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August 9, 2010

Terry J. Romine, Executive Secretary
Public Service Commission
Of Maryland
6 St. Paul Street, 16th Floor
Baltimore, Maryland 21202

**Re: Case No. 9232**

Dear Ms. Romine:

Enclosed please find an original and seventeen (17) copies of the Reply Testimony of each of Mr. Stephen G. Hill, Mr. Jonathan Wallach and Mr. David J. Effron on behalf of the Office of People's Counsel in the above-referenced case. A copy has been provided to all parties of record.

If you have any questions, please do not hesitate to contact me.

Very truly yours,

/***Electronic signature/***

Anne L. Johnson
Assistant People's Counsel

ALJ/eom
Enclosure
cc: All Parties of Record

BEFORE THE
PUBLIC SERVICE COMMISSION
OF MARYLAND

| | |
|---|---|
| IN THE MATTER OF | ) |
| | ) |
| THE REVIEW OF DELMARVA POWER & LIGHT | ) |
| COMPANY STANDARD OFFER SERVICE | ) Case No. 9226 |
| ADMINISTRATIVE CHARGE | ) |
| | ) |
| AND | ) |
| | ) |
| THE REVIEW OF POTOMAC ELECTRIC POWER | ) |
| COMPANY STANDARD OFFER SERVICE | ) Case No. 9232 |
| ADMINISTRATIVE CHARGE | ) |

REPLY TESTIMONY OF STEPHEN G. HILL

ON BEHALF OF

MARYLAND OFFICE OF PEOPLE'S COUNSEL

AUGUST 9, 2009

REPLY TESTIMONY OF STEPHEN G. HILL
Case Nos. 9226, 9232

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## I. INTRODUCTION / SUMMARY

Q: PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.

A: My name is Stephen G. Hill. I am self-employed as a financial consultant, and principal of Hill Associates, a consulting firm specializing in financial and economic issues in regulated industries. My business address is P.O. Box 587, Hurricane, West Virginia, 25526 (e-mail: hillassociates@gmail.com).

Q: BRIEFLY, WHAT IS YOUR EDUCATIONAL BACKGROUND?

A: After graduating with a Bachelor of Science degree in Chemical Engineering from Auburn University in Auburn, Alabama, I was awarded a scholarship to attend Tulane Graduate School of Business Administration at Tulane University in New Orleans, Louisiana. There I received a Master's Degree in Business Administration. More recently, I have been awarded the professional designation, "Certified Rate of Return Analyst" by the Society of Utility and Regulatory Financial Analysts. This designation is based upon education, experience and the successful completion of a comprehensive examination. I have also served on the Board of Directors of that national organization. A detailed account of my educational background and occupational experience appears in Appendix A attached to this testimony.

Q: HAVE YOU TESTIFIED BEFORE THIS OR OTHER REGULATORY COMMISSIONS?

A: Yes, I have appeared previously before this Commission. In addition, over the past 29 years, I have testified on cost of capital, corporate finance and capital market issues in more than 250 regulatory proceedings before the following regulatory bodies: the West Virginia Public Service Commission, the Texas Public Utilities Commission, the Arizona Corporation Commission, the Oklahoma State Corporation Commission, the Public Utilities Commission of the State of California, the Pennsylvania Public Utilities Commission, the Washington Utilities and Transportation Commission, the Public Utilities Commission of the State of Minnesota, the State of Connecticut Department of Public Utility Control, the Ohio Public Utilities Commission, the Insurance Commissioner of the State of Texas, the North Carolina Insurance Commissioner, the Massachusetts Department of Public Utilities, the Rhode Island Public Utilities Commission, the City Council of Austin, Texas, the Texas Railroad Commission, the Missouri Public Service Commission, the South Carolina Public Service Commission, the Public Utilities Commission of the State of Hawaii, the New Mexico Corporation Commission, the State of Maine Public Utilities Commission, the Georgia Public Service Commission, the Public Service Commission of Utah, the Illinois Commerce Commission, the Kansas Corporation Commission, the Indiana Utility Regulatory Commission, the Virginia Corporation Commission, the Montana Public Service Commission, the Public Service Commission of Wisconsin, the Vermont Public Service Board, the Federal Communications Commission and the Federal Energy Regulatory Commission. I have also testified before the West Virginia Air Pollution Control Commission regarding appropriate pollution control technology and its financial impact on the company under review and have been an advisor to the Arizona Corporation

Commission on matters of utility finance.

Q: ON BEHALF OF WHOM ARE YOU TESTIFYING IN THIS PROCEEDING?

A: I am testifying on behalf of the Maryland Office of People's Counsel (OPC).

Q: WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A: In this proceeding, I have been retained by the OPC to review, analyze and comment on the financial/rate of return aspects of the proposed change in the ratemaking treatment of cash working capital (CWC) for the standard offer service (SOS) function of the electric utility distribution operations of Delmarva Power and Light Company (Delmarva) and the Potomac Electric Power Company (PEPCO; Delmarva and Pepco are collectively referred to herein as the Companies). In addition, I will comment on the appropriateness of the "return" allowance included in the return component of what is termed the "Administrative Charge" (as defined in the Settlement Agreement, discussed subsequently)

Q: PLEASE SUMMARIZE YOUR TESTIMONY AND FINDINGS CONCERNING THE COMPANIES' CASH WORKING CAPITAL AND THE RETURN PORTION OF THE ADMINSTRATIVE CHARGE.

A: According to the Direct Testimony of PEPCO/Delmarva witness Simpson, the original settlement regarding cash working capital and the Administrative Charge related to SOS service expired, for both companies, in mid-2008. Until the filings in these proceedings, the Companies have continued to operate under the terms of the original SOS Administrative Charge Settlement Agreement.[1] However, according to Mr. Simpson, the cash working capital requirement associated with offering SOS service changed when PJM changed its billing cycle to weekly from monthly, and, in addition, as a result of the increase in the wholesale cost of electricity since the original 2003 settlement. As a result, the Companies request that their incremental CWC-related costs be recovered as additional SOS supply costs passed on to customers, while the originally established Administrative Charge, which will continue to be collected, is left unchanged.

As discussed in the testimony of Jonathan Wallach on behalf of OPC, rather than retaining part of the original (now expired) Settlement Agreement, in which a portion of CWC-related costs are "deemed to be recovered" through a return component in the Administrative Charge, he recommends that actual CWC-related costs should be recovered in their entirety in a charge that will be reset annually.

With regard to the rate of return aspects of the CWC charge, my testimony shows that the "return" aspect of the Administrative Charge established in the original Settlement Agreement (1.5 mills/kWh) that the Companies want to maintain is unnecessary, economically inefficient, and allows the Companies to earn a return that exceeds their cost of capital. As such, a continuation of that fixed "return" allowance in the Administrative Charge would unnecessarily enrich stockholders at ratepayer expense, would be unfair to ratepayers in these difficult economic times and would not promote

[1] The "Settlement Agreement" refers to the Settlement Agreement, which was filed on November 15, 2002, and adopted pursuant to Order No. 78400, issued April 29, 2003, in Case No. 8908 ("Order No. 78400").

the balancing of utility and ratepayer interests. The "return" component of the SOS-related Administrative Charge should be replaced by the CWC component, as described by Mr. Wallach.

The other aspect of my testimony addresses the cost rate to be applied to the CWC balances in order to determine the charges to be included in rates. Cash working capital is a regulatory construct in which the amount of monies necessary to finance the shortfall between the payment of expenses and the receipt of ratepayer monies to meet those expenses is assumed to be a rate base "asset" and is allowed to earn a return at a rate equal to the utility's overall cost of capital.

Although the CWC "asset" construct is short-term in nature, because it arises from an on-going requirement, it is assumed, for regulatory purposes, that the cost of those monies is equal to the long-term pre-tax overall cost of capital of the utility. That ratemaking assumption is very generous to the utility because, even though the shortfall between the payment of expenses and the receipt of ratepayer funds to pay those expenses is continuing, it is difficult to reason that any savvy financial manager would issue common equity to pay power costs that will be covered by receipts from ratepayers within 30 days. That is, short-term assets (such as the CWC construct at issue in these proceedings) are most economically financed with similar-term (short-term) liabilities, which, because the lag between incurring the expense and receiving the payment is 33 to 37 days[2], would be short-term debt—not the average mix of capital used to fund the entire utility rate base.

[2] Simpson Direct, p. 9, Delmarva and Pepco, respectively.

However, the regulatory tradition in Maryland for allowing a return on the CWC "asset" is the use of the Companies' overall cost of capital and recommends the continuance of that practice for the cash working capital as traditionally billed by PJM, i.e., monthly. However, for the incremental costs associated with the change in PJM's billing cycle to weekly (an even shorter-term issue), we recommend that a short-term debt cost rate be assigned to that portion of the CWC "asset."

OPC witness David Effron provides a calculation of the total CWC costs for Pepco and Delmarva using the overall cost of capital to calculate the costs as traditionally applied to the monthly billing by PJM and a short-term debt cost rate applied to the incremental CWC due to the change to weekly billing. As shown in the Chart below, while the OPC-recommended CWC costs allow the Companies to earn a fair return on their CWC "assets" (i.e., meeting the financing costs of their power supply revenue lag), they are more economically efficient and impart a lower cost to ratepayers.

Table I.

OPC and Companies' Recommended Total CWC Costs
$/MWh

| Customer Type | OPC | | Company[3] | |
|---|---|---|---|---|
| | Pepco | Delmarva | Pepco | Delmarva |
| Residential | $0.700 | $0.540 | $1.230 | $1.118 |

[3] Company CWC data from Simpson Direct Testimony: PEPCO__(AGS)-4, Col. D, DPL__(AGS)-4, Col. D.

## II. ADMINISTRATIVE "RETURN" CHARGE

Q. SECTION 7-510 OF THE MARYLAND PUBLIC UTILITY COMPANIES ARTICLE, PARAGRAPH (C)(3)(ii)(2) REQUIRES THAT ELECTRIC COMPANIES PROVIDE TRADITIONAL UTILITY SERVICE (TERMED "STANDARD OFFER SERVICE") AT A PRICE THAT PERMITS RECOVERY OF PRUDENTLY INCURRED COSTS AND A REASONABLE RETURN. DOES THAT REQUIREMENT NECESSITATE A SEPARATE "RETURN" CHARGE BE INCLUDED IN THE SOS ADMINISTRATIVE CHARGE?

A. No, it does not. An explicit additional "return" charge included in the SOS Administrative Charge is unnecessary because the Companies and their stockholders are already receiving appropriate, full compensation for the risks pertaining to the provision of utility service in the return that is allowed in their distribution utility rate proceedings. Moreover, the Settlement Agreements related to the provision of SOS for both Pepco and Delmarva expired in mid-year 2008, and this proceeding provides the opportunity for a Commission review of the appropriateness of any administrative "return" charge. That "return" portion of the Administrative Charge for SOS service, the previously agreed upon 1.5 mills per kWh, should be discontinued.

