

STATE OF MARYLAND
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of the Review of the)
Delmarva Power and Light Company) **Case No. 9226**
Standard Offer Service Administrative Charge)

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

THIRD REPLY TESTIMONY OF
JONATHAN WALLACH
ON BEHALF OF
THE OFFICE OF PEOPLE’S COUNSEL

Resource Insight, Inc.

SEPTEMBER 15, 2015

TABLE OF CONTENTS

I. Introduction and Summary..... 1

II. The Administrative Charge..... 5

III. Incremental Costs..... 10

IV. Uncollectible Costs 11

V. Cash Working Capital..... 12

VI. Return..... 15

VII. Administrative Adjustment 16

Exhibit JFW-1 Professional Qualifications of Jonathan F. Wallach

Attachment JFW-1 Responses to OPC Data Requests

1 **I. Introduction and Summary**

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

3 A: My name is Jonathan F. Wallach. I am Vice President of Resource Insight, Inc.,
4 5 Water Street, Arlington, Massachusetts.

5 **Q: Please summarize your professional experience.**

6 A: I have worked as a consultant to the electric-power industry since 1981. From
7 1981 to 1986, I was a research associate at Energy Systems Research Group. In
8 1987 and 1988, I was an independent consultant. From 1989 to 1990, I was a
9 senior analyst at Komanoff Energy Associates. I have been in my current
10 position at Resource Insight since September of 1990.

11 Over the past thirty years, I have advised and testified on behalf of clients
12 on a wide range of economic, planning, and policy issues relating to the
13 regulation of electric utilities, including: electric-utility restructuring; wholesale-
14 power market design and operations; transmission pricing and policy; market-
15 price forecasting; market valuation of generating assets and purchase contracts;
16 power-procurement strategies; risk assessment and mitigation; integrated
17 resource planning; mergers and acquisitions; cost allocation and rate design; and
18 energy-efficiency program design and planning.

19 My resume is attached as Exhibit JFW-1.

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

22 A: I have advised and testified on behalf of the Office of People's Counsel
23 ("OPC") in most of the major proceedings relating to Maryland's restructuring
24 process since 1997. During that time, I assisted OPC during settlement

1 negotiations and testified in support of the settlement agreement that established
2 the Administrative Charge in Case No. 8908 (“2003 Settlement”).¹ I also
3 testified in Case Nos. 8994 and 8995 regarding derivation of the uncollectible-
4 cost component of the Administrative Charge for Potomac Electric Power
5 Company (“PEPCO”) and Delmarva Power and Light Company (“Delmarva”).
6 In addition, I testified in Case No. 9099 regarding the Commission’s
7 investigation of residential Standard Offer Service (“SOS”) rates, including the
8 Administrative Charge. In 2010 and again in 2014, I testified in Case Nos. 9226
9 and 9232 regarding proposals by Delmarva and PEPCO (collectively “the
10 Companies”) for modifying the Administrative Charge. Finally, in 2010 and
11 again in 2015, I testified in Case No. 9221 regarding proposals by Baltimore
12 Gas and Electric Company to modify the Administrative Charge.

13 **Q: Have you testified previously in other utility regulatory proceedings?**

14 A: Yes. I have sponsored expert testimony in more than seventy state, provincial,
15 or federal proceedings in the U.S. and Canada. Exhibit JFW-1 includes a
16 detailed list of my previous testimony.

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

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

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

20 A: On March 3, 2015, the Commission issued Order No. 86881 remanding to the
21 Public Utility Law Judge the matter of a proposed settlement agreement in Case
22 Nos. 9226 and 9232 regarding the Administrative Charges for Delmarva and
23 PEPCO. On July 24, 2015, the Companies filed supplemental direct testimony

¹ The 2003 Settlement was filed on November 15, 2002, and adopted pursuant to Order No. 78400, issued April 29, 2003, in Case No. 8908.

1 by Susan A. DeVito regarding the Companies’ proposals for the structure and
2 pricing of the Administrative Charge and direct testimony by Kevin M.
3 McGowan supporting the Companies’ request for an increase in the recovery of
4 SOS-related cash working capital (“CWC”) revenue requirements and regarding
5 the Companies’ estimate of SOS costs currently recovered through distribution
6 rates.

7 This testimony responds to the Companies’ proposals regarding the
8 Administrative Charge and cash working capital for residential SOS customers.
9 People’s Counsel is also sponsoring testimony in this proceeding by David
10 Effron regarding the calculation of CWC revenue requirements and by Stephen
11 Hill regarding the return component of the Administrative Charge and the cost
12 to finance SOS-related cash working capital.

