

Ex 166

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Data Center
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ORDER NO. 88033

IN THE MATTER OF THE APPLICATION
OF DELMARVA POWER & LIGHT
COMPANY FOR ADJUSTMENTS TO ITS
RETAIL RATES FOR THE DISTRIBUTION
OF ELECTRIC ENERGY

* BEFORE THE
* PUBLIC SERVICE
* COMMISSION
* OF MARYLAND

*
*
* CASE NO. 9424

Issue Date: February 15, 2017

To: Parties of Record and Interested Persons

On July 20, 2016, Delmarva Power & Light Company (“Delmarva” or the “Company”) filed with the Maryland Public Service Commission (“the Commission”) a request to increase its electric distribution rates in the amount of \$56,970,183.¹ The Commission docketed the matter and delegated it to the Public Utility Law Judge Division for consideration. On January 4, 2017, the Chief Public Utility Law Judge (“Chief Judge”) issued a Proposed Order authorizing a maximum increase of \$34,100,454 in Delmarva’s electric distribution rate base, based on an authorized return on equity (“ROE”) of 9.48%, and findings regarding the Company’s: 1) Advanced Metering Infrastructure (“AMI”) deployment; 2) rate base operating income and expenses; 3) depreciation rates; 4) cost of service; and 5) rate design.² On January 18, 2017, before the Proposed Order became final, Delmarva and the Maryland Office of

¹ Delmarva last filed an application to increase its rates in March 2013, prior to its parent Pepco Holdings, Inc.’s merger with Exelon Corporation.

² The Proposed Order also addresses other issues, such as the continuation of Delmarva’s grid resiliency plan, storm costs, and reliability reporting.

KCP&L Exhibit No. 166
Date 2-22-17 Reporter MM
File No. ER-2016-0285

People's Counsel ("OPC") noted their respective appeals and concurrently filed their supporting memoranda. Neither the Commission's Technical Staff ("Staff") nor the Maryland Energy Group – North East and Hanover Foods Company (together "MEG") filed any notice of appeal. All four parties filed reply briefs on February 1, 2017.

I. The Parties' Issues on Appeal

A. Delmarva

Delmarva appeals the Proposed Order and asks the Commission to reject the Chief Judge's findings with respect to: 1) the Company's authorized ROE; 2) the treatment of merger synergy savings and costs-to-achieve associated with the merger of Pepco Holdings, Inc. ("PHI") and Exelon Corp. in 2016; 3) depreciation-related issues concerning net salvage rates and the rebalancing of depreciation reserves; and 4) benefits associated with the Company's AMI system.

First, Delmarva contends that the ROE adopted by the Proposed Order is inconsistent with Commission precedent, given that the Commission has consistently identified a higher risk associated with a utility's electric operations as compared to its gas operations. Delmarva further avers that the authorized ROE is unsupported by the record and fails to consider the recent increase in the federal interest rates.

Second, Delmarva argues that the Proposed Order is inconsistent with Commission precedent favoring the symmetrical treatment of merger synergies and costs to achieve. Delmarva also argues that the Proposed Order's asymmetrical approach

On appeal, Delmarva provides “corrected” depreciation rates for Staff, based upon book depreciation reserve amounts.⁵⁰ We find these revised depreciation rate calculations sufficiently resolve the conflict in the Proposed Order. Under the revised rates, Delmarva’s depreciation adjustment increases to \$4,628,734. This in turn reduces the Company’s net operating income and increases its total revenue requirement.⁵¹

F. Return on Equity

Delmarva and OPC separately allege that the Chief Judge improperly set Delmarva’s ROE at 9.48%, a 33-basis point reduction from the Company’s current ROE of 9.81%. Delmarva argues that the authorized ROE is inconsistent with purported Commission precedent recognizing that “a utility’s electric operations present a slightly elevated risk to investors compared to natural gas operations, and investors in the electric utility will therefore require a slightly higher return to compensate for that risk.”⁵² Delmarva further argues that a 30-basis point reduction in its ROE is further inconsistent with the Commission’s emphasis on gradualism and recent increases in short-term and long-term interest rates.⁵³

OPC argues that the Chief Judge erred in adopting Staff’s recommended ROE, which OPC Witness Woolridge criticized as “results-oriented.” OPC also objects that the Proposed Order gave less credence to Dr. Woolridge’s analysis and testimony that

⁵⁰ See Delmarva Appeal, Attachment B.

