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PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
1333 "H" STREET, N.W., SUITE 200, WEST TOWER
WASHINGTON, D.C. 20005

OPINION AND ORDER

May 15, 2013

FORMAL CASE NO. 1093, IN THE MATTER OF THE INVESTIGATION INTO THE REASONABLENESS OF WASHINGTON GAS LIGHT COMPANY'S EXISTING RATES AND CHARGES FOR GAS SERVICE, **Order No. 17132**

Before the Commission:

Betty Ann Kane, Chairman
Joanne Doddy Fort, Commissioner

Appearances:

Cathy Thurston-Seignious, Rose T. Lennon, Meera Ahamed, Bernice McIntyre, for Washington Gas Light Company; Jennifer Weberski, Sandra Mattavous-Frye, Karen R. Sistrunk, Danielle Lopez, Scott H. Strauss, Jeffrey Schwarz, Daniel Silverman, Stephen Pearson, for Office of the People's Counsel; Frann G. Francis, W. Shaun Pharr, Nicola Y. Whiteman, for Apartment and Office Building Association of Metropolitan Washington; and Brian Caldwell for the District of Columbia Government.

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I. BACKGROUND

1. On November 2, 2011, the Commission opened this investigation to review the reasonableness of Washington Gas Light Company's ("Washington Gas," "WGL," or "Company") base rates, because of the time that has elapsed since WGL's last base rate case, the Company's earnings level, and an apparent decrease in WGL's depreciation expense.[1] In response, on February 29, 2012, WGL filed an Application requesting authority to increase its existing firm delivery rates and charges for gas service in the District of Columbia. It sought a $29.0 million increase in the Company's weather-normalized revenues, representing an overall increase of approximately 14% in its District of Columbia ("District") revenues. WGL requests authority to earn an overall 8.91% rate of return, including a return on equity of 10.90%. The Company states that its requested rates are designed to collect $236.7 million in total revenues.

2. A pre-hearing conference was held on April 12, 2012. By Order No. 16770, the Commission designated the issues for consideration and set the procedural schedule for this proceeding.[2] We granted petitions to intervene filed by the Apartment and Office Building Association of Metropolitan Washington ("AOBA") and the District of Columbia Government ("District Government"). The Office of People's Counsel of the District of Columbia ("OPC") is a party as of right.[3]

3. The Commission held evidentiary hearings on October 4, 5, 15, 16 and 17, 2012.[4] In addition, the Commission held four community hearings on Saturday, September 15, 2012 (Ward 5) Wednesday, September 19, 2012 (Ward 2), Thursday, September 20, 2012 (Ward 8), and Monday, October 22, 2012 (Ward 6).

4. All the parties filed post-hearing briefs on November 7, 2012, and all parties except the District Government filed reply briefs on November 20, 2012. In its reply brief, WGL revised its revenue request down to $28.4 million based on adjustments that it accepted following the evidentiary hearing.

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[1] *See Formal Case No. 1093, In the Matter of the Investigation Into the Reasonableness of Washington Gas Light Company's Existing Rates and Charges for Gas Service ("Formal Case No. 1093"),* Order No. 16596 (November 2, 2011) ("Order No. 16596"). The Commission's orders in this proceeding (*Formal Case No. 1093*) and in other Commission proceedings are cited as *Formal Case No.*___, *Case Name*, Order No. ___ ¶ ___ (Date). Court decisions are cited as *Case Name,* ___ A.3d___, ___ (D.C. (Year))." Transcripts of the Commission's Evidentiary Hearings are cited as "Tr.___."

[2] *Formal Case No. 1093,* Order No. 16770, ¶¶ 27-30 (April 26, 2012).

[3] *See* D.C. Code § 34-804 (2001) (OPC is a party, as of right, in any Commission investigation, valuation, or reevaluation, concerning any public utility operating in the District of Columbia). In this case, the Direct Testimony of OPC, WGL or an intervenor is designated (for example) as "OPC (_) (name of witness)"; while Rebuttal Testimony is cited as "WGL (2_) (name of witness)"; a post-hearing initial brief is "AOBA Br."; and a post-hearing reply brief is "District Government R. Br."

[4] *Formal Case No. 1093*, Order No.16964, ¶ 4 (November 13, 2012) (granting motions submitted by WGL and OPC to correct the transcript of the evidentiary hearings.)

5. On January 4, 2013, based on information in the briefs, we reopened the record to receive supplemental testimony from the parties on Washington Gas's pension and Other Post-Employment Benefits ("OPEB") expenses, before we formally closed the record of this proceeding effective February 15, 2013.[5]

II. TEST YEAR [Issue a][6]

6. The purpose of adopting a test year is to ensure that rate levels and the revenues they produce have a realistic relationship to the revenue requirements of the Company and to determine costs and investments as accurately as possible to allow the Company a reasonable opportunity to recover its costs.[7] WGL proposed a test year of actual results for the twelve months ending September 30, 2011. This was the most recent period that was audited by independent accountants. According to WGL, it fairly presents the costs and revenues that the Company is reasonably likely to incur during the rate effective period, *i.e.*, the initial 12 months that the rates resulting from this proceeding will be in effect.[8] OPC does not challenge the use of WGL's proposed test year, although it disputes many of WGL's proposed adjustments to its historical test year data.[9] None of the other parties objected or commented on WGL's proposed test year.

DECISION

7. Test years are adopted, in general, to minimize speculation about a utility's revenue and cost levels, and to ensure that Commission-set rate levels and the revenues they produce have a realistic relationship to the revenue requirements of the Company.[10] WGL's proposed test year is uncontested. The Commission concurs that WGL's proposed test year ending September 30, 2011 is reasonable and an appropriate test year on which to review WGL's Application.

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5 *See Formal Case No. 1093,* Order No. 17029, ¶ 9-10 (January 4, 2013) (reopening the record and directing WGL to file supplemental written testimony on specific pension and OPEB issues) and Order No. 17077, ¶ 11-12 (February 15, 2013) (accepting into the record WGL's supplemental reply testimony (WGL (5D)), supplemental testimony (WGL (4D)) and supporting Exhibits; admitting into evidence AOBA's supplemental testimony (AOBA (4A)); and closing the record).

6 Designated Issue asks: "Is WGL's proposed test-year appropriate in this case?"

7 *See Formal Case 610*, *In the Matter of the Application of Washington Gas Light Company for Authority to Increase Existing Rates, Tolls, Charges and Schedules for Gas Service* ("*Formal Case No. 610*"), Order No. 5685, p. 6 (January 23, 1975).

8 WGL Br. 9.

9 OPC Br. 12.

10 *See, e.g.*, *Formal Case No. 610,* Order No. 5685, p. 6 (January 23, 1975).

III. CAPITAL STRUCTURE AND RATE OF RETURN [Issue b][11]

8. The Commission must determine a reasonable rate of return including the cost of capital, the cost of debt, and the projected capital structure for WGL. Our decisions consistently follow the well-settled standards established in *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1209-1215 (D.C. 1982) (review of *Formal Case No. 686*).[12] We also adhere to the standards derived from the Supreme Court's decisions in *Bluefield Waterworks & Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*") and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"). The Commission determines the Company's authorized overall rate of return[13] by the "cost of capital" method. That method seeks to determine what return the Company must offer its investors in order to attract the capital investment in its stocks and bonds necessary to finance its construction and operations. It is assumed that the cost of capital, when competently computed, is essentially and practically the equivalent of a fair rate of return. The overall cost of a utility's capital is calculated by determining the cost of each component in the company's capital structure. A weighted cost for each component is derived by multiplying its cost by its ratio to total capital. The sum of these weighted costs then becomes the utility's overall rate of return, which is multiplied by the company's rate base to determine the company's revenue requirement.[14] With these standards forming the backdrop for our consideration of Issue b, we turn to its various components and the evidence submitted into the record of this proceeding by the parties.

A. Capital Structure

9. **WGL.** Washington Gas proposes a capital structure that contains 59.30% common equity, 39.07% debt (consisting of 38.23% long-term debt and 0.84% short-term debt) and 1.63% preferred stock.[15] To arrive at its proposed capital structure, the Company uses as a starting point WGL's actual capital structure as of September 30, 2011 that contains 58.8%

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11 Designated Issue b asks: "What is the appropriate capital structure and rate of return (including cost of equity and debt) for WGL?"

12 *See, e.g.*, *Formal Case No. 850, In the Matter of Investigation into the Reasonableness of the Authorized Return on Equity, Rate of Return, and Current Charges and Rates for Telecommunication Services Offered by Chesapeake and Potomac Telephone Company* ("*Formal Case No. 850*"), Order No. 9927, p. 7-8 (January 27, 1992); *see also Office of People's Counsel v. Public Service Commission*, 455 A.2d 391, 397-398 (D.C. 1982) (review of *Formal Case No. 685*).

13 "The rate of return is an expression, in terms of percentage of rate base, of: 'the amount of money a utility earns, over and above operating expenses, depreciation expense, and taxes expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the returns are interest on debt, dividends on preferred stock, and earnings on common stock equity. In other words, the return is that money earned from operations which is available for distribution among the various classes of contributors of money capital." *Formal Case No. 685, In The Matter of Application of Potomac Electric Power Company for an Increase in its Retail Rates for the Sale of Electric Energy ("Formal Case No. 685)*, Order No. 6096, p. 6 (June 14, 1979).

14 *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1209, n. 30 (D.C. 1982).

15 WGL (B) at 11 (Nee); WGL Br. 11.

common equity, 39.5% long-term debt, 0.0% short-term debt, and 1.7% preferred stock, to which it makes three adjustments. First, WGL adjusts long-term debt to exclude financing associated with energy efficiency projects under the Company's area-wide contract with the federal government, which is not associated with utility plant or included rate base. Second, WGL adjusts short-term debt to include the Company's average daily balance of short-term debt for the twelve months ended September 30, 2011, to reflect seasonal fluctuations. Third, WGL adjusts the retained earning component of common equity to reflect the average balance of retained earnings for the five quarters ended September 30, 2011, and to reflect seasonal fluctuations in earnings.[16] The Company states that, currently, certain WGL ratios are not in line with what is expected of a company with WGL's risk profile. WGL maintains that it is essential that it meet the requirements of Standard and Poor's ("S&P") financial measurements to retain its current credit ratings. WGL argues that its relatively strong capital structure benefits the Company and ratepayers by providing financing flexibility and the ability to access capital in tight capital markets.[17] Because of its strong cash flow during the past few years, WGL maintains that it has issued very little long-term and short-term debt, which caused its debt ratio to be lower than in prior years.[18]

10. WGL contests the capital structures proposed by OPC and AOBA arguing that their hypothetical capital structures have no relationship to the Company's actual capital structure as of the end of the test year and give no consideration to the Company's actual rate base.[19] The Company contends that any adjustment of an actual capital structure without also adjusting rate base leads to a mismatched result and a misstatement of the revenue requirement.[20] WGL also contends that OPC and AOBA fail to account for the benefit of cash flows that reduce rate base and financing costs that are directly related to, and matched with, the actual capital structure.[21] The Company adds that the need to issue long-term debt was reduced as a result of an $85.1 million tax refund in 2010 due to a change in tax accounting methods, which reduced the Company's financing requirement by $60.8 million. According to WGL, the lower debt ratios

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[16] WGL (B) at 10-11 (Nee). The debt costs (long-term note) related to the area wide contract represents a "pass-through" of the costs that WGL incurred to finance certain construction projects. As part of the financing arrangement, the customer, in this case the federal government agrees to make the principal and interest payments on the note. When the project is completed and accepted by the customer, the customer assumes full responsibility for the note.

[17] WGL (B) at 5-7 (Nee); WGL Br. 13. According to WGL, as of September 30, 2011, S&P considered the Company's ratio of Total Debt to Total Equity more risky than S&P's target range for companies such as WGL with an "Intermediate" financial risk profile primarily because of the Company's increasing pension liabilities and asset retirement obligations. Also, the Company's cash flow ratio (Funds from Operations to Total Debt) was considered more risky than the lower end of the target range. In addition, the Total Debt to Earnings before Interest, Tax, and Depreciation ratio was considered riskier than the standard for "Intermediate" financial risk companies. *Id.* at 7; WGL (B)-1 (Nee).

[18] Tr. 151-153 (WGL witness Nee); WGL Br. 14.

[19] WGL (2B) at 2 (Nee).

[20] WGL (2B) at 6 (Nee).

