016).

the offset.[313] While Pepco's position on this issue improved in later filings—the Company has moved closer to offsetting appropriately rate base for ADIT and the impact of the NOLC on the ADIT offset to rate base—additional adjustments are still needed.

Witness Ramas also testified that Pepco booked in December 2015 a cash payment from PHI for the use of Pepco's NOL balance, but that the Company has proposed to apply only a portion of that payment to the test year.[314] OPC recommended that the impact of the settlement be annualized so that the full impact its incorporated into the test year.[315] The Company responded by filing testimony raising a concern that OPC's recommendation would violate IRS tax rules.[316] OPC contends that the Company's concern is unfounded. The Office maintains its recommendation that the impact be annualized, but, out of an abundance of caution, recommends that it be implemented provisionally, that the Company be directed to pursue a Private Letter Ruling with the IRS concerning the issue, and that an adjustment be made if the IRS outcome so dictates. We address each issue in turn below.

1. The proposed NOLC offset for ADIT associated with Pepco Adjustments 25 and 26 should be removed from the adjusted test year.

In response to OPC's recommendation that the NOLC offset be removed from Pepco Ratemaking Adjustments 24-26, Pepco agreed to do so as to Adjustment 24 and further revised Adjustment 23.[317] While Pepco's rebuttal position also removed the NOL deferred federal

313 Exhibit OPC (B) (Ramas) at 21-22.

314 Exhibit OPC (B) (Ramas) at 24.

315 Exhibit OPC (B) (Ramas) at 26.

316 Exhibit Pepco (M) (Warren) at 4.

317 *See* Exhibit Pepco (3E) (Ziminsky) at 18-19, 46 (indicating that as a result of Exelon's use of Pepco's federal tax losses starting in May 2016, which reduces Pepco's NOL deferred tax asset balance, the Company is

income tax asset offset from its ratemaking Adjustments 25 and 26,[318] in an errata to its rebuttal, Pepco reversed this position, indicating that: "[u]pon further review, the Company is projecting a taxable loss in 2017, and an increase in its NOL DTA balance."[319] This time it added back in the NOL deferred tax offset to the ADIT liability associated with the adjustments.[320]

As addressed in subpart (c) of this issue above, it is OPC's position that Pepco's ratemaking Adjustments 25 and 26 should be rejected in their entirety. If the Commission nonetheless allows a portion of these post-December 31, 2016 plant additions to be included in rate base, then OPC recommends that the associated ADIT not be offset by projected growth in the NOL deferred tax asset. The reason is that the alleged projected NOL growth is neither known nor measurable. As previously indicated, the NOL deferred tax asset on the Company's books has declined substantially both during and subsequent to the test year. Pepco Witness Ziminsky admitted at hearing that his rebuttal errata recommendation was based on "forecast[s]" and "projection[s]" of what the Company thinks the NOLC balance will look like in 2017.[321] Forecasts and projections can change—as is apparent with the Company's own flip-flop-reflip on ADIT issues in Pepco's various filings. Moreover, the Company could potentially receive cash payments during 2017 for the use of its 2017 NOL position (should Pepco in fact end up in a NOL position for all of 2017) or its NOLC balance. As Pepco Witness McGowan testified,

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actually receiving cost free capital associated with the post-test year plant additions); Exhibit Pepco (3E)-1 at 29; Exhibit Pepco (4E) (Ziminsky) at 1-2; Exhibit Pepco (4E)-1 at 1.

318 Exhibit Pepco (3E) (Ziminsky) at 46-47; Pepco (3E)-1 at 30-31.

319 Exhibit Pepco (4E) (Ziminsky) at 2.

320 *Id.*; Exhibit Pepco (4E)-1 at 2-3.

321 Tr. at 2067, line 20 – p. 2072, line 11; *id.* at 2082, line 15 – p. 2084, line 2.

"[t]he company always tries to utilize the NOLs of any subsidiary, including PEPCO . . . we look for opportunities to do that."[322]

2. The Company should annualize the impact of PHI's IRS Global Tax Settlement.

As explained by Witness Ramas, Pepco booked in December 2015, a payment as a reduction to its NOL deferred federal income tax asset and during January and February 2016, received $42 million in cash payments from PHI for use of Pepco's Federal NOLC balance.[323] PHI used Pepco's NOLC balance to offset the tax liabilities related to a Global Tax Settlement with the IRS involving tax years 2003 through 2011 ("IRS Global Tax Settlement").[324]

At hearing, Company Witness McGowan testified that the IRS Global Tax Settlement was associated with cross-border energy lease investments structured as sale-in, lease-out, or "SILO" transactions.[325] In 2005, the IRS alerted taxpayers that SILO arrangements were tax-avoidance transactions identifying those and substantially similar transactions, as "listed" transactions that required reporting.[326] As explored in discovery and at hearing, following PHI reporting of such transactions, the IRS Global Tax Settlement was reached which resolved "all tax issues related to the utilities and all tax issues related to the non-regulated companies" for tax

322 Tr. at 1737, lines 7-9.

323 Exhibit OPC (B) (Ramas) at 26; Exhibit OPC (B)-8.

324 *Id.*

325 Tr. at 1714, line 21 – p. 1716, line 19 (discussing OPC Cross-Examination Exhibit No. 51 at 3-4).

326 OPC Cross-Examination Exhibit No. 53; *accord* Tr. at 1721, line 5 – p. 1722, line 6. OPC Cross-Examination Exhibit No. 52.

years 2003 through 2011.[327] The IRS Global Tax Settlement did not address income tax liabilities during the test year.[328]

Witness Ramas testified that the IRS settlement and the impact of the IRS settlement on Pepco's NOL deferred federal tax asset was "a known and measurable event that took place during the test year."[329] Explaining that the IRS settlement involved tax years pre-dating the test year, Witness Ramas recommended that the reduction in Pepco's NOL deferred tax asset balance resulting from the IRS Global Tax Settlement be annualized so that the full impact of the settlement on the NOL deferred tax asset balance is included in the adjusted test year.[330] She noted that such a directive would be consistent with the treatment of the IRS Global Tax Settlement in Pepco's Maryland rate case.[331]

In rebuttal testimony, Pepco Witness Warren contended that OPC's recommendation to annualize the impacts of the IRS Global Tax Settlement would violate the "Consistency Rule" of the normalization rules in Internal Revenue Code Section 168(i)(9)(b)(ii).[332] Witness Warren asserted that annualizing the IRS Global Tax Settlement impact, while other rate base items are

327 Tr. at 1709, lines 11-22.

328 *Id.*

329 Exhibit OPC (B) (Ramas) at 26.

330 *Id.*; *See also id.* at 27 (Witness Ramas stating that to reflect the annualized impact of the IRS Global Tax Settlement on Pepco's NOL deferred tax asset balance, "rate base should be reduced by . . . $25,846,000 on a total Pepco basis and $10,484,000 on a DC distribution basis.") (citing Exhibit OPC (B)-4, Schedule 4).

331 Exhibit OPC (B) (Ramas) at 27 (citing *Maryland P.S.C. Case No. 9418, In the Matter of the Application of Potomac Electric Power Company for Adjustments to its Retail Rates for the Distribution of Electric Energy,* Order No. 87884 at 68, rel. Nov. 15, 2016).

332 Exhibit Pepco (M) (Warren) at 14.

determined based on the 13-month average basis, would conflict with the normalization statute.[333]

OPC Witness Ramas testified hearing that she did not believe that the IRS Tax Code and Treasury Regulation sections cited by Witness Warren in fact supported this position.[334] Pepco's own accounting practices are contrary to Witness Warren's concern, though he does not address them. For example, several of the rate base items in Pepco's filing—e.g., the annualization of the test year reliability plant additions in Adjustment 23, Adjustments 24-26 for post-test year reliability plant additions, and the extension of several regulatory assets to periods beyond the end of the test year in Pepco ratemaking Adjustments 27-29—were based on end of period or post-test period amounts. Additionally, through Ratemaking Adjustment 34 Pepco has annualized the impact of a different cash payment from PHI that Pepco received during the test year. Adjustment 34 annualized the September 2015 cash payment received by Pepco from PHI as though that payment had been accrued by Pepco during 2014, resulting in an adjustment that reduced the NOL deferred tax asset by approximately $1.2 million on a Pepco D.C. distribution basis.[335]

Pepco emphasized that the impact of the IRS Global Tax Settlement on Pepco's NOL deferred tax asset balance was not booked by Pepco until December 2015.[336] But Witness Ramas explained why that date should not be considered definitive, noting that the settlement addressed

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333 *Id.* at 17.

334 Tr. at 1128, lines 10-14.

335 Exhibit Pepco (E) (Ziminsky) at 26-27; Exhibit OPC (B) at 24-25; *see also* Tr. at 1739, line 8 – p. 1740, line 15 (noting "the taxable events" that led to the use of Pepco's NOL balance "occurred in 2014").

336 *See, e.g.*, Tr. at 1710, line 1-12; Exhibit Pepco (M) (Warren) at 5-6.

"tax years well before the test year in this case."[337] Additionally, Witness Ramas testified that the accumulated deferred income tax liability on Pepco's books that is offset by the NOL deferred tax asset was on the Company's books before the start of the test year.[338] Moreover, it was known as far back as 2013 that PHI had agreed that it would settle matters with the IRS instead of pursuing litigation, causing PHI to account for the liability,[339] and it was known before the test year that PHI would have a fairly substantial obligation to the IRS. As "[t]he company always tries to utilize the NOLs of any subsidiary, including PEPCO,"[340] it was also certainly known before the test year that Pepco's NOLC could be used to offset, in part, that obligation.

While Pepco and OPC have divergent views on the applicability of IRS normalization principles to the annualization of the impacts of the IRS Global Tax Settlement on Pepco's NOL deferred tax asset, the Commission need not settle this disagreement in order to resolve this dispute in a manner satisfactory to both the Company and the Office. Pepco Witness Warren testified that if the Commission has doubts regarding the potential normalization impacts of annualizing the settlement payment, then the Commission could—prior to making a final determination—direct Pepco to apply for guidance from the IRS through the submission of a Private Letter Ruling.[341] Witness Warren further testified that there would be no violation of the normalization rules if the Commission were to adopt—provisionally—OPC's recommended

337 Tr. at 1126, lines 4-14 & at 1140, lines 5-12.

338 Tr. at 1125, lines 1-4, at 1126, lines 7-14 & at 1140, lines 5-10.

339 Tr. at 1730, line 21 – p. 1733, line 1.

340 Tr. at 1737, lines 7-9.

341 Exhibit Pepco (M) (Warren) at 18; *see also* Tr. at 1129, lines 2-12 (OPC Witness Ramas agreeing that there is no harm in requesting a Private Letter Ruling from the IRS on this issue).

adjustment with the impacts being either tracked or recorded in a regulatory asset account, subject to final determination based upon the outcome of an IRS Private Letter Ruling.[342]

Regardless of the decision the IRS may make in any Private Letter Ruling, Witness Warren testified that $8.5 million of the payment received by Pepco in connection with the IRS Global Tax Settlement did not involve amounts that would be protected under the normalization rules.[343]

OPC recommends that: (i) the impacts of the IRS Global Tax Settlement be annualized; (ii) that the Company be directed to pursue, in consultation with the OPC, a Private Letter Ruling with the IRS, and (iii) the final outcome of $33.5 million of the cash payment to Pepco associated with that IRS Global Tax Settlement be dependent upon the IRS ruling.

ISSUE No. 6 ARE PEPCO'S PROPOSED OPERATING REVENUES, TEST YEAR SALES, AND NUMBER OF CUSTOMERS, AS ADJUSTED, JUST AND REASONABLE?

ISSUE No. 6(a) Issue No. 6(a) Is Pepco's weather normalization study reasonable and in compliance with the previous Commission directives?

Pepco's test year includes $488,109,000 in operating revenues for the sales of electricity and $3,641,000 of other revenues. OPC takes no position on the level of operating revenues Pepco has proposed to include in its revenue requirements calculation. OPC also takes no position on Pepco's weather normalization study.

342 Tr. at 1472, lines 1-16; *accord* OPC Cross-Examination Exhibit No. 46.

343 Tr. at 1458, line 9 – p. 1459, line 16 (discussing OPC Cross-Examination Exhibit No. 41).

ISSUE No. 7 ARE PEPCO'S PROPOSED OPERATING EXPENSES, AS ADJUSTED, JUST AND REASONABLE?

Pepco's test year operating expenses are significantly higher than in other recent, historic periods. Specifically, OPC Witness Ramas testified that:[344]

> Pepco's distribution-only operating expenses increased by over 13.92% between 2014 and 2015, and increased by an astounding 19.54% between calendar year 2014 and the test year ended March 31, 2016. Prior to 2015, Pepco's distribution-only operating expenses were actually declining on an annual basis between 2012 and 2014.

Witness Ramas also testified that "service company charges to Pepco increased by 21.62% between calendar year 2014 and the test year ended March 31, 2016."[345]

As discussed under Designated Issue No. 2, OPC contends that Pepco's proposed test year does not reflect typical operations or typical operating expenses. OPC Witness Ramas explained that the exponential increase in operating expenses is, in part, reflective of the unique circumstance of the test year. She highlighted the fact that the test year ended eight days after the Pepco-Exelon merger closed, and that test year expenses include several merger accounting harmonization adjustments and certain merger transition and integration costs that are non-recurring and that inflate operating expense levels beyond those experienced in a typical rate year.[346] Additionally, Pepco transitioned to a new customer and billing system shortly before the start of the test year. Test year expenses include both on-going expenses associated with the new system as well as transition costs related to the switch.[347] Although Pepco adjusted some of the

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344 Exhibit OPC (B) (Ramas) at 29.

345 *Id.* at 30.

346 *Id.* at 31-32.

347 *Id.*

aforementioned expenses, its adjustments do not go far enough. Moreover, other Pepco adjusted test year expenses are contrary to Commission precedent and are not just and reasonable for purposes of determining Pepco's adjusted test year revenue requirements.

OPC contends that additional adjustments must be made to Pepco's proposed operation and maintenance expense, amortization expense, and depreciation expense to produce a reasonable test year. The Office's recommended adjustments to the Company's test year expenses are set forth in Exhibit OPC (B)-2 and include:

$ 589,000	Impact of Revised Depreciation Rates on PTY Reliability Closing - April through December 2016
$ 999,000	Depreciation Impact of PTY Reliability Closings - January through June 2017
$1,240,000	Depreciation Impact of PTY Reliability Closings - April through Sept. 2017
$2,442,000	Remove Non-Recurring SolutionOne Stabilization Costs
$ 316,000	Remove Legacy CIS Archiving System Costs
$ 98,000	Adjustment to Outside Tax Services Expense
$ 232,000	Remove Accounting Correction – Account 935
$1,108,000	Additional Merger Accounting Adjustment
$2,227,000	Remove I Street Substation Rent Expense Increase
$ 35,000	Remove Amortization of Third Party Audit Costs
$ 686,000	Revision to Wage Increase Adj. w/Payroll Taxes
$ 35,000	Remove Executive Perks
$2,179,000	Remove SERP Expense w/Depreciation Impact
$ 548,000	Remove Remaining LTIP Expense
$ 871,000	Revised Synergy/CTA Adjustment
$ 258,000	Reduction to Depreciation Expense

In its rebuttal testimony, Pepco accepted OPC's proposed removal of Executive Perquisite expenses,[348] which included costs associated with covering executives' automobile allowances, spousal travel, financial and tax planning, and club dues and memberships.[349]

348 Exhibit Pepco (3E) (Ziminsky) at 46.

349 Exhibit OPC (B)-23 at 1-2.

Pepco's rebuttal testimony further proposed to adjust or revise its treatment of other categories of expenses, including those related to post-test year reliability closings, merger accounting items, and its legacy and new billing systems. Pepco also abandoned its proposal to increase the expense levels associated with a projected new lease for the Company's I Street substation if—as has turned out to be the case—the lease was not executed before the commencement of evidentiary hearings, and agreed to remove certain merger synergy costs. While OPC accepts certain of Pepco's proposed revisions, they fail to address OPC's concerns fully. OPC addresses its remaining concerns (and their related tax impacts) below.

A. Non-recurring SolutionOne stabilization expenses and Legacy Customer Information System ("Legacy CIS") non-labor costs should be removed in full from the test year and the costs should be denied regulatory asset treatment.

In early 2015, Pepco began transitioning to PHI's new customer relationship management and billing system ("CRM&B"), known as "SolutionOne." According to Pepco, its legacy billing system, referred to as the Legacy CIS, "was based on decades-old technology that became increasingly difficult and expensive to maintain and enhance to meet customer and regulatory requirements."[350]

The SolutionOne system went live in January 2015, prior to the start of the test year. In addition to on-going expenses associated with the new system, test year expenses include certain non-recurring transition costs associated with switching to SolutionOne from the Legacy CIS, and costs for both the SolutionOne and the Legacy CIS systems that Pepco incurred during the initial transitioning period.[351]

350 Exhibit OPC (B)-12 at 1.

351 Exhibit OPC (B) (Ramas) at 31.

Because Commission policy is to disallow non-recurring expenses in the test year,[352] OPC recommended excluding the non-recurring costs associated with switching the systems from the test year expenses. Specifically, OPC Witness Ramas testified that $2,442,000 of SolutionOne system stabilization expenses should be removed from the test year because they are non-recurring.[353] Witness Ramas also recommended excluding $316,000 in non-labor costs associated with the Legacy CIS systems that were replaced by the SolutionOne system.[354] The basis for this adjustment was explained in Witness Ramas' testimony. She explained there that the same discovery response that showed non-labor costs were included in test year expenses in Account 903 also showed "that the Legacy CIS system expenses declined substantially in the latter months of the test year and subsequent to the test year,"[355] demonstrating that they were non-recurring in nature. AOBA Witness Bruce Oliver recommended excluding all non-recurring transition costs associated with the new billing system and all non-recurring legacy system costs from operating expense calculations, but proposed that the Company could recover those transition costs through a five-year amortization.[356]

In rebuttal testimony, Pepco acknowledged that the SolutionOne stabilization costs are non-recurring.[357] Pepco agreed to add new Adjustment 38 and remove the full $2,442,000 from the test period, but proposed to place the costs in a regulatory asset to be amortized and

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352 *See, e.g., Formal Case No. 989, In the Matter of the Office of the People's Counsel's Complaint for a Commission-Ordered Investigation Into the Reasonableness of Washington Gas Light Company's Existing Rates* ("*Formal Case No.* 989"), Order No. 12589, ¶ 147, rel. Oct. 29, 2002.

353 Exhibit OPC (B) at 32 (citing Exhibit OPC (B)-2).

354 *Id.* at 35.

355 *Id.* (citing Exhibit OPC (B)-13).

356 Exhibit AOBA (A) (Oliver) at 76.

357 Exhibit Pepco (3E) (Ziminsky) at 40, 45.

recovered over a five-year period.[358] Pepco also acknowledged that $299,000 of the $316,000 in non-labor Legacy CIS costs identified by OPC Witness Ramas are non-recurring in nature—proposing similarly to remove those costs from the test period O&M expenses (Adjustment 39) and move them into a regulatory asset.[359] As to the remaining $17,000, Pepco Witness Ziminsky claims that such costs "are ongoing in nature and relate to the Legacy CIS archiving software and the maintenance of that system."[360]

Pepco has not demonstrated that the $17,000 remaining in the adjusted test year actually relate to recurring costs. OPC maintains its position that the non-labor Legacy CIS costs should be removed in full. And while OPC supports Pepco's removal from test period expenses the non-recurring SolutionOne stabilization costs and $299,000 of non-labor Legacy CIS costs, the Office does not support the Company's proposal to place these costs into a regulatory asset and to recover them over a five-year period. Doing so would be contrary to Commission precedent. In Formal Case No. 989, the Commission declined to accept the proposed adjustment to include a test year, non-recurring employee bonus and the Company's alternate recovery scheme stating: "[t]he Commission's policy has been to disallow non-recurring expenses in the test year. While WGL reverses the bonus expense for the test year, it then amortizes the expense over three years. However, that does not make the expense any less a non-recurring item."[361] Similarly, while Pepco has reversed the inclusion of these non-recurring expenses in the test year, it is nonetheless continuing to seek their recovery through a five-year amortization.

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358 *Id.*at 40-41, 45; *see also* Exhibit Pepco (3E)-1 at 43.

359 Exhibit Pepco (3E) (Ziminsky) at 40-41, 44, 45-46; *see also* Tr. at 2065, lines 9-14.

360 Exhibit Pepco (3E) (Ziminsky) at 40; Tr. at 2065, lines 2-4.

361 Order No. 12589 ¶ 147.

There is no need for such treatment, as Pepco has already recovered a more than significant level of expense for its billing system. Pepco's billing-system related test year expenses in its last rate case included both labor costs and $1.151 million (on a D.C. distribution basis) of non-labor costs.[362] Pepco Witness Ziminsky claims that the non-recurring SolutionOne costs "were necessary to ensure a successful transition and stabilization during the roll out of the new system" and were related to such activities as bill verification and issue resolution,[363] and, similarly, that the system Legacy CIS costs "were incurred in order to ensure a successful transition over to the new billing system."[364] But Pepco provided no evidence that the costs for which it now requests regulatory asset treatment are outside the scope of the billing-system related expenses that it has already recovered and is continuing to recover in rates.

In sum, the Commission should exclude from test year expenses non-recurring SolutionOne stabilization costs and non-labor Legacy CIS costs and should deny Pepco's request to place the removed costs in a regulatory asset for amortized recovery.

B. Pepco's outside tax services expenses should be reduced to reflect typical annual levels for such service.

Pepco included in its test year expenses $191,477.04 (on a D.C. distribution basis) of tax preparation costs.[365] OPC Witness Ramas contended that while "the expense associated with the preparation and review of annual federal and state tax returns is a typical cost to the Company,"

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362 OPC Cross-Examination Exhibit No. 73. The non-labor costs on a total Pepco basis totaled $3.347 million. *Id.*

363 Exhibit Pepco (3E) (Ziminsky) at 40.

364 *Id.*

365 Exhibit OPC (B)-14 at 48.

Pepco's proposed level of expense is not typical.[366] OPC Witness Ramas recommended excluding two sets of tax preparation costs from the test year: (i) $292,000 (on a total PHI basis) associated with the preparation of 2015 tax returns, and (ii) $386,000 associated with preparing amended state tax returns to reflect the impact of the IRS Global Tax Settlement.[367]

As to the first, Witness Ramas explained:[368]

> Pepco's agreement with Deloitte Tax LLP for 2015 tax return services indicated that the 2015 tax returns would cover the short period beginning January 1, 2015 through the date of the [merger] transaction with Exelon Corporation. Thus, as a result of the anticipation of PHI of possible merger closing during 2015, the test year expenses include services from Deloitte Tax LLP associated with two separate tax years.

In response, Pepco Witness Ziminsky claimed that "OPC Witness Ramas is mistaken that double fees were incurred in the test period for 2015 income tax returns due to the Exelon merger."[369] Pepco is missing the point. OPC is not concerned that double fees were incurred for 2015 income tax returns, OPC is concerned that Pepco test year expenses includes services from two different tax years—2014 and 2015.

Pepco's breakdown of its tax preparation costs (Exhibit OPC (B)-14 at 48) confirms that OPC's concerns are valid. Pepco includes both $531,757 of charges for the preparation of 2014 tax returns ($143,000 of which was incurred on March 21, 2015 prior to the commencement of the test year) as well as $292,000 for the preparation of 2015 tax returns ($146,124 of which was incurred on April 27, 2016 after the end of the test year). It is atypical to prepare two sets of tax

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366 Exhibit OPC (B) (Ramas) at 36 (stating that the expense is based on a total PHI amount of $1,320,848).

367 *Id.* at 37.

368 *Id.* at 36-37 (citing Exhibit OPC (B)-14).

369 Exhibit OPC (3E) (Ziminsky) at 41.

returns in one year, and it is even more atypical to procure tax preparation services for the current tax year on the exact same date (dated February 18, 2015) as the date on which tax services were procured for the upcoming tax year.

Given that the stated purpose of the engagement letter for 2015 tax services was to cover the time period between the start of the year and the "date of the [merger] transaction with Exelon Corporation,"[370] it is logical to conclude that Pepco procured these atypical services as a result of the unique circumstances of the merger. But, whatever the circumstances, Pepco has failed to justify including the expense associated with two years of tax preparation services within a twelve month historical test period.

Moreover, Pepco should exclude from test year expenses costs related to the preparation and review of hundreds of separate amended state tax returns for the 2000 through 2011 tax years. The circumstances that necessitated the preparation of these particular tax returns are neither recurring nor typical[371]—rather, they relate to PHI's IRS Global Tax Settlement with the IRS for Federal income tax issues during tax years 2000 through 2011.[372] Pepco does not dispute the non-recurring nature of the services, claiming only "these outside tax services expenses were prudent and necessary in complying with state income tax requirements."[373] OPC does not dispute that Pepco must comply with the law, but that does not mean it has a blank

370 Exhibit OPC (B)-14 at 18; *see also id.* at 21 (noting that "Deloitte Tax will be ready to begin work at an agreed upon time after the closing date of the contemplated transaction with Exelon Corporation" and that the "target date for completion of the 2015 federal tax return is 2 months after" the receipt of necessary information).

371 Exhibit OPC (B) (Ramas) at 37.

372 *Id.*

373 Exhibit Pepco (3E) (Ziminsky) at 42.

check to include non-recurring tax preparation costs in test year expenses. These non-recurring charges relating to long past periods should not be included in current rates.

C. Account 935 - Maintenance of General Plant should be reduced by $232,000

OPC has concerns that the expense level record in Account 935 – Maintenance of General Plant may be overstated. Witness Ramas testified that "the expenses recorded in Account 935, on a distribution only basis, increased from approximately $2.56 million in 2013 to $3.47 million in 2014 and $4.25 million during the test year. Between calendar year 2014 and the test year ended March 31, 2016, expenses in Account 935 increased by 22.6%."[374] In response to a data request, OPC learned that:

> The primary driver of the increase in general plant maintenance account 935 from 2014 to the twelve months ended March 31, 2016 is corrections related to construction work (approximately $464K [$232,455 on a D.C. distribution basis[375]]). In 2015 the Company began a review of work requests older than one year that had not been closed to plant in service. This review was primarily related to communication equipment in account 397. The primary reason for corrections was duplicate work requests established for the same work and maintenance work charged to capital work requests.[376]

I. Witness Ramas recommended that test year expenses be reduced by $232,000 on a D.C. distribution basis to remove the impacts of the accounting corrections related to construction work.[377] In support of her recommendation, Witness Ramas testified that although Pepco recorded the corrections during the test period, the entries

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374 Exhibit OPC (B) (Ramas) at 38.

375 Exhibit OPC (B)-16 at 2.

376 Exhibit OPC (B)-15 at 1.

377 Exhibit OPC (B) (Ramas) at 39.

were for "costs incurred prior to the test year that were incorrectly recorded in construction accounts."[378]

Pepco's objection to Witness Ramas' recommendation is premised on a mischaracterization. Witness Ziminsky erroneously claimed that OPC's proposed adjustment is to "remove[] the $232,000 difference in re-classification expense between the test period and calendar year 2014 from DC O&M expense ($464,000 on a total Pepco Basis)."[379] The basis for the adjustment is simple: the costs were incurred well outside of the test year, and therefore do not belong in current rates.[380]

D. Additional Merger Accounting Adjustments are needed to ensure rate neutral merger accounting.

PHI changed several of its accounting policies to align them with Exelon's accounting policies which are in place post-merger.[381] In so doing, Pepco booked during the test year several one-time entries or accounting policy "harmonization[s]" that increased test year operating expenses exponentially. Because Merger Commitment 28 requires Exelon to "ensure that merger accounting is rate-neutral for Pepco customers . . . [and] that any accounting treatments associated with merger accounting do not affect rates,"[382] any harmonization that does not reflect on-going expenses should be removed.