Q. CAN YOU EXPLAIN IN MORE DETAIL WHY A SEPARATE "RETURN" CHARGE INCLUDED IN THE ADMINSTRATIVE CHARGES ASSOCIATED WITH SOS SERVICE IS UNNECESSARY?

A. Yes, there are many reasons why a separate "return" charge in the SOS Administrative Charge is unnecessary. First, the term "return" applied to that particular portion of the Administrative Charge is a misnomer; it's not really a return at all. There can be no return, in a financial sense, unless there is an investment on which the return can be earned. In the service of procuring purchased power for customers that do not contract for their own supply, there is no investment base on which any actual return can be earned. It is simply a service. What has been termed the "return" portion of the Administrative Charge as a result of the settlement of Case No. 8909 is simply an additional charge passed on to ratepayers and is not a return on any plant investment whatsoever.

As set out in Bluefield, one of the seminal U.S. Supreme Court decisions that have governed the determination of allowed returns for utilities, the "return" to be allowed is proportional to the investment in utility property undertaken.

> A public utility is entitled to such rates as will permit it to earn a return upon the *value of the property* which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit, and enable it to raise the money necessary for the proper discharge of its public duties. (*Bluefield Water Works and Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 692 (1923). Emphasis added)

Second, "standard offer service," which is defined in § 7-510(c)(2) as "electricity purchased from a customer's electric company" cannot exist in the abstract. As defined in the Statute, SOS is just electricity, and, therefore, cannot be transported, sold, or used unless it is delivered through the transmission and distribution assets of the customer's utility. As such, SOS service is simply standard utility service—electricity purchased by the utility for delivery through its distribution system to its customers. SOS service is, then, inextricably tied to the routine provision of utility service. It is not a stand-alone service that has risks different and apart from the provision of normal utility service—it is utility service.

Third, because buying and delivering purchased power to customers is a routine utility function, the risks attendant to that function and the return necessary to properly compensate investors for those risks are accounted for in the returns allowed in distribution rate cases. As noted in the above cite from *Bluefield*, the return allowed regulated utilities should be similar to that earned by firms with corresponding risks. That requirement is also echoed in the *Hope*[4] decision, which also is a fundamental reference for an appropriate utility return. An analysis and review of the cost of capital of sample groups of similar-risk utilities is the procedure used by this Commission in determining the appropriate overall return to be allowed in setting utility rates in Maryland, and is used in all other regulatory jurisdictions in the U.S.

For example, in Pepco's and Delmarva's most recent rate cases, in order to estimate the cost of capital for their distribution operations, the Companies' cost of capital witness used sample groups that consisted of both wires companies as well as fully-integrated electric companies (e.g., ALLETE, CMS Energy, Empire District Electric, MGE Energy, and Wisconsin Energy).[5] Setting aside the fact that the fully-integrated companies have generation and/or unregulated operation risk that Pepco and Delmarva do not have, purchasing power and delivering it to customers is a normal part

[4] FPC v. Hope Natural Gas Company, 320 US 591 (1944)
[5] Case No. 9217, Direct Testimony of Dr. R. Morin, PEPCO (RAM)-7. Dr. Morin also testified for Delmarva in Case No. 9093 and, in that case, used sample groups of gas distributors and integrated electric utilities.

of business for these types of companies. Similarly, electric distribution companies and gas distributors commonly buy the electricity or gas needed by their customers. That is, the energy supply activity termed SOS in this jurisdiction is simply business-as-usual for many utilities. For the electric companies listed above, which were part of the sample group selected by Pepco as similar in risk to its Maryland distribution operations, on average, 45% of the power needs for their customers were derived from purchased power. Therefore, the risks attendant to supplying "standard offer service" in Maryland is accounted for in the cost of capital determined in the distribution rate proceedings because that type of activity (purchasing power for customer use) is a normal part of the utility function for the companies that are included in the similar risk sample groups from which the cost of capital is estimated. Including any additional charge, such as the so-called "return" charge that was included in the SOS Administrative Charges as a result of the Settlement Agreement, would amount of double-recovery of any attendant SOS risk-related charges, would constitute over-recovery of the utility's cost of capital and, finally, would unnecessarily enrich stockholders at ratepayer expense.

Q. ISN'T THE PROVISION OF SOS SERVICE RISKIER THAN THE POWER PURCHASES OF OTHER UTILITIES BECAUSE THE MARYLAND UTILITIES HAVE TO PURCHASE ALL OF THE POWER NEEDS OF THEIR CUSTOMERS THAT UTILIZE SOS SERVICE, NOT JUST PART OF IT?

A. No. First, for the other companies, the power they provide to their customers that is not purchased from other suppliers is provided by their own generation. As this Commission is aware, generation risk is greater than distribution and transmission risk, and a firm that supplies 55% of its supply from its own generation and 45% from purchased power would have greater investment risk than a pure-play distribution company like Pepco or Delmarva.

Second, there are specific risk-reducing measures at play here in Maryland that tend to minimize the risk of providing SOS for distribution companies. This Commission pre-approves the two-year purchased power plans that will provide the SOS energy for the distributors under its purview. While this pre-approval process does not guarantee that there would never be any non-recovery of purchased power costs due to imprudence on the part of the Companies, it must be considered to lower the risk of that possibility compared to those companies whose power purchases are not subject to such regulatory review. In addition, the electric distributors in Maryland are not at risk for the revenue impact of usage shortfalls. Revenues from SOS customers are reconciled against payments to SOS suppliers, and distribution utilities are held harmless from default of an SOS supplier. These factors lower the risks of supplying SOS service in Maryland.

Third, the recommendations being made by Mr. Wallach in this proceeding to collect actual SOS-related incremental costs in an annual proceeding rather than collect a fixed amount of costs that may or may not meet actual costs (as existed during the settlement period) lowers the operational risk of SOS service. By recovering actual incremental costs and cash working capital costs based on the most recent “test year” actuals, the Companies are not subject to the risks that may have existed during the settlement period when the recovery of costs was limited to a fixed amount.

Q. ARE THERE OTHER FACTORS THAT THIS COMMISSION SHOULD CONSIDER IN ASSESSING THE NEED FOR A SEPARATE "RETURN" CHARGE IN THE SOS ADMINISTRATIVE CHARGES TO BE ASSESSED IN THESE PROCEEDINGS?

A. Yes. As I have noted, the provision of SOS is a service, and that service entails a cost. It is a cost of doing business and the prudent costs of doing utility business should be included in the rates that customers pay. That is true for line worker's salaries; for utility office expenses like paper clips; and for expenses like purchased power. Also, just as regulation allows no "return" adders to the salary of a line worker or to the price of a paper clip, there should be no "return" adder to the cost of power purchased to provide standard utility service—SOS.

Q. IS THERE ANY ASPECT OF "RETURN" THAT SHOULD BE CONSIDERED IN THE SOS ADMINISTRATIVE CHARGES?

A. Yes. Because it is standard regulatory procedure to create a hypothetical rate base "asset" for the purposes of determining an allowance for cash working capital, there is an asset on which a legitimate return can be earned—and the resulting charge is appropriately included in the cost of supplying SOS service. The only appropriate return associated with standard offer service, then, is that related to cash working capital, which I will address in the next section of my testimony.

## II. CASH WORKING CAPITAL RETURN

Q. WHY DOES A NEED FOR WORKING CAPITAL ARISE?

A. When a business has to pay expenses prior to the receipt of sales from customers, a need for "working capital" arises. That is capital must be raised to provide the monies to pay the expenses incurred in providing the product prior to the time that the product is sold. For utilities, and particularly in this instance with the provision of SOS service, the power must be purchased prior to the time that customers pay for that power, and the purchase of the power must be financed over a relatively short-term period.

Q. ARE UTILITIES THE ONLY TYPE OF COMPANIES THAT EXPERIENCE A LAG BETWEEN THE PAYMENT OF EXPENSES AND THE RECEIPT OF CUSTOMER MONIES?

A. No. Practically any business would have to have funds available to finance short-term cash needs like working capital. For example, car dealers would have to pay the factory for an automobile when it arrives on their lot and would have to finance that purchase until the car is sold. However, utilities have a considerable advantage over competitive firms when it comes to working capital—they can explicitly include the charges for financing a short-term revenue short-fall in the price of their product. A non-regulated firm may or may not be able to recover those costs, depending on the competitive price of the product. Therefore, although utility regulation is designed to emulate the results that would obtain under competition, there are instances in which utilities, due to the important nature of the service they provide, are provided certain “allowances” that competitive firms do not enjoy—cash working capital is one of those allowances.

Q. HOW IS A CASH WORKING CAPTIAL “ALLOWANCE” CONSTRUCTED?

A. In order to provide the utility with an estimated cost of financing its short-term working capital needs, the average time between the payment of expenses and the receipt of ratepayer monies is calculated in a lead-lag study. That time difference (usually, a number of days) is multiplied by the average daily expenses to be financed (in the case of SOS service, that is the daily cost of the SOS supply). The product of those two estimates, the net revenue lag days and the daily commodity costs per kWh, provides an estimate of the amount of working capital necessary to provide the SOS service.

Q. HOW IS THE COST OF THAT WORKING CAPITAL DETERMINED?

A. In order to calculate an increase to rates that will cover the utility’s working capital financing costs, the amount of working capital determined in the lead-lag study is assumed to be a rate base “asset.” Then, to calculate the cost of financing the working capital, the utility’s pre-tax overall cost of capital is applied to the hypothetical rate base “asset” to determine the amount to be included in rates.

Q. YOU HAVE NOTED THAT THE NEED TO FINANCE CASH WORKING CAPITAL IS RELATIVELY SHORT-TERM IN NATURE. WHY THE COMPANIES ASSUME THAT SUCH FINANCING WOULD BE ACCOMPLISHED WITH THE SAME MIX

OF CAPITAL THAT FINANCES THE UTILITY'S PLANT EQUIPMENT, WHICH ARE LONG-LIVED ASSETS?

A. Although Pepco/Delmarva witness Simpson does not discuss it directly in his testimony, the rationale usually propounded for the use of the overall weighted-average cost of capital as the cost rate for financing the working capital "asset" is that the need for financing is re-occurring in nature. That is, although there are ratepayer monies flowing into the company after about a month, there are power costs to be paid for which revenues will not be realized for another month.

While that logic is not untrue—the need for financing cash working capital is certainly an ongoing cost of doing business—that does not change the fact that the financing need itself is short-term in nature. It would not be economically efficient for a company to issue long-term capital such as common equity, preferred stock or even long-term debt to finance power purchases for 30 to 40 days. The more common practice in corporate finance is to match the duration of assets and liabilities.[6] That is, short-term assets are usually financed by short-term liabilities and, because the yield curve is normally upward-sloping, short-term liabilities have a lower cost than long-term liabilities. Therefore, the current practice of applying a pre-tax overall cost of capital to the working capital "asset" is a ratemaking procedure that is generous to utilities in that it probably imparts a higher cost to ratepayers of financing working capital than is actually incurred by the utilities.

