

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
1333 H STREET N.W., 2nd FLOOR, WEST TOWER
WASHINGTON, D.C. 20005

ORDER ON RECONSIDERATION

October 20, 2004

FORMAL CASE NO. 1017, IN THE MATTER OF THE DEVELOPMENT AND DESIGNATION OF STANDARD OFFER SERVICE IN THE DISTRICT OF COLUMBIA, ORDER NO. 13407

I. INTRODUCTION

1. By this Order, the Public Service Commission of the District of Columbia ("Commission") hereby denies the Application for Reconsideration of Order No. 13268, filed by the Office of the People's Counsel ("OPC") in this proceeding.

II. BACKGROUND

2. In Order No. 13115, the Commission directed the Potomac Electric Power Company ("PEPCO") to file a proposal regarding an Administrative Charge component of SOS rates.¹ On April 8, 2004, PEPCO complied with the Commission's directive.² Replies to PEPCO's proposal were filed on May 3 and May 4, 2004.³ Rebuttal Testimony and Supplemental Rebuttal Testimony were also filed.⁴ Hearings on the Administrative Charge were held on June 23, June 24, and July 7, 2004.⁵ Initial Briefs were filed on July 15, 2004, and Reply Briefs were filed on July 27, 2004.⁶ On August 19, 2004, the Commission issued Order No. 13268 in this proceeding.⁷ Order No. 13268 held that the Administrative Charge would

¹ See *Formal Case No. 1017, In the Matter of the Development and Designation of Standard Offer Service in the District of Columbia ("F.C. 1017")*, Order No. 13115 at 11.

² See *F.C. 1017*, Direct Testimony and Exhibits of PEPCO Witness Browning, filed April 8, 2004 ("PEPCO Administrative Charge Proposal").

³ OPC, PEPCO Energy Services, Inc. ("PES"), and Washington Gas Energy Services, Inc. ("WGES") filed reply testimony on May 3 and May 4, 2004. Constellation Power Source, Inc. and Constellation New Energy, Inc. (collectively, "Constellation") and the Mid-Atlantic Power Supply Association ("MAPSA") filed comments on the PEPCO's Administrative Charge Proposal on May 3 and May 4, 2004, respectively. Constellation and MAPSA reformatted their comments as testimony and filed Reply Testimony on June 8, 2004. Constellation revised its June 8 Reply Testimony with a filing on June 21, 2004.

⁴ PEPCO filed Rebuttal Testimony to the parties' reply submissions on May 17, 2004. See also *F.C. 1017*, Motion for Leave to File Supplemental Rebuttal Testimony and Supplemental Rebuttal Testimony of the Office of the People's Counsel.

⁵ All transcript cites referenced herein are to the transcripts of these proceedings.

⁶ Initial Briefs and Reply Briefs were filed by PEPCO, MAPSA, Constellation, WGES, OPC and PES.

⁷ See Order No. 13268, rel. Aug. 19, 2004.

include the following components: Incremental Costs, Uncollectible Costs, a Before Gross-up Margin and an Adder.⁸

3. OPC filed an Application for Reconsideration on September 20, 2004 alleging that the Commission erred by approving the margin and adder components.⁹ On September 27 and September 30, 2004, parties filed responses to OPC's Application.¹⁰ The following addresses OPC's specifications of error and this Order presents the Commission's response to OPC's arguments in serial fashion.

III. THE APPLICABLE LEGAL STANDARD

Position of OPC

4. OPC contends that the standard for review in this proceeding is the arbitrary and capricious standard set forth in D.C. Code § 34-606. There, the statute provides that the Commission's findings are conclusive "unless it shall appear that such findings of the Commission are unreasonable, arbitrary or capricious."¹¹ Citing the District of Columbia Court of Appeals, OPC defines an arbitrary action as one not based on facts or reason.¹² OPC argues that the Commission is entitled only to deference where it has fully and clearly explained its decision and demonstrates a rational connection between the facts found and the choice made.¹³ Applying this standard, OPC contends that the Commission's actions were arbitrary in that it "failed to demonstrate any rational connection between those facts and the Commission's findings" as presented in Order No. 13268.

Commission Decision

5. We strongly disagree with OPC's contention that our actions were arbitrary and capricious. The Commission's actions in Order No. 13268 were just and reasonable in that we fully stated both our factual findings and the rationale supporting the adoption of those findings. More specifically, the Commission addressed directly PEPCO's proposed methodology for

⁸ See Order No. 13268 at Attachment B.

⁹ See *F.C. 1017*, Application for Reconsideration of Order No. 13268 of the Office of the People's Counsel, filed Sept. 20, 2004 ("OPC Application").

¹⁰ See *F.C. 1017*, Response of PEPCO, filed Sept. 27, 2004 ("PEPCO Response"). See also *F.C. 1017*, Response of Constellation Power Source, Inc. and Constellation New Energy, Inc. to Application for Reconsideration of Order No. 13268 ("Constellation Response") and PEPCO Energy Services, Inc. Response to the Office of People's Counsel Application for Reconsideration of Order No. 13268, filed September 30, 2004 ("PES Response").

¹¹ OPC Application at 4 citing Washington Gas Light Co. v. Public Service Commission, 452 A.2d 375, 379 (1982). See also D.C. Code Ann. § 34-606 (2004).

¹² OPC Application at 4.

¹³ OPC Application at 4, citing Office of People's Counsel v. Public Service Commission, 845 A.2d 1128, 1133 (D.C. 2004) citing Office of People's Counsel v. Public Service Commission, 797 A.2d 719, 725 (D.C. 2002).

establishing an Administrative Charge. PEPCO proposed components to be included in such charge and gave its estimate of the cost level of each component.¹⁴ In determining that each component was appropriate, the Commission relied upon the requirements of the SOS Rules as well as the positions advanced by the parties in the record and as summarized in briefs.¹⁵ In this regard, it is important to place the Administrative Charge in its proper context. The Administrative Charge is one component of the rate to be charged to SOS customers in the District.¹⁶ This single component has within it four sub-components including incremental costs, uncollectible costs, a margin and an adder. To the extent that the SOS Rules define the components of the SOS rate, the Commission's determination that these four sub-components were appropriate was tantamount to a determination that the inclusion of these sub-components would result in a just and reasonable SOS rate.

6. Courts have found that "it is not theory but the impact of the rate order which counts."¹⁷ In this case, the Commission assessed the impact of the proposed sub-components on the overall Administrative Charge and found that their inclusion was appropriate. The implication in our finding was that the inclusion of these sub-components would result in just and reasonable SOS rates. To the extent that this implication was previously unclear, we more clearly state that finding now and repeat our rationale below:

- a. Incremental Costs: Rule 2953.4 specifies that the Administrative Charge is to be designed to recover the Electric Company's incremental costs.¹⁸ The parties in this proceeding each support inclusion of this sub-component in the Administrative Charge and the only disagreement was with respect to the level of incremental costs to be included in the charge.¹⁹ Consistent with the requirements

¹⁴ Order No 13268 at 2 ¶ 3.

¹⁵ Order No. 13268 at 5 ¶¶ 16-18, at 8 ¶¶ 23-24, and at 18 ¶¶ 62-71.

¹⁶ Rule 2953.1 requires that the retail rate to SOS customers of the Electric Company consist of the sum of the following components:

- (a) The seasonally-differentiated and, if applicable, time-of-use differentiated load weighted average price of all awarded contracts for Wholesale Full Requirements Service for each SOS Customer Group;
- (b) Retail charges designed to recover, on an aggregate basis, FERC-approved Network Integrated Transmission Service charges ("NITS") and related charges and any other PJM charges and costs incurred by the Electric Company directly related to the Electric Company's SOS load obligation for each SOS Customer Group;
- (c) An administrative charge; and
- (d) Applicable taxes.

Therefore, the Administrative Charge is but a component of the overall SOS Rate.