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378 *Id.*

379 Exhibit Pepco (3E) (Ziminsky) at 42.

380 *E.g., Formal Case No. 989*, Order No. 12589 ¶ 146; *Formal Case 1053, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution* Service, ("*Formal Case No. 1053*"), Order No. 14712 ¶ 208.

381 OPC Exhibit (B) at 39-40.

382 *Formal Case No. 1119*, Order No. 18148, Attachment B ¶ 28.

Pepco Witness Ziminsky explained in his direct testimony that Pepco Adjustment 20 proposes to adjust test year base and operating income to ensure rate neutral merger accounting for Pepco customers.[383] While OPC agrees that an adjustment is necessary, the adjustment proposed by Pepco does not ensure rate neutral merger accounting.

OPC Witness Ramas identified two separate policy harmonization charges that were booked to Account 598 during the test period—one related to material handling costs of undistributed stores and the other to establish an obsolete inventory reserve—that Pepco did not remove from the test year.[384] To neutralize the rate effect of Pepco's merger accounting, Witness Ramas recommended reducing Account 598 test period expenses by $2,214,532 ($858,382 D.C. distribution basis) and $858,404 ($332,729 D.C. distribution basis) to remove the harmonization adjustments associated with material handling costs and obsolete inventory, respectively.[385] Pepco agreed in its rebuttal testimony to the former adjustment, but amended its proposal to request cost recovery of the adjustment amount through its inclusion in a regulatory asset. The Company continued to recommend inclusion of full test year costs related to the obsolete inventory reserve. OPC contends that Pepco's proposals violate the intent of Merger Commitment 28 and that the Commission should adopt OPC's recommendations. We address each account in turn below.

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383 Exhibit Pepco (E) (Ziminsky) at 16.

384 *Id.* at 42.

385 *Id.* at 42-44.

1. $2 million of the test period material handling costs should be removed from the adjusted O&M expense.

OPC Witness Ramas testified that "$2,214,532 ($858,382 DC distribution basis) of the accounting policy harmonization adjustment made to Account 598 was associated with . . . 'PEPCO distribution handling costs which were incurred during the test year, but were allocated to material inventory which had not been issued.'"[386] Witness Ramas further explained that "Exelon's accounting policy allocates annual store room handling costs to materials that are issued during the year. The accounting policy harmonization adjustment took all of Pepco's store room handling costs that were charged to material inventory during the year and shifted them to expense."[387]

Through discovery, OPC learned that "if the Exelon accounting policy had been in place during the full test year, only $200,000 of the $2.2 million charged to expense in the accounting policy harmonization adjustment would have been charged to distribution expense on Pepco's books, and $2 million would have been capitalized."[388] Based on this response, Witness Ramas concluded that $2 million dollars of the total harmonization adjustment does not reflect going-forward cost levels and recommended removal from the expenses booked in Account 598 during the test year.

On rebuttal, Pepco did not challenge that the going-forward level of expense in Account 598 should be $2 million less than what was filed. Instead, the Company contended that Witness Ramas's recommendation ignores that "had the Exelon policy been in place all

386 *Id.* at 42 (quoting Exhibit OPC (B)-17 and Exhibit OPC (B)-17).

387 *Id.* at 42-43 (footnote omitted).

388 *Id.* at 43 (citing Exhibit OPC (B)-18).

along, these costs would have been capitalized" and that "the material handling costs are normal costs of business that were prudently incurred," Witness Ziminsky proposed to include the costs in a regulatory asset and to recover them over a five-year period.[389]

OPC contests this proposal. This accounting change was triggered by the merger. As Witness Ramas explained, "[u]nder both PHI's prior accounting policies and Exelon's accounting policies, materials that are used during the year are charged to either expense accounts or capital accounts depending upon what the materials are used for."[390] Pepco chose to "write[] off to expense[s]" even though it later acknowledged that "building the entire amount that otherwise would have been capitalized into the ongoing expense level is inappropriate."[391] While the Company wants to be "made whole" for their merger-triggered accounting entry, they did not include the $2 million in costs they capitalized in the test year and their latest proposal is also inappropriate. The Commission should remove the $2 million in expenses from Account 598 and reject Pepco's proposal to create a regulatory asset.

2. The test period O&M expense should be reduced by $332,729 D.C. distribution basis to remove the harmonization adjustment for obsolete inventory.

OPC Witness Ramas testified that that the Account 598 accounting harmonization adjustments "include[] $858,404 ($332,729 DC distribution basis) associated with an obsolete inventory reserve."[392] Pepco's test year expenses include both a $41,877 (D.C. distribution

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389 Exhibit Pepco (3E) (Ziminsky) at 31.

390 *Id.* at 43.

391 Exhibit Pepco (3E) (Ziminsky) at 31-32.

392 *Id.* at 44.

basis) expense reflecting the write-off of inventory that occurred during the test year[393] and the $332,729 for the impact of a *one-time* entry to establish the initial obsolete inventory reserve balance on Pepco's books.[394] OPC recommends removing from the operating expense the policy harmonization adjustment of $332,729 for a simple reason: it is not reflective of on-going expense levels.

Pepco disputed OPC's recommendation, claiming that Witness Ramas "assum[ed] that there will not be an ongoing charge to expense."[395] Witness Ramas made no such assumption. As Witness Ziminsky himself acknowledged at hearing, if OPC's recommendation is accepted, the test year would still include an expense associated with obsolete inventory.[396] OPC does not dispute the ongoing expense for obsolete inventory; the Office disputes the inclusion in test year expenses of the policy harmonization adjustment costs to establish a reserve balance.

Witness White explained that the harmonization adjustment was recorded to reflect a change in the timing of when obsolete material is recognized under Exelon as compared to PHI policy.[397] Witness White explained further that:[398]

> Under the Exelon policy, utilities perform a quarterly obsolescence review in which a population of excess inventory is defined to be at risk for obsolescence. The "at risk" population includes all items for which the historical usage and demand would take more than 2 years for the current level of inventory to be depleted. Items within

393 *See* Tr. at 2058, lines 8-14.

394 OPC Cross-Examination Exhibit No. 72.

395 Exhibit Pepco (3E) (Ziminsky) at 32.

396 Tr. at 2056, line 21 – p. 2057, line 10.

397 Exhibit Pepco (3J) (White) at 3-4 (explaining that "[u]nder the PHI policy, utilities defined the population of items to be reviewed for obsolescence as those which were slow-moving (not issued out of storerooms in 3 years), and filtered the data to only include high-dollar items.").

398 *Id.* at 3.

> the "at risk" population are reviewed to calculate an estimate for obsolescence and recorded as an adjustment to the reserve on a quarterly basis.

But whatever this change in practice may mean, Pepco has acknowledged that it will not result in an increase in obsolete inventory write-off levels. Instead, Witnesses Ziminsky and White have made clear that "ongoing level[s] of O&M expense associated with inventory write-offs is *not* expected to be materially different than pre-merger."[399] Witness Ziminsky agreed at hearing that $42,000 charged to expense on a D.C. distribution basis reflected obsolete inventory written off during the test year.[400] And, as Witness Ramas explained, the $42,000 "is fairly reflective of prior year levels and consistent with the average expense recorded by Pepco for the most recent five-year period."[401] Given these facts, the Company has failed to justify including the $332,000 policy harmonization adjustment in O&M expense.

E. The Company should not be allowed to defer I Street Substation rent expense increases until the later of the rate effective date or the effective date of the new lease payments.

In its initial application, Pepco proposed to increase unadjusted test year expenses by $2,227,000 to reflect a projected increase in rental payments associated with its I Street Substation (Adjustment 12). Pepco Witness Verner explained that the current lease was executed in 1976 with a forty-year term starting on December 1, 1978, and an approximate rental

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399 OPC Cross-Examination Exhibit No. 72 (emphasis added); *see also* OPC Cross-Examination Exhibit No. 70 (Witness White clarifying that the policy accounting change should "not cause the annual amount of expense to be higher" than it was prior to the merger).

400 Tr. at 2058, line 8-14.

401 Exhibit OPC (B) (Ramas) at 45.

rate of $320,000 annually.[402] She went on to note that "[m]arket prices have increased significantly since the time when this substation was built" and Pepco's proposed increase in expenses reflected the landowner's offer to base the new lease on comparable lease fees in the same area as the substation.[403]

OPC Witness Ramas recommended removing the proposed adjustment.[404] Instead, she posited that if Pepco were to enter into a new lease, it might be permissible for the Company to defer in a regulatory asset the increase in rent expense between the new lease and the rental expense incorporated in base rate through this proceeding, so that the costs could be considered in Pepco's next rate case.[405] Witness Ramas, however, clarified that "deferral should not begin before the later of: (i) base rates from the current case taking effect, or (ii) the date the new higher rental payments actually begin."[406] And she also suggested that the resulting regulatory asset be subject to a prudency review in the next rate case as there will have been no showing that Pepco considered other options before entering into the lease or that it had acted prudently in negotiating the new lease payments.[407]

On rebuttal, Company Witness Ziminsky offered two alternatives proposals: (i) adopt an expense adjustment reflecting the increase in rental payments if a new lease is executed before

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402 Exhibit Pepco (C) (Verner) at 17-18. OPC Witness Ramas further clarified that though Pepco has an option to extend the lease until November 30, 2023, it has been in lease negotiations with the landlord. Exhibit OPC (B) (Ramas) at 46.

403 Exhibit Pepco (C) (Verner) at 17-18; Tr. at 909, lines 6-8 (noting the substation is located near I and 19th Streets NW).

404 Exhibit OPC (B) (Ramas) at 47 (citing, *e.g.*, Exhibit OPC (B)-20 (public response), Exhibit OPC (B)-21).

405 Exhibit OPC (B) (Ramas) at 48.

406 *Id.*

407 *Id.*

the start of the evidentiary hearings, or (ii) if not so executed, adopt OPC's proposal to establish a regulatory asset for the incremental increase in rent expense, to be reviewed in Pepco's next rate case.[408] Pepco did not enter into a new lease before the hearings.[409]

While OPC and the Company agree that Adjustment 12 should be removed, the Company's regulatory asset proposal is not consistent with the one presented by OPC. The Company recommended starting deferral of the incremental increase, including a rate base return, on the date on which the new rental payments become effective, even if that date is before the start of the rate effective year.[410] That proposal is neither reasonable nor supported.

As OPC explored at hearing, under the Company's proposal, if a lease had been executed before the hearing, then the Company would have begun recovering the increased payments as of the rate effective date (which is expected to be around June 2017).[411] But if the lease were to be executed after the start of the hearing, then under the Company's proposal it would place the new lease payments in a regulatory asset as of the rental payment effective date.[412] A simple example demonstrates why the Company's proposal is not reasonable: assume that the lease had been executed the week before the hearing, had an annual rental payment of $2.5 million, and that Pepco had demonstrated at trial that the payment amount was prudent. In that instance, Pepco would have begun recovering the new payments in rates starting June 2017.

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408 Exhibit Pepco (3E) at 26.

409 Tr. at 907, lines 3-9.

410 Exhibit Pepco (3E) at 26.

411 Tr. at 2038, line 16 – p. 2039, line 3.

412 Tr. at 2039, lines 4-19.

On the other hand, if the lease had been executed the day after the hearing ended, then (under Pepco's proposal) it would begin recording the incremental expense in a regulatory asset and earn a return as of that date. In that way, a delay in executing the new lease would be the basis to impose additional charges on Pepco ratepayers. The Company, thus, has a better deal if it waits to execute a lease until *after* the hearing. There is no basis to impose this "heads I win, tails you lose" scheme on ratepayers. The Commission should accept OPC's proposal that deferral begin with the *later of* this proceeding's rate effective date or the effective date of the higher rental payments.

F. Pepco's Adjustment 30 for the Amortization of Third Party Audit Costs should be denied.

Pepco seeks to include in its cost of service $106,000 in expenses that Pepco incurred in 2010 and 2011 to procure an independent audit of PHI Service Company costs allocated to Pepco's D.C. operations (Adjustment 30).[413] Pepco requested that the costs be placed in a regulatory asset to be collected over three years.[414] But that adjustment would be improper, for at least two reasons: first, the Commission ordered Pepco to pay the costs of such an audit; second, the costs are remote from the test period in this case.

The Company conducted the audit in question at the Commission's direction in Formal Case 1053.[415] In that case—which addressed Pepco's 2006 rate application—OPC and

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413 Exhibit OPC (B) (Ramas) at 48-49 (referencing Exhibit OPC (B)-22); Exhibit Pepco (E) (Ziminsky) at 25.

414 *Id.*

415 *Formal Case 1053*, Order No. 14712 ¶ 170.

intervenors protested that the Service Company charges were unreasonable. The Commission approved the Service Company charges with certain modifications, but held that:[416]

> In order to minimize the adverse impacts on ratepayers in future cases, PEPCO shall procure the services of a contractor, subject to the Commission's approval of the RFP and the Commission's selection of a contractor, to conduct an independent audit of the costs of PHI's Service Company allocated to PEPCO in the District.

The Commission's order was clear that "[t]he costs of the contract audit is [sic] to be paid for by PEPCO."[417]

This directive notwithstannding, Pepco Witness Ziminsky claimed that "[n]othing in the referenced Order precludes the Company from subsequently seeking recovery," referencing a recent WGL Gas case in which WGL proposed an unopposed adjustment seeking permission to defer costs related to an audit of its Mechanically Coupled Pipe Project.[418] Pepco's reference to the WGL proceeding does not modify the Commission's directive that the Company—not its ratepayers—is to foot the bill for audit Pepco was told to conduct.

Moreover, and Pepco Witness Ziminsky's claims aside, "[t]he length of time that has passed since the costs were incurred" is relevant, as it bears directly on recoverability.[419] Even if the audit costs were potentially rate-recoverable, Commission precedent on the sort of out-of-period adjustment Pepco is attempting to justify here is clearly to the contrary: "[t]he Commission has [only] permitted adjustments beyond the test year that are known, certain, and

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416 *Id.* (emphasis added).

417 *Id.*

418 Exhibit Pepco (3E) (Ziminsky) at 35 (citing *Formal Case 1137*).

419 Exhibit Pepco (3E) (Ziminsky) at 34-35. Witness Ziminsky's claim that "[i]f Pepco would have sought recovery of these costs in Formal Case No. 1103, the costs would be the same as they are today,"[419] is irrelevant to the issue of remoteness. The fact is that Pepco did not seek to recover the costs in Formal Case No. 1103.

measurable, *and not too remote from the test year.*"[420] As the Commission explained in Formal Case 989:[421]

> The integrity of the test year is important in this and every rate proceeding. Here, as in every rate proceeding, the Commission's standard of remoteness must also be considered. The Commission has previously declined to recognize [adjustments for expenses] that were to occur approximately 13 and 18 months beyond the test year . . . [or] that were scheduled to occur 21 months beyond the test year. The Commission, in this proceeding, also declines to accept [adjustments] that occur 16 and 18 months beyond the test year, although known with reasonable certainty, they are too remote to support an increase in the cost of service.

It would similarly erode the integrity of the test year concept if Pepco were authorized here to include 5-year-old expenses in the cost of service. "[T]he burden of justifying an out-of-period adjustment is on the party seeking the adjustment," *Office of People's Counsel v. Public Service Commission*, 610 A.2d 240, 247 (D.C. 1992). Pepco has not met that burden.

G. Post-Test Year Union Wage Increases should be removed from the Adjusted Test Year.

Pepco proposes through its Adjustment 2 to increase test year salary and wage expenses for Pepco and PHI Service Company employees for test year and post-test-year salary and wage increases. OPC does not challenge the portions of the increase that occurred during the test year (i.e. the annualization of June 1, 2015 union wage increases and the March 1, 2016 management employee salary increases), nor does it challenge the 3% union wage increase that took effect June 1, 2016. These increases are known and certain, and are within or close in time to the end of the test period. OPC is likewise no longer contesting the 2.5% management salary increase which went into effect on March 1, 2017. OPC maintains, however, its recommendation that the

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420 *Formal Case No. 989*, Order No. 12589, ¶ 146 (emphasis added); *Formal Case 1053*, Order No. 14712, ¶ 208.

421 *Formal Case No. 989*, Order No. 12589, ¶ 147.

Company remove from test year operation and maintenance expenses the costs associated with a 3% union wage increase that is to be effective June 1, 2017.

As discussed earlier, Commission policy on post-test-year adjustments is clear: they must be "known, certain, and measurable, and not too remote from the test year."[422] Both prongs of the standard must be met—an adjustment may be known with reasonable certainty, but may still be inappropriate to include in the test year because it is too remote.[423] Proposed wage increases that are scheduled to go into effect 14 months after the end of the test period fail the second prong of the Commission's requirements.[424] OPC Witness Ramas testified that she was unaware "of any instances in which the Commission has allowed an inclusion in rates of salary and wage increases that occur more than 12-months after the end of the test year."[425] Pepco apparently does not know of any either, as it offers none. Instead Pepco Witness Ziminsky offered as justification that the increase "will happen before rates determined as a result of this proceeding go in to effect."[426] But the witness is using the wrong measuring stick; Commission policy measures remoteness from the end of the *rate period*, not from the rate effective date.

The Commission should remove the post-test-year union wage increase from adjusted test year expenses.

ISSUE No. 7(a) Are Pepco's proposed adjustments for Supplemental Executive Retirement Plan (SERP), Annual Incentive Plan (AIP), Executive

422 *Formal Case No. 989*, Order No. 12589, ¶ 146; *accord Formal Case No. 1053*, Order No. 14712, ¶ 208.

423 *Id.*

424 *See, e.g., Formal Case No.* 989, Order No. 12589 (discussing previous Commission findings rejecting adjustments that were scheduled to occur 13 to 18 months beyond the test year).

425 Exhibit OPC (B) (Ramas) at 51.

426 Exhibit Pepco (3E) (Ziminsky) at 23.

Incentive Compensation Plan (EICP) and Long Term Incentive Plan (LTIP) expenses just and reasonable?

The Company's adjusted test year includes $2,146,000 in Supplemental Executive Retirement Plan ("SERP") expenses and $548,000 in executive Long Term Incentive Compensation Plan ("LTIP") costs.[427] The inclusion of either set of costs in rates is contrary to Commission precedent. And Pepco has provided no basis to depart from the Commission's long-settled ratemaking policies.

OPC notes that in its last rate case, Formal Case 1103, Pepco excluded voluntarily the costs associated with its SERP and LTIP plans.[428] While nothing precludes a utility from filing a rate application of its choosing, OPC is troubled that Pepco is seeking in this case—the first rate case in the District after the merger—to "attempt[] to change long-standing Commission practices to increase the costs that are passed on to Pepco's District customers."[429] Moreover, and as Witness Ramas explained, it is also a concern that "the Company will seek to include SERP and LTIP charges from Exelon Business Service Company to Pepco in rates in future rate cases."[430] Consistent with its previous rulings, the Commission should again exclude the costs associated with these programs from rates charged to Pepco's District of Columbia ratepayers.[431]

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427 Exhibit OPC (B) (Ramas) at 53.

428 *Formal Case No. 1103*, Order No. 17424 ¶ 178; *see also id.* ¶ 372 (noting that "many of the drivers of the 2011 to 2012 increase [in Pepco's expenses] relate to items not included in cost of service such as a $4.4 million increase in Long-term Incentive Plan, a $5.8 million increase in incentives, a $2.0 million increase in Supplemental Executive Retirement Plan . . .").

429 Exhibit OPC (B) (Ramas) at 62.

430 *Id.*

431 OPC takes no position on the AIP and EICP costs remaining in Pepco's adjusted test year operation and maintenance expenses.

A. The Commission should reject recovery of Pepco's Supplemental Executive Retirement Plan Costs

Commission precedent on rate-based recovery of SERP expenses is clear: "all costs for SERP should be properly borne by shareholders, not ratepayers."[432] Time and again, the Commission has rejected Pepco's proposals to recover SERP expenses, and the same result should be reached here. As the Commission explained more than two decades ago in Formal Case No. 939:

> As a policy matter, the Commission determines that it would be improper to approve for ratepayer funding the Company's supplemental retirement and incentive plans. We agree with OPC that these plans are designed to allow payment of additional pension benefits to PEPCO's executives which could not be paid under a qualified pension plan according to current IRS Regulations. . . . PEPCO's own testimony confirms that the benefits under these plans relate to the dollar limitations on qualified plan contributions and benefits under [the Internal Revenue Code] . . . which are requirements for any qualified plan to maintain its preferential tax treatment. . . . We conclude, therefore, that if PEPCO wishes to compensate its executives over and above its qualified pension plan, then this cost is properly borne by the shareholders, not the ratepayers.

Formal Case No. 939, Order No. 10646 at 128 (citations omitted). The Commission applied the same precedent in rejecting Pepco's SERP proposals in Formal Case No. 1053, and again recently in rejecting WGL's SERP proposal in Formal Case No. 1137.

Pepco's current SERP plan is the same as those that the Company presented in earlier rate proceedings: the Company uses its SERP to provide certain executives supplemental

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432 *Formal Case No. 1137, In the Matter of the Application of Washington Gas Light Company for Authority to Increase Existing Rates and Charges for Gas Service* ("*Formal Case No. 1137*"), Order No. 18712, ¶ 259, rel. March 3, 2017; *Formal Case No. 1093,* Order No. 17132, ¶ 66, rel. May 15, 2013; *accord Formal Case No. 1053*, Order No. 14712, ¶ 190, rel. January 30, 2008; *Formal Case No. 939, In the Matter of the Application of the Potomac Electric Power Company for an Increase in Retail Rates for the Sale of Electric Energy* ("*Formal Case No. 939*"), Order No. 10646 at 128, rel. June 30, 1995.

retirement benefits in excess of limits set by the IRS on its qualified plans.[433] As Pepco Witness McGowan explained in his testimony and at hearing, under "qualified plans," companies are limited to calculating retirement benefits on a maximum salary of around $270,000.[434] By offering a SERP plan, Pepco is able to provide additional retirement benefits to certain executives whose salaries exceed that cap.[435]

The Company claimed that the costs for the SERP plan were "prudently incurred"[436] and that if it fails to offer SERP benefits, "it would be at a disadvantage in both attracting and retaining the key executive talent needed to operate the company."[437] But, even if accurate, these statements address a different question than the one at issue here. The question before the Commission is not whether the Company should offer SERP benefits, but *who should bear the cost burden* of Pepco and PHI Service Company's SERP plans—the shareholders or the ratepayers.[438] The Commission has held consistently that the shareholders should bear that burden.[439]

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433 Exhibit Pepco (B) (McGowan) at 20; *accord* Tr. at 115, line 14 – p. 117, line 2; Exhibit OPC (B) (Ramas) at 53-54.

434 Exhibit Pepco (B) (McGowan) at 20-21; Tr. at 117, lines 9-14; OPC Cross-Examination Exhibit No. 1.

435 Exhibit Pepco (B) (McGowan) at 21; Tr. at 115, line 18 – p. 116, line 3; OPC Cross-Examination Exhibit No. 1.

436 Tr. at 118, lines 9-10.

437 Exhibit Pepco (B) (McGowan) at 21.

438 Exhibit OPC (B) (Ramas) at 56.

439 *See* n. 146 *supra*; *see also* Exhibit OPC (B) at 56 (OPC Witness Ramas explaining that "[i]t is the shareholders that decide to implement and continue the plans and the costs should be borne by the shareholders.").

Notwithstanding the 20-plus year history of the Commission's SERP policy, the Company has continued to offer this plan to its executives.[440] And, even more important, Pepco has presented no evidence that it has been "unable to attract or retain quality executives during" this time period.[441] In short, Pepco "has not provided any arguments that are sufficiently compelling to persuade [a] depart[ure] from [the Commission's] policy."[442]

B. The Commission should adjust Pepco's test year expenses to exclude costs associated with Pepco's Long-Term Incentive Plan.

Pepco seeks to recover $547,637 of LTIP expenses (on a Pepco D.C. distribution basis) for certain executives and members of its Board of Directors.[443] Pepco Witness McGowan testified that the Company's LTIP request does not include the portions of LTIP payments either made to named executive officers or based on shareholder return.[444] Witness McGowan further explained that "[t]he Company is only seeking to recover the time-based portion of the LTIP payment, which is approximately 32% of the total LTIP."[445] While OPC agrees with Pepco's exclusion from rates of certain LTIP costs, Pepco's proposal to recover any LTIP costs through rates is contrary to Commission precedent. The entire LTIP expense should be excluded from adjusted test year expenses. At a minimum, the level of LTIP costs that Pepco seeks to include

440 Exhibit OPC (B) (Ramas) at 55-56; *accord* Tr. at 122, line 21 – p. 123, line 5.

441 Exhibit OPC (B) (Ramas) at 55 (referencing Exhibit OPC (B)-25).

442 Order No. 18712, ¶ 259.

443 Exhibit OPC (B) (Ramas) at 58 (citing Exhibit OPC (B)-27); *see also* Exhibit Pepco (E) (Ziminsky) at 10-11.

444 Exhibit Pepco (B) (McGowan) at 18; *accord* Tr. at 124, line 19 – p. 125, line 4.

445 Exhibit Pepco (B) (McGowan) at 18.

in rates is both higher than normally attributable to time-based calculations and contrary to the calculations made by Pepco's own witness.

"The standard th[e] Commission has set for a utility to receive cost recovery for LTIP in rates requires [Pepco] to show that LTIP provides a tangible benefit to ratepayers." [446] Pepco failed to make such a showing. Pepco claimed "[t]he time-based portion of the LTIP provides an incentive for key employees to remain with the Company" which the Company believes benefits the customer because "experienced employees operate more efficiently, are safer, provide better customer service and, in general, result in reduced overall costs."[447] But Pepco failed to make any "demonstrat[ion] that there is an appropriate connection between the payment of [LTIP] awards" and the alleged benefits.[448] In fact, Pepco's rebuttal testimony highlights this failure. Despite the acknowledgment that neither OPC nor the intervenors "raised any detailed objections to AIP recovery," Pepco Witness McGowan spent multiple pages presenting alleged customer benefits of the *AIP* program.[449] No such explanation is provided for the Company's *LTIP* program.[450] OPC Witness Ramas made clear why this is the case. The time-based LTIP award

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446 *Formal Case No. 1137*, Order No. 18712, ¶ 255 (accepting OPC's adjustment to exclude all LTIP expenses from rates); *accord Formal Case No. 1093*, Order No. 17132 ¶ 174 ("to receive cost recovery for LTIP in rates . . . [a utility is] require[d] . . . to show that LTIP provides a tangible benefit to ratepayers").

447 Exhibit Pepco (B) (McGowan) at 18-19.

448 *Formal Case No. 929, In the Matter of the Application of Potomac Electric Power Company for an Increase in Retail Rates for the Sale of Electric Energy* ("*Formal Case No. 929*"), Order No. 10387, at 93, rel. March 4, 1994.

