1053-E-549

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

ORDER

September 28, 2009

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, Phase II, Order No. 15556

I. INTRODUCTION

1. By this Order, the Public Service Commission of the District of Columbia ("Commission") approves the Potomac Electric Power Company's ("Pepco" or "Company") Bill Stabilization Adjustment ("BSA"), as modified, to become effective on November 1, 2009. Pepco shall file a compliance filing within 10 days from the date of this Order and shall implement the BSA in accordance with the directives set forth in this Order.

II. BACKGROUND

2. As part of its most recent distribution rate case, Pepco proposed a revenue decoupling adjustment, the BSA, designed to decouple revenues from the variation in kWh sales, allowing the Company to adjust its base (delivery) rates to reflect actual changes in the revenue it collects on a per customer basis from adjusted test-year levels. The BSA is intended to account for changes in usage due to variations in weather, customer response to price increases or energy-efficiency programs. On January 30, 2008, the Commission issued its Opinion and Order on Pepco's rate case.[1] In that Order, the Commission agreed with the BSA mechanism, in concept,[2] but determined that Pepco's proposed BSA would be considered in a Phase II proceeding to address whether and how the BSA can be implemented consistent with the relevant statutory requirements regarding utility rate changes.[3] In its decision, the Commission raised several questions regarding the BSA implementation process in light of the statutory requirements of D.C.

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1 *Formal Case No. 1053, In the Matter of the Application of the Potomac Electric Power Company For Authority To Increase Existing Retail Rates and Charges for Electric Distribution Service*, Order No. 14712 (January 30, 2008) ("*F.C. 1053*").

2 Order No. 14712, ¶ 351.

3 *Id.*, ¶¶ 352-354.

Code §§ 34-909(a), 34-908, and 34-910(a).[4] Order No. 14740, issued February 28, 2008, initiated Phase II of Formal Case No. 1053.[5]

3. By Order No. 15042, the Commission determined that it possesses statutory authority to implement Pepco's BSA proposal. In addition, the Commission determined that the BSA formula is a rate and, once it is approved, any periodic adjustments made pursuant to the formula do not constitute a change in the rate itself and would not trigger the notice and hearing provisions under the applicable D.C. Code provisions. However, the Commission went on to state that the record was, as yet, insufficiently developed to make a finding that Pepco's BSA proposal is just and reasonable. As a result, the Commission directed the parties to develop a list of issues that they believe require resolution in this phase of the proceeding. Subsequently, by Order No. 15135, the Commission designated six (6) issues for consideration and established a procedural schedule for the Phase II proceeding.[6]

4. In accordance with the adopted procedural schedule, Pepco submitted Supplemental Direct Testimony on January 30, 2009. The Office of the People's Counsel ("OPC") and the District of Columbia Government, District Department of the Environment ("DDOE") submitted Supplemental Direct Testimony on March 4, 2009. The Apartment and Office Building Association ("AOBA") submitted its Supplemental Direct testimony on March 6, 2009. Rebuttal testimony was filed by Pepco on March 30, 2009. An evidentiary hearing was held on May 11, 2009, to address the six issues and whether Pepco's BSA is just and reasonable.[7] Initial Briefs were filed by Pepco, OPC, AOBA and DDOE and Washington Gas Light Company ("WGL") on May 29, 2009. The same parties, except for WGL, filed Reply Briefs on June 12, 2009.

III. Bill Stabilization Adjustment ("BSA") Overview

Pepco's Initial BSA Proposal

5. As initially proposed, the BSA was to be applied on a quarterly basis to the distribution charge for most customer classes but not to street lighting ("SL") and telecommunications network ("TN") customers. As explained by Pepco witness Bumgarner, the BSA was designed to provide the Company with a stable revenue stream

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4 *Id.*

5 *F.C. 1053,* Order No. 14740 (Feb. 28, 2008).

6 *F.C. 1053,* Order No. 15135 (Jan. 2, 2009).

7 The Commission is vested with authority to set rates that are "just and reasonable." D.C. Code § 34-911 (2001 Ed.). Although there is no formula for determining what constitutes a reasonable rate, courts have defined the lower boundary of the zone of reasonableness as one that is not confiscatory in the constitutional sense, *i.e.,* it must allow the company to earn a fair rate of return on its investment, and the upper boundary as one that is not exorbitant. *See OPC v. Public Service Commission,* 797 A.2d. 719 (rates must fall within zone of reasonableness safeguarding interests of both investors and consumers).

based on the test-year revenue requirement.[8] For each rate class and for each billing month in a given quarter, the approved test-year revenue per customer for each service classification is applied to the number of customers in each billing month to arrive at target quarterly revenue for each service classification, and the difference between the target revenue and the actual revenue forms the basis for the BSA for the following quarter.[9]