¹⁷ Washington Gas Light Company v. Public Service Commission, 452 A.2d 375, 379 citing, FPC v. Hope, 320 U.S. 591, 602, 64 S.Ct. 281, 287, 88 L. Ed. 33 (1944).

¹⁸ See Section 2953.4 Wholesale SOS Rules (2003).

¹⁹ Order No. 13268 at 2-5.

in Rule 2953.4, the inclusion of incremental costs in the Administrative Charge will result in just and reasonable SOS rates.

- b. Uncollectible Expense: Rule 2953.4 similarly specifies that the incremental costs to be reflected in the Administrative Charge shall include, but not be limited to, a proportionate share of SOS uncollectibles for each SOS Customer Group.²⁰ The parties in this proceeding generally agreed with PEPCO's methodology for estimating uncollectible costs and the only area of disagreement centered around the amount of information available to support the level of uncollectible expense PEPCO proposed.²¹ Consistent with the requirement in Rule 2953.4, the inclusion of uncollectible expense in the Administrative Charge will result in just and reasonable rates.
- c. Margin: PEPCO proposed a margin to provide it with a return sufficient to compensate the Company for any regulatory and market risk it will assume as the administrator of SOS. WGES, MAPSA, Constellation and PES each supported PEPCO's proposal but differed as to the appropriate level of a margin.²² OPC opposed PEPCO's proposal for numerous reasons articulated in Order No. 13268.²³ The Commission found²⁴ and continues to find that if an appropriate margin is not recovered, suppliers will leave the market ultimately increasing prices to the detriment of consumers. Thus, the inclusion of a margin in the Administrative Charge is appropriate and will result in just and reasonable SOS rates.
- d. Adder: PEPCO proposed an adder sub-component of the Administrative Charge to be reflective of the differential remaining after the incremental costs, including the uncollectible expense, and the margin are deducted from the fixed Administrative Charge. Again, most parties except OPC supported the adder, but differed as to its level.²⁵ OPC opposed the adder for myriad reasons identified in Order No. 13268.²⁶ The Commission found²⁷ and continues to find that one of the factors competitive suppliers will evaluate is whether they are able to offer a price that can compete with the price of SOS. To the extent that competitive suppliers have costs associated with establishing themselves to compete in the market in the

²⁰ Rule 2953.4.

²¹ Order No. 13268 at 6 ¶ 19.

²² Order No. 13268 at 9-18.

²³ Order No. 13268 at 9-18.

²⁴ Order No. 13268 at 18 ¶ 62.

²⁵ While WGES supported the concept of an adder, it was not fully supportive of PEPCO's proposed adder component. See WGES Initial Brief at 10-11; and WGES Reply Brief at 9-10.

²⁶ Order No. 13268 at 22-23.

²⁷ Order No. 13268 at 28 ¶ 103.

District, an adder will ensure that the price of competitive supply will be on par with the price of SOS. Thus, the inclusion of an adder in the Administrative Charge is appropriate and will result in just and reasonable SOS rates.

7. Thus, for the reasons expressed above and those articulated in Order No. 13268, the Commission finds that PEPCO's proposed sub-component parts are appropriate and will result in just and reasonable retail SOS rates.

IV. THE ADMINISTRATIVE CHARGE AND THE JUST AND REASONABLE STANDARD

Position of OPC

8. OPC asserts that the Commission assumed that the only statutory constraint on its decision making about an Administrative Charge is the provision of the Electric Competition Act specifying that the price established for PEPCO's services "not hinder the development of a competitive electric supply market in the District of Columbia."²⁸ OPC further contends that the Commission is bound by D.C. Code § 34-1101(a) which, OPC argues, requires PEPCO to maintain a reasonable, just, and nondiscriminatory rate for each of the services it renders.²⁹

9. OPC comments that in performing wholesale SOS service PEPCO will be performing a regulated utility service and is thus fully subject to the central command of the Code, Section 34-1101(a), which mandates PEPCO maintain a "reasonable, just, and nondiscriminatory" rate for each of the services which it renders.³⁰ Moreover, OPC argues that the Commission failed to consider the complete statutory framework within which it must operate.³¹ OPC contends that selecting the wholesale rather than retail option drastically changes the posture of the Commission vis-à-vis the SOS provider.³² OPC argues that the premise underlying retail SOS is that, in a freely competitive market, competition will discipline the prices offered to retail customers and ensure that those prices are reasonable.³³ OPC comments that under retail SOS, the market largely determines the price that retail customers pay for their electricity.³⁴ OPC states that rather than seeking to protect retail SOS customers through competitive retail bidding, the Commission, by selecting a wholesale form of SOS, chose to direct PEPCO to seek out a competitive market for wholesale supplies of SOS electricity.³⁵

²⁸ See OPC Application at 6.

²⁹ See OPC Application at 6.

³⁰ See OPC Application at 6.

³¹ See OPC Application at 7.

³² See OPC Application at 7.

³³ See OPC Application at 7.

³⁴ See OPC Application at 7.

³⁵ See OPC Application at 7.

10. OPC further argues that it is wrong to assume that the City Council's January 2004 amendment adding wholesale SOS as an option was intended to give PEPCO complete freedom to add whatever profit margin it wanted to the wholesale cost of power obtained through the wholesale auction market.³⁶ Rather, OPC asserts that amended section 107 contains language that plainly authorizes the Commission to maintain regulatory control over the retail SOS prices charged by PEPCO.³⁷ OPC contends that subsection (C) authorizes the Commission, by regulation or order, to establish the terms and conditions under which Standard Offer Service will be provided which includes..."an appropriate rate design, subject to the restrictions in subsection (d) of this section."³⁸ OPC comments that preservation of the Commission's regulatory authority under subsection (C) means that section 102(a) of the Electric Competition Act, D.C. Code § 34-1502(a), does not override the Commission's statutory obligation.³⁹ OPC further argues that PEPCO's sales of retail SOS electricity are not deregulated because the provision for their regulation is expressly made elsewhere in the statute, *i.e.*, amended section 109(C).⁴⁰ Finally, OPC asserts that since PEPCO continues to be a regulated utility and since its retail SOS sales are not exempted from regulation, D.C. Code § 34-1101(a) is fully applicable.⁴¹

Response of the Parties

11. PEPCO contends that OPC strains to demonstrate that the just and reasonable standard set forth in D.C. Code § 34-1101(a) is the "central command" which should have controlled the Commission's decisions on the margin and adder issues.⁴² PEPCO agrees that its provision of SOS is a regulated service and that the "just and reasonable" standard set forth in D.C. Code § 34-1509(b)(3)(A) specifically applies during the rate cap period, which extends through February 7, 2005, pursuant to the settlement agreement.⁴³ PEPCO argues that assuming *arguendo* that D.C. Code § 34-1101(a) applies after the end of the rate cap period, the section is still not the central command of the D.C. Code; rather § 34-1509 contains numerous provisions that are relevant to how SOS should be implemented.⁴⁴ Moreover, PEPCO comments that D.C. Code § 34-1509(d)(1)(A) is relevant and instructive to the margin and adder issues and, when considered in connection with the evidence submitted by PEPCO and other parties, fully supports the Commission's decisions on those issues.⁴⁵

³⁶ See OPC Application at 8.

³⁷ See OPC Application at 8.

³⁸ See OPC Application at 8.

³⁹ See OPC Application at 8.

⁴⁰ See OPC Application at 8.

⁴¹ See OPC Application at 8.

⁴² See PEPCO Response at 3.

⁴³ See PEPCO Response at 4.

⁴⁴ See PEPCO Response at 4.

⁴⁵ See PEPCO Response at 5.

