ORDER NO. 79097

In the Matter of the Commission's Inquiry into the Competitive Selection of Electricity Supplier/Standard Offer Service.	* * * * *	Case No. 8908

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I. Introduction

On April 16, 2004 the Public Service Commission Staff ("Staff") notified the Commission that an issue had arisen as to whether the utility return components of the proposed Standard Offer Service ("SOS") prices is subject to income tax "gross up."[1] The utilities[2] and competitive marketers[3] (jointly "Proponents") urge the Commission to find that the return component of the SOS Administrative Charges is subject to gross up for income taxes. Conversely, the "Opponents"[4] argue that the return components in the Phase I Settlement represent finite figures that should not be adjusted for income taxes. All but one of the Parties signed the Phase I Settlement in this case[5], and the Settlement was approved by the Commission without change on April 29, 2003 in Order No. 78400.

The Phase I Settlement ("Settlement") states that retail SOS prices will be calculated based upon four components: A) supply, B) transmission and related charges,

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[1] The phrase "gross up" refers to the process of applying the tax effect to taxable income. This calculation necessarily produces a higher number to account for the taxes.

[2] Baltimore Gas and Electric Company ("BGE"); Potomac Electric Power Company ("Pepco") and Delmarva Power and light Company d/b/a Conectiv Power Delivery ("Conectiv") (jointly "PHI"); and The Potomac Edison Company, d/b/a Allegheny Power ("AP").

[3] Pepco Energy Services ("PES"); Washington Gas Energy Services ("WGES"); and the Mid-Atlantic Power Supply Association ("MAPSA").

[4] The Opponents are Staff; the Maryland Office of People's Counsel ("OPC"); the Maryland Energy Administration and the Power Plant Research Program of the Department of Natural Resources (jointly "MEA"); the Maryland Energy Users' Group ("MEUG"); and the Maryland Industrial Group ("MIG").

[5] WGES opposed the Phase I and II Settlements.

C) an Administrative Charge, and D) applicable taxes.[6] The Administrative Charge contains a return component or profit, for the utilities' role in the provision of SOS.[7] The Settlement also provides that the return is for retention by the utilities' shareholders.[8]

The Proponents argue that the utility return is subject to income tax gross up alleging: 1) the plain language of the Settlement requires it; 2) income taxes represent a "cost" that the utilities have a right to recover; and 3) gross up tax treatment is the treatment normally given to taxes on returns authorized by the Commission in utility rate cases. The Opponents assert that: 1) the negotiated returns represent finite figures that should not be altered by grossing up the returns for taxes; 2) the Settlement should be interpreted in light of Staff witness Timmerman's explicit return calculations; and 3) income taxes on returns do not represent a "cost" to the utilities under § 7-510(c)(3) of the PUC Article.[9]

II. Commission Decision

A. Ambiguity in the Settlement

The Opponents assert that the use of the word "applicable," together with "taxes," means that some taxes are intended to be recovered in the Administrative Charge, but others are not. In their view, the term is intended to be inclusive of those taxes directly imposed upon the supply component of a customer's electricity bill, but that the term does not include a tax indirectly imposed on the utility's profits earned from the provision

[6] Phase I Settlement, Paragraphs 11, 30, 49, 67.
[7] The Commission notes that the negotiated returns are small because the utilities are guaranteed full SOS cost recovery and therefore have minimal or no risk.
[8] Settlement Paragraphs 12(a), 31(a), 50(a), 68(a), and 82(a).
[9] Public Utility Companies Article of the Annotated Code of Maryland.

of SOS.[10] The Proponents, on the other hand, contend that the phrase is synonymous with "all taxes,"[11] and thus an income tax gross up should be included in the Administrative Charge. In the Commission's view, both constructions are reasonable, and thus an ambiguity exists in the language of the Settlement in the use of the term "applicable taxes."

Proponents find support for their asserted meaning of "applicable taxes" elsewhere in the Settlement in language that states the return component is for retention by the utilities' shareholders.[12] The Proponents argue that by failing to gross up the return component, the shareholders would be denied the full value of the return component. While the Proponents' point is an accurate observation, the Commission is not persuaded that this language resolves the ambiguity in the term "applicable taxes." Opponents point out, also correctly, that the utilities will receive a return or profit for the provision of SOS whether there is a gross up or not. The substantive argument on this issue is addressed in Section II D of this Order, but the Commission is not persuaded that this language offers any clarity on the use of the term "applicable taxes" in the Settlement.

