

BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND

In the matter of the Application of	*	
Baltimore Gas And Electric Company		
For Approval of Changes	*	Case No. 9096
In Depreciation Rates		
	*	

* * * * *

INITIAL BRIEF OF THE OFFICE OF PEOPLE’S COUNSEL

The Office of People’s Counsel (“**OPC**”), by the undersigned, hereby submits its Post-Hearing Brief in which OPC will state the issues, present its positions and offer argument in support thereof.

I. BRIEF HISTORY AND CURRENT POSTURE

In April 2005, when Baltimore Gas Electric (“**BGE**” or “**the Company**”) filed an application to increase its base rates for gas service by 4.7% (about \$52.7 million), the Commission noted that the last major revision of the Company’s depreciation rates occurred in 1995.¹ Case No. 9036, Order No. 80460 at 1, 48.² Accordingly, the Commission followed Staff’s recommendation and ordered BGE to perform and submit an updated depreciation study no later than December 31, 2006. On December 27, 2006, the Company initiated the instant case by filing an “Application . . . For Changes in its Depreciation Rates.”

Between 1995 and filing of the instant case, however, the Company divested its generating plants pursuant to the enactment of the “Electric Customer Choice and Competition Act of 1999,” Ann. Code Md., PUC §§ 7-501, *et seq.*, and the Commission’s

¹ A 1999 review revised only one depreciation account.

² *In The Matter Of The Application Of The Baltimore Gas And Electric Company For Revision In Its Gas Base Rates*, 96 Md. P.S.C. 334 (2005).

Order No. 75757 approving a settlement which included, *inter alia*, recovery through a competitive transition charge of \$528 million in stranded generation costs -- i.e., an estimate of the difference between the net book value and the fair market value of BGE's generation-related assets. *Re Baltimore Gas & Electric Co*, 90 Md. P.S.C. 197 (November 10, 1999).

In other words, since its last depreciation review, the Company's business profile was radically transformed from that of an investor owned (i.e. vertically integrated) utility ("IOU") to a smaller business focused on transmission and distribution ("T&D"). Among the many results of this transformation, such as acquiring a lower business risk profile, OPC Ex. 1., the most notable for these purposes was that BGE's net salvage, which was positive when it owned plants, changed to negative (and often substantially negative) after the plants were sold. Tr. at 243-44;; 270, l. 4-11..

On December 27, 2006, the Company filed with the Commission its Application for changes in its depreciation rates. During discovery, the Company corrected errors which required some additional rounds of pre-filed testimony. With the Company's Application, Dr. White filed Direct Testimony. BGE Ex. 5. OPC Witness King filed "Reply Testimony," OPC Ex. 12, and Staff Witness Dunkel filed "Direct" [sic] Testimony, Staff Ex. 15. Mr. King then filed an "Amended Reply," OPC Ex. 13, and Mr. Dunkel filed a "Supplemental Direct Testimony." Staff Ex. 16. In the next round, Mr. King filed "Supplemental and Rebuttal Testimony," OPC Ex. 14, Mr. Dunkel filed "Rebuttal Testimony," Staff Ex. 17, and Dr. White filed "Rebuttal Testimony." BGE Ex. 6. Additionally, on behalf of BGE, Mark Case filed "Rebuttal Testimony," BGE Ex. 1, as did Jason Manuel. BGE Ex. 4. Mr. King filed

Surrebuttal Testimony, OPC Ex. 15, as did Mr. Dunkel. Staff Ex. 18. A filing by Dr. White of “Rejoinder Testimony,” BGE Ex. 7, concluded the rounds of pre-filed testimonies.

On September 24 and 25, 2007, the Honorable Dennis H. Sober, presided over the hearing of this matter with live testimony from various witnesses as recorded in the record of these proceedings [hereinafter cited as “Tr. at ____”].

II. SUMMARY OF ISSUES

At the end of the hearing, the Hearing Examiner requested each party to include a “chart” stating the final positions of each party regarding the major issues in the case. Tr. at 448-49. Because the parties’ respective positions are often either nuanced or somewhat difficult to parse, the summary below is as reasonably accurate as space would otherwise allow:

	ISSUE	Company Position	Staff Position	OPC Position
1	Life and Curve Shape Parameters	Use Dr. White's recommended parameters	No objection to Dr. White's recommended parameters	Accepts Dr. White's recommended parameters
2	Requirement to separate “actual” depreciation from removal costs for purposes of reporting to PSC in future depreciation/rate cases	BGE does not object to the disclosure of removal costs separate from actual depreciation on a go forward basis but cautions about its interpretation, the cost of implementing and need for continual update	No formal position but believes that such separation is in accord with recent trends and agreed with OPC that separation would enhance transparency	Strongly recommends: 1. As removal costs and actual depreciation expenses serve two separate functions, transparency for PSC review would be significantly enhanced 2. BGE is already performing this separation for FERC and GAAP

	ISSUE	Company Position	Staff Position	OPC Position
3	Present Valuing of Removal Costs	Not necessary; would reduce cash flow due to delaying Company's recovery	Necessary to be fair to ratepayers who overpay if the use of the "straight line" method of calculating future removal costs continues to be employed	Conceptually appropriate but its application requires forecast estimates of removal costs which cannot be accurately predicted.
4	Calculation of Removal Cost Allowances	Use traditional method <u>but</u> if HE decides to apply the PV method to calculate future removal costs, then use Dr. White's compound interest method	Use SFAS 143 procedures	Ratio 5-year average removal cost to plant; If the Hearing Examiner elects to apply the PV method, however, then the Commission should accept Staff's recommendation and use the SFAS 143 procedures.
5	Declaring the current removal cost reserve as a regulatory liability and returning it to ratepayers in the form of credits	Opposes	Staff Proposal does not include such a proposal ³	Supports
6	Treatment of Amortized Account Reserve Imbalance	Allocate imbalance to depreciable accounts, Even though it inaccurately accelerates their depreciation.	Believes that the Company and OPC, respectively, are right in part and wrong in part. No formal position but Mr. Dunkel believes a fair solution would be to have the Company set up separate amortization over a period equal to the remaining life of depreciable accounts. Thus, the Company would be paid back for its investment but the depreciation accounts would not be improperly inflated.	Use book reserves for depreciation; let reserve imbalance remain as an over-statement of net plant; following BGE's proposed solution is retroactive ratemaking

³ Staff Ex. 18 at 30, l. 13-15.

	ISSUE	Company Position	Staff Position	OPC Position
7	Treatment of Third Party Reimbursements	Credit to depreciation reserve; exclude from net salvage studies; to apply depreciation accounting would not be cost efficient	Credit to depreciation reserve; treat as positive salvage. Mr. Dunkel asserts that this is required depreciation treatment	Accepts Staff's position
8	Treatment of Insurance Reimbursements	Credit to plant in service	Credit to depreciation reserve; treat as positive salvage. Mr. Dunkel asserts that this is required depreciation accounting treatment.	No stated position.

III. AUTHORITY OF HEARING EXAMINER

A. The Commission and its Hearing Examiners are not bound by conclusions stated in previous Commission orders but, as a Commission practice, refer to previous orders for guidance.

Near the close of the hearing, the Hearing Examiner requested the Parties to address “the issue of whether a hearing examiner in the delegated proceeding has the authority to make a policy change in reference to the straight line present value controversy considering the recent cases that have come down from the Commission.” Tr. at 448.

The Hearing Examiner does have authority to make (or at least recommend) a change in policy determinations made in PSC Case Nos. 9092 (Pepco)⁴ and 9093⁵ (Delmarva).

⁴ *In The Matter Of The Application Of Potomac Electric Power Company For Authority To Revise Its Rates And Charges For Electric Service And For Certain Rate Design Changes*, ___ Md. P.S.C. ___, 258 P.U.R.4th 463, 2007 WL 2159658 (July 19, 2007) (wherein the Commission rejected the use of the prior straight line method and adopted a “new 'Present Value' methodology for calculating the cost of removing depreciated property -- i.e., negative net salvage).

⁵ *In The Matter Of The Application Of Delmarva Power And Light Company For Authority To Revise Its Rates And Charges For Electric Service And For Certain Rate Design Changes*, ___ Md. P.S.C. ___, 2007 WL 2159659, *2 (July 19, 2007)

Indeed, where a party (such as OPC here) has introduced relevant and significant evidence, heretofore neither presented nor available to the Commission in Case Nos. 9092 and 9093, regarding the dispute as to the best way to calculate estimated future removal costs by using either the “straight line” (“SL”), “present value” (“PV”) or “5-year rolling average” (also referred to as the “**historical recovery**”) methods, the Hearing Examiner is obligated to conform his decision to the evidence in the record.⁶ That being said, the Hearing Examiner cannot, and should not, ignore the Commission’s determinations in 9092 and 9093 and proceed to rule here as if the results were being written on an entirely clean slate. Based on Commission past practices, both the relevance as well as the recency of those Orders require the Hearing Examiner to give due and respectful consideration to the Commission’s policy determinations – and the reasons for those conclusions – rendered in those prior Orders before recommending that the Commission chart an entirely new course.

As a delegee of the Commission, *see* PUC § 3-104 (d)(1),⁷ a hearing examiner’s authority in presiding over a hearing can be coequal with, but may not exceed, the authority of the Commission. *See Core Communications, Inc. v. Verizon Maryland Inc.*, 96 Md. P.S.C. 15 (2005) (“the Hearing Examiner Division . . . is an extension of the Commission itself . . .”) To fully answer the question, then, it is first necessary to determine whether the Commission itself has authority to deviate from a previous order.

⁶ At the hearing, in response to the Hearing Examiner’s question, BGE Witness Case testified that he “certainly [has] assumed that in this proceeding, you [i.e. the Hearing Examiner] have the authority to make that determination.” Tr. II at 110, l. 3-15.

⁷ The “Commission may delegate to a commissioner or to a hearing examiner the authority to conduct a proceeding that is within the Commission’s jurisdiction . . .” PUC § 3-104 (d)(1).