12. **Constellation** argues that OPC's Application fails to demonstrate that the challenged Commission decisions in Order No. 13268 are in any way unlawful or erroneous, as required by Rule 140.2, or that the Commission's factual findings are unreasonable, arbitrary or capricious. Constellation further asserts that OPC's application fails to prove that the Commission did not base its decision on a substantial record or correct legal standard.⁴⁶

13. **PES** argues that it is incorrect to accept OPC's assertions that the approved Administrative Charge is unjust and unreasonable.⁴⁷ PES contends that OPC's rejection of the wholesale SOS model or the inclusion of an adder and margin in the Administrative Charge does not mean that the Commission's findings are unjust and unreasonable.⁴⁸ PES asserts that the Commission properly balanced compliance with the Restructuring Act and the need to fairly compensate the Electric Company for the costs associated with the provision of SOS.⁴⁹ Moreover, PES argues that the Commission adopted a reasonable approach to satisfy all stakeholders' interests, consumers, and the interests of the Electric Company, therefore, the Commission did not commit error.⁵⁰

Commission Decision

14. OPC argues that the Commission erred by authorizing a rate, i.e., the Administrative Charge component of the SOS rate, that it contends is unjust and unreasonable. In making its assertion, OPC largely attacks the Commission's adoption of the wholesale SOS model over the retail SOS model.⁵¹ The Commission finds persuasive arguments made by PEPCO and PES that OPC's recitation of the history of this proceeding, including its disagreement with the selection of the wholesale SOS model, is irrelevant to the issues presented regarding the appropriateness and magnitude of the Administrative Charge component of the SOS rate.

15. Moreover, while the Commission recognizes that it is bound by Section 34-1101(a) of the D.C. Code which ensures that utilities charge just and reasonable rates, the Commission does not find persuasive OPC's argument that the Commission has failed to meet that obligation. In adopting the margin and adder components of the Administrative Charge, the Commission took into consideration all of the interests at stake and determined the inclusion of a margin in the Administrative Charge to be in the public interest. In this regard, Courts have given the Commission considerable latitude to formulate standards and to exercise its ratemaking function free from judicial interference, so long as the result of the Commission's actions fall

⁴⁶ See Constellation Response at 1.

⁴⁷ See PES Response at 2.

⁴⁸ See PES Response at 3.

⁴⁹ See PES Response at 3.

⁵⁰ See PES Response at 5.

⁵¹ OPC Application at 7-8.

within a zone of reasonableness reflective of the Commission's obligation to safeguard the public interest.⁵² Therein, the Courts have also recognized that both investor and consumer interests are subsumed in the definition of the public interest.⁵³ As the Commission stated in Order No. 13268, the inclusion of the margin and adder components ensures a level playing field for competitive suppliers, that rates will remain competitive providing consumers with alternatives for electricity supply in the District and that investors remain properly incented. Therefore, the Commission finds that the inclusion of a margin and an adder complies with the directive of § 34-1101(a) of the D.C. Code and, as such, will result in just and reasonable SOS rates.

V. THE MARGIN COMPONENT OF THE ADMINISTRATIVE CHARGE

1. OPC's Contention that the Commission Erred in Finding that PEPCO's Margin Proposal Does Not Permit PEPCO to Earn a Return Twice on the Same Service

Position of OPC

16. OPC argues that under PEPCO's proposal, the incremental cost component includes the incremental costs of providing SOS service, per Rule 2953.4, including cash working capital costs and incremental capital investment.⁵⁴ OPC asserts that PEPCO's margin is entirely unrelated to the incremental costs set forth by Rule 2953.4 and instead the margin that PEPCO has proposed is over and above any capital costs incurred by PEPCO in the provision of SOS.⁵⁵ OPC admits that the Commission has considered, and rejected its position, but claims that the Commission has failed to adequately address OPC's point that PEPCO will earn two returns on each kWh of SOS sold.⁵⁶

Response of the Parties

17. PEPCO argues that the Commission properly addressed OPC's argument regarding a double return in Order No. 13268 by stating that the two returns are intended to compensate for two different costs, i.e., the cost associated with the risks PEPCO will incur in

⁵² Office of People's Counsel v. Public Service Commission, 797 A.2d. 719, 727. See also Bluefield Waterworks & Imp. Co. v. Public Service Commission of W. Va., 262 U.S. 679, 692 (1923)(Where the Court held that a utility was entitled to a return "reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties"; FPC v. Hope Natural Gas, 320 U.S. 591, 603 (1944)(Where the Court held that "the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests").

⁵³ Office of People's Counsel v. Public Service Commission, 797 A.2d. 719, 727.

⁵⁴ See OPC Application at 12.

⁵⁵ See OPC Application at 12.

⁵⁶ See OPC Application at 12-14.

providing SOS, and the direct costs associated with a cash working capital requirement and any incremental capital investment.⁵⁷

18. PES also asserts that the Commission did not violate its own rules by approving the Administrative Charge in excess of PEPCO's demonstrable incremental costs. PES contends that Rules 2953.4 and 2953.5 clearly give the Commission the discretion to provide a return component to the Electric Company, therefore, the decision to include a margin component is consistent with the Commission's rules.⁵⁸

Commission Decision

19. The Commission has fully considered OPC's position regarding PEPCO's alleged double recovery and has responded fully to OPC's concerns in Order No. 13268. Contrary to OPC's claim, the Commission has not erroneously awarded PEPCO twice for the same service. Moreover, the Commission agrees with PEPCO's rationale for awarding it a margin. As stated in Order No. 13268, Paragraph 63, the purpose of the awarded margin component is to compensate PEPCO for the risks associated with serving as the SOS provider. In contrast, the return component associated with PEPCO's SOS-related cash working capital and capital investment costs are direct costs that are incremental in nature and recoverable through SOS rates.

2. **OPC's Contention that the Commission Erred in Approving a Margin that Requires District SOS Customers to Compensate PEPCO for Speculative Future Risks**

Position of OPC

20. OPC argues that the only risks to PEPCO that the Commission identified as warranting the adoption of PEPCO's margin proposal were: (1) legislative or regulatory fiat that may change the Wholesale SOS Rules and (2) the provision of SOS service just as retail rate caps are lifted.⁵⁹ OPC asserts that these risks are in fact speculative and do not justify approving a margin for PEPCO.⁶⁰ Moreover, OPC argues that a margin will allow PEPCO to recover a margin for risks that it does not currently face, and may never face.⁶¹ OPC also claims that the Commission failed to address its argument that PEPCO Witness Browning agreed that the Company's circumstances are not comparable to those in California, particularly with respect to PG&E. OPC reiterates its position that when the retail rate caps expire in February 2005, the

⁵⁷ See PEPCO Response at 6.

⁵⁸ See PES Response at 3-4.

⁵⁹ See OPC Application at 14.

⁶⁰ See OPC Application at 14.

⁶¹ See OPC Application at 14-15.

Wholesale SOS Rules then in effect will insulate PEPCO from all risk.⁶² Finally, OPC argues that the Commission has not identified any risk that will remain for PEPCO while the Wholesale SOS Rules are in effect, and therefore no margin component is warranted.⁶³

Response of the Parties

21. **PEPCO** argues that the Commission's authorization of margins was not based upon speculative risks but real risks that OPC has conceded exist in an industry subject to regulation which can have the rules changed by statute or regulation.⁶⁴

22. **Constellation** contends that contrary to OPC's assertions, if wholesale prices rise, the SOS wholesale suppliers – not consumers – bear the risk of increasing wholesale market prices between solicitations.⁶⁵

Commission Decision

23. The Commission has previously acknowledged that the Wholesale Rules are intended to eliminate many of the known risks associated with the provision of SOS service. We agree with PEPCO that the elimination of many risks, however, is not the elimination of all risks. Moreover, OPC Witness Pavlovic testified that replacement costs borne by the electric company in the event of a supplier default are not automatically recovered from SOS customers and may be contested.⁶⁶ Witness Pavlovic's testimony identifies one of the real risks faced by the company. Additionally, Rule 2951 provides for Commission review following the first year of SOS. It is conceivable that after the examination of one year under SOS, parties or the Commission itself may identify aspects of the program that are ripe for reformation. While the likelihood that any such changes will occur is far from certain, the possibility exists and thereby creates regulatory ambiguity that presents a risk to the Company. This is another example of the real risks faced by the Company. Actual experience in the new SOS regime may prompt action by the City Council. The prospect of such change also creates risk for the Company. The Commission stated clearly in Order No. 13268 that it identified differences between the District and California such that the risk PEPCO faces is not on par to that faced by California utilities.⁶⁷ However, notwithstanding these distinctions, the Commission is not persuaded that PEPCO is insulated from all risk by the Wholesale SOS Rules, or that it is reasonable to conclude that PEPCO's shareholders are indifferent to the new generation supply paradigm that begins in

⁶² See OPC Application at 14-15.