449 Exhibit Pepco (3B) (McGowan) at 20-22.

450 Tr. at 1707, line 20 – p. 1708, line 13.

is for Restricted Stock units that, like the shareholder-based portion of the award, "would align the participants' interests with the interests of the stockholders."[451]

As the proponent of the disputed request, the Company has the burden of demonstrating that its request is both reasonable and provides a tangible benefit to ratepayers. The Company's initial and supplemental testimony failed to make such a demonstration, and neither the Pepco Witness that sponsored the adjustment (McGowan) nor the Pepco Witness that reflected the adjustment in the cost of service (Ziminsky) addressed OPC concerns in their respective rebuttal testimonies. The Commission should continue to exclude all LTIP expenses from the adjusted test year.

Alternatively, if the Commission does not reject inclusion of LTIP costs in their entirety, then OPC challenges Witness McGowan's claim that the Company is seeking only to recover the time-based portion of LTIP, and that such costs are approximately 32% of the total. OPC Witness Ramas explained that "[i]n Exhibit PEPCO (2E)-1, at page 12 of 45 (Pepco Adjustment 7, as revised), Pepco removed the test year LTIP expenses associated with the LTIP benefits provided to named executives and 44.45% of the remaining LTIP costs attributable to other executives and the Board of Directors."[452] In other words, Pepco is seeking recovery of approximately 55.55% of its LTIP costs associated with non-named executives and the Board of Directors.

OPC Witness Ramas explained that the reason for the higher percentage of time-based LTIP costs is because the amount "is based on a 3-year average percentage of LTIP that consists

[451] Exhibit OPC (B) (Ramas) at 61 (discussing amendments filed with the SEC regarding Pepco's LTIP that address aligning executive participant interests with the interest of shareholders and long-term shareholder value).

[452] Exhibit OPC (B) (Ramas) at 58.

of time based Restricted Stock Units ('RSU') instead of shareholder return based RSUs," which in 2013 and 2014 was 33.33%, but in 2015 was 100%.[453] Witness Ramas further explained that the difference in 2015 was due to "[t]he then-pending merger with Exelon." Essentially, the "PHI Board . . . shift[ed] all the [LTIP] plan payouts to time-based RSUs instead of shareholder return base RSUs" to create "a form of retention payment to participating executives."[454] The circumstances that led to a higher percentage of time-based LTIP payments in 2015 are unique, and should not be used as the basis for a going-forward cost allocation.

ISSUE No. 8 ARE PEPCO'S PROPOSED DEPRECIATION ADJUSTMENTS AND DEPRECIATION RATES REASONABLE?

1. The discount rate and reserves are not consistent with Order No. 17424.

Pepco's proposed deprecation rates are not reasonable because the Company has not used updated inflation-based discount rates based on Handy Whitman Indices as the SFAS 143 discount rate. As OPC witness Ralph Smith explained, Pepco's current depreciation rates were determined in Formal Case No. 1103.[455] Relevant to this issue, the Commission determined and directed as follows in Order No. 17424:[456]

> 355. *The Commission's preference is to use updated inflation-based discount rates based on Handy Whitman Indices as the SFAS 143 discount rate*; however, no unmodified discount rate based on Handy Whitman Indices are entered in to this record, and the Handy Whitman Indices are not publically available to the Commission. Those rates are the starting point used by Pepco's expert witness. That leaves the Commission with a less than ideal choice: use the Company's proposed discount rates based on modified 2011 Handy Whitman indices data; or

453 *Id.* at 58-60.

454 *Id.* at 60.

455 OPC (D) (Smith) at 8:8-9:34.

456 *Formal Case No. 1103, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service,* (*"Formal Case No. 1103"*), Order No. 17424, March 26, 2014.

> use OPC's proposal to maintain the rates from Formal Case No. 1076. The Company did not adequately explain how its proposed discount rates were modified based on the "professional judgment" of its expert, even after those proposed discount rates were subject to focused, persuasive challenge; therefore, the Company failed to carry its burden of proof. Therefore, the Commission will maintain the status quo and use the discount rates that were approved initially in Formal Case No. 1076 and carried over in Formal Case No. 1087. *In its next case, the Company is directed to provide an updated discount rate with the appropriate Handy Whitman Indices, supported by testimony with supporting workpapers explaining the assumptions on which Pepco's witnesses base their judgements.*[457]

Despite the Commission's explicit statement in Formal Case No. 1103 regarding its preference, Pepco did not propose in the instant case "to use updated inflation-based discount rates based on Handy Whitman indices as the SFAS 143 discount rate."[458] Instead, the Company presented the updated discount rates for the cost of removal component of depreciation rates for its Distribution Plant,[459] but recommends against updating the depreciation rates in the current case to reflect this updated information. According to Pepco witness Allis, there is no need to follow the Commission's stated preference and directive from Formal Case No. 1103 in the instant proceeding, because following the Commission's directive would result in discount rates that are "in aggregate, very similar to the depreciation rates approved by the Commission in Formal Case No. 1103."[460]

The Commission's stated preference to use updated inflation-based discount rates based on Handy Whitman Indices was unqualified. There is no mention in Order No. 17424, quoted above, of any degree of impact as a condition of following the Commission's preference.

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457 *Formal Case No. 1103*, Order No. 17424. at ¶ 355 (citations omitted, emphasis added).

458 *Id.*

459 PEPCO (I)(Allis) at 4:18-5:22; PEPCO (I)-2.

460 PEPCO (I) (Allis) at 6:5-7.

Instead, the Commission stated its preference, Pepco did not challenge that preference, yet now seeks to disregard the Commission's preference on the basis that it would not have much of an impact. Simply put, the Commission should not excuse the Company from following the Commission's preference as stated in Order No. 17424, even if witness Allis believes the updated discount rates are not "materially more accurate"[461] than the preexisting discount rates. In Formal Case No. 1103, the Commission declined to update the discount rates because the Company did not provide the Commission with unmodified Handy Whitman Index data. Now the Company has provided the updated discount rates with Handy Whitman Indices, but still does not follow the Commission's preference to use the updated discount rates. Having been informed of the Commission's preference and directed to provide the updated information in this rate case, and having provided the updated discount rates based on Handy Whitman Indices, it is unreasonable for the Company not to update its depreciation rates. As OPC witness Smith has calculated and explained, the Commission should direct Pepco to apply the depreciation rates, calculated using the updated discount rates. OPC recommends that the Commission require the Company to reflect the reduction to test year depreciation expense of $257,514, which results from the application of updated discount factors and depreciation rates for Pepco's Distribution Plant.

Pepco also contends that the Commission should not follow its own preference for using updated deprecation rates in this case, because the Commission has not ordered a complete depreciation study and because Pepco witness Allis contends that the Commission should not use a discount rate for the SFAS 143 calculations that is higher than the inflation rate.[462] First, Mr.

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461 *Id.* at 7:10-12.

462 PEPCO (3I) (Allis) at 2:18-3:21; 9:1-10:9.

Allis agrees that the Company was directed in Order No. 17424 to provide updated discount rates in the instant case, and even quoted the same language quoted above that the Commission's "preference is to use updated inflation-based rates based on Handy Whitman Indices as the SFAS 143 discount rate . . ." [463] The Company has not pointed to any Commission determination that this preference to use updated discount rates can only be exercised in the context of a full depreciation study. Mr. Allis' position is that a depreciation study can only be undertaken at the direction of the Commission and he acknowledged the Commission's stated preference for updated discount rates. Assuming both of these, it would be expected that if the Commission required a depreciation study in order to update the discount rates based on Handy Whitman Indices as the SFAS 143 discount rate, then in Order No. 17424 the Commission would have ordered the Company to provide a full depreciation study as opposed to only directing the Company to provide the updated discount rate with the appropriate Handy Whitman Indices. Instead, the Commission directed the updated discount rates *without* requiring an updated depreciation study, which indicates the Commission's willingness to update discount rates without requiring a full depreciation study. Second, Mr. Allis' current disagreement with respect to use of Handy Whitman Indices is belied by both the Commission's directive to the Company to use Handy Whitman Indices to update discount rates in this case, as well as the Company's use of Handy Whitman Indices in Formal Case No. 1103, as opposed to inflation rates based on the Consumer Price Index or another method.[464] As it did in Formal Case No. 1103, Pepco has not met its burden of proof to demonstrate that the Commission should vary from its preference to use updated inflation-based discount rates based on Handy Whitman Indices as the SFAS 143

[463] OPC Cross-Examination Exhibit No. 37, citing *Formal Case No. 1103*, Order No. 17427.

[464] OPC Cross-Examination Exhibit No. 39.

discount rate. OPC has calculated depreciation rates using the updated discount rates. Applying the updated discount rates to Pepco's average Distribution Plan for the test year ending March 31, 2016 would reduce depreciation expense by $257,514.[465] This comports with the Commission's preference for updated discount rates as well as its directive to the Company regarding same in Order No. 17424. Therefore, the Commission should adopt OPC's recommendation.

ISSUE No. 9 ARE THE PHI SERVICE COMPANY COSTS AND ANY EXELON BUSINESS SERVICES COMPANY ("EBSC") COSTS CHARGED TO PEPCO AND ALLOCATED TO THE DISTRICT OF COLUMBIA JUST AND REASONABLE?

As the Pepco-Exelon merger closed eight days before the end of the test year, the Exelon Business Service Company ("ESBC") costs charged to Pepco are limited. Witness Ramas explained that the only ESBC cost that Pepco included in above-the-line accounts during the test year was $447,565 for employee severance payments.[466] Through Company Adjustment 19, the Company removed these costs from the adjusted test year in favor of treating them as merger Costs to Achieve.[467] Given this action, OPC takes no position at this time on whether the costs are reasonable.[468]

The expenses charged to Pepco by PHI Service Company, however, are not just and reasonable. As presented under Designated Issue No. 7, these charges increased significantly

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[465] OPC (D) (Allis) at 13:1-8; Exhibit OPC (D)-1 page 1.

[466] Exhibit OPC (B) (Ramas) at 63.

[467] *See also* Tr. at 223, line 6 – p. 225, line 20 (Company Witness McGowan explaining that prior to March 31st, ESBC costs were removed from the test year but April 1 going forward the EBSC costs have been allocated to Pepco).

[468] As discussed under Designated Issue No. 10 below, it is OPC's understanding that the Company will present the merger Costs to Achieve for review in the next rate case.

during the test year as compared to calendar years 2014 and 2015. Pepco has removed or reduced several of the increased charges, including costs associated with executive long-term incentive payments; the financial portion of executive short-term incentive compensation; the severance costs moved by Pepco to merger Costs to Achieve; and executive perks. Nevertheless, further adjustments are necessary. Under Designated Issue Nos. 7 and 10, OPC recommends several additional adjustments, including: removal of non-recurring SolutionOne stabilization costs; removal of Legacy CIS archiving system costs; adjustment to outside tax services expense; removal of accounting correction in Account 935; revision to wage increase adjustment; removal of SERP expense; removal of the remaining LTIP expense from the test year, and removal of additional costs charged to Pepco from PHI Service Company during the test year for merger integration activities.

ISSUE No. 9(a) Has Pepco appropriately reflected known and measurable EBSC costs and savings for the rate effective period?

While Pepco Witness Ziminsky claimed that "[t]he PHISCO costs allocated to Pepco during the test period are a reasonable proxy for EBSC and PHISCO costs in the rate-effective period,"[469] the Company has nowhere shown that this statement is correct. Moreover, as discussed under Designated Issue No. 10, the Company's projected post-merger EBSC savings are based on high level estimates from the merger proceeding. Witness Ramas explained that neither the amount of EBSC costs that will be directly charged and allocated to Pepco during the rate-effective period nor the cost savings Pepco may realize as a result of integrating the PH1 Service Company and EBSC operations during the rate-effective period are currently known or

[469] Exhibit Pepco (2E) (Ziminsky) at 6.

measurable.[470] She based this position on information provided by the Company in both this proceeding and in Formal Case No. 1119.

OPC recommends that the service company costs included in the revenue requirement be based on the actual historic test year known and measurable amounts, as adjusted to ensure the amounts are just and reasonable. They should not be based on high-level projections of potential cost savings that *may* be achieved during the rate effective period.

ISSUE No. 10 ARE ALL FORMAL CASE NO. 1119 MERGER COMMITMENTS PROPERLY REFLECTED IN THE APPLICATION?

Multiple merger commitments apply to this rate proceeding including directives on implementing a customer bill credit, proper treatment of merger costs and savings, and ensuring merger accounting rate neutrality. As discussed in this issue and above, Pepco's application does not reflect its Merger Commitments properly.

A. Is Pepco's proposed treatment of the costs to achieve and merger synergy savings just and reasonable and consistent with Merger Commitment 27?

Merger Commitment 27 states:[471]

> Pepco will amortize the costs to achieve synergy savings ("CTA") over a five-year period of time commencing with the effective date of the first Pepco base rate case filed after Merger close. To the extent CTA are incurred after the first rate case, such CTA will be amortized over a five-year period commencing with the effective date of the first rate case after such costs are incurred. Pepco shall not recover CTA in a Pepco rate case in an amount greater than the synergy savings that Pepco demonstrates for the applicable test year.

470 Exhibit OPC (B) (Ramas) at 66.

471 *Formal Case 1119, In the Matter of the Joint Application of Exelon Corporation, Pepco Holdings, Inc., Potomac Electric Power Company, Exelon Energy Delivery Company, LLC and New Special Purpose Entity, LLC for Authorization and Approval of Proposed Merger Transaction*, Order No. 18148, Attachment B, ¶ 27.

As Witness Ramas explained, Merger Commitment 27 requires that the CTA amounts recovered in rates cannot exceed the actual synergy savings demonstrated for the applicable test year.[472] Costs associated with the merger were incurred during the test year, but because the merger closed just eight days before the end of the test year, no savings were realized in this time period. While Pepco's initial filing was not in compliance with its merger commitment, revisions adopted in Pepco's rebuttal testimony have moved the Company closer to—but not yet at—full compliance. OPC recommends that further merger costs be removed from the test year.

In its initial application, Pepco removed CTA totaling $3,671,000 on a D.C. distribution basis associated with employee severance costs from the test year.[473] It also included in its adjusted test year high level forecasts of costs savings and an amortization of projected total CTA.

As OPC Witness Ramas explained, Merger Commitment 27 concerns cost and savings that are actually incurred or realized.[474] Witness Ramas recommended that both the forecasted cost savings and the amortization of the projected total CTA be disallowed.[475] Witness Ramas also testified that Merger Commitment 27 limited CTA recovery to demonstrated synergy savings.[476] She recommended that 100% of the CTA—$5.6 million of merger integration costs—be removed from the test year, as no merger savings were realized within the test year.[477]

472 Exhibit OPC (B) (Ramas) at 70-71.

473 Exhibit Pepco (2E)-1 at 24.

474 *See generally* Exhibit OPC (B) (Ramas) at 70-71.

475 *Id.* at 73.

476 *Id.* at 70-73.

477 *Id.* at 73; *see also* Exhibit OPC (B)-32.

In its rebuttal filing, Pepco adopted OPC's recommendation to remove the projected synergy savings from the adjusted test year.[478] It also excluded the unrecovered CTA from rate base and deferred it to be reviewed in the next base rate case filing, and agreed that some additional merger integration costs should be removed from the test year, such as facilities improvement costs, contractor costs and "dedicated integration team labor costs."[479] Under its revised Adjustment 19, the Company has removed $4.4 million from the test year on a D.C. distribution basis for CTA costs incurred and booked during the test year.[480] While OPC is pleased that the Company has removed additional CTA from the test year, $1.2 million on a D.C. distribution basis ($3.7 million on a Pepco basis) of CTA are still included in Pepco's adjusted test year expenses. OPC recommends that these amounts be removed.

In its testimony, Pepco attempted to minimize the $3.7 million, stating that "[m]any of these costs represent non-incremental labor and other expenses associated with internal PHI and Pepco employees working limited hours on integration activities" and that "[t]hese costs were not incremental to Pepco's normal run rate of operating expense."[481] But these claims do not stand up to scrutiny. 3.7 million dollars hardly seems reflective of "working limited hours." Moreover, Company Witness Ziminsky indicated during the hearings that the costs were associated with employees who before the merger "may have been doing accounting, IT work, Treasury work," but as part of the integration efforts, "their efforts were focused there."[482]

478 Exhibit Pepco (3E) (Ziminsky) at 28.

479 *Id.* at 29.

480 *Id.* at 30; Pepco (3E)-1 at 24.

481 Exhibit Pepco (3E) (Ziminsky) at 29-30.

482 Tr. at 2043, lines 10-13.

Additionally, Witness Ziminsky contended that "the activities of the group pre-merger were still getting done."[483] The Company has not contended that there was a degradation of the quality of customer service or a degradation of the reliability of service during the test year while approximately $3.7 million of internal costs were focused on merger integration activities. If the tasks were still "getting done" while such a large portion of employee activities were focused on merger integration, then the associated costs cannot fairly be considered as reflective of a "normal run rate." Considering the magnitude of the costs Pepco claims are "non-incremental" but that were focused on merger integration efforts during the test year, it would be fair to require Pepco demonstrate why these purported "non-incremental" costs are needed going forward. OPC stands by its recommendation that the entire $5,623,000 of merger integration costs recorded on Pepco's books during the test year should be removed from test year expenses.

B. Is Pepco's request to establish regulatory assets for costs to achieve appropriate and reasonable?

Under Merger Commitment 26, Pepco is required to track and account for merger-related savings and the costs to achieve those savings.[484] Under Merger Commitment 27, addressed above, Pepco will amortize the CTA over a five-year period after the costs are incurred as long as the CTA recovered in rates does not exceed the savings being passed on to customers.[485] OPC Witness Ramas testified that the establishment of a CTA regulatory asset would be an appropriate mechanism for deferring the costs to achieve for future amortization.[486] Witness

483 Tr. at 2044, lines 1-2.

484 *Formal Case No. 1119*, Order No. 18148, Attachment B ¶ 26.

485 *Id.* at ¶ 27.

486 Exhibit OPC (B) (Ramas) at 76.

Ramas also testified that the CTA regulatory asset, if approved, should be based on actual verifiable costs, and that any CTA incurred prior to the test year should be excluded.[487]

Witness Ramas also recommended that the regulatory asset should be subject to strict reporting requirements, and that any CTA in the regulatory asset not supported by verifiable evidence should be disallowed. She explained that Pepco should be required to maintain detailed records supporting the actual costs recorded in the regulatory asset that can be reviewed and audited in future rate case proceedings before any such costs are passed on to Pepco's D.C. ratepayers.[488] Any costs that are allocated to Pepco should also be fully supported with detailed records substantiating the costs and the allocation factors used.[489]

Pepco's treatment of merger communication costs demonstrates the need for detailed record-keeping. Witness Ramas recommended that merger "communication" costs should be excluded from CTA.[490] The Company claimed in response to discovery that its CTA did not include any communication costs.[491] At hearing, OPC probed Company Witness Ziminsky on the details of OPC Exhibit (B)-33 which includes among the CTA costs, expenditures associated with table throws for rebranding, logo replacements, and other rebranding efforts.[492] Pepco Witness Ziminsky acknowledged that there are such rebranding costs included and that it would be fair to characterize such costs as communications costs.[493] The inclusion of such costs in the

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487 *Id.*

488 *Id.*

489 *Id.*

490 Commission Cross-Examination Exhibit No. 78

491 OPC Cross-Examination Exhibit No. 71.

492 Tr. at 2053, line 20 – p. 2054, line 22.

CTA demonstrates the need for close scrutinization prior to permitting their inclusion in rates charged to D.C. customers.

OPC also recommends that Pepco's D.C. ratepayers not be required to pay a return to Pepco's investors on the costs incurred to implement the merger. As Witness Ramas testified, requiring ratepayers to pay a return on the costs incurred by Pepco and its affiliates in merging PHI and Exelon is simply unfair.[494] Witness Ramas explained that Pepco is realizing the benefits of merger-related cost savings and will retain such savings until the time rates from Pepco's next base rate case go into effect. Since the cost savings are not being deferred, it would be unfair to allow the Company to earn a return on the merger integration costs being incurred.

C. Are all the merger transaction costs (as defined in Merger Commitment 28) properly excluded from the test year?

Merger Commitment 28 lists four categories of merger-related "Transaction Costs" that Pepco is prohibited from recovering in distribution rates:[495]

> (a) consultant, investment banker, regulatory fees . . . and legal fees associated with the Merger Agreement and regulatory approvals, (b) purchase price, change-in-control payments, retention payments, executive severance payments and the accelerated portion of supplemental executive retirement plan ("SERP") payments, (c) costs associated with the shareholder meetings and proxy statement related to Merger approval by the PHI shareholders, and (d) costs associated with the imposition of conditions or approval of settlement terms in other state jurisdictions.

To maintain compliance with the merger commitments, Pepco must exclude these costs from the test year in this proceeding.

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493 Tr. at 2053, line 14 – p. 2056, line 4.

494 Exhibit OPC (B) (Ramas) at 12.

495 *Formal Case No. 1119*, Order No. 18148, Attachment B ¶ 28.

At this time, OPC has not identified any merger Transaction Costs that have been included in the adjusted test year. OPC Witness Ramas testified that based on her review "the majority of the merger transaction costs were recorded on PHI and Exelon's books and have not been passed on to Pepco" and those "that were recorded on Pepco's books were recorded in below-the-line accounts, thereby ensuring that they were not included in the cost of service."[496]

ISSUE No. 11 DOES PEPCO'S PRESENTATION OF ITS REVENUE REQUIREMENT PROPERLY REFLECT THE IMPACTS OF DISTRICT OF COLUMBIA AND FEDERAL TAX REGULATIONS?

OPC has not raised any specific concerns with respect to Pepco's reflection of the impact of District of Columbia and federal tax regulations on the Company's proposed revenue requirements. However, Pepco's effective revenue requirement must account properly for the additional tax impacts that result from the Commission's approval of any OPC or other party-recommended adjustments and revisions.

Furthermore, and relatedly, as discussed under Designated Issue No. 5(d), OPC contends that its recommendations regarding PHI's use of Pepco's NOLC are consistent with federal tax rules.

ISSUE NO. 12 IS PEPCO'S PROPOSED JURISDICTIONAL COST ALLOCATION STUDY FOR DISTRIBUTION SERVICE JUST AND REASONABLE?

For the reasons set forth in Dr. Dismukes' Direct Testimony, OPC recommends that the Commission accept Pepco's proposed jurisdictional allocations in this proceeding.[497]

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496 Exhibit OPC (B) (Ramas) at 77.

497 Exhibit OPC (A) (Dismukes) at 21:18 to 23:4.

ISSUE NO. 13 IS PEPCO'S PROPOSED ALLOCATION OF ITS REVENUE REQUIREMENT JUST AND REASONABLE?

Pepco proposes to allocate the rate increase that is ultimately granted in this case in a manner that moves toward the goal of eliminating negative class rates of return over three successive rate cases.[498] To achieve that goal, Pepco proposes to take the absolute difference between zero and the estimated rate of return for each residential class, and then divide that difference by three. Pepco would apply one third of that difference to the total requested increase in this case to determine the percentage of the revenue requirement increase for which the residential class (or any other customer class that is currently earning a negative class rate of return) will be responsible. While Pepco does not know the level of the increases that it will propose in the next two rate cases, it proposes that the remaining two-thirds of this difference be recovered equally over the next two rate cases from the residential class.[499] Pepco believes that, by the third rate case, the negative residential class rates of return will be eliminated.

At the same time, Pepco proposes to offset the one-third increase in this case, in its entirety, with funds from the Customer Base Rate Credit ("CBRC"), which is a fund made available by Exelon as a condition of securing merger approval in Formal Case No. 1119. Under

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[498] Exhibit Pepco (B) (McGowan) at 7:15 to 8:16; *see also* Exhibit Pepco (G)-8 at 4:15-22. Dr. Dismukes summarizes Pepco's proposed allocation of the revenue requirement increase at Exhibit OPC (A) (Dismukes) at 36:1-13.

[499] For instance, the primary residential customer class (*i.e.*, the R class) is estimated to be currently earning a negative 0.88% rate of return. Exhibit Pepco (2F)-1 at 2. The absolute difference between negative 0.88 and zero is 0.88. One third of that absolute difference is 0.293%. Using Pepco's proposed test year cost of service results, that 0.293% figure results in $11.3 million in financial cost. Pepco will take that $11.3 figure from the system wide average increase (*i.e.*, 22.72% in the initial Application) for a total residential class increase of 22.72% in this case. It will apply that same 0.293% figure to the total increases in the next two rate cases. Exhibit OPC (A) (Dismukes) at 36:1-13.

Pepco's proposal, the use of CBRC funds will result in a $21.2 million credit to residential customers and a $4.4 million credit to the MMA rate class.[500]

OPC addresses these proposals in the following three sub-parts.

1. The Commission Should Approve Pepco's Proposed Allocation of the Revenue Requirement in this Case, But Not Prejudge the Percentage Increases that Will Apply in Future Rate Cases.

While the level of rate increase the Commission will ultimately authorize has not been determined, OPC recommends that the Commission accept Pepco's proposed revenue allocation in this case.[501] However, OPC does not agree that the Commission should predetermine, in this case, the percentage increases that will apply to the residential classes in the next two rate cases.

It is, by definition, arbitrary and capricious to determine *in this case* the percentage increases that will apply *in future rate cases*. It is impossible to know when Pepco will file the second and third rate cases in its three-part proposal. While Pepco has expressed its intent to file rate case applications every 12 to 18 months,[502] actual experience demonstrates that a multitude of factors can protract that schedule. Before submission of its June 30, 2016 Application that initiated the instant proceeding, Pepco filed its last rate case application on March 8, 2013. Thus, there is no basis to conclude that Pepco will, in fact, file the second and third rate case applications of its three-part proposal by 2019.

Second, even if Pepco does submit two additional rate case applications within the rate case cycle it anticipates for the District (*i.e.*, by 2019), there is no evidence in the record in this case: (1) identifying the overall amount of the increases that Pepco may request in those cases;

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500 Application, ¶ 2; *see also Exhibit* (G)-8.

501 Exhibit OPC (A) (Dismukes) at 13:2; *see also* Tr. at 1026:17-21, 1031:13-16, and 1093:9-22; *id.* at 1073:14-21 (colloquy between Chairman Kane and OPC Witness Dismukes).

502 Tr. at 168:20 to 169:1.

(2) identifying the level of the increases that may be allocated to residential customers; or (3) explaining other policy factors (*e.g.*, the avoidance of rate shock, the impact on low-income and senior-citizen customers, etc.) that may justify the specific allocations to residential customers. By predetermining *in this case* the percentage increases that will apply *in future rate cases*, the Commission would be depriving OPC, customers, and other interested an opportunity to be meaningfully heard on such issues based on the evidentiary record of future proceedings.

In addition to these substantial concerns, OPC submits that it would be bad public policy for the Commission to bind itself and future Commissions by preapproving specified levels of rate increases that would apply in future cases. It is impossible to know what circumstances may change between now and 2019. Given the transformation of the electric industry, however, it is reasonably foreseeable that circumstances will change. The likelihood for circumstances to change would greatly increase if the Commission accepts OPC's proposal and initiates a separate rate design investigation. Predetermining the percentage increases that will apply to future rate cases would foreclose consideration of, or at least extremely limit the Commission's ability to consider, whether changes are necessary to address new proposed tariff structures. Further, while a party, presumably, could argue that changed circumstances warrant revisiting the predeterminations made here, it would be prudent for the Commission to avoid the need and administrative burden of addressing changed circumstances in the first instance, especially when considering the above-stated limitations that such predeterminations could have on a review of rate design.

Finally, OPC demonstrates in response to Issue 13(a) below that Pepco's proposal will *not* achieve the goal of eliminating negative class rates of return. To avoid burdening the record, OPC will not repeat that discussion here. However, that discussion demonstrates the absurdity of adopting an approach that gives rise to the above-stated concerns in order to achieve a result that the adopted approach will *not* achieve.