Simply, there are no statutory or regulatory requirements that the Commission is bound by its prior decisions and, thus, there is no formal or technical Commission “precedent.” To the contrary, the Commission is obligated to decide each case on its own merits to ensure that the operation of a public utility is in the “interest of the public,” PUC § 2-113, and that rates imposed by public utilities are “just and reasonable.” PUC §§ 4-101 and 4-102. Accordingly, a decision and order issued by the Commission is proper if it is “based on consideration of the record” made in that particular case and the decision “state[s] the grounds for the conclusions of the Commission.” PUC § 3-113(a). As well, no grounds for reversal by a civil court on appeal in any manner preclude the Commission from modifying, amending or reversing what may have appeared to be a set policy or course.⁸

Moreover, legal doctrines such as *stare decisis*⁹ generally do not constrain the Commission with regard to prior Commission orders.¹⁰ “The Commission, unlike a judicial body, is an administrative agency charged with implementing its statutory authority, and as such, ‘the Commission is not bound by the rules of evidence or procedure of any court . . .’” *Core Communications, Inc. v. Verizon Maryland Inc.*, 96 Md. P.S.C. 15 (2005), citing PUC § 3- 101.

⁸ As PUC § 3-203 states, “Every final decision, order, or regulation of the Commission is prima facie correct and shall be affirmed unless clearly shown to be: (1) unconstitutional; (2) outside the statutory authority or jurisdiction of the Commission; (3) made on unlawful procedure; (4) arbitrary or capricious; (5) affected by other error of law; or (6) if the subject of review is an order entered in a contested proceeding after a hearing, unsupported by substantial evidence on the record considered as a whole.” None of these grounds would apply to an otherwise lawful modification, amendment or reversal of a prior Commission policy determination.

⁹ The doctrine of *stare decisis* reflects a “policy which entails the reaffirmation of a decisional doctrine of an appellate court, even though if considered for the first time, the Court might reach a different conclusion.” *Harrison v. Montgomery County Bd. of Educ.* 295 Md. 442, 458 (1983).

¹⁰ The Commission, of course, cannot act in derogation of its enabling statute and, overall, must follow the interpretations of pertinent law contained in the published opinions of Maryland appellate courts.

While the Commission is not bound by the technical rules of evidence or procedure of courts of law or equity, it nonetheless must observe the basic rules of fairness as to the parties appearing before it. *Re Potomac Elec. Power Co.*, 81 Md. P.S.C. 150, 154 -155 (1990). “So long as the due process rights of parties are protected . . . [however] . . . Commission deference to efficiency and practicality considerations is entirely appropriate.” *Core Communications, Inc., supra*. As the Commission is prohibited from engaging in retroactive ratemaking, see *Baltimore County v. Baltimore*, 329 Md. 692, 705 (1993)¹¹, due process (or fairness) concerns usually do not arise with regard to depreciation because the effect of the Commission’s rate determinations are always *prospective*. Contrast, *CBS Inc. v. Comptroller of the Treasury*, 319 Md. 687, 698 (1990) (wherein the Court of Appeals reversed the Comptroller’s action because his “materially modified or new standards *were applied retroactively* to the detriment of a company that had relied upon the [Comptroller’s] past pronouncements.”)

Moreover, and with specific regard to the issue of depreciation, the Commission had already put all utilities on *notice* – a key component of due process - that the Commission intended to examine and perhaps change the SL method of recovering removal costs as part of a broader examination of utility depreciation practices. Specifically, in a 2004 published order, the Commission expressly stated that the Commission expected the parties to assist it “in a broader examination of depreciation practices in WGL’s *next* depreciation case.” *Re Washington Gas Light Company*, 95 Md. P.S.C. 106 (2004) (the “**2004 WGL Case**”)].

¹¹ The general prohibition against retroactive ratemaking by a public utility regulatory commission is grounded upon the principle that a regulated public utility is bound by its filed tariffs in effect at any point in time and must charge the rate set forth therein. *Baltimore County*, 329 Md. at 705.

While not binding, the Commission's prior decisions containing statements of policy do provide a framework for future cases. See *Core Communications, Inc.*, *supra*, ("the Commission's proceedings are to be governed by the regulations and practices established by the Commission.") Because each Commission order is presumably the product of reasoned decision-making, it would be illogical and perhaps even contrary to the public interest for the Commission to change its policies willy-nilly from case to case, or from utility to utility.

The question, then, should not be if the Commission is bound by its prior decisions – it is clearly not – but, rather, under what circumstances will the Commission modify or veer from a policy preference stated in a prior case? While a number of such circumstances may be inferred from past Commission orders, the most significant is that the Commission will modify or reverse a prior policy when presented with **new facts, circumstances or arguments**. As Hearing Examiner Frank J. Wasowicz opined, "I do not believe the Commission to be bound by any past practices or traditional formulations if new circumstances warrant change nor is it precluded from making changes even though they may have jurisdictional ramifications." *Re Washington Gas Light Co.*, 77 Md. P.S.C. 30, 39 - 40 (1986).

Similarly, Chief Hearing Examiner Paul H. Harrington changed past Commission policy because certain "facts and arguments" had not "previously been addressed to the Commission" in prior cases which had applied that policy, including the utility's last rate case. *Re Herrington Harbour, Inc.*, 80 Md. P.S.C. 465, 487-88 (1989) (wherein the Commission included an income tax allowance because "it would be inappropriate to impute any tax loss

carry-forwards to the 'utility' in order to offset, in whole or in part, any income tax liability otherwise found to exist in this case.”)

In the instant case, OPC introduced highly relevant statistical **evidence** concerning the SL/PV/historical recovery dispute which was not before or considered by the Commission in either the 2004 WGL case or the 2007 Pepco and Delmarva cases (9092 and 9093). From the outset, as stated in the 2004 WGL case, the Commission noted its determination “in the future” to examine “how actual removal costs compare to the estimates used in the **derivation** of the **depreciation rates** .” *Id.* Unlike the historical recovery method which may be applied without reference to predictions or estimates of future removal costs, both the SL and PV methods of calculating removal costs rely on the alleged validity of the same underlying assumption, *i.e.*, that *the amount of retirements accurately predict the incurrence of removal costs*. At the hearing, Staff Witness Dunkel acknowledged that, in recommending the application of the present value method, he relied upon the Company’s estimates of future removal costs, Tr. at 437, l. 2-11, those estimates were predicated upon these “past relationships” between retirements and removal costs, Tr. at 440, l. 1-14, and that those estimates were inherently “imprecise.” Tr. at 441, l. 16-18.

In response to the Hearing Examiner’s request to Mr. King to discuss the differences between his testimony in 9092/9093 and the instant matter, however, Mr. King explained that, as a response to the Commission’s decisions in 9092/9093, here he “attacked frontally the proposition that you can forecast future removal costs by ratioing past removal costs to past retirements.” Tr. at 377, 7-13. Specifically, Mr. King used a statistical analysis that showed that, for eleven different accounts, removal costs of plant were *not* explained in any

significant degree by retirements. OPC. Ex. 12 at 21-22. Thus, the application of either the SL or the PV methods result in estimates that arguably move beyond “imprecise” and into arbitrary and capricious happenstance. Additionally, while producing satisfactory results in 9092 and 9093, application of the PV method to the Company’s gas plant reveals that its allowance of \$1,139,890 is inadequate to recover recent net removal average costs of \$2,486,332. OPC Ex. 14 at 7, l. 14-24. For these reasons alone, an appellate court would almost certainly reverse the Commission if it itself were hearing this case but *refused to discuss and consider* this evidence before deciding whether to reaffirm or change its prior determinations, notwithstanding their relatively recent issuance.

As the Commission does have authority to modify its policy determinations even in recent decisions, so the Hearing Examiner in this delegated proceeding has authority to make such policy changes, especially in reference to the dispute in which the benefits and detriments of the application of the SL, PV and historical recovery methods, respectively, is at issue. First and foremost, there are no regulations which either require a hearing examiner to follow the Commission’s prior decisions or forbid the Hearing Examiner from reaching a different conclusion. Indeed, the Commission certainly could have promulgated such a regulation had it felt the need. *Contrast* COMAR 20.07.01.01 *et seq.* (PSC regulations) with COMAR 31.02.01.09-1 and COMAR 31.02.01.10-2 (Md. Insurance Administration

regulations).¹²

Second, as noted in the examples above, hearing examiners not only may deviate from prior Commission determinations when certain “facts and arguments” had not “previously been addressed to the Commission,” *Re Herrington Harbour, Inc., supra*, but rather *must* do so to ensure that the hearing examiner’s decision is “based on consideration of the record . . .” made in that particular case. PUC § 3-113(a). As discussed above, OPC has presented *new and material facts* which were not before or available to the Commission in the Pepco and Delmarva cases.

Finally, separating a “precedential” policy determination from a factual determination is not always readily apparent. For example, in both 9092 and 9093, Pepco and Delmarva were already segregating removal costs from plant-only depreciation expenses – a crucial prerequisite for implementing the “PV” methodology of calculating removal costs -- and the Commission expressly “directed” each utility to “continue” to do so. In the instant case, and in great contrast to Pepco and Delmarva, BGE opposes this

¹² COMAR 31.02.01.09-1 .09-1 (“Decision by an Administrative Law Judge”) – Maryland Insurance Administration; “Powers and Duties – Hearings,” C. *Effect of Regulations, Bulletins, Final Orders, and Preexisting Policies*. Except as provided in Regulation .10-2H of this chapter, in making a decision, the **administrative law judge** is **bound** by any regulation, bulletin, **final order, or settled and preexisting policy of the Commissioner** to the same extent that the Commissioner is or would have been bound if the Commissioner were hearing the case.