6. As proposed, the BSA was to be billed on a per kWh basis, calculated quarterly for each service classification on a per customer basis, and applied with a 10 percent cap on any quarterly adjustment. This cap would produce a charge or credit that would be carried over into a subsequent quarter's adjustment and a "true-up" that will account for over-collections or under-collections in the BSA in prior quarters. The balance from any over-collection or under-collection would be added to the revenue differences to arrive at a final BSA revenue target for each rate class for the current quarter. This revenue target would be divided by the projected sales for the upcoming billing period, and this rate will be compared to 10 percent of the rate class average test year quarterly rate per kWh to determine the final BSA for the quarter.[10]

7. In describing the theory underlying the revenue decoupling provided by the BSA, Pepco's witness Chamberlin explained that, although distribution costs are largely fixed and change little in the short-run as usage levels change, the distribution tariffs have a significant volumetric component.[11] Additionally, changes in sales result from weather, price elasticity, building standards, expanded energy efficiency programs, and changes in appliance efficiency.[12]

8. Chamberlin argued that the existing cost-of-service rate structure provides a strong incentive for utilities to sell as much electricity or gas as possible, and the current rate recovery mechanism does not encourage energy efficiency through demand-side resources, because demand-side resources reduce sales and, consequently, revenues and fixed cost recovery decline. This creates a disincentive for the utility to consider demand-side resources even when they are the lowest cost option.[13]

9. Pepco's witness Morin proposed a return on equity ("ROE") reduction of 25 basis points to reflect the value of the BSA.[14] Pepco also proposed an alternative $2.3

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8 Pepco (H) at 18 (Bumgarner Direct), Phase I. All references to the testimony, exhibits and briefs are from F.C. 1053, Phase II, unless designated otherwise.

9 *Id.* at 19.

10 *Id.*

11 Pepco (G) at 3 (Chamberlain Direct), Phase I.

12 *Id.* at 8.

13 *Id.* at 9.

14 Pepco (B) at 90 (Morin Direct), Phase I.

million "repression adjustment" to account for lower sales resulting from higher Standard Offer Service ("SOS") prices in lieu of the BSA, were the BSA not implemented.[15]

Pepco's Modified BSA Proposal

10. Subsequently, Pepco modified its proposal in response to comments raised by the parties about the time lag involved in the BSA. Pepco indicated that it could provide monthly adjustments, rather than the quarterly adjustments proposed, in order to address concerns about the timing of the BSA adjustment.[16] In addition, in order to address the perceived impact of the BSA on service restoration following major storm service outages, Pepco also proposed to exclude from the BSA lost revenues associated with outages affecting at least 10,000 customers for over 24 hours.[17]

OPC's Position

11. OPC argued that the Commission should reject the BSA because it would shift a significant amount of risk associated with the operation of Pepco's distribution system from the stockholders to the ratepayers and would essentially guarantee Pepco's recovery of its revenue requirement, including a return, regardless of the quality of service it provided.[18] Specifically, OPC argued that the BSA is unlikely to stabilize customers' bills because multiple factors will be at issue, including: the current monthly adjustment to "normalize revenue" and over- or under-recovery of the prior quarter's BSA and any possible carryover from prior months' excess over the cap.[19]

12. OPC's witness Rothschild stated that the BSA is a risk elimination measure, noting that the BSA virtually eliminates the "non-diversifiable" risks to Pepco investors and provides a guaranteed revenue stream.[20] While some non-diversifiable risks would remain, Rothschild argued that the main risk, cost escalations due to general economic conditions, is an inflation risk that is already factored into the cost of high-rated corporate debt, because such inflation would reduce the purchasing power of the stream of payments that debtors make to their lenders.[21] Given the positive financial

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15 Pepco (F) at 20-22 (Browning Direct), Phase I.

16 *Id.* at 7.