Given these substantial concerns, in this case the Commission should avoid pre-determining the percentage increases that will apply in future rate cases. Rather, the more prudent and legally justifiable course would be to accept Pepco's proposed revenue allocation in this case and consider future proposed allocation of revenue requirement increases in future cases, after conducting a comprehensive investigation into rate design.

2. The Record in this Case Supports a Finding that Pepco's Proposal to Allocate the CBRC to Residential and MMA Customers is Just and Reasonable.

As explained above, Pepco proposes a relatively substantial rate increase for residential customers, which it then proposes to offset by applying funds from the CBRC.[503] OPC agrees with Pepco's proposed allocation of the CBRC and recommends that it be adopted.[504] Pepco's proposed allocation is consistent with the allocation that a number of diverse entities, including entities that represent the interests of commercial customers,[505] agreed to in Formal Case No. 1119. From OPC's perspective, allocating $21.3 of the total $25.6 million rate credit to residential customers was the "principal benefit" of the settlement agreement in Formal Case No. 1119.[506] Residential ratepayers should not be deprived of the benefit of their bargain.

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503 Exhibit OPC (A) (Dismukes) at 47:15-17.

504 Exhibit OPC (A) (Dismukes) at 47:2-5.

505 In Formal Case No. 1119, AOBA asserted that it is "acutely sensitive to achieving a greater equity of costs responsibilities for Pepco's District of Columbia operations as a result of [the] merger." Exhibit OPC (2A)-3 at 7. Even then, AOBA explained that "the manner in which the residential rate credits will be applied should enable to the Commission's efforts to eliminate negative class rates of return." *Id.* at 10.

506 Exhibit OPC (2A)-1 at 3.

OPC recognizes that, in Formal Case No. 1119, the Commission rejected the proposal to allocate the $25.6 million credit to residential and MMA customers. However, that decision is not binding. First, the Commission expressly left open the possibility that the $25.6 million credit could be allocated to residential and MMA customers in this case.[507] Second, the Commission's rejection of the allocation of the $25.6 million in Formal Case No. 1119 was based on "the evidentiary record of th[at] proceeding," (*i.e.*, in Formal Case No. 1119).[508] OPC submits that the record in this case contains evidence that: (1) was not in the record in Formal Case No. 1119; and (2) demonstrates that Pepco's proposal to allocate the $25.6 million rate credit to residential and MMA customers should be approved as just and reasonable.

Unlike the instant proceeding, Formal Case No. 1119 was not a rate case.[509] As such, the record in Formal Case No. 1119 was devoid of any concrete rate proposals demonstrating the impact of the proposed allocation of the rate credit on the Commission's policy to eliminate negative class rates of return. Further, in Formal Case No. 1119, the Commission found that:

> [t]here was no evidence presented that showed the Settling Parties had taken into account the Commission's policy concern about correcting the commercial class' long history of subsidizing the residential class through the negative ROR, and developed a proposal that would not undermine the policy goal. Nor could the Settling Parties adequately demonstrate that the proposed Customer Base Rate Credit for residential customers would not result in further 'subsidizations'

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507 *See* Order No. 18160, Attachment B, ¶ 5 ("The parties in the next Pepco base rate case will be provided an opportunity to propose to the Commission how the Customer Base Rate Credit...will be allocated among Pepco customers....").

508 Order No. 18109, ¶ 32.

509 The Commission expressly rejected arguments that the merger was a rate case, deeming it an "other investigation." *See Formal Case No. 1119, In the Matter of the Joint Application of Exelon Corporation, Pepco Holdings, Inc., Potomac Electric Power Company, Exelon Energy Delivery Company, LLC and New Special Purpose Entity, LLC for Authorization and Approval of Proposed Merger Transaction*, Order No. 17597, ¶144 (rel. Aug. 22, 2014).

> because it provides immediate rate relief for the residential class while excluding the nonresidential class.[510]

The Commission also expressed concern that the proposed allocation that "would impact the Commission's ability to continue to implement its expressed policy of addressing the negative class rate of return that currently exists for residential ratepayers and the resulting subsidies that are placed on non-residential customers."[511]

In addition, then-Commissioner Fort opined that the record in Formal Case No. 1119 did not provide "a complete understanding about the details of the proposals. For example, the parties were unclear whether the deferral would apply to related increases on all elements of the distribution bill (*e.g.*, to fixed and variable charges as well as related taxes, fees and surcharges that are volumetrically based)...."[512] Such detail has been provided in this case (*see* the discussion in the following sub-part regarding OPC's proposed application of the CBRC).

Then-Commissioner Fort also opined that "the operational impact of the proposal...is largely dependent upon the size and the number of revenue increase applications to be filed by Pepco over the next two years – two factors that were not established with certainty on the evidentiary record."[513] Then-Commissioner Fort concluded that, "without knowledge of the size of a revenue requirement increase being sought in a rate application, there is insufficient information to credibly determine whether residential ratepayers would experience rate shock under the proposal in NSA Paragraph 4."[514] While we do not know the size of revenue increase

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510 Order No. 18109, ¶ 37.

511 Order No. 18109, ¶ 37.

512 Order No. 18109, ¶ 87 (Fort, concurring).

513 Order No. 18109, ¶ 87 (Fort, concurring).

514 Order No. 18109, ¶ 87 (Fort, concurring).

applications that Pepco will file over the next two rate cases, we *do* know the size of the revenue increase that is pending in this case.[515] Thus, then-Commissioner Fort's concern about theoretical rate impacts can now be addressed based on specific facts about rate impacts.

In the instant proceeding, Pepco presented a concrete rate proposal that demonstrates the impact of the proposed allocation of the rate credit on the Commission's policy to eliminate negative class rates of return [516] As Dr. Dismukes explained, Pepco's revenue distribution proposal will increase the allocation of its revenue deficiency to residential customers in such a fashion to address this historic revenue distribution anomaly and offset the proposed increase with the funds available from the CBRC in this rate case as well as future rate cases up to the point where the CBRC is financially exhausted.[517] Consequently, there *is* evidence in the instant proceeding that shows that the proposed allocation "take[s] into account the Commission's policy concern about correcting the commercial class' long history of subsidizing the residential class."[518] Further, OPC's recommendation that the Commission consider its policy of eliminating negative class rates of return as part of a comprehensive investigation into rate design *facilitates* the Commission's ability to continue to explore "its expressed policy of addressing the negative class rate of return that currently exists for residential ratepayers and the resulting subsidies that are placed on non-residential customers."[519]

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515 *See* Exhibit OPC (A) (Dismukes) at 48:10-20 and 49:16-21 (addressing rate shock in the context of this case).

516 Exhibit Pepco (B) (McGowan) at 7:15 to 8:16; *see also* Exhibit Pepco (G)-8 at 4:15-22; Exhibit OPC (A) (Disukes) at 36:1-13.

517 Exhibit OPC (A) (Disukes) at 46:7-11.

518 Order No..18109, ¶ 37.

519 Order No. 18109, ¶ 37.

In summary, the Commission's prior rejection of the proposal to allocate the $25.6 million rate credit to residential and MMA customers is not binding in this case. Rather, the dispositive issue is whether record evidence *in this case* supports a finding that the proposed allocation is just and reasonable. The foregoing discussion demonstrates that the proposal to allocate the $25.6 million rate credit to residential and MMA customers expressly accounts for the concerns expressed in Formal Case No. 1119 and establishes, unequivocally, the justness and reasonableness of that proposed allocation.

3. The Commission Should Direct Pepco to Apply the CBRC as a Monthly Per Customer Bill Credit.

The Commission should apply the CBRC as a monthly per customer bill credit. Such an application has several benefits. First, it maintains appropriate rate signals for customers by allowing them to see the increases in volumetric rates arising from this and future rate cases. Second, by separately stating the CBRC credit that is being applied to rates resulting from the revenue requirement approved in this case, OPC's approach will assist in eliminating what could be otherwise be a dramatic shock with respect to the volumetric rate increases future rate cases when the CBRC is exhausted.[520] Notably, while Pepco proposes a slightly different application, Pepco Witness McGowan agrees that OPC's proposed allocation is "appropriate" and "could be applied" in this case.[521]

As part of its proposal to apply the CBRC as a monthly per customer bill credit, OPC also recommends that the Commission direct Pepco to educate ratepayers about the future expiration of the CBRC and the per customer monthly credit. Educational efforts are critical to help to

520 Exhibit OPC (A) (Dismukes) at 49:16-21.

521 Tr. at 1747:12 to 1748:7.

alleviate the potential bill shock that could arise when the CBRC is exhausted.[522]

ISSUE NO. 13(a) Is Pepco's Proposed Plan for Eliminating Negative Class Rates of Return Reasonable?

No, Pepco's proposed plan for eliminating negative class rates of return is not reasonable. As explained in sub-part 1 below, overwhelming record evidence demonstrates that Pepco's proposal is likely to fail to eliminate negative class rates of return. There is simply no way for the Commission to simultaneously support the Company's efforts to make investments needed to improve reliability and correct its long-standing ratemaking challenges regarding negative class rates of return. Therefore, in sub-part 2 below, OPC discusses its proposal for addressing the issue of negative class rates of return as part of a comprehensive investigation into rate design. That proposal is also discussed in more detail in response to Issue 19.

1. Overwhelming Record Evidence Shows that Pepco's Proposal Will Not Achieve the Goal of Eliminating Negative Class Rates of Return.

Dr. Dismukes examined the historic trends in Pepco's allowed revenue distribution. Those trends show that over the past several years the Commission has allocated a greater than average share of the Company's past rate increases to the residential rate classes. Those trends also show that the residential classes' relative rates of return have not improved, despite getting higher and higher shares of the Company's requested rate increases. Exhibit OPC (A)-7 examines the Commission's authorized revenue allocations across customer classes, going back to FC 1053 decided in 2007, almost a decade ago. In each of the last three rate cases (prior to FC 1139), the Commission has approved increases to base rates for R and R-AE customers that are between 2.12 and 2.82 times the system average rate increase. In other words, residential base rate increases for these classes are more than double – and in the case of the Company's last rate

522 Exhibit OPC (A) (Dismukes) at 49:21 to 50:1.

case, nearly triple – the rate increases that were approved for the system average of all rate classes.

The simple fact is that allocating substantial, larger-than-average percentages of rate increases on residential classes has failed to improve estimated rates of return for those classes. Exhibit OPC (A)-7 shows that in Formal Case No. 1076—*i.e.*, the rate case in which the Commission first articulated its policy of eliminating negative class rates of return—the R class was estimated to be earning a rate of return of negative 0.59%. In the next rate proceeding—Formal Case No. 1087—the rate of return for the R class became more negative despite the fact that residential customers were assessed with a rate increase that was 2.12 times the system average.[523] In the following rate case—Formal Case No. 1103—residential customers reported a rate of return of negative 0.60%. The slight movement from the previous case was achieved by allocating to the R class an increase that was 2.52 times the overall system average.[524] However, in the instant rate case, Pepco estimates that the negative rate of return for the R class increased to the worst position of any estimate over the past five rate cases, notwithstanding the fact that the R class received a rate increase that was 2.82 times the overall system average in the Formal Case No. 1103.[525] These results strongly suggest, if not conclusively establish, that failure will result if the approach is simply to seek to improve negative rates of return by allocating substantially-increasing-revenue-responsibilities to the residential classes.[526]

The Commission should recognize that the analysis presented in Exhibit OPC (A)-7 is

523 The rate of return was negative 0.73%. Exhibit OPC (A)-7.

524 Exhibit OPC (A) (Dismukes) at 38:10-12.

525 Exhibit OPC (A) (Dismukes) at 38:12-14; *see also* Exhibit Pepco (G)-1.

526 There is simply no reason to believe that pursuing the same revenue distribution strategy in this rate case will achieve any different result. *See* Exhibit OPC (A) (Dismukes) 12:14-21; *see also id.* at 38:17-18; Tr. at 1025:3-12, 1027:1-18, and 1031:8-10 (Dismukes).

not merely a mathematical exercise. Rather, saddling residential customers with larger and larger allocations of Pepco's rate increases—and the rate increases have proven to be larger and larger themselves—has real-world impacts on the members of the R and AE classes that the Commission is charged with protecting. OPC demonstrated that the R and AE classes have received allowed revenue increases of more than 102% over the past decade, compared to the 29% increase experienced by other commercial classes.[527] If the Commission approves Pepco's proposed rate case as filed, customers in the R and AE classes will have experienced rate increases of 140% since the time of Formal Case No. 1053. In that same time, other customer classes will have received rate increases of only 68 percent.[528] Further, the residential classes' combined per kWh revenue has grown from $0.0183 per kWh in 2007 to $0.0335 per kWh as of the time of Formal Case No. 1103. If the Commission approves Pepco's proposed rate case as filed, that rate will grow to $0.0398 per kWh.[529] Again, this analysis strongly suggests, if not conclusively establishes, that Pepco's proposal seeking to improve negative rates of return by allocating substantially-increasing-revenue-responsibilities to the residential classes is an approach that will negatively impact residential customers *without improving negative class rates of return.*

2. Record Evidence Supports Findings that: (1) Negative Rates of Return are Caused by Increasing Reliability-Related Capital Investments; and (2) Commercial and Industrial Customers Realize Greater Value from Reliability-Related Capital Investments than Residential Customers Realize.

In Exhibit OPC (A)-9, Dr. Dismukes presents an analysis of the historical operating

[527] Unlike commercial customers, members of the R and AE classes do not have customer they can pass those charges onto.

[528] Exhibit OPC (A) (Dismukes) at 39:1-6.

[529] Exhibit OPC (A) (Dismukes) at 39:6-9.

revenues and costs to serve residential customers in each of Pepco's last four rate cases. Dr. Dismukes' analysis shows that Pepco's growth in revenues has been sufficient to keep pace with its overall increase in costs. For residential customers, however, the growth in revenues has lagged growth in costs.[530] Since the time of Formal Case No. 1076, revenue from residential customers has grown by about 29%. Over the same period, costs have grown by as much as 34%.[531]

As Dr. Dismukes explains, Pepco's ever-increasing investment in reliability infrastructure is the primary motivator for these increased costs.[532] This fact leads the Commission to two conclusions. First, the Commission should conclude that its goal of eliminating negative rates of return is incompatible with efforts to financially support Pepco's efforts to improve reliability. Given the mutual exclusivity of these policies, OPC recommends that the Commission choose the more important policy initiative (*i.e.*, improving and maintaining reliability) and defer[533] pursuit of eliminating negative rates of return for the time being.[534]

Second, there is no legitimate doubt that reliability investments provide greater benefits to commercial and industrial customers in terms of economic value than those same investments

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530 The evidence shows that this shortfall is not driven by contractions, or a flattening of revenue growth. Rather, Exhibits OPC (A)-8 and OPC (A)-9 demonstrate that revenue growth has been relatively strong dating back to the time of Formal Case No. 1076. Exhibit OPC (A) (Dismukes) at 40:14-16.

531 Exhibit OPC (A) (Dismukes) at 40:14-16.

532 Exhibit OPC (A) (Dismukes) at 40:18-20.

533 By defer, OPC does not mean "abandon."

534 Whether to eliminate negative class rates of return is a policy decision for the Commission, not a requirement to which the Commission must adhere. *See Washington Gas Light Co. v. Pub. Serv. Comm'n. of Dist. of Columbia*, 450 A.2d 1187, 1206 (D.C. 1982) (holding that "[i]t is not necessary that differences in rate of return be specifically and quantitatively supported by customer class-cost considerations") (internal quotations and citations omitted).

provide to residential and low-income customers.[535] As such, the Commission should conclude that customer classes that make a greater-than-average contribution to Pepco's overall rate of return may *not* be subsidizing customer classes that make less-than-average contributions to Pepco's overall rate of return, as least not on a dollar-for-dollar basis. This fact supports a finding that it may be inappropriate to strictly adhere to a policy of eliminating negative rates of return,[536] particularly where the Commission can investigate restructuring legacy tariffs to ensure that cost responsibility is assigned to customers on a more granular basis that is more reflective of the manner in which they use the system.[537] OPC's recommendation for an investigation on rate design, discussed in more detail below in response to Issue 19, would facility such a review of legacy tariffs. It could also ensure that the Commission expressly accounts for other policy goals and initiatives to transform the electric industry in a comprehensive manner.

ISSUE NO. 14 IS PEPCO'S PROPOSED CUSTOMER CLASS COST OF SERVICE STUDY JUST AND REASONABLE?

For the reasons set forth below, the Commission should condition its approval of Pepco's Class Cost of Service Study ("CCOSS") on Pepco's acceptance of revisions to three of the five allocators used in Pepco's CCOSS.[538]

1. The Commission Should Allocate the Costs of Secondary Lines Using a 50/50 Weighting of Non-Coincident Area Peak Demands and the Sum of Individual Customer Maximum Demands.

535 *See* Tr. at 1809:2-8 (Stipulation). *See also* Tr. at 1032:9 to 1033:9 (Dismukes).

536 "Allocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science." *See Washington Gas Light*, 450 A.2d at 1206; *see also* Exhibit OPC (A) (Dismukes) at 32:16 to 33:9 (discussing policy considerations that should guide revenue distribution).

537 Pepco Witness McGowan agrees that the Commission should conduct a separate investigation into rate design and consider "how customers use the system and [how] to assign the costs to run the system to those customers based on how they use it." Tr. at 1699:22 to 1700:14.

538 Exhibit OPC (A)-2 compares OPC's proposed allocation factors to the allocation factors Pepco used in its CCOSS. Exhibit OPC (A)-4 shows the CCOSS that results from using OPC's recommended allocation factors.

In the CCOSS included in its initial filing, Pepco proposed the SMX2ND allocator to allocate the costs of secondary voltage facilities on its distribution system.[539] The SMX2ND is based on the sum of individual customer maximum annual demands, as measured at the output of individual line transformers.[540]

Secondary distribution lines are located close to end-use customers and thus have less load diversity than higher-voltage systems.[541] Despite that characteristic, Dr. Dismukes explained that Pepco's proposed SMX2ND allocator places undue emphasis on individual customer peak loads and, therefore, prejudices lower load-factor customers such as residential and small commercial customers.[542] Using an allocator that incorporates a Non-Coincident Area Peak ("NCAP") measure of demand would be more appropriate because it would not have that effect.[543] To "temper" Pepco's sole reliance on individual customer demands, Dr. Dismukes recommended that the Commission direct Pepco to average individual customer demands with class NCAP.[544] In support of that recommendation, Dr. Dismukes noted that his proposed allocation method is equivalent to the general method that Pepco uses to allocate costs associated with line transformers (FERC Account 368).[545]

In his Rebuttal Testimony, Pepco Witness Normand recognized the merit of Dr. Dismukes' proposed approach to allocating the costs of secondary lines. Specifically, Mr.

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539 Exhibit Pepco (F)-5 at 1.

540 Exhibit Pepco (F)-5 at 1; Exhibit OPC (A) (Dismukes) at 22:13-14.

541 *See* Exhibit Pepco (F) (Normand) at 6:16-19; *see also* Exhibit OPC (A) (Dimsukes) at 27:1-5.

542 Exhibit OPC (A) (Dismukes) at 29:15-18.

543 Exhibit OPC (A) (Dismukes) at 29:15-16; *see also* Exhibit OPC (A)-25 at 17.

544 Exhibit OPC (A) (Dismukes) at 29:20-21.

545 Exhibit OPC (A) (Dismukes) at 29:20 to 30:17.

Normand "agree[d] that there should be more consistency between the allocation methods used for line transformers and secondary conductors."[546] Further, Mr. Normand agreed with Dr. Dismukes' proposal and recommended "allocat[ing] secondary lines utilizing a 50/50 weighting of non-coincident area peak demands and the sum of individual customer maximum demands."[547] Pepco's revised recommendation further demonstrates the reasonableness of OPC's approach to allocating the costs of secondary lines.

For the reasons set forth above, substantial evidence supports a finding that Pepco should use a 50/50 weighting of NCAP demands and the sum of individual customer maximum demands to allocate the costs of secondary lines and facilities.

2. The Commission Should Allocate Subtransmission Costs Using the AED-4CP Allocator to Properly Recognize the Role that Subtransmission Assets Play in the Larger Electric System.

Pepco proposes the Subtransmission Average and Excess Demand ("SUBTAED") allocator to allocate subtransmission costs.[548] The SUBTAED allocator, in turn, uses the Average and Excess NCAP ("AED-NCAP") allocator,[549] which is a measure of system demands involving two components that are combined using a weighted average.[550] The first component, referred to as the "average" component, represents the average hourly energy consumption

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546 Exhibit Pepco (3F) (Normand) at 7:3-4.

547 Exhibit Pepco (3F) (Normand) at 7:11-14; *see also id.* at 3:22 to 4:1 (where Pepco Witness Normand states that he "changed the allocation of secondary conductors to a 50/50 weighting of non-coincident area peak and sum of individual customer maximum demands per OPC Witness Dismukes").

548 Exhibit (F)-5 at 1; Exhibit Pepco (F) (Normand) at 6:20-22, 9:7-10. Pepco's subtransmission system is composed of 69 kV facilities. Exhibit OPC (A) at 27:18-19.

549 The AED-NCAP allocator "is the analog to AED-NCP" allocator in the context of Pepco's CCOSS. Exhibit Pepco (3F) (Normand) at 5:25-26.

550 Exhibit OPC (A) (Dismukes) at 23:11-12.

throughout the test year for each rate class.[551] It is calculated by simply dividing annual energy consumption for each rate class by 8,784, the number of hours in the test year.[552] The second component, referred to as the "excess" component, represents the difference between this "average" use and non-coincident peak demand for each rate class.[553] The first component (*i.e.*, average) is weighted by the utility's overall system load factor while the second (*i.e.*, excess) component is weighted by the inverse of the system load factor (*i.e.*, 1 minus the system load factor).[554]

The Commission should reject Pepco's proposed use of the AED-NCAP allocator for subtransmission assets because it fails to recognize the unique role that subtransmission assets play. As Dr. Dismukes explained: (1) higher-voltage electric systems are generally designed to meet broader, less-localized demands; (2) lower-voltage electric systems are generally designed to meet more-localized demands that can exhibit less load diversity; and (3) subtransmission systems are designed to facilitate bulk power supply movements throughout the distribution system.[555] These distinctions are important because they demonstrate with granularity the different functions of different types of assets. For example, subtransmission facilities perform a

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551 Exhibit OPC (A) (Dismukes) at 23:12-14.

552 Since 2016 is a leap year, this calculation uses 8,784 hours rather than the standard 8,760 hours in a year. Exhibit OPC (A) at 23 n.11.

553 Exhibit OPC (A) (Dismukes) at 23:15-17.

554 Exhibit OPC (A) (Dismukes) at 23:18-20. *See id.* at 24:13-14 (explaining that the NCAP is a traditional measure of non-coincident area customer class peaks).

555 Exhibit OPC (A) (Dismukes) at 26:21 to 27:12; *see also id.* at 27:15-19 (explaining that the National Association of Regulatory Utility Commissioners' ("NARUC") Electric Cost Allocation Manual recognizes that sub-transmission facilities are designed to deliver electric power from interstate transmission facilities to a utility's distribution system) (citing NARUC Electric Cost Allocation Manual at 8, excerpts of which are reproduced as Exhibit OPC (A)-25); *id.* at 26:11-16; Exhibit OPC (A)-25 at 40-41.

quasi-transmission role in delivery of electric power supply,[556] whereas lower-voltage facilities serve customers in a particular load area. Indeed, organizations like the National Council on Electricity Policy and the Occupational Safety and Health Administration recognize the distinct characteristics of these various system components.[557]

In addition to the industry's general acceptance of these distinctions, these distinctions apply specifically to Pepco.[558] Record evidence demonstrates that Pepco's subtransmission assets are *not* like primary and secondary facilities that can be directly assigned to either the District of Columbia or Maryland. Rather, Pepco's subtransmission facilities facilitate bulk power supply deliveries to both its District of Columbia and Maryland service territories.[559] These distinct functions mean that it would be inappropriate at worst, and a gross generalization at best, to conclude that Pepco's subtransmission facilities serve the same function as secondary feeders that can be confined to a single neighborhood.

The problem with Pepco's proposed AED-NCAP allocator is that it does not recognize these important distinctions. Rather, it affords the same treatment to: (1) lower-voltage electric systems (*e.g.*, secondary lines and transformers) that are designed to serve more-localized loads; and (2) subtransmission facilities that, as explained above, are *not* designed to meet localized

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556 Exhibit OPC (A) (Dismukes) at 27:15-18.

557 Exhibit OPC (A) (Dismukes) at 27:18 to 28:3; Exhibit OPC (A)-27 at 24; Exhibit OPC (A)-28 at 1.

558 AOBA Witness Bruce Oliver claims that Dr. Dismukes provided a "generalized discussion of sub-transmission facilities without any discussion of the specifics of the Pepco system…." AOBA (2A) (B. Oliver) at 3:6-7. As explained immediately below, Mr. Oliver's claim is unfounded. In fact, it is Mr. Oliver who fails to cite any evidence to support *his* conclusory statements about Pepco's subtransmission system. AOBA (2A) (B. Oliver) at 3:20 to 4:1.

559 Exhibit OPC (A) (Dismukes) at 28:9-11.

loads.[560] In so doing, the AED-NCAP allocator fails to recognize the function that subtransmission assets play in facilitating transfers of bulk power from the larger electric transmission system.[561]

To reflect the appropriate function of subtransmission facilities, OPC recommends that the Commission direct Pepco to use the AED-4CP allocator, which allocates subtransmission facilities among customer classes within Pepco's CCOSS on the basis of an average and excess allocation utilizing a demand factor. The demand factor is calculated on the basis of an average of class contributions to Pepco's overall Coincident Peak ("CP") during the four peak-period months, June through September.[562] In other words, it is a "4CP" factor. Like Pepco's proposed AED-NCAP allocator, the AED-4CP allocator uses energy and demand components, which are then combined using a weighted average based on the utility's system load factor. As compared to Pepco's proposed AED-NCAP allocator, however, the AED-4CP allocator is superior because it is less sensitive to the maximum demand of the rate class and gives more appropriate consideration to energy use of the rate class at other hours of the year. Further, the AED-4CP allocator appropriately recognizes the contribution of the rate class to system-wide capacity restrictions.[563]

As explained above, the Commission should allocate the costs of subtransmission facilities between customer classes within the Company's CCOSS on the basis of the AED-4CP allocator.

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560 The basis for this allocation method is Pepco's claim that subtransmission plant "serves lower voltage substations that reflect more distributed load and geography." Exhibit Pepco (3F) (Normand) at 4:21 to 5:1.

561 Exhibit OPC (A) (Dismukes) at 26:6-11.

562 Exhibit OPC (A) (Dismukes) at 28:15-19.

563 Exhibit OPC (A) (Dismukes) at 29:3-11.

3. The Commission Should Allocate Commission Assessment Fees Using Calculated Gross Revenues from Each Customer Class.

Pepco proposes to allocate costs associated with its assessment to customers within its CCOSS based on the aggregate assignment of subtransmission and distribution plant within the CCOSS.[564] OPC opposes Pepco's proposal because it is inconsistent with the manner in which Pepco incurs these costs.[565] As the Commission is aware, Commission assessments are allocated to utilities in the District based on their proportion of the gross revenues of all public utilities and alternative providers' utility operations in the District in a given calendar year.[566] As such, OPC recommends that the Commission direct Pepco to allocate its Commission assessments to customer classes based on the calculated gross revenues Pepco receives from such customer classes. This method will appropriately allocate costs to Pepco customer classes in a manner comparable to which the Company is assessed such fees by the Commission.[567]

ISSUE NO. 15 ARE PEPCO'S PROPOSED RATE DESIGNS FOR EACH DISTRICT OF COLUMBIA RATE CLASS JUST AND REASONABLE?