COMAR 31.02.01.10-2 H. *Effect of Summary Affirmance*. (1) If the Commissioner issues a final order that summarily affirms the proposed order of an administrative law judge without discussing the facts and legal issues and without expressly adopting the administrative law judge's legal analysis and proposed conclusions of law, neither the final order nor the proposed order is precedent within the rule of stare decisis. (2) Notwithstanding §H(1) of this regulation, a final order of the Commissioner that summarily affirms the proposed order of an administrative law judge without discussing the facts and legal issues and without expressly adopting the administrative law judge's legal analysis and proposed conclusions of law may be cited and relied on in a proceeding before the Commissioner, the Office, or a court: (a) When relevant under the doctrine of the law of the case, res judicata, or collateral estoppel; or (b) In any subsequent disciplinary proceeding involving a party to the final order.

segregation for purposes of Maryland regulatory review. In its Argument, OPC contends that the Commission decision reflects a policy determination to which the Hearing Examiner should give great consideration but BGE will likely differ. Thus, while reference to the Commission's determinations in 9092 and 9093 is both appropriate and necessary, the Hearing Examiner nonetheless must make his own evaluation, based on the record, of the reasons for imposing this requirement on BGE in its Maryland filings.

For all of these reasons, it is not only required but imperative that the Hearing Examiner make an independent assessment of the record made in this case and come to a reasoned conclusion. Due to the relevance and recency of the decisions rendered in 9092 and 9092, such an assessment does not (and should not) preclude the Hearing Examiner's due consideration of the Commission's conclusions and reasons therefore. Such consideration, however, must include an examination of the differences as well as the similarities between the facts presented in those cases and facts presented in evidence in the instant case. As well, the virtue of attaining uniformity of policy amongst utilities is undone if, *as applied to the instant facts*, the policy – as a consequence of its wrong and failed assumptions -- allows *certain* utilities to recoup their prudently-incurred expenses in a more timely manner than others. Lastly, and as a check, in addition to the right of any party to appeal to the Commission itself, if the Hearing Examiner “misconstrue[s] the intended binding nature of the Commission's decisions, the Commission may [always] review [the Hearing Examiner's] Proposed Order on its own motion.” *Re Herrington Harbour, Inc., supra*.

IV. DISCUSSION

A. Overview

As the precursor to an impending filing for a rate increase, depreciation is an important issue because it represents at least \$28.75 million in contested revenues.¹³ Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of utility property used to generate revenue. Of numerous definitions of depreciation, one commonly cited is included in FERC's Uniform System of Accounts for electric plant:

Depreciation, as applied to depreciable electric plant, means the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities.

OPC Ex. 5.

According to the Commission, depreciation is "the method companies use to recover the original cost of their investment [less] any net salvage." Order No. 81517 at 13, Case No. 9092. Annual depreciation rates are "developed based upon the remaining book value of the assets placed in service, amounts received as gross salvage and expenses incurred for the cost of removal."

Company Witness Ronald White proposed life and survivor curve parameters, BGE Ex. 5 (White Dir. At 7-8, Ex. REW-2 at 10-14), which OPC Witness King accepted, OPC Ex. 12

¹³ Since the numbers are based on 2005 plant accruals, amounts in contest have likely grown along with current plant accruals.

at 4, l. 7-8, and to which Staff Witness Dunkel has not objected. Tr. at 417, l. 19-22. Thus, the most significant issues still in dispute relate to the calculation and treatment of estimated future removal costs for all plant categories, and the treatment of the proposed change for certain accounts from depreciation to amortization. For future removal costs, OPC opposes the Company's request to continue its past practice of recovering amounts significantly greater than its current annual costs. OPC also seeks to restrain the continued growth of the Company's removal reserves for which it charges ratepayers in present dollars but which is never true-up. Both of these situations have caused ratepayers to pay far more than the just and reasonable costs of depreciation.

The dispute is reflected in the great disparities between the three main witnesses' respective recommendations. The value of total plant in service for December 2005 was approximately \$4.63 billion, comprising electric plant of approximately \$3.25 billion, gas plant of approximately \$1.1 billion and common plant of approximately \$278 million. The Company recommends accrual of \$170,511,113 million which results in a composite accrual rate of 3.68%. The Company's recommendation exceeds by \$23,739,202 million Staff's recommended accruals of \$146,771,911.00 which results in a composite accrual rate of 3.17%, and exceeds by \$27,955,415 million OPC's recommended accrual of \$142,555,698 which results in a composite accrual rate of 3.08%. If the Hearing Examiner decides to follow the Commission's decisions in Case Nos. 9092 and 9093 and apply the PV method to calculate future removal costs, BGE Witness White offered as an alternative a *sui generis* "Compound Interest Treatment" which recommends total plant accrual of \$155,564,477 resulting in a

composite accrual rate of 3.36%. The chart below shows the respective amounts proposed by each expert witness::

	Recommended Accrual					Composite Accrual Rates				
	BG&E	Staff	OPC	OPC	BG&E	BG&E	Staff	OPC	OPC	BC
				3rd Pty	CI/PV				3rd Pty	CI
				Reimb.					Reimb.	
Elect.Plant										
Distrib.	\$109,032,283	\$90,990,647	\$84,109,685	\$80,052,616	\$98,030,302	3.49%	2.92%	2.70%	2.57%	3.36%
Gen'l	<u>7,930,144</u>	7,897,363	<u>7,682,778</u>	<u>7,675,455</u>	<u>7,885,873</u>	<u>6.22%</u>	<u>6.22%</u>	<u>6.03%</u>	<u>6.02%</u>	<u>6.03%</u>
Total	116,962,427	98,888,010	91,792,463	87,728,071	105,916,175	3.60%	3.05%	2.83%	2.70%	3.36%
Gas Plant										
Prod.	337,079	320,750	568,224	546,981	289,345	2.73%	2.60%	4.61%	4.43%	2.97%
Trans.	1,246,941	1,184,594	1,191,140	1,150,655	1,133,181	3.46%	3.29%	3.31%	3.20%	3.36%
Distrib.	29,783,156	24,217,101	28,762,810	28,032,529	25,718,900	2.84%	2.31%	2.74%	2.67%	2.97%
Gen'l	<u>357,839</u>	<u>357,839</u>	<u>361,120</u>	<u>361,120</u>	<u>357,839</u>	<u>6.10%</u>	<u>6.10%</u>	<u>6.15%</u>	<u>6.15%</u>	<u>6.15%</u>
Total	31,725,015	26,080,284	30,883,294	30,091,285	27,499,265	2.87%	2.36%	2.80%	2.73%	2.97%
Common Plant	<u>\$ 21,823,671</u>	<u>21,803,617</u>	<u>19,879,941</u>	<u>19,879,941</u>	<u>22,149,038</u>	<u>7.84%</u>	<u>7.83%</u>	<u>7.14%</u>	<u>7.14%</u>	<u>7.14%</u>
Total Plant	170,511,113	146,771,911	142,555,698	137,699,297	155,564,478	3.68%	3.17%	3.08%	2.97%	3.36%

B. The Hearing Examiner should require the Company’s regulatory accounting practice for removal cost reserves to conform to recent Commission determinations and FERC rulemaking.

In accord with the Commission’s direction in Case Nos. 9092 and 9093, the Hearing Examiner should require the Company to separate the accounting for removal costs from the accounting for “actual” (or “pure”) depreciation for purposes of reporting to PSC in future depreciation and rate cases.¹⁴ According to Staff Witness Dunkel, the Company’s “present depreciation rates do not show net salvage components separate from the plant only

¹⁴ Case No. 9092, Order No. 81517 at 32 (“the Commission directs Pepco to continue to segregate removal costs from plant-only depreciation expenses.”)

component.” Tr. at 403, l. 10-12. OPC Witness King recommends that the Company record “pure depreciation” separately from accrual for net removal costs because, while it will not affect depreciation rates *per se*, it will positively enhance “the transparency of the depreciation process.” Tr. at 385, l. 7-19. At the hearing, Company Witness Manuel concurred with Mr. King that this separation would provide “greater transparency” to the Commission, Tr. at 178, l. 1-10. Additionally, Company Witness White testified that the Company is not objecting to the disclosure of removal cost accruals separately from actual depreciation on a going forward basis, and that, “as a matter of principle, there is nothing wrong with segmenting the depreciation reserve and segmenting the depreciation accrual.” Tr. at 272-76, Tr. at 276, l. 12-14. While Mr. Dunkel did not make a specific recommendation regarding this disclosure requirement, he testified (for reasons explained below) that the way companies “are now going” is to show in their state regulatory filings their plant only depreciation rates separately from their cost of removal depreciation rates. Tr. at 401, l. 2-22; 403, l. 6-14.

Removal costs are any costs that are required to retire a unit of plant and include dismantlement, physical removal and restoration of the site to a permanent, stable condition. OPC Ex. 12 at 17, l. 1-3. The Company incurs removal costs for all but two of its electric distribution plant accounts and all but two of its gas plant accounts, exclusive of general plant. OPC Ex. 12 at 17, l. 7-9.

Depreciation and removal costs serve two completely different functions. On one hand, “depreciation” is the process of restoring capital that investors effectively loaned to ratepayers for costs that have already been incurred. OPC Ex. 12 at 24, l. 12-18. Because

capital has been spent on plant, actual depreciation can be calculated in a fairly straightforward and accurate manner. On the other hand, “removal cost” accruals are advances from ratepayers to the company and its investors for costs that have *not* been incurred. *Id.* Since those costs have not yet been incurred and, in fact, will not be incurred for many years hence, removal costs require estimation and judgment.

Those very different functions notwithstanding, historically “most regulatory commissions have required that both gross salvage and cost of removal be reflected in depreciation rates.” Public Utility Depreciation Practices. Nat’l Assoc. Reg. Utility Commissioners (August 1996); OPC Ex. 12 at 20, l. 4-18. The theory underlying this requirement was premised on the assumption that physical plant in service would have a residual value at its retirement. *Id.* (“Since most physical plant placed in service will have some *residual value* at the time of its retirement, the original cost recovered through depreciation should be reduced by that amount.”) These removal cost allowances were recorded as part of depreciation expense, and plant removal expenditures were charged to depreciation reserves. OPC Ex. 12 at 12, l. 5-11.