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

14 A: The Companies’ proposals regarding the components of the Administrative
15 Charge are unreasonable and economically harmful to residential ratepayers. As
16 discussed in detail by OPC witness Hill, the Companies’ proposal to recover a
17 return over and above the return on SOS-related cash working capital is
18 economically inefficient. Mr. Hill also finds that the revenues the Company is
19 seeking to recover through the proposed CWC component of the Administrative
20 Charge would substantially exceed the Companies’ actual cost to finance CWC
21 balances. Finally, as discussed below, the Administrative Adjustment, as
22 continued under the Companies’ proposal, bears no relation to actual SOS-
23 related costs and serves no purpose other than to arbitrarily and unreasonably
24 increase the price paid by residential customers for Standard Offer Service.

1 To address these problems with the Companies' filing, and taking into
2 account the recommendations of OPC witnesses Effron and Hill, I recommend
3 the following:

- 4 • Adopt the Companies' proposal to replace the fixed rate for the
5 incremental-cost component with a rate set to recover actual, verifiable,
6 prudently incurred incremental costs. In addition, adopt the Companies'
7 proposal to establish an annual process to: (1) review and assess the
8 prudence of the prior period's spending on incremental costs; (2) reconcile
9 incremental-cost revenues against actual costs; and (3) reset the rate for the
10 upcoming period.
- 11 • Adopt the Companies' proposal to continue setting the rate for the
12 uncollectible-cost component as part of distribution rate cases.
- 13 • Implement a separate component of the Administrative Charge to recover
14 SOS-related cash working capital revenue requirements. Set CWC revenue
15 requirements based on the Companies' cost of short-term debt. As part of
16 the annual process for reconciling incremental costs, update the rate for the
17 CWC component as appropriate to reflect changes in wholesale SOS
18 supply costs, revised estimates of net lag days, or approved changes to the
19 assumed finance rate.
- 20 • Limit the return component to recovery of the return on SOS-related cash
21 working capital, with the rate of return on CWC balances set at the
22 difference between the Companies' overall cost of capital and the short-
23 term debt rate. Allow no other costs or other deemed return to be recovered
24 through the return component.
- 25 • Eliminate the Administrative Adjustment.

1 I further recommend that the rates for each component of the
2 Administrative Charge for residential SOS customers be set initially as shown in
3 Table 1.

4 **Table 1. Recommended Initial Administrative Charge**

	Delmarva	PEPCO
Incremental Cost	0.20 mills/kWh	0.13 mills/kWh
Uncollectible Cost	1.38 mills/kWh	1.59 mills/kWh
Cash Working Capital	0.02 mills/kWh	0.02 mills/kWh
Return	0.84 mills/kWh	0.73 mills/kWh
Administrative Charge	2.44 mills/kWh	2.47 mills/kWh

5 The incremental-cost rates shown in Table 1 are set at the actual
6 incremental cost per kilowatt-hour of SOS sales for the twelve months ending
7 May 31, 2015. The uncollectible-cost rates are those approved in the most-
8 recent distribution rate cases. Finally, the recommended initial rates for CWC
9 revenue requirements and for the return component are derived by OPC witness
10 Effron.

11 **II. The Administrative Charge**

12 **Q: Please describe the 2003 Settlement in Case No. 8908.**

13 A: The 2003 Settlement resolved a number of key concerns at that time associated
14 with the continued provision of a regulated standard offer service to residential
15 customers, by establishing, among other things, the terms and conditions, the
16 pricing mechanism, and the framework for competitive procurement of
17 wholesale supply for residential SOS.

18 Specifically, the 2003 Settlement:

- 19 • Established the obligation of each of Maryland's four investor-owned
20 utilities to provide residential SOS after the end of each utility's current

1 rate-cap or rate-freeze transition period, and defined the period of time
2 during which the obligation would continue.

- 3 • Established that wholesale supply for residential SOS would be procured
4 through a competitive procurement process.
- 5 • Established that wholesale supply for residential SOS would consist of a
6 portfolio of one-, two-, and three-year supply contracts, and specified the
7 percentages of these one-, two-, and three-year contracts that would
8 comprise the portfolio.
- 9 • Specified the components of the retail price for residential SOS.
- 10 • Established an “Administrative Charge” as one part of the retail price for
11 residential SOS, set the rate for the Administrative Charge at 4 mills/kWh,
12 and specified four individual components of the Administrative Charge:
13 (1) incremental cost; (2) return; (3) uncollectible cost; and (4)
14 Administrative Adjustment.
- 15 • Specified the rates for each of the four components of the Administrative
16 Charge, and established mechanisms for recovering and re-setting such
17 rates.
- 18 • Provided that residential customers could switch freely between SOS and
19 competitive retail service without restriction.