⁶³ See OPC Application at 14-15.

⁶⁴ See PEPCO Response at 7-8.

⁶⁵ See Constellation Response at 3.

⁶⁶ See *F.C. 1017*, Transcript of Hearing on the Administrative Charge, June 23, 2004, at 257-59.

⁶⁷ Order No. 13268 at 19 ¶ 64.

February 2005. As such, the Commission has determined that it is appropriate to include a margin component in the Administrative Charge.

3. OPC's Contention that the Commission Erred in Failing to Explain its Departure from Precedent in Approving a Margin that Includes an Adjustment for Speculative Risks that are not Known, Certain and Measurable

Position of OPC

24. OPC argues that the Commission has departed from precedent by allowing PEPCO to recover speculative costs.⁶⁸ OPC cites to Order No. 12986 where the Commission refused to allow Washington Gas Light Company increases in its rates because the adjustments to actual expenses were not known, certain, measurable and too remote from the test year.⁶⁹

Response of the Parties

25. PEPCO asserts that the Commission did not depart from precedent in approving a margin because the risks identified by PEPCO and conceded on brief by OPC, are not speculative.⁷⁰

Commission Decision

26. The Commission disagrees that it departed from any precedent in approving the margin component of the Administrative Charge. As stated previously, the Administrative Charge is but a component of the overall SOS rate. This component contains the four sub-components established in Order No. 13268. The delineation of these four sub-components is akin to the adoption of a formula rate. Formula rates are rates that adjust to reflect updated actuals. In this case, the true-up provisions in Rule 2957 serve as the adjustment mechanisms and the four sub-components – incremental costs, uncollectibles, margin and adder – comprise the formula. Formula rates are cost-based rates that recognize the validity of the cost components but take into account time lags attendant to establishing actual costs. Here, the adjustments that will be made to the Administrative Charge will be based on actual incremental and uncollectible costs that will be incurred by the Company. No adjustments, per se, will be made to PEPCO's margin. Therefore, counter to OPC's claim, all adjustments to the Administrative Charge will be known, measurable, and certain.

4. OPC's Contention that the Commission Erred in Permitting PEPCO to Charge a Margin that Is Not Cost-Based

⁶⁸ See OPC Application at 16-17.

⁶⁹ See OPC Application at 17.

⁷⁰ See PEPCO Response at 9.

Position of OPC

27. **OPC** claims that the margin approved by the Commission is not cost-based and therefore violates the Wholesale SOS Rules.⁷¹ OPC argues that the record does not support the conclusion that the allowed margin is necessary to compensate PEPCO for risk and to attract capital.⁷² OPC also cites the testimony of PEPCO witness Morin submitted in Formal Case No. 1002, who recommends an overall rate of return for PEPCO of 8.83%.⁷³ OPC concludes that, if PEPCO is subject to risk as the SOS provider, the Company is adequately compensated for such risk via the currently authorized overall rate of return of 9.09%.⁷⁴

Response of the Parties

28. **PEPCO** contends that the Commission-approved margins are cost-based as demonstrated by Witness Browning's testimony.⁷⁵ PEPCO asserts that Maryland Public Service Commission's Witness Timmerman's study provides further evidence that PEPCO's margin is cost-based.⁷⁶ PEPCO argues that OPC's reliance on Witness Morin's testimony from Formal Case No. 1002 is irrelevant and misplaced as it pertains to electricity delivery operations in the District.⁷⁷

29. **PES** also comments that OPC's assertion that the margin is not cost-based is misplaced.⁷⁸ PES states that it is unsure of what type of cost-based analysis OPC expected the Commission to undertake in evaluating the risks associated with providing SOS given that the Commission considered the testimony of Witness Browning as well as the realistic assessment of the volatility of the generation market in drawing the conclusion that a margin was appropriate.⁷⁹

Commission Decision

30. The Commission does not find persuasive OPC's argument that the approved margin is not cost-based. The margin, i.e., the Company's return on equity, is not based upon

⁷¹ See OPC Application at 18.

⁷² See OPC Application at 18.

⁷³ See OPC Application at 19.

⁷⁴ See OPC Application at 20.

⁷⁵ See PEPCO Response at 9.

⁷⁶ See PEPCO Response at 9.

⁷⁷ See PEPCO Response at 10.

⁷⁸ See PES Response at 4.

⁷⁹ See PES Response at 4.

actual costs incurred as is the case with other cost components. Rather, the margin is set based upon the best evidence of the costs of equity in similar markets. In this case, the Commission found the range of margin levels credible and before gross-up margin levels consistent with Mr. Timmerman's testimony in the Maryland case.⁸⁰ As previously explained, the Commission has determined that PEPCO is not insulated from all risk as the SOS provider. Accordingly, it is appropriate to include a margin in the Administrative Charge to compensate shareholders for assuming additional risk. The Commission agrees with PEPCO that Formal Case No. 1002 relates solely to the distribution service function. Thus, we fail to see how Dr. Morin's recommended overall rate of return in a distribution rate proceeding is relevant to the provision of SOS service.

5. OPC's Contention that the Commission Erred in Failing to Explain Its Departure from Precedent in Approving a Guaranteed Margin on SOS Sales

Position of OPC

31. OPC argues that the Commission has failed to explain and to justify its approval of a guaranteed return in the face of long-standing precedent that provides the investor with only the opportunity to earn a return on investment.⁸¹ OPC further asserts that the Commission has approved a margin that guarantees PEPCO a return in the form of a margin.⁸²

32. OPC contends that the Commission has failed to explain why, with all of the guarantees built in to the Wholesale SOS Rules, PEPCO needs a guaranteed margin, in the form of a flat per kWh adder, over and above the return it will be guaranteed on the capital it actually has at risk, i.e., cash working capital and incremental investment, in order to be compensated for providing SOS.⁸³

Response of the Parties

33. PEPCO contends that the Commission appropriately rejected OPC's argument that a margin is a guaranteed return.⁸⁴ PEPCO further cites its Initial Brief and Reply Brief where PEPCO further rebutted OPC's claims by distinguishing between the opportunity to earn a return and a guaranteed return.⁸⁵

⁸⁰ Order No. 13268 at 21 ¶ 70.

⁸¹ See OPC Application at 21.

⁸² See OPC Application at 21.

⁸³ See OPC Application at 22.

⁸⁴ See PEPCO Response at 11.

⁸⁵ See PEPCO Response at 11 citing PEPCO Initial Brief at 9-10 and PEPCO Reply Brief at 3-5.

34. **Constellation** contends that PEPCO has already adequately rebutted OPC's argument that PEPCO will be guaranteed a profit.⁸⁶ Constellation cites PEPCO's Initial Brief which states that there are no guarantees that any requests to pass through higher costs for transmission, supply or incremental costs will be approved by the Commission.⁸⁷ Constellation also contends that competition among retail suppliers may cause customers to migrate away from PEPCO's SOS at any time, eliminating the payment of any margin to PEPCO.⁸⁸

Commission Decision

35. The Commission affirms its holding in Order No. 13268 that a margin is designed to provide PEPCO the opportunity to earn a return on an investment which in this instance, is the procurement payment made to wholesale suppliers. The profit margin authorized in this case equates to a relatively small percentage of the total SOS payment to the suppliers. If SOS prices are higher, then the percentage will be further reduced. The Commission affirms its decision to give PEPCO a margin that corresponds to a reasonable rate of return in a traditional cost of service model.