⁵¹ In finalizing the Order, we noted that a typographical error occurred in the exhibits in the record related to calculating the annualized depreciation expense. In some instances, the net salvage value was not added to the plant accrual rate; thus, the revenue requirement in the Proposed Order was approximately \$4 million too low, which we correct herein.

⁵² See Delmarva Appeal at 3 (quoting Case No. 9299, *In the Matter of the Application of Baltimore Gas & Electric Company for Adjustments to its Electric and Gas Base Rates*, Order No. 85374, at 77 (Feb. 22, 2013)).

⁵³ Delmarva notes that the Federal Reserve increased its short-term interest rates on December 14, 2016.

“authorized ROEs for distribution-only electric utilities (like Delmarva) have been about 20 basis points below those for integrated electric utilities.”⁵⁴

We find that Delmarva’s reliance on our comparative risk observations in BGE’s rate cases is misguided. Our comments in Case No. 9299⁵⁵ and again in Case No. 9406⁵⁶ were intended to distinguish between BGE’s electric and gas distribution operations because “combining BGE’s separate operations to produce a single return for the Company would lead to cross subsidization of services.”⁵⁷ Unlike BGE, however, Delmarva has no gas distribution operations. Likewise, Delmarva’s assertion that we must treat it the same as BGE in this instance is equally untenable. Delmarva has not pointed us to, nor are we aware of, any rule, regulation or precedent that would require us to grant the Company the same ROE as another electric utility or one higher than any gas utility in Maryland.

We turn now to consider the salient question of whether the authorized ROE of 9.48% should be affirmed. The Chief Judge thoroughly reviewed and discussed the parties’ respective ROE methodologies. Their respective ROEs and ROE ranges can be summarized in the following table:

⁵⁴ OPC Appeal at 17 (citing OPC Ex. 18 (Woolridge Direct) at 8).

⁵⁵ Case No. 9299, Order No. 85374.

⁵⁶ Case No. 9406, Order No. 87591.

⁵⁷ Order No. 85374 at 77.

| Method | Delmarva | Staff | OPC |
|------------------------------|------------------|-------|----------------|
| DCF (Constant Growth) | 8.89% to 9.72% | 9.36% | 8.40% to 8.70% |
| DCF (Multi-Stage) | 9.40% to 10.99% | n/a | n/a |
| CAPM | 9.14% to 12.99% | 9.61% | 7.90% to 8.0% |
| ECAPM | 10.16% to 13.65% | n/a | n/a |
| Risk Premium | 10.04% to 10.47% | n/a | n/a |
| Flotation Adjustment | 12 bp | n/a | n/a |
| | | | |
| ROE Recommendation | 10.60% | 9.48% | 8.60% |

The Chief Judge also considered among other things the Company's risk profile, the capital market environment, the equity returns authorized by other jurisdictions, and the fact that Delmarva will not issue its own stock. Despite the Chief Judge's thoughtful considerations, it is concerning to us that the adopted ROE represents a 33-basis point reduction in the Company's current ROE. We have historically followed principles of gradualism when implementing major rate design changes, noting more recently that implementing gradual movement in lowering a utility's ROE could be appropriate "to lessen the impact on the company and investors."⁵⁸ As to Delmarva, we do not fault the Chief Judge's reasoning and decision to reject Delmarva's requested ROE in favor of a lower ROE. However, we find that gradualism warrants a lesser reduction in Delmarva's ROE. Consequently, we find that an ROE of 9.60% is both adequate and appropriate for Delmarva, considering the risks associated with its electric distribution

⁵⁸ See Order 87884 at 101.

operations in Maryland, the capital market conditions at the time of this proceeding, and the fact that Delmarva does not issue its own stock.

On appeal, Delmarva does not oppose removing the six-basis point flotation adjustment previously awarded to the Company in Case No. 9285, as it would be consistent with our ROE award to Pepco in Case No. 9418.⁵⁹ In the Proposed Order, the Chief Judge denied Delmarva's request for flotation costs because Delmarva does not issue its own stock and is now a component of Exelon. We agree and further find that the previous flotation adjustment of six basis points awarded to Delmarva is no longer appropriate. This does not end our discussion, however.