20 The 2003 Settlement was intensively negotiated over many months by a
21 large and diverse group of parties with competing interests. While each party
22 may not have been satisfied with particular provisions of the 2003 Settlement,
23 and would not have necessarily agreed to such provisions in isolation, the
24 negotiated package as a whole apparently provided tangible benefits and served
25 the interests of the settling parties.

1 **Q: Please describe the structure of the Administrative Charge established in**
2 **the 2003 Settlement for residential SOS.**

3 A: As noted above, the 2003 Settlement established an Administrative Charge as
4 part of the retail price for residential SOS, and specified a rate of 4 mills/kWh
5 for the Administrative Charge. The 2003 Settlement further specified that there
6 would be four components to the Administrative Charge: (1) incremental cost;
7 (2) return; (3) uncollectible cost; and (4) Administrative Adjustment.

8 The 2003 Settlement set the rate for the incremental-cost component at 0.5
9 mills/kWh, and further specified that this rate would remain fixed over the term
10 of the agreement. Incremental costs were defined in the 2003 Settlement to
11 exclude both SOS-related cash working capital, which was deemed to be
12 collected through the return component, and SOS-related uncollectible costs.

13 The 2003 Settlement set the rate for the return component at 1.5
14 mills/kWh. As with the incremental-cost component, the return rate was fixed
15 for the term of the agreement. As noted above, the return component was
16 defined as the sole means for recovery of cash working capital. Consequently,
17 recovery of SOS-related CWC revenue requirements was limited to 1.5
18 mills/kWh, regardless of the actual magnitude of those revenue requirements.

19 For both Delmarva and PEPCO, the rate for SOS-related uncollectible
20 costs was initially set at zero. The 2003 Settlement then provided for changes to
21 that initial rate in subsequent distribution rate cases. By the end of the term of
22 the 2003 Settlement, the rate for uncollectible costs was 0.2 mills/kWh for
23 Delmarva and 0.7 mills/kWh for PEPCO.

24 Finally, the 2003 Settlement established the rate for the Administrative
25 Adjustment as the remainder of the 4 mills/kWh Administrative Charge after
26 subtracting the rates for the incremental-cost, return, and uncollectible-cost
27 components. Thus, at the outset of the 2003 Settlement, the Administrative

1 Adjustment for both Delmarva and PEPCO was set at 2 mills/kWh, which is
2 equal to 4 mills less 0.5 mills for incremental cost, less 1.5 mills for return, and
3 less 0 mills for SOS-related uncollectible costs. By the end of the term of the
4 2003 Settlement, the Administrative Adjustment declined to 1.8 mills/kWh for
5 Delmarva and to 1.3 mills/kWh for PEPCO, reflecting the increase in the rate
6 for the uncollectible-cost component.

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

9 A: The 2003 Settlement provided that all revenues associated with the
10 Administrative Adjustment would be returned to residential distribution
11 customers, regardless of whether they were SOS customers or were served by a
12 competitive retail supplier.

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

18 **Q: Please describe the Companies' proposals regarding the structure and**
19 **pricing of the Administrative Charge for residential SOS.**

20 A: The Companies propose two changes to the current design of the Administrative
21 Charge. First, the Companies propose that the fixed rate for the incremental-cost
22 component be replaced with a rate set to recover actual incremental costs. The
23 incremental-cost rate for both Delmarva and PEPCO would be initially set at 0.2
24 mills/kWh, and then updated annually. Second, under the Companies' proposal,
25 the return on CWC balances would no longer be deemed to be recovered
26 through the return component, and would instead be recovered separately from

1 the Administrative Charge. However, the rate for the return component would
2 remain fixed at 1.5 mills/kWh.