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[6] J.R. Graham, C.R. Harvey, "the theory and Practice of Finance: Evidence from the Field," *Journal of Financial Economics* 61 (MY 2001), pp. 187-243.

Q. DO YOU RECOMMEND, THEN, THAT THE COST RATE TO BE APPLIED TO THE WORKING CAPITAL "ASSET" BE CHANGED IN THIS PROCEEDING TO A SHORT-TERM DEBT COST RATE?

A. Not entirely; no. The "prime mover" with regard to CWC charges in this proceeding is the change in billing for power purchases initiated by PJM, the Companies' wholesale power supplier. PJM changed its billing procedures from a monthly cycle to a weekly cycle. While that change in billing cycles—the change from one month to one week—is entirely short-term in nature, that difference causes a substantial shift in the calculation of net lag days. Power bills must be paid sooner, while customer revenue collection cycles are unchanged.

Because the *incremental* change in the net lag days related to the change in PJM billing cycle is due to a short-term timing difference, OPC recommends that the cost rate of that *incremental* change in cash working capital be set equal to a short-term debt cost rate. However, because the use of the overall cost of capital as the cost rate for cash working capital has been traditionally used by this Commission, I recommend that the return allowed on the cash working capital asset that arises from a monthly billing cycle (that which existed prior to PJM's change in billing) be the overall cost of capital of the utility, as it was prior to the change in billing.

Therefore, the calculation of the return on CWC will be a two-step process. First the net lag days appropriate for a monthly PJM billing cycle will be calculated and multiplied by the appropriate commodity cost to determine the size of the working capital asset. Then that amount will be multiplied by the pre-tax overall cost of capital. To that amount will be added the cost of short-term debt times the product of the revenue lag difference between the weekly and monthly PJM billing and the appropriate commodity cost. The total of those two calculations will determine the appropriate return on cash working capital that will be added to rates in order to provide the Companies a return on their CWC "assets."

This procedure provides a balance between the interests of the Company and that of its ratepayers. The Company recovers its costs as it previously did for the monthly billing cycle. As noted above, it is reasonable to believe that, through the use of a pre-tax overall cost of capital cost rate, those costs may be somewhat over-recovered. With the *incremental* change from monthly to weekly billing, the Company is allowed to recover a short-term debt cost rate on those "assets" because it is related to the timing difference between one month and one week. The Companies are able to recover a reasonable cost of short-term capital on these monies and the ratepayers are able to realize a smaller increase in their cost of financing the Companies' working capital.

Q. FOR PURPOSES OF THIS CALCULATION, WHAT SHORT-TERM DEBT COST RATE DO YOU RECOMMEND?

A. For purposes of determining the incremental portion of the cash working capital costs, I recommend using the prime rate of interest as published by the Federal Reserve in its weekly Statistical Release H.15. The June 28, 2010 publication indicates that the current Prime Rate (the rate that commercial banks charge for short-term loans to businesses) is

3.25%. This rate of interest is generous for the utilities and probably overstates their short-term capital costs. For example, that same edition of the Federal Reserve's H.15 indicates that the current six-month LIBOR (London Interbank Offering Rate), which is often a benchmark lending rate for short-term debt, is 0.75%—much lower than the 3.25% Prime Rate. Again, in my view, pricing the Companies' incremental CWC financing costs at the current prime rate of interest (3.25%) is beneficial to both the Companies and its ratepayers.

Q. HAVE YOU PERFORMED THE CASH WORKING CAPITAL CALCULATIONS YOU DESCRIBE?

A. I have not. Those calculations are performed by OPC witness David Effron and presented in his testimony. The results of those calculations are shown below.

OPC and Companies' Recommended CWC Costs
$/MWh

| Customer Type | OPC | | Company[7] | |
|---|---|---|---|---|
| | Pepco | Delmarva | Pepco | Delmarva |
| Residential | $0.700 | $0.540 | $1.230 | $1.118 |

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

[7] Company CWC data from Simpson Direct Testimony: PEPCO__(AGS)-4, Col. D, DPL__(AGS)-4, Col. D.

# Appendix A SGH-1

PSC 9232 – In the Matter of the Review of

Potomac Electric Power Company

Standard Offer Service Administrative Charge

# EDUCATION AND EMPLOYMENT HISTORY
# STEPHEN G. HILL

## EDUCATION

Auburn University - Auburn, Alabama - Bachelor of Science in Chemical Engineering (1971); Honors - member Tau Beta Pi national engineering honorary society, Dean's list, candidate for outstanding engineering graduate; Organizations - Engineering Council, American Institute of Chemical Engineers

Tulane University - New Orleans, Louisiana - Masters in Business Administration (1973); concentration: Finance; awarded scholarship; Organizations - member MBA curriculum committee, Vice-President of student body, academic affairs

Continuing Education - NARUC Regulatory Studies Program at Michigan State University

## EMPLOYMENT

West Virginia Air Pollution Control Commission (1975)
Position: Engineer ; Responsibility: Overseeing the compliance of all chemical companies in the State with the pollution guidelines set forth in the Clean Air Act.

West Virginia Public Service Commission-Consumer Advocate (1982)
Position: Rate of Return Analyst ; Responsibility: All rate of return research and testimony promulgated by the Consumer Advocate; also, testimony on engineering issues, when necessary.

Hill Associates (1989)
Position: Principal; Responsibility: Expert testimony regarding financial and economic issue in regulated industries.

## PUBLICATIONS

"The Market Risk Premium and the Proper Interpretation of Historical Data," Proceedings of the Fourth NARUC Biennial Regulatory Information Conference, Volume I, pp. 245-255.
"Use of the Discounted Cash Flow Has Not Been Invalidated," Public Utilities Fortnightly, March 31, 1988, pp. 35-38.
"Private Equity Buyouts of Public Utilities: Preparation for Regulators," National Regulatory Research Institute, Paper 07-11, December 2007.

## MEMBERSHIPS

American Institute of Chemical Engineers; Society of Utility and Regulatory Financial Analysts (Certified Rate of Return Analyst, Member of the Board of Directors)

**STATE OF MARYLAND**

**BEFORE THE PUBLIC SERVICE COMMISSION**

| | | |
|---|---|---|
| **In the Matter of the Review of** | **)** | |
| **Potomac Electric Power Company** | **)** | **Case No. 9232** |
| **Standard Offer Service Administrative Charge** | **)** | |

**REPLY TESTIMONY OF**

**JONATHAN WALLACH**

**ON BEHALF OF**

**THE OFFICE OF PEOPLE'S COUNSEL**

Resource Insight, Inc.

**AUGUST 9, 2010**

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## I. Introduction and Summary

**Q: Please state your name, occupation, and business address.**

A: I am Jonathan F. Wallach. I am Vice President of Resource Insight, Inc., 5 Water Street, Arlington, Massachusetts.

**Q: Please summarize your professional education and experience.**

A: I have worked as a consultant to the electric-power industry since 1981. From 1981 to 1986, I was a research associate at Energy Systems Research Group. In 1987 and 1988, I was an independent consultant. From 1989 to 1990, I was a senior analyst at Komanoff Energy Associates. I have been in my current position at Resource Insight since September of 1990.

Over the last twenty-nine years, I have advised clients on a wide range of economic, planning, and policy issues including: electric-utility restructuring; wholesale-power market design and operations; transmission pricing and policy; market valuation of generating assets and purchase contracts; power-procurement strategies; integrated resource planning; cost allocation and rate design; and energy-efficiency program design and planning.

My resume is attached as Exhibit JFW-1.

**Q: Please summarize your experience with regard to the establishment and derivation of the Administrative Charge.**

A: I have advised and testified on behalf of the Office of People's Counsel ("OPC") in most of the major proceedings relating to Maryland's restructuring process since 1997. During that time, I assisted OPC during settlement negotiations, and testified in support of the settlement agreement that established the Administrative Charge, in Case No. 8908. I also testified in Case

Nos. 8994 and 8995 regarding derivation of the uncollectible-cost component of the Administrative Charge for Potomac Electric Power Company ("PEPCO"; "the Company") and Delmarva Power and Light Company. Finally, I testified in Case No. 9099 regarding the Commission's investigation of residential SOS rates, including the Administrative Charge.

**Q: On whose behalf are you testifying?**

A: I am testifying on behalf of the Office of People's Counsel.

**Q: What is the purpose of your testimony?**

A: On March 9, 2010, PEPCO filed in Case No. 8908 a request to increase the recovery of cash working capital ("CWC") costs from residential Standard Offer Service ("SOS") customers. On May 20, 2010, the Commission, ruling on a motion by OPC, issued Order No. 83345 expanding the scope of the investigation to encompass all elements of the Administrative Charge for residential SOS. In response, the Company filed on June 14, 2010 the Direct Testimony and Exhibits of Company Witness A. Glenn Simpson regarding the Company's proposals for each component of the Administrative Charge and the Company's request for an increase in SOS-related CWC costs.

This testimony responds to the Company's proposals regarding the Administrative Charge and CWC costs for residential SOS customers. People's Counsel is also sponsoring testimony in this proceeding by David Effron regarding the calculation of CWC costs and Steven Hill regarding the return component of the Administrative Charge and the cost to finance SOS-related cash working capital.

**Q: Please summarize your conclusions and recommendations.**

A: In Order No. 83345 establishing this proceeding, the Commission found that the structure and component values of the Administrative Charge for residential

SOS were negotiated as part of a larger settlement package that balanced the competing interests of settling parties. As a result, the Commission concluded that approving a change to one component without assessing the reasonableness of the other components could "adversely alter this balance to the detriment of the ratepayers and significant benefit to the Companies."[1]

In addition, the Commission found in Order No. 83345 that the utilities now have actual cost data for the components of the Administrative Charge. The Commission therefore concluded that "any changes needed to any of the components may be determined using this actual data, rather than changing one component using actual data while maintaining the other components at a fixed rate…."[2]

The Company's proposals with regard to the Administrative Charge and CWC costs run contrary to the Commission's conclusions in Order No. 83345. The Company's proposal upsets the balance of competing interests achieved in the Settlement Agreement in Case No. 8908 by changing one component of the Administrative Charge – the amount recovered for CWC costs – without more than a cursory assessment of the reasonableness of the other components.[3] Moreover, the Company proposes to increase the amount recovered for CWC costs based on actual data, but proposes to maintain the current fixed rate for incremental costs despite the fact that actual incremental costs would support reducing the incremental-cost rate by more than half.

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[1] *Order No. 83345*, Case Nos. 9226 and 9232, May 20, 2010, p. 3.