The Chief Judge also reasoned that an ROE around 9.5% would be consistent with the approved equity returns in other jurisdictions as well as the Commission's authorized ROE of 9.55% for Pepco. In its Reply Memorandum, Staff indicated that the national averages for authorized ROEs were 9.6% in 2015, 9.52% during the first six months of 2016, and 9.64% for the first nine months of 2016.⁶⁰ An ROE of 9.60% therefore matches the average authorized ROE in 2015 and is within four basis points of the average ROE for two-thirds of 2016.

We previously held in Case No. 9418 that current market conditions favored a cost of equity lower than 9.62%. Here, the Chief Judge reached similar conclusions in rejecting the Company's requested ROE. She gave little weight to Delmarva Witness

⁵⁹ *See id.* at 100. In Case No. 9418, we also considered the risks associated with Pepco's electric distribution operations in Maryland and the then-current market environment.

⁶⁰ Staff Reply Mem. at 10. In response to Delmarva's comparative risk argument, Staff explains that "a higher ROE for electric utilities as compared to gas utilities is often justified, in part, due to the higher risks faced by electric utilities that own and operate power plants (referred to here as integrated utilities); these integrated utilities are in States where the utilities have not been required to divest their power plants." *Id.* at 11.

Hevert's predictions of an upward trend in interest rates.⁶¹ We are similarly unpersuaded by Delmarva's argument that the Chief Judge should have considered the recent change in Federal Reserve rates. The noted interest rate change occurred after the close of the evidentiary record in this case. Moreover, as the Chief Judge concluded, the increase in the Federal Reserve rate "is small and not enough to justify the increase in Delmarva's ROE proposed by [the Company]."⁶² Given the above-stated ROE trends and record evidence supporting the Chief Judge's conclusions regarding Delmarva's risk profile and financial strength, we believe the market can sustain an ROE of 9.60%. It is unlikely that the ROE we authorize for Delmarva will deter investors of Exelon or hurt the Company's access to credit.

We also find that an ROE of 9.60% falls within Delmarva's Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") ranges and, in particular, toward the upper end of the Company's constant growth DCF range. Although Staff witness VanderHeyden did not provide separate ROE ranges for his DCF and CAPM calculations, his DCF and CAPM ROE calculations effectively represent the upper and lower boundaries for his recommended ROE, which is an average of his two calculations. An ROE of 9.60% also falls within these boundaries, albeit closer to Mr. VanderHeyden's CAPM calculation.⁶³

⁶¹ Proposed Order at 152-53.

⁶² *Id.* at 153.

⁶³ This should not be interpreted as any preference by this Commission for the CAPM method of calculating the cost of capital. Indeed, we have repeatedly stated that we are unwilling to rule that there can be only one correct method for calculating an ROE. *See, e.g.*, Order No. 87884 at 97.

Finally, this ROE further complies with the standards for *Bluefield*⁶⁴ and *Hope*⁶⁵. It is comparable to the returns investors can expect to earn on investments of similar risk in the current market. It is sufficient to assure confidence in Delmarva's financial integrity and enable the Company to receive a fair return commensurate with its risk. It is further adequate to sustain Delmarva's credit so that the Company can continue to attract needed capital at reasonable rates and provide safe and reliable service to customers.

G. Rate Design and Customer Charge

In its application, Delmarva proposed that the fixed customer charge for the residential class be increased to \$12.00 per month, with the remaining revenue requirement for residential service to be recovered through seasonal volumetric rates. For each of the non-residential classes, Delmarva proposed that the increase in the revenue requirement be apportioned to gradually shift the recovery of distribution costs from the volumetric rate component to the customer and demand charge components.⁶⁶ In contrast, Staff did not support an increase to the residential customer charge and recommended that the fixed charges for the other schedules not go beyond the percentage increase in the new revenue requirement.⁶⁷ Nevertheless, because the Chief Judge found that the Base Cost of Service Study ("COSS") submitted by Delmarva inappropriately allocates AMI meter costs as customer-related, she rejected the Base COSS for use in the

⁶⁴ *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923).

⁶⁵ *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

⁶⁶ DPL Ex. 22 (Santacecilia Direct) at 11.

⁶⁷ Staff Ex. 28 (Blaise Direct) at 18.