[21] WGL (2B) at 3 (Nee).

resulted in lower financing requirements, lower accumulated deferred taxes, and lower interest expenses.[22]

11. WGL further contends that OPC's proposed capital structure inappropriately uses the consolidated capital structures of the Company's Proxy Groups, which include the capitalization of non-gas distribution subsidiaries.[23] With regard to AOBA's recommended capital structure, WGL argues that its capital structure should not be based on the average capital structures of New Jersey Resources and Northwest Natural Gas, as alleged by AOBA, because that ignores the mismatch with actual rate base that would accompany any deviation from the actual capital structure.[24]

12. **OPC.** OPC recommends that WGL adopt the capital structure of OPC's Gas Proxy Group,[25] which contains 51.46% of common equity, 36.33% of long-term debt, 12.04% of short-term debt, and 0.17% of preferred stock.[26] To arrive at its proposed capital structure, OPC uses the average quarterly capitalization data of its gas proxy group for the period ended June 30, 2011. It maintains that both WGL's and WGL Holdings' common equity ratios are well above the common equity ratios of other gas distribution companies[27] and that WGL Holdings has the highest common equity ratio of any of the companies in OPC's Gas Proxy Group.[28] OPC suggests that one of the reasons for WGL's higher level of common equity is due possibly to WGL Holdings' greater reliance on unregulated revenues.[29] OPC contends that, due to WGL's abnormally high level of common equity and the interrelationship between that level and WGL Holding's unregulated operations, the average capital structure of OPC's Gas Proxy Group would be more appropriate for WGL.[30]

22 WGL (2B) at 2-6; WGL (B)-1 at 1 (Nee); WGL Br. 15.

23 WGL (2G) at 8 (Nee). WGL's Gas Proxy Group includes: AGL Resources, Atmos Energy, Laclede Group, New Jersey Resources Corp., Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries, Southwest Gas, and WGL Holdings. WGL (C) at 8-9 (Hanley). The Non Utilities Proxy Group includes: Bard (C.R.), Becton Dickinson, Clorox Co., Dun & Bradstreet, Hormel Foods, Kraft Foods, Cocoa-Cola, McDonalds Corp., PepsiCo, Inc., Sysco Corp., Tootsie Roll Inc., and Wal-Mart Stores. WGL (C) at 41-42; WGL (C)-13 at 2 (Hanley).

24 WGL (2G) at 12 (Nee).

25 OPC's Gas Proxy Group includes: AGL Resources, Atmos Energy, Laclede Group, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries, Southwest Gas, and WGL Holdings. OPC (B) at 15, OPC (B)-4 (Woolridge). The only difference between OPC's and WGL's gas proxy groups is that OPC excludes New Jersey Resources Corp., because it receives only 30% of its revenues from regulated operations.

26 OPC (B) at 17, OPC (B)-5, Panels C and D (Woolridge).

27 OPC Br. 16.

28 OPC (B)-5 at 2 (Woolridge).

29 OPC Br. 16, OPC (B)-5 (Woolridge).

30 OPC Br. 16.

13. **AOBA.** AOBA proposes a capital structure based on the average of the 2011 actual capital structures of the two highest rated companies in WGL's Gas Proxy Group (excluding WGL Holdings), New Jersey Resources, and Northwest Natural Gas, which contains 51.56% of common equity, 38.02% of long-term debt, 8.79% of short-term debt, and 1.63% of preferred stock. The only adjustment AOBA makes to the average capital structure of the two companies is to recognize WGL's existing preferred stock and to make an offsetting adjustment to the percentage of short-term debt.[31] AOBA maintains that, based on the difference between the effective costs of debt versus common equity, WGL should be increasing its use of short-term and long-term debt to hold down the overall cost of capital for D.C. ratepayers. AOBA states that debt costs have rarely been more attractive than they are in the current market.[32]

14. AOBA argues that the Company's continuous increase to the common equity component of its capital structure through retained earnings, to the detriment of ratepayers, warrants a departure by the Commission from its policy of using the Company's actual test year capital structure.[33] AOBA notes that the majority of the companies in WGL's proxy groups make greater use of short-term debt. Short-term debt represented more than 10% of their respective capital structures for 2010 and on average for 2006-2010.[34] AOBA argues that the difference in debt costs associated with different credit ratings are relatively small when compared to the difference between WGL's cost of debt versus its cost of equity.[35] AOBA points out that the average common equity ratio for WGL's Gas Proxy Group (including WGL Holdings) for 2006 through 2010 is 49.24% and in 2011, excluding WGL Holdings, 47.82%; significantly lower than what WGL is proposing in this case.[36] AOBA further notes that the Company's District service territory has remained comparatively strong, with a stable economic base and affluent population, which reduces investor's risk and enhances the expected return for WGL's District service territory in comparison to other gas distribution utilities.[37] Additionally, AOBA states that the Company's asset management revenue sharing program and interruptible margin revenues provide below-the-line earnings that are not reflected in the Company's cost of equity analysis, which enhances WGL's overall earning potential and reduces risk faced by investors.[38]

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[31] AOBA (A) at 52 (Oliver). AOBA notes that New Jersey Resources and Northwest Natural Gas were able to achieve S&P bond ratings, business risk profile scores, and financial risk profile scores identical to those of WGL despite the fact that they have significantly less common equity than WGL.

[32] AOBA Br. 45.

[33] AOBA (A) at 42 (Oliver).

[34] AOBA (A) at 49 (Oliver); AOBA Br. 49.

[35] AOBA Br. 47, 50.

[36] AOBA Br. 49; AOBA (A) at 50-51 (Oliver).

[37] AOBA Br. 52.

[38] AOBA Br. 52-53; AOBA R. Br. 3-4.

DECISION

15. At issue is whether we should accept WGL's proposed adjusted capital structure with an equity ratio of 59.3% or use one of the hypothetical capital structures proposed by OPC or AOBA that are based on proxy groups with significantly lower equity ratios. Our determination of an appropriate capital structure for WGL for this case starts with the recognition that it is the long-standing policy of this Commission to use a company's actual end-of-year capital structure adjusted to reflect known and measurable changes anticipated through the mid-point of the rate-effective period.[39] Rarely have we deviated from this policy and never have we used a totally hypothetical capital structure, as we are urged to do by OPC and AOBA. To date, our deviations from the use of the actual adjusted capital structure of a utility have occurred in cases where we have elected to use the capital structure of a utility's parent company where there was persuasive record evidence that the utility's capital structure had been manipulated to include a larger amount of high cost equity than was warranted for an independent utility company with the same risk profile.[40] Although we are free to depart from our precedent of relying on actual capital structure, as we did when evidence established that the capital structure had been manipulated, OPC and AOBA have a heavy burden in persuading us that a departure is warranted.[41]

16. OPC and AOBA advance several arguments to persuade us to deviate from our general policy. First, they argue that the proxy companies used for their Discounted Cash Flow ("DCF") analysis all have equity ratios that are substantially lower than WGL's. Second, they argue that the higher equity ratio places an unfair financial burden on D.C. ratepayers because it raises the rate of return in a base rate case and causes the Company's revenue requirement to rise. Third, they argue that the Company's continuous increase to the common equity component of its capital structure through retained earnings, to the detriment of ratepayers, warrants a departure by the Commission from its policy. Next, they cast doubt on the argument that the higher equity ratio is required to retain its bond ratings because WGL's service territory in the District has remained comparatively strong, with a stable economic base and affluent population, which reduces investor's risk and enhances the expected return for WGL's District service territory in comparison to other gas distribution utilities.

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[39] *See, e.g., Formal Case 1016, In the Matter of the Application of Washington Gas Light Company, District of Columbia Division, for Authority to Increase Rates and Charges for Gas Service* ("*Formal Case No. 1016*"), Order No. 12986, ¶ 21 (November 10, 2003); *Formal Case No. 989, In the Matter of the Office of the People's Counsel's Complaint for a Commission-Ordered Investigation into the Reasonableness of Washington Gas Light Company's Existing Rates and In the Matter of the Application of the Washington Gas Light Company, District of Columbia Division, for Authority to Increase Existing Rates and Charges for Gas Service* ("*Formal Case No. 989*"), Order No. 12589, ¶ 41 (October 29, 2002); *Formal Case No. 922, In the Matter of the Application of Washington Gas Light Company, District of Columbia Division for Authority to Increase Existing Rates and Charges for Gas Service* ("*Formal Case No. 922*"), Order No. 10307, p. 16 (October 8, 1993).

[40] *Bell-Atlantic, Washington D.C., Inc. v. Public Service Commission*, 655 A.2d 1231 (D.C. 1995) (upholding the Commission's adoption of Bell-Atlantic D.C.'s parent company's (Bell Atlantic) consolidated capital structure in place of BA-DC's actual capital structure because of the Commission's factual findings that the parent company was manipulating the capital structure of its subsidiary utility).

[41] *Bell-Atlantic, Washington D.C., Inc. v. Public Service Commission*, 655 A.2d 1231 (D.C. 1995).

17. WGL responds to each of these arguments. First, WGL argues that the capital structure of the proxy companies have no relationship to the actual structure of WGL and warns about the a mismatch that occurs between capital needs and WGL's actual rate base when there is any deviation from the use of a company's actual capital structure. Second, WGL argues that the higher equity ratio was not burdensome to ratepayers because the Company required lower financing requirements for major purchases such as gas, which resulted in accumulated deferred taxes and lower WGL interest expense. Third, WGL asserted that there are costs associated with returning equity to shareholders one year only to turn around and require an equity infusion the next year with its associated financing costs that ratepayers would have to pay. WGL also noted that a special cash flow event impacted its capital structure and its rate base. In 2010, the Company received a Federal and State income tax refund in the amount of $85.1 million due to an accounting change resulting in a 13-month average of approximately $60.8 million of net cash flow. The refund reduced the Company's need for debt financing thereby reducing the amount of long-term debt in the Company's capital structure. WGL claims that its equity ratio would have decreased to 57.23% and the debt ratio would have risen to 41.19% if it had issued long-term debt to raise the capital that it received from its tax refund.

18. We are not persuaded by the arguments of OPC and AOBA that there is a sufficiently compelling reason to depart from our long-standing policy of using the actual capital structure and adopt the hypothetical capital structures that they propose in this proceeding. However, like OPC and AOBA, we find WGL's pronounced equity build-up over the past decade to be troubling because it is so out of line with the companies that WGL itself identifies as proxy companies and because its higher equity ratio raises the Company's rate of return and the rates that D.C. ratepayers must pay. While we acknowledge that the Company's $84.1 million tax refund, related to the change in tax accounting methods, was an unusual event that had an impact on its debt-to-equity ratio, we note that WGL's equity ratio would still have been 57.23% if WGL had replaced the tax refund with long-term debt. That ratio is still greater than its equity ratio of 55.48% in *Formal Case No. 1054*, and 50.30% in *Formal Case No. 1016*.[42] Many years ago, we gave a utility company the warning that "if the Company's capital structure includes too much equity, the Commission may be compelled to use a more appropriate hypothetical capital structure in [the utility's] next base rate proceeding."[43] We are issuing that same warning to WGL today. The Company's equity ratio at 59.3% has reached the upper bounds of reasonableness. If it continues to be so significantly out of line with the capital structure of similar companies, the Commission may have no choice but to seriously consider the use of some form of a hypothetical capital structure for rate-setting purposes in the Company's next base rate case. Thus, while we adopt WGL's proposed capital structure in this case, we do so with the aforementioned caveat.

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42 AOBA (A) at 36 (Oliver).

43 *Formal Case No. 896, In the Matter of the Application of the Potomac Electric Power Company for a Certificate of Authority to Issue Debt and Equity Securities,* Order No. 9516, p. 6 (Aug. 9, 1990).

B. Cost of Capital

1. Cost of Debt and Preferred Stock

19. With respect to cost rates for long-term debt and preferred stock, there is agreement among the parties. WGL, OPC, and AOBA agree on the cost rates for long-term debt and preferred stock of 6.16% and 4.79%, respectively.[44] While WGL and OPC agree on a cost of short-term debt of 1.21%, AOBA contends that the cost rate of WGL's short-term debt should not reflect the fixed expense associated with revolving credit fees, which should be recovered as a test year operating expense.[45] AOBA argues that the Company's cost of short-term debt is inflated by revolving credit agreement fees, which do not vary with the amount of short-term funds borrowed, and therefore, recommends that they be treated similarly to that of the Potomac Electric Power Company's ("Pepco") in *Formal Case No. 1076*. When removing the revolving credit agreement fees, AOBA calculates the cost of short-term debt to be 0.268%.[46] The Company opposes AOBA's recommendation arguing that it is appropriate to include revolving credit fees in the cost of short-term debt because the fees support the issuance of short-term debt in the form of commercial paper.[47]

<u>DECISION</u>

20. The Commission agrees with the parties that the cost rates for long-term debt and preferred stock proposed by WGL are reasonable and supported by the evidence of record. However, while WGL and OPC agree that the cost rate for short-term debt is appropriate, AOBA objects to the inclusion of fixed costs associated with revolving credit agreement fees as part of the cost of short-term debt, arguing that the costs should be treated as expenses consistent with the Commission's treatment of similar costs in *Formal Case No. 1076.* The Commission finds that the treatment of short-term debt in this case is distinguishable from the treatment of Pepco's credit facility costs in *Formal Case No. 1076*. We have consistently recognized short-term debt as part of WGL's overall financial strategy.[48] On the other hand, Pepco's capital structure does not include short-term debt. Pepco uses short-term debt as a temporary funding source that is

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44 OPC (B) at 18 (Woolridge); AOBA (A) at 54 (Oliver).

45 AOBA (A) at 69 (Oliver), citing *Formal Case No. 1076, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, ("*Formal Case No. 1076*"), Order No. 15710, ¶¶ 120-122 (March 3, 2010).