Thus, until December 2006 when Pepco and Delmarva filed their respective Applications for an increase in rates, *see* Case Nos. 9092 and 9093, *supra*, all Maryland utilities employed a procedure that *combined* depreciation, salvage and removal costs from which was derived a composite rate. OPC Ex. 12 at 5, l. 18-24. This procedure adjusts depreciation rates to capture (or recover) an estimate of future “net salvage” costs, which is the *difference between* positive salvage (i.e. the remaining market value of an asset at retirement) *and* its cost of removal. OPC Ex. 12 at 5, l. 1-3. The procedure begins with a “*net salvage ratio*,” which is

the ratio of net salvage to plant in service., and is used to inflate or deflate the amount to be recovered through depreciation. OPC Ex. 12 at 5, l. 26-28. That amount is *deflated* when net salvage is *positive* but is *inflated* when net salvage is *negative*. *Id.* Net salvage will be negative “if removal costs are forecasted to exceed any remaining value of the assets at the time of retirement.” Order No. 81517 at 13.

Except for the common power equipment account, the Company has very little positive salvage. OPC Ex. 12 at 5 l. 21-24. To the contrary, Dr. White concurs with Mr. King that the Company’s “net salvage” is now substantially negative, which means that the depreciation rate is increased to capture future removal costs. OPC Ex. 12 at 5 l. 21-24; Tr. at 270, l. 4-11.

But the incorporation of net salvage into depreciation rates has obscured its impact on accrual rates. OPC Ex. 12 at 16. A serious drawback of having depreciation rates recover estimated future removal costs is that as time passes it becomes increasingly difficult to sort out how much ratepayers paid for actual depreciation and how much they paid for estimated future removal costs. As Mr. King stated, “Only through careful analysis has it been possible to identify how many dollars of annual depreciation went to recover past capital expenditures – true depreciation – and how many dollars were accrued to offset future removal costs.” OPC Ex. 12 at 12, l. 5-11.

The problem is exemplified by the Company’s inability to provide testimony about the composition of its existing depreciation reserve. Mr. Manuel, BGE’s Director of Regulatory Accounting, testified at the hearing that he did not know the amount that the Company collected for removal costs from 2001 through 2005. Tr. at 175. He acknowledged

that this type of breakdown was not included in his pre-filed testimony. *Id.* Similarly, Company Witness testified that he did not know what proportion of the total depreciation and amortization is associated with the cost of removal. Tr. at 88, l. 12-17. As well, Dr. White acknowledged that, while he had undertaken some analysis in his personal work papers, he also did not provide anything in his testimony which would quantify how much of BGE's total accrued depreciation was collected for estimated future removal costs rather than for "pure" depreciation. Tr. at 249-51. Dr. White also conceded that, in his testimonies, he did not provide any testimony similar to the net salvage accrual amounts or the five year average net cost of removal expense provided by Mr. King. Tr. at 248-49.

Since 2003, the Federal Energy Regulatory Commission ("FERC") provided at least a partial remedy to this problem by promulgating new reporting rules ("**Rule 631**") for "jurisdictional entities," such as the Company, under FERC's Uniform System of Accounts. In short, FERC now requires the Company "to maintain separate subsidiary records for cost of removal for non-legal retirement obligations that are included as specific identifiable allowances recorded in accumulated depreciation in order to separately identify such information to facilitate external reporting and for regulatory analysis, and rate setting purposes . . ." OPC Ex. 6; OPC Ex. 12 at 11-12.¹⁵ While Dr. White is technically correct that Rule 631 "permits" companies to implement this segregation on a go-forward basis, the Rule's is broader than he ascribes as it expressly states that jurisdictional entities "*must*

¹⁵ Accounting, Financial Reporting, and Rate Filing Requirements for Asset Retirement Obligations, [68 Fed Reg 19610 \(April 9, 2003\)](#). Legal asset retirement obligations ("**ARO's**") are typically related to statutes which obligate a company to retire plant, such as the dismantling or entombing of a nuclear generating plant at the end of its life. Non-legal ARO's comprise the removal costs for plant at issue in the present case. See discussion in Section D, *infra*.

identify and quantify in separate subsidiary records the amounts, if any, of *previous* and current accrued accumulated removal costs for other than legal retirement obligations recorded as part of the depreciation accrual . . . “ OPC Ex. 6 at ¶ 39 (Emphasis added). Only if jurisdictional entities “do not have the required records to separately identify such prior accruals for specific identifiable allowances collected in rates for non-legal asset retirement obligations recorded in accumulated depreciation,” may they proceed “prospectively” with separate identifications of current accruals and allowances for future estimated removal costs. *Id.*

As with FERC Rule 631, requiring the Company here to account separately for its actual depreciation expenses and its estimated future removal costs would not, in and of itself, change the current regime in depreciation accounting and decouple actual depreciation from estimated future removal costs in the Company’s accruals. Nonetheless, the greater transparency of the regulatory liability treatment of removal cost accrual will enhance the ability of the Commission to monitor these accruals of estimated future removal costs. The Company should incur relatively little additional expense to comply with this requirement as the Company is already reporting in this manner to the FERC and in its GAAP accounting.¹⁶ Additionally, and as Dr. White acknowledged, the Company already provides estimates of its future removal costs in a deferred liability disclosure to the federal Securities and Exchange Commission (“SEC”). Tr. at 277, l. 10-15, at 278, l. 4-8.

¹⁶ The Company is now required to recognize and account for certain asset retirement obligations (“AROs”) in its financial accounting that differs from the amount of negative salvage reflected in depreciation expense that is used for regulatory ratemaking purposes. See discussion, *infra*.

- C. **The Hearing Examiner should cap the perpetual and ever-expanding removal costs reserves by requiring the Company to forego the use of the straight line method to calculate estimated future removal costs and instead use either a 5 year rolling average or “present value” method.**

The Company’s present system of depreciation accounting, which incorporates inflated estimates of future net salvage into depreciation rates, has unjustly and unreasonably increased accrual rates to the great detriment of Maryland residential ratepayers. If the Hearing Examiner were to adopt Dr. White’s primary recommendations based on the “straight line” (“SL”) method of accruing estimated future removal costs, for electric plant the Company would collect from ratepayers \$44.2 million in removal cost accruals, which is 2.67 times the Company’s recent average annual removal cost experience of \$16.55 million. OPC Ex. 12 at 19, as amended, OPC Ex. 13 at 4. Similarly, for gas plant, the Company would collect from ratepayers \$7.9 million in net removal cost accrual, which is 2.4 times the Company’s roughly \$3.3 million actual average removal cost experience for that plant. OPC Ex. 12 at 19. This is a manifestly unjust result and should therefore be unequivocally be rejected.

In their primary recommendations, both Staff Witness Dunkel and OPC Witness King offer alternatives to the current regime which are not only significantly fairer to ratepayers but also, as Company Witness Case conceded, would permit the Company to recover its full actual depreciation expense as well as its future removal costs. Tr. at 69, l. 14-23. Neither Mr. Dunkel nor Mr. King recommend the continuation of the existing regime using the current “straight line” (“SL”) method. OPC Ex. 12 at 17; Staff Ex. 15 at 41-43. Mr. Dunkel prefers the application of the aforementioned “present value” (“PV”) method of

calculating estimated future removal costs, Staff Ex. 15 at 45, while Mr. King believes that the application of a “5-year rolling average” (or “**historical recovery**”) method would obtain more accurate results. OPC Ex. 12 at 24-25. At the same time, Mr. Dunkel believes that the historical recovery method is “superior” to all other recommended approaches other than the PV method, Staff Ex. 15 at 45, while Mr. King would support the application of the PV method as an alternative to the continuation of the current unjust regime which results in a perpetual and ever-expanding removal costs reserve. OPC Ex. 12 at 24-25.

In Case No. 9092,¹⁷ the Commission adopted the PV method. OPC believes that the Commission misconstrued the application of the “5-year rolling average” recovery method and, moreover, presents here significant new evidence which demonstrates that the PV method is based on a fundamentally flawed premise. Overall, OPC asserts that the application of the historical recovery method would result in a significantly more accurate year-to-year recovery by the Company of its future removal costs and thus be fairer to ratepayers overall.

Before comparing the various methods, an examination of the workings and flaws of the current composite/SL regime is required. The SL method by which Dr. White reaches his removal costs estimate is denominated descriptively by Mr. King as the Traditional Inflated Future Cost Approach (“**TIFCA**”).¹⁸ OPC Ex. 12 at 19-24. For each major category of plant, Dr. White compares the original cost of retirements during recent years with the experienced costs of removal during those same years. OPC Ex. 12 at 19. The ratio of the removal costs to

¹⁷ As previously noted, the Commission made identical determinations and conclusions in Case No. 9093.