Opponents also look to other parts of the Settlement for support of their asserted meaning of "applicable taxes." Opponents point out that the Settlement specifically addressed the inclusion of a gross up for taxes of the revenue requirement for cash

[10] The Opponents assert that the four components of the SOS retail price are separate and independent components, in contrast the Proponents say that Component D – applicable taxes – was meant to apply to all taxes in Components A, B and C.

[11] Even if the term "all taxes" was used in the Settlement, the ambiguity concerning whether the term only applies to direct taxes imposed on SOS would remain. The inclusion of gross up is an addition to a revenue requirement applied in traditional rate cases to account for anticipated taxes. The gross up is an accounting device, not a tax in and of itself.

[12] Paragraphs 12a, 31a, 50a, 68a and 82a.

working capital collected through the incremental cost component of the Administrative Charge.[13] The Opponents assert that because the gross up was expressly included in the calculation of the incremental cost component of the Administrative Charge, but not for the return component of the Administrative Charge, that the intent of the Parties is clear that no gross up should be applied to the return component. The Proponents counter that the Commission should draw the exact opposite conclusion. Proponents assert that inclusion of specific gross up language for the cash working capital revenue requirement collected through the incremental cost component reinforces the Proponents' view that the Parties understood that the return component would be subject to a gross up for taxes. They argue that the specific inclusion of the gross up for cash working capital was designed to ensure similar treatment in the incremental costs component to that of the return component, which would be subject to a gross up as part of the "applicable taxes" on the costs of provisioning SOS.

The Commission is not persuaded that either argument fully resolves the Parties' intended meaning of "applicable taxes" in the Settlement. On close scrutiny, however, Opponents have raised a valid point about the structure of the Settlement. The Parties clearly understood and explicitly contemplated the gross up for income taxes when it was their intent to do so. If one accepts Proponents' position for the implied inclusion of a gross up of the return component based upon the "applicable taxes" language, the inclusion of specific gross up language for cash working capital in the incremental cost component would be unnecessary. Although the inclusion of specific gross up language elsewhere in the Settlement would tend to support Opponents' construction, the

[13] Paragraphs 31b(2), 50b(2), 68b(2), and 82b(6).

Commission views this argument as insufficient alone to render the meaning of "applicable taxes" clear and unambiguous.

For all these reasons, the Commission finds that the phrase "applicable taxes" in Component D is ambiguous in the Settlement. Both sides have presented entirely plausible, but nonetheless very different, interpretations of this language. Since the Settlement is ambiguous on this issue, and the ambiguity cannot be definitively resolved within the four corners of the Settlement, the Commission must turn to the record to determine the Parties' intent.

B. Treatment of return component in Settlement approval proceedings before Commission

Aside from the Settlement itself, the next best evidence of the intent of the Parties is the record compiled before the Commission and the Commission's Order approving the Settlement. The Parties have each pointed to various aspects of that record in support of their respective positions on the gross up issue.

Based on the record, the Commission concludes that the best evidence is provided by the direct testimony of Staff witness Timmerman, specifically his exhibit CLT-5 (attached as Appendix A).[14] The Commission was concerned with the reasonableness of the negotiated return the utilities would receive in this case, and only Mr. Timmerman addressed this issue with specific figures. He calculated **pre-tax** return margins[15] based upon the specified returns for each service in the Settlement in exhibit CLT-5. The Commission cited Mr. Timmerman's testimony in its Order approving the Phase I Settlement.[16] No party has argued in this proceeding that anyone contested Mr.

[14] Staff Exhibit No. 1. Docket No. 129.
[15] After-tax return margins would be lower.
[16] Order No. 78400 at 19. *See* Docket No. 184.

Timmerman's calculations. Based upon the record the Commission concluded that the returns were fair and reasonable.[17] Furthermore, the Commission found "the record shows that the estimated returns are reasonable and thus comports with § 7-510(c) and the Electric Act generally."[18] It is Mr. Timmerman's calculations that give meaning to the return components by converting the millage amounts in the Settlement into percentage returns.

The Proponents assert that Mr. Timmerman's testimony is ambiguous since it refers in several places to "net" returns, which in their opinion is after taxes.[19] This argument is a red herring. First, the word "net" does not appear in the top section of exhibit CLT-5 where Mr. Timmerman estimated the Return Margin For Specified [Settlement] Services. Furthermore, the Proponents assertion does not alter the fact that Mr. Timmerman clearly calculated Pre-Tax Settlement return margins and that this was the understanding of the Commission in Order No. 78400.[20]

Finally, the Proponents argue that a statement by a BGE witness is the "only testimony about the meaning of Component D."[21] However, in the cited testimony BGE witness Harbaugh referred to the treatment of tax changes and changes in other costs passed through to customers in the SOS price.[22] His testimony does not mention a gross up. Beyond some very generalized statements, his testimony does not convey what was