[2] *Id.*

[3] The "Settlement Agreement" refers to the Settlement Agreement, which was filed on November 15, 2002, and adopted pursuant to Order No. 78400, issued April 29, 2003, in Case No. 8908.

To correct these flaws in the Company's filing, and taking into account the recommendations of OPC witnesses Effron and Hill, I recommend the following:

- Replace the fixed rate for the incremental-cost component with a rate set to recover actual, verifiable, prudently incurred incremental costs. Establish an annual proceeding to: (1) review and assess the prudence of the prior year's spending on incremental costs; (2) reconcile incremental-cost revenues against actual costs; and (3) reset the rate for the upcoming year.
- Limit the return component strictly to recovery of the return on SOS-related cash working capital. Allow no other costs or other deemed return to be recovered through the return component.
- Replace the fixed rate for the return component with a rate set to recover all SOS-related CWC costs. As part of the annual proceeding for incremental costs, update the return rate as appropriate to reflect revisions to estimates of CWC costs due to changes in wholesale SOS supply costs or approved changes to the Company's cost of capital.
- Continue to set the rate for the uncollectible-cost component as part of distribution rate cases.
- Eliminate the Administrative Adjustment.

I further recommend that the rates for each component of the Administrative Charge for residential SOS customers be set initially as follows:

| | |
|---|---|
| Incremental Cost | 0.19 mills/kWh |
| Uncollectible Cost | 1.59 mills/kWh |
| CWC Cost | 0.70 mills/kWh |
| Administrative Charge | 2.48 mills/kWh |

The incremental-cost rate shown above is based on an average of actual costs incurred by the Company in recent years. The uncollectible-cost rate is set at the rate proposed by the Company and authorized by the Commission in a recent order in Case No. 9217. Finally, the recommended initial rate for CWC costs is derived by OPC witness Effron.

## II. The Administrative Charge

**Q: Please describe the Settlement Agreement in Case No. 8908.**

A: The Settlement Agreement resolved a number of key concerns at that time associated with the continued provision of a regulated standard-offer service to residential consumers, by establishing, among other things, the terms and conditions, the pricing mechanism, and the framework for competitive procurement of wholesale supply for residential SOS.

Specifically, the Settlement Agreement:

- Established the obligation of each of Maryland's four investor-owned utilities to provide residential SOS after the end of each utility's current rate-cap or rate-freeze transition period, and defined the period of time during which the obligation would continue.
- Established that wholesale supply for residential SOS would be procured through a competitive procurement process.
- Established that wholesale supply for residential SOS would consist of a portfolio of one-, two-, and three-year supply contracts, and specified the percentages of these one-, two-, and three-year contracts that would comprise the portfolio.
- Specified the components of the retail price for residential SOS.
- Established an "Administrative Charge" as one part of the retail price for residential SOS, set the rate for the Administrative Charge at 4 mills/kWh, and specified four individual components of the Administrative Charge:

(1) incremental cost; (2) return; (3) uncollectible cost; and (4) Administrative Adjustment.

- Specified the rates for each of the four components of the Administrative Charge, and established mechanisms for recovering and re-setting such rates.
- Provided that residential customers could switch freely between SOS and competitive retail service without restriction.

The Settlement Agreement was intensively negotiated over many months by a large and diverse group of parties with competing interests. While each party may not have been satisfied with particular provisions of the Settlement Agreement, and would not have necessarily agreed to such provisions in isolation, the negotiated package as a whole apparently provided tangible benefits and served the interests of settling parties.

**Q: Please describe the structure of the Administrative Charge established in the Settlement Agreement for residential SOS.**

A: As noted above, the Settlement Agreement established an Administrative Charge as part of the retail price for residential SOS, and specified a rate of 4 mills/kWh for the Administrative Charge. The Settlement Agreement further specified that there would be four components to the Administrative Charge: (1) incremental cost; (2) return; (3) uncollectible cost; and (4) Administrative Adjustment.

The Settlement Agreement set the rate for the incremental-cost component at 0.5 mills/kWh, and further specified that this rate would remain fixed over the term of the agreement. Incremental costs were defined in the Settlement Agreement to exclude both SOS-related CWC costs, which were deemed to be collected through the return component, and SOS-related uncollectible costs.

The Settlement Agreement set the rate for the return component at 1.5 mills/kWh. As with the incremental-cost component, the return rate was fixed for the term of the agreement. As noted above, the return component was defined as the sole means for recovery of SOS-related CWC costs. Consequently, recovery of SOS-related CWC costs was limited to 1.5 mills/kWh, regardless of the actual magnitude of CWC costs.

The rate for SOS-related uncollectible costs was initially set at zero for PEPCO. The Settlement Agreement then provided for changes to that initial rate in subsequent distribution rate cases. By the end of the term of the Settlement Agreement for PEPCO, the rate for uncollectible costs was 0.7 mills/kWh; the Commission recently authorized the Company's request in Case No. 9217 to increase the uncollectible-cost rate to about 1.6 mills/kWh, or more than two times the current rate.

Finally, the Settlement Agreement established the rate for the Administrative Adjustment as the remainder of the 4 mills/kWh Administrative Charge after subtracting the rates for the incremental-cost, return, and uncollectible-cost components. Thus, at the outset of the Settlement Agreement, the Administrative Adjustment for PEPCO was set at 2 mills/kWh, which is equal to 4 mills less 0.5 mills for incremental cost, less 1.5 mills for return, and less 0 mills for SOS-related uncollectible costs. By the end of the term of the Settlement Agreement for PEPCO, the Administrative Adjustment was set at 1.3 mills/kWh (4 mills less 0.5 mills for incremental costs, 1.5 mills for return, and 0.7 mills for uncollectible costs.)

**Q: Please describe the treatment of revenues associated with the Administrative Adjustment.**

A: The Settlement Agreement provided that all revenues associated with the Administrative Adjustment would be returned to residential distribution customers, regardless of whether they were SOS customers or were served by a competitive retail supplier.

This treatment of Administrative Adjustment revenues – collection from residential SOS customers, and refund to all residential distribution customers – gives rise to slight cross-subsidization of switching customers by SOS customers, since customers that switch to competitive retail supply will not be charged the Administrative Adjustment, but will be credited a portion of the revenues.

**Q: Is PEPCO proposing in this proceeding to alter the rate for the Administrative Charge?**

A: No. The Company proposes to continue collecting 4 mills/kWh for the Administrative Charge. The Company further proposes the following rates for the individual components of the Administrative Charge:

| | |
|---|---|
| Incremental Cost | 0.5 mills/kWh |
| Return | 1.5 mills/kWh |
| Uncollectible Cost | 1.6 mills/kWh |
| Administrative Adjustment | 0.4 mills/kWh |
| | 4.0 mills/kWh |

In addition to the 4 mills/kWh Administrative Charge, PEPCO proposes to charge consumers 0.94 mills/kWh for CWC costs over and above the amount that PEPCO assumes to be recovered through the 1.5 mills/kWh return component of the Administrative Charge.

In total, then, the Company proposes to charge consumers 4.94 mills/kWh for the Administrative Charge and incremental CWC costs.

I discuss below the Company's proposals for each of the components of the Administrative Charge and for the additional charge for incremental CWC costs.

## III. Incremental Costs

**Q: What does PEPCO propose for the incremental-cost component of the Administrative Charge?**

A: According to Mr. Simpson, the Company proposes to continue charging ratepayers 0.5 mills/kWh for incremental costs. The Company recommends maintaining the rate at 0.5 mills/kWh, because that rate was agreed to by a "diverse group of parties" during the settlement negotiations and because the current charge has "worked well for the past six years."[4]

**Q: Is the Company's rationale a reasonable basis for its proposal?**

A: Neither of Mr. Simpson's arguments are valid reasons for continuing to charge ratepayers 0.5 mills/kWh for incremental costs. The fact that a diverse group of parties agreed to this charge as part of a broader settlement package, the term of which has expired, has no bearing on whether the charge is reasonable on its own. As I discussed above, parties agreed to this charge as part of a comprehensive settlement package that balanced the competing interests of those parties. The fact that parties agreed to the 0.5 mills/kWh rate as part of a broader package in no way indicates that any of those parties approved of the 0.5 mill charge in isolation.

[4] *Direct Testimony and Exhibits of Company Witness A.G. Simpson*, Case No. 9232, June 14, 2010, p. 15.

As to Mr. Simpson's second argument, the current charge for incremental costs has certainly "worked well" for the Company in the sense that it has proved profitable for PEPCO's shareholders. According to data provided in the Company's reports on actual incremental costs and in response to OPC DR 2-11, revenues collected through the incremental-cost component of the Administrative Charge have greatly exceeded actual incremental costs in the first five of the six years since establishment of the Administrative Charge.[5] As indicated in the following table, PEPCO has profited to the tune of almost $8 million over the first five years that the Company has been collecting incremental-cost revenues.[6]

| | Incremental-Cost Revenues | Actual Incremental Cost | Profit |
|---|---|---|---|
| 2004-2005 | $2,472,109 | $1,095,439 | $1,376,670 |
| 2005-2006 | 2,788,184 | 1,024,475 | 1,763,709 |
| 2006-2007 | 2,837,468 | 1,490,402 | 1,347,066 |
| 2007-2008 | 2,793,163 | 1,069,913 | 1,723,250 |
| 2008-2009 | 2,779,198 | 1,015,946 | 1,763,252 |
| 5-Year Total | $13,670,122 | $5,696,175 | $7,973,947 |

Fundamentally, the Company's arguments are unreasonable because they continue to request reimbursement far in excess of their historical actual costs. Furthermore, the Commission's ruling in Order No. 83345 states that proposals for maintaining or changing the current charge should be based on actual cost data:

[5] Data on actual incremental costs is not yet available for the most recent year.

[6] Values for 2004-2005 derived from data provided in *Report of Potomac Electric Power Company on 2004-2005 SOS Actual Incremental Costs*, Case No. 8908, September 7, 2005. Values for remaining years from the Company's response to OPC DR 2-11(b). A copy of the Company's response to OPC DR 2-11 in its entirety is attached hereto as Attachment JFW-1.

> The Companies now have actual data on their incremental costs and the amounts collected through the Administrative Charge. Accordingly, any changes needed to any of the components may be determined using this actual data, rather than changing one component using actual data while maintaining the other components at a fixed rate that was determined using estimates and projections.[7]

**Q: Was there a benefit to adopting a fixed rate for incremental costs as part of the Settlement Agreement?**

A: As I discussed in my direct testimony supporting the Settlement Agreement in Case No. 8908, adopting a fixed rate over the term of the agreement provided a measure of price certainty, while protecting consumers from the risk of unanticipated cost increases. At that point in time, forecasts of incremental costs were highly uncertain, since there was no directly relevant experience to rely on to develop such forecasts. It therefore seemed prudent from residential ratepayers' perspective to fix the rate until more experience was gained with the procurement process and data on the costs associated with that process became available.