¹⁸ Staff Witness Dunkel refers to the TIFCA as the “Traditional Approach.” Tr. at 416-17; Staff Ex. 15 at 37-42.

plant retirements becomes the removal cost ratio which is used to develop annual removal cost rates. *Id.* As Dr. White's report indicates, however, this ratio can be as high as 75 percent. *Id.* Thus, if the removal cost ratio is 75 percent for a plant balance, Dr. White increases (or, in other words, "inflates") the amount to be recovered by 75 percent. OPC Ex. 12 at 17. In this manner, Dr. White produces depreciation rates that recover both the original investment and the expected estimated future cost to remove that investment. *Id.*

Because the Company's overall net salvage is currently -- and projected to stay -- negative, the TIFCA method overcharges ratepayers because it fails to recognize the present value of future costs.¹⁹ As Mr. King explained, the TIFCA procedure charges ratepayers *now*, in *undiscounted current dollars*, for the *projected cost* of removal that presumably will be incurred at the time of plant's retirement perhaps decades hence. OPC Ex. 12 at 22; *see* Staff Ex. 15 at 33. For instance, and as Dr. White conceded, when the Company places an overhead conductor in 2007, under Dr. White's SL-based proposal the Company would add a removal cost allowance of 75 cents to *each dollar* of construction cost recovered. *Id.*; Tr. at 269. Yet that 75 cents will not be spent, on average, for another 35 years. OPC Ex. 12 at 22. Because a dollar spent in 2042 is worth far less than a dollar collected in 2007, "[n]ot only will inflation erode the value of the 2042 dollar, but the holder of the dollar [i.e. the Company] has the benefit of its earning (or spending) value in the intervening 35 years." In other words, and as the Commission stated in its Case No. 9092 Order, "today's ratepayers would

¹⁹ According to Staff Witness Dunkel, "The theoretical foundation for [the traditional, or TIFCA,] method was developed back when Net Salvage was generally positive. With positive Net Salvage, investors provided the investment and the positive Net Salvage was used to pay back some of the investor provided funds. When Net Salvage [is] positive there is no prepayment by customers." Staff Ex. 15 at 39.

pay more in 'real' dollars under the Straight Line Method for the recovery costs of the plant they consume than would future ratepayers when net salvage is negative, as everyone projects." Order No. 81517 at 30.

The application of the TIFCA not only results in unjustly larger accruals than reasonable but also perpetuates a permanent and growing loan from ratepayers to the Company. OPC Ex. 12 at 21 at l. 1-2. While the rationale for the TIFCA is arguably valid for large, single units of plant such as power plants (and then only when the future costs are discounted to the present,) the Company's present removal cost accruals are *not* based on an individual unit of plant but rather are "*flows of money generated by the installation and retirement of large numbers of individual items in mass property accounts.*" OPC Ex. 12 at 23-24. In short, and as Dr. White agreed, there is no "end of life" for mass property accounts and the property contained in each such account is in a continual state of change. Tr. at 266, l. 5-18. Due to load growth, the inflow of newly installed plant always exceeds the outflow of retired plant. OPC Ex. 12 at 23-24. Due to inflation, the dollars added each year will always exceed the dollars retired. *Id.* As a result, there is *always* more new plant generating higher removal cost charges than old plant that has accumulated removal cost reserve. *Id.* Since there can never be – and will never be – anything analogous to a "true-up," under the TIFCA/SL approach, ratepayers never catch up as the in-flows keep exceeding the out-flows.

Since Mr. Dunkel generally concurs about the nature of problems using the TIFCA/SL approach, as a remedy Mr. Dunkel recommends the PV method of calculating estimated future removal costs. He favors the PV method because its premise is consistent with the present value treatment of asset retirement obligations ("**AROs**") under Statements of

Financial Accounting Standards Number 143 (“SFAS 143”) promulgated in June 2001 by the Financial Accounting Standards Board (“the Board”). Staff Ex. 46-47.²⁰ SFAS 143 was developed “because entities were applying different accounting practices to record retirement obligations associated with tangible long-lived assets.”²¹ SFAS 143 primarily applies to legal obligations associated with the retirement of tangible, long-lived assets and requires that those legal “asset retirement obligations” (“AROs”) be recognized “at fair value at the time the legal obligations are incurred if a reasonable estimate of fair value can be made.” OPC Ex. 12 at 8; FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations – an Interpretation of FASB Statement No. 143*, <http://www.fasb.org/pdf/fin%2047.pdf> (March 2005, accessed November 8, 2007). The “fair value” is defined as the cost of a contract with an independent party to retire the asset, negotiated when the asset is installed. OPC Ex. 12 at 7. In effect, “this fair value is the present value of the future cost, using as the discount factor the risk-adjusted interest rate when the liability was recognized.” *Id.*

Mr. King recommends that the Hearing Examiner apply the historical recovery method which accrues removal cost allowances based on the average of net removal costs during the most recent five years for which data are available. In other words, the basis for quantifying the Company’s annual removal cost allowances would be a rolling average of the Company’s last five year’s actual removal costs. OPC 12 at 24-25. This average,

²⁰ SFAS 143, “*Accounting for Asset Retirement Obligations*,” became “effective for financial statements issued for fiscal years beginning after June 15, 2002.” Staff Accounting Bulletin No. 106, Securities and Exchange Commission, 17 CFR PART 211.

²¹ *In the Matter of the Petition of Cascade Nat’l Gas Corp. For An Accounting Order Regarding Treatment of Certain Asset Retirement Obligations (SFAS 143)*, 2006 WL 3087113 (Wash. U.T.C.).

computed for each account, is ratioed to the account balance to derive the annual removal cost rates for each account. *Id.* As Mr. King explained, this historical recovery procedure “preserves the practice of accruing removal cost reserves by means of rates applied to plant balances, but it *effectively halts any further increase in the reserves already accumulated.*”

Both opposing experts noted significant advantages to applying the historical recovery method advocated by Mr. King. First and foremost, Staff Witness Dunkel concluded that, with the application of the historical recovery method “customers [i.e. ratepayers] *do not overpay* for removal costs.” Staff Ex. 15 at 44-45. Second, and as Mr. Dunkel also testified, the historical recovery method “eliminates any significant issues pertaining to inflation, the change in the value of dollars over time, or issues related to the Company holding the customer’s money for extended periods.” *Id.* “Since the dollar amount to be currently collected from the customers are based on the current actual expenditures for actual removals,” inflation concerns are mitigated because “there is little or no difference between the value of the dollars collected from the customers and the values of the dollars used by the Company to pay for the removals.” Staff Ex. 15 at 44, l. 16-20. Third, as an alternative to the SL method, the historical recovery method is easier and less expensive to implement than either the PV method or Dr. White’s alternative “compound

interest” method.²² As Dr. White testified, a utility would encounter difficulties in implementing either the PV or “compound interest” methods without having maintained age property records, while a utility would not need those records to implement the historical recovery method. Tr. at 237.

The main problem with all of the methods of calculating estimated future removal costs -- other than with historical recovery -- is that they proceed on an unproven and erroneous assumption that there is an historical correlation between removal costs and retirements, OPC Ex. 12 at 21, and, based thereupon, “the relationship [i.e. ratio] between net salvage and retirements is a *predictor* of future net salvage.” Tr. at 288-89 (Test. of Dr. White). In other words, “TIFCA assumes that retirements are responsible for removal costs, so it is reasonable to take the ratio of one to the other as a predictor of future removal costs when present plant retires.” OPC Ex. 12 at 21. This same assumption underlies not only the TIFCA but also the PV method. At the hearing, Mr. Dunkel agreed that use of either the TIFCA/SL or SFAS methods are “inextricably intertwined” with assumptions based on

²² Dr. White proposed his “compound interest” method as an alternative to the PV method in the event that the Hearing Examiner rejected the SL method. Conceptually, the “compound interest” method is somewhat similar to an SFAS 143 fair valuation method but discounts the present value of the estimated future removal costs in a future manner. According to Dr. White, while SFAS 143 allocates asset retirement costs in a “straight line” manner, in a compound interest method, Dr. White has an implied asset retirement cost that he allocates for the “sinking fund,” or compound interest. Tr. at 316-17. According to Mr. King, the “compound interest” is not a new methodology but to his knowledge it has not previously been proposed for the discounting of future removal cost in the environment of regulatory depreciation accounting. Tr. at 382-83. While that does not rule out its consideration by the Hearing Examiner, weighing significantly in favor of the 5-year rolling average method is that it has been adopted by the Delaware Public Service Commission for Delmarva Power & Light’s Delaware service territory, OPC Ex. 12 at 24-25, is used for all utilities in Pennsylvania, and has been adopted by the New Jersey Board of Public Utilities for Rockland Electric Company, Atlantic City Electric Company, Jersey Central Power & Light Company and Public Service Electric & Gas Company, and with a slight modification by the Georgia PSC for the Georgia Power Company. Georgia. OPC Ex. 12 at 25-26.

estimates of future predictions, Tr. at 436-37, and confirmed that he applied his PV calculations “to the *Company’s estimate* as to what it would cost in the future to remove investments,” Tr. at 437, l. 2-11. Those estimates, necessarily, were derived from this ratio of net salvage and retirements. Tr. at 439, l. 16-22.

While this assumption appears commonsensical, the assumption does not stand up to statistical analysis derived from *facts, i.e.* the actual records of retirements and removal costs for the major categories of electric and gas plant, respectively, and which demonstrates that retirements do *not* predict the incurrence of removal costs. OPC Ex. 12 at 21-22; Sch.4 in Exhibits CWK-1 and CWK-2. As Mr. King’s statistical analysis revealed, nine out of eleven categories of electric and gas plant did not reflect any significant correlation between retirements and removal costs and, thus, removal costs were not explained in any significant degree by retirements.²³ *Id.* Thus, while Mr. King concurs with Dr. White that removal costs are incurred only when there are retirements, “the values of both retirements and removal

²³ As Mr. King testified, the coefficient of determination (or “R²”) measures the extent to which one variable is explained by changes in the other variable. OPC Ex. 12 at 21-22. In this case, the R² describes the degree to which removal costs are explained by retirements. If the R² is 1.00, the removal costs are fully explained by retirements. *Id.* A .50 R² means that half of the year-to-year variations in removal costs are explained by year-to-year variations in retirements. *Id.* Data in Schedules attached to Mr. King’s Reply Testimony, CWK 1, Sch. 4 and CWK-2, Sch. 4, showed the following R² values, which reflect the disparity amongst these relationships:

Electric Plant:	R²	Gas Plant – Distribution	R²
Station Equipment	.079	Structures & Improvements	.009
Overhead Plant	.051	Gas Mains	.103
Underground	.702	Measuring Equipment – General	.012
Meters	.674	Measuring Equipment – City Gate	.083
Customer Installations	.231	Services	.381
		House Regulators	.033

costs are so extremely variable as to render meaningless any ratios between them.”²⁴ OPC Ex. 15 at 8. In cross-examination Dr. White conceded that -- irrespective of any validity to his critique of Mr. King’s statistical analysis – he had not demonstrated affirmatively that there *is* a predictive relationship between retirements and removal costs in depreciation account categories. Tr. at 291-93. Indeed, as Dr. White further acknowledged, because mass property accounts essentially have no “lives” and go on indefinitely, “Until a company closes the doors for the last time, [he] will *never* know whether or not [he has] accurately estimated their future net salvage traits, anymore than their service lives.” Tr. at 337, l. 8-11, (emphasis added).