36. The Commission finds the testimony of PEPCO Witness Browning persuasive and notes that the margin proposed by PEPCO is akin to the return on equity that utilities earn in traditional rate cases. The margin should compensate PEPCO for the risks associated with serving as the SOS provider. In contrast, PEPCO's cash working capital and capital investment costs are direct costs that will increase as a result of PEPCO's obligation to serve as SOS provider. As such, these costs are incremental in nature and recoverable through SOS rates.

37. The Commission notes that PEPCO's risks are not solely limited to the cash working capital and the incremental investment costs that OPC identifies. Instead, PEPCO's risk is inherent in the entire SOS procurement process within the wholesale market. Thus, PEPCO's risks go beyond the SOS-related cash working capital and incremental capital costs relied upon by OPC. Therefore, the margin is designed to compensate PEPCO for both the risk it faces in providing SOS service, and for the opportunity costs associated with its investment dollars needed to provide SOS.

6. **OPC's Contention that the Commission Erred in Finding that the Wholesale SOS Rules Insulate PEPCO from Many Known Risks of Providing SOS; the Wholesale SOS Rules Insulate PEPCO from All Known Risks**

Position of OPC

38. **OPC** argues that the Wholesale SOS Rules insulate PEPCO from all known risks of providing SOS, and that PEPCO cannot lose money as the SOS provider under any scenario

⁸⁶ See Constellation Response at 2.

⁸⁷ See Constellation Response at 2.

⁸⁸ See Constellation Response at 2.

based upon the facts and circumstances that now exist.⁸⁹ OPC further asserts that the Commission has established a risk-free service for PEPCO and guaranteed it a substantial profit as the SOS provider.⁹⁰

Response of the Parties

39. PEPCO argues that OPC is merely repeating its argument that PEPCO faces no risks and that OPC's argument is without merit.⁹¹

Commission Decision

40. As stated above in paragraphs 35-37 and in Order No. 13268, the margin seeks to compensate PEPCO for the risks it faces in administering SOS, over and above the incremental costs it faces in its administration.

7. OPC's Contention that the Commission Erred in Finding that in a Competitive Market Suppliers Earn a Margin Over Short Run Marginal Cost

Position of OPC

41. OPC asserts that the Commission mischaracterized its argument.⁹² OPC states that its argument is that in a competitive market, prospective sellers are not guaranteed a margin over their marginal costs but rather prices are bid down to marginal costs, incremental cost including a cost of capital.⁹³ OPC states that the margin it opposes is not the margin or opportunity cost of capital included in short run or long run marginal costs, but instead a margin over and above that level.⁹⁴ OPC asserts that the margin component granted in Order No. 13268 is over and above the opportunity cost of capital.⁹⁵

Response of the Parties

42. PEPCO argues that in making its argument, OPC fails to acknowledge its own Witness Pavlovic's statement that no market is perfect; therefore, prices will not be bid down to

⁸⁹ See OPC Application at 24.

⁹⁰ See OPC Application at 24.

⁹¹ See PEPCO Response at 11.

⁹² See OPC Application at 24.

⁹³ See OPC Application at 24.

⁹⁴ See OPC Application at 25.

⁹⁵ See OPC Application at 25.

marginal cost.⁹⁶ PEPCO also states that the margin that the Commission has authorized is a component of the opportunity cost of capital, since the company is taking on a risk.⁹⁷

Commission Decision

43. The Commission finds PEPCO's interpretation persuasive and notes that PEPCO's risks as SOS provider go beyond the opportunity costs associated with SOS cash working capital and incremental capital costs. As such, the approved margin component of the Administrative Charge is a part of PEPCO's overall opportunity cost of capital, and does not represent an excess return that would be bid out of the price established in a competitive market.

8. OPC's Contention that the Commission Erred in Relying on an Irrelevant and Unsupported Analysis Presented by a Witness in a Proceeding Before the Maryland PSC To Support the Level of Margin PEPCO will be Entitled to Earn on District SOS Sales

Position of OPC

44. OPC states that PEPCO witness Browning declined to be associated with the Timmerman analysis and that the Commission failed to address the unrebutted evidence of record that demonstrates the inherent unreliability of the Timmerman analysis.⁹⁸ OPC further states that Order No. 13268 contains no findings regarding the similarities between industries included in Mr. Timmerman's work and the provision of SOS in the District, in terms of capital investment or any other measures of comparison.⁹⁹ OPC comments that with respect to a regional comparison, Dr. Pavlovic testified that Value Line's Net Profit number used by Timmerman to calculate the margins in his study is largely return to share equity and, in fact, is used by Value Line to calculate Return on Share Equity in its Industry Reports.¹⁰⁰ OPC contends that return on share equity is a measure that can be used to compare industries with different levels of capital investment.¹⁰¹ OPC notes that PEPCO declined to provide any evidence as to what percent return on share equity its proposed margin represented.¹⁰² OPC asserts that as a result, the Commission could not use the appropriate numbers from the Value Line reports to provide support for PEPCO's proposed margin.¹⁰³ Therefore, OPC contends that it was error for

⁹⁶ See PEPCO Response at 12.

⁹⁷ See PEPCO Response at 12.

⁹⁸ See OPC Application at 26.

⁹⁹ See OPC Application at 28.

¹⁰⁰ See OPC Application at 28.

¹⁰¹ See OPC Application at 28.

¹⁰² See OPC Application at 28.

¹⁰³ See OPC Application at 28.

the Commission to rely upon the Timmerman analysis as supporting the level of the margin approved by the Commission.¹⁰⁴

Response of the Parties

45. **PEPCO** argues that the Commission reasonably relied on the Timmerman study in authorizing specific margins.¹⁰⁵ PEPCO contends that the Timmerman study shows the same pre-tax margins under the Maryland SOS settlement as those approved by the Commission in this proceeding.¹⁰⁶ PEPCO further asserts that Witness Browning noted that the customer classes served by PEPCO in Maryland and the District as well as the regulatory risks faced by PEPCO in both jurisdictions, are substantially the same.¹⁰⁷ PEPCO asks the Commission to clarify that it rejects Witness Pavlovic's criticisms of the Timmerman study.¹⁰⁸ Finally, PEPCO argues that OPC's claim that no party had the opportunity to cross-examine Mr. Timmerman is moot because OPC addressed Mr. Timmerman's testimony through Witness Pavlovic's testimony, waiving any right to object.¹⁰⁹

Commission Decision

46. The Commission does not find OPC's arguments persuasive. The Commission notes that PEPCO did support Mr. Timmerman's analysis in its Reply Brief where PEPCO states that the Timmerman study is probative evidence of the reasonableness of PEPCO's proposed margin.¹¹⁰ The Commission also notes that although Mr. Timmerman's analysis did not generate exact margins for each customer class, it did compare the margins in different industries and support the range of margins adopted by this Commission. Mr. Timmerman further found that the net profit margin for electric utility companies is 4.16%, similar to the estimated return margins for most of the other service industries cited in his testimony. Moreover, Mr. Timmerman verified the return component proposed in the Maryland Settlement yields a pre-tax return component of 3.11% to 6.22%, which is in an acceptable range given the 4.16% margin for electric utility companies. Although this method does not generate the margin level, it does support the margin levels adopted by the Maryland Settlement and accepted by the Maryland Public Service Commission.

47. Furthermore, the Commission reviewed the information received from the parties regarding the margins established for other jurisdictions. Based upon that information, it is clear

¹⁰⁴ See OPC Application at 28.

¹⁰⁵ See PEPCO Response at 13.

¹⁰⁶ See PEPCO Response at 13.

¹⁰⁷ See PEPCO Response at 14.

¹⁰⁸ See PEPCO Response at 14.

¹⁰⁹ See PEPCO Response at 14.