**Q: Does the experience so far indicate that consumers would continue to benefit from a fixed rate for the incremental-cost component?**

A: Experience over the last six years has shown that there is very little risk of a substantial increase in incremental costs from one year to the next. As indicated in the following table, actual incremental costs per kilowatt-hour of residential SOS sales have been fairly stable over the first five of the six years since establishment of the Administrative Charge.[8] Moreover, experience indicates

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[7] *Order No. 83345*, Case Nos. 9226 and 9232, May 20, 2010, p. 3.

[8] Data on actual incremental costs is not yet available for the most recent year. Values for 2004-2005 derived from data provided in *Report of Potomac Electric Power Company on 2004-2005 SOS Actual Incremental Costs*, Case No. 8908, September 7, 2005. Values for remaining

that incremental costs are predictable and controllable, suggesting that consumers face little risk of unexpected cost increases so long as the Company prudently manages its costs. Consequently, it no longer appears that consumers require the protection of a fixed rate for incremental costs.

| | Actual Incremental Cost ($) | Residential SOS Sales (MWh) | Actual Incremental-Cost Rate (mills/kWh) |
|---|---|---|---|
| 2004-2005 | 1,095,439 | 4,944,217 | 0.22 |
| 2005-2006 | 1,024,475 | 5,576,367 | 0.18 |
| 2006-2007 | 1,490,402 | 5,674,937 | 0.26 |
| 2007-2008 | 1,069,913 | 5,586,327 | 0.19 |
| 2008-2009 | 1,015,946 | 5,558,397 | 0.18 |

**Q: What do you recommend with respect to the incremental-cost component of the Administrative Charge?**

A: I recommend replacing the current fixed rate with a rate that is set once a year to recover actual, verifiable, prudently incurred incremental costs. I further recommend that the Commission establish an annual proceeding for the purposes of setting the rate for the incremental-cost component of the Administrative Charge. These annual proceedings would provide the Commission the opportunity to:

- Audit and assess the prudence of the prior year's incremental costs.
- Determine the reasonableness of the Company's proposed allocation of incremental costs to SOS service types.
- Reconcile incremental-cost revenues against actual costs.

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years from the Company's responses to OPC DR 2-11(b) and OPC DR 2-11(c). A copy of the Company's response to OPC DR 2-11 in its entirety is attached hereto as Attachment JFW-1.

- Reset the rate for the upcoming year in order to recover expected spending in the next year and outstanding balances from prior years' reconciliations.

Finally, I recommend that the incremental-cost rate be set initially at 0.19 mills/kWh, based on the average annual spending rate from June 1, 2007 to May 31, 2009. Although this recommended rate is based on somewhat-dated cost data, a May 27, 2010 filing by the Company in this proceeding of updated incremental-cost data indicates that the Company continued to incur incremental costs through the end of 2009 at a rate of 0.19 mills/kWh.

## IV. Return

**Q: What does the Company propose for the return component of the Administrative Charge?**

A: According to Mr. Simpson, the Company proposes to continue charging ratepayers a return rate of 1.5 mills/kWh for incremental costs.

**Q: Should the Company be allowed to continue charging a fixed rate of 1.5 mills/kWh for the return component of the Administrative Charge?**

A: No. According to OPC witness Hill, it is unnecessary and economically inefficient to provide PEPCO any additional "return" beyond the return on SOS-related cash working capital, since any risks associated with utility provision of standard-offer service are already accounted for in the equity returns allowed in distribution rate cases. Accordingly, Mr. Hill recommends that the Company's return be limited strictly to the return on SOS-related cash working capital.

Based on Mr. Hill's recommendations, I recommend that the return rate be set so that the return component recovers only that amount required to provide the Company with a reasonable return on SOS-related cash working capital.[9] The Company should not be allowed to recover any other costs or other deemed return through the return component of the Administrative Charge for residential SOS.

## V. Uncollectible Cost

**Q: What is the Company's proposal with regard to the uncollectible-cost component of the Administrative Charge for residential SOS?**

A: The Company proposes to continue the process established under the Settlement Agreement, whereby the rate for SOS-related uncollectible costs is set as part of a distribution rate case.

**Q: Is the Company's proposal reasonable?**

A: Yes. It makes sense to continue setting the rate for SOS-related uncollectible costs in distribution rate cases. This process allows for full evidentiary review of the Company's methods for unbundling total uncollectible costs into distribution and SOS-related portions, and provides a record for the Commission to rely on to ensure that uncollectible costs are unbundled in a consistent manner and that the distribution and SOS-related portions are appropriately reflected in base rates and the Administrative Charge, respectively.

**Q: What rate is PEPCO proposing for the uncollectible-cost component of the Administrative Charge?**

[9] I provide my recommendations regarding the recovery of CWC costs in Section VII, below.

A: The Company proposes a rate of 1.59 mills/kWh for uncollectible costs. This is the rate requested by the Company and recently authorized by the Commission in Case No. 9217.[10]

## VI. Administrative Adjustment

**Q: What does PEPCO propose for the Administrative Adjustment?**

A: The Company proposes to continue collection of the Administrative Adjustment as part of the 4 mills/kWh Administrative Charge for residential SOS. The Company also proposes to continue crediting the amounts collected through the Administrative Adjustment to all residential distribution customers.

Under the Company's proposal for the Administrative Charge and the rates for the individual components of the Administrative Charge, the Administrative Adjustment would amount to approximately 0.4 mills/kWh (4 mills/kWh, less 0.5 mills for incremental cost, 1.5 mills for return, and 1.6 mills for uncollectible costs.)

**Q: What was the purpose of the Administrative Adjustment in the Settlement Agreement?**

A: In comments and testimony in Case No. 8908, certain parties expressed the belief that, at least at the outset of competition, competitive retail suppliers would be at a competitive disadvantage to residential SOS in terms of the costs associated with supplying retail service. Specifically, some parties argued that utility incremental cost was not fully compensatory of the retailers' cost to provide retail service, and thus would impede retailer entry during the early stages of market development. In contrast, other parties argued that consumers

[10] *Order No. 83516*, Case No. 9217, August 6, 2010.

should pay no more than incremental cost for providing a regulated service, and that charging more than incremental cost as part of the SOS price would distort price signals and be economically inefficient. The Administrative Adjustment was designed to balance these competing concerns by: (1) increasing the apparent price of providing the retail service against which competitive retailers would compete, and (2) providing for the refund to residential ratepayers of all revenues associated with the Administrative Adjustment.

**Q: Does the Administrative Adjustment continue to serve a useful purpose?**

A: No. After a decade of competition in the supply of electricity to consumers, the retail market is fully developed and mature. At this point, it is neither necessary nor reasonable to charge SOS customers more than the actual cost of residential SOS – and to require that SOS customers subsidize customers served by retail suppliers in the process of crediting Administrative Adjustment revenues – in order to provide an artificial competitive edge to retail suppliers.

Accordingly, I recommend elimination of the Administrative Adjustment from the Administrative Charge for residential SOS.

## VII. CWC Costs

**Q: What is SOS-related cash working capital?**

A: The Company pays the bills from wholesale SOS suppliers prior to receiving the revenues from SOS customers to cover those payments. Cash working capital is the short-term capital the Company needs to fund payments during the period that revenue recovery lags bill payments.[11] Cash working capital costs are the costs to finance that capital during the lag period.

**Q: Why is PEPCO requesting an increase in CWC costs for residential SOS customers?**

A: According to Mr. Simpson, the need for SOS-related cash working capital and the lag period over which that working capital must be financed have both increased substantially over the last six years. The need for cash working capital has increased due to a dramatic rise since 2004 in the cost of wholesale power for SOS load. The lag period has increased due to a change in the PJM settlement process that requires PEPCO to pay SOS suppliers on a weekly basis, rather than on a monthly basis under the old settlement process. Since ratepayers continue to be billed on a monthly basis, the lag between bill payments to SOS suppliers and revenue receipts from ratepayers has increased with the change in the PJM settlement process from a monthly to a weekly cycle.

Accounting for these two changes, and applying the Company's overall cost of capital to estimate the cost to finance cash working capital, PEPCO requests recovery of residential CWC costs at a rate of 1.23 mills/kWh.

**Q: Is the Company's proposed rate for residential CWC costs reasonable?**

A: According to OPC witness Hill, it is more appropriate to use a short-term debt rate rather than the overall cost of capital to calculate the cost to finance SOS-related cash working capital. However, in order to balance the interests of shareholders and ratepayers, Mr. Hill recommends that the short-term debt rate be applied solely to the incremental change in cash working capital due to the

[11] The Company's calculation of SOS-related cash working capital also accounts for lags in the recovery of incremental costs and income taxes.

change in the PJM settlement cycle, and that the overall cost of capital be applied to the remainder of the cash working capital.

Based on Mr. Hill's recommendations to use a short-term debt rate of 3.25% and to apply that rate to the incremental change in cash working capital due to the change in the PJM settlement cycle, OPC witness Effron calculates a rate for residential CWC costs of 0.70 mills/kWh.

**Q: How does PEPCO propose to recover CWC costs?**

A: According to Mr. Simpson, the Company proposes to recover residential SOS-related CWC costs in two parts. First, the Company proposes to collect through the 1.5 mill return component an amount of CWC cost that was "deemed to be included in the utility's allowed return as part of the Settlement Agreement." [12] The Company assumes that this "deemed" amount is equal to its estimate of CWC costs for the first year of the term of the Settlement Agreement. Second, the Company proposes to recover through a separate charge any remaining CWC costs after consideration of the "deemed" amount in the return component.

**Q: Is the Company's proposal consistent with the provisions of the Settlement Agreement?**

A: No. The Company's proposal inappropriately assumes that a specific amount was "deemed' by settling parties to be included in the return component of the Administrative Charge for residential SOS. In fact, the only agreement by parties reflected in the Settlement Agreement with respect to residential CWC costs was that such costs would be recovered through, and only through, the return component. Contrary to the Company's characterization, the Settlement

[12] *Direct Testimony and Exhibits of Company Witness A.G. Simpson*, Case No. 9232, June 14, 2010, pp. 10-11.

Agreement was silent as to the amount of CWC costs to be recovered through the return component at the outset or at any time during the term of the agreement. Instead, the Settlement Agreement explicitly provided that the return element was the sole source of recovery for CWC costs, and that the recovery of such costs was capped at 1.5 mills regardless of the magnitude of actual CWC costs. As a settling party, PEPCO therefore agreed to assume all risk of an unexpected increase in actual CWC costs, and agreed that the remaining amount of the 1.5 mill return rate over and above actual CWC costs was reasonable compensation for assuming CWC risk or any other risk associated with the provisions of the Settlement Agreement.