3 Furthermore, according to the Companies' response to OPC Data Request
4 No. 17-14, the Companies propose a "placeholder" total rate for the
5 Administrative Charge of 3.7 mills/kWh for both Delmarva and PEPCO.² In
6 other words, the Companies are not advocating for a specific rate for the
7 Administrative Charge but instead are leaving it to the Commission to determine
8 the appropriate total rate. The Companies have not explained why they selected
9 3.7 mills/kWh as the "placeholder" rate for the residential Administrative
10 Charge nor offered any argument in support of the Companies' selection.
11 However, it appears that this rate was adopted so that the rates for the
12 Administrative Adjustment under the Companies' proposal would equal current
13 rates.³

14 As noted above, the charge for the return on cash working capital would be
15 in addition to the 3.7 mills/kWh Administrative Charge. According to
16 Companies witness DeVito, the total charge to residential SOS customers for the
17 Administrative Charge and cash working capital would be 4.56 mills/kWh for
18 Delmarva's ratepayers and 4.45 mills/kWh for PEPCO's ratepayers. The initial
19 rates for the individual components of the Administrative Charge and for the
20 separate CWC return charge would be as shown in Table 2.⁴
21

² Copies of all responses to OPC data requests cited herein are provided as Attachment JFW-1.

³ For example, compare Schedules SAD-1 and SAD-2 of the *Supplemental Direct Testimony of Susan A. DeVito*, Case Nos. 9226 and 9232, July 24, 2015.

⁴ DeVito Direct, Schedule SAD-2.

1

Table 2. Companies' Proposal for the Initial Administrative Charge and CWC

	Delmarva	PEPCO
Incremental Cost	0.20 mills/kWh	0.20 mills/kWh
Uncollectible Cost	1.38 mills/kWh	1.59 mills/kWh
Return	1.50 mills/kWh	1.50 mills/kWh
Administrative Adjustment	0.62 mills/kWh	0.41 mills/kWh
Administrative Charge	3.70 mills/kWh	3.70 mills/kWh
Cash Working Capital	0.86 mills/kWh	0.75 mills/kWh
Total Charge	4.56 mills/kWh	4.45 mills/kWh

2

3

I discuss below the Companies' proposals for each of the components of the Administrative Charge and the additional charge for cash working capital.

4

5 **III. Incremental Costs**

6 **Q: What do the Companies propose for the incremental-cost component of the Administrative Charge for residential SOS?**

7

8 A: According to Ms. DeVito, the Companies propose to replace the existing fixed
9 rate of 0.5 mills/kWh with a rate that is set to recover actual, verifiable, and
10 prudently incurred incremental costs. The incremental-cost rates for both
11 Delmarva and PEPCO would be initially set at 0.2 mills/kWh, and then updated
12 annually based on a report filed by the Companies each year regarding actual
13 incremental expenditures during the previous year. These annual proceedings
14 would provide the Commission the opportunity to:

- 15 • Audit and assess the prudence of the prior year's incremental costs.
- 16 • Determine the reasonableness of the Companies' proposed allocation of
17 incremental costs to SOS service types.
- 18 • Reconcile incremental-cost revenues against actual costs.

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

3 **Q: Is the Companies' proposal for the incremental-cost component**
4 **reasonable?**

5 A: Both the proposal to replace the current fixed rate with a rate set to recover
6 actual, verifiable, prudently incurred costs and the proposal for verifying and
7 reconciling incremental costs appear reasonable.

8 **Q: What do you propose for the initial rate for the incremental-cost**
9 **component of the Administrative Charge for residential SOS?**

10 A: I recommend setting the initial rate at the actual incremental cost per kilowatt-
11 hour of SOS sales incurred in the twelve-month period ending May 31, 2015.⁵
12 According to the Companies' response to OPC Data Request No. 17-16(b),
13 actual incremental costs for residential SOS incurred during the twelve-month
14 period ending May 31, 2015 were 0.20 mills/kWh for Delmarva and 0.13
15 mills/kWh for PEPCO.

16 **IV. Uncollectible Costs**

17 **Q: Please describe the Companies' proposal with regard to the treatment of**
18 **uncollectible costs for residential SOS.**

19 A: The Companies propose to continue the process established under the 2003
20 Settlement, whereby the rate for SOS-related uncollectible costs is set as part of
21 a distribution rate case.

⁵ As noted above, the Companies propose the same initial rate of 0.20 mills/kWh for both Delmarva and PEPCO. This initial rate is equal to the actual incremental cost per kilowatt-hour incurred by Delmarva during the twelve-month period ending May 31, 2015.

1 **Q: Is this treatment reasonable?**

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

9 **Q: What do you recommend as initial rates for the uncollectible-cost**
10 **component of the residential Administrative Charge?**

11 A: I recommend adoption of the Companies' proposal to set initial rates at the
12 amounts established in the most-recent distribution rate cases. Specifically,
13 initial rates should be set at 1.38 mills/kWh for Delmarva and 1.59 mills/kWh
14 for PEPCO.