46 AOBA Br. 57.

47 WGL (2B2G) at 13 (Nee).

48 *Formal Case No. 1016,* Order No. 12986, ¶ 34 (November 10, 2003); *Formal Case No. 989,* Order No. 12589, ¶ 40 (October 29, 2002); *Formal Case No. 870, In the Matter of the Application of District of Columbia Natural Gas, a Division of Washington Gas Light Company, for Authority to Increase Existing Rates and Charges for Gas Service* ("*Formal Case No. 870*"), Order No. 9146, pp. 16-17, n. 25 (n. 25 is on page 8 of Order No. 9146) (October 28, 1988); *Formal Case No. 787, In The Matter of the application of Washington Gas Light Company for authority to increase existing rates and charges for gas service* ("*Formal Case No. 787*"), Order No. 7749, p. 16 (February 25, 1983).

later replaced by a more permanent funding source; costs that would normally be reflected in the calculation of short-term debt.[49] Because of the way Pepco treats short-term debt, the Commission included these fixed fees as part of Pepco's operating expenses. Because of this difference in the treatment of short-term debt between Pepco and WGL, and because we have consistently recognized short-term debt as part of WGL's overall financial strategy, we decline to include the fixed costs associated with revolving credit agreement fees as part of WGL's expenses. AOBA's proposed adjustment is, therefore, rejected, and we find that the cost of short-term debt should be set at 1.21%.

2. Cost of Equity

21. **WGL.** WGL proposes a return on common equity of 10.90%, which represents the midpoint of WGL's 10.40% to 11.40% cost of equity range.[50] WGL arrived at its proposed return on equity by measuring the cost of equity of two proxy groups, one composed of nine natural gas distribution companies ("WGL's Gas Proxy Group") and the other, a risk-comparable sample of competitive non-price-regulated companies ("Non-Utilities Proxy Group"),[51] using three methods: the Discounted Cash Flow ("DCF") method, the Risk Premium Model ("RPM"), and the Capital Asset Pricing Model ("CAPM").

22. According to WGL, the DCF method produces a median cost of equity for WGL's Gas Proxy Group of 8.07%.[52] The DCF method requires the use of an expected dividend yield plus an expected growth rate in dividends per share to establish an investor-required cost of equity. WGL calculates the unadjusted dividend yield based on the January 12, 2012 dividend, divided by the average closing price of the last 120 trading days ending January 9, 2012. WGL then adjusts the dividend yield upward by one-half the annual dividend growth rate to make it representative of the next 12-month period for an adjusted dividend yield of 3.8%.[53] WGL relies on the average projected five-year (long-term) growth rate in earnings per share ("EPS") from Value Line, Reuters, Zack's, and Yahoo Finance for a projected long-term growth rate of 4.27%.[54] WGL then adjusts the cost of equity to reflect the difference in business risk between WGL and WGL's Gas Proxy Group. WGL states that, when interest rates are relatively low and utility industry market-to-book ratios are in excess of one, the DCF model often understates investors' required cost of equity. Thus, WGL sees the need to rely on multiple cost of equity models.[55]

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49 *Formal Case No. 1076*, Order No. 15710, ¶¶ 120, 122 (March 3, 2010).

50 WGL (C) at 2 (Hanley).

51 The companies in each WGL proxy group are listed in footnote 24, *supra*.

52 WGL (C) at 26 (Hanley).

53 WGL (C)-6, Column 7 (Hanley).

54 WGL (C) at 25, WGL (C) at 6, Column 6. (Hanley).

55 WGL (C) at 21 (Hanley).

23. Under the second cost of equity model used by WGL, the risk premium method, the cost of equity is determined by corporate bond yields plus a premium to account for the higher risk of equity compared to debt (the risk premium). To calculate the bond yield, WGL uses the consensus forecasts of the expected Moody's Aaa-rated corporate bond yield for six calendar quarters ending with the second quarter of 2013 from Blue Chip Financial Forecasts, which is 4.23%, and then adjusts it upward 39 basis points because WGL's Proxy Group bonds generally are rated A2 by Moody's. This results in an estimated bond yield of 4.62%. According to WGL, an average A2 bond rating of the proxy group is equal to the A2 Moody's rating of WGL's bonds.[56]

24. WGL uses three indicators to estimate the risk premium. The first, the beta approach, involves the development of three different risk premiums and then applying a beta[57] to the average of the three premiums.[58] The second method involves subtracting the arithmetic yield on Moody's A-rated public utility bonds from the monthly returns of the S&P Public Utility Index from 1928 to 2010.[59] The third and final method involves the regression analysis of allowed returns on equity for 301 rate cases of gas distribution companies. The average of three risk premium results (6.14%, 4.42%, and 5.08%) produces an average risk premium of 5.21%, to which WGL added the 4.62% prospective yield on A2-rated public utility bonds for a risk premium cost of equity estimate of 9.83%.[60]

25. With regard to the third method of determining the cost of equity, the CAPM, that method uses the yield on a risk-free interest bearing obligation plus a rate of return that is proportional to the systematic risk of an investment. WGL performs a traditional CAPM and an empirical CAPM ("ECAPM"). An ECAPM is a study using actual market data in order to assess the validity of the CAPM. WGL calculates median cost rates of 10.13% and 11.03% using the CAPM and ECAPM, respectively, for a CAPM cost rate average of 10.58%.[61]

26. WGL applies the same DCF, RPM, and CAPM analysis to the Non-Utilities Proxy Group. WGL states that these companies have similar betas and standard errors which means they have similar total investment risks (non-diversifiable market risk and diversifiable company-specific risk). The results of the DCF, RPM, and average median CAPM and ECAPM cost of equity estimates for the Non-utilities Proxy Group are 11.70%, 10.62%, and 10.36%, of which the median cost rate is 10.62%.[62]

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[56] WGL (C) at 26-27, WGL (C)-8 (Hanley).

[57] Beta measures a stock's volatility, i.e., the degree to which the stock's price will fluctuate. It is used to compare a stock's market risk to the greater market as a whole.

[58] *See* WGL (C) 28-32, WGL (C)-8 at 6 (Hanley).

[59] WGL (C) at 32-33, WGL (C)-8 at 8 (Hanley).

[60] WGL (C) at 33-34, WGL (C)-8 at 1, 8, WGL (C)-11 (Hanley).

[61] WGL (C) at 38-40, WGL (C)-12 (Hanley).

[62] WGL (C) at 40-46, WGL (C)-14 (Hanley).

27. The median of the various methods (DCF,8.07%, RPM, 9.83%, CAPM, 10.58%, and the Non-Utilities Proxy Group, 10.62%) results in a 10.21% cost of equity. WGL then makes two additional upward adjustments to the cost of equity to account for business risks differences attributable to: (1) WGL's smaller size relative to its Proxy Group; and (2) WGL's lack of a decoupling mechanism. WGL argues that smaller companies tend to be more risky, causing investors to require greater returns to compensate them for the greater risks. The Company states that the rate base of the gas distribution companies in WGL's Gas Proxy Group is nine times larger than WGL's rate base. Based on this, WGL believes an upward adjustment of 283 basis points is warranted. However to be conservative, WGL applies an upward adjustment of only 25 basis points to the 10.21% cost of equity.[63]

28. The second adjustment relates to the fact that WGL does not have any decoupling mechanism, while many of the companies in WGL's Gas Proxy Group do. Since decoupling mechanisms tend to reduce risk, and WGL has no decoupling mechanism, WGL believes an upward adjustment to the cost of equity is warranted. WGL argues that both this Commission and the Maryland Commission ordered 50 basis point reductions in Pepco's allowed returns on equity in recognition of decoupling mechanisms. WGL estimates that 95.68% of the customers/meters in WGL's Gas Proxy Group are decoupled; therefore, an upward adjustment of 48 basis points (50 basis points x 95.68%) is warranted.[64] With adjustments of 25 basis points for its small size and 48 basis points for its lack of a decoupling mechanism, Washington Gas calculates a cost of equity of 10.94%, which it rounded downward to 10.90%.[65]

29. In response to OPC's criticism of WGL's use of a Non-Utilities Proxy Group in its analysis, WGL argues that similar betas reflect similar non-diversifiable risks and similar standard errors of the same regression indicate similar company-specific diversifiable risk. The Company asserts that it is the total risk, diversifiable and non-diversifiable, that makes Non-Utilities Proxy Group companies similar to its gas proxy group. The Company submits that it is the common equity used to finance WGL's District rate base that is at issue, not a diversified portfolio of stocks. Consequently, since non-price regulated companies have similar total risk, it is appropriate to use their market-based (DCF, RPM, and CAPM) equity costs rates as indicators of the common equity cost rates of WGL's Gas Proxy Group.[66]

30. Regarding OPC's criticism of WGL's reliance upon analysts' forecasts of EPS growth rates in the DCF model, WGL argues that over the long run, there can be no growth in dividends per share ("DPS") without growth in EPS. WGL contends that EPS growth rates in the DCF model provides a better match between investors' market price appreciation expectations and the growth rate component of the DCF model. The Company states that it is evident that analysts' forecasts have the greatest impact of all accounting measures of growth and hence on

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63 WGL (C) at 46-49, WGL (C)-15 (Hanley).

64 WGL (C) at 9-11, 51-52; WGL (C)-4 (Hanley).

65 WGL (C) at 4-5, 51-52; WGL (C)-4 (Hanley).

66 WGL (2C) at 18-20 (Hanley).

the market prices that investors' pay for stocks. As it relates to the alleged upward bias in analysts' earnings forecasts, WGL claims that the empirical evidence shows that the market discounts any systematic upward bias in forecasts. Additionally, investors are aware of the accuracy of and any perceived bias in analysts' forecasts and reflect that awareness in the price they are willing to pay for a stock.[67]

31. Regarding its RPM and CAPM analyses, the Company disagrees with OPC's estimate of the risk-free rate and the market risk premium. WGL maintains that it is appropriate to use a prospective bond yield or risk-free rate, and not a current or historical yield in RPM and CAPM analyses. In response to OPC's criticisms of WGL's use of long-term historic returns, WGL maintains that the use of long-term data is consistent with the long-term investment horizon for utility stocks consistent with the use of the DCF model. Contrary to OPC's position, WGL asserts that it is appropriate to use the arithmetic mean because it captures the effect of changing economic conditions over time. The Company also argues that OPC's survivorship bias argument should be ignored, maintaining that while the survivorship bias may be compelling on worldwide basis, the entity being valued is WGL and the relevant information is the performance of equities in the U.S. market.[68]

32. **OPC.** OPC relies primarily on the DCF to determine the appropriate cost of equity. Although OPC calculates a CAPM estimate, it believes risk premium studies are less reliable.[69] OPC uses a Gas Proxy Group comprised of eight gas distribution companies, including WGL Holdings that are listed as a Natural Gas Distribution Transmission and/or Integrated Gas Company in AUS Reports and a Natural Gas Utility in the Value Line Investment Survey and have an investment grade bond rating by Moody's and Standard & Poor's. For its DCF analysis, OPC uses a 3.9% unadjusted dividend yield for OPC's Gas Proxy Group, which reflects the median of a six-month average and July 2012 dividend yield, and multiplied by "1 + g/2" to reflect growth over the upcoming twelve-month period. For the growth rate, OPC utilizes Value Line's historical and projected estimates for EPS, DPS, and book value per share ("BVPS"), the average five-year EPS growth rate forecast of Wall Street analysts as provided by Zack's, Reuters, and Yahoo, and prospective sustainable growth as measured by earnings retention rates and earned returns on equity.[70] The historical growth rates for EPS, DPS, and BVPS result in an OPC Gas Proxy Group average growth rate of 4.5%. The projected EPS, DPS, and BVPS growth rates for the proxy group average 4.0%. The average five-year EPS growth rate indicates a 4.6% median growth rate for the OPC Gas Proxy Group. WGL's sustainable growth rate, using retention ratios and earned returns on equity yields a 4.7% growth rate. The average of these growth rates results is a 4.5% expected growth rate. The expected growth rate combined with the adjusted dividend yields an 8.50% cost of equity.[71]

[67] WGL (2C) at 9-10, 20-27 (Hanley).

[68] WGL (2C) at 28-32(Hanley).

[69] OPC (B) at 25 (Woolridge).

[70] OPC (B) at 29-31, OPC (B)-10 at 1-3 (Woolridge).

[71] OPC (B) at 37-39; OPC (B)-10 at 3, 5-6 (Woolridge).