**Q: What do you recommend with respect to the recovery of CWC costs?**

A: I recommend that the current fixed rate for the return component be replaced with a rate that is set to recover all SOS-related CWC costs. Based on calculations by OPC witness Effron, I also recommend that the return rate be set initially at 0.70 mills/kWh.

Finally, I recommend that, as part of the annual proceeding for incremental costs, the rate for the return component be updated as appropriate to reflect revisions to estimates of SOS-related CWC costs due to changes in wholesale SOS supply costs or approved changes to the Company's cost of capital.

**Q: Do you recommend that return revenues be reconciled against actual SOS-related CWC costs as part of the update of the return rate?**

A: Reconciliation is not appropriate in this instance, since there are no "actual" CWC costs against which revenues can be reconciled. Instead, as discussed by OPC witness Hill, cash working capital is a regulatory construct whose costs are determined by applying a finance rate deemed appropriate by the Commission. Reconciliation in this case, then, would not be against actual costs to finance cash working capital, which Mr. Hill indicates would most likely be financed with short-term debt, but against a cost derived using a pre-determined rate of return.

**Q: Does this conclude your testimony?**

A: Yes.

# Exhibit JFW-1

PSC 9232 – In the Matter of the Review of

Potomac Electric Power Company

Standard Offer Service Administrative Charge

**Exhibit JFW-1**


Qualifications of

# JONATHAN F. WALLACH

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## SUMMARY OF PROFESSIONAL EXPERIENCE

*1990–Present* **Vice President, Resource Insight, Inc.** Provides research, technical assistance, and expert testimony on electric- and gas-utility planning, economics, regulation, and restructuring. Designs and assesses resource-planning strategies for regulated and competitive markets, including estimation of market prices and utility-plant stranded investment; negotiates restructuring strategies and implementation plans; assists in procurement of retail power supply.

*1989–90* **Senior Analyst, Komanoff Energy Associates.** Conducted comprehensive cost-benefit assessments of electric-utility power-supply and demand-side conservation resources, economic and financial analyses of independent power facilities, and analyses of utility-system excess capacity and reliability. Provided expert testimony on statistical analysis of U.S. nuclear plant operating costs and performance. Co-wrote *The Power Analyst*, software developed under contract to the New York Energy Research and Development Authority for screening the economic and financial performance of non-utility power projects.

*1987–88* **Independent Consultant.** Provided consulting services for Komanoff Energy Associates (New York, New York), Schlissel Engineering Associates (Belmont, Massachusetts), and Energy Systems Research Group (Boston, Massachusetts).

*1981–86* **Research Associate, Energy Systems Research Group.** Performed analyses of electric utility power supply planning scenarios. Involved in analysis and design of electric and water utility conservation programs. Developed statistical analysis of U.S. nuclear plant operating costs and performance.

## EDUCATION

BA, Political Science with honors and Phi Beta Kappa, University of California, Berkeley, 1980.

Massachusetts Institute of Technology, Cambridge, Massachusetts. Physics and Political Science, 1976–1979.

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"Maryland Office of People's Counsel's Comments on Staff Restructuring Report: Case No. 8738." 1997. Filed by the Maryland Office of People's Counsel in PSC Case No. 8738.

"Protest and Request for Hearing of Maryland Office of People's Counsel." 1997. Filed by the Maryland Office of People's Counsel in PSC Docket Nos. EC97-46-000, ER97-4050-000, and ER97-4051-000.

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"Comments of the New Hampshire Office of Consumer Advocate on Restructuring New Hampshire's Electric-Utility Industry" (with Bruce Biewald and Paul Chernick). 1996. Concord, N.H.: NH OCA.

"Estimation of Market Value, Stranded Investment, and Restructuring Gains for Major Massachusetts Utilities" (with Paul Chernick, Susan Geller, Rachel Brailove, and Adam Auster). 1996. On behalf of the Massachusetts Attorney General (Boston).

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"Preliminary Review of Entergy's 1995 Integrated Resource Plan." 1995. On behalf of the Alliance for Affordable Energy (New Orleans).

"Comments on NOPSI and LP&L's Motion to Modify Certain DSM Programs." 1995. On behalf of the Alliance for Affordable Energy (New Orleans).

"Demand-Side Management Technical Market Potential Progress Report." 1993. On behalf of the Legal Environmental Assistance Foundation (Tallahassee)

"Technical Information." 1993. Appendix to "Energy Efficiency Down to Details: A Response to the Director General of Electricity Supply's Request for Comments on Energy Efficiency Performance Standards" (UK). On behalf of the Foundation for International Environmental Law and Development and the Conservation Law Foundation (Boston).

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“Review of Jersey Central Power & Light’s 1992 DSM Plan and the Demand-Side Management Rules” (with Paul Chernick et al.). 1992. Report to the New Jersey Department of Public Advocate.

“Review of Rockland Electric Company’s 1992 DSM Plan and the Demand-Side Management Rules” (with Paul Chernick et al.). 1992.

“Initial Review of Ontario Hydro’s Demand-Supply Plan Update” (with David Argue et al.). 1992.

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“Statistical Analysis of U.S. Nuclear Plant Capacity Factors, Operation and Maintenance Costs, and Capital Additions.” 1989.

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“The Economics of Seabrook 1 from the Perspective of the Three Maine Co-owners.” 1984. ESRG Study No. 84-38.

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“Electric Rate Consequences of Cancellation of the Midland Nuclear Power Plant.” 1984. ESRG Study No. 83-81.

“Power Planning in Kentucky: Assessing Issues and Choices—Project Summary Report to the Public Service Commission.” 1984. ESRG Study No. 83-51.

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“Power Planning in Kentucky: Assessing Issues and Choices—Conservation as a Planning Option.” 1983. ESRG Study No. 83-51/TR III.

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"The Economics of Alternative Space and Water Heating Systems in New Construction in the Jersey Central Power and Light Service Area, A Report to the Public Advocate." 1982. ESRG Study No. 82-31.

"Review of the Kentucky-American Water Company Capacity Expansion Program, A Report to the Kentucky Public Service Commission." 1982. ESRG Study No. 82-45.

"Long Range Forecast of Sierra Pacific Power Company Electric Energy Requirements and Peak Demands, A Report to the Public Service Commission of Nevada." 1982. ESRG Study No. 81-42B.

"Utility Promotion of Residential Customer Conservation, A Report to Massachusetts Public Interest Research Group." 1981. ESRG Study No. 81-47

## PRESENTATIONS

"Office of People's Counsel Case No. 9117" (with William Fields). Presentation to the Maryland Public Utilities Commission in Case No. 9117, December 2008.

"Electricity Market Design: Incentives for Efficient Bidding, Opportunities for Gaming." NASUCA Northeast Market Seminar, Albany, N.Y., February 2001.

"Direct Access Implementation: The California Experience." Presentation to the Maryland Restructuring Technical Implementation Group on behalf of the Maryland Office of People's Counsel. June 1998.

"Reflecting Market Expectations in Estimates of Stranded Costs," speaker, and workshop moderator of "Effectively Valuing Assets and Calculating Stranded Costs." Conference sponsored by International Business Communications, Washington, D.C., June 1997.

## EXPERT TESTIMONY

*1989* **Mass. DPU** on behalf of the Massachusetts Executive Office of Energy Resources. Docket No. 89-100. Joint testimony with Paul Chernick relating to statistical analysis of U.S. nuclear-plant capacity factors, operation and maintenance costs, and capital additions; and to projections of capacity factor, O&M, and capital additions for the Pilgrim nuclear plant.

*1994* **NY PSC** on behalf of the Pace Energy Project, Natural Resources Defense Council, and Citizen's Advisory Panel. Case No. 93-E-1123. Joint testimony with John Plunkett critiques proposed modifications to Long Island Lighting Company's DSM programs from the perspective of least-cost-planning principles.

*1994* **Vt. PSB** on behalf of the Vermont Department of Public Service. Docket No. 5270-CV-1 and 5270-CV-3. Testimony and rebuttal testimony discusses rate and bill effects from DSM spending and sponsors load shapes for measure- and program-screening analyses.

*1996* **New Orleans City Council** on behalf of the Alliance for Affordable Energy. Docket Nos. UD-92-2A, UD-92-2B, and UD-95-1. Rates, charges, and integrated resource planning for Louisiana Power & Lights and New Orleans Public Service, Inc.

*1996* **New Orleans City Council** Docket Nos. UD-92-2A, UD-92-2B, and UD-95-1. Rates, charges, and integrated resource planning for Louisiana Power & Lights and New Orleans Public Service, Inc.; Alliance for Affordable Energy. April, 1996.

Prudence of utilities' IRP decisions; costs of utilities' failure to follow City Council directives; possible cost disallowances and penalties; survey of penalties for similar failures in other jurisdictions.

*1998* **Massachusetts Department of Telecommunications and Energy** Docket No. 97-111, Commonwealth Energy proposed restructuring; Cape Cod Light Compact. Joint testimony with Paul Chernick, January, 1998.

Critique of proposed restructuring plan filed to satisfy requirements of the electric-utility restructuring act of 1997. Failure of the plan to foster competition and promote the public interest.

**Massachusetts Department of Telecommunications and Energy** Docket No. 97-120, Western Massachusetts Electric Company proposed restructuring; Massachusetts Attorney General. Joint testimony with Paul Chernick, October, 1998. Joint surrebuttal with Paul Chernick, January, 1999.

Market value of the three Millstone nuclear units under varying assumptions of plant performance and market prices. Independent forecast of wholesale market prices. Value of Pilgrim and TMI-1 asset sales.

*1999* **Maryland PSC** Case No. 8795, Delmarva Power & Light comprehensive restructuring agreement, Maryland Office of People's Counsel. July 1999.

Support of proposed comprehensive restructuring settlement agreement

**Maryland PSC** Case Nos. 8794 and 8808, Baltimore Gas & Electric Company comprehensive restructuring agreement, Maryland Office of People's Counsel. Initial Testimony July 1999; Reply Testimony August 1999; Surrebuttal Testimony August 1999.

Support of proposed comprehensive restructuring settlement agreement

**Maryland PSC** Case No. 8797, comprehensive restructuring agreement for Potomac Edison Company, Maryland Office of People's Counsel. October 1999.

Support of proposed comprehensive restructuring settlement agreement

**Connecticut DPUC** Docket No. 99-03-35, United Illuminating standard offer, Connecticut Office of Consumer Counsel. November 1999.

Reasonableness of proposed revisions to standard-offer-supply energy costs. Implications of revisions for other elements of proposed settlement.

*2000* **U.S. FERC** Docket No. RT01-02-000, Order No. 2000 compliance filing, Joint Consumer Advocates intervenors. Affidavit, November 2000.

Evaluation of innovative rate proposal by PJM transmission owners.

*2001* **Maryland PSC** Case No. 8852, Charges for electricity-supplier services for Potomac Electric Power Company, Maryland Office of People's Counsel. March 2001.