15 **V. Cash Working Capital**

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

17 A: The Companies pay the bills from wholesale SOS suppliers prior to receiving
18 the revenues from SOS customers to cover those payments. Cash working
19 capital is the short-term capital the Companies need to fund payments during the
20 period that revenue recovery lags bill payments.

21 **Q: How is cash working capital currently reflected in the residential**
22 **Administrative Charge?**

23 A: As noted above in Section II, CWC revenue requirements are currently deemed
24 to be recovered through the return component.

1 **Q: How do the Companies propose to revise this treatment of CWC revenue**
2 **requirements?**

3 A: Under the Companies' proposal, CWC revenue requirements would no longer
4 be deemed to be recovered through the return component. Instead, CWC
5 revenue requirements would be recovered in a new, stand-alone charge that is
6 separate from the residential Administrative Charge.

7 In addition, according to Companies witness McGowan, the Companies
8 propose to apply the most-recently authorized rate of return to determine the
9 return on CWC balances to be recovered through this new CWC charge.⁶ The
10 Companies apply the most-recently authorized rates of return to CWC balances
11 for the twelve-month period ending May 31, 2015 to derive initial rates for the
12 proposed residential CWC charge of 0.86 mills/kWh for Delmarva and 0.75
13 mills/kWh for PEPCO.

14 **Q: Is this a reasonable approach for setting the rate for CWC revenue**
15 **requirements?**

16 A: According to OPC witness Hill, it would be more appropriate to use a short-term
17 debt rate rather than the overall cost of capital to calculate SOS-related CWC
18 revenue requirements. Based on Mr. Hill's recommendations to use a short-term
19 debt rate of 0.29% for Delmarva and 0.30% for PEPCO, OPC witness Effron
20 calculates a rate for residential CWC revenue requirements of 0.02 mills/kWh
21 for both Delmarva and PEPCO. These rates are derived by Mr. Effron based on
22 CWC balances for the twelve-month period ending May 31, 2015.

23 **Q: Under the Companies' proposal, what would be the total initial charge to**
24 **residential SOS customers for return and CWC revenue requirements?**

⁶ *Direct Testimony of Kevin M. McGowan*, Case Nos. 9226 and 9232, July 24, 2015, p. 13, ll. 22-23.

1 A: The Companies' proposal would increase the total charge to consumers for
2 return and CWC revenue requirements from the current rate of 1.5 mills/kWh to
3 2.36 mills/kWh for Delmarva and from 1.5 mills/kWh to 2.25 mills/kWh for
4 PEPCO.

5 **Q: Should CWC revenue requirements be recovered through a stand-alone**
6 **charge, as proposed by the Companies?**

7 A: No. There is no apparent tangible benefit to residential ratepayers from the
8 Companies' proposal to recover CWC revenue requirements through a stand-
9 alone charge, rather than through a separate component of the Administrative
10 Charge. To the contrary, under the Companies' proposal, ratepayers would be
11 charged more for the combination of the revised residential Administrative
12 Charge, at 3.7 mills/kWh, and the separate CWC return charge than under the
13 current rate of 4 mills/kWh for the residential Administrative Charge. Moreover,
14 the Companies' proposal for a stand-alone charge is inconsistent with Baltimore
15 Gas and Electric's proposal in Case No. 9221 to recover CWC revenue
16 requirements through a separate component of the residential Administrative
17 Charge.

18 **Q: What do you recommend with respect to the recovery of CWC revenue**
19 **requirements?**

20 A: I recommend that SOS-related CWC revenue requirements be recovered
21 through a new component of the residential Administrative Charge. Based on
22 calculations by OPC witness Effron, I also recommend that the rates for the
23 CWC component of the residential Administrative Charge be set initially at 0.02
24 mills/kWh for both Delmarva and PEPCO.

25 I further recommend that CWC revenues be reconciled as part of the
26 annual true-up process for incremental costs. Specifically, such revenues should

1 be reconciled against a revenue amount based on actual wholesale supply costs
2 and any changes in estimated net lag days during the preceding period.

3 Finally, I recommend that, as part of the annual true-up process for
4 incremental costs, the rates for the CWC component be updated as appropriate
5 to reflect changes in wholesale SOS supply costs, changes in estimated net lag
6 days, or approved changes to the assumed finance rate.

7 **VI. Return**

8 **Q: What do the Companies propose for the return component of the**
9 **residential Administrative Charge?**

10 A: As noted above in Section II, the Companies propose to continue charging
11 ratepayers at the current rate of 1.5 mills/kWh for the return component of the
12 residential Administrative Charge. Under their proposal, the Companies would
13 collect a “return” through the return component that is in addition to the return
14 on SOS-related cash working capital recovered through the proposed stand-
15 alone CWC charge.