This proof of the unpredictable variability of calculating estimated future removal costs -- which is inherent in both the SL and PV methods – was not presented as evidence in Case No. 9092 but it dramatically undermines the basis for the Commission’s conclusions. In 9092, Pepco’s average removal cost between 2001 and 2005 was \$5.37 million, but its 2005 year costs were \$9.0 million. Order No. 81517 at 17. For future removal costs, Pepco had requested \$37,163,195 using the SL method and Staff had calculated an annual accrual of \$15,858,014. *Id.* at 17, 21. The Commission chose the PV method because it accepted

²⁴ Mr. King posited an explanation for why the “commonsense” assumption does not work in this instance: “The value of a retirement is largely a function of its age, and the age distribution of retirements can vary radically from year to year. Moreover, the units within each removal cost category are quite varied, particularly since BG&E combines all underground and all overhead plant into composite categories for purposes of quantifying removal costs. As a consequence, the underground plant retired in 2003 may represent an altogether different mix of physical units than the underground plant retired in 2004. The same variability applies to removal costs. Because the mix of plant retired varies each year, the type of removal cost activity also varies. As a consequence, there is no consistent relationship between removal costs and retirements. Dr. White’s assumed relationships, embodied in his net salvage ratios, are therefore totally inadequate as the basis for forecasting future removal costs.” OPC Ex. 15 at 9.

testimony, similar to that presented here, that with removal costs (*i.e.* negative net salvage) increasing due to inflationary pressures and environmental requirements, “use of a [backward looking] historical average would only exacerbate the apparent under-funded removal cost reserve and it would not reflect anticipated future expenses.” *Id.* at 31.

The Commission’s determination rests on three assumptions: (1) that removal costs are not only growing over time – which no one disputes -- but also that they are growing proportionately larger relative to plant each successive year; (2) that the PV method would always ensure that the Company would obtain sufficient recovery; and, (3) the historical recovery method would always be “behind” because it is derived from an historical average.

The evidence in the instant case demonstrates that, while the Commission’s concerns were sound, their assumptions – as applied to *all* utilities -- were wrong. First, while removal costs will certainly grow larger over extended periods of time, Mr. King’s statistical analysis predicts that removal costs will not *necessarily* increase progressively on a year to year basis, particularly in proportion to plant in service. The randomness inherent in both the SL and PV methods is borne out by the numbers in this case. For example, the Company’s actual removal costs for electric plant noticeably fluctuated in the years 2001 through 2003 and then rose significantly in 2004 but dropped dramatically in 2005:

2001	---	\$14,507,111
2002	---	\$12,024,002
2003	---	\$12,863,069
2004	---	\$26,116,850
2005	---	\$17,189,184

OPC Ex. 12, Exhibit CWK-1, Sch. 5.

Second, once reimbursements proposed by Mr. Dunkel are included as an offset to removal costs, Mr. Dunkel's removal costs allowance for gas plant of \$1,139,890 is less than half of what is required to recover average net removal costs of \$2,486,332, even after third party reimbursements have been factored in, and is substantially less than Mr. King's proposal as a removal cost allowance.²⁵ OPC Ex. 12 at 28, l. 1-6; OPC Ex. 14 at 7, l. 14-24.²⁶ Thus, contrary to the Commission's assumption based on the limited results before it in 9092, the application of the PV method does *not always* ensure that a utility will stay "ahead of the curve" and ensure a sufficient recovery.

Third, even if the "5-year rolling average" method results in a removal cost allowance somewhat smaller than the actual cost in the last year of the average, subsequent numbers derived from the correct application of the method will quickly catch up and provide sufficient recovery. After calculating the Company's last five year's actual removal costs, those costs are averaged for each account. OPC Ex. 12 at 24-25. But then those averages are *ratioed* to the account balance to derive the annual removal cost rates for each account. *Id.* In short, as plant in service increases, the annual removal cost allowance will increase because the method applies a removal cost *rate* to plant in service to derive the annual removal cost

²⁵ While Mr. Dunkel believes that the actual numbers would be somewhat higher, he does not dispute the overall accuracy of Mr. King's assertion. Staff Ex. 18 at 30.

²⁶ Before taking into account the Company's inappropriate booking of third party reimbursements which resulted in an overstatement of removal costs, Mr. King's removal cost allowances were \$16,551,972 for electric plant (as revised in his Amended Reply Testimony) and \$3,295,570 for gas plant (as originally presented in his Reply Testimony). OPC Ex. 14 at 4-5. With third party reimbursements factored in to correct the overstatement, Mr. King's removal costs allowances amounted to \$12,487,580 for electric plant (which are similar to Mr. Dunkel's revised removal cost allowance of \$12,568,064) and \$2,486,332 for gas plant, based on year-end 2005 plant balances. OPC Ex. 14 at 5, l. 16-24.

allowance. As plant in service increases each year, so the allowance for removal costs increases correspondingly.

Mr. Dunkel did not investigate or rebut Mr. King's statistical analysis because, regardless of its possible soundness, the field of depreciation relies on "estimates" of future events that often can be "imprecise." Tr. at 443. As a generality, Mr. Dunkel's position certainly comports with an oft-stated premise that depreciation accounting requires the application of "considerable judgment and future prognostications . . ." *Re Potomac Electric Power Company*, 72 Md. P.S.C. 375 (1981).

By improperly and inaccurately conflating an "estimate" with a "guess," however, Mr. Dunkel is requesting the Hearing Examiner to remove any requirement for a *rational* basis to determine estimated future removal costs. An "estimate" means "to form an approximate judgment or opinion regarding the worth [or] amount . . . of [something] or to calculate approximately."²⁷ In contrast, a "guess" means "to arrive at or commit oneself to an opinion about (something) *without having sufficient evidence* to support the opinion fully."²⁸ Here, even though Mr. Dunkel's preferred PV method of calculating future removal costs is based on the assumption that the ratio between net salvage and retirements directly predict removal costs, Mr. Dunkel has neither provided evidence to support this conclusion nor has he deigned to rebut evidence that this assumption is false. In the meantime, while Dr. White

²⁷ "Estimate," *Dictionary.com Unabridged (v 1.1)*. Random House, Inc. <http://dictionary.reference.com/browse/estimate> (accessed: November 12, 2007).

²⁸ "Guess," *Dictionary.com Unabridged (v 1.1)*. Random House, Inc. <http://dictionary.reference.com/browse/guess> (accessed: November 12, 2007).

has attempted to challenge the validity of Mr. King's analytical conclusions,²⁹ Dr. White has conceded that he himself has not introduced any evidence to prove the affirmative, i.e. that the ratio between net salvage and retirements *is* a valid predictor of future net salvage, and that he could not do so in any event with any kind of certainty. Thus, the amount of future removal costs derived from the application of either the SL or PV methods are merely guesses rather than informed estimates. In contrast, while no one can predict with certainty how long any particular pole will last, the survivor curves applied by Dr. White are based on years of past retirement experience, i.e. accumulated observations of the lives of thousands of poles, to which is then applied "informed judgment and expectations about the future," and that is likely why none of the experts here are disputing the application of the survivor curves. *See*, BGE Ex. 5 at 4-8.

Mr. Dunkel's preference for the PV method, and his main objection to requiring the use of the "5-year rolling average," is somewhat more founded in theory than in practice. Mr. King agreed with Mr. Dunkel that the PV method conforms to generally accepted accounting standards as embodied in SFAS 143 because it is an accrual method that spreads the expected future costs of removal over the life of the plant. OPC Ex. 14 at 6, l. 15-27. In contrast, by using a rolling average, the historical recovery method departs from the underlying premise of depreciation theory of recovering an investment during the

²⁹ As Mr. King explained, Dr. White computes an R^2 of 5.76% which apparently assumes a positive intercept. Such an intercept is counter-intuitive, since it implies that there would be removal cost even if there were no retirements. OPC Ex. 15 at 8, fn 2. Dr. White's own chart demonstrates that there is no linear relationship between retirements and removal costs of station equipment. OPC Ex. 15 at 8.

investment's service life. Staff Ex. 15 at 44³⁰; *See also*, Order No. 81517 at 31. In that limited sense, but as Mr. King readily acknowledged in his Rebuttal Testimony, the PV method is "conceptually" superior to the historical recovery method. OPC Ex. 14 at 6.

Overall, however, the 5-year rolling average method is in accord with general depreciation and accounting theory (although it need not be³¹). The 5-year rolling average "preserves the practice of accruing removal cost reserves by means of rates applied to plant balances, but it effectively halts any further increase in the reserves already accumulated." OPC Ex. 12 at 25, l. 4-6. Mr. King's approach comports with the "matching principle" of accounting, with the only difference between Dr. White's and Mr. King's respective procedures being that Dr. White derives his removal cost ratios by comparing the record of recent net removal costs to retirements, while Mr. King derives his ratios by comparing that same record of net removal costs to plant in service. OPC Ex. 15 at 7. The 5-year rolling average is also not "retirement accounting," which recognizes a capital cost that was incurred at the installation of an asset only when that asset retires perhaps many years thence and cost recognition is delayed through the life of the asset. OPC Ex. 15 at 7-8. "The 5-year rolling average approach to removal costs recognizes those costs as they are being incurred, so there is no delay in cost recognition." OPC Ex. 15 at 8, l. 1-3. Nor is the approach "current period recognition," which would simply expense removal costs as they

³⁰ Using as a reference a hypothetical "single pole" example, Mr. Dunkel explained that, in applying the historical recovery method, "customers paying \$1,000.00 in 2007 will have paid enough to fully remove one pole removed in 2007, but the customers would not have paid for removing the **particular** pole the customers are utilizing, because that **particular** pole will be removed in the future." Staff Ex. 15 at 44, l. 8-12. (Emphasis in original).