¹¹⁰ See PEPCO's Reply Brief at 14.

that the margin component represents a very new area and that little formal analysis of this issue has been conducted to date. Certainly, no party submitted information which included a more formal or precise margin analysis than that contained in the Timmerman study. Given the limited margin information provided on the record, and in this area in general, the Commission affirms its decision to utilize the Timmerman study in Order No. 13268 as fully justified and reasonable.

VI. THE ADDER COMPONENT OF THE ADMINISTRATIVE CHARGE

1. OPC's Contention that the Commission Erred by Failing to Respond to OPC's Argument that Approval of the Adder is Contrary to Rule 2953.4

Position of OPC

48. OPC argues that Rule 2953.4 requires that the Administrative Charge recover only the incremental costs of procuring and providing SOS.¹¹¹ OPC claims that since the Commission does not state that the adder is an incremental cost of providing SOS, it is in contravention of Rule 2953.4.¹¹² Furthermore, OPC argues that the Commission has failed to fully and clearly explain its decision, contrary to the standard set by the Court of Appeals.¹¹³

Response of the Parties

49. PEPCO argues that the approval of an adder is not contrary to Rule 2953.4, but that if there is any conflict, the Rule must be changed as required by § 34-1509 (d) (1) (A).¹¹⁴ PEPCO asserts that if Rule 2953.4 is inconsistent with the approval of an adder, the Commission must revise it because the Commission does not have the authority to issue a Rule that is contrary to a statutory mandate.¹¹⁵

50. Constellation charges OPC with repeating its faulty interpretation of the Commission's SOS rules in an attempt to satisfy the Commission's reconsideration standards.¹¹⁶ Constellation argues that the Commission did not violate its own rules by approving an Administrative Charge in excess of PEPCO's demonstrable incremental costs of providing SOS.¹¹⁷ Constellation contends that there is no law or regulation that states that the retail price for SOS shall equal the incremental costs of providing SOS.¹¹⁸ In fact, Constellation comments

¹¹¹ See OPC Application at 29.

¹¹² See OPC Application at 29.

¹¹³ See OPC Application at 29.

¹¹⁴ See PEPCO Response at 14.

¹¹⁵ See PEPCO Response at 15.

¹¹⁶ See Constellation Response at 3.

¹¹⁷ See Constellation Response at 3.

¹¹⁸ See Constellation Response at 3.

that the law mandates that the price for SOS will not hinder the development of a competitive electricity supply market in the District.¹¹⁹ Constellation asserts that pricing a retail SOS service based only on incremental costs would clearly violate the Act's prohibition of hindering the market.¹²⁰

Commission Decision

51. Rule 2953.4 states:

The Administrative Charge will be designed to recover the Electric Company's incremental costs for procuring and providing the service. **Actual incremental costs shall include, but not be limited to,** a proportionate share of SOS customer uncollectibles for each SOS Customer Group, Commission Consultant expenses (as described in Section 2958.2), wholesale bidding expenses, working capital expenses related to SOS for each SOS Customer Group, wholesale supply transaction costs related to wholesale supplier administration and transmission service administration, wholesale payment and invoice processing, incremental billing process expenses, customer education costs, incremental system costs, and legal and regulatory filing expenses related to SOS requirements.

52. The language in Rule 2953.4 is not exclusive in nature, meaning components other than those listed in the rule can be included in the Administrative Charge. As stated in Order No. 13268, SOS serves as backstop service provided to customers in the wake of a flourishing competitive market in the District. Retail competition can flourish only in an environment whereby competitive suppliers are encouraged to enter the market and compete. The adder mechanism will be included in the SOS rate to represent the costs that new entrants will incur to establish themselves in the market. As Rule 2953.4 states above, incremental costs are not limited to the costs identified. Therefore, the Commission finds that the adder mechanism conforms with the guidelines set forth above and is not in contravention of Rule 2953.4.

2. OPC's Contention that the Commission's Findings Regarding the Adder are Without Support in the Record

Position of OPC

53. OPC argues that there is no record evidence that states that competitors will incur costs higher than those of PEPCO.¹²¹ Furthermore, OPC asserts that PEPCO, as the proponent of

¹¹⁹ See Constellation Response at 3.

¹²⁰ See Constellation Response at 3-4.

¹²¹ See OPC Application at 30.

the adder, bore the burden of proof and has failed to meet its burden since it did not submit any evidence in support of an adder.¹²²

Response of the Parties

54. **PEPCO** argues that contrary to OPC's assertions, there is substantial record evidence in support of an adder.¹²³ PEPCO further asks the Commission to clarify that the record evidence supports that absent an adder, SOS rates would likely be below what the market for competitive supply will demand.¹²⁴

Commission Decision

55. In Order No. 13268, the Commission found that "[a]bsent an adder, SOS rates would likely be below what the market for competitive electricity supply will demand."¹²⁵ The Commission's finding here was partially based upon PEPCO Witness Browning's statements that "competitive suppliers contemplating providing service in the District will have to weigh the costs of doing business in this market against their chances of attracting and sustaining a customer base."¹²⁶ The Commission also found persuasive the arguments advanced by PES that competitive suppliers face customer acquisition costs that PEPCO, as the SOS provider, does not face; and that the adder is simply a proxy for some of the additional costs faced by competitive suppliers.¹²⁷ It is for these reasons established in the record that the Commission determined that "PEPCO's proposed adder mechanism is a reasonable means of accounting for cost differences in a way that places SOS rates on an expected par with those to be offered by competitive suppliers."¹²⁸ The Commission continues to hold this view. Competitive suppliers entering the District market will attempt to recoup costs of market entry that PEPCO, as the SOS provider, does not have. Inasmuch as PEPCO does not incur these same types of costs because of its established presence in the market, such costs will not be reflected in SOS rates absent the provision for the adder in the Administrative Charge. The resulting temporary uplift created by the adder is appropriate because (1) it places SOS on par with competitive suppliers and (2) any adder revenues collected will be refunded to customers on the system. For these reasons, the Commission continues to find the adder component will result in just and reasonable SOS rates and is supported by substantial evidence in the record.

3. **OPC's Contention that the Commission Erred in Finding that Section 34-1509 of the District of Columbia Code Supports Approval of the Adder**

¹²² See OPC Application at 31.

¹²³ See PEPCO Response at 17.

¹²⁴ See PEPCO Response at 17.

¹²⁵ Order No. 13268 at 29 ¶ 107.

¹²⁶ Order No. 13268 at 28 ¶ 103.

¹²⁷ Order No. 13268 at 24 ¶ 84.

¹²⁸ Order No. 13268 at 24 ¶ 84.

Position of OPC

56. **OPC** states that Section 34-1509(d)(1)(A) requires that the Commission take care in formulating a rate for SOS so as "not to hinder" the development of competition; it clearly does not provide that the Commission is required to subsidize competitors.¹²⁹ OPC contends that the Commission is effectively interpreting Section 34-1509(d)(1)(A) to require that the SOS rates reflect the costs of either PEPCO or competitive suppliers, whichever is greater.¹³⁰

Response of the Parties

57. **PEPCO** argues that the Commission's decisions approving a margin and an adder are in full accord with statutory standards.¹³¹ PEPCO agrees that its provision of SOS is a regulated service subject to the just and reasonable standard set forth in § 34-1509 (b) (3) (A) which terminates at the end of the rate cap period. PEPCO asserts that even if the just and reasonable standard set forth in § 34-1101 (a) applies after the end of the rate cap period, it is not the only provision of the D.C. code applicable to SOS.¹³² PEPCO contends that § 34-1509 specifically addresses SOS and contains numerous provisions relevant to the implementation of SOS.¹³³ PEPCO further states that the Commission must interpret statutes in conformity with basic principles of statutory construction which mandate that each provision of a statute be construed so as to give effect to all provisions of the statute not rendering any provision superfluous.¹³⁴ Finally, PEPCO asserts that the Commission's approval of an adder is in full accord with the intent expressed in § 34-1509(d)(1)(A), as set forth in the Committee Report and clearly stated in 34-1509(d)(1)(A).¹³⁵

58. **Constellation** contends that the non-margin component of the Administrative Charge represents a reasonable proxy for the costs included in providing retail services associated with SOS service.¹³⁶ Constellation further asserts that OPC confuses short term marginal costs with long run average total costs that include all the expenses and operating costs of providing retail service to customers.¹³⁷ Constellation argues that the non-margin portions of the Administrative Charge approved by the Commission are representative of the retail costs

¹²⁹ See OPC Application at 32.