16 **Q: Should the Company be allowed to collect a return in excess of the return**
17 **on cash working capital?**

18 A: No. According to OPC witness Hill, it would be economically inefficient to
19 provide the Companies any additional “return” beyond the return on SOS-
20 related cash working capital. Accordingly, Mr. Hill recommends that the
21 Company’s return be limited strictly to the return on SOS-related cash working
22 capital.

23 **Q: What do you recommend with regard to the return component of the**
24 **residential Administrative Charge?**

1 A: Based on Mr. Hill's recommendations, I recommend setting the rate for the
2 return component at a level that provides the Companies with a reasonable
3 return on SOS-related cash working capital.⁷ The Companies should not be
4 allowed to recover any other costs or other deemed return through the return
5 component of the Administrative Charge for residential SOS.

6 Specifically, Mr. Hill recommends that the allowed return to the
7 Companies be derived by applying a rate of return to CWC balances that is set
8 at the difference between the Company's overall cost of capital and the short-
9 term debt rate. I then recommend that this allowed return on cash working
10 capital be recovered through the return component. Accordingly, based on
11 calculations by OPC witness Effron, I recommend that the rates for the return
12 component of the residential Administrative Charge be set initially at 0.84
13 mills/kWh for Delmarva and 0.73 mills/kWh for PEPCO.

14 **VII. Administrative Adjustment**

15 **Q: What do the Companies propose for the Administrative Adjustment?**

16 A: The Companies propose to continue collection of the Administrative
17 Adjustment whenever the sum of the rates for incremental costs, return, and
18 uncollectible costs is less than the total rate for the residential Administrative
19 Charge.⁸ Under the Companies' proposal, the rate for cash working capital

⁷ I provide my recommendations regarding the recovery of CWC costs in Section V, above.

⁸ The Companies have not indicated what the rates would be for the Administrative Charge and for the Administrative Adjustment under their proposal in the event that the total for incremental costs, return, and uncollectible costs exceeded the Commission-determined rate for the Administrative Charge. I presume that the Companies' would propose in that case to set the Administrative Charge at the sum of the rates for incremental costs, return, and uncollectible costs and to set the Administrative Adjustment to zero.

1 would not be included in the derivation of the Administrative Adjustment since
2 cash working capital is recovered in a stand-alone charge separately from the
3 Administrative Charge. The Companies also propose to continue crediting the
4 amounts collected through the Administrative Adjustment to all residential
5 distribution customers.

6 **Q: Have the Companies proposed initial rates for the Administrative**
7 **Adjustment?**

8 A: No. As discussed above in Section II, the Companies are not advocating for a
9 specific rate for the Administrative Charge or the residual Administrative
10 Adjustment. Instead, the Companies adopted a “placeholder” value for the
11 Administrative Charge rate which yields rates for the Administrative
12 Adjustment under the Companies’ proposal that are equal to current rates. The
13 Companies have not offered any justification for continuing to charge current
14 rates for the Administrative Adjustment nor any evidence that current rates
15 reasonably reflect actual costs incurred by the Companies for the provision of
16 standard offer service.

17 **Q: What was the purpose of the Administrative Adjustment in the 2003**
18 **Settlement?**

19 A: In comments and testimony in Case No. 8908, certain parties expressed the
20 belief that, at least at the outset of competition, competitive retail suppliers
21 would be at a competitive disadvantage to residential SOS in terms of the costs
22 associated with supplying retail service. Specifically, some parties argued that
23 utility incremental cost was not fully compensatory of the retailers’ cost to
24 provide retail service, and thus would impede retailer entry during the early
25 stages of market development. In contrast, other parties argued that consumers
26 should pay no more than incremental cost for providing a regulated service, and

1 that charging more than incremental cost as part of the SOS price would distort
2 price signals and be economically inefficient. In light of the many uncertainties
3 at the outset of restructuring regarding market structure and costs, the
4 Administrative Adjustment was a transitional mechanism designed to balance
5 these competing concerns.