³¹ As Justice Brandeis stated, "there is no regularity in the development of depreciation," *United R. & Electric Co. of Baltimore v. West*, 280 U.S. 234, 262 (1943), and, consequently "[o]ver the past half century, depreciation practices of the regulated industries have changed significantly."

are incurred, because the 5-year rolling average continues effectively to use the practice of applying an accrual rate to plant in service in a manner similar to depreciation. Tr. at 381, l. 17-22.

In summary, in consideration of the statistical analysis presented here that was unavailable to the Commission in Case Nos. 9092 and 9093 and which undermines the validity of the assumptions upon which the Commission made its determinations, and because the 5-year rolling average method not only assures that ratepayers do not overpay for removal costs but also eliminates any significant issues pertaining to inflation, the change in the value of dollars over time, or issues related to the Company holding the customer's money for extended periods, and because of its ease of application, the Hearing Examiner should calculate the costs of the Company's future removal costs by using the 5-year rolling average.

D. The Hearing Examiner should declare the existing removal reserve as a regulatory liability.

Mr. King recommends that, if the Hearing Examiner applies either the PV or the 5-year rolling average methods for calculating future removal costs, the Hearing Examiner should also recognize accrued removal cost reserves as regulatory liabilities for ratemaking purposes. Information in the Company's Annual Report Forms 10-K for the years 2005 and 2006, obtained by OPC in discovery, sheds some light on the significance of the dollars involved. Excluding transmission plant depreciation, Mr. King calculated the Company's total depreciation reserve at about \$1.69 billion. OPC Ex. 12, CWK-1, 2 and 3. Of that amount,

about \$148.7 million for 2005 (increasing to \$161.3 million for 2006) represents monies collected from rate payers for future estimated removal costs.³² OPC Ex. 12 at 14-15.

While the Commission declined to adopt this recommendation in Case No. 9092, Order No. 81517 at 31-32, developments in accounting and financial reporting requirements strongly and persuasively support Mr. King's recommendation to declare the existing removal cost reserve as a regulatory liability on the Company's books for purposes of regulation. OPC Ex. 12 at 17, l. 25-27. Under SFAS 143, regulated utilities are now required to account for non-legal AROs (i.e. regular future removal costs) by recognizing them as a regulatory liability. As previously noted, SFAS 143 primarily applies to legal obligations associated with the retirement of tangible, long-lived assets such as nuclear generating plants. In commentary, however, the Financial Accounting Standards Board concluded that, for regulated utilities, a separate **regulatory liability** should be recognized for *non-legal* AROs if the costs of those obligations are (as in the instant case) being recovered in rates. As the Board stated, "if asset retirement costs are charged to customers of rate-regulated entities but no liability is recognized, a regulatory liability should be recognized if the requirements of Statement 71 are met."³³ See ¶ B73, <http://www.fasb.org/pdf/fas143.pdf> at p. 42 (accessed November 12, 2007); OPC Ex. 12 at 8-10. Moreover, in 2005, the Board clarified that "the term '*conditional asset retirement obligation*' as used in FASB Statement 143...refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of

³² The regulatory liabilities applicable to the Company's 2005 plant are, respectively: Electric, \$14,986,970.46; Gas, \$139,892,741.70; Common, (\$6,219,705.63), for a total of \$148,660,006.53.

³³ "SFAS 71 allows a company to defer all or part of an incurred cost otherwise chargeable as an expense, when it is probable that the Commission will approve a future rate increase to cover the cost." *Public Service Co. of Colorado v. Public Utilities Com'n*, 26 P.3d 1198, 1203 (Colo. 2001).

settlement are conditional on a future event that may or may not be within the control of the entity.” FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations – an Interpretation of FASB Statement No. 143*, <http://www.fasb.org/pdf/fin%2047.pdf> (March 2005, accessed November 12, 2007); OPC Ex. 12 at 8-9. The Interpretation clarifies that “an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability’s fair value can reasonably be estimated.” *Id.*

Similarly, by directives the federal Securities and Exchange Commission (“SEC”) now requires all rate-regulated utilities that accrue future removal costs to account for those costs separately from depreciation – and thus identify removal cost accrual rates, annual removal cost accruals and removal cost reserves -- and must report as “**regulatory liabilities**” the accrual of reserves against future removal costs. OPC Ex. 12 at 13-15; OPC Ex. 7.

Thus, the Company is now required to recognize and account for removal costs as regulatory liabilities in its financial accounting, and accordingly the Company reports its removal cost reserve as a regulatory obligation in its financial Annual Report Forms 10-K reports. OPC Ex. 12 at 14-15. Mr. King acknowledged from the outset that the Hearing Examiner is not obligated to adopt and apply SFAS 143 for ratemaking purposes,³⁴ OPC Ex. 12 at 10. However, there are compelling arguments for doing so. Accounting’s most basic

³⁴ *But see, In re Carolina Power & Light Co.*, 2003 WL 21049546, *5 (N.C.U.C.) in which the North Carolina Utilities Commission accepted the argument of Public Staff that, because the federal Securities and Exchange Commission was authoritative with regard to Generally Accepted Accounting Principles (“GAAP”) in the United States, and the requirements included in FASB Statements are essentially mandatory for any publicly traded entity, it was appropriate to consider the adoption of SFAS 143 to be, effectively, a governmental action.

purpose is the goal of presenting a financial picture to investors and others that would most accurately portray the current condition of the venture, primarily attempting to match costs and revenues to relate costs to the period in which they occur and against the revenues generated for which those costs were incurred. *Re Amendment of Uniform System of Accounts for Class A and Class B Telephone Companies*, 40 P.U.R.4th 251 (F.C.C., 1980). Here, the accounting community has determined that even non-legal retirement obligations should be separately identified as regulatory liabilities, and SFAS 143 establishes a clear-cut procedure for recording these obligations on the Company's balance sheet and a procedure for recognizing them in income statements. OPC Ex. 12 at 10.

E. The Hearing Examiner should recommend that the Company refund its removal cost regulatory liability to ratepayers over a five-year period.

Because the use of the 5-year rolling average methods should supply sufficient funds on a current and on-going basis to cover all of the Company's removal costs, the existing reserve will remain at approximately its present level indefinitely but will never be used to offset removal costs. OPC Ex. 12 at 29. That being the case, the reserve should be refunded to ratepayers.

In Case No. 9092, the Commission rejected this proposal, stating as follows:

The Commission rejects Mr. King's proposal to return to ratepayers the current removal cost reserve. Mr. Robinson's analysis indicates that the reserve is currently under funded. Moreover, as Staff has pointed out, adoption of Mr. King's amortization proposal effectively eliminates any removal costs from rates for several years when combined with OPC's historic removal cost proposal, which would clearly be an unreasonable result. The accruals to date reflect plant consumption in earlier years that has actually occurred. OPC's amortization proposal would simply saddle future ratepayers with an even larger burden. Therefore, the Commission will not adopt Mr. King's amortization proposal.

Order No. 81517 at 31-32.

With due respect for the Commission's decision, because the consequences of any alternative action are inherently unfair to residential ratepayers, OPC nonetheless urges the Hearing Examiner to give full consideration to the arguments presented herein.

Under accounting principles, rate actions of a regulator can impose a liability on a regulated enterprise and those liabilities are usually obligations to the enterprise's customers. OPC Ex. 12 at 13, citing SFAS No. 71, ¶ 11. In this instance, the regulatory liability imposed by the Commission would represent funds collected from ratepayers that the utility is expected to spend in the future to remove or dismantle plant. OPC Ex. 12 at 14. If it appears that the Company will not spend these funds for their intended purpose, then the Company should refund them to ratepayers by means of amortization that is recognized in rates. *Id.* Regardless, and as Mr. King noted, "the greater transparency of the regulatory liability treatment of removal cost accrual will enhance the ability of the Commission to monitor these accruals so that if the money collected from ratepayers is not spent, it can be refunded, or alternatively, if the costs exceed the funds collected, adjustments can be made in the accruals to compensate the utility." OPC Ex. 12 at 16, l. 12-16.

To resolve the problem of the existing but unused removal cost reserve, Mr. King recommends that the amount be amortized over a five year period which corresponds generally with the period between rate cases, and it matches the period during which BG&E recovered its stranded generating costs. OPC Ex. 12 at 29-30. In response to a data request, the Company identified the year-end 2005 removal cost reserve for electric plant as \$14.99 million and that for gas plant as \$139.89 million. *Id.* If these amounts were amortized over

five years, electric ratepayers would receive a credit of \$3 million annually, and gas ratepayers would receive \$28 million annually. *Id.* If the application of the PV method shows that there is an excess accumulation of removal cost reserve, then that should be either flowed back to ratepayers over five years, or treated in the remaining life calculation. Tr. at 378.

- F. While allowing the Company to adopt amortization accounting for most of its common and general plant as the Company proposes, the Hearing Examiner should not allow the Company to shift reserve balances which results in a set of remaining life rates that are designed to recover amounts far in excess of the investments in the accounts, to the great detriment of residential ratepayers.**

In its Application, BGE Ex. 5 at 9-10, the Company proposes to eliminate conventional depreciation for most of its common plant³⁵, as well as most of the “general plant” associated with either gas or electric operations. OPC Ex. 12 at 30. Instead, it will amortize the investment over fixed periods of time corresponding to the Company’s estimate of the average service life of the respective categories of investment. *Id.* The Company states that its proposal is “needed to eliminate reserve imbalances created by the initialization of amortization accounting proposed for the several General support asset accounts.” BGE Ex. 5 at 9, l. 22-24.