Before discussing its rate design proposals with regard to the Issue 15 and its sub-issues, OPC reiterates that its rate design proposals are part of a suggested comprehensive approach to addressing the totality of issues that must be considered in setting Pepco's distribution rates in an equitable manner, *e.g.*, affordability, distribution of the revenue requirement to customer classes, gradualism, the extent to which different customers classes realize disproportionate benefits from

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[564] Exhibit Pepco (F)-5 at 6.

[565] Exhibit OPC (A) (Dismukes) at 31:1-2. Pepco agrees that "[t]he chosen allocator must be essentially unbiased and cost based." Exhibit Pepco (3F) (Normand) at 8:2-3.

[566] D.C. Code § 34-912(b)(3)(A).

[567] Exhibit OPC (A) (Dismukes) at 31:2-6.

reliability investments, the need to consider restructuring Pepco's tariffs, etc.[568] While OPC submits that it would be inappropriate for the Commission to consider any one of these elements in isolation, the recommendations presented in response to Issue 15's sub-issues present OPC's attempt to balance the important timing considerations of (1) issuing a decision in this case; but also (2) conducting a comprehensive perspective review of rate design in order to ensure that the District positions itself to effectively manage the evolution of the electric industry on a prospective basis.

ISSUE NO. 15(a) Is Pepco's proposed rate design for the residential rate classes (Schedules R and AE) just and reasonable? Should R and AE be shown as separate rate classes or combined?

In response to the first question posed by Issue 15(a), OPC submits that there is insufficient evidence in the record of this proceeding to support a Commission finding that Pepco's proposed rate design for the residential rate classes (Schedules R and AE) is just and reasonable. The basis for OPC's position is set forth in sub-part 1 below. With regard to the second question posed by Issue 15(a), OPC explains in sub-part 2 below that it is premature to answer this question in the instant proceeding.

1. The Commission Should Reject Pepco's Proposal to Increase Customer Charges for the R and AE Classes.

Pepco proposes to increase the customer charges for classes R and AE to $16.75, an increase of $3.75.[569] According to Pepco, its proposed increase "continues to move the customer charge closer to the cost basis."[570] OPC has two principal concerns with Pepco's proposal.

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568 *See* the discussion in Issue 19, *infra*.

569 Exhibit PEPCO (2G)-1, at 3-4. As Dr. Dismukes explained, Pepco's proposal results in an increase of almost 29%. Exhibit OPC (A) (Dismukes) at 53:12-14.

570 Exhibit Pepco (3G) (Janocha) at 6:19; *see also* Tr. at 1049:7-17.

The first principal concern relates to overall the level of Pepco's customer charges, which is *already* noticeably greater than the average customer charges of regional utilities.[571] In the Atlantic region, there are only four electric distribution utilities with residential customer charges greater than the Company's proposed $16.75 per month, and 19 companies with a customer charge less than the Company's proposal.

As compared to regional utilities, Pepco would have the Commission establish some of the highest customer charges for the PHI distribution utilities. By way of comparison, Pepco's affiliate Atlantic City Electric assesses a $4.44 customer charge to residential customers, which is "significantly below [its] customer-related costs…."[572] Pepco's residential customer charges in Maryland are 43.7% lower that the customer charges in the District. If the Commission accepts Pepco's proposed increase to the residential customer charge, the differential between Maryland and the District will grow to 55.9%, meaning that residential customer charges in the District will be more than double Maryland's residential customer charges.[573] While the determinations of regulators in New Jersey and Maryland are not binding on this Commission, the magnitude of the differential in customer charges should give the Commission pause when considering whether further increases are appropriate.

OPC's second principle concern pertains to the bases for the proposed increase. As explained above, Pepco claims that its proposed increase "continues to move the customer

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[571] *See* Exhibit OPC(A)-14 (showing that Pepco's residential customer charge of $13.12 per month is noticeably greater than the regional average of $10.48 per month). Exhibit OPC (A)-14 surveys current residential and small commercial customer charges for major electric distribution companies operating in the Atlantic region. The Atlantic region include New York, Pennsylvania, New Jersey, Maryland, Delaware, District of Columbia, West Virginia, North Carolina, South Carolina, Virginia, Georgia, and Florida as defined by the U.S. Census Bureau. *See* Exhibit OPC (A) at 55 n75. *See also* Exhibit OPC (A) at 59:13-17.

[572] Tr. at 1847:2:6 (Janocha).

[573] Exhibit OPC (A) (Dismukes) at 55:11-15.

charge closer to the cost basis."[574] To put that claim in context, OPC notes that the customer charge revenue associated with the R and AE rate classes is 76% and 72%, respectively, of their class cost responsibility.[575] The Commission should find that such a high revenue recovery share for the R and AE rate classes satisfies cost-causation principles and does not justify any dramatic change in rate design policy by the Commission in this case.[576]

In addition to a cost-causation rationale (which, as discussed immediately above, does not justify Pepco's proposal), Dr. Dismukes explained that achieving revenue stability is another common rationale for increasing customer charges.[577] However, the presence of a revenue decoupling mechanism negates the need for significant increases to customer charges because such mechanisms are designed to recover shortfalls in revenues per customer that may arise between rate cases. In this case, the BSA has that precise effect,[578] a point that Pepco readily acknowledges.[579] OPC's examination of the BSA surcharge balances over the past eight years shows that residential class balances have been relatively small and stable as compared with other customer classes. Thus, to the extent Pepco's proposed increase to customer charges is based on a problem with revenue stability, the record demonstrates that such a problem does not appear to be attributable to residential customers.[580]

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[574] Exhibit Pepco (3G) (Janocha) at 6:19; *see also* Tr. at 1049:7-17 (Dismukes).

[575] Exhibit OPC (A)-15; *see also* Exhibit OPC (A) (Dismukes) at 56:21-23.

[576] Exhibit OPC (A) (Dismukes) at 57:14-17.

[577] Exhibit OPC (A) (Dismukes) at 57:22 to 58-2 ("Recovering more revenues through customer charges, as opposed to through volumetric charges, can lead to greater revenue stability because changes in the number of customers can often be more stable than changes in volumetric use").

[578] Exhibit OPC (A) (Dismukes) at 58:5-7; *see also* Tr. at 1049:17-21.

[579] 1850:6-10 (Janocha). The relevant question begins on page 1849, line 14.

[580] Exhibit OPC (A) (Dismukes) at 58:9-12; *see also id.* at 94:1-12.

For the foregoing reasons, OPC recommends that the Commission hold customer charges constant and authorize Pepco to recover any revenue shortfalls found in this case through volumetric rates.[581] Specifically, using OPC's alternative CCOSS, which is discussed above in response to Issue 14, OPC developed the volumetric rates for the R and AE classes that are shown on page 1 of Exhibit OPC (A)-13.[582]

In the context of its broader rate design proposal, OPC notes that is proposal to hold customer charges constant accounts for interrelated policy issues that the Commission should consider. Namely, OPC's proposal is not inconsistent with, and will not undermine in any way, the Commission's policy of eliminating negative class rates of return.[583] Moreover, OPC's proposed investigation into rate design would facilitate discussion of the appropriate role and method by which customer charges (or grid access charges) are determined.[584]

2. Whether to Consolidate the R and AE Rate Classes is a Decision the Commission Should Make in the Context of a Holistic Review of Rate Designs.

The second sentence of Issue 15(a) asks: "Should R and AE be shown as separate rate classes or combined?" It is premature to answer this question in the instant proceeding. As explained below in response to Issue 19, the Commission should initiate a separate investigation into alterative rate designs. In that investigation, the Commission should use AMI data and other studies to determine what changes, if any, should be made to legacy tariff structures.[585] In

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581 Exhibit OPC (A) at 42:13-15; *see also* Tr. at 1053:13 to 1055:3 (Dismukes) (explaining the basis for OPC's proposal).

582 Dr. Dismukes presents OPC's volumetric rate design proposals for all rate classes (*see* Exhibit OPC (A)-13), which is based on the alternative CCOSS that is discussed in response to Issue 14.

583 Tr. at 1849:14 to 1850:5 (Janocha).

584 Exhibit OPC (A) at 59:6-10; *see also* Tr. at 1053:13 to 1055:17 (Dismukes).

585 Tr. at 1062:6 to 1063:12, 1065:9-11, 1065:19 to 1066:8 (Dismukes).

addition to addressing whether the R and AE should be shown as separate rate classes or combined, that investigation could determine whether other structural changes are needed to better reflect the usage characteristics of customers in the R and AE classes (and assign cost responsibility to customers on a more granular basis).

ISSUE NO. 15(b) Is Pepco's proposed rate design for Master Metered Apartments, including discontinuing the use of the number of dwelling units, just and reasonable?

As explained above in the context of the R and AE rate classes, OPC recommends that class specific rate increases be recovered entirely through volumetric rates. Thus, OPC proposes a $10.25 customer charge for the Master Metered Apartments ("MMA") class.[586] The results of OPC's approach are increases in volumetric rates that are slightly higher than, but fairly comparable to, Pepco's proposed increases in volumetric rates.[587]

To the extent rate design for the MMA class remains an issue after the conclusion of this proceeding, it would be appropriate to address any open questions in the separate investigation on rate design that OPC addresses below in its discussion on Issue 19.

ISSUE No. 15(c) Are Pepco's proposed rate designs for the commercial customer classes (i.e., Rate Schedules GS-ND, GS-D, GS-HV, GT-LV, GT-3A, and GT-3B) just and reasonable?

Similar to the discussion above, OPC recommends that class specific rate increases be recovered entirely through volumetric rates.[588] Thus, OPC proposes to maintain the current customer charges for the GS-ND, GS-D, GS-HV, GT-LV, GT-3A, and GT-3B rate classes.[589]

586 Exhibit OPC (A)-13 at 1.

587 Exhibit OPC (A)-13 at 1.

588 Dr. Dismukes presents OPC's volumetric rate design proposals, which is based on the alternative CCOSS that is discussed in response to Issue 14.

589 Exhibit OPC (A)-13 at 1.

The results of OPC's rate design for these classes are shown on pages 2 and 3 of Exhibit OPC (A)-13.

It would be appropriate to address any open questions regarding rate design for these classes in the separate investigation on rate design that OPC addresses below in its discussion on Issue 19.

ISSUE NO. 15(d) Is Pepco's proposed rate design for the rate schedule for Street Lighting ("SL") just and reasonable?

The SL rate class has a rate structure composed of a customer charge and a per-lamp charge. In order to determine a distinct per-lamp charge for the SL rate class, Pepco "refined" its CCOSS to allocate the per-lamp charges between the SL and TS rate classes, in accordance with the Commission directive in Formal Case 1087, Order No. 16930.[590] The results of OPC's rate design for this class are shown on page 3 of Exhibit OPC (A)-13.

It would be appropriate to address any open questions regarding rate design for this class in the separate investigation on rate design that OPC addresses below in its discussion on Issue 19.

ISSUE NO. 15(e) Is Pepco's proposed rate design for the rate schedule for Traffic Signals ("TS") just and reasonable?

The TS rate class has a rate structure composed of a customer charge and a per-lamp charge. In order to determine a distinct per-lamp charge for the TS rate class, Pepco "refined" its CCOSS to allocate the per-lamp charges between the SL and TS rate classes, in accordance with the Commission directive in Formal Case 1087, Order No. 16930.[591] The results of OPC's rate design for this class are shown on page 3 of Exhibit OPC (A)-13.

[590] Exhibit OPC (A) (Dismukes) at 63:6-9.

[591] Exhibit OPC (A) (Dismukes) at 63:6-9.

It would be appropriate to address any open questions regarding rate design for this class in the separate investigation on rate design that OPC addresses below in its discussion on Issue 19.

ISSUE NO. 15(f) Should Residential Time Metered ("RTM") tariff/rates be restructured and if so, how?

Pepco proposes to increase the customer charge for the RTM class by $5.63, from $17.52 to $23.15.[592] As Dr. Dismukes explains, the customer charge revenue associated with the RTM class is 42% of its class cost responsibility.[593] Consistent with the discussion above regarding the proposed increases to customer charges for the R and AE customer classes, OPC submits that this level of revenue recovery share for the RTM rate class satisfies cost-causation principles and does not justify any dramatic change in rate design policy by the Commission in this case.[594]

OPC submits that it is premature to determine whether, and if so, how, the RTM tariff should be restructured. Rather, as explained below in response to Issue 19, the Commission should initiate a separate investigation into alterative rate designs. In that investigation, the Commission should use AMI data and other studies to determine what changes, if any, should be made to legacy tariff structures, including the RTM tariff.[595]

ISSUE NO. 15(g) Has Pepco appropriately factored in the results of its Appliance Saturation Study in its rate design?

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592 Exhibit PEPCO (2G)-1, at 6. As Dr. Dismukes explained, Pepco's proposal results in an increase of almost 32%. Exhibit OPC (A) (Dismukes) at 53:14-16.

593 Exhibit OPC (A)-15; *see also* Exhibit OPC (A) (Dismukes) at 56:21-23.

594 Exhibit OPC (A) (Dismukes) at 57:14-17.

595 Tr. at 1062:6 to 1063:12, 1065:9-11, 1065:19 to 1066:8 (Dismukes).

As discussed below regarding Issue 19, improvements that Pepco could make to its appliance saturation study could be addressed in the separate investigation on rate design that OPC recommends the Commission initiate.

ISSUE NO. 15(h) Should Pepco develop tariffs to implement rates for LED Outdoor Lighting?

OPC sees benefits in LED lighting and would not oppose a directive for Pepco to develop tariffs to implement rates for LED outdoor lighting. If the Commission does not issue such a directive in its order in this case, design of tariffs to implement rates for LED outdoor lighting may be an appropriate issue to include in the separate investigation on rate design that OPC addresses below in its discussion on Issue 19.

ISSUE NO. 16 ARE PEPCO'S PROPOSED CHANGES IN TARIFF LANGUAGE JUST AND REASONABLE? IF NOT, WHAT CHANGES SHOULD BE MADE?

A detailed discussion on the Office's position on the tariff changes is located in Issue 15, *supra*.

ISSUE NO. 17 IS PEPCO'S DISTRIBUTION CONSTRUCTION PROGRAM, AS FILED IN PEPCO (C)-1 AND (C)-2, JUST AND REASONABLE AND IN COMPLIANCE WITH ORDER NOS. 16930 AND 17424?

I. PEPCO'S DISTRIBUTION CONSTRUCTION PROGRAM HAS NOT BEEN SHOWN TO BE JUST AND REASONABLE.

Pepco's Distribution Construction Program, as filed in Pepco (C)-1 and (C)-2, contains the information required by the Commission and is in general compliance with the content and formatting obligations imposed by the Commission in Order Nos. 16930 and 17424. As demonstrated in the Office's discussion of Issue 18, however, the Construction Program Report is based on a flawed load forecasting methodology that significantly overstates demand on the Pepco distribution system. The forecasting error infects many of the construction budget items included in the Construction Program Report that are justified based on load growth that is forecasted by the

Company, but not actually occurring on the Pepco distribution system. The Office address these concerns in its discussion of Issue 18, below. In addition, the Office demonstrates in this Section that the Company should be ordered to: (i) investigate and report to the Commission on whether additional improvements to the Company's System Average Interruption Duration Index ("SAIDI") and a System Average Interruption Frequency Index ("SAIFI") could be achieved though a reduction in Customer Average Interruption Duration Index ("CAIDI"); and (ii) exclude from rates all expenses associated with Remote Monitoring Systems ("RMS") and Conservation Voltage Reduction ("CVR") until the Company has cost-justified those programs through appropriate filings with this Commission.

A. The Company Should Investigate Whether There Are More Cost-Effective Ways to Achieve Improved Reliability Than Through Additional Capital Spending.

Pepco has made substantial improvements in reliability following the adoption of the EQSS standards. Pepco witness Verner has testified that Pepco has achieved the EQSS goals with a SAIDI value of 112 minutes, or 1.86 hours, and a SAIFI value of 0.69.[596] The Company's construction program identifies additional capital expenditure programs designed to further improve those numbers. The Company has stated in this proceeding, however, that "additional improvement in reliability performance over the initial gains has become more difficult," and that because of diminishing marginal returns, "the remaining possible improvement will require more resources to achieve similar gains."[597] It is therefore reasonable for the Commission to require the Company to investigate whether there are other ways to achieve reliability gains that are more cost-effective for District ratepayers.

596 Exhibit PEPCO (C) (Verner) at 4, Table 1.

597 Exhibit PEPCO (C) (Verner) at 9:4-10.

OPC witness Mara believes that additional, cost-effective improvements in SAIDI could be achieved through a reduction in the Company's CAIDI, which can be achieved by "reducing the time to dispatch, respond to, and clear outages."[598] As Mr. Mara notes, one way to achieve an improvement in CAIDI is through the automation of distribution devices in the field such as switches and sensors,[599] which is generally the approach that the Company proposes in the Construction Program Report. Mr. Mara also believes, however, that "even more improvements in CAIDI can be gained by a review of Pepco's outage response procedures, including critical review of the available personnel, the training of these personnel for the type of outage (network, underground, overhead), the location of the personnel relative to the outage, and priority given to restoration by the field personnel."[600] Under this approach the reduction in CAIDI, and subsequently in SAIDI, is therefore "achieved through [operating and maintenance ("O&M")] spending, and not necessarily by means of capital spending."[601] As the Company has said that it will become an increasingly difficult and more expensive to achieve reliability gains through capital spending, the Commission should order the Company to prepare and submit a study investigating whether there are more cost-effective ways of achieving reliability gains through improvements in CAIDI.

B. The Company Has Not Cost Justified The RMS Or CVR Systems Included In the Construction Program Report.

The Construction Program Report includes spending on two significant programs—RMA and CVR—that the Company has not cost-justified before this Commission. As Mr. Mara explained, RMS is "a system that provides control of network transformers and monitoring of the

598 Exhibit OPC (E) (Mara) at 26:4-5.

599 *Id.* at 26:5-7.

600 Exhibit OPC (E) (Mara) at 26:7-11.

601 Exhibit OPC (E) (Mara) at 26:11-14.

network protector and its associated transformer."[602] Pepco's long-term plan is to install this technology, including the communication network, on all of its 4,200 network transformers. In 2013, Pepco estimated the capital cost to install the RMS over a 15-year period is $73.4 million which includes 3,494 network transformers remaining to be converted to RMS.[603]

In response to an OPC data request in this proceeding, Pepco provided the RMS Business Case which concluded that "RMS is a cost effective investment" and recommended that the Company "proceed to implement RMS on all transformers/network protectors in the Pepco region over the next 15 years."[604] Pepco cited a present worth analysis, which had a benefit to cost ("B/C") ratio of a "a high of 2.36/1 to a low of 1.14/1."[605] As Mr. Mara explained, however, this analysis is flawed "because it analyzes the benefits ***for Pepco*** and not for the customers that it serves and who will fund the project through rates."[606] For example, Pepco counts as a significant "benefit" from RMS the elimination of the possibility of a regulatory penalty of 50 basis points on the Company's rate of return on equity.[607] Similarly, Pepco's analysis also included an annualized potential fine of $1 million imposed by the Commission.[608] Reducing Pepco's risk of a penalty for failure to meet standards it is required to meet by law, regulation or Commission order should not be considered in a cost-benefit analysis; these are benefits to Pepco not the ratepayers that would be required to fund the RMS project. Mr. Mara concluded that "[t]he 50 basis points penalty along with the $1 million fine represent 54.7% of the benefits as

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602 *Id.* at 28:3-5; Exhibit OPC (E)-5 Pepco Response to OPC Data Request 6, Question 24 Attachment C at 4.

603 Exhibit OPC (E) (Mara) at 28:5-8; Exhibit OPC (E)-5 Pepco Response to OPC Data Request 6, Question 24 Attachment C at 8.

604 Exhibit OPC (E)-5 Pepco Response to OPC Data Request 6, Question 24 Attachment C at 5

605 *Id.*

606 Exhibit OPC (E) (Mara) at 29:5-6 (emphasis in original).

607 *Id.* at 29:6-8.

608 *Id.* at 29:12-13; Exhibit OPC (E)-5.

presented by Pepco."[609] Using the same method as the Company, Mr. Mara eliminated the 50 basis point "benefit" and the annualized $1 million fine and found the benefit to cost ratio was 0.86, meaning that the project is non-cost justified from the ratepayer's perspective.[610] Accordingly, the Company's analysis is irreparably flawed and the Commission should require the Company to exclude all RMS expense included in rates in this proceeding.

Similarly, the Company has included in its construction budget expenses associated with CVR. As a general proposition, the Office supports CVR as a load reduction measure, however, that does not eliminate the need for the Company to cost-justify the program and demonstrate that it is being implemented in a reasonable manner. For example, Mr. Mara notes that "[i]n 2013, Pepco conducted a pilot CVR program in Maryland which showed a reduction in both energy and demand by means of reducing the operating voltage by 1.5%."[611] And, in rebuttal testimony in this proceeding, Pepco witness Verner submitted a "Impact Evaluation of Pepco Maryland's Phase I Conservation Voltage Reduction (CVR) Program."[612] Accordingly, it appears that the Company demonstrated benefits to the Maryland Public Service Commission as part of a phased implementation of CVR in that jurisdiction. This Commission deserves the same opportunity before the Company begins recovering any costs associated with CVR in the District. The Commission should therefore order that the Company suspend any further rollout of CVR in the District until the program has been cost-justified and authorized by the Commission.

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609 Exhibit OPC (E) (Mara) at 29:14-15; Exhibit OPC (E)-5.

610 Exhibit OPC (E) (Mara) at 30:1-2.

611 *Id.* at 27:5-7; *see* Exhibit OPC (E)-3, Sanem Sergici, The Brattle Group (in collaboration with Pepco MD), "Conservation Voltage Reduction Econometric Impact Analysis," presented to AESP Spring Conference, May 11, 2016.

612 Exhibit PEPCO (3C)-1.

ISSUE 18 ARE PEPCO'S SHORT-TERM AND LONG-TERM LOAD FORECASTS REASONABLE?

I. PEPCO'S LOAD FORECASTING SIGNIFICANTLY OVERESTIMATES ACTUAL DEMAND AND IS NOT REASONABLE.

The unrebutted evidence of record in this proceeding demonstrates that the Company's load forecasts significantly overestimate load on the Pepco distribution system when compared to the actual, observed load levels in the District. The Company concedes that while actual system load growth in the District has been negative since 2011, the Company's load forecasts have continued to project significant increased load in every year since 2011.[613] The Company also concedes that until very recently its load forecasting methodology ignored: (i) improvements in energy efficiency; (ii) increased levels of distributed generation operating in the District; and (iii) increased enrollment in demand response programs.[614] In short, the Company's load forecasts are completely divorced from the realities of what has been and is occurring in the District of Columbia and on its distribution system—including the impacts of policy initiatives of the District Government and this Commission—that have changed energy consumption patterns by consumers on the Pepco distribution system.

The Company does not deny that its load forecasts are significantly overstated when compared to actual loads. Instead, the Company's position is that actual loads are not relevant for load forecasting. Pepco witness Hall testified that "[t]he purpose of load forecasting is not to predict actual demand that will be experienced on the system from year to year."[615] Rather, Mr. Hall claims that "the purpose of load forecasting is to plan for the potential peak under extreme

613 Tr. at 806:14-807:2.

614 *Id.* at 803:1-8.

615 Exhibit PEPCO (2K) (Hall) at 7:3-4.

(on-in-ten) weather, which can occur during any summer peak period."[616] The Office recognizes that planning to the one-in-ten peak (referred to as the 90/10 methodology) is common in the industry and that there is a legitimate need to plan for extreme weather conditions, but the Pepco's application of the 90/10 methodology has resulted in Company investment in excess system capacity based on forecasts that are routinely 8%-18% above the actual load in the District. Contrary to the Company's position in this proceeding, this sizable overestimation of future load cannot be attributed to weather variance alone.

As the Commission is well aware, the Office has been a leading advocate for improved Pepco reliability for more than a decade. The issue with Pepco's forecasting methodology is not whether it should include a margin for extreme weather: it should. The issue is how to balance the need for a reasonable margin for reliability against the costs of an over-built distribution system that is premised on ever-increasing load growth projections when the reality is that load in the District is not growing, it is declining. Pepco's historical load growth methodology, and its "new" methodology just implemented in October 2016, contain significant upward biases.

The evidence in this proceeding demonstrates that the Company immediately recognizes and incorporates into its load forecasts all new information that is likely to increase forecasted load (*e.g.* the additional of prospective new businesses ("PNBs") on the distribution system), but it ignores available information that would decrease future load levels (*e.g.* increased use of more energy efficient air conditioning and other home appliances). This mismatch creates a pronounced upward bias in the Company's load forecasts that will inevitably result in District ratepayers funding construction projects to expand system capacity projects that are either unnecessary or could be delayed.

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616 Exhibit PEPCO (2K) (Hall) at 7:4-6.

Furthermore, the advances in technology (including the deployment of Advanced Metering Infrastructure ("AMI") and improved system modeling and weather forecasting) offer an opportunity to refine Pepco's load forecasting approach to more accurately predict future load. Updating the Company's approach would permit the Company to account for District Government and Commission policies, as well as changing economics and customer usage trends, that have and will continue to drive changes in energy consumption on the Pepco distribution system. These factors compel a reexamination of the appropriateness of the 90/10 methodology and, in particular the application of that approach by the Company.

OPC witness Mara has provided an example of methodology that incorporates recent load and energy usage data and adjusts those data points to account for the risk of extreme weather. The Office requests that the Commission institute a separate proceeding to investigate ways of improving Pepco's load forecasting in order to ensure that the appropriate balance between the Company's construction budget and the risk of outages during extreme weather conditions.

A. The Company's Approach Significantly Overstates Load on the Pepco System.

In Order No. 17816, the Commission ordered the Company to submit, as part of the Company's 2015 Annual Consolidated Report, five years of historical Pepco load forecasts versus actual demand experienced on the Pepco distribution system.[617] The results, reported by Pepco and reproduced in the graph below, show that Pepco's load forecasts consistently overestimated demand in each year from 2010 through 2015.[618]

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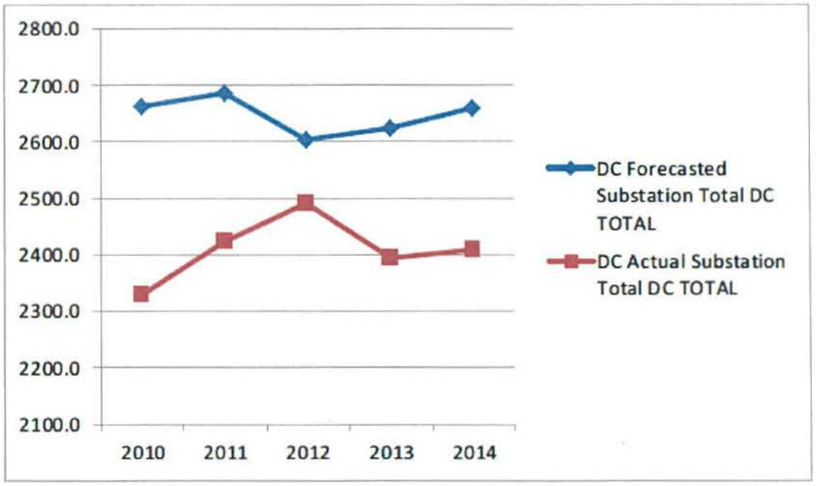
617 *Formal Case No. PEPACR-2014-01, In The Matter Of The Commission's Fuel Adjustment Clause Audit And Review Program-Annual Consolidated Report*, Order No. 17816 at ¶ 169, rel. Feb. 27, 2015.