6 **Q: Why do the Companies support a continuation of the Administrative**
7 **Adjustment?**

8 A: Companies witness McGowan claims that distribution rates recover SOS-related
9 customer-service, customer-information, and administrative and general costs
10 that are in addition to incremental costs recovered through the Administrative
11 Charge. Mr. McGowan then argues:

12 These costs would be directly incurred by retail energy suppliers and
13 included in their energy rates. To make SOS rates comparable to the retail
14 energy suppliers' rates, the SOS Administrative Adjustment was
15 implemented to recover these types of costs in SOS rates.⁹

16 **Q: Do the Companies offer any evidence that SOS rates would not be**
17 **comparable to competitive retail suppliers' rates if the Administrative**
18 **Charge did not include an Administrative Adjustment?**

19 A: No. According to the Companies' response to OPC Data Request No. 17-1(b),
20 the Companies do not have any information regarding the magnitude of the
21 customer-service, customer-information, or A&G costs recovered through retail
22 suppliers' rates. Consequently, the Companies lack evidence to support their
23 claim that SOS rates would not be comparable with retail supplier rates if the
24 Administrative Charge did not include an Administrative Adjustment.

⁹ McGowan Direct, p. 16, ll. 6-9.

1 **Q: Would it be appropriate to use the Administrative Adjustment as a proxy**
2 **for costs allegedly incurred by retail suppliers or to eliminate an alleged**
3 **competitive advantage of SOS over competitive retail supply?**

4 A: No. By statute, Public Utilities Article §7-510(c)(3)(ii)(2), the Administrative
5 Charge should be set to recover no more than a utility’s “verifiable, prudently
6 incurred costs to procure or produce the electricity plus a reasonable return.”
7 Artificially increasing the rate for the Administrative Charge beyond that
8 required to recover actual, verifiable, and prudently incurred costs (plus a
9 reasonable return) in an attempt to level the playing field or to more closely
10 reflect retailers’ costs would be contrary to statute.

11 **Q: What did the Commission conclude in Order No. 86881 with regard to the**
12 **Administrative Adjustment?**

13 A: In Order No. 86881, the Commission found as follows:

14 In Order No. 85797 we stated that the PULJ should develop a record and
15 make a finding regarding whether the Administrative Charge should
16 continue to include an Administrative Adjustment. In his Proposed Order
17 he noted his finding that “the inclusion of the administrative adjustment [is]
18 the most troubling aspect of the settlement agreement.” Further he noted
19 that it is “speculation” as to how large, if any, it needs to be. We believe
20 that after a decade it is appropriate to examine this issue in more detail.
21 Consequently, we direct the Companies to file an analysis that provides a
22 basis for any SOS costs that may be included in present distribution rates.¹⁰

23 **Q: How did the Companies respond to this directive?**

24 A: According to Mr. McGowan, the Companies complied with the Commission’s
25 request by conducting a functional-allocation analysis of 2014 embedded
26 distribution expenses which divided customer service, customer information,
27 and administrative and general costs into distribution-related and SOS-related

¹⁰ Order No. 86881, Case Nos. 9226 and 9232, March 3, 2015, pp. 21-22. Emphasis added.

1 portions. Mr. McGowan notes that the distribution costs deemed to be SOS-
2 related under the Companies' analysis are fixed, not incremental costs:

3 These allocated SOS costs would not be avoided if the Companies were not
4 providing SOS service. The Companies' distribution business would still
5 require functions such as Billing and Collections, Call Center, Accounting,
6 Treasury, Human Resources, Information Technology, Legal, Corporate
7 Communications and Executive Management.¹¹

8 In other words, the Companies assert that the incremental cost to provide
9 customer service, customer information, and administrative and general
10 functions is zero, since the cost to provide such functions would neither
11 decrease as customers switch to competitive supply or increase if customers
12 returned to SOS.

13 **Q: Would it be appropriate to recover the “SOS-related” portion of embedded**
14 **distribution costs through the Administrative Charge?**

15 A: No. Because these costs are fixed, not incremental, it would be economically
16 inefficient and contrary to principles of cost causation to recover such costs
17 through the Administrative Charge.

18 **Q: Why would it be economically inefficient to recover fixed costs through the**
19 **Administrative Charge?**

20 A: Recovery of such fixed costs through the Administrative Charge would
21 overstate the true economic value of switching from standard offer service to
22 competitive retail supply. In other words, recovering fixed costs through the
23 Administrative Charge would falsely signal that such costs were avoidable with
24 customer migration to competitive retail supply.

¹¹ McGowan Direct, p. 16, ll. 11-15.

1 **Q: Why would recovery of fixed costs through the Administrative Charge be**
2 **contrary to principles of cost causation?**

3 A: These embedded costs were incurred to serve all distribution customers, whether
4 taking standard offer or competitive retail service. If non-incremental costs were
5 recovered through the Administrative Charge, those customers who switch to
6 retail supply would be able to avoid paying their fair share of such costs, while
7 customers remaining on SOS would be obligated to subsidize switching
8 customers for such costs.¹² It would be contrary to cost-causation principles to
9 allow customers to bypass non-incremental costs that had been incurred on their
10 behalf simply by switching to competitive retail supply. Thus, non-incremental
11 customer-service costs should continue to be recovered from all customers
12 through distribution rates.