33. In its CAPM analysis, OPC considers a wide range of methods. OPC summarizes the results of over thirty risk premium studies and develops an equity risk premium of 5.01%. OPC then uses this risk premium in its CAPM analysis. It argues that this risk premium is consistent with the risk premium used by Chief Financial Officers, professional forecasters, financial analysts, and leading consultant firms. For its CAPM analysis, OPC notes that the recent range in the 30-year Treasury bond yields has been between 2.6% and 4.0%. Given the prospect of higher rates in the future, OPC uses the upper limits of the range, 4.0%, as the risk-free rate in its CAPM. For its beta term, OPC uses the average of the reported beta of OPC's Gas Proxy Group. The result is a 7.4% cost of equity.[72]

34. Based on its DCF and CAPM analyses, OPC concludes that the appropriate cost of equity range is 7.4% to 8.5%. Giving greater weight to the DCF model, OPC adopts 8.5% as its recommended cost of equity in this case. OPC argues that this result is reasonable because gas distribution companies have the lowest risk as measured by beta, capital costs are at historic lows, utility stocks have been solid performers over the past two years, and because interest rates, inflation, and expected returns on financial assets are low at this time.[73]

35. OPC takes issue with WGL's use of a Non-Utilities Proxy Group asserting that companies in the proxy group are vastly different from gas distribution companies because they do not operate in a highly regulated environment. Additionally, OPC notes that the upward bias in the EPS growth rate forecasts of Wall Street analysts is particularly severe for non-regulated companies, which can inflate the DCF estimate. OPC states that WGL's reliance on the analysts' EPS growth rate forecasts is not appropriate because it has been shown that those forecasts are not accurate."[74]

36. OPC also disagrees with WGL's risk premium analyses. OPC claims that the risk-free rate is grossly overstated, given that the current yield on long-term A-rated utility bonds is below 4.0%; and that given credit risk, the yield to maturity is above the expected return on bonds. OPC contends that WGL's RPM analysis produces an excessive cost rate because the base yield is above current market interest rates and is based on flawed studies of historical, projected, and authorized returns, and does not reflect the growth and expected return realities of the economy and capital markets. As it relates to WGL's CAPM analysis, OPC asserts that the market risk premium approaches used by WGL in its CAPM analysis are the same ones it used in its RPM analysis and contain the same flaws and problems.[75]

37. OPC does not believe any upward adjustments to the cost of equity, due to the small size of WGL as compared to other utilities or due to the lack of a decoupling mechanism, are warranted. Concerning WGL's 25 basis point size adjustment, OPC contends that the historic

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72 OPC (B) at 41-42, 46-48, OPC (B)-11 (Woolridge).

73 OPC (B) at 49-50 (Woolridge).

74 OPC (B) at 52-54 and Appendix B (Woolridge).

75 OPC (B) at 54-63 and Appendix B (Woolridge).

stock and bond return data (Ibbotson) on which WGL relies is flawed because they provide inflated estimates of expected risk premiums due to, among other errors, survivorship bias and unattainable return bias. According to OPC, Ibbotson's size premiums are poor measures for risk adjustment to account for the size of the Company. OPC contends that research has shown that utility stocks do not exhibit a significant size premium primarily because utilities operate in a regulated environment.[76] OPC states that one-half of historical return premiums for small companies disappear once biases are eliminated and historical returns are properly calculated. Additionally, when analyzed over longer periods of time (without annual rebalancing), the size premium disappears within two years.[77]. In regard to the decoupling mechanism adjustment, OPC contends that reliance on two cases is an insufficient basis on which to quantify the impact of decoupling. OPC argues that the impact of revenue stabilization mechanisms ("RSM") is better measured by the percentage of revenue, not the percentage of customers that are subject to RSMs. Further, OPC maintains that WGL has overstated the percentage of customers with full decoupling mechanisms by including customers with just weather normalization adjustments and straight-fixed variable rate designs. OPC states that WGL's Gas Proxy Group receives approximately 60% of its revenues from regulated gas operations, while WGL receives 100% of its revenues from regulated gas operations. Consequently, OPC contends that the stock prices of WGL's Gas Proxy Group reflect the higher risk of its unregulated operations.[78]

38. **AOBA.** AOBA recommends a cost of equity no greater than 9.5%. AOBA's 9.5% cost of equity is based on the average of the results of DCF and CAPM analyses developed for WGL's Gas Proxy Group (excluding WGL Holdings) and a proxy group of gas and distribution companies ("AOBA's Proxy Group").[79] AOBA's first group is a Gas Proxy Group with identical gas distribution companies as WGL's Gas Proxy Group with the exception of the inclusion of WGL Holdings. Its second proxy group is a combination of gas and electric distribution utilities. In its DCF analysis, AOBA estimates unadjusted dividend yields for its Gas Proxy Group and the AOBA Proxy Group of 4.19% and 3.88%, respectively. AOBA adjusts the dividend yields by between 14 and 21 basis points and uses growth rate estimates that range from 3.58% to 5.12%, resulting in an average DCF for both proxy groups of 8.83%.[80] In its CAPM analysis, AOBA uses a risk-free rate of 4.75% and a market-based risk premium of 7.0% to 8.0%. AOBA uses an adjusted beta of 0.67 for its Gas Proxy Group and 0.67 for its Gas/Electric Proxy Group. AOBA's CAPM analysis results are 10.13% and 10.10% for the Gas/Electric and the Gas Proxy groups, respectively, with an average of 10.11%. The average of AOBA's DCF and CAPM estimates is a 9.50% (rounded) cost of equity.[81]

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76 OPC (B) at 67 (Woolridge).

77 OPC (B) at 67-68 (Woolridge).

78 OPC (B) at 66-71 (Woolridge).

79 AOBA (A) at 61; AOBA (A)-3 (Oliver). AOBA's Gas/Electric Proxy Group includes: Atmos Energy, Consolidated Edison, Laclede Group, NiSource, New Jersey Resource Corp, Northwest Natural Gas, Piedmont Natural Gas, Pepco Holdings, Inc., and South Jersey Industries.

80 AOBA (A)-4 at 1-3 (Oliver).

81 AOBA (A)-4 at 1, 4-5 (Oliver).

39. AOBA also challenges the appropriateness of WGL's use of a Non-Utilities Proxy Group. AOBA argues WGL's Gas Proxy Group has significantly less risk, therefore less equity return requirements than WGL's Non-Utilities Proxy Group. AOBA also questions the development of a Non-Utilities Proxy Group based on the comparability of betas. AOBA states that there are other profiles of risk that provide a much broader assessment of risk. AOBA claims that if one were to compare the cost of equity estimates from WGL's models, it would reveal that the non-utility group is riskier than the gas companies.[82]

DECISION

40. The District of Columbia Court of Appeals, in *Metropolitan Board of Trade v. Public Service Commission of the District of Columbia,* 432 A.2d 343, 350 (D.C. 1981), set out the standards for setting rates as follows:

> The Commission, not this court, has the responsibility for establishing rate designs and for setting specific utility rates. *** Rate design principles and specific rates approved by the Commission, however, must be "reasonable, just, and nondiscriminatory." *** This statutory authority is deliberately broad and gives the Commission authority to formulate its own standards and to exercise its ratemaking function free from judicial interference, provided the rates fall within a zone of reasonableness which assures that the Commission is safeguarding the public interest that is, the interests of both investors and consumers. *** From the investor standpoint, courts have defined the lower boundary of this zone of reasonableness as "one which is not confiscatory in the constitutional sense." *** From the consumer standpoint, the upper boundary cannot be so high that the rate would be classified as "exorbitant." [Citations omitted][83]

The establishment of a rate of return on common equity at any point within the range of reasonableness is within the Commission's statutory authority to set just, reasonable, and nondiscriminatory rates.[84]

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[82] AOBA (A) at 59-61 (Oliver).

[83] *See Metropolitan Board of Trade v. Public Service Commission*, 432 A.2d 343, 350 (D.C. 1981) (citing *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942); *Washington Public Interest Organization v. Public Service Commission*, 393 A.2d 71, 76 (D.C. App. 1978), *cert. denied sub nom.*; *Potomac Electric Power Co. v. Public Service Commission*, 444 U.S. 926 (1979).

[84] *See* D.C. Code § 34-1101; *see also Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Waterworks & Improvement Co. v. Public Service Commission of the State of West Virginia,* 262 U.S. 679 (1923); *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1209-1215 (D.C. App. 1982.)

41. In its decisions, the Commission has relied primarily on the DCF method to determine a utility's appropriate cost of common equity because the Commission consistently has found that the DCF method produces results more reasonable than those of other calculation methods.[85] Nevertheless, the Commission's preference for the DCF model does not preclude consideration of other methods like the CAPM and RPM for calculating cost of equity in some instances. In fact, in Pepco's last rate case, the Commission clarified that its reliance on the DCF method did not foreclose the parties from advocating the use of other methods in future rate proceedings.[86] In addition, in determining the just and reasonable cost of equity, the Commission considers the entire record, which may include comparative results derived from other models.[87]

42. The cost of equity using the DCF model ranges from WGL's 8.07% to OPC's 8.50% to AOBA's 8.83%. In determining the cost of equity using the DCF model, the major point of conflict is the appropriate long-term growth rate to be employed in the DCF model.[88] WGL estimates its expected long-term growth rates based on the consensus EPS forecasts of Wall Street analysts which are available from Value Line, Reuters, Zack's and Yahoo Finance.[89] WGL contends that the Wall Street analysts' estimates provide a better match between investors' market price appreciation and the growth rate component of the DCF model. OPC criticizes WGL's reliance on Wall Street analysts' long-term EPS growth rate forecasts contending that the forecasts tend to be overly optimistic and upwardly biased.[90] OPC argues instead that the appropriate growth rate should be estimated using historical and projected growth rates and using multiple sources and measures. Thus, OPC proposes a DCF growth rate based on historical and projected growth rates in EPS, DPS, and BVPS, as well as consideration of the Company's sustainable growth rate.[91] WGL counters that Wall Street analyst forecasts of long-term EPS should receive significant, if not sole, emphasis when employing the DCF model.[92] While the Commission implicitly has given considerable weight to forecasted earnings growth rates in the

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85 *See, e.g., Formal Case No. 939, In the Matter of the Application of the Potomac Electric Power Company for an Increase in Retail Rates for the Sale of Electric Energy* ("*Formal Case No. 939*"), Order No. 10646, p. 38 and n. 16 (June 30, 1995) (citing *Formal Case Nos. 929, 912, 905, 889*, and *869*); *Formal Case No. 929, In the Matter of the Application of Potomac Electric Power Company for an Increase in Retail Rates for the Sale of Electric Energy* ("*Formal Case No. 929*"), Order No. 10387, pp. 38-41 (March 4, 1994); *Formal Case No. 912*, Order No. 10044 (June 26, 1992).

86 *Formal Case No. 939*, Order No. 10646, p. 38 (June 30, 1995).

87 *See, e.g., Formal Case No. 1016*, Order No. 12986, ¶¶ 57-64 (November 10, 2003) (the Commission also considered other record evidence when determining whether adjustments to DCF calculations should be made); *D.C. Telephone Answering Service Committee v. Public Service Commission*, 476 A.2d 1113, 1124 (D.C. 1984) ("the law required only that the approved rate fall within a 'zone of reasonableness'").

88 The dividend yields of WGL and OPC are very similar with WGL's being 3.80% and OPC's 4.0%.

89 WGL (C) at 24-26 (Hanley).

90 OPC (B) at 6 (Woolridge).

91 OPC (B) at 35-38 (Woolridge).

92 WGL (2C) at 28 (Hanley).

recent past, as opposed to historical growth rates in earnings, dividends, book value, and sustainable growth rates using retention ratios and earned returns on equity, we are persuaded by OPC's argument that the forecasted growth rates should not be exclusively relied upon, subject, as they are, to the highly subjective judgment of analysts. Nonetheless, neither WGL's recommended long term growth rate of 4.27% or OPC's rate of 4.5% adequately reflect investors' expectation in that both parties DCF cost of equity estimates are substantially lower than the Company's most recent authorized returns on equity of 9.60% and 9.75% in the Maryland and Virginia retail jurisdictions, respectively.[93]

43. AOBA recommends that the Commission use an average cost of equity of the DCF results of its two proxy groups.[94] WGL argues that AOBA's recommended cost of equity is flawed because the equity cost rate is erroneously mismatched in that it does not comport with either AOBA's recommended capital structure or the actual common equity, which is financing WGL's rate base.[95] Based on our review, we too find that AOBA's recommended cost of equity is flawed for the same reason argued by WGL.

44. WGL maintains that, although it has not proposed an adjustment, the DCF tends to understate investors' required return rate when the market value of the common stock is significantly higher than its book value. We note that gas distribution companies' market prices have been well above book value for more than twenty years. Thus, we must reject the parties' DCF results as being too low when viewed in relationship with current authorized returns of other similar gas utility companies, the effect of authorizing such a low authorized cost of equity on the Company's bond rating, and the potential resulting higher costs for capital that will be borne by ratepayers. We note that all the cost of equity estimates calculated by the parties (WGL's 8.07% to OPC's 8.50% to AOBA's 8.83%), with their respective infirmities, are well below the cost of equity authorized for gas utilities around the country.[96] Based on the foregoing, we believe that consideration of costs of equity using other market-based models is warranted in this case.

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93 *Maryland Public Service Commission, Case No. 9276, In the Matter of the Application of the Washington Light Gas Company for Authority to Increase Its Existing Rates and Charges and to Revise Its Terms and Conditions for Gas Service ("Maryland PSC Case No. 9267"),* Order No. 84475, p. 75 (November 14, 2011); *Virginia State Corporation Commission, Case No. PUE-2010-00139, Application of Washington Gas Light Company for a General Increase in Rates and Charges and to Revise Its Terms and Condition for Service ("Virginia SCC Case No. PUE-2010-00139"),* Order, p. 10 (July 2, 2012).