618 OPC Cross Examination Exhibit 59 at 13.

Comparison of Forecasted Loads versus Actual Loads

Loads in Mega-Volt-Amperes (MVA)



	2010	2011	2012	2013	2014	
DC Forecasted Substation Total	**2661.2**	**2684.6**	**2603.3**	**2623.9**	**2660.6**	Avg. Trend = -0.01%
DC Actual Substation Total	**2328.3**	**2422.9**	**2491.6**	**2394.5**	**2409.9**	Avg. Trend = -0.12%
Variance from Forecasted to Actual	**10%**	**8%**	**9%**	**9%**	**15%**	

Notes: All substations supply 13.8kV of primary power unless otherwise noted.
Trends shown are based on the straight line regression of the loads
2010 Forecasted loads from the 2010 Consolidated Report - Table 2.2-C
2011 Forecasted loads from the 2011 Consolidated Report - Table 2.2-C
2012 Forecasted loads from the 2012 Consolidated Report - Table 2.2-C
2013 Forecasted loads from the 2013 Consolidated Report - Table 2.2-C
2014 Forecasted loads from the 2014 Consolidated Report - Table 2.2-C

Mr. Mara demonstrated that the Company's forecasting also overstates load at the substation level. For example, Mr. Mara's analysis of the Benning Substation No. 7 showed that the Company's three-year forecasted demand were overstated by as much as 40%.[619]

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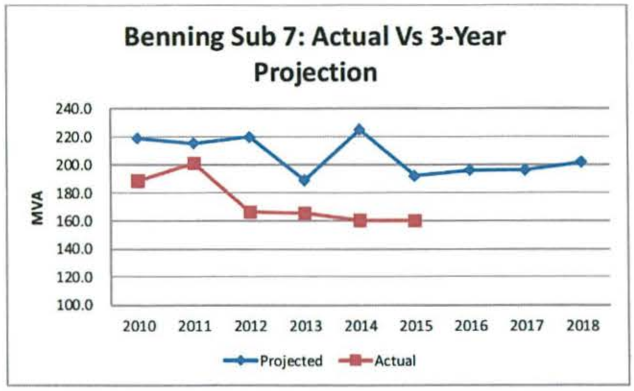
619 Exhibit OPC (E) (Mara) at 36:14-37:2; Exhibit OPC (E) (Mara), Fig. OPC (E)-6.

Benning Substation	2010[1]	2011[2]	2012[3]	2013[4]	2014[5]	2015[6]	2016[7]	2017[8]	2018[9]
Projected	218.7	215.2	219.9	188.9	224.9	192.1	196.3	196.5	201.9
Actual	189.0	201.3	166.8	165.9	160.7	160.2			
Variance	16%	7%	32%	14%	40%	20%			

[1] Forecasted loads from the 2008 ACR - Table 2.2C
[2] Forecasted loads from the 2009 ACR - Table 2.2C
[3] Forecasted loads from the 2010 ACR - Table 1.2C
[4] Forecasted loads from the 2011 ACR - Table 1.2C
[5] Forecasted loads from the 2012 ACR - Table 1.2C
[6] Forecasted loads from the 2013 ACR - Table 1.2C
[6] Forecasted loads from the 2014 ACR - Table 1.2C
[6] Forecasted loads from the 2015 ACR - Table 1.2C
[6] Forecasted loads from the 2016 ACR - Table 1.2C



Pepco, through its witness Hall, has taken the position in this proceeding that the variances identified by Mr. Mara and reported by the Company in the 2015 Consolidated Report should be expected because the Company is forecasting to account for "extreme" weather which will not be present in all years.[620] The evidence of record in this proceeding, however, demonstrates that the Company's forecasting errors cannot be attributed solely to weather variances. For example, if the Company's forecasting method was accurate, the Company's load forecasts should be close to actuals in years when extreme weather is actually experienced on the Pepco distribution system. But when the system experienced extreme weather conditions in 2011 and a new 90/10 peak was established, the Company's load forecasts still overestimated demand by 8% or approximately 262 MVA. Mr. Hall conceded during cross examination that none of this error could be attributed to weather variation.[621]

The Company's data also shows that once a new 90/10 peak is established, the Company's load forecasts become increasingly inaccurate over time. In the 2015 Consolidated

620 Exhibit PEPCO (2K) (Hall) at 7:3-4; OPC Cross Examination Exhibit 18.

621 Tr. at 1775:2-5 (Hall).

Report, the Company reported that "[t]he reason for the 8% variance [in 2011] was due to accumulation of error in assumed load going in service over the years between the previous 90/10 peak 2007 and the new 90/10 peak of 2011."[622] The available data suggests that this same trend is occurring again. By 2014, the Company's load forecasts were overstated by 15%, and Commission Staff's review of data reported in the 2016 Annual Consolidated Report found that in 2016, the Company's load forecast was overstated by 18%.[623]

Pepco's significantly overstated load forecasts can result in unnecessary expense for District ratepayers. Mr. Mara conducted a review of the Company's load forecasts beginning with the 2008 Annual Consolidated Report and found that the projected system load for 2015 was 2,932.0 MW.[624] The Company reported actual demand of 2,274.9 MW in 2015.[625] While some error can be expected in an 8-year forecast, the Company's load forecast was overstated by approximately 650 MW meaning that the forecast would have caused the Company to construct potentially unnecessary facilities to expand the distribution system for unrealized load growth. In an attempt to put the costs of such forecasting error in perspective, Mr. Mara notes that "the new Waterfront Substation has an ultimate capacity of 350 MVA with a projected install cost of $187 Million."[626]

The Company's margin of error is also unreasonable when compared to available data for Baltimore Gas & Electric Company ("BGE"), a neighboring utility and, like Pepco, an Exelon Company. Commission Staff prepared an analysis of BGE's load forecasting as part of the 2016

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622 OPC Cross Examination Exhibit 59 at 5.

623 OPC Cross Examination Exhibit 61 at 2.

624 Exhibit OPC (E) (Mara) at 37:7-9

625 *Id.* at 37:10.

626 *Id.* at 38:5-7.

ACR proceeding and found that, between 2009 and 2014, BGE's mean absolute percentage load forecasting error was 4.8% or 1.1% using weather-normalized data is used.[627] During that same time, Commission Staff found that Pepco's mean absolute percentage error was 11.4%.[628]

When presented with this data in the 2016 Consolidated Report Proceeding, the Company responded to Commission Staff by citing "mild summer weather conditions" in 2014 and 2015.[629] But mild weather alone cannot explain the significant overstatement in the Company's load forecasts. Mr. Mara testified that he reviewed data for the PHI companies and found that for the eight-year period ending in 2012, the 2011 peak was "only about 4 percent higher" when compared to the average peak.[630] Similarly, Mr. Hall testified that an "adjustment reflecting the weather impact between 2011 and 2016 is 3% . . . ."[631] Pepco's position cannot be reconciled with the fact that BGE was able to accurately predict load on its system while experiencing weather that was the same or very similar to the weather that Pepco claims was the source of its 11.4% average forecasting error.[632] The evidence in this proceeding therefore demonstrates that the significant variance between the Company's forecasts and the actual load measured on the Pepco system cannot be explained away as a simple weather adjustment. To the contrary, the record demonstrates that there are several sources of error that create the significant upward bias in the Company's load forecasting methodology.

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627 OPC Cross Examination Exhibit 61 at 4.

628 OPC Cross Examination Exhibit 61 at 2.

629 *Id.*

630 Tr. at 1223:19-22 (Mara).

631 Exhibit PEPCO (2K) (Hall) at 13:2-3.

632 Mr. Hall testified that the weather experience in Baltimore and the District would be similar. Tr. at 1785:14-17 (Hall).

1. The Company's Load Forecasting Ignores Changes In Consumption Patterns That Have Occurred Since The Last 90/10 Peak.

The Company's load forecasting process begins with an analysis of historical load in the District. Under the 90/10 methodology, the Company identifies the highest peak load experienced in the District in the past 10 years.[633] It is from this one-in-ten, extreme peak that the Company begins its load forecasting.[634] Currently, the Company's load forecasts are based on the system peak that was observed on July 22, 2011, when the temperature in the District reached 102 degrees Fahrenheit.[635] In each successive year, Pepco calculates load forecasts with this peak demand data as a baseline; adds the Prospective New Business ("PNB") load for each feeder and modified the peak load based on load transfers and prior system construction work.[636] This adjusted 2011 peak demand is then compared to the latest seasonal peak loads as recorded by the Company's SCADA. The higher of the latest seasonal peak and the adjusted 2011 peak is used as the forecast base value.[637] Mr. Hall confirmed that in each year since 2011, the metered demand has been lower than the 2011 peak and, therefore, the Company has retained the 2011 peak as its starting point for load forecasting.[638]

The problem with Pepco's approach is that it does not account for the significant changes in energy consumption patterns since 2011, which have resulted in decreased energy usage on the Pepco distribution system. As Mr. Hall testified, the 2011 peak load includes a snapshot of the Distributed Energy Resources ("DER")—which he defines as the energy efficiency,

633 Exhibit PEPCO (K) (Hall) at 7 n.3

634 *Id.* at 7:9-14.

635 Exhibit OPC (E) (Mara) at 46:6-8.

636 Exhibit OPC (E)-12 (Mara), Pepco Response to OPC Data Request 13, Question No. 7, Attachment C at 8.

637 Exhibit OPC (E)-13 (Mara), Pepco Response to OPC Data Request 13, Question No. 7, Attachment C at 9.

638 Tr. at 800:2-22 (Hall).

distributed generation, and demand response—that existed and happened to be running at the time of the 2011 peak.[639] But the Company's approach does not account for increased DER penetration that has occurred since 2011 and that will continue in the forecasted years.

During questioning from Chairman Kane, Mr. Hall conceded that the Company's load forecasting methodology does not capture many of the recent developments fostered by District policy that serve to reduce energy consumption in the District. For example, the Company's load forecasting does not account for LEED certification of District buildings[640] or changes to the building codes including the adoption of the green building code.[641] Mr. Hall also conceded that the Company can only capture increased installation of distributed solar generation after they have been installed, despite the existence of District laws requiring that 2.5% of electric energy must come from solar facilities by 2023.[642] Similarly, Mr. Hall states that the Company's forecasts would only be able to account for the impacts of the DC Solar For All program on an after-the-fact basis.[643]

Mr. Hall contends that these flaws in the Company's load forecasting are acceptable because "[i]n prior time periods, the impact of these systems on peak load did not have any significant impact and the historical review of actual loads included any impacts that may have occurred,"[644] but that contention is vastly overstated. In Order No. 17424, the Commission found that Pepco's load forecasting was flawed because it failed to consider the effects of demand response resources that existed in 2013.[645] The Commission noted that "in prior proceedings Pepco estimated that

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639 Tr. at 802:17-22 (Hall).

640 *Id.* at 838:4-9.

641 *Id.* at 839:19-840:2.

642 *Id.* at 840:9-841:9.

643 *Id.* at 841:10-842:7.

644 Exhibit PEPCO (K) (Hall) at 4:18-20.

645 *Formal Case No. 1103*, Order No. 17424 at ¶ 538.

direct load control programs will reduce peak load by 24.9 MW and indicated that its dynamic pricing program is expected to achieve a peak demand reduction in the District by 40 MW by 2017."[646] The Commission, therefore, was concerned that significant amounts of DER and other load reducing programs that existed four years ago were ignored by Pepco's methodology. The Commission directed Pepco in Order No. 17424 "to explain in its next Construction Program Report how the Demand Response program in the District is factored into its load forecast which is used to determine the need and timing for certain construction projects."[647] In response, the Company submitted a Construction Program Report based on the same flawed load forecasting approach that the Commission ordered the Company to change in Order No. 17424.

The Construction Program Report is based upon forecasts of load increases but not on forecasts of load reducing developments such as energy efficiency, DER, and the policies of the District. It seems clear that Pepco will not properly account for the increased penetration of energy efficiency, distributed generation and other load reducing developments unless the Commission establishes a proceeding to investigate and establish precisely how that should be done as part of a new load forecasting methodology based upon best industry practices.

2. The Company's Load Forecasts Ignore The Diversity Inherent On The Distribution System.

Mr. Hall testifies that the Company's forecasts plan to the non-coincident peak on each feeder and those numbers are "rolled-up" to create a system-level forecast. Mr. Hall states that because the Company must "deliver[] energy to each individual customer such that each individual customer will always be reliably served, whenever energy is needed,"[648] the Company

646 *Id.*

647 *Id.*

648 Exhibit PEPCO (2K) (Hall) at 7:12-14.

must plan to the non-coincident peak on the Distribution system. While this argument may be true at the individual customer or feeder level, it ignores the ability of the Company to transfer load at the substation level as part of its normal operations. In Order No. 17819, the Commission noted that Siemen's audit had challenged Pepco's practice of maintaining firm capacity at the substation level as opposed to the system level:

> Siemens notes, however, that while Pepco has a practice of maintaining individual substation firm capacity, some utilities do not require this, but instead, firm capacity is maintained at the Planning Area level. Pepco's procedure, Siemens concludes, is conservative but may not be optimum.[649]

Similarly, the Company's Construction Program Report indicates that Pepco ratepayers have paid for and continue to fund reliability upgrades that allow the Company to monitor and "redirect the flow of power in real time."[650] The effect of this capability is to allow the Company to move load from one substation to another in times of high demand. The Company's load forecasts, however, ignore this capability and instead assume that every substation must be built to accommodate its non-coincident peak load.

This practice creates another upward bias in the Company's forecasts and may result in unnecessary construction because, as Mr. Hall testified, "Pepco's project planning is derived from the local area substation and feeder forecasts and not from any overall system forecast, be it

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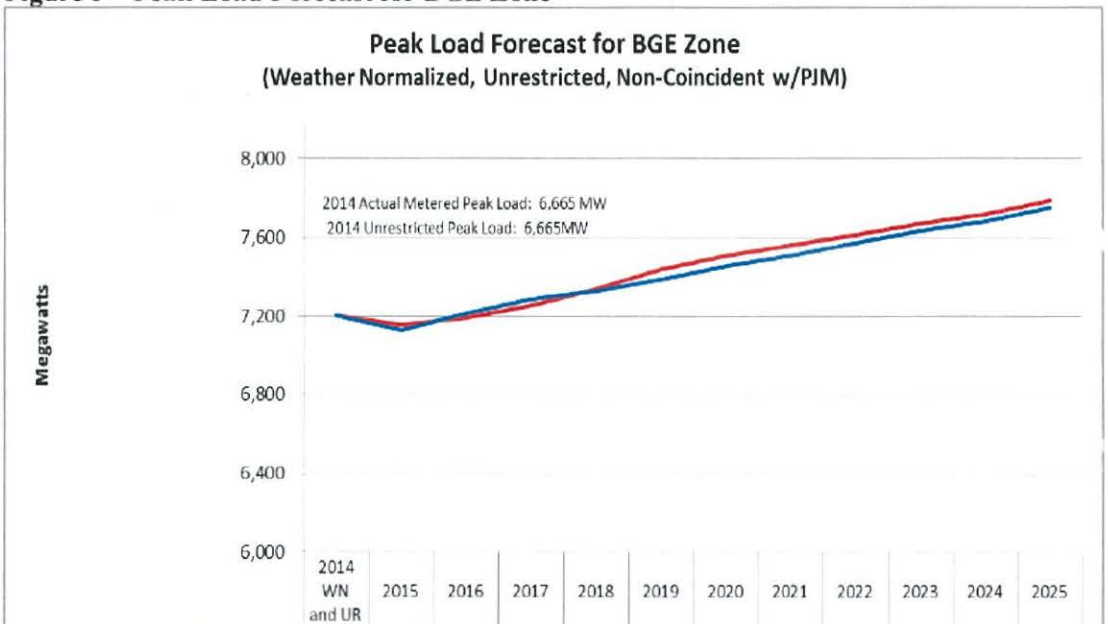
649 *RPS 15-30, In The Matter Of The Application Of U.S. Photovoltaics, Inc. For Certification Of The Pansegrouw Residence Solar Energy Facility As A Renewable Energy Standards Generating Facility*, Order No. 17819 at ¶ 158, rel. Mar. 4, 2015.

650 Exhibit PEPCO (C)-1 (Verner) at 96.

Pepco's or PJM's"[651] Mr. Hall contends that planning to Pepco's coincident system peak would create reliability problem and therefore contends that a comparison of the Company's load forecast to the PJM load forecast is inappropriate.[652] In contrast, in a May 28, 2015 filing made with the Maryland Public Service Commission, BGE stated that it was confident that its forecast were accurate because it "lines up well with the PJM forecast in the near term."[653] As part of that filing, BGE submitted the following graph demonstrating that the BGE load forecast and the PJM load forecast were nearly identical through 2025.[654]

Figure 1 – Peak Load Forecast for BGE Zone



	2014 WN and UR	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
BGE Peak Load Forecast 2015	7,200	7,155	7,190	7,258	7,340	7,439	7,507	7,563	7,616	7,672	7,722	7,787
PJM Peak Load Forecast 2015	7,200	7,127	7,212	7,287	7,330	7,388	7,457	7,511	7,573	7,637	7,685	7,753

All-time metered peak load of 7,236 MW was recorded on July 21, 2011 @ 99°F

OPC Cross Examination Exhibit 60 at 2, Fig. 1.

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651 Exhibit PEPCO (2K) (Hall) at 8:13-14.

652 *Id.* at 7:10-22.

653 OPC Cross Examination Exhibit 60 at 1.

654 *Id.* at 2.

Pepco's position with respect to system level planning is another example of how the Company ignores the reality on its system. Unlike its neighboring Exelon Company, Pepco does not believe that its load forecasts should reflect the realities of its system capability or closely track the actual load that will be experienced on the system. Indeed, Mr. Hall has taken the position that it is reasonable for the Company's load forecasts to overstate demand by 15% or more when compared to the actual load experienced on the system.[655] The evidence in this proceeding demonstrates that the margin of error in Pepco's load forecasts is unreasonable, and that other utilities in the area have demonstrated to their regulators that comparisons to actual demand can and should be used to test the assumptions underlying a load forecast and to determine if those forecasts are reasonable.

3. The Company Overstates the Impact of New Residential and Business Loads.

Once the analyzed historical peak load is determined, the Company continues the load forecasting process by adding load to account for Prospective New Businesses ("PNBs") on its system. As Mr. Mara explained, the Company assumes that there is no diversity associated with this load.[656] Mr. Hall confirmed that if, for example, eight new businesses were expected to go into service on the same feeder, the Company's load forecast would assume that all of those businesses would be contributing their assumed output to the peak at the time of the peak on that feeder. As with the Company's use of an unadjusted 90/10 peak and the Company's insistence on planning to the non-coincident peak, the Company's treatment of PNBs creates an upward bias in the Company's load forecasts.

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655 OPC Cross Examination Exhibit 18.

656 Exhibit OPC (E) (Mara) at 49:1-7.

In addition, the Company states that "[n]ew loads are added at the anticipated level of load that PHI expects a building of the same size and energy use would add to the distribution system."[657] Mr. Hall testified that these estimated are performed by taking AMI meter readings from similar buildings to estimate the expected usage during the forecast period.[658] Mr. Hall conceded, however, that using historical meter readings to estimate the amount of load that a new commercial building or residential home would add to the system cannot account for improvements in building practices since the last time the Company made its estimate and cannot account for increased energy efficiency measures, or increased penetration of distribution energy resources during the forecasted period.[659] Accordingly, the Company's load forecasts are likely to overstate energy usage in the forecasted period and, as the Company reported in the 2015 Consolidated Report, this can be a significant source of forecasting error.[660]

B. The Company's Revised Load Forecasting Methodology Is Incomplete And Will Not Fix the Company's Forecasting Problems.

Pepco has presented a moving target with respect to load forecasting in this case. The Company desires that the Commission ignore the flaws in the historical approach used by the Company and instead focus on a new approach that the Company began implementing in September of 2016 and finalized on October 1, 2016. That methodology, however, was not completed until well after the Company's Construction Program Report was submitted in this case,[661] is entirely untested, and does not appear to fix the errors in the Company's historical methodology that produce a significant upward bias in the Company's load forecasts.

657 Exhibit PEPCO (K) (Hall) at 7:18-8:2.

658 Tr. at 819:9-820:12; OPC Cross Examination Exhibit 14.

659 Tr. at 821:17-823:2; OPC Cross Examination Exhibit 13.

660 OPC Cross Examination Exhibit 59 at 4-5.

661 Tr. at 810:9-811:4.

Furthermore, while presented as an entirely new methodology, the changes made by the Company only effect the one aspect of the Company's forecasting—*i.e.*, treatment of DER—and, as discussed below, does so in a way that is not likely produce much change to the Company's forecasts for the foreseeable future.

Pepco did not file its new load forecasting methodology in this case. It was not until the Office submitted a data request to Pepco,[662] that the addendums to the Company's Distribution System Planning and Design Criteria implementing the new methodology were even produced by the Company in this proceeding. Furthermore, the documents that have been produced by the Company evidence that the planning process is a work in progress and may be subject to change by the Company. For example, the Company's new DER Addendum to Distribution System Planning and Design Criteria provides:

> *Note: PHI's load forecasting methodology includes some amount of load reduction from non-firm DERs. This occurs because there are occasions when such a resource, while not firm, provides a load reduction that is coincident with a facility peak, and as such, is embedded in the historical AMI and SCADA reading that serve as an input to the forecast. To the degree that the distribution system may thus become "underbuilt" in the future because of the inclusion of these coincident load historical reductions which may or may not exist in future years, this is for the time being to be not considered a material factor, *pending future additional study*.[663]

662 The Company's addendums to the current planning manuals were produced by the Company in response to OPC Data Request 13-7.

663 OPC Cross Examination Exhibit 11 at Attachment B at 9 (emphasis supplied).

Accordingly, despite the clear evidence that the Company's failure to consider energy efficiency, distributed generation, and demand response resources in its past load forecasts has produced severely overstated load forecasts, the Company's updated forecasting methodology suggests that the Company believes it may have been ***underbuilding*** its system because its meters picked up load reductions that the Company considers to be non-firm DER in past readings. It is also troubling that, despite this Commission's directive to the Company in Formal Case No. 1103 to address demand response resources in this rate case, the Company's new methodology to address DER is subject to "future additional study." There is therefore no basis for the Commission to find that the new load forecasting process is reasonable on the basis of this record. At a minimum, the Commission should conduct a thorough review of the Company's proposed methodology, understand how the process will be implemented, and assess whether the forecasts it produces are reasonable.

What is clear from a review of the Company's new planning documents is that many of the same problems that have produced the upward bias in the Company's historical planning process will persist under the new methodology. For example, the Company's new DER Addendum to PHI System Planning Group Procedures Manual reveals that the Company intends to rely on information provided by the DC Sustainable Energy Utility to adjust historical load levels for energy efficiency measures occurring in the District. During cross examination from Chairman Kane, it became clear that the Company's new proposal would ignore energy efficiency measures other than the small portion of such activity reported by the DC Sustainable Energy Utility.[664]

Furthermore, in response to an OPC data request regarding the implementation of the new DER methodology, the Company reported that it had adjusted the 2016 analyzed historical peak,

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664 Tr. at 836:5-837:12.

but the data response indicated that the Company had made no update to the current 90/10 peak from 2011.[665] This is troubling for several reasons. First, as discussed above, much of the overstatement in the Company's current load forecasts can be attributed to the fact that those forecasts only reflect the DER penetration that was "baked-in" to meter reading in 2011, but ignores all of the advancements in energy efficiency, green building technology, distributed generation, and demand response that has occurred since 2011. If the Company only adjusts the historical analyzed load from 2016 forward under the new methodology for the load-reducing effects of DER, there will be a significant bias when the Company compares those seasonal peaks to the 2011 peak. As it is the Company's practice to use the highest load recorded as between the last 90/10 peak and the most recent seasonal peak, the impact of the Company's approach will most likely be to ensure that the 2011 will remain the starting point for the Company's load forecast until it becomes too old to be considered a 90/10 peak. And, when the Company reviews the demand over the past 10 years in 2021, it is likely that one of the unadjusted peaks (*i.e.*, 2012, 2013, 2014, and 2015) will be higher than the DER-adjusted peaks and will become the new 90/10 peak. It will not be until 2025, when the Company has ten years of DER-adjusted data under its new methodology, that the Commission and District ratepayers are likely to see 90/10 peak established that is not infected with upward biases of Pepco's old methodology.

The Company presented its new approach as a means to "take into account the changes that are likely to occur relative to energy efficiency and other distributed resources,"[666] but it appears that the Company's new approach will only ensure that the problems in the Company's load

665 OPC Cross Examination Exhibit 58.

666 Exhibit PEPCO (K) (Hall) at 4:15-16.

forecasting will linger far longer than necessary. The Commission should not permit such a result under the guise of addressing the impacts of DER in the District.

C. The Commission Should Institute a Separate Proceeding To Investigate the Company's Load Forecasting Methodology.

As discussed above, the Company's new approach to account for DERs is untested, incomplete, and unlikely to address many of the flaws that produced the significant upward bias in the Company's past load forecasts. The Office therefore requests that the Commission institute a separate proceeding to investigate the Company's load forecasting methodology and to determine what changes and improvements can be made to more accurately predict load levels on the Pepco distribution system.

Mr. Mara has provided an example of an alternative forecasting approach that ties load forecasts to forecasted energy consumption thereby accounting for recent economic and usage trends in the forecast.[667] Mr. Mara explained that comparing the energy forecast to the load forecast permits a forecaster to check on the reasonableness of the load forecast against the load factor required to reach the peak forecast.[668] For example, as Mr. Mara demonstrated, the load factor for the Pepco system has varied from 0.536 to 0.613 between 2010 and 2015.[669] But to hit Pepco's projected load for 2018, the load factor would have to be 0.445, which is not reasonable in light of the history of energy usage on the Pepco system.[670]

1Mr. Mara explained during the hearing that using these multiple forecasting approaches as a check allows for the creation of a target—which Mr. Mara referred to as a "dart board"—

667 Exhibit OPC (E) (Mara) at 57:20-22.

668 *Id.* at 57:19-20.

669 *Id.* at 58:1-3; Exhibit OPC (E)-9.

670 Exhibit OPC (E) (Mara) at 58:4-6.

that allows the forecaster to test whether their assumptions are in a reasonable range.[671] Pepco does not do this type of sanity check; rather as Mr. Mara explained, "[w]hat Pepco is doing is a single shot, and we have no idea if it even hit the wall, let alone the dart board."[672]

In addition, Mara explained how the Company could remove the stale data that infects the Pepco load forecasts while still accounting for extreme weather:

> [T]he forecasting should rely more on recent history and less on past peak data that is more than 5 years old. The reliance on the 2011 past peak ignores the changes at the customer premises in terms of energy efficiency and behind the meter resources. If the load projections are made based on recent history, then adjustments can be made for 90/10 peak if so desired. Essentially, the load projection can be based on the previous few years' data coupled with Pepco's PNBs. This would result in what can be described as a "weather normal" projection. This weather normal projection can then be modified using a "U" curve that displays the relationship between temperature and demand.[[673]]

Mr. Mara explained, by way of example, that an alternative load forecasting method could start with the 2015 peak with the embedded new loads, new energy efficiency, the effects of DER, and demand response programs and add new loads/growth to the 2015 peak value.[674]

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671 Tr. at 1221:11-1222:1.