¹³⁰ See OPC Application at 32.

¹³¹ See PEPCO Response at 3.

¹³² See PEPCO Response at 4.

¹³³ See PEPCO Response at 4.

¹³⁴ See PEPCO Response at 4.

¹³⁵ See PEPCO Response at 18.

¹³⁶ See Constellation Response at 4.

¹³⁷ See Constellation Response at 4.

required to provide all the administrative functions associated with SOS service.¹³⁸ Therefore, Constellation asserts, OPC's argument that PEPCO's adder would unreasonably increase the retail rates of all District consumers continues to be without merit and should be rejected.¹³⁹

Commission Decision

59. As stated previously, the adder is designed to place potentially competitive services, i.e., SOS and non-SOS supply offers, on par with one another. Absent an adder, SOS rates would likely be below what the market for competitive electricity supply will demand, which would clearly hinder the development of competition. The Commission does have a statutory obligation to set rates at a just and reasonable level for SOS service and by approving an adder that will be returned to ratepayers in its entirety, the Commission has appropriately balanced the directive contained in Section 34-1509(d)(1)(A) with its statutory obligation to set just and reasonable rates. As a component part of the SOS rate, the Administrative Charge established by the Commission in Order No. 13268 meets the Commission's statutory obligation in that its component parts – the incremental costs, uncollectibles, margin and adder – all result in a rate that is just and reasonable for the reasons expressed in this Order and in Order No. 13268.

4. **OPC's Contention that the Commission Erroneously Failed to Address OPC's Arguments that the Proposed Adder Would Force SOS Customers to Subsidize Customers of Competitive Suppliers**

Position of OPC

60. **OPC** asserts that the Commission failed to fully explain its decision adopting the proposed adder by failing to respond to OPC's arguments concerning the adverse consequences that would flow from implementation of an adder.¹⁴⁰ OPC contends that it demonstrated at hearing that approval of PEPCO's adder would result in a cross-subsidy from SOS customers to customers of retail suppliers.¹⁴¹

Response of the Parties

61. **PEPCO** contends that OPC's argument is based on the fact that under PEPCO's proposal, and Order No. 13268, the adder will be returned to all distribution customers instead of only to SOS customers.¹⁴² PEPCO argues, however, that if the credit were returned only to SOS

¹³⁸ See Constellation Response at 4.

¹³⁹ See Constellation Response at 4.

¹⁴⁰ See OPC Application at 34.

¹⁴¹ See OPC Application at 34.

¹⁴² See PEPCO Response at 19.

customers the result would be to unfairly and anti-competitively encourage customers to remain on SOS.¹⁴³ PEPCO further asserts that returning the adder to all customers is consistent with the Commission's decision to provide Generation Procurement Credits to all distribution customers, not just SOS customers.¹⁴⁴

62. **Constellation** argues that, contrary to OPC's claims, the Commission's Order sought to minimize and eliminate a double payment by customers on competitive service of administrative costs embedded in distribution rates charged to all customers.¹⁴⁵ Constellation contends that the Commission recognized this retail subsidy and adopted PEPCO's administrative crediting mechanism as a means of addressing the subsidy.¹⁴⁶

63. **PES** also comments that OPC's assertion that the adder creates a subsidy to suppliers is misplaced.¹⁴⁷ PES argues that the Administrative Charge will include (a) incremental costs of providing the service; (b) uncollectible expenses; (c) a margin for shareholders and (d) an additional adder (consisting of the fixed overall Administrative Charge amount minus items (a) (b) and (c)).¹⁴⁸ PES contends that the adder is in no form a subsidy to suppliers because the costs of providing the service are calculated and the over recovery is returned to the customers.¹⁴⁹

Commission Decision

64. The Commission finds the arguments advanced by PEPCO, Constellation and PES persuasive. The adder, as approved in Order No. 13268, would be collected from all SOS customers, and subsequently returned to all distribution customers, on a customer class basis. Neither PEPCO nor competitive suppliers would retain any portion of adder revenues. OPC's claim that the adder would force SOS customers to subsidize non-SOS customers is grounded upon the fact that adder revenues would be returned to all customers within a given customer class, not just the portion who choose to remain on SOS service.

65. The Commission has determined, in part, that the adder is both necessary and appropriate in order to ensure that the price for SOS service does not hinder the development of a competitive electricity market in the District. Thus, the existence of an adder component in the SOS rate works to the benefit of all of PEPCO's distribution customers, because absent the adder fewer competitive suppliers are likely to compete in the District. With fewer competitors in the market, the rates charged by competitive suppliers are likely to be higher than they otherwise

¹⁴³ See PEPCO Response at 19.

¹⁴⁴ See PEPCO Response at 19.

¹⁴⁵ See Constellation Response at 5.

¹⁴⁶ See Constellation Response at 5.

¹⁴⁷ See PES Response at 4.

¹⁴⁸ See PES Response at 4.

¹⁴⁹ See PES Response at 5.

would be if a larger number of suppliers were competing in the market. Therefore, to the extent the adder levels the playing field and attracts more competitive suppliers, all consumers benefit.

66. Having determined that an adder is necessary, the pertinent question becomes how to return adder revenues to customers. In approving PEPCO's proposal to return adder revenues to all distribution customers, the Commission insured that the adder is competitively neutral. Moreover, such an approach is consistent with our previous decision to provide Generation Procurement Credits to all distribution customers. Finally, we note that any attempt to address OPC's subsidy concerns by returning adder revenues solely to SOS customers would defeat the whole purpose of the adder, since it would effectively remove the adder from the price to compare for each respective customer class. For these reasons, and because all consumers ultimately benefit from the inclusion of the adder, the return of adder revenues to all customers is appropriate.

5. OPC's Contention that the Commission Erred by Failing to Address OPC's Demonstration that PEPCO's Proposed Adder Would Unreasonably Increase the Retail Rates of All District Customers

Position of OPC

67. OPC argues that the Commission failed to address its demonstration that the approval of PEPCO's requested adder would increase the retail price of electricity to all customers in the District, SOS and shopping customers alike.¹⁵⁰ OPC asserts that in markets dominated by a few suppliers, each market participant's independent pricing decisions will naturally affect the entire market.¹⁵¹ OPC states that accepting this economic theory, courts have recognized that each seller will take into account the other seller's reactions when setting its price.¹⁵² OPC further comments that courts also have recognized that all market participants in such markets know that they will maximize their profits by avoiding price competition with their rivals.¹⁵³ Thus, OPC contends, even in the absence of a tacit or express agreement, interdependent pricing at supra-competitive rates can characterize markets with few suppliers.¹⁵⁴ Finally, OPC asserts that oligopoly pricing is even more likely to succeed in markets with a standardized product and publicly announced prices, such as the District.¹⁵⁵

Commission Decision

¹⁵⁰ See OPC Application at 37.

¹⁵¹ See OPC Application at 38.

¹⁵² See OPC Application at 38.

¹⁵³ See OPC Application at 38.

¹⁵⁴ See OPC Application at 38.

¹⁵⁵ See OPC Application at 38.

68. As stated previously, the adder is necessary to satisfy § 34-1509(d)(A). While the adder will be included in the generation rates paid by SOS customers, all revenue collected through the adder will be subsequently returned to distribution customers. Thus, the adder will not affect PEPCO's revenue at all. Since the additional revenue generated from the adder will be credited back to all distribution customers, the total rates paid by SOS customers will increase, but in an amount which is less than the adder. For switching customers, the net impact of the adder is actually a net reduction in total rates, not an increase. Thus, OPC's conclusion that an adder will unnecessarily increase rates for all customers is incorrect.