17 Phase I Tr. at 380-381; Phase II Tr. at 28.

18 OPC (H) at 4-5 (Larkin Direct), Phase I.

19 OPC (H) at 10-11 (Larkin Direct), Phase I; OPC Brief at 49 citing Phase I Tr. 584:15-585:5.

20 OPC (B) at 8 (Rothschild Supp. Direct).

21 *Id.* at 10.

implications of the BSA, OPC recommended a cost of equity reduction of 100 to 200 basis points.[22]

13. OPC's witness Larkin testified that the BSA might partially circumvent individual customer actions since the BSA will decouple the delivery of kWh from the revenue generated from customers. He explained that if an individual customer desires to conserve energy and reduces his consumption, that reduction in consumption would be circumvented because, if Pepco did not collect the average revenue per customer as calculated by Pepco from the rate case, then the total customer group would have to make up that shortfall in revenue through the BSA.[23]

14. Larkin further argued that, although the basic calculations for the BSA are verifiable, the inputs for those calculations are not.[24] He concluded that, because there is no current demand-side management ("DSM") program the Company is proposing to be implemented in conjunction with the BSA, there is no justification to implement the BSA at this time.[25]

15. However, to the extent the Commission adopts the BSA, OPC recommended that it be applied to all customers except the SL and TN classes.[26]

AOBA's Position

16. AOBA was generally opposed to Pepco's BSA proposal and argued that it is primarily intended to shift risk traditionally borne by shareholders to its District of Columbia customers. AOBA's witness Oliver stated that customers may not see the stability that Pepco promotes as a benefit of the BSA due to the lag in the application of adjustments under the BSA and the effect of other adjustments and that, under certain circumstances, the Company's BSA proposal may have the effect of amplifying the volatility in Pepco's billed charges for distribution service. He explained that the BSA could increase volatility of billed distribution service charges because weather variations could cause past under-collection from decreased usage to adversely impact customers at a future point. [27]

17. While Pepco contended that the BSA will eliminate the disincentive for the Company to promote energy efficiency by decoupling revenues from sales, AOBA's

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22 OPC (A) at 5 (Rothschild Supp. Direct).

23 OPC (H) at (17) (Larkin Direct), Phase I.

24 OPC (H) at 25 (Larkin Direct), Phase I.

25 *Id.* at 28-29.

26 OPC Brief at 32.

27 AOBA Brief at 3-6.

witness noted that several of Pepco's proposed rate design changes were targeted at similar goals. As an example, AOBA cited Pepco's proposed rate design changes for demand-metered non-residential rate classifications, which shift significant cost recovery from usage (kilowatt-hour) charges to demand charges. AOBA further noted that Pepco does not actively promote increased use of electricity and has implemented DSM programs to improve efficiency in the past without the BSA. Witness Oliver argued that this demonstrates that the BSA is not a necessary prerequisite for DSM programs.[28]

18. AOBA's witness Oliver recommended a downward adjustment of at least 50 basis points to the return on equity if the BSA is adopted. He argued that Pepco has indicated that adoption of its proposed price elasticity based adjustment to test-year revenue is unnecessary if the BSA is approved; therefore, it is reasonable to assume that the benefits of the proposed BSA, less the value of the ROE adjustment, should yield a net value that is equal to or greater than the dollar value of the Company's proposed test-year revenue adjustment. Therefore the total value of expected BSA benefits for Pepco shareholders should be at least $4.15 million on an annual basis, and that equated to a 55 basis point adjustment to the Company's ROE.[29]

19. According to AOBA, Pepco's level of commitment to demand-side resources and the importance of that level of commitment are yet to be determined. Oliver noted that Pepco filed the Blueprint Plan, in which it proposed certain demand-side initiatives, but that Blueprint Plan is being addressed in a separate proceeding. AOBA suggested that, given the unbundled nature of Pepco's service in the District of Columbia, the appropriate role for the Company's demand-side initiatives, particularly for large commercial customers, is at best questionable.[30]

20. AOBA also recommended that large commercial customers and Temporary Service customers, as well as the SL and TN customers, should be exempted from the BSA.[31]

WMATA's Position

21. WMATA argued that Pepco can accomplish the decoupling of sales from revenues through rate design and that Pepco's changes in rate design move toward decoupling because they shift a substantial portion of Pepco's fixed costs to customer charges and demand charges. WMATA's witness Foster stated that the BSA is not needed for stability and, in fact, may result in wider fluctuations from quarter to quarter. He argued that the Budget Billing Plan, already available to Pepco's residential customers, allows customers to pay their yearly costs in equal monthly installments and,

[28] AOBA (A) at 22 (Oliver Direct) Phase I.

[29] AOBA Brief at 7; AOBA (A) at 65 (Oliver Direct).

[30] AOBA (A) at 28 (Oliver Direct) Phase I.

[31] AOBA Brief at 16.

therefore, there is no benefit of bill stability from the BSA since Pepco's customers may already choose to have a set monthly electric bill.[32]

WGL's Position

22. WGL supports the concept of a decoupling mechanism but does not believe that a downward adjustment to return on equity is necessary when weather risk is already factored into the return of equity analysis.[33]

DDOE's Position

23. DDOE recommends that Residential Aid Discount[34] customers be excluded from the BSA.[35]

IV. Discussion

24. Pepco's BSA is a decoupling mechanism. Decoupling is a regulatory tool designed to separate a utility's revenue from changes in energy sales. Under traditional regulation, a utility's profitability is dependent on its sales volume. Decoupling has been offered as a solution to further public policy goals of encouraging the development of energy efficiency or to make a utility indifferent with respect to encouraging reduced energy consumption initiatives.