94 AOBA (A)-4 at 1 of 5 (Oliver).

95 WGL (2C) at 44 (Hanley).

96 We observe that the DCF results in this particular case are well below the recent WGL allowed costs of equity of 9.60% and 9.75% in Maryland and Virginia, respectively. *Maryland PSC Case No. 9267*, Order No. 84475 at 75; *Virginia SCC Case No. PUE-2010-00139*, Order, at 10 (July 2, 2012). *See also* AOBA Br. 44-45. We also observe that the parties' proposed costs of equity are well below the average approved returns on equity for gas utilities over a more recent period (January 2011 to date) of 9.90%. This information was obtained from SNL.com's website from data compiled by Regulatory Research Associates, available at: http://www.snl.com/interactivex/RateCaseHistory.aspx.

45. We note that the CAPM estimates provided by the parties range from OPC's 7.4% to AOBA's 10.11% to WGL's 10.58%, with the average CAPM estimate of the parties being 9.36%. The primary difference in the CAPM estimates is the parties' estimates of the market risk premium. OPC contends that WGL's CAPM-ECAPM equity cost rate of 10.58% is excessive based on WGL's use of a 10.28% market risk premium. OPC calculates a CAPM estimate based on an ex-ante equity risk premium of 5.01%.[97] We find that WGL's CAPM estimate is excessive because of the excessive risk premium.[98] We further note that OPC's resulting CAPM cost of equity of 7.4% is below a reasonable required return, since it is only 1.24% higher than the cost of debt employed for WGL (6.16%) and 0.72% less than the overall rate of return authorized in WGL's last litigated base rate proceeding.

46. WGL asserts that the Commission should also consider the DCF, RPM, and CAPM analysis of its Non-Utilities Proxy Group. WGL states that these companies have similar betas and standard errors, which means they have similar total investment risks (non-diversifiable market risk and diversifiable company-specific risk). WGL contends that the standards set forth in *Hope*[99] and *Bluefield*,[100] *supra*, did not specify that comparable risk companies had to be utilities.[101] While we acknowledge that neither case required that the rate-making process under the Federal Power Act use companies that were utilities, the cases focused on the determination of the returns to the equity owner that were "commensurate with returns on investments in other enterprises having corresponding risks."[102] In this case, the Company has not provided persuasive evidence that the risks that non-utility entities face are similar to WGL's risks. We find the evidence provided by OPC to be more persuasive. These non-utility companies are fundamentally different from the gas distribution companies in that they do not operate in a highly regulated environment.[103] The non-utility entities are subject to greater fluctuations in business risk because of the competition inherent in their respective markets. We

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97 OPC (B)-11 (Woolridge).

98 OPC (B) at 57-62 (Woolridge).

99 "[T]he fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests. *** From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. *** By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944) (Citations omitted).

100 "What annual rate will constitute just compensation depends upon many circumstances, and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties." *Bluefield Waterworks & Improvement Co. v. Public Service Commission of the State of West Virginia,* 262 U.S. 679, 692 (1923).

101 WGL (C) at 40 (Hanley).

102 *Washington Gas Light Co. v. Public Service Commission,* 450 A.2d 1187, 1214 (D.C. App. 1982).

103 OPC Br. 23.

find it noteworthy that WGL witness Hanley was unable to provide the raw data associated with the Company's analysis, even when requested by AOBA's counsel during the cross-examination.[104] Additionally, we find the use of betas as the single predictor of comparable risk for long-term investment to be too simplistic. Betas do not account for changes taking place in the various industries, such as a new line of business or industry shift; are not indicative of what lies ahead for WGL or the non-regulated comparables; and do not address the price paid for the stock in relation to its future cash flow. Overall, based on the evidence provided in this record, we find the Non-Utilities Proxy Group to be less representative of WGL's business risk. In light of the foregoing, we conclude that the specific companies selected are not comparable to WGL.

47. Taking into account the positions of all of the parties, the overall cost of equity recommendations range from OPC's 8.5% to AOBA's 9.5% to WGL's 10.21%. The parties' DCF costs of equity range from 8.07% to 8.83%. WGL's risk premium estimated cost of equity, adjusted to reflect the current yield on a long-term Aa-rated public bond, is 9.21%. The parties' CAPM cost of equity recommendations range from 7.4% to 10.58%. In reviewing the range of the proposed costs of equity, we conclude that none of the experts' presentations are overwhelmingly persuasive to the exclusion of the other views expressed. After considering all the rate of return analyses submitted by the parties, the legal considerations (*e.g.*, *Hope and Bluefield*), and policy arguments regarding the cost of equity and its relationship to just and reasonable rates, we find a cost of equity range of reasonableness to be between 9.0% to 9.5%, because we believe that investors require a return on common equity that is closer to the allowed returns for gas utilities and one that represents a less dramatic decline from the currently allowed return. Within this range, we conclude that, in accord with prior Commission practice, the mid-point of the range (i.e., 9.25%) is the appropriate, just and reasonable cost of equity to be used in determining the cost of capital for WGL.[105]

48. WGL proposes two upward adjustments to the cost of equity, the first to reflect WGL's small size and the second to reflect WGL's lack of a decoupling mechanism. WGL contends that a 25 basis point upward size adjustment is warranted to account for the size of WGL relative to the companies in the WGL Gas Proxy Group based on a SBBI (Ibbotson) study. We are not convinced that, in a regulated environment such as the public utility industry, small size implies greater risk. OPC has presented evidence that utility stocks do not exhibit a significant size premium because all utilities, large and small, are regulated and are not exposed to the size-differentiated competitive pressures seen in unregulated competitive markets.[106] WGL refuted this evidence citing the SBBI 2011 and other materials, which analyze the relationship between size and equity returns.[107] However, we find OPC's position to be more persuasive. According to OPC's testimony, research shows that one-half of the historical return premiums for small companies disappear once biases are eliminated and historical returns are properly

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[104] Tr. 202-209 (WGL witness Hanley).

[105] It has been the Commission's practice to select the midpoint in the range of reasonableness. *See Formal Case No. 929*, Order No. 10387, p. 41 (March 4, 1994).

[106] OPC (C) at 66-67 (Woolridge).

[107] WGL (2C) at 35-38 (Hanley).

computed. Additionally, an analysis of small company stock returns over a long period of time, not just one year (without annual rebalancing), suggests that size premiums disappear within two years.[108] Further, research demonstrates that, with correction of biases in studies, the size premium disappears.[109] Additionally, when asked by AOBA, in AOBA Cross-examination Exhibit 27, WGL was unable to provide a citation to any other rate decision in which an upward adjustment to a utility's cost of equity was granted to reflect a "small size adjustment."[110] Moreover, WGL acknowledges that neither Moody's nor S&P consider size as a factor in developing their respective bond ratings.[111] As the proponent of a new adjustment, WGL has failed to meet its burden of persuasion that the Commission should adopt the adjustment it proposes.

49. Concerning its second proposed upward adjustment, Washington Gas contends that a 48 basis point upward adjustment to its cost of equity is warranted to reflect its lack of a decoupling mechanism. WGL also contends that the stock prices of the many companies in the WGL Gas Proxy Group reflect the effects of a decoupling mechanism. WGL states that many of the companies already have some type of RSM. However, OPC witness Woolridge asserted that the important issue regarding the impact of RSMs on the risk of gas companies is not based on the percentage of customers subject to RSMs, but on the percentage of revenues that are subject to RSMs. Additionally, OPC witness Woolridge noted that WGL's analysis includes customers of companies that have a weather normalization adjustment or straight-fixed variable rates that overstates the percentage of customers fully decoupled. Moreover, because WGL receives 100% of its revenues from its regulated operations while many in the WGL Gas Proxy Group receive only 60% of their revenues from regulated operations, a significant portion of the proxy group's revenues are not subject to a RSM.[112] In fact, 41%, 15% and 12% of the WGL Gas Proxy Group's revenues, assets, and EBIT, respectively, are attributable to unregulated activities.[113] WGL also notes that both this Commission and the Maryland Commission ordered a 50 basis point reduction in Pepco's allowed returns on equity because Pepco was granted a decoupling mechanism that reduced the company's risk. WGL estimates that 95.68% of the customers/meters in WGL's Gas Proxy Group are decoupled. Based solely on these observations, WGL contends that an upward adjustment of 48 basis points (50 basis points x 95.68%) is warranted. Although a reduction in risk may warrant a reduction in basis points, other than its bald assertion, WGL has not shown that the inverse is true such that the absence of a decoupling mechanism should be viewed as an increased risk to the Company. We find that WGL has failed to meet its burden of persuasion and to convincingly articulate the basis for an upward adjustment due to its lack of a decoupling mechanism. We further find that, if indeed

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108 OPC (C) at 67-68 (Woolridge).

109 OPC (C) at 66-68 (Woolridge).

110 AOBA Cross-examination Exhibit 27; AOBA Br. 56.

111 Tr. 184-185 (WGL witness Hanley).

112 OPC (B) at 69-70 (Woolridge).

113 Tr. 167-168 (WGL witness Hanley); Commission Bench Data Request No. 1 (October 12, 2012).

WGL is exposed to slightly higher risks than its Gas Proxy Group because of the lack of a decoupling mechanism, which we are convinced it is not, that risk is offset by WGL's lack of unregulated activities. Therefore, we reject the Company's proposed adjustment to reflect its lack of decoupling mechanism.[114]

Overall Cost of Capital

50. Based on the above findings, we determine that the appropriate overall cost of capital for WGL is 7.93% that is determined as follows.

WGL

Capital Components	**Ratio**	**Cost**	**Weighted Cost**
Long-Term Debt	38.23%	6.16%	2.355%
Short-Term Debt	0.84	1.21	0.010
Preferred Stock	1.63	4.79	0.078
Common Equity	59.30	9.25	5.485
			7.928
			(7.93% rounded)[115]

This rate of return will allow WGL to maintain its financial integrity, attract capital on reasonable terms, and earn a return commensurate with those of other investments of corresponding risks.

IV. RATE BASE [Issue c][116]

51. Rate base represents the investment the Company makes in plant and equipment in order to provide service to its customers. It is the value of a company's property used and useful in providing that service minus accrued depreciation.[117] WGL proposes a net rate base of $206.9 million, a revision downward from the $209.3 million it originally proposed in its

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114 Although our decision is based on the evidence presented, we note that WGL provided only two cases in support of its proposed decoupling adjustment, which is insufficient in our opinion to justify an upward adjustment based on the lack of a decoupling mechanism.

115 WGL shall continue to file with the Commission quarterly reports of its weather-normalized jurisdictional earned returns. These reports shall cover the Company's most recent quarter and the year ending with that quarter. The Company is reminded that it has a continuing obligation to provide this information to the Commission. In addition, the Company shall provide, as part of its reporting, any material events or transactions that could affect the interpretation of the reports. For the purposes of these reports, a material event or transaction is one of the scope and scale that would cause a reasonable person's interpretation of the reports to change.

116 Designated Issue c asks: "Is WGL's proposed rate base -- including, but not limited to, plant in service, CWIP, post-test plant additions and cash working capital – appropriate, properly calculated, and consistent with the proposed adjustments to rate base components and related operating income adjustments?"

117 *Potomac Electric Power Co. v. Public Service Commission,* 380 A.2d 126, 133, n.8 (D.C. 1977).

Application that includes seven (7) rate base adjustments.[118] OPC proposed a net rate base of $188.2 million, $21.1 million less than the $209.3 million originally proposed by the Company and offers six (6) rate base adjustments.[119] The specific rate base adjustments proposed by the parties are discussed below.

A. Uncontested Adjustments

52. Four (4) of the Company's rate base rate-making adjustments ("RMA") are unopposed by the parties: RMA No. 20, East Station Environmental Costs; RMA No. 26, Storage Gas Inventory; RMA No. 27, Materials and Supplies; and RMA No. 28, Supplier Refunds.

DECISION

53. The Commission has reviewed the adjustments that are unopposed or agreed to by the parties and has independently found them just and reasonable. Therefore, we approve these four (4) rate base ratemaking adjustments totaling $(22,702,015).

B. Cash Working Capital (RMA No. 19)

54. **WGL.** Based on the lead-lag study it performed, WGL proposes to include a cash working capital allowance ("CWC") of $15.7 million in rate base, a revision downward from the $18.4 million it originally proposed.[120] The components of WGL's test year lead-lag study used in determining the CWC include: (1) a service lag of 15.21 days; (2) a billing lag (the period between the meter read date and the billing date) of 4.34 days; and (3) a collection lag of 44.58 days, for a total revenue lag of 64.13 days.[121] WGL's CWC also reflects reductions that resulted from the fact that it stopped advancing funds to third-party marketers for the amounts billed on their behalf, as ordered by the Commission.[122]

55. WGL's billing lag is based on three business days. When non-business days (weekends and holidays) are included, the average lag time between meter reading and bill preparation and mailing is 4.34 days, which the Company says is consistent with service level requirements in the Master Service Agreement ("MSA") with Accenture.[123] WGL contends that

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118 WGL's Updated Revenue Requirement, filed October 31, 2012; WGL Br. 21.

119 OPC (A) at 11 (Ramas); OPC Br. 28.

120 WGL (3D) at 39, WGL (D) at 65 (Tuoriniemi); WGL Br. 23. The lower amount reflects $2.7 million in adjustments that OPC proposed which were accepted by WGL.