[17] Order No. 78400 at 82.
[18] Order No. 78400 at 85. Mr. Timmerman's testimony states that the pre-tax return margins on exhibit CLT-5 are estimated. Docket No. 129 at 21.
[19] Mr. Timmerman refers to a "net profit margin" when talking about transportation services and electric utility companies generally on page 21; and also makes general references to utility profit margins in the Settlement on page 22. Finally, the word "net" appears before "profit margin" (pre-tax) under Profit Margins For Various Industry Composites on CLT-5.
[20] Order No. 78400 at 19 states: "Staff produced a list of the estimated pre-tax return margins . . .".
[21] Docket No. 317 at 3.
[22] Transcript at pp. 1048-1056 and pp. 1077-1081.

intended by the term "applicable taxes."[23] Thus, Mr. Harbaugh's testimony goes to a change in taxes, not to a determination regarding the meaning of applicable taxes in the Settlement. The Commission finds that these general references in Mr. Harbaugh's testimony about taxes do not specifically address the issue before the Commission, nor do they contradict the figures calculated by Mr. Timmerman on exhibit CLT-5.

The Proponents seek to have the Commission imply language that is not in the Settlement. Furthermore, they were on notice regarding Mr. Timmerman's testimony.[24] Indeed, the Opponents herein were Settling Parties with the Proponents. If Mr. Timmerman made an error in his exhibit CLT-5, or the Proponents disputed the calculations contained in that exhibit, it was incumbent upon the Proponents to bring their alternate interpretation to the Commission's attention prior to issuance of the Phase I Order. The Commission finds that the Proponents are estopped from now asserting a new and different interpretation than the one relied upon by the Commission in approving the Phase I Settlement.

C. Utilities' Cost Recovery for Provision of SOS

Section 7-510(c)(3) of the PUC Article states that if the Commission extends the utilities' SOS obligation they will recover "the verifiable, prudently incurred costs to procure or produce the electricity plus a reasonable return." The Proponents argue that denying them recovery of income taxes on the return component of SOS would "be inconsistent with the cost recovery mandate set forth in Section 7-510(c)(3)."[25] The

[23] Transcript at 1053.
[24] Transcript Vol. V, December 6, 2002 at 1138-1139.
[25] Docket No. 324 at 4.

Opponents say that the term applicable taxes in Component D only refers to taxes on the SOS supply portion.[26]

The Commission finds the Proponents' argument unpersuasive. It is the opinion of the Commission that the statute allows utilities a return that is an additional amount and separate from their costs to procure SOS. Full prudent cost recovery is mandated. However, income taxes are not a cost of procurement and are not incurred as a result of procuring electric supply. Income taxes only arise because the utilities are authorized a return. Utilities will receive sufficient margins to pay income taxes from the return component of the Administrative Charge. Moreover, the Settlement did not specify a gross up for the return component as it did for other elements. Therefore, the Commission concludes that the statute does not mandate recovery of income taxes on the return component because income taxes are not an incurred cost to procure electric supply.

D. Analogies to Traditional Ratemaking

The Proponents argue that the return components must be grossed up for income taxes because "utility returns are always grossed up for taxes in setting rates."[27] The Commission finds this analogy to traditional utility ratemaking fallacious. This is not a traditional rate case.[28] Not only are the utilities guaranteed full cost recovery, but they are guaranteed a specified return when they have minimal or no risks.[29] Utility returns are not guaranteed in traditional ratemaking, utilities have only an opportunity to earn a

[26] *See* Docket No. 314 at 8.
[27] Docket No. 317 at 4.
[28] BGE witness Harbaugh acknowledged that this SOS proceeding is a different paradigm from traditional utility ratemaking. Transcript at 1140-1142.
[29] Transcript of Phase II hearing dated August 26, 2003 at 1533-36 and 1587-91. Docket No. 247.

fair and reasonable return. In fact, the record is clear that the Parties took steps to avoid any confusion between the SOS rates developed as a result of this proceeding and the now ongoing and future rate cases to be filed by the utilities. For these reasons, the Commission finds the Proponents' analogy not applicable.

III. Conclusion

The term "applicable taxes" in Component D of the Settlement SOS retail prices is ambiguous in the Settlement itself. The Commission finds that the overwhelming best evidence of what taxes are to be recovered is found in Staff witness Timmerman's exhibit CLT-5, which clearly demonstrates that the return margins accepted and approved by Order No. 78400 were on a **pre-tax** basis. In the event the Parties to the Settlement desired to utilize gross up amounts as argued in this proceeding, the Settlement should have specified gross up calculations for the return component as it did for cash working capital. Consequently, the Commission finds that the record does not support the Proponents' interpretation regarding the return component. Accordingly, the Commission finds that the return components specified in the Phase I Settlement were not intended by the Parties to be grossed up for income taxes.