25. A number of states have recently considered the decoupling issue as a means of removing disincentives for utilities to invest in energy efficiency measures. The approaches vary but, in general, the mechanism insulates the utility's revenue from such factors as changes in sales volume, weather and economic activity. One of the key issues surrounding the imposition of these decoupling mechanisms is striking the appropriate balance of interests for customers, the utility and its shareholders.

26. Because the utility reaps such benefits as reduced risk, less regulatory lag, and revenue stability, it is imperative that on the other side of the ledger that the customers receive an offsetting benefit. This balancing of interests has resulted in some state public service commissions imposing reduction in the utility's ROE, imposition of certain reporting requirements, establishment of specified efficiency performance requirements and benchmarking requirements, as well as the creation of reliability standards with attendant penalties for failure to meet said standards. Consistent with the aforementioned, as this Commission undertakes the decision-making process in this

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32 WMATA (A) at 11 (Foster Direct) Phase I.

33 WGL Brief at 1.

34 The RAD Rider is a discount that is applied to and is part of Schedule R-Residential Service and Schedule AE- Residential All-Electric Service. The Rider is applied for 18 months after a customer is certified to be eligible for the Low-Income Home Energy Assistance Program (LIHEAP).

35 DDOE (A) at 2 (Lawrence Direct).

matter, it is acutely aware of the need to strike the appropriate balance in protecting the interests of consumers, the utility, and shareholders.

Return on Equity ("ROE")

27. In Phase I, each party providing testimony on this issue recommended an ROE adjustment to reflect the reduced risk associated with the implementation of the BSA. These parties agreed that there would be reduced volatility in Pepco's earnings and that the chances of the Company not earning its approved revenues would be reduced if a BSA were adopted. Pepco initially recommended an adjustment of 25 basis points to reflect the approval of the BSA adjustment, but subsequently modified its position. In particular, Pepco maintained that "[w]hile a 25 basis point adjustment would have been appropriate in the context of Phase I of this proceeding, when the Commission set rates intended to provide the Company the opportunity to earn a fair return, due to the passage of time and intervening erosion of the Company's earned return, a downward adjustment would be unjust and would send a negative signal to the financial community."[36] OPC recommended a reduction of 375 basis points, but suggested that "a compromise could be reached if the Commission is uncomfortable with such an unprecedented low cost of equity."[37] AOBA's recommendation was for a 50 basis point reduction. The basis of AOBA witness Oliver's adjustment is based on Pepco's willingness to give up its repression adjustment if the BSA is adopted, and his estimate of the dollar value of the Company's proposed repression adjustment, along with the dollar value of Pepco's 25 basis point ROE adjustment, if the BSA is approved.[38] In other words, he assumes that the benefits of the BSA are equal to or greater than the total value of the repression adjustment and the ROE adjustment.

28. Notwithstanding Pepco's position that a downward adjustment to the ROE is ill-advised at this juncture, the Commission cannot ignore the fact that, under questioning from the Commission about whether there may be more than a half notch bond rating adjustment to the cost of equity—a half notch representing something near 25 basis points—as the result of the BSA, Dr. Morin [Pepco's witness] said "I think I agree with you that a gesture like approval of the BSA would precipitate an avalanche in a sense, over the next several years of upgrades, one notch at a time, provided that the other pieces of the equation, for example, the ROE and the allowed capital structure, would be fair and reasonable as well." [39] Furthermore, the Commission is not persuaded by Pepco's contention that there should be no downward adjustment to the ROE as part of the implementation of BSA due to the erosion of its earnings in the interim. ROE is a measurement of the return received by shareholders on their investment. It is reflective of, *inter alia*, the effectiveness of management, financial decisions and economic

36 Pepco Brief at 11.

37 OPC (B) at 48 (Rothschild Direct), Phase I.

38 AOBA (A) at 64 (Oliver Direct).

39 Tr. at 163.

conditions. A utility is allowed, but not guaranteed, the opportunity to earn the ROE authorized in a rate case proceeding. To the extent Pepco's earnings are eroded, the available course of redress is the filing of a base rate application,[40] not the denial of an offsetting benefit to consumers for the additional risks they will assume with the approval of the BSA.