121 WGL R. Br. 24; WGL (3D) at 27 (Tuoriniemi).

122 WGL (D) at 65-66 (Tuoriniemi); *see Formal Case No. 1016,* Order No. 12986, ¶ 138 (November 10, 2003).

123 WGL (3D) at 28-29 (Tuoriniemi); Tr. 1087-1089; s*ee* OPC (A)-19 (Ramas) (WGL's response to OPC Data Request No. 9, Question No. 9-17(c)).

its calculation of the collection lag comports with accepted accounting practices and Commission precedent. It eliminates the need for any special treatment of bad debt, since uncollectibles are specifically reflected in the lead-lag study as a line item, and the amount included in the study is based on actual charge-offs.[124] WGL contends that its calculations are consistent with the adjustments accepted by the Commission in *Formal Case Nos. 989* and *1016*. WGL claims that, in this case, it is using a one-year computation period for the calculation of the revenue lag that the Commission approved in the two prior cases.[125]

56. WGL's revised CWC includes the impact of several adjustments proposed by OPC and accepted by the Company. In regards to the expense adjustments, WGL agrees with OPC's proposed O&M expense adjustments which reduce labor expense by removing the double counting of the union signing bonus and reduces FICA expense for the double application of average-to-end-of-period factor. These adjustments reduce CWC. WGL also accepts OPC's adjustment that reclassifies OPEB as an employee benefits expense; however, it does not agree that 401(k) expenses should be reclassified, arguing that the amounts are already included in employee health benefits. WGL agrees with OPC's recommendations that the amortization of the pension, OPEB, and regulatory commission tracker balances and carrying costs should not be included in the net lag. The Company also agrees that the environmental regulatory asset, which is reflected in rate base, should not be included in CWC.[126]

57. However, WGL does not agree to the exclusion of uncollectibles, pension and OPEB (including the amortization of the phase-in amounts) expenses from CWC since they represent cash items and, therefore, should be reflected in CWC. In addition, WGL argues that the Costs to Achieve[127] is appropriate for inclusion in CWC due to the fact that the cash outlay for this expense has not been reflected in rates or rate base. WGL contends that including the expense related to the amortization of Costs to Achieve in CWC will generate lower cost to ratepayers. Finally, WGL has included Supplemental Executive Retirement Plan ("SERP") costs in CWC; but concedes that whether these costs are ultimately reflected in CWC will depend on the Commission's decision on WGL's proposed SERP adjustment.[128]

58. **OPC.** OPC proposes two adjustments to CWC. The first is a revision to the revenue lag based on billing days, and the second is to reflect the impact of OPC's proposed expense adjustments in this case. In its first adjustment, OPC argues that the correct revenue lag based on billing days is not based on 64.13 days but 56.42 days, a difference of 7.71 days.[129]

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[124] WGL (3D) at 30-31 (Tuoriniemi).

[125] WGL R. Br. 28-29, citing *Formal Case No. 989*, Order No. 12589, ¶¶ 135-136, 139 (October 29, 2002); and *Formal Case No. 1016*, Order No. 12986, ¶ 139 (November 10, 2003).

[126] WGL (3D) at 32-34, WGL (3D)-7 (Tuoriniemi); WGL Br. 23.

[127] The Costs to Achieve are the costs associated with implementing the Business Processing Outsourcing ("BPO") contract with Accenture LLC for the operation of certain Company functions.

[128] WGL (3D) at 34-38 (Tuoriniemi); WGL R. Br. 30; Tr. 1094 (WGL witness Tuoriniemi).

[129] OPC (A) at 38-43 (Ramas).

OPC contends that the billing lag should be reduced from 4.34 days to 3.34 days and the collection lag should be reduced from 44.58 days to 37.87 days, which would reduce rate base by $3.8 million.[130] OPC contends that the Company's Compliance Filing work papers and the service level agreements of the MSA demonstrate that the billing lag should be reduced by one day to reflect the removal of the lag time between the preparation and subsequent mailing of the bills. As for the collection lag, OPC argues that WGL's 44.58 days collection lag does not recognize the impact of uncollectibles on the collection lag and that WGL should have reduced the 13 month average accounts receivable balance by the 13-month average balance of uncollectible reserves.[131] Citing *Formal Case No. 989*, OPC asserts that the revenue lag should be based on five (5) years of data with regard to the calculation of CWC.[132]

59. In its second adjustment, OPC opposes the inclusion of certain employee benefit expenses that it alleges are in incorrect categories, as well as the inclusion of non-cash and other items in CWC.[133] Specifically, OPC contends that WGL has incorrectly classified OPEB and 401 (k) expenses as part of O&M expense instead of employee benefits expense. It also contends that uncollectible expense, pension expense and OPEB amortization phase-in expense, SERP expense, environmental regulatory asset, and Costs to Achieve should be removed from CWC.[134] OPC also asserts that uncollectibles is a non-cash item that is recovered in rates. In addition, OPC asserts that OPEB amortization phase-in costs should be removed because the costs were deferred during the period in which the Commission phased-in the impacts of the accrual accounting method. According to OPC, these costs were incurred many years ago and are still being amortized in rates and have no associated cash outlay. OPC argues that pension expense is a non-cash item that should be excluded based on the Company's testimony (WGL (D)-4 at 9), which specifically exclude pension benefit because it was a non-cash item. It also argues that SERP should be disallowed as contrary to Commission precedent.[135] Finally, regarding Costs to Achieve, OPC recommends that these costs be removed from test year expenses because they are associated with cash outlays that occurred several years before.[136] Based on the foregoing, OPC submits that its group of adjustments result in an additional $3.5 million reduction in CWC.[137]

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130 OPC (A) at 49-50 (Ramas).

131 OPC (A) at 39-41 (Ramas).

132 OPC Br. 53-54.

133 OPC (A) at 38 (Ramas).

134 *See* OPC (A) at 46-49 (Ramas).

135 *See* OPC (A) at 60-62 (Ramas).

136 OPC (A) at 44-50; see OPC (A)-4, Schedule 7 at 2 (Ramas).

137 OPC (A) at 49-50 (Ramas).

DECISION

60. The Commission finds that the Company's lead-lag study methodology is consistent with what the Commission approved in *Formal Case No. 1016*.[138] The parties do not dispute the calculation of the service lag proposed by WGL in this proceeding; however, they do dispute the appropriate billing and collection lags. OPC contends that the billing lag is overstated and that the collection lag has been calculated incorrectly. WGL maintains that the billing lag has been computed correctly, and that the collection lag, adjusted to reflect certain OPC recommendations, has been calculated properly. Regarding the billing lag, OPC argues that the billing lag should be reduced by one day, from 4.34 to 3.34 lag days, based on its review of the terms of the service level requirements outlined in the MSA. WGL contends that a closer reading of the service level requirements of the MSA and OPC (A)-19[139] shows that the 4.34 lag days is consistent with the terms of the MSA and the computation thereof is reasonable and fully explained. The Company calculates the billing lag based on a three business day lag: a two business day lag between the meter read date and bill preparation date, and a one day lag between the bill preparation date and the bill mailing date. According to WGL, when non-business days weekends and holidays) are factored in over all billing cycles (21 day billing cycle) over the year, the average day lag between meter reading and bill preparation and mailing computes to 4.34 days.[140] Based on our review of the service level requirements of the MSA and WGL's explanation of the billing lag computation process, we accept the Company's representation that its billing lag is, in practice, 4.34 days.

61. Regarding the collection lag, the Commission finds that the Company's approach is reasonable and calculated consistent with the Commission's and industry practices.[141] While we agree with OPC that WGL's use of monthly balances, as opposed to daily balances, could influence the collection lag, OPC's recommended methodology to calculate the collection lag is both inconsistent and inappropriate because it proposes to divide <u>net</u> receivables by <u>gross</u> sales. OPC also argues that the Company fails to factor in uncollectible expense in its lead-lag calculation. We disagree. WGL specifically accounts for uncollectible expense as a separate line item in the lead-lag study. The uncollectible expense amounts used in the study are based on actual charge-offs and not based on bad debt reserves. We find that, because net charge-offs are reflected as a reduction in revenues, it is appropriate to include them in CWC to present an accurate picture of the Company's operating cash requirements.

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[138] In *Formal Case No. 1016*, the Commission directed WGL to file a lead/lag study in all future rate cases. The Commission also directed WGL to reflect in CWC the change in its collection of payments for third party marketers and to provide the supporting documentation showing in its lead-lag study how it calculated and reflected the payments it collected from customers on behalf of third-party marketers. *Formal Case No. 1016,* Order No. 12986, ¶ 139 (November 30, 2003).

[139] WGL's Response to OPC Data Request No. 9, Question No. 9-17 (c).

[140] WGL R. Br. 25.

[141] WGL R. Br. 28, citing Robert L. Hahne and Gregory E. Aliff, *Accounting for Public Utilities*, § 5.04(3).

62. OPC maintains that WGL incorrectly calculated the revenue lag in this case because the Company uses one year of data as opposed to five years of data that OPC alleges we directed in Order No. 12986 issued in *Formal Case No. 1016*.[142] To the contrary, the Commission specifically stated that WGL's CWC should be calculated to reflect 72.92 revenue lag days, which reflects the use of one year of data.[143] In *Formal Case No. 1016*, OPC had proposed using a four year instead of a one year average because of the colder than normal weather.[144] The Commission rejected OPC's recommendation stating that OPC did not make a compelling showing that the colder than normal weather caused the large variance in the revenue lag. The Commission stated that OPC had failed to persuade the Commission why it should deviate from its policy.[145] Based on our review in this proceeding, we find that the calculation based on a one year computation is consistent with Commission precedent, and we, therefore, approve the same.

63. OPC and WGL differ on the appropriate recognition of pension expense, OPEB phase-in expense, SERP and Costs to Achieve in the calculation of CWC. Regarding the phase-in of OPEB expenses and the Costs to Achieve, OPC maintains that while these two items may have involved the outlay of cash in prior years, they do not involve a current outlay of cash and therefore should not be included in the calculation of CWC even if the costs are included as expenses.

64. Regarding Phase-in of OPEB expenses included in CWC, the amortization of these costs was approved in *Formal Case No. 922*, Order No. 10307. The phase-in approach directed by the Commission included a twenty year period that included a five year ramp up.[146] OPC argues that the OPEB costs occurred many years ago and have no associated cash outlay. WGL argues that all amounts collected in rates related to OPEBs are required to be funded and are appropriate to include in CWC. Our review of the contributions made and estimated for fiscal year 2012 show that rather than a reduction in expense, as proposed by OPC, the amount to include in CWC is higher by $314,305.[147] We find that the Company made significant cash outlays for OPEB in 2010, 2011, and 2012 that averaged $4.19 million per year for the District,[148] and this cash outlay is appropriately included in CWC. In a related argument, OPC also asserts that the amortization of the pension expense is largely a non-cash item that WGL has

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142 OPC Br. 54; Tr. 1084-107 (WGL witness Tuoriniemi). OPC incorrectly references Order No. 12589, instead of Order No. 12986, as support that WGL should have used five years of data.

143 *Formal Case No. 1016* , Order No. 12986, ¶ 139 (November 10, 2003).

144 *See Formal Case No. 1016*, OPC (B) at 22-23 (Bright).

145 *See Formal Case No. 1016*, Order No. 12986, ¶139 (November 10, 2003). *See also Formal Case No. 922*, Order No. 12589 (October 29, 2002) and *Formal Case No.989*, Order No. 10307 (October 8, 1993) (revenue lags computed based on the use of one year of data).

146 *Formal Case No.989*, Order No. 10307, pp. 98-99 (October 8, 1993)

147 WGL (3D) at 36 (Tuoriniemi).

148 WGL (3D) at 36 (Tuoriniemi).

previously excluded from its CWC calculations and that exclusion should continue. WGL explains that the costs were excluded when there was a negative pension expense, but should be included when the pension expenses are positive. We found that, beginning in 2010, the Company began making contributions to the pension trust and has averaged cash contributions of $4.17 million per year for the District for the last three years. Rather than a reduction in expense as proposed by OPC, the number should actually increase by $820,425.[149] This cash outlay is appropriately included in CWC.

65. Regarding the Costs to Achieve, the Commission's decision in paragraphs 202-209 explains that WGL has not had an opportunity to recover these costs. We find that, although these are out of period costs, the Company was allowed to defer and amortize the Costs to Achieve. No party has argued that the Costs to Achieve are not prudent costs. The Commission's policy is to compensate a regulated utility for a prudently incurred cost.[150] Based on record evidence, the Commission finds that the Costs to Achieve were prudent. The question before us is how to reflect these prudent costs in rates. The Company testified that the unamortized balance of the Costs to Achieve is $2,132,457.[151] WGL could have proposed to reflect this amount in rate base, but instead the Company reflected the equivalent of one year of amortization expense in the amount of $370,862 in CWC. Including the costs in CWC will result in lower costs to ratepayers because the Company proposes to include the equivalent of one year's worth of the deferred balance in CWC to reflect that the Company has financed these costs. The inclusion in CWC results in return <u>on</u> the amount, not a return <u>of</u> the amount that would have occurred if the Company had included the full amount in rate base and amortized it as an expense over the life of the MSA.

66. Finally, we reject the inclusion of $873,531 of SERP costs in CWC as contrary to the Commission's policy. We held previously in *Formal Case No. 939*, and more recently in *Formal Case No. 1053*, that all costs for SERP should be properly borne by shareholders, not ratepayers.[152] WGL has not provided any arguments that are sufficiently compelling to persuade us to change that policy in this case.