672 *Id.* at 1222:2-4.

673 Exhibit OPC (E) (Mara) at 58:7-15.

674 *Id.* at 60:8-10.

This weather normal projection could be adjusted for the effects of the 90/10 peak weather.[675] These approaches should be vetted by the Company and reported to the Commission.

Pepco, in introducing its new methodology, has conceded that its historical approach to load forecasting is flawed, but the Company failed to submit its new approach to this Commission in a way that permitted a full vetting of the reasonableness of the Company's new proposal. Currently, OPC, the Commission, and interested stakeholders do not have enough information about how the new forecasting methodology will work and, in particular, the reasonableness of the forecasts that it will produce. The Commission should therefore institute a separate proceeding in which to fully vet the proposal as well as the alternative approaches suggested by Mr. Mara in this proceeding. The Office submits that the Commission should require that this proceeding be finalized and an order issued by the Commission before the Company submits its next rate case so that the projects identified in the Construction Program Report can be properly scrutinized.

ISSUE NO. 19 SHOULD THE COMMISSION EXPLORE ALTERNATIVE RATEMAKING STRUCTURES? (FOR EXAMPLE, A FULLY FORECASTED TEST YEAR, PERFORMANCE BASED RATEMAKING ("PBR"), PRICE REGULATION, RANGES OF AUTHORIZED RETURN, CATEGORIES OF SERVICES, PRICE-INDEXING, AND OR OTHER ALTERNATIVE MECHANISMS). IF SO, WHICH, WHY, AND WHAT ELEMENTS OF PEPCO'S RATES, INCENTIVES, AND OPERATIONS AND EXPENSES ARE POTENTIAL CANDIDATES FOR PBR?

Pepco's initial application did not contain any request for the alternative ratemaking structures identified in Issue 19. After the Commission established Issue 19, however, Pepco sponsored Supplemental Direct Testimony that helped establish the scope of the alternative ratemaking structures to be addressed under Issue 19. In practical terms, Pepco limited the scope

675 *Id.* at 60:11-12.

of the issues by electing not to sponsor testimony on performance based ratemaking, price regulation, ranges of authorized return, categories of services, or price-indexing.[676] Rather, Pepco focused its pre-filed testimony on "two separate categories" of alternative ratemaking.[677]

The first category involves "alternative rate designs," which, according to Pepco, address the manner in which it allocates its total revenue requirement to customers. OPC addresses alternative rate designs in sub-section 1 below. The second category involves "alternative recovery mechanisms," which, according to Pepco, address the manner in which it recovers its investments.[678] More specifically, Pepco states that "[a]n alternative recovery mechanism establishes a process to set rates outside the context of a formal rate case."[679] Pepco asks the Commission to consider two alternative recovery mechanisms, *i.e.*, a fully forecasted test year and a multi-year rate plan.[680] OPC addresses alternative recovery mechanisms in sub-section 2 below.

1. At the Close of this Case, the Commission Should Initiate a Comprehensive Investigation of Alternative Rate Designs.

Pepco asks the Commission to establish a separate proceeding to evaluate the various rate design options in the District of Columbia.[681] In support of that request, Pepco explains that a separate proceeding is warranted given: (1) the level of analysis required and the need for input

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676 Tr. at 191:18 to 193:2 (McGowan).

677 Exhibit Pepco (2B) at 10:1-5; Tr. at 129:1-5 (McGowan).

678 Exhibit Pepco (2B) at 10:1-3.

679 Exhibit Pepco (2B) at 10:8-9.

680 As explained below, Pepco does not ask the Commission to adopt any specific proposals. Rather, it focuses, conceptually, on these two mechanisms and asks for the Commission's blessing to provide details in the future.

681 Exhibit Pepco (2B) at 14:5-7.

from interested stakeholders;[682] and (2) the complexity and importance of the policy issues underlying potential changes to rate design.[683] OPC agrees that reassessing the District's rate design is a complex undertaking that would involve review of a substantial volume of data and analyses. OPC sees great value in undertaking that reassessment, and concurs that the Commission should initiate a separate proceeding to explore potential changes to rate design.[684] However, precisely because of the complexity involved in such an undertaking, OPC takes different view than Pepco with regard to the appropriate scope of such an investigation.

The record in this proceeding, and the collective experience of the parties over the past few years, demonstrates a compelling need for a comprehensive, holistic review of all of the components and considerations influencing a decision on the appropriate level of Pepco's base rates. For example, record evidence was elicited on the following major issues: (1) Pepco's continuing investment in substantial reliability infrastructure and O&M; (2) the affordability of rates for senior citizens, customers enrolled in the RAD program, low-income customers that are not enrolled in the RAD program, the working poor, and the middle class;[685] (3) the extent to which different customers classes benefit from reliability investments; (4) the manner in which different customers use the system; (5) the Commission's desire to place a greater emphasis on customer charges and demand rates and less emphasis on volumetric charges; (6) the Commission's desire to eliminate negative class rates of return; (7) the opportunity to use AMI data to inform decisions on rate design; (8) what improvements Pepco could make to its load

682 Exhibit Pepco (2B) at 14:4-7.

683 *See* OPC Cross Examination Exhibit #7 at 3-5.

684 *See, e.g.*, Tr. at 1028:6-22 (Dismukes).

685 Tr. at 1082:17 to 1083:9 (Dismukes).

research, demand analysis, and appliance saturation study to produce more useful data;[686] (9) whether Pepco's current rate classes are relevant in today's market or whether they should be restructured;[687] (10) whether the BSA should be discontinued; and (11) the Commission's interest in alternative ratemaking structures.

Given the interrelated nature of these important issues, OPC cautions against a parochial focus on any one issue or a subset of issues in isolation.[688] Instead, OPC recommends that the Commission take a step back, establish a new proceeding to thoughtfully consider these interrelated issues in a comprehensive manner, and chart a course for the future that accounts for the complexities of the changing utility and regulatory landscapes and also harmonizes the District's various policy goals. Despite its recommendation about charting a course for the future in a new proceeding, OPC recognizes that these interrelated issues discussed above are important on another time horizon. Namely, OPC readily acknowledges that the Commission must also make a decision on the requested revenue requirement increase that is pending in this case. Consequently, OPC's recommendations in the instant case balance these timing considerations.

For example, Pepco proposes to allocate the rate increase that is ultimately granted in this case in a manner that moves toward the goal of eliminating negative class rates of return.[689] OPC recommends that the Commission accept Pepco's proposal *in this case.*[690] However, in this

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686 *See generally* Tr. at 761:16 to 784:2 (colloquy between Chairman Kane and Pepco Witness Janocha).

687 Tr. at 1062:6-18 (Dismukes).

688 Tr. at 1074:9 to 1075:14 (colloquy between Chairman Kane and OPC Witness Dismukes).

689 Exhibit Pepco (B) at 7:15 to 8:5.

690 Exhibit OPC (A) at 13:2; *see also* Tr. at 1026:17-21, 1031:13-16, and 1093:9-22 (Dismukes); *id.* at 1073:14-21 (colloquy between Chairman Kane and OPC Witness Dismukes).

case it would be imprudent to prejudge the percentage rate increases that will apply to customer classes in the next two rate cases. Coupled with a comprehensive investigation into rate design, OPC's proposal allows the Commission to render a decision in this case without foreclosing consideration of important policy issues that could change the way rates are set in subsequent rate cases.

Consider the myopic proposals to eliminate negative rates of return by assessing a two-times-the-system-average increase to residential customers. There is an utter lack of evidence in the record of this case to that any such a proposal would actually serve to eliminate negative class rates of return,[691] and it would be imprudent to exalt such a near-sighted approach over the importance of considering the full spectrum of policy issues at play.[692] For example, strict adherence to the results of a class cost of service study would ignore the fact that commercial classes (which are making greater-than-average contributions to Pepco's overall rate of return) receive disproportionately more value benefits from investments in reliability than residential customers (which are making less-than-average contributions to Pepco's overall rate of return) receive from those same investments.[693] Further, increasing the percentage increases to residential customers to two-times the system average, or prejudging percentage increases that will be allocated to residential customers in future rate cases, would cut off the ability to explore

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691 As Dr. Dismukes explains, the Commission has allocated a significant share of Pepco's requested rate increase to the residential classes over the last several rate cases. "[D]espite those increases, the residential classes' RRORs have not improved. There is no reason to assume that pursuing the same revenue distribution strategy in this rate case will result in any differing results...." Exhibit OPC (A) 12:14-21; *see also id.* at 38:17-18; Tr. at 1025:3-12, 1027:1-18, and 1031:8-10 (Dismukes).

692 Exhibit OPC (A) 12:14-17; *see also* Tr. at 1025:12-15 (stating that "maybe some different thinking needs to be done and considered in terms of correcting these particular deficiencies") (Dismukes).

693 The record supports a finding that reliability investments provide greater benefits to commercial and industrial customers in terms of economic value than those same investments provide to residential and low-income customers. Tr. at 1809:2-8 (Stipulation). *See also* Tr. at 1032:9 to 1033:9 (Dismukes).

whether changes are needed to Pepco's legacy rate designs.[694] In contrast, OPC's proposal strikes the appropriate balance by honoring the Commission's stated policy on negative class rates of return while providing flexibility for the Commission and the parties to fully develop a record and gain a better understanding of the issues underlying the negative class rates of return before making any decision that would lock-in rate increases for residential customers.

As another example, Pepco proposes substantial increases to customer charges, whereas OPC recommends that the Commission hold customer charges constant and authorize Pepco to recover any revenue shortfalls found in this case through volumetric rates.[695] While OPC acknowledges the Commission's desire to place a greater emphasis on customer charges and demand rates, OPC has concerns with the level of Pepco's customer charges proposed in this proceeding.[696] OPC also questions the basis for further increases.[697] In light of the differing views on the merits or demerits of increasing customer charges, OPC's proposal asks the Commission to recognize that the role and method by which customer charges (or grid access) are determined is a significant issue. As one part of a comprehensive investigation into rate design, OPC submits the best approach is for the Commission to investigate customer charges as a whole, independent of the merits for or against increases to customer charges in this proceeding, before deciding its future policy regarding customer charges.[698]

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694 Tr. at 1025:3 to 1026:9, 1065:22 to 1066:8, and 1098:8 to 1099:14 (Dismukes).

695 Exhibit OPC (A) at 42:13-15.

696 *See* Exhibit OPC(A)-14 (showing that Pepco's residential customer charge of $13.12 per month is noticeably greater than the regional average of $10.48 per month); *see also* Exhibit OPC (A) at 59:13-17.

697 Exhibit OPC (A) at 5:621 to 58:15; *see also* Tr. at 1049:7-21 and 1053:13 to 1055:3 (Dismukes).

698 Exhibit OPC (A) at 59:6-10; *see also* Tr. at 1053:13 to 1055:17 (Dismukes).

Some parties may criticize OPC's proposal as being self-serving. To the contrary, OPC's proposal emphasizes the need for the Commission to reach the right result. Tellingly, OPC is not a supporter of the BSA. As explained above, however, OPC recognizes that the BSA is one of the interrelated components that influences decisions on the level and allocation of Pepco's distribution rates. As such, OPC proposes that the Commission leave the BSA unchanged at this time in order to consider it as part of the comprehensive review discussed above. Leaving the BSA unchanged is hardly a self-serving proposal for OPC. Rather, it is an example of the type of difficult decisions that parties and the Commission need to make in order to issue a rate decision in this case, balanced with the critical need to "get it right" on a prospective basis.

The electric industry and utility regulation in the District are at a critical juncture. As explained above, substantial investment in reliability infrastructure and O&M is continuing, particularly in light of the reliability-related merger commitments. These substantial investments highlight ever-present concerns regarding affordability of rates. Customers' uses of the system are changing[699] and Pepco is collecting more data on those uses than at any time in history.[700] There is near-consensus agreement that conventional wisdom on eliminating negative class rates of return have failed to actually eliminate that phenomenon. These complex, novel, and interrelated issues present the Commission with a unique opportunity to demonstrate great leadership and foresight by fully scrutinizing paradigms from the past and new proposals before establishing the direction for the future. As such, the Commission should adopt OPC's comprehensive approach to addressing rate design, both in this case and in the future.

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[699] Tr. at 1030:6-9; *see also* Tr. at 1700:6-14 (where Pepco Witness McGowan agrees that a separate investigation into rate design should consider "how customers use the system and [how] to assign the costs to run the system to those customers based on how they use it").

[700] Tr. at 1062:6 to 1063:12, 1065:9-11, 1065:19 to 1066:8 (Dismukes).

2. Consistent with Prior Decisions, the Commission Should Affirm that the District's Current Approach to Cost-of-Service Ratemaking Remains Appropriate for Pepco.

While OPC and Pepco agree that the Commission should establish an investigation to further consider "alternative rate designs," OPC and Pepco do not agree on the separate issue of "alternative recovery mechanisms."[701] For the reasons set forth below, the Commission should decline to adopt any new alternative recovery mechanisms.

a. Pepco Creates a Classic Strawman by Mischaracterizing the District's Current Approach to Ratemaking.

Pepco begins its discussion of alternative recovery mechanisms by purporting to explain the ratemaking process to which its proposals are an alternative. Specifically, Pepco contends that the Commission uses a "traditional ratemaking process" that "looks at a 'past test' year in an effort to set rates that will reflect a utility's cost during a future rate-effective period…."[702] Pepco then criticizes that approach on the grounds that it does not accurately align rates with the costs that are actually incurred to provide service.[703] Pepco is correct that that "[t]he historical test year is the preferred proposed test year,"[704] however, the accuracy of Pepco's description ends there. In essence, Pepco's description of the District's approach to ratemaking is a classic strawman that has no basis in fact.

Pepco's discussion of the District's approach to ratemaking fails to acknowledge that, when submitting an application to increase base rates, Rule 200.4 affords Pepco the option of

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701 Exhibit Pepco (2B) at 10:3-5.

702 Exhibit Pepco (2B) at 10:11-13.

703 *See* Exhibit Pepco (2B) at 10:11-14 (purporting to compare a historical test year to a fully forecasted test year); *see also* Exhibit Pepco (3B) at 26:24 to 27:4.

704 DCMR § 200.6.

using a partially forecasted test year consisting of six months of forecasted data.[705] Pepco Witness McGowan described a partially forecasted test year as an alternative recovery mechanism.[706] In addition, Pepco does not acknowledge that Rule 200.6 enables Pepco to seek an adjustment to provide "relief from attrition."[707] Pepco Witness McGowan explained that an attrition adjustment is a form of alternative recovery mechanism.[708] Further, Pepco Witness McGowan described Pepco's BSA as an alternative recovery mechanism.[709] Yet, he failed to account for the BSA in criticizing the District's "traditional" approach to ratemaking. Further, Pepco proposed a number of ratemaking adjustments in this proceeding that would recover the costs of post-test year additions to plant. Pepco Witness McGowan characterized these types of ratemaking adjustments as alternative ratemaking mechanisms, but failed to account for them in criticizing the District's "traditional ratemaking approach."[710]

Each of these aforementioned alternative recovery mechanisms are within the District's *current* approach to ratemaking, belying Pepco's claims that the District's ratemaking process is traditional,[711] outdated,[712] or not reflective of the costs incurred during the rate effective

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705 DCMR § 200.4. The Commission has explained that "Rule 200.4 *clearly* permits Pepco to use up to six months of forecasted test-year data." Order No. 16930, ¶ 20 (emphasis added). In Formal Case No. 1054, the Commission addressed the argument that a historical test year is not aligned with the costs incurred during the rate-effective period. The Commission dismissed that argument, explaining that utilities are "well aware" of their "discretion to select a different test year...." *See also Formal Case No. 1054, In the Matter of the Application of Washington Gas Light Company for Authority to Increase Existing Rates and Charges for Gas Service*, Order No. 14391, ¶ 10 (rel. July 24, 2007).

706 Tr. at 136:15-18 (McGowan).

707 DCMR § 200.6.

708 Tr. at 139:10 to 140:5 (McGowan).

709 Tr. at 129:10-13 (McGowan).

710 Tr. at 142:18 to 143:5 (McGowan).

711 Exhibit Pepco (2B) at 10:11.

period.[713] Rather, consistent the Commission's prior decisions[714] and Dr. Dismukes' testimony,[715] it is more accurate to describe the District of Columbia's ratemaking process as a "modified" approach to traditional cost-of-service regulation.[716] Indeed, Pepco appears to have reluctantly conceded this point.[717]

b. Because It Mischaracterized the District's Approach to Ratemaking, Pepco Ignores the Benefits of that Approach.

The record contains substantial evidence to support a finding that the District's modified approach to traditional cost-of-service regulation has served the District well. For example, in unrebutted testimony, Dr. Dismukes explained that:

> traditional regulation yields many positive benefits. To cite one example from the District, the Commission began focusing on Pepco's reliability performance in semi-regular rate case proceedings, which allowed the Commission to oversee steady and consistent improvement in reliability performance as well as the investments (and other costs) necessary to make those reliability improvements. It would have been difficult, if not impossible, for the Commission and other parties to exercise the same degree of diligence and oversight, from a

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712 Exhibit Pepco (3B) at 26:24-25 (claiming that the traditional ratemaking process has not "kept pace" with changes in the regulated transmission and distribution industry).

713 Exhibit Pepco (2B) at 10:11-19.

714 For example, the Commission has explained that, "Under traditional regulation, a utility's profitability is dependent on its sales volume." However, "Pepco's BSA is a decoupling mechanism. Decoupling is a regulatory tool designed to separate a utility's revenue from changes in energy sales." *See Formal Case No. 1053, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, Order No. 15556, ¶ 24 (rel. Sept. 28, 2009).

715 *See* Exhibit OPC (A) at 68:11-18 (explaining that forward looking adjustments to a historical test year "demonstrate that traditional ratemaking in the District is not as inflexible as the Company would have the Commission believe").

716 Tr. at 1064:9-11 (Dismukes).

717 Pepco Witness McGowan testified: "[T]raditional regulation is a historical 12 [months of actual data] and zero [months of projected data] test period. Mechanisms like the BSA, the ability to have post-test period capital adjustments in the test period, those are mechanisms that help better align the cost of the service to the rates." Tr. At 196:15-20; *see also id.* at 143:6-10 (where Pepco Witness McGowan explains that the Commission's process is a "slight modification" to traditional ratemaking).

> comprehensive cost-performance perspective, outside the traditional rate case process.[[718]]

The Commission's order in Formal Case No. 1087 articulates this same point. Specifically, the Commission found that "Pepco's proposed massive construction program to improve D.C. reliability should be guided by a practical, upfront cost-benefit analysis of categories of projects to prioritize investments and to try to achieve the biggest 'bang for the buck,' (*i.e.*, value for the money spent or effort expended)."[719] There are no policy or evidentiary bases for reaching a different conclusion in this case.

The Commission's current approach to ratemaking provides other benefits as well. When rejecting a proposed alternative recovery mechanism in Formal Case No. 1087, the Commission explained that "traditional rate cases provide an opportunity to look at a public utility's entire financial outlook, and to determine whether to increase or decrease its overall ROE depending upon what is a just and reasonable rate for ratepayers."[720] Similarly, the Commission found that "traditional ratemaking's regulatory lag can serve positive functions."[721] Dr. Dismukes sponsored substantial, unrebutted testimony on this point.[722]

Pepco's characterization and discussion of the District's approach to ratemaking ignores these benefits. Its proposed alternative recovery mechanisms would eliminate them. Rather than deprive the District's ratepayers of these benefits, the Commission should find that its

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718 Exhibit OPC (A) at 65:18 to 66:1; *see also id.* at 70:5-16 (explaining that the Commission's current approach to ratemaking has "yielded positive results"); *id.* at 85:8 to 86:2 (further explaining the important role that rate cases play in this period of high capital spending); Tr. at 1060:20 to 1061:10 (Dismukes).

719 Order No. 16930, ¶ 483.

720 Order No. 16930, ¶ 476.

721 Order No. 16930, ¶ 476.

722 Exhibit OPC (A) at 78:3 to 80:16; *see also* Exhibit OPC (A)-33 and Exhibit OPC (A)-34.

"modified" approach to traditional cost-of-service regulation is well-established, has served the District well, and will be affirmed in this case.

c. Pepco Fails to Offer Any Details Regarding Two Proposed Alternative Recovery Mechanisms.

After purporting to define the District's approach to ratemaking and criticizing that approach on the grounds that it does not accurately align rates with the costs that are actually incurred to provide service,[723] Pepco then identifies two alternative recovery mechanisms, *i.e.*, a fully forecasted test year and a multi-year rate plan. Pepco claims that a fully forecasted test year "aligns rates with the costs actually being incurred to provide service."[724] Pepco makes a similar claim about a multi-year rate plan, claiming that "rate increases coincide with the expenses and investments being made over the multi-year plan."[725] The problem with Pepco's claims is that they cannot be tested on the record that exists in this proceeding because Pepco was either unwilling or unable to provide any details about its alternative recovery mechanisms.[726]

Pepco made clear that it was *not* presenting the Commission with a concrete proposal for approval of a fully forecasted test year or multi-year rate plan in this case.[727] Rather, Pepco took an approach similar to that which it took in Formal Case No. 1087, when it proposed an

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723 *See* Exhibit Pepco (2B) at 10:11-14 (purporting to compare a historical test year to a fully forecasted test year); *see also* Exhibit Pepco (3B) at 26:24 to 27:4.

724 Exhibit Pepco (2B) at 10:13-14.

725 Exhibit Pepco (2B) at 10:116-19.

726 Tr. at 1099:19 to 1100:1 (testifying that "[t]her are no specifics" to Pepco's proposals) (Dismukes).

727 Pepco Witness McGowan explained that "we're not asking the Commission to approve it now." *See* Tr. at 162:16-17; *see also id.* at 162:10-15 ("[I]f the Commission approves us to be able to file [a fully forecasted test year or a multi-year rate plan] in the context of [the] next rate case, it's that time where we'll look at the issues of the design that we have and the evidence that we can support the forecast and the reasonableness of our numbers."); *id.* at 176:14-15 (when asked about the details of a fully forecasted test year, Mr. McGowan confirmed that Pepco is "not proposing any specific designs at this time").

alternative recovery mechanism "in principle."[728] The Commission rejected Pepco's conceptual proposal in Formal Case No. 1087.[729] There is no basis for reaching a different result here.

Another major flaw with Pepco's approach is that adopting a fully forecasted test year or multi-year rate plan requires consideration of more complex details than Pepco would have the Commission believe are necessary to consider.[730] For example, would Pepco's authorized return be reduced to reflect the lower risk associated with a fully forecasted test year or multi-year rate plan? Under a fully forecasted test year, would Pepco forego recovery of costs that exceeded the forecasts?[731] What would the "framework," "metrics," and "other criteria" consist of with regard to adjusting "categories of costs?"[732] What categories of costs would fall within the alternative recovery mechanism? With respect to Issue 19, Pepco's cursory and unsupported positions deprive the parties and the Commission of any opportunity to explore how its proposals would work. How would Pepco address OPC's concerns about forecast error?[733] While Pepco seeks the Commission's blessing to adopt these alternative recovery mechanisms, there is a major hole in the record on key issues that should be considered when decided whether to give that blessing.

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728 *See* Order No. 16930, ¶ 429 (discussing Pepco's proposal that the Commission approve a proposed surcharge "in concept" or "in principle" subject to "further refinement" that would "occur before [the surcharge] becomes effective"); *see also id.*, ¶ 436 (stating that "Pepco is only seeking approval of the RIM 'in principle'"); *id.*, ¶ 479 (stating that "Pepco's request for approval of its [surcharge] "in principle[]'suggest[s] that Pepco is looking to the Commission to refine its [surcharge] proposal and to determine what construction costs are eligible for...recovery").

729 Order No. 16930, ¶ 481 ("We decline to approve [the surcharge proposal] 'in principle'").

730 Tr. at 159:21 to 161:13 (expressing the view that alternative recovery mechanisms can be addressed in the context of a base rate case, but it is appropriate to consider the complex issues of alternative rate design in a separate proceeding) (McGowan).

731 Tr. at 177:1-12 (McGowan).

732 Exhibit Pepco (2B) at 11:9-11.

733 Exhibit OPC (A) at 82:9-1 and 84:17 to 85:5.

It is neither OPC's nor the Commission's obligation to fashion Pepco's proposals. Further, it is unfair and prejudicial to OPC for the Commission to pre-approve a conceptual proposal in the absence of any record evidence to support the prudence of such a proposal.[734] As explained above, the Commission reached that precise finding in rejecting an alternative recovery mechanism in Formal Case No. 1087. The details of the Pepco proposal—which are not present in this record—are part and parcel of the proposal itself and must be factor into the consideration of whether to adopt the proposal in the first instance. The lack of details would render any Commission decision accepting Pepco's proposed alternative recovery mechanisms arbitrary and capricious or an abuse of discretion.

d. Pepco Provides a Superficial and Unsupported Assessment of the Purported Benefits of a Fully Forecasted Test Year and a Multi-Year Rate Plan.

In his Supplemental Direct Testimony, Pepco Witness McGowan lists eight purported benefits that he alleges will be realized under a fully forecasted test year and a multi-year rate plan.[735] The clear implication is that these benefits do not materialize under the District's current approach to ratemaking, thereby rendering a fully forecasted test year and a multi-year rate plan superior approaches. As demonstrated below, however, those benefits do not withstand scrutiny.

Pepco Witness McGowan's discussion of these eight benefits does not include any supporting citations to any studies, documents, or other evidence that would corroborate the otherwise-conclusory statements. As part of its thorough review of Pepco's rate filing, OPC propounded data requests to Pepco, asking for studies that quantify or qualify many of these

734 As Dr. Dismukes explained, "OPC believes that it is important to get the details right...." Exhibit OPC (A) at 87:15.

735 Exhibit Pepco (2B) at 11:5 to 12:3.

benefits. Pepco's consistent response was that it "is not aware of any studies."[736] In addition to testing the veracity of Pepco's claims in discovery, OPC Witness Dismukes sponsored testimony that addressed and refuted each of these eight purported benefits.[737] Remarkably, Pepco's rebuttal testimony offered no direct response to Dr. Dismukes on these points. OPC further explored the basis or support for these alleged benefits at the evidentiary hearing. On cross examination, Mr. McGowan testified that the eight benefits listed on pages 11 and 12 of his Supplemental Direct Testimony apply to both a fully forecasted test year and a multi-year rate plan.[738] However, he was unable to clearly explain how, in fact, several of these purported benefits would be achieved under both a fully forecasted test year and a multi-year rate plan.[739] The Commission should find that one-and-a-half pages of conclusory statements fails under the substantial evidence test.

In contrast to the lack of evidence supporting Pepco's claimed benefits, OPC presented voluminous evidence showing that these benefits would not, in fact, materialize.[740] This evidence is in addition to Dr. Dismukes' unrebutted testimony, which as explained above, raised serious questions about the purported benefits that Pepco identified. For example, OPC presented evidence that refuted Mr. McGowan's claim that Pepco's proposed alternative recovery mechanisms will result in fewer rate cases. Notably, this evidence came in the form of

736 Exhibit OPC (A)-29 at 1 (responses to sub-parts A, B, and C of OPC Data Request No. 17-4).

737 Exhibit OPC (A) to 70:17 to 78:2. Dr. Dismukes also sponsored testimony detailing the problems with fully forecasted test years and multi-year rate plans. *Id.* at 80:17 to 85:5. Pepco's rebuttal testimony offered no direct response.