29. Given the positive financial implications associated with the implementation of the BSA as discussed by Pepco Witness Morin, OPC Witness Larkin and AOBA Witness Oliver, the Commission finds that a 50 basis point adjustment to the return on equity is reasonable. A 50 basis point reduction in ROE as part of the approval of the BSA balances the ledger by providing a benefit to consumers in exchange for the benefit to the Company and shareholders of reaping lowered business risk.[41]

30. A basic tenet of utility ratemaking is that it involves a delicate balancing of investor and consumer interests.[42] The Commission is free to exercise its ratemaking function provided the rates fall within a zone of reasonableness which assures that the Commission is safeguarding the public interest – that is, the interests of both investors and consumers.[43] We therefore are of the opinion that a 50 basis point downward adjustment in the ROE is required upon implementation of the BSA. The record, as well as public policy, supports this conclusion. We find that implementation of the BSA insulates Pepco from losing revenues which, in turn, lowers the Company's business risk and results in a lower cost of capital.[44] This benefit to the Company and its shareholders requires a concomitant benefit to the ratepayers who are essentially guaranteeing that the Company will collect its revenue requirement as determined in its last base rate case. Thus, fairness to ratepayers requires that approval of a utility revenue decoupling mechanism should be accompanied by substantial utility concessions in other areas, and a downward adjustment to the ROE as part of the BSA implementation provides that concession to consumers in this case.[45]

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40 In fact, Pepco has already availed itself of this remedy by filing an application for an increase in its retail rates and charges for electric service on May 22, 2009. *See, Formal Case 1076, In the Matter of the Application of the Potomac Electric Power Company For Authority To Increase Existing Retail Rates and Charges for Electric Distribution Service*, filed May 22, 2009 ("*F.C. 1076*")

41 The fact that the Maryland Public Service Commission has approved a 50 basis point reduction in Pepco's ROE upon implementation of the company's BSA in that jurisdiction lends support to an ROE reduction in the matter herein. *See,* In the Matter of the Application of Potomac Electric Power Company for Authority to Revise its Rates and Charges and for Certain Rate Design Changes, Case No. 9092.

42 *Potomac Electric Power Co. v. Public Service Commission*, 380 A.2d 126, 132 (D.C. 1977).

43 *Office of the People's Counsel v. Public Service Commission of the District of Columbia,* 797 A.2d 719, 727 (D.C. 2002).

44 *See F.C. No. 1053,* Order No. 14712, ¶ 351 (January 30, 2008).

45 Tr. at 121-122.

31. Because the ROE is applied to the rate base, we determine that the ROE reduction should be allocated according to the rate base as well. Allocating the ROE adjustment based upon class rate base would match the ROE adjustment to the rate base that would have been made at the time of Order No. 14712 had the details of the BSA been determined at that time. Class rate base can be determined within the class cost of service study filed as part of the base rate case in Phase I of F.C. No. 1053. The ROE adjustment will not apply to the SL, TN, and T classes and their associated rate base since these three rate classes will not be covered by the BSA. (This issue will be discussed in more detail below.) In Order No. 14712, this Commission directed that an increased level of revenue be collected from customer and demand (non-energy) rates.[46] To preserve the effect intended, each class's ROE reduction shall be implemented by reducing only the energy (kWh) rates of the rate schedules affected.

Calculation of the BSA

32. The calculation of the BSA is set forth in Pepco's Exhibit (A)-4 and is described as follows:

$$BSA = \frac{(B \times C) - A + D}{E} = \text{monthly adjustment for the class in dollars per kWh}$$

B = average class distribution base revenue per customer for the corresponding month in the test period (as approved in Order No. 14712)
C = class customer count for the current billing month
A = actual monthly class distribution base revenue adjusted for any major service outage (excluding outages involving 10,000 or more customers for over 24 hours would increase the revenue attributable to the class)
D = cumulative true-up for over/under-collections from the class in previous months
E= class forecasted kWh sales for the second succeeding month[47]

The calculations for a given billing month will be performed in the following month (e.g. the calculations for the billing month of April will be done in May), and the BSA adjustment will then be applied to customer bills in the subsequent month (e.g. the BSA adjustment for the billing month of April will be placed on customer bills for June).[48] The adjustment is subject to a 10 percent cap. That is, any rate adjustment applied shall be limited to plus or minus 10 percent of the average test year rate per kWh for the rate class.[49]

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46 F.C. No. 1053, Order No. 14712, ¶¶ 369, 407.

47 Pepco Exhibit (A)-4.

48 Pepco (A) at 7 (Browning Supp. Direct).

49 Pepco (A) at 9-10 (Browning Supp. Direct); Pepco Exhibit (A)-4.