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[149] WGL (3D) at 37 (Tuoriniemi).

[150] *See, e.g., Formal Case No. 917, In the Matter of the Application of Potomac Electric Power Company for Approval of its Second Least-Cost Plan ("Formal Case No. 917")*, Order No. 10291, p. 17 (September 8, 1993) (The recovery of advertising costs is based upon whether they are reasonable and prudent. "This involves the traditional standards of prudent management (*i.e.*, reasonable goals and objectives and the attainment of these goals and objectives in a reasonable manner) and the reasonableness of costs.").

[151] WGL (D), at 96 (Tuoriniemi).

[152] *See Formal Case No. 939*, Order No. 10646, p. 128 (June 30, 1995); *Formal Case No. 1053, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail rates and Charges for Electric Distribution Services* ("*Formal Case No. 1053*"), Order No. 14712, ¶ 190 (January 30, 2008).

C. Gas Plant in Service /Construction Work in Process (RMA No. 30)

67. This adjustment includes the elimination from rate base of $19.5 million, which represents the 13-month average balance of Construction Work in Progress ("CWIP"),[153] additions to plant in service of $1,410,462 for safety-related replacement plant and the addition of $5,733,318 for the new Springfield Center.

1. Safety-Related Additions

68. **WGL.** The Company makes post-test year adjustments and adds $1.4 million to Utility Plant in Service ("UPIS") to reflect the safety-related costs of its distribution mains, services, and meters replacement program.[154] The Company states that the projects include: (1) projects that were open and had CWIP balances at the end of the test year; and (2) projects that were initiated prior to the end of the test year, that were closed to plant in service in the test year and had follow-up costs after the test year.[155] The Company maintains that any costs incurred to make the system safe and more reliable meet the definition of "unique and compelling" circumstances.[156] WGL also contends that the limited nature of the adjustments in this case differs from the traditional safety replacements, which also makes them "unique and compelling."[157] The Company further asserts that the expenditures represent "known and certain changes that can be calculated with precision that were needed, reasonable and beneficial to ratepayers during the rate-effective period."[158]

69. **OPC.** OPC recommends the rejection of the entire post-test year safety plant additions adjustment. OPC argues that: (1) these projects represent regular and routine replacement work that is neither unique nor unusually large;[159] and (2) the Company has not demonstrated that the projects represent known and measureable changes that can be calculated with precision, and are needed, reasonable, and beneficial to ratepayers during the rate-effective period.[160] Moreover, OPC asserts that labeling a plant addition "safety-related" is hardly a distinguishing factor, since virtually all replacement activities include some element of service

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[153] WGL (D) at 73 (Tuoriniemi).

[154] WGL witness Tuoriniemi states that although the Company transferred an additional $1.2 million from CWIP to UPIS for a total of $2.6 million, the Company is still only seeking recovery for $1.4 million.

[155] WGL Br. 25-27; Tr. 263-264, 1053-1054 (WGL witness Tuoriniemi).

[156] WGL (3D) at 11 (Tuoriniemi); Tr. 268 (WGL witness Tuoriniemi).

[157] In a colloquy with Commissioner Fort, the Company stated that projects were determined to be "unique and compelling" based on their individual circumstances, whether there were leaks or damage, and that determined if the plant had to be replaced. Tr. 1144.

[158] WGL (3D) at 11(Tuoriniemi).

[159] Tr. 265-272 (OPC witness Ramas); OPC (A) at 16-21 (Ramas).

[160] OPC Br. 31-34.

reliability or safety.[161] OPC notes that the majority of the work orders were for small scale projects of less than $5,000 each, which is a strong indication that there is nothing “unique and compelling” about the requested additions.[162] OPC further submits that WGL admitted, on cross-examination, that six of the listed projects, constituting $605,000 of the $1.4 million, represent open projects not in service.[163] Thus, OPC claims that the projects are not providing benefits to customers.

DECISION

70. The Commission accepts WGL’s elimination of the 13 month average CWIP from rate base. No party challenges this adjustment to reduce rate base by $19,468,672, and we find it to be appropriate because it represents construction work that has not been completed and that is not currently serving ratepayers.[164]

71. In its proposed safety plant adjustment, WGL is encouraging the Commission to include in the rate base under our “unique and compelling” exception the costs related to all of its safety-related additions that are currently still recorded as CWIP. OPC opposes the adjustment because the projects at issue involve regular and routine repair work and because labeling a project as “safety-related” should not, in and of itself, make a project “unique and compelling” for the purpose of qualifying the project for rate base treatment under the “unique and compelling” exception. Additionally, OPC argues that those projects that are not “plant in service” during the test year should be excluded from the rate base.

72. The Commission’s general rule concerning the inclusion of CWIP in rate base, as repeated in a number of Commission decisions, is that “the rate base of a utility can properly include the cost of a construction project that is in service during the test period, and in appropriate circumstances, a project completed outside the test period, as long as its in-service date is not too remote in time from the test period.”[165] To be placed in rate base, it must be shown that these projects and their related costs are “known and certain changes that can be calculated with precision, that were needed, reasonable, and beneficial to ratepayers during the rate-effective period.” In administering this rule, we have held that “it is reasonable to allow the costs of construction projects to be included in rate base when projects are in fact placed in service before the end of the test year, but are not recorded as being test year plant in service because of delays in bookkeeping.”[166]

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161 OPC Br. 1059; Tr. 249, 268 (OPC witness Ramas).

162 OPC (A) at 21 (Ramas); OPC Cross Ex. No. 43; OPC Br. 34; Tr. 1059-1060.

163 Tr. 1057-1059 (WGL witness Tuoriniemi).

164 In its updated revenue requirement filed on October 31, 2012, WGL shows Gas Plant in Service of $774,447 and CWIP of $(19,468,672) resulting in net amount of $(18,694,225) for WGL Adjustment No. 30.

165 *Formal Case No. 1053*, Order No. 14712, ¶ 68 (January 30, 2008).

166 *Formal Case No. 1053* at ¶ 69 (January 30, 2008) quoting *Formal Case No. 1016* at ¶ 187 (November 10, 2003).

73. The record shows that many of the projects listed in OPC Cross-Examination Exhibit No. 43 were placed in service before the end of the test year, but had not yet been recorded in UPIS. Even OPC concedes that some of the projects included in this adjustment were in service.[167] We have also determined that it is reasonable and consistent with our general policy to include in rate base the costs of these projects that were placed in service before the end of the test year, but have yet to be recorded in UPIS due to accounting differences.[168] Many of the work orders included within OPC Cross-Examination Exhibit No. 43 meet the criterion stated in *Formal Case No. 1016*, *i.e.,* the projects were in service before the end of the test year, but are not recorded in UPIS due to accounting delays. Thus, as we have in the past, we will allow cost recovery of these projects. There has been no showing that the costs were imprudent or that the projects were unnecessary. However, the Company admitted that "[s]ix of the listed projects, all of which involve distribution main replacement activities," totaling $605,000 have no completion and in-service dates.[169] Thus, there is no basis to support the inclusion of these projects in rate base under our general rule. Therefore, we reject the inclusion of the costs related to these six projects in rate base. Our decision reduces rate base by $605,068 and depreciation expense by $16,276.

74. The Commission also has an exception to its general rule under which it has, on at least one occasion, allowed some non-pollution CWIP to be included in rate base if there is a "unique and compelling" reason.[170] At times, parties have mistakenly conflated this exception and the general rule rather than treat it as the exception that it was intended to be.[171] To date, the Commission has only found a "unique and compelling" reason to deviate from its general policy on non-pollution control CWIP on one occasion. WGL was allowed to include some CWIP in rate base in the unique circumstances of *Formal Case No. 989* where there was pronounced regulatory lag. On the other hand, we have rejected a number of requests to apply the "unique and compelling" exception to certain CWIP. For example, in *Formal Case No. 1016*, when WGL argued that many of its replacement CWIP projects were near term projects and some would be placed in service before or during the rate-effective period, and therefore should be allowed into

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167 OPC Br. 35-36.

168 *See Formal Case No. 1016,* Order No. 12986, ¶187 (November 10, 2003).

169 OPC Br. 35, citing Tr. 1057 (WGL witness Tuoriniemi).

170 *Formal Case No. 685*, Order No. 6095, p. 52 (June 7, 1979) (announcing Commission's general policy of excluding CWIP from rate base).

171 We do acknowledge, however, that we have stated in a couple of prior cases that the Commission has allowed the rate base to include the costs outside the test year in certain "unique and compelling circumstances when the (1) project completion date is not too remote in time from the test year; (2) the costs of the project are known; and (3) the project will 'be used and useful' thus beneficial to ratepayers during the entire rate-effective period." We unintentionally and in artfully referred to the "unique and compelling" standard in those cases when we were really referring to the "known and measurable" standard. We did not, and do not, intend to conflate the two standards. *See, e.g., Formal Case No. 1087, In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service ("Formal Case No. 1087")*, Order No. 16930, ¶ 61 (September 27, 2012).

rate base under the exception, we held that "the Company has not presented any "unique and compelling" circumstances that warrant a departure from our general policy in this case.[172]

75. In this proceeding, WGL has classified certain projects as "safety-related additions" and requested that these projects be added to rate base under the "unique and compelling" exception. OPC maintains that these projects, which represent regular and routine replacement work, are not "unique and compelling" warranting extraordinary relief and should not be treated as such merely because WGL has chosen to label them "safety-related additions." We agree with OPC. We were especially struck by the argument made by WGL's witness that every project that has a safety component should be considered within the "unique and compelling" exception. That interpretation would make the exception the rule since there is a safety component in a majority of a utility's CWIP. Our exception has never been that broadly construed, and we decline to change our policy now and give it the interpretation that WGL is advocating. We therefore hold that the safety-related additions that do not qualify under our general rule as discussed above will also be excluded from rate base under the "unique and compelling" exception.

2. The New Springfield Center

76. **WGL.** The Company adds to rate base $5,733,318 to reflect the District's share of the incremental cost of the new Springfield Center. WGL includes only those costs incurred through January 2012 in the revenue requirement.[173] WGL states that 67% of the total monies were expended during the test year and by March 2012, 93% of the costs were incurred, with the remaining costs for the installation of final technology components of the facilities.[174] WGL notes that the old facilities were outdated (42 years old), oversized based on the existing work force, and obsolete.[175] The Company states that, in comparison, the new facilities reflect a more efficient and less costly use of space with an up-to-date infrastructure. The Company claims that annual operating costs are projected to be reduced by approximately $800,000,[176] and the new facilities reflect known and measurable costs.[177] The Company also claims that labor costs will be reduced by $435,068 due to the redeployment of personnel who will not be needed at the new

[172] *Formal Case No. 1016*, Order No. 12986, ¶ 186 (November 10, 2003). *See also Formal Case No. 785, In the Matter of the Application of Potomac Electric Power Company for an Increase in its Retail Rates for the Sale of Electric Service*, Order No. 7716 (December 29, 1982) (Denying Pepco's proposal to include CWIP representing non-pollution control retrofitting of Chalk Point Units 1 and 2 in its 1981 test period rate base because Pepco's "case does not present such unique and compelling circumstances as would persuade us to depart from our fundamental policy.").

[173] WGL Br. 27-29.

[174] WGL (3D) at 14 (Tuoriniemi).

[175] WGL (3D) at 14 (Tuoriniemi).

[176] WGL (3D) at 24 (Tuoriniemi).

[177] *See* WGL (3D)-4 and -5 (Tuoriniemi) (invoices for the primary costs of the new facility and financial information showing the total cost of the facility broken down by vendor).

facilities.[178] The Company does acknowledge that costs will increase by $313,160 to reflect principally higher electricity costs.[179] WGL also alleges that the facilities meet the "unique and compelling" requirement for inclusion in the rate base, and to leave the old facilities in rates would be inappropriate.[180] WGL further contends that the replacement of the old operation center is an extraordinary event, not done in the usual course of business.[181] Finally, the Company claims that a prudency review is unwarranted, all the parties having had an opportunity in discovery to investigate and evaluate the new facilities, and the Company provided sufficient evidence as to the reasonableness of the new facilities.[182]

77. **OPC.** OPC argues that the new facilities do not meet the requirements for post-test year additions inclusion in rate base, nor has the Company presented a "unique and compelling" reason to justify its inclusion. OPC submits that WGL offers no evidence that the costs were needed, reasonable, and beneficial to ratepayers during the rate-effective period. OPC also asserts that WGL failed to show that ratepayer impacts were assessed as part of the analysis regarding whether or not the project was beneficial to ratepayers.[183] OPC claims that, although WGL alleges there will be $800,000 in annual savings ($640,000 in lower gas costs), the bulk of the cost savings will be realized by Maryland and Virginia, with District ratepayers realizing approximately $118,000 in savings. Moreover, according to OPC, there are no labor savings associated with the new facilities, and the bulk of the savings will be in lower gas costs associated with the new building.[184] OPC also asserts that the inclusion of the Springfield Center in rate base would result in a mismatch of the components of the revenue requirement calculations. OPC argues that no analysis has been performed to measure the costs and impact of the new facilities on rates or how the facilities compared to other options. Additionally, OPC questions whether the facilities are properly sized for WGL's workforce.[185] OPC, therefore, recommends that the Commission initiate a prudence review prior to permitting the facilities to be included in rate base.[186]

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178 Tr. 1072-1073 (WGL witness Tuoriniemi); WGL (3D) at 23 (Tuoriniemi).