738 Tr. at 167:21 to 168:1 (testifying that "all of these benefits pertain to both a multi-year rate plan and a fully forecasted test period") (McGowan).

739 *See, e.g.*, Tr. at 170:6-15, 177:13-21 (McGowan).

740 To the extent these "benefits" exist at all, they are one-sided benefits that tend to accrue to utilities and their shareholders, not ratepayers. *See* Exhibit OPC (A) at 66:14-16; *see also id.* at 67:3-9 (explaining that alternative recovery mechanisms shift performance-based risk away from the utility and onto ratepayers).

a statement by the expert witness that *Pepco* engaged to address alternative ratemaking in Formal Case No. 1087.[741] According to that expert, "rate cases may still be frequent in periods when high capital spending produces newly used and useful facilities of considerable value annually, as when a utility is accelerating modernization of its distribution system...."[742] This statement is consistent with the Commission's finding in Formal Case No. 1087, *i.e.*, that the alternative recovery mechanism proposed therein "would not reduce the burdens of the parties from a traditional rate case."[743]

OPC also presented evidence refuting Mr. McGowan's claim that alternative recovery mechanisms provide stakeholders an "enhanced level of due diligence review over spending, as compared to review in a traditional rate case proceeding."[744] Specifically, OPC provided a report by the Vermont Attorney General, which concluded that "the current Alt. Reg. [*i.e.*, alternative regulation] plan does not give Department [of Public Service's] experts enough time to review [the utility's] proposed rate base investments."[745] Because it did not submit any concrete proposals, Pepco did not present any evidence demonstrating the concerns in Vermont would not apply to the District.

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741 Exhibit Pepco (2B) at 11:5-8.

742 OPC Cross Examination Exhibit #8 at 1. While this statement was made in 2011, Pepco Witness McGowan agreed that it describes Pepco's current circumstances in terms of capital spending. Tr. at 185:4 to 186:14 (McGowan).

743 Order No. 16930, ¶ 476. This statement is also consistent with Dr. Dismukes' opinion, which is based on his years of serving as an expert witness, that "[i]t is often the case that the number of litigated issues associated with alternative recovery mechanisms can increase and even become more contentious, especially when using forecasted information." *See* Exhibit OPC (A) at 72:1-3. Dr. Dismukes provides a number of examples to corroborate his experience. *Id.* at 72:6-23.

744 Exhibit Pepco (2B) at 10:19-22.

745 OPC Cross Examination Exhibit #8 at 5.

At most, the evidentiary record supports a finding that Pepco overstated its claims about the purported benefits of a fully forecasted test year or a multi-year rate plan. More appropriately, the Commission should conclude that the record does not support a finding that a fully forecasted test year or a multi-year rate plan will produce the benefits that Pepco claims they will produce.

Finally, the record in this case does not include any indicia of benefits in adopting a fully forecasted test year or a multi-year rate plan in several key areas. There is no evidence that a fully forecasted test year or a multi-year rate plan will address the concerns about affordability for working-class customers or the ability of seniors to age-in-place. Likewise, there is no evidence that a fully forecasted test year and a multi-year rate plan will help achieve the goal of eliminating negative class rates of return and gradualism. In fact, the opposite is true.[746]

In contrast to alternative rate designs, which are discussed above, alternative recovery mechanisms are a "solution in search of a problem."[747] Consequently, the Commission should not consider a fully forecasted test year or a multi-year rate plan.

e. Pepco's Own Actions Demonstrate that the District's Current Approach to Ratemaking is Appropriate.

Notwithstanding the independent bases for rejecting Pepco's proposal regarding alternative recovery mechanisms, Pepco's own actions demonstrate there is no need for the Commission to establish new alternative recovery mechanisms. The record shows that alternative recovery mechanisms are available to Pepco and Pepco has declined to pursue those alternatives on its own volition. For example, Pepco defines cost trackers and surcharges as

746 Tr. at 1097:13-21 (Dismukes).

747 Exhibit OPC (A) at 85:6-8.

alternative recovery mechanisms.[748] Pepco Witness McGowan claims that trackers and surcharges "provide timely recovery of prudently incurred costs and reduce the time and expense required by all parties to prosecute frequent rate cases."[749]

Similarly, as explained above, Pepco Witness McGowan described an attrition adjustment as a tracker that is a form of alternative recovery mechanism.[750] Despite the fact that the Commission's regulations authorize an attrition adjustment, Mr. McGowan could not think of any recent instance where Pepco availed itself of this adjustment.[751]

In addition, Pepco acknowledges that D.C. Code Section 34-1504(d) authorizes the Commission "to implement alternative forms of regulation upon certain findings...."[752] The "certain findings" that must be reached are that the alternative forms of regulation: (1) protects consumers; (2) ensures the quality, availability, and reliability of regulated electric services; and (3) is in the public interest.[753] Pepco could not point to any instance in which asked the Commission to implement alternative recovery mechanisms under D.C. Code Section 34-1504(d).[754] Pepco certainly cannot point to any evidence in this case that would warrant a

748 Tr. at 134:9-17 (McGowan).

749 Exhibit Pepco (2B) at 12:6-10. OPC notes, but does not generally agree with, this claim. There are some circumstances where trackers and surcharges may be appropriate, such as District of Columbia Power Line Undergrounding ("DC PLUG"). Further, as discussed in more detail above, Pepco fails to produce any evidence supporting its claims about the purported benefits of alternative recovery mechanisms in this proceeding.

750 Tr. at 139:10 to 140:5 (McGowan).

751 Tr. at 140:8-18 (McGowan). Mr. McGowan "suspect[s]" that Pepco may have requested an attrition adjustment when it was a vertically integrated utility. *Id.*

752 OPC Cross Examination Exhibit #7 at 5.

753 D.C. Code § 34-1504(d).

754 Tr. at 164:8-13 (McGowan).

finding that a fully forecasted test year or a multi-year rate plan are appropriate under the standard set forth by D.C. Code Section 34-1504(d).[755]

Further, despite the option of using a partially forecasted test year,[756] Pepco elected to use a historical test year in this case.[757] Pepco Witness Ziminsky explained the basis for that decision. "This test year was chosen because it is a recent period that is representative of the level of return that the Company's current rates are producing on its distribution cost of service."[758] Pepco Witness McGowan further explained that "the adjusted test year is an appropriate and reasonable proxy for costs that will be reflected in the rate-effective period."[759] Pepco's decision to use a historical test year, and the basis for that decision, undercut the claim that new alternative recovery mechanisms are necessary.

Finally, OPC acknowledges that, in Formal Case No. 1087, Pepco asked the Commission to consider initiating a proceeding to consider use of a fully forecasted test year.[760] However, the Commission did not take Pepco up on that request.[761] It is telling that, between Formal Case No. 1087 and the filing of its application in the instant proceeding, Pepco never asked the Commission to consider a fully forecasted test year. Rather, Pepco only proposed consideration

755 As explained in more detail below, the only evidence Pepco supplied to support its proposals regarding alternative recovery mechanisms is the cursory testimony of Pepco Witness McGowan, which is wholly inadequate for purposes of Section 34-1504(d).

756 *See* the discussion above regarding Rule 200.4.

757 Exhibit Pepco (E) at 3:6 ("The proposed test year is the actual 12 months ended March 31, 2016").

758 Exhibit Pepco (E) at 3:6-9.

759 Exhibit Pepco (2B) at 3:5-6.

760 Order No. 16930, ¶ 15.

761 Appropriately, the Commission found that "Pepco's proposed massive construction program to improve D.C. reliability should be guided by a practical, upfront cost-benefit analysis of categories of projects to prioritize investments and to try to achieve the biggest 'bang for the buck,' (*i.e.*, value for the money spent or effort expended)." Order No. 16930, ¶ 483.

of a fully forecasted test year *after* the Commission, *sua sponte*, proposed Issue 19 in this case. Even then, Pepco devoted just two and half pages of Supplemental Direct Testimony to the matter.[762] Pepco's Rebuttal Testimony on Issue 19 consists of a mere 67 lines of testimony, more than half of which are quotations to Commission orders or Dr. Dismukes' testimony.[763] Clearly, a fully forecasted test year has not been a priority for Pepco. It should not now be a priority for the Commission.[764]

The key takeaway is that alternative recovery mechanisms are currently available to Pepco and Pepco has not availed itself of those mechanisms. To be clear, OPC is *not* advocating for Pepco to use these alterative recovery mechanisms, but demonstrating that there is no basis in this case for establishing new alternative recovery mechanisms.[765]

VI. CONCLUSION

WHEREFORE, the Office respectfully requests that the Commission, pursuant to applicable law, consider the record evidence and issue a written decision summarizing the evidence and make findings of fact and conclusions of law on the disputed issues based on the positions of the Office on each of the designated issues in this proceeding and adopt OPC's recommendations, as set forth herein.

762 Tr. at 128:6 to 129:5 (McGowan).

763 Exhibit (3B) at 25:3 to 26:13.

764 "The Commission should be mindful that parties like OPC have limited resources that are already dedicated to examining the traditional rate case issues of this proceeding, as well as a number of post-merger compliance issues. Alternative regulation carries with it an entirely separate set of ratemaking issues that were not included in the Company's originally-filed rate case. The discussion of these proposals in the Company's supplemental testimony is very general, and also implies that the issue should be considered in more detail in a later proceeding, like its next base rate case. Addressing a specific proposal in this proceeding is burdensome and problematic for OPC and its ratepayer clients." Exhibit OPC (A) at 87:6-13.

765 At worst, establishing new alternative recovery mechanisms could run counter to, or confound, Pepco's merger commitments. Exhibit OPC (A) at 89:17-20; *see also* Tr. at 1061:11 to 1062:2 (Dismukes). At best, there could be few marginal benefits to be gained from alternative recovery mechanisms in light of the merger commitments. Tr. at 1061:11-21 and 1065:9-18 (Dismukes).

Respectfully submitted,

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Dated: April 12, 2017

Appendix A

Potomac Electric Power Company
District of Columbia
Formal Case No. 1139

Ratemaking Results and Revenue Requirement
Test Year Ended March 31, 2016
(Thousands of Dollars)

Line No.		Test Year Per Pepco (A)	Adjustments (B)	D.C. Adjusted per OPC (C)	Revenue to Achieve OPC ROR (D)	Adjusted to Reflect OPC Rate of Return (E)
	Rate Base					
1	Electric Plant in Service	$ 3,008,840	$ 76,044	$ 3,084,884		$ 3,084,884
2	Accumulated Depreciation	(998,356)	8,730	(989,626)		(989,626)
3	Accumulated Amortization	(14,231)	(17)	(14,248)		(14,248)
4	Materials and Supplies	29,065	(993)	28,072		28,072
5	Cash Working Capital	12,794	(793)	12,001		12,001
6	Accumulated Deferred Income Taxes	(618,693)	(16,714)	(635,407)		(635,407)
7	Prepaid Pension/OPEB Liab. (net of tax)	52,167	(4,821)	47,346		47,346
8	Customer Deposits	(11,006)		(11,006)		(11,006)
9	Pepco Portion of Servco Assets	39,152		39,152		39,152
10	Regulatory Assets	24,890	16,608	41,498		41,498
11	Unamortized Credit Facility Costs	298		298		298
12	Total Rate Base	$ 1,524,920	$ 78,044	$ 1,602,964		$ 1,602,964
	Operating Revenues					
13	Sale of Electricity	$ 488,109	$ -	$ 488,109		
14	Other Revenues	3,741		3,741		
15	Operating Revenues	$ 491,850	$ -	$ 491,850	$ 25,139	$ 516,989
	Operating Expenses					
16	Operation and Maintenance	$ 138,772	$ (14,984)	$ 123,788		$ 123,788
17	Depreciation	84,570	1,757	86,327		86,327
18	Amortization	3,384	5,971	9,355		9,355
19	Other Taxes	143,009	(402)	142,607		142,607
20	D.C. Income Tax	4,771	(1,646)	3,125	$ 2,263	5,388
21	Federal Income Tax	27,261	3,011	30,272	8,007	38,279
22	Total Operating Expenses	$ 401,767	$ (6,293)	$ 395,474	$ 10,270	$ 405,744
23	Operating Income	$ 90,083	$ 6,293	$ 96,376	$ 14,870	$ 111,246
24	D.C. Jurisdictional Return on Rate Base	5.91%		6.01%		6.94%

Source/Notes:
Columns (A): Exhibit PEPCO (2E)-1, page 1 of 45 and Exhibit PEPCO (3E)-1, page 1 of 45
Column (B): See Page 2

POTOMAC ELECTRIC POWER COMPANY
District of Columbia
Formal Case No. 1139

Summary of OPC Adjustments
Test Year Ended March 31, 2016
(Thousands of Dollars)

Source	Adjustments	Rate Base (1)	Revenue (2)	Operation & Maintenance (3)	Depreciation (4)	Amortization (5)	Other Taxes (6)	DCIT (7)	FIT (8)	Operating Income (9)
Co. Adj 1	Reflection of 3-year average overtime level			$ (169)			$ (12)	$ 16	$ 58	$ 107
Co. Adj 2	Annualization of Wage Increases			2,468			168	(237)	(840)	(1,559)
OPC Sch. 12 (d)	Revision to Wage Increase			(642)			(44)	62	218	406
Co. Adj 3	Annualization of employee health & welfare costs			493				(44)	(157)	(292)
Co. Adj 4	Reflection of 2016 pension and OPEB expense	(4,821)		594				(53)	(189)	(352)
Co. Adj 5	Removal of F.C. 939 disallowed gainsharing and wages				(28)			3	9	16
	- Plant in service	(694)								
	- Accumulated depreciation	588								
Co. Adj 7	Adjustment for exempt and executive incentive plan costs			(2,556)	(10)			231	817	1,518
	- Plant in service	(137)								
	- Accumulated depreciation	20								
OPC Sch. 15	Remove Remaining LTIP Expense from Test Year			(548)				49	175	324
Co. Adj 8	Removal of adjustments erred compensation balances			(14)				1	5	8
Co. Adj 9	Reflection of 3-year average regulatory expense			44				(4)	(14)	(26)
Co. Adj. 10	Reflection of current rate case costs	2,170				1,467		(132)	(467)	(868)
Co. Adj 11	Reflection of 3-year average storm costs			(766)				69	244	453
Co. Adj 13	Removal of employee association costs			(55)				5	18	32
Co. Adj 14	Removal of industry contributions and membership fees			(342)				31	109	202
Co. Adj 15	Removal of institutional advertising/selling expense			(179)				16	57	106
Co. Adj 16	Reflection of increase in WASA rates			134				(12)	(43)	(79)
Co. Adj 17	Removal of Benning environmental liability			(2,190)				197	698	1,295
Co. Adj 18	Inclusion of customer deposit interest & credit facility exp			178				(16)	(57)	(105)
Co. Adj 19 (a)	Revision of synergies, net of costs to achieve	4,316		(3,671)		(1,081)		428	1,513	2,811
OPC Sch 16	Revised Synergy/CTA Adjustment	(4,316)		(1,952)		1,081		78	278	515
Co. Adj 20 (a)	Adjustment for merger accounting items			(1,528)	8		(514)	183	648	1,203
	- Plant in service	119								
	- Accumulated depreciation	(4)								
	- Materials and supplies	(993)								
OPC Sch 9	Additional merger accounting adjustments			(1,108)				100	353	655
Co. Adj 21	Inclusion of projects completed and in service				58			(5)	(19)	(34)
	- Plant in service	2,146								
	- Accumulated depreciation	(29)								
Co. Adj 22	Removal of 25% of 69 kV lines (FC 1076)				(17)			2	5	10
	- Plant in service	(635)								
	- Accumulated depreciation	635								
Co. Adj 23	Annualization of test year reliability closings				591			(53)	(188)	(350)
	- Plant in service	21,915								
	- Accumulated depreciation	3,297								

POTOMAC ELECTRIC POWER COMPANY
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Summary of OPC Adjustments
Test Year Ended March 31, 2016
(Thousands of Dollars)

Source	Adjustments	Rate Base (1)	Revenue (2)	Operation & Maintenance (3)	Depreciation (4)	Amortization (5)	Other Taxes (6)	DCIT (7)	FIT (8)	Operating Income (9)
Co. Adj 24 (a)	Inclusion of post test year reliablity plant-closings Apr - Dec 2016				2,035			(183)	(648)	(1,204)
	- electric plant in service	75,489								
	- accumulated depreciation	3,733								
	- accumulated deferred taxes	-								
OPC Sch 1 (b)	Revision to post test year reliability closings Apr - Dec 2016				(589)			53	188	348
	- electric plant in service	(21,640)								
	- accumulated depreciation	295								
	- accumulated deferred taxes	(5,032)								
Co. Adj 27 (a, c)	Reflection of direct load control program costs	7,610		1,221		2,859		(345)	(1,219)	(2,516)
Co. Adj 28 (a, c)	Reflection of interval billing costs	2,483				933		(77)	(273)	(583)
Co. Adj 29 (a, c)	Reflection of AMI true-up	4,563		873		1,714		(202)	(716)	(1,669)
Co. Adj 31	Amortization of FC 1076 management audit costs	856				579		(52)	(184)	(343)
Co. Adj 32	Removal of completed amortization on reg. assets	(1,074)				(1,571)		141	501	929
Co. Adj 33	Annualization of software amortization	(17)				(10)		1	3	6
Co. Adj 34	Reflection of cash payment for 2014 NOL	(1,198)								
OPC Sch 4	Annualization of Dec. 2015 cash payment for use of Pepco NOLC	(10,484)								
Co. Adj 35	Reflection of DC tax rate change							(2,273)	795	1,478
Co. Adj 36 (a)	Reflection of CWC impact of ratemaking adjustments	(176)								
OPC Sch 17 (d)	Reflection of CWC impact of ratemaking adjustments	(617)								
OPC Sch 5	Remove Non-Recurring SolutionOne Stabilization Costs			(2,442)				220	778	1,444
OPC Sch 6	Remove Legacy CIS Archiving System Costs			(316)				28	101	187
OPC Sch 7	Adjustment to Outside Tax Services Expense			(98)				9	31	58
OPC Sch 8	Remove Accounting Correction - Account 935			(232)				21	74	137
OPC Sch 13	Remove Executive Perks			(35)				3	11	21
OPC Sch 14	Remove SERP Expense			(2,146)	(33)			196	694	1,289
	- electric plant in service	(519)								
	- accumulated depreciation	195								
Exh OPC(B)-2	Reduction to Depreciation Expense				(258)			23	82	153
Page 7	Interest synchronization							(124)	(438)	562
	Total Ratemaking Adjustments	$ 78,044	$ -	$ (14,984)	$ 1,757	$ 5,971	$ (402)	$ (1,646)	$ 3,011	$ 6,293

OPC Schedule references to Exhibit OPC (B)-4. Also provided on Exhibit OPC (B)-2.
Company Adjustments per Exhibit PEPCO (2E)-1 at pages 2 and 3. Same amounts as also found in Exhibit PEPCO (3E)-1 at pages 2 and 3, unless noted.
(a) Adjustment per Company Supplemental Direct Testimony per PEPCO (2E)-1 pages 2 and 3. Does not include Company Rebuttal Testimony Revision.
(b) This adjustment was revised by OPC post-hearing to reflect revisions in Mr. Mara's recommendation after receipt of Company rebuttal testimony.
(c) While adjustment does not reflect Company Rebuttal Testimony revision in Exhibit PEPCO (3E)-1 pages 2 and 3, OPC has not opposed the update in the Company Rebuttal Testimony revision for this issue.
(d) This adjustment was revised by OPC post-hearing as OPC is no longer opposing the March 2017 management salary and wage increase.

POTOMAC ELECTRIC COMPANY
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Revenue Requirement of Adjustments at OPC Recommended ROR
Test Year Ended March 31, 2016
(Thousands of Dollars)

Source:	Description	Rate Base	Net Operating Income	Revenue Requirement Impact at per OPC ROR
	Pepco Unadjusted Test Year Amounts Based on Per Pepco ROR (8.0%)	$ 1,524,920	$ 90,083	$ 53,949
Page 5	Reduction to OPC Recommended ROR of 6.94%			(27,331)
	Pepco Unadjusted Test Year Amounts Based on Per OPC ROR (6.94%)	$ 1,524,920	$ 90,083	26,621
	Adjustments:			
Co. Adj 1	Reflection of 3-year average overtime level		107	(181)
Co. Adj 2	Annualization of Wage Increases		(1,559)	2,636
OPC Sch. 12 (d)	Revision to Wage Increase		406	(686)
Co. Adj 3	Annualization of employee health & welfare costs		(292)	494
Co. Adj 4	Reflection of 2016 pension and OPEB expense	(4,821)	(352)	29
Co. Adj 5	Removal of F.C. 939 disallowed gainsharing and wages	(106)	16	(39)
Co. Adj 7	Adjustment for exempt and executive incentive plan costs	(117)	1,518	(2,580)
OPC Sch. 15	Remove Remaining LTIP Expense from Test Year		324	(548)
Co. Adj 8	Removal of adjustments erred compensation balances		8	(14)
Co. Adj 9	Reflection of 3-year average regulatory expense		(26)	44
Co. Adj. 10	Reflection of current rate case costs	2,170	(868)	1,722
Co. Adj 11	Reflection of 3-year average storm costs		453	(766)
Co. Adj 13	Removal of employee association costs		32	(54)
Co. Adj 14	Removal of industry contributions and membership fees		202	(342)
Co. Adj 15	Removal of institutional advertising/selling expense		106	(179)
Co. Adj 16	Reflection of increase in WASA rates		(79)	134
Co. Adj 17	Removal of Benning environmental liability		1,295	(2,189)
Co. Adj 18	Inclusion of customer deposit interest & credit facility exp		(105)	178
Co. Adj 19 (a)	Revision of synergies, net of costs to achieve		2,811	(4,752)
OPC Sch 16	Revised Synergy/CTA Adjustment		515	(871)
Co. Adj 20 (a)	Adjustment for merger accounting items	(878)	1,203	(2,137)
OPC Sch 9	Additional merger accounting adjustments		655	(1,107)
Co. Adj 21	Inclusion of projects completed and in service	2,117	(34)	306
Co. Adj 22	Removal of 25% of 69 kV lines (FC 1076)		10	(17)
Co. Adj 23	Annualization of test year reliability closings	25,212	(350)	3,550
Co. Adj 24 (a)	Inclusion of post test year reliablity plant-closings Apr - Dec 2016	79,222	(1,204)	11,331
OPC Sch 1 (b)	Revision to post test year reliability closings Apr - Dec 2016	(26,377)	348	(3,683)
Co. Adj 27 (a, c)	Reflection of direct load control program costs	7,610	(2,516)	5,146
Co. Adj 28 (a, c)	Reflection of interval billing costs	2,483	(583)	1,277
Co. Adj 29 (a, c)	Reflection of AMI true-up	4,563	(1,669)	3,357
Co. Adj 31	Amortization of FC 1076 management audit costs	856	(343)	680
Co. Adj 32	Removal of completed amortization on reg. assets	(1,074)	929	(1,697)
Co. Adj 33	Annualization of software amortization	(17)	6	(12)
Co. Adj 34	Reflection of cash payment for 2014 NOL	(1,198)		(141)
OPC Sch 4	Annualization of Dec. 2015 cash payment for use of Pepco NOLC	(10,484)		(1,230)
Co. Adj 35	Reflection of DC tax rate change		1478	(2,499)
Co. Adj 36 (a)	Reflection of CWC impact of ratemaking adjustments	(176)		(21)
OPC Sch 17 (d)	Reflection of CWC impact of ratemaking adjustments	(617)		(72)
OPC Sch 5	Remove Non-Recurring SolutionOne Stabilization Costs		1,444	(2,441)
OPC Sch 6	Remove Legacy CIS Archiving System Costs		187	(316)
OPC Sch 7	Adjustment to Outside Tax Services Expense		58	(98)
OPC Sch 8	Remove Accounting Correction - Account 935		137	(232)
OPC Sch 13	Remove Executive Perks		21	(36)
OPC Sch 14	Remove SERP Expense	(324)	1,289	(2,217)
Exh OPC(B)-2	Reduction to Depreciation Expense		153	(259)
Page 7	Interest synchronization		562	(950)
	Total OPC adjustments	$ 80,918	$ 1,781	$ (1,482)
	Revenue Requirement at OPC's Recommended ROR	$ 1,605,838	$ 91,864	$ 25,139

Source:
See Pages 2 and 3 for source references.

POTOMAC ELECTRIC POWER COMPANY
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Revenue Requirement of Adjustments
- Impact of OPC Recommended Rate of Return
(Thousands of Dollars)

Line	Description	Amount
1	Unadjusted Rate Base, per Pepco (Page 1, Column A, Line 12)	$ 1,524,920
2	Pepco Requested Rate of Return	8.00%
3	Required Net Operating Income At Pepco ROR (Line 1 x Line 2)	$ 121,995
4	OPC Recommended Rate of Return (Page 6, line 10)	6.94%
5	Required Operating Income at OPC Rate of Return (Line 1 x Line 4)	$ 105,829
6	Decrease in Net Operating Income	$ (16,166)
7	Revenue Requirement Factor (Page 6, line 6)	1.690617
8	Decrease in Revenue Requirement at OPC's Rate of Return	$ (27,331)

Revenue Requirement of Adjustments
 - Tax Rates and OPC Recommended Rate of Return
(Thousands of Dollars)

Line No.	Description			Statutory Tax Rate
1	D.C. Franchise Tax Rate			9.000%
2	Federal Income Tax Rate			35.00%
				Tax Factor
3	D.C. Franchise Tax Factor			9.00000%
4	Federal Income Tax Factor	(100% - (line 3)) x line 2		31.85000%
5	Complement of Composite Tax Factor	100% - (line 3 + line 4)		59.15000%
6	Revenue Requirement Factor	1 / Line 5		1.69062
	OPC Recommended Rate of Return	Capital Structure	Per OPC Cost Rates	Weighted Cost Rate
7	Short Term Debt	1.39%	0.68%	0.009%
8	Long Term Debt	49.75%	5.48%	2.726%
9	Common Equity	48.86%	8.60%	4.202%
10	OPC Recommended Rate of Return	100%		6.94%

Source
Exhibit OPC (B)-3, page 3 of 3

POTOMAC ELECTRIC POWER COMPANY
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Interest Synchronization Adjustment
Test Year Ending March 31, 2016
(Thousands of Dollars)

Line No.	Description		Amount
1	Rate Base, per OPC		$ 1,602,964
2	Weighted Cost of Debt, per OPC		2.74%
3	Ratemaking Interest on Debt, per OPC		43,921
4	Interest on Debt, per Company (Included in average unadjusted test year column)		42,545
5	Adjustment to Interest Expense		1,376
6	Adjustment to DC Income Taxes	-Line 5 x 9.0%	$ (124)
7	Adjustment to Federal Income Taxes	-(Line 5 + Line 6) x	$ (438)
8	Adjustment to Net Operating Income		$ 562

Sources:
Line 1: Page 1
Line 2: Page 6
Line 4: Exhibit PEPCO (2E)-1, page 43 or Exh. PEPCO (3E)-1, page 46

CERTIFICATE OF SERVICE

Formal Case No. 1139 – In the Matter of the Application of Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service

I certify that on April 12, 2017, a copy of the "Office of the People's Counsel for the District of Columbia's Initial Post-Hearing Brief (Public)" was served on the following parties of record by hand delivery, first class mail, postage prepaid or electronic mail:

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