IT IS, THEREFORE, this 27th day of April, in the year Two-Thousand and Four, by the Public Service Commission of Maryland,

ORDERED: (1) The utilities shall immediately file and publish by April 30, 2004 Standard Offer Service retail rates that include a return component that is not grossed up for taxes.

(2) All motions not specifically granted are denied.

(3) Staff is directed to re-file its recently issued Report with corrected data reflecting the Commission's decision in this Order.

/s/ Kenneth D. Schisler

/s/ Gail C. McDonald

/s/ Ronald A. Guns

/s/ Harold D. Williams

Commissioners*

* Commissioner J. Joseph Curran, III dissents from the majority opinion.

APPENDIX A
Exhibit CLT-5 Page 1 of 1

RETURN MARGIN FOR SPECIFIED SERVICES

Service Type	Return	Return Margin (Pre-Tax)*
Residential SOS	1.5 mills/kWh	3.11%
Type I SOS	2.0 mills/kWh	4.15%
Type II SOS	2.0 mills/kWh	4.15%
Type III Large-Customer Service	3.0 mills/kWh	6.22%
Hourly-Priced Non-Residential Service	2.25 mills/kWh	4.67%

PROFIT MARGINS FOR VARIOUS INDUSTRY COMPOSITES

Industry	Net Profit Margin (Pre-Tax) **
(1) Auto and Truck Industry	2.13%
(2) Retail Stores (including Wal-Mart)	2.85%
Wal-Mart	3.20%
(3) Machinery Industry	3.28%
(4) Packaging and Container Industry	3.45%
(5) Natural Gas Distribution	3.92%
Exploration/production/transportation	4.81%
(6) Electric Utility Companies (average of East, Central and West)	4.16%
(7) Maritime Industry	4.87%
(8) Chemical Industry (Basic)	4.65%
Chemical Industry (Diversified)	6.95%
(9) Oilfield Services/Equipment	7.42%
(10) Restaurant Industry (inclusive)	7.90%
(Starbucks)	6.62%

* Values derived from: (Return Costs)/(Wholesale Generation & Transmission Costs). Wholesale Generation/Transmission Costs were approximated at $.0482/kWh.

** Data abstracted directly from Value Line Investment Survey, (dtd. 8/16/02-11/01/02), calculated as (Net Profit/Sales). Data reflects averages for calendar years 2000-2001, and 2002 estimate(s).

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DISSENT OF COMMISSIONER J. JOSEPH CURRAN, III

While my colleagues make a very forceful argument in the majority opinion, I nevertheless must respectfully dissent from their conclusion, which disallows the investor owned utilities the ability to gross-up the shareholders' return for federal and state income taxes.

Resolution of this issue necessarily calls for an examination of the language of the Phase I Settlement Agreement approved by the Commission in April of 2003. The evidence presented in Phase I provided scant discussion on how taxes would be treated. Therefore, I am left without much to guide me in my analysis of this issue other than the plain meaning of the word "return" and how taxes are conventionally applied.

A return is conventionally defined as a net figure, meaning it is free of all further expense claims that can be made on it. The Settlement does not specify that "return" should assume a meaning other than its ordinary meaning. On the contrary, the Settlement specifies that the return shall be for retention by shareholders.

The language of the Phase I Settlement Agreement is clear. Paragraphs 11, 30, 49, and 67 discuss the retail price of standard offer service for the residential class, the Type I category, the Type II category, and the Type III category, respectively. There are four components to the retail price of standard offer service. They are: (1) the wholesale cost of supply; (2) transmission and related charges; (3) the Administrative Charge; and (4) applicable taxes. The Commission approved the recovery of each of these four distinct components and should not now render any of these cost elements unrecoverable.

In the development of retail electricity rates, returns are grossed-up for income taxes. Taxes are operating costs rather than reductions from investors' returns. Despite the majority's conclusion to the contrary, no part of the verifiable and prudently incurred

operating costs should be misplaced or disallowed. Specifically, the income tax gross-up on the return component of the Administrative Charge should not be deducted from the agreed upon shareholder return in lieu of including it in the applicable tax component. Applicable taxes are clearly an agreed upon cost element of the retail price of standard offer service. Federal and state income taxes are without debate taxes that are applied to the shareholders' return and therefore, appropriately included in the applicable tax component of the retail standard offer service prices.

For these reasons, I respectfully dissent from the majority opinion.

/s/ J .Joseph Curran, III

J. Joseph Curran, III
Commission