Reasonableness of proposed fees for electricity-supplier services.

**Maryland PSC** Case No. 8890, Merger of Potomac Electric Power Company and Delmarva Power and Light Company, Maryland Office of People's Counsel. September 2001; surrebuttal, October 2001. In support of settlement: Supplemental, December 2001; rejoinder, January 2002.

Costs and benefits to ratepayers. Assessment of public interest.

**Maryland PSC** Case No. 8796, Potomac Electric Power Company stranded costs and rates, Maryland Office of People's Counsel. December 2001; surrebuttal, February 2002.

Allocation of benefits from sale of generation assets and power-purchase contracts.

*2002* **Maryland PSC** Case No. 8908, Maryland electric utilities' standard offer and supply procurement, Maryland Office of People's Counsel. Direct, November 2002; Rebuttal December 2002.

Benefits of proposed settlement to ratepayers. Standard-offer service. Procurement of supply.

*2003* **Maryland PSC** Case No. 8980, adequacy of capacity in restructured electricity markets; Maryland Office of People's Counsel. Direct, December 2003; Reply December 2003.

Purpose of capacity-adequacy requirements. PJM capacity rules and practices. Implications of various restructuring proposals for system reliability.

*2004* **Maryland PSC** Case No. 8995, Potomac Electric Power Company recovery of generation-related uncollectibles; Maryland Office of People's Counsel. Direct, March 2004; Supplemental March 2004, Surrebuttal April 2004.

Calculation and allocation of costs. Effect on administrative charge pursuant to settlement.

**Maryland PSC** Case No. 8994, Delmarva Power & Light recovery of generation-related uncollectibles; Maryland Office of People's Counsel. Direct, March 2004; Supplemental April 2004.

Calculation and allocation of costs. Effect on administrative charge pursuant to settlement.

**Maryland PSC** Case No. 8985, Southern Maryland Electric Coop standard-offer service; Maryland Office of People's Counsel. Direct, July 2004.

Reasonableness and risks of resource-procurement plan.

*2005* **FERC** Docket No. ER05-428-000, revisions to ICAP demand curves; City of New York. Statement, March 2005.

Net-revenue offset to cost of new capacity. Winter-summer adjustment factor. Market power and in-City ICAP price trends.

**FERC** Docket No. PL05-7-000, capacity markets in PJM; Maryland Office of People's Counsel. Statement, June 2005.

Inefficiencies and risks associated with use of administratively determined demand curve. Incompatibility of four-year procurement plan with Maryland standard-offer service.

**FERC** Dockets Nos. ER05-1410-000 & EL05-148-000, proposed market-clearing mechanism for capacity markets in PJM; Coalition of Consumers for Reliability, Affidavit October 2005, Supplemental Affidavit October 2006.

Inefficiencies and risks associated with use of administratively determined demand curve. Effect of proposed reliability-pricing model on capacity costs.

*2006* **Maryland PSC** Case No. 9052, Baltimore Gas & Electric rates and market-transition plan; Maryland Office of People's Counsel, February 2006.

Transition to market-based residential rates. Price volatility, bill complexity, and cost-deferral mechanisms.

**Maryland PSC** Case No. 9056, default service for commercial and industrial customers; Maryland Office of People's Counsel, April 2006.

Assessment of proposals to modify default service for commercial and industrial customers.

**Maryland PSC** Case No. 9054, merger of Constellation Energy Group and FPL Group; Maryland Office of People's Counsel, June 2006.

Assessment of effects and risks of proposed merger on ratepayers.

**Illinois Commerce Commission** Docket No. 06-0411, Commonwealth Edison Company residential rate plan; Citizens Utility Board, Cook County State's Attorney's Office, and City of Chicago, Direct July 2006, Reply August 2006.

Transition to market-based rates. Securitization of power costs. Rate of return on deferred assets.

**Maryland PSC** Case No. 9064, default service for residential and small commercial customers ; Maryland Office of People's Counsel, Rebuttal Testimony, September 2006.

Procurement of standard-offer power. Structure and format of bidding. Risk and cost recovery.

**FERC** Dockets Nos. ER05-1410-000 & EL05-148-000, proposed market-clearing mechanism for capacity markets in PJM; Maryland Office of the People's Counsel, Supplemental Affidavit October 2006.

Distorting effects of proposed reliability-pricing model on clearing prices. Economically efficient alternative treatment.

**Maryland PSC** Case No. 9063, optimal structure of electric industry; Maryland Office of People's Counsel, Direct Testimony, October 2006; Rebuttal November 2006; surrebuttal November 2006.

Procurement of standard-offer power. Risk and gas-price volatility, and their effect on prices and market performance. Alternative procurement strategies.

**Maryland PSC** Case No. 9073, stranded costs from electric-industry restructuring; Maryland Office of People's Counsel, Direct Testimony, December 2006.

Review of estimates of stranded costs for Baltimore Gas & Electric.

*2007* **Maryland PSC** Case No. 9091, rate-stabilization and market-transition plan for the Potomac Edison Company; Maryland Office of People's Counsel, Direct Testimony, March 2007.

Rate-stabilization plan.

**Maryland PSC** Case No. 9092, rates and rate mechanisms for the Potomac Electric Power Company; Maryland Office of People's Counsel, Direct Testimony, March 2007.

Cost allocation and rate design. Revenue decoupling mechanism.

**Maryland PSC** Case No. 9093, rates and rate mechanisms for Delmarva Power & Light; Maryland Office of People's Counsel, Direct Testimony, March 2007.

Cost allocation and rate design. Revenue decoupling mechanism.

**Maryland PSC** Case No. 9099, rate-stabilization plan for Baltimore Gas & Electric; Maryland Office of People's Counsel, Direct, March 2007; Surrebuttal April 2007.

Review of standard-offer-service-procurement plan. Rate stabilization plan.

**Connecticut DPUC** Docket No. 07-04-24, review of capacity contracts under Energy Independence Act; Connecticut Office of Consumer Counsel, Joint Direct Testimony June 2007.

Assessment of proposed capacity contracts.

**Maryland PSC** Case No. 9117, residential and small-commercial standard-offer service; Maryland Office of People's Counsel. Direct and Reply, September 2007; Supplemental Reply, November 2007; Additional Reply, December 2007; presentation, December 2008.

Benefits of long-term planning and procurement. Proposed aggregation of customers.

**Maryland PSC** Case No. 9117, Phase II, residential and small-commercial standard-offer service; Maryland Office of People's Counsel. Direct, October 2007.

Energy efficiency as part of standard-offer-service planning and procurement. Procurement of generation or long-term contracts to meet reliability needs.

*2008* **Connecticut DPUC 08-01-01**, peaking generation projects; Connecticut Office of Consumer Counsel. Direct (with Paul Chernick), April 2008.

Assessment of proposed peaking projects. Valuation of peaking capacity. Modeling of energy margin, forward reserves, other project benefits.

**Ontario EB-2007-0707,** Ontario Power Authority integrated system plan; Green Energy Coalition, Penimba Institute, and Ontario Sustainable Energy Association. Evidence (with Paul Chernick and Richard Mazzini), August 2008.

Critique of integrated system plan. Resource cost and characteristics; finance cost. Development of least-cost green-energy portfolio.

*2009* **Maryland PSC** Case No. 9192, Delmarva Power & Lights rates; Maryland Office of People's Counsel. Direct, August 2009; Rebuttal, Surrebuttal, September 2009.

Cost allocation and rate design.

**Wisconsin PSB** Docket No. 6630-CE-302, Glacier Hills Wind Park certificate, Citizens Utility Board of Wisconsin. Direct and Surrebuttal, October 2009.

Reasonableness of proposed wind facility.

**PUC of Ohio** Case No 09-906-EL-SSO, standard-service-offer bidding for three Ohio electric companies, Office of the Ohio Consumers' Counsel. Direct, December 2009.

Design of auctions for SSO power supply. Implications of migration of FirstEnergy from MISO to PJM.

*2010* **PUC of Ohio** Case No 10-388-EL-SSO, standard-service offer for three Ohio electric companies, Office of the Ohio Consumers' Counsel. Direct, July 2010.

Design of auctions for SSO power supply.

# Attachment JFW-1

PSC 9232 – In the Matter of the Review of

The Potomac Electric Power Company

Standard Offer Service Administrative Charge

POTOMAC ELECTRIC POWER COMPANY
MARYLAND CASE NO. 9232
RESPONSE TO OPC DATA REQUEST NO. 2

QUESTION NO. 11

Q. REFERENCING EXHIBIT PEPCO (AGS)-5 OF MR. SIMPSON'S TESTIMONY:

A. PLEASE PROVIDE AN ELECTRONIC SPREADSHEET VERSION OF EXHIBIT PEPCO (AGS)-5, INCLUDING ALL CELL FORMULAS AND LINKED SPREADSHEETS.

B. FOR THE RESIDENTIAL SERVICE TYPE, PLEASE PROVIDE FOR SOS YEARS (STARTING JUNE 1) 2 THROUGH 5 THE REVENUES RECOVERED FOR EACH OF THE RETURN, INCREMENTAL-COST, AND UNCOLLECTIBLE COMPONENTS AND THE ACTUAL COSTS INCURRED FOR INCREMENTAL COSTS, CWC, AND UNCOLLECTIBLE COSTS.

C. FOR THE RESIDENTIAL SERVICE TYPE, PLEASE PROVIDE THE RATES AND SALES FIGURES USED TO CALCULATE THE REVENUE AMOUNTS FOR THE RETURN, INCREMENTAL-COST, AND UNCOLLECTIBLE COMPONENTS.

D. PLEASE PROVIDE COPIES OF ALL WORKPAPERS, INTERNAL MEMORANDA, STUDIES, REPORTS, OR OTHER DOCUMENTATION RELIED ON TO DETERMINE THE AMOUNT OF $1,425,889 FOR ACTUAL INCREMENTAL COSTS FOR ALL SOS SERVICE TYPES (AS SHOWN IN THE "TOTAL" COLUMN).

E. PLEASE PROVIDE COPIES OF ALL WORKPAPERS, INTERNAL MEMORANDA, STUDIES, REPORTS, OR OTHER DOCUMENTATION RELIED ON TO FUNCTIONALIZE JURISDICTIONAL DISTRIBUTION-SERVICE COSTS AS SOS-RELATED INCREMENTAL COSTS.

F. PLEASE PROVIDE A DETAILED EXPLANATION OF HOW THE FUNCTIONALIZATION PROCESS REFERENCED IN DATA REQUEST 11(E) ABOVE DETERMINED THAT $1,425,889 OF TOTAL JURISDICTIONAL DISTRIBUTION-SERVICE COSTS WERE ATTRIBUTABLE TO THE SOS FUNCTION.