Mr. King agrees with the Company’s plan to adopt amortization accounting. OPC Ex. 12 at 31-32. With amortization, there is no attempt to keep track of the value of each year’s retirements or to charge those retirements to a depreciation reserve. OPC Ex. 12 at 31.

A fixed percentage (reciprocal of the amortization period) of the value of the account is

³⁵ Common plant is plant that is not discrete to either gas or electric service, but supports both operations. It consists of office buildings, furniture, computers, software and communications equipment. OPC Ex. 12 at 30, l. 11-16.

amortized each year regardless of the actual experience on the ground. *Id.* While Dr. White did not articulate the reasons for adopting amortization accounting, Mr. King's experience elsewhere suggested that "the reason has to do with the difficulty of keeping track of a large number of small items that do not retire by reason of age, but rather as a result of office moves, technological changes or computer and communications system upgrades." OPC Ex. 12 at 31, l. 17-26. Because maintaining records of these items can be difficult and time-consuming, amortization eliminates the need for such record-keeping. *Id.*

Under the Company's proposal, amortization accounting would apply to \$209.9 million of the Company's \$278.4 million in general plant investment as of the end of 2005. OPC Ex. 12 at 31. For the remaining \$68.5 million in common plant, the Company proposes to maintain conventional remaining life depreciation. *Id.*

In implementing this proposal, however, Dr. White would have these remaining depreciated accounts absorb all of the reserve imbalances of the entire common plant functional category. *Id.* Dr. White finds that the category has a reserve shortfall of approximately \$108.9 million. *Id.* Once Dr. White has shifted this entire imbalance to the four depreciated accounts, they are found to have a reserve deficiency of \$85.0 million. *Id.* Dr. White calculates rates designed to recover this deficiency, along with the accounts' original investment, over their respective remaining lives.

Mr. King believes that it is improper to accelerate depreciation on four common plant accounts in order to recover a perceived shortfall in past accruals from another nine accounts. OPC Ex. 15 at 10. This shifting of reserves results in a set of remaining life rates that are designed to recover amounts far in excess of the investments in the accounts. As

shown by the following chart, the percentage of investment to be recovered is more than double in two accounts:

Common Plant

<u>Account</u>	<u>Description</u>	<u>% of Investment To Be Recovered</u>
390.00	Structures & Improvements	115.93%
391.32	Mainframe Computer Hardware	104.13%
394.30	CNG Fueling Stations	259.34%
396.00	Power Operated Equipment	201.66%

OPC Ex. 12 at 32, l. 5-10.

Mr. King provides two main reasons to support his belief. First, because the Company's proposal relies on manipulating the process by lifting the under-accruals from one set of accounts and assigning them to another set of accounts, the Company's proposed shifting of cost recovery is contrary to the principle of cost causation. OPC Ex. 12 at 32, l. 12-22; OPC Ex. 15 at 10, l. 22-28. In other words, because the computer account under-accrued during the past decade, "Dr. White would have the depreciation of the structures and improvements account accelerated to close to double the rate required to recover its investment." OPC Ex. 15 at 10, l. 22-28.

A consequence of that increased depreciation rate, as Staff Witness Dunkel commented, is that it would not necessarily be consonant with a future investment by the Company. Tr. at 429-30. For example, an 80% depreciation rate intended to recover current investment based on a certain dollar amount could result in an "excess recovery" by the Company if it bought a new office building and the investment thereby doubled. *Id.*

Second, the impropriety here is compounded by the high probability that the amortizable accounts and their reserves are not altogether accurate. *Id.* As previously noted, the

reason for adopting amortization is that it is very difficult to keep track of the many small items in these general plant accounts. Absent a costly and largely irrelevant audit, however, the Company cannot know for certain that these investment amounts and the reserves are an accurate reflection of the movement of property in and out of these accounts. *Id.* Thus, it is even more inappropriate to shift a perceived reserve shortfall out of these amortizable accounts and on to the accounts that continue to be depreciated. *Id.*

The admitted consequence of rejecting the Company's proposed shifting of reserved deficiencies from the amortizable plant to the depreciated plant, *i.e.*, a permanent \$97.9 million shortfall in the reserves for the amortizable plant, does not outweigh the consequences of implementing the Company's proposal, which would be to "impose a dramatic increase in depreciation rates on totally unrelated accounts, and in effect charge future ratepayers for the inadequacy of past depreciation recoveries." Tr. at 383, l. 13-18. When BG&E adopts amortization accounting, it abandons the reserve imbalance recovery embedded in remaining life depreciation. OPC Ex. 15, l. 16-20. In doing so, it surrenders the opportunity to recover past under-accruals. *Id.* As Mr. King explained, doing otherwise could be considered as unlawful retroactive ratemaking:

Ratepayers during the past ten years have been undercharged for the depreciation of common and general plant, so Dr. White's solution is to play catch-up on ratepayers in the coming ten years. We allow this to a limited extent through the use of remaining life depreciation, but when the inter-generational shift comes to \$97.9 million, it becomes unreasonable. The next generation of ratepayers will pay higher amortization rates than past generations paid in depreciation. Dr. White would have the next generation of ratepayers also pay the under-accruals that previous ratepayers failed to pay.

OPC Ex. 5 at 11, l. 1-11.

Although Mr. Dunkel did not take a position on this issue in his pre-filed testimony, he commented under cross-examination that it is “a very difficult issue [because] both sides are right.” Tr. at 419, l. 1-4. As Mr. Dunkel explained, the reserve deficiency of \$85.0 million for the four depreciated accounts is akin to having an outstanding balance on a car loan worth more than the car itself Tr. at 419, l. 5-12. While the Company could over time ultimately recover that deficit in remaining life depreciation, “there is no mechanism under amortization” to recover that amount.” Tr. at 419, l. 13-20. Thus, the Company has proposed taking the deficit and moving it to some other accounts where, because the Company will not only be recovering its normal depreciation rates but also recovering this “transfer deficit,” the depreciation rates will be 80% a year, which is “very high.” Tr. at 419-20. Mr. Dunkel therefore concludes that Mr. King is “right” on this point. Mr. Dunkel also believes, however, that, based on his “overriding rule [of] fairness to the [Company’s] shareholders,” the shareholders should recover what would otherwise be considered prudently incurred investment in the Company’s provision of service. Tr. at 419-421.

As a compromise to what he called being between “a rock and a hard place,” Mr. Dunkel would have “preferred” a proposal to take the reserve deficiency of \$85.0 million for the four depreciated accounts and amortize it as a “separate line item.” Tr. at 421, l. 8-13. In this manner, the existing depreciations rates for other accounts would not be disturbed, and thereby resolve at least one of Mr. King’s (and Mr. Dunkel’s) concerns. *Id.* At the same time, the company will recover in full its reserve deficiency. Tr. at 422, l. 9-13. If this approach were adopted, Mr. Dunkel would recommend that the amortization period be a weighted average of the remaining life of the accounts to which the Company moved the deficit, which he roughly

calculated as 28 years. Tr. at 422, l. 1-8; Tr. at 427, l. 11-13. When the amortization is done, it ends by itself rather than having significantly inflated depreciation rates applied for perhaps up to 20 years. Tr. at 422-23.

For all of the above-stated reasons, the Hearing Examiner should allow the Company to adopt amortization accounting for most of its common and general plant as the Company proposes, but should not allow the Company to shift reserve balances which results in a set of remaining life rates that are designed to recover amounts far in excess of the investments in the accounts, to the great detriment of residential ratepayers. If, for the latter issue, the Hearing Examiner determines that the Company should recover the reserve deficiency arising from the switch from depreciation to amortization, then the OPC would adopt as a proposal Staff Witness Dunkel's "preference" and request that the Hearing Examiner amortize the resulting deficiency as a "separate line item" with a 28 year amortization period derived from the weighted average of the remaining life of the accounts to which the Company moved the deficit.

G. The Hearing Examiner should order the Company to credit third party reimbursements to the depreciation reserve and treat it as positive salvage, which conforms to standard depreciation treatment.

Third party reimbursements compensate the Company for the costs of removing and relocating facilities due to such factors as road widenings, public facility construction and accidental damage from excavation. OPC Ex. 14 at 3, l. 9-19. Since 1995, BG&E has been booking these third party reimbursements as deductions from plant in service. *Id.* In his pre-filed written testimony, Staff Witness Dunkel contended that this is an inappropriate procedure by which BG&E books third party reimbursements and that these reimbursements

should instead be credited to the depreciation reserve as positive salvage. *Id.* Mr. Dunkel adjusted his recommended depreciation rates to reflect these positive salvage amounts. *Id.*

OPC Witness King concurred with Mr. Dunkel, per the reasons provided in Mr. Dunkel's testimony, and Mr. King similarly adjusted his recommended depreciation rates to reflect these positive salvage amounts. *Id.* The amounts of these reimbursements were significant and, for 2001 through 2005, cumulatively totaled \$24,368,147. OPC Ex. 14 at 3-4. Mr. King's revised removal costs rates generated removal cost accruals of \$12,487,580 for electric plant and \$2,486,332 for gas plant, based on year-end 2005 plant balances, OPC Ex. 14 at 5, l. 16-24, and they are the numbers which are generally cited above in this Discussion. Mr. King also noted that even these reduced allowances for removal cost accruals would still be overstated if the Hearing Examiner adopted Staff Witness Dunkel's related but separate argument that the Company should not be permitted to include insurance reimbursements as an offset to removal costs. OPC Ex. 14 at 5, l. 22-24.

V. CONCLUSION

For all of the above stated reasons, the Office of People's Counsel recommends its that its recommendations and proposals, as stated in the Summary Chart in Section II and its Discussion in Section IV above, be adopted by the Hearing Examiner which result in an overall decrease in the Company's proposed depreciation accruals and rates.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 14th day of November, 2007, the foregoing "Initial Brief of the Office of People's Counsel" for Case No. 9096 was either hand-delivered, e-mailed or mailed first-class, postage prepaid to all parties of record to this proceeding.

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