13 **Q: Are you opposed to further separation of customer-service costs into**
14 **distribution and SOS functions?**

15 A: No. However, it is critical that the Companies unbundle only those customer-
16 service costs which have been determined to be incremental, i.e., potentially
17 avoidable as a result of customers migrating to competitive retail service. For
18 example, certain billing expenses may be avoidable if a customer switches to a
19 retail supplier that offers separate billing for supply. On the other hand, metering
20 expenses are not avoidable, since such expenses would be incurred whether a
21 customer takes standard offer or competitive service. As discussed above,
22 migrating customers would be able to avoid paying their fair share of embedded

¹² As customers migrate to competitive supply, the Administrative Charge paid by non-switching customers would need to be increased to recover the non-incremental costs no longer paid by the customers who migrated.

1 distribution costs if non-incremental costs were recovered through the
2 Administrative Charge.

3 It is also critical that the Companies charge retail suppliers for the full
4 amount of supply-related incremental costs associated with any customer
5 services provided to those retail suppliers. For example, retail suppliers who rely
6 on the Companies to render a consolidated bill should be charged for all
7 incremental billing expenses incurred to render the supply portion of the
8 consolidated bill.¹³ If not, then SOS customers would inappropriately subsidize
9 retail suppliers for such costs.

10 **Q: What process do you recommend for determining the amount to be**
11 **recovered through the residential Administrative Charge for SOS-related**
12 **customer-service, customer-information, and administrative and general**
13 **costs?**

14 A: As with the rate for the uncollectible-cost component of the residential
15 Administrative Charge, the charge for these SOS-related costs should be
16 determined in a distribution rate case through a full evidentiary review of the
17 Companies' proposed functional unbundling of distribution costs into
18 distribution-related and SOS-related cost categories. This process would provide
19 a record for the Commission to rely on to ensure that:

- 20 • The only distribution costs classified as SOS-related and recovered through
21 the Administrative Charge are those incremental costs incurred as a result
22 of providing standard offer service.

¹³ In other words, the supplier fee for consolidated-billing services should recover the same incremental cost per bill that would be recovered through the Administrative Charge for incremental SOS-related billing expenses. The Companies may therefore need to revise the fees currently charged to retail suppliers for consolidated-billing services.

- 1 • Distribution costs are unbundled in a reasonable and consistent manner and
2 that the distribution and SOS-related portions are appropriately allocated to
3 distribution rate classes and SOS service types, respectively.¹⁴
- 4 • Supplier fees are set at appropriate amounts to reflect supply-related costs
5 attributable to the provision of customer services to retail suppliers.

6 **Q: Would the Administrative Adjustment serve as reasonable proxy for SOS-**
7 **related costs in lieu of an explicit unbundling?**

8 A: No. There is no reason to expect that the rate for the Administrative Adjustment
9 would approximate the Company's actual unbundled SOS-related costs since
10 the rate is derived based on costs other than unbundled costs. Specifically, under
11 the Companies' proposal, the rate for the Administrative Adjustment is derived
12 as the difference between a fixed rate for the residential Administrative Charge
13 and the sum of the rates for incremental costs, uncollectible costs, and return as
14 those rates vary over time. If, for example, uncollectible costs were to increase,
15 the rate for the Administrative Adjustment would decrease, all else equal.
16 However, the effect on the Administrative Adjustment in this instance
17 notwithstanding, there is no reason to believe that an increase in uncollectible
18 costs would actually lead to a reduction in unbundled costs. Thus, the
19 Administrative Adjustment under the Companies' proposal would not serve as a
20 reasonable proxy for unbundled SOS-related costs.

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

22 A: No. The retail market has developed and matured over more than a decade of
23 competition in the supply of electricity to consumers. Consequently, it is neither
24 necessary nor reasonable to charge SOS customers more than the actual

¹⁴ The Companies did not attempt to allocate functionally unbundled SOS-related costs to SOS service types as part of its analysis.

1 incremental cost of residential SOS – and to require that SOS customers
2 subsidize customers served by retail suppliers in the process of crediting
3 Administrative Adjustment revenues – in order to provide an artificial
4 competitive edge to retail suppliers.

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

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

8 A: Yes.