G. PLEASE PROVIDE ALL WORKPAPERS, INTERNAL MEMORANDA, STUDIES, REPORTS, OR OTHER DOCUMENTATION RELIED ON TO ALLOCATE TO THE RESIDENTIAL SERVICE TYPE $1,015,946 OF THE TOTAL $1,425,889 INCREMENTAL COSTS FOR ALL SERVICE TYPES.

RESPONSE:

A. a. See Attachment A.

b. See Attachment B.

c. See Attachment C.

d. See the Company's Incremental Costs Report in Case No. 8908, which is available on the Commission's website.

e. – f. No distribution-service costs were included as SOS incremental costs.

g. See response to d) above.

SPONSOR: A. Glenn Simpson

**POTOMAC ELECTRIC POWER COMPANY**
Maryland SOS
Year 6 (June 1 2009 through May 31, 2010)
Pro-Forma *

| | Residential | Type I | Type II | HPS | Total |
|---|---|---|---|---|---|
| Return Component | $ 8,337,595 | $ 802,126 | $ 3,003,478 | $ 765,119 | $ 12,908,318 |
| Incremental Cost Component | 2,779,198 | 73,291 | 274,483 | 62,169 | 3,189,141 |
| Cash Working Capital Component | - | 52,619 | 165,792 | 51,008 | 269,419 |
| Uncollectible Component | 3,890,878 | 455,098 | 891,612 | - | 5,237,588 |
| | $ 15,007,671 | $ 1,383,134 | $ 4,335,365 | $ 878,296 | $ 21,604,466 |
| | | | | | |
| Actual Incremental Costs | $ 1,015,946 | $ 73,291 | $ 274,483 | $ 62,169 | $ 1,425,889 |
| Cash Working Capital ** | 6,836,827 | 501,329 | 1,696,965 | 323,050 | 9,358,171 |
| Uncollectible Costs | 7,919,937 | 455,098 | 891,612 | - | 9,266,647 |
| | $ 15,772,710 | $ 1,029,718 | $ 2,863,060 | $ 385,219 | $ 20,050,707 |
| | | | | | |
| Net Return | (765,039) | 353,416 | 1,472,305 | 493,077 | 1,553,759 |

* Year 5 usage and costs used
** Based on updated SOS Study

Pepco
Maryland SOS

Residential Class

| | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|
| Return Component | $ 8,364,551 | $ 8,512,405 | $ 8,379,490 | $ 8,337,595 |
| Incremental Cost Component | 2,788,184 | 2,837,468 | 2,793,163 | 2,779,198 |
| Uncollectible Component | 1,576,439 | 1,604,305 | 2,694,984 | 3,890,878 |
| Total Admin Charge Revenue | 12,729,174 | 12,954,178 | 13,867,637 | 15,007,671 |
| | | | | |
| Actual Incremental Costs | $ 1,024,475 | $ 1,490,402 | $ 1,069,913 | $ 1,015,946 |
| Cash Working Capital * | 1,617,147 | 1,645,732 | 1,620,035 | 1,611,935 |
| Uncollectible Costs | 2,774,324 | 5,006,477 | 7,460,643 | 7,919,937 |
| Total Expenses | 5,415,946 | 8,142,611 | 10,150,591 | 10,547,818 |
| | | | | |
| Net Return | $ 7,313,228 | $ 4,811,567 | $ 3,717,046 | $ 4,459,853 |

* CWC requirement assumed at the SOS Year 1 rate, not updated for increased supply costs.

Pepco
Maryland

Rates and Sales - Administrative Charge Revenue
Residential Class

| Year | Utility Return Rate | Incremental Cost Rate Rate | Uncollectible Allowed Rate | kWh Sales |
|---|---|---|---|---|
| Year 2 | $ 0.001500 | $ 0.000500 | $ 0.0002827 | 5,576,367,422 |
| Year 3 | $ 0.001500 | $ 0.000500 | $ 0.0002827 | 5,674,936,947 |
| Year 4 | $ 0.001500 | $ 0.000500 | $ 0.0002827 (1) | 2,912,641,170 (1) |
| | | | $ 0.0007000 (2) | 2,673,685,488 (2) |
| Year 5 | $ 0.001500 | $ 0.000500 | $ 0.0007000 | 5,558,396,595 |

(1) June 2007 - November 2007
(2) December 2007 - May 2008

**CASE NO. 9232**

**IN THE MATTER OF**
**REVIEW OF**

**POTOMAC ELECTRIC POWER COMPANY**

**STANDARD OFFER SERVICE**
**ADMINISTRATIVE CHARGE**

**BEFORE THE MARYLAND PUBLIC SERVICE COMMISSION**

**REPLY TESTIMONY OF DAVID J. EFFRON**
**ON BEHALF OF THE**
**MARYLAND OFFICE OF PEOPLE'S COUNSEL**

**AUGUST 9, 2010**

**CASE NO. 9232**
**REPLY TESTIMONY OF DAVID J. EFFRON**
**TABLE OF CONTENTS**



## EXHIBITS AND ATTACHMENTS

APPENDIX 1 – RESUME OF DAVID J. EFFRON

SCHEDULE DJE-1 – SOS CWC REVENUE REQUIREMENT

## I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My address is 12 Pond Path, North Hampton, New Hampshire, 03862.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. I have analyzed numerous electric, telephone, gas and water rate filings in different jurisdictions. Pursuant to those analyses, I have prepared testimony, assisted attorneys in rate case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in approximately two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and Washington.

My other professional experience and educational background are summarized in Appendix 1 accompanying this testimony.

## II. PURPOSE OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Maryland Office of People's Counsel (or "OPC").

Q. What is the purpose of your testimony?

A. Potomac Electric Power Company ("Pepco" or "the Company") is requesting recovery of the cash working capital ("CWC") costs incurred to provide standard offer service ("SOS") in Maryland as part of the SOS supply costs that are recovered from customers. The purpose of my testimony is to calculate the CWC revenue requirement for residential customers, consistent with the recommendation of Mr. Hill and to convert that CWC revenue requirement into a rate per kWh for residential customers

## III. SOS CWC REVENUE REQUIREMENT

Q. Please explain your calculation of the SOS CWC revenue requirement.

A. My calculation of the SOS CWC revenue requirement is shown on Schedule DJE-1. Mr. Hill recommends that the return on the SOS CWC requirement under the previous monthly power supply payment schedule of PJM Interconnection LLC ("PJM") (the "base CWC") should be the overall authorized rate of return, and that the return on the incremental CWC requirement resulting from the acceleration by PJM to a weekly payment schedule (the "incremental CWC") should be a short-term debt rate of 3.25%. I begin by separating the total CWC requirement into the base CWC and the incremental CWC. I then apply the recommended rates of return to each of the components of the CWC to calculate the total SOS CWC revenue requirement for residential customers.

Q. How do you separate the total CWC requirement into the base CWC and the incremental CWC?

A. I begin by calculating the total SOS CWC requirement based on the factors shown on Pepco Exhibit AGS-3, Page 1. The total SOS CWC for residential customers is $60,848,000. I then calculate the incremental CWC requirement resulting from the acceleration of the power supply payment from monthly in arrears (35.79 days) to weekly in arrears (13.16 days). This amount is $37,534,000. The residual amount of $23,314,000, or the base CWC, is what the CWC requirement would be if the payment lag for the power supply had remained at 35.79 days.

Q. What is the revenue requirement of this SOS CWC requirement?

A. Applying a pre-tax authorized rate of return of 11.43% (updated to reflect the Commission's order in Case No. 9217) to the base CWC and a short term debt rate of 3.25% to the incremental CWC, the total residential revenue requirement for the return on the SOS CWC is $3,884,000 (Schedule DJE-1).

Q. What is the resulting rate per residential kWh?

A. Based on the 5,558,397,000 on Pepco Exhibit AGS-3, the residential rate is $0.00070 per kWh (or $0.70 per mWh).

Q. Does this conclude your direct testimony?

A. Yes.

**APPENDIX 1**

# RESUME OF DAVID J. EFFRON

## UTILITY REGULATION EXPERIENCE

Assistance to offices representing customer interests in Rhode Island, Maryland, Massachusetts, Illinois, and Texas regarding electric utility restructuring matters.

Presentation of testimony on various utility regulation matters involving electric, gas, telephone, and water utilities in the following jurisdictions: Alabama, Arizona, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, Washington, and FERC.

Assistance to attorneys in preparing discovery, cross-examination, post-hearing briefs, and analysis of orders; provision of technical assistance during settlement negotiations.

## OTHER BUSINESS EXPERIENCE

Supervision of capital project analysis, capital budgets, spending reports, leasing program, and special studies; feasibility studies, accounting systems, statistical surveys; audits of publicly held companies in various industries.

## EMPLOYMENT HISTORY

| Dates | Company |
|---|---|
| March 1982 - Present | Berkshire Consulting Services (Self employed) |
| January 1977 - February 1982 | Georgetown Consulting Group |
| April 1975 - January 1977 | Gulf & Western Industries |
| February 1973 - March 1975 | Touche Ross & Company |

## EDUCATION

Columbia University, MBA, 1973
Dartmouth College, BA Economics, 1968

## HONORS AND AWARDS

Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 Certified Public Accounting Examination in New York State.
Graduated from Dartmouth College with distinction in the field of Economics.

# Exhibit DJE-1

PSC 9232 – In the Matter of the Review of

Potomac Electric Power Company

Standard Offer Service Administrative Charge

Schedule DJE-1

# POTOMAC ELECTRIC POWER COMPANY
## CASH WORKING CAPITAL - POWER SUPPLY
($000 Except per KWH)

| | | | RES |
|---|---|---|---|
| 1 | Net Power Supply Expense | AGS-3 | $ 619,511 |
| 2 | Expense per Day | 1/365 | 1,697 |
| 3 | Net Lag Days | AGS-3 | 35.85 |
| 4 | Total Cash Working Capital | 2*3 | $ 60,848 |
| 5 | Energy Procurement Expense | AGS-3 | $ 605,386 |
| 6 | Expense per Day | 1/365 | 1,659 |
| 7 | Lag Days - Present | AGS-3 | 13.16 |
| 8 | Lag Days - Prior | AGS-2 | 35.79 |
| 9 | Decrease in Lag Days | 8-7 | 22.63 |
| 10 | Incremental Cash Working Capital | 9*6 | $ 37,534 |
| 11 | Base Cash Working Capital | 4-10 | $ 23,314 |
| 12 | Pre-tax Rate of Return | CN 9217 | 11.43% |
| 13 | Short-Term Debt Rate | Mr. Hill | 3.25% |
| 14 | Revenue Requirement - Base | 12*11 | $ 2,664 |
| 15 | Revenue Requirement - Incremental | 13*10 | 1,220 |
| 16 | Total Revenue Requirement | 14+15 | $ 3,884 |
| 17 | MWH Sales | AGS-3 | 5,558,397 |
| 18 | Rate per KWH | 16/17 | $ 0.00070 |