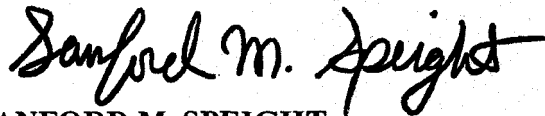
THEREFORE, IT IS ORDERED THAT:

69. The Application for Reconsideration of OPC is hereby denied, consistent with the discussion of this Order.

A TRUE COPY:

CHIEF CLERK

BY DIRECTION OF THE COMMISSION:



**SANFORD M. SPEIGHT
ACTING COMMISSION SECRETARY**

**PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
1333 H STREET N.W., 2nd FLOOR, WEST TOWER
WASHINGTON, D.C. 20005**

DISSENTING OPINION OF COMMISSIONER ANTHONY M. RACHAL III

ORDER ON RECONSIDERATION

October 20, 2004

FORMAL CASE NO. 1017, IN THE MATTER OF THE DEVELOPMENT AND DESIGNATION OF STANDARD OFFER SERVICE IN THE DISTRICT OF COLUMBIA, ORDER NO. 13407

I. INTRODUCTION

1. By this Order, the Public Service Commission of the District of Columbia ("Commission") hereby denies the Application for Reconsideration of Order No. 13268, filed by the Office of the People's Counsel ("OPC") in this proceeding. For the reasons expressed below, and in my dissent to Order No. 13268, I must respectfully dissent from the majority opinion.

II. BACKGROUND

2. In Order No. 13115, the Commission directed the Potomac Electric Power Company ("PEPCO") to file a proposal regarding an Administrative Charge component of SOS rates.¹ On April 8, 2004, PEPCO complied with the Commission's directive.² Replies to PEPCO's proposal were filed on May 3 and May 4, 2004.³ Rebuttal Testimony and Supplemental Rebuttal Testimony also were filed.⁴ Hearings on the Administrative Charge were held on June 23, June 24, and July 7, 2004.⁵ Initial Briefs were filed on July 15, 2004, and Reply Briefs were filed on July 27, 2004.⁶ On August 19, 2004, the Commission issued Order

¹ See *Formal Case No. 1017, In the Matter of the Development and Designation of Standard Offer Service in the District of Columbia ("F.C. 1017")*, Order No. 13115 at 11.

² See *F.C. 1017*, Direct Testimony and Exhibits of PEPCO Witness Browning, filed April 8, 2004 ("PEPCO Administrative Charge Proposal").

³ OPC, PEPCO Energy Services, Inc. ("PES"), and Washington Gas Energy Services, Inc. ("WGES") filed reply testimony on May 3 and May 4, 2004. Constellation Power Source, Inc. and Constellation New Energy, Inc. (collectively, "Constellation") and the Mid-Atlantic Power Supply Association ("MAPSA") filed comments on the PEPCO's Administrative Charge Proposal on May 3 and May 4, 2004, respectively. Constellation and MAPSA reformatted their comments as testimony and filed Reply Testimony on June 8, 2004. Constellation revised its June 8 Reply Testimony with a filing on June 21, 2004.

⁴ PEPCO filed Rebuttal Testimony to the parties' reply submissions on May 17, 2004. See also *F.C. 1017*, Motion for Leave to File Supplemental Rebuttal Testimony and Supplemental Rebuttal Testimony of the Office of the People's Counsel.

⁵ All transcript cites referenced herein are to the transcripts of these proceedings.

⁶ Initial Briefs and Reply Briefs were filed by PEPCO, MAPSA, Constellation, WGES, OPC and PES.

No. 13268 in this proceeding.⁷ Order No. 13268 held that the Administrative Charge would include the following components: Incremental Costs, Uncollectible Costs, a Before Gross-up Margin and an Adder.⁸ As noted, I filed a dissent to this Order.⁹

3. OPC filed an Application for Reconsideration on September 20, 2004 alleging that the Commission erred by approving the margin and adder components.¹⁰ On September 27 and September 30, 2004, parties filed responses to OPC's Application.¹¹

III. DISCUSSION

4. I maintain the positions expressed in my dissent to Order No. 13268 with respect to the tax treatment associated with the Administrative Charge. I continue to support a true gross-up tax methodology regarding the overall margin requested by PEPCO, in order to accommodate the tax impact of that margin. As noted, the majority opinion claims to support the gross-up tax methodology, while reducing the overall margin requested by PEPCO,¹² in order to accommodate the tax impact of that margin. In my opinion this approach is disingenuous because it effectively fails to recognize the true tax impact on the requested margin component of the Administrative Charge. I believe that the margins requested by PEPCO for residential, small and large commercial customers in the District of Columbia are reasonable, as was also found to be the case in the recent Public Service Commission of Maryland decision.¹³ However, due to the tax treatment required by the majority, those margins are reduced significantly.¹⁴

5. PEPCO should be allowed to earn a reasonable return that will adequately compensate the Company and its shareholders for the risks involved in providing SOS service in the District of Columbia. The provisioning of SOS service is not a voluntary or non-profit activity. To do otherwise does not provide the Company with adequate incentives to perform this service at the highest standard possible. Furthermore, an insufficient margin embodied in the Administrative Charge sends the wrong price signal to ratepayers. As we all know, the rates

⁷ See Formal Case No. 1017, *In the Matter of the Development and Designation of Standard Offer Service in the District of Columbia*, Order No. 13268, rel. Aug. 19, 2004 ("Order No. 13268").

⁸ See Order No. 13268 at Attachment B.

⁹ See Order No. 13268, Dissenting Opinion of Commissioner Anthony M. Rachal III, rel. Aug. 19, 2004.

¹⁰ See *F.C. 1017*, Application for Reconsideration of Order No. 13268 of the Office of the People's Counsel, filed Sept. 20, 2004 ("OPC Application").

¹¹ See *F.C. 1017*, Response of PEPCO, filed Sept. 27, 2004 ("PEPCO Response"). See also *F.C. 1017*, Response of Constellation Power Source, Inc. and Constellation New Energy, Inc. to Application for Reconsideration of Order No. 13268 ("Constellation Response") and PEPCO Energy Services, Inc. Response to the Office of People's Counsel Application for Reconsideration of Order No. 13268, filed September 30, 2004 ("PES Response").

¹² Margins as Proposed: Residential Customers- 1.5000; Small Commercial Customers- 2.0000; Large Commercial Customers- 3.0000; Mills per kWh.

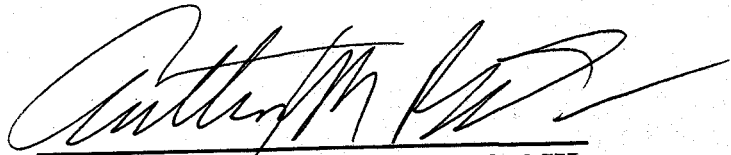
¹³ See Formal Case No. 8908, *In the Matter of the Commission's Inquiry into the Competitive Selection of Electricity Supplier/Standard Offer Service, Maryland Public Service Commission*, Order No. 79097, issued April 27, 2004 ("Maryland Order").

¹⁴ Margins as Adjusted: Residential Customers- 0.8777; Small Commercial Customers- 1.1703; Large Commercial Customers -1.7555; Mills per kWh.

for electric service in the District of Columbia are likely to increase once the rate caps expire. At that time, I believe that the new rates to be implemented should fully reflect the costs of service under the new paradigm. The approach supported by the majority simply postpones the rate impact of the true cost of providing SOS service in the post price cap era.

THEREFORE, IT IS ORDERED THAT:

6. For the reasons expressed above, I must respectfully dissent from the majority opinion with respect to the tax treatment associated with the Administrative Charge in Order No. 13268, as it relates to OPC's Application for Reconsideration.



Commissioner Anthony M. Rachal III