179 WGL (3D) at 23 (Tuoriniemi).

180 WGL (3D) at 14 (Tuoriniemi).

181 WGL Br. 37.

182 WGL Br. 34-35.

183 OPC Br. 37-41.

184 OPC Br. 41.

185 OPC Br. 42.

186 OPC Br. 40-42; OPC (A) at 24-30 (Ramas).

DECISION

78. OPC argues that Washington Gas has not presented any evidence that the costs were needed, reasonable, and beneficial to ratepayers during the rate-effective period. OPC further argues that there is nothing "unique or compelling" about the new Springfield facility that would warrant including it in rate base.[187] We disagree. Applying the standard discussed above to determine the Center's inclusion in rate base, we find that WGL has provided sufficient evidence in this case that shows that the new Springfield facilities are "used and useful," and the costs just and reasonable and known and certain. The Springfield Center, which was placed in service in March 2012, six months after the end of the test year, currently serves existing customers and will serve customers during the rate-effective period. WGL provided sufficient evidence that the costs are reasonable, known, and measurable.[188]

79. The Company's new Springfield Center replaces the obsolete Springfield Operation Center that cost $8 million to operate and maintain and no longer met the operational needs of the Company.[189] The total square footage of the new facility is less than half of the old facilities and uses half of the acreage it previously used.[190] Although OPC alleges the new Springfield Center may prove to be oversized in light of WGL's Business Processing Outsourcing ("BPO")[191] initiatives, it provides no concrete evidence to support this assertion.[192] OPC argues that most of the savings will go to Maryland and Virginia ratepayers. While that may be true, District of Columbia ratepayers will receive their proportionate share of the cost savings just as they paid their proportionate share of the costs for the inefficient and oversize old facilities.

80. OPC also asserts that inclusion of the costs in rates without the inclusion of related revenues from the sale of the old facilities that ratepayers have helped to finance and the revenues from any self-generation of gas would result in a mismatch of the components of the revenue requirement. OPC's arguments regarding the possible additional revenues that the Company may gain from a sale of the facilities to a buyer for self-generation and the potential sale of the old facilities are speculative at best and do not present a known and certain adjustment that can be made in this proceeding. Nor do they present a reason to prevent known and certain costs from being included in the rate base. We note OPC is free to raise this issue again when the old facility is sold.

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187 OPC Br. 37-38; OPC R. Br. 8.

188 *See* WGL (2D) at 3; WGL (3D)-4 and -5 (Tuoriniemi).

189 WGL R. Br. 37.

190 WGL (3D) at 19 (Tuoriniemi).

191 The BPO is an agreement between WGL and Accenture, LLC that outsourced various business functions necessary for the operation of the Company, including Consumer Services, Finance, Human Resources, Information Technology Services, and Supply Chain areas of the Company.

192 OPC Br. 43.

81. In light of the evidence obtained on this record, we see no reason to conduct a further prudence review of the Company's decision that would be an additional cost burden for rate payers. The Commission provided OPC and the parties with ample opportunity through discovery to evaluate the prudence of constructing the new Springfield Center, including other possible alternatives and the reasonableness of the costs. WGL demonstrated the process that it used to conclude that constructing the new facilities was the best and least costly option for ratepayers.[193] We have reviewed the Company's data, and are satisfied that the old facility had outlived its usefulness, that the Company did consider a range of options, and that the costs of the Center are reasonable. We note that OPC provided evidence that showed that the final cost of the new building was higher than the original planned cost; however, that evidence did not show that the additional costs were imprudently incurred.[194] The replacement of the Company's former operation center was a major undertaking, not an activity usually done in the normal course of business. It involves a significant financial outlay and requires significant design and logistical planning which took several years to complete.[195] The construction of the new facility and the close of the former facility represent the culmination of a process that is intended to provide District ratepayers with up-to-date facilities capable of meeting the Company's and ratepayers' needs today and in the future. Additionally, the new Springfield Center, which has applied for LEED gold certification, is consistent with our efforts to encourage ratepayers to invest in more energy efficient technologies when serving their business and residential everyday needs.[196] The use of energy efficient technologies will help to lessen the need for new power generation facilities; therefore, we find the construction of the new Center to be prudent. Based on the foregoing, we will allow WGL to include the District's share of the incremental costs of the Springfield Center (i.e. $5,733,318) in rate base.[197]

3. Removal of Uncertain Tax Positions (OPC RMA No. 5)

82. **OPC.** OPC requests that the Commission prohibit WGL from retaining $6.8 million for reserves for uncertain tax positions, which will result in an increase in Accumulated Deferred Income Tax ("ADIT") and reduce rate base by $6.8 million.[198] OPC argues that accounting standards[199] require that WGL evaluate and disclose uncertain tax positions, and

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[193] WGL R. Br. 42 (Confidential).

[194] OPC Br. 42-43 citing to testimony of OPC witness Ramos.

[195] WGL Br. 28; WGL R. Br. 37.

[196] WGL (3D) at 14 (Tuoriniemi).

[197] We further note that it would be inappropriate to reflect the unoccupied Springfield Operation Center in rate base.

[198] OPC (A) at 31 (Ramas).

[199] *See* Financial Accounting Standards Board ("FASB") Accounting Standards Codifications ("ASC") -740-10-20; ASC-740-10-25-6; ASC-740-10-25-8. ASC 740, formerly known as FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"), addresses how a company reports uncertain tax positions on its financial statements under a "more-likely-than-not" recognition standard. It requires a company to track uncertain tax positions for both tax compliance and financial reporting. ASC-740 defines an uncertain tax position as the "recognition of tax balances on financial statements that are not recorded on corporate tax returns, if those returns

create a reserve for the uncertain amounts, often referred to as the FIN 48 reserve. OPC argues that the Company should not be allowed to include the FIN 48 reserve in rate base and earn a return on it. To do so would increase rates while failing to reflect deferred income taxes (and actual tax benefits) claimed on WGL's tax returns that represent a cost-free source of funds that should be used to offset rate base.[200] According to OPC, the Commission should follow the Federal Energy Regulatory Commission's ("FERC") guidance ruling on FIN 48 reserve and not allow WGL to use the FIN 48 reserve associated with uncertain tax positions to reduce the ADIT offset to rate base.[201]

83. **WGL.** WGL urges the Commission to continue to allow the reserve to be used as an offset to ADIT. It states that the IRS is currently reviewing the transaction, and, if the IRS were to make a ruling adverse to WGL, it would require the Company to pay the taxes, plus interest. Alternatively, the Company proposes that it be allowed to compute and record a regulatory liability equal to the revenue requirement of the reserve. If the IRS requires the Company to return a portion of the refund, it would be reflected in the determination of the regulatory liability. According to WGL, this would balance its concerns with that of OPC regarding the treatment of this reserve and have no effect on the revenue requirement.[202] The Company submits that it booked a $20.2 million reserve out of an $85.1 million tax refund for uncertain IRS tax positions, which resulted in a 13-month average net cash flow of approximately $60.8 million.[203]

DECISION

84. The Commission finds OPC's argument to remove from rate base the impacts of the uncertain tax positions more persuasive than the positions advanced by the Company. As noted by OPC, the tax savings realized by claiming the deductions represent cost-free money that should be used to offset rate base.[204] The Company should not be permitted to include the FIN 48 reserves in rate base and earn a return thereon, especially when WGL has not paid taxes related to the amounts held in the FIN 48 reserve. This would effectively be increasing rates without recognition of the full deferred income taxes claimed by WGL on its tax returns. We are also persuaded and guided by FERC's ruling on this matter. According to FERC, the FIN 48 reserve

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include uncertain tax positions." A tax position is a position in a previously filed return or position expected to be taken in a future return that is reflected in measuring current or deferred income tax assets or liabilities for interim and annual periods. It can result in a permanent deduction of income tax payable, a deferral of income taxes otherwise currently payable to a future year, or a change in the expected deferred assets. ASC-740-10 clarifies the requirements of ASC-740.

200 OPC (A) at 33-34 (Ramas).

201 OPC (A) at 35-36; s*ee also* OPC (A)-18 (Accounting and Financial Reporting for Uncertainty in Income Taxes, FERC Docket No. AI07-2-00, May 25, 2007) (Ramas).

202 WGL (3D) at 40 (Tuoriniemi); Tr. 1104-1105; WGL Br. 43-44.

203 WGL Br. 15.

204 OPC (A) at 33 (Ramas); OPC Br. 46.

related to uncertain tax positions should not to be used to reduce the ADIT offset to rate base.[205] We also reject the Company's alternative proposal to compute and record a regulatory asset equal to the revenue requirement of the reserve. The Company's alternative proposal would have no impact on WGL's revenue requirement, and thus, would have the effect of maintaining the status quo. We believe that it is reasonable and appropriate that any savings be used to reduce rate base and benefit ratepayers. Therefore, we accept OPC's adjustment and direct WGL to remove the $6.8 million FIN 48 reserve for uncertain tax positions from rate base and to increase ADIT by the same amount.

V. DEPRECIATION [Issue d] (RMA No. 22, 23)[206]

85. The Commission opened this case to investigate WGL's rates, in part because WGL's most recent depreciation study (2010) suggests that the Company's composite depreciation rate should be lowered.[207] Moreover, both this Commission and the Maryland PSC recently set new standards for calculating depreciation while approving new, lower depreciation rates for Pepco.[208]

86. **WGL**. WGL's new 2010 Depreciation Study in Exhibit WG (E)-2 (White), performed by Foster Associates, recommends that WGL periodically update the data that is fed into its system for calculating depreciation, which utilizes the straight-line method, vintage group procedure, and remaining-life technique. The Company used the retirement rate method to estimate average service lives, and it used historical salvage/cost of removal data from 1980 to 2010 to estimate net salvage. Foster Associates recommends a new composite rate of 2.94% for primary account depreciation rates (as compared with the current composite rate of 3.08%). While current rates would provide WGL with an annualized depreciation expense of $17.49 million, the new study would provide an annualized depreciation expense of $16.68 million (a reduction of $810,020).[209]

87. WGL claims that its depreciation proposals are reasonable and appropriate and are not invalidated by the fact that OPC has presented "a different standard of acceptability."[210]

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[205] OPC (A)-18 (Accounting and Financial Reporting for Uncertainty in Income Taxes, FERC Docket No. AI07-2-00, May 25, 2007) (Ramas).

[206] Designated Issue d asks: "Are the Company's new depreciation study developed and depreciation rates calculated in a reasonable and appropriate manner, and are the results of that study properly employed in the determination of the Company's accumulated depreciation and depreciation expense?"

[207] *See Formal Case No. 1093,* Order No. 16770, ¶ 2 (April 26, 2012) (Order and Report on Prehearing Conference).

[208] *See Formal Case No. 1076,* Order No. 15710, ¶¶ 251-252 (March 2, 2010); *Maryland Public Service Commission Case No. 9092*, *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* ("*Maryland PSC Case No. 9092*"), Order No. 81517, p. 30 (July 19, 2007).

[209] WGL Br. 45; WGL R. Br. 44-45; WGL (E) at 11-12 (White); WGL (3D) at 46-47 (Tuoriniemi). WGL states that its depreciation studies should be performed, and parameters adjusted, every 3 to 5 years. WGL Br. 30-32.

[210] WGL R. Br. 45-46; *see* WGL R. Br. 44-46, 63, 69-71.

As a result of the two different studies, WGL submits that the two major depreciation issues in this case are: (1) the appropriate service lives for certain assets; and (2) whether there is any validity to OPC's claim that the Company front-loaded its collection of anticipated net removal costs.

88. *(A)* Service Lives. Using WGL's traditional methodology, blending statistical analysis of past retirement experience with expectations about the future, WGL witness White found that the service lives for WGL's distribution service plant remained largely unchanged from its previous study in 2006.[211] WGL argues that, by contrast, OPC's geometric mean turnover ("GMT") method for calculating service lives is outdated and unreliable because WGL's plant accounts are not stable. Similarly, WGL maintains, OPC's actuarial life analysis technique is outdated. WGL claims that it employs a "more disciplined analysis" that yields more accurate service lives that are significantly closer to industry averages than OPC's recommended service lives.[212] WGL argues that the service-life values estimated in Foster Associates' 2006 study (which OPC accepted)[213] remain reasonable and appropriate at December 31, 2009. WGL argues that it has met its burden of proof to establish the reasonableness of its proposed service lives; and that OPC's alternative opinions about service lives do not show that WGL's proposals are unreasonable.[214]

89. *(B)* Net Salvage Value. Washington Gas submits that depreciation rates traditionally include an allowance for inflation in estimating future net salvage rates.[215] WGL claims this is necessary because a higher percentage rate must be charged when the base is older, lower-cost assets (as opposed to newer higher-cost assets) in order to yield the same dollars-needed-for-removal. The Company also defends its traditional straight-line method (as opposed to a compound interest method, or the Maryland PSC's present value method) for determining accruals for net salvage value.[216]

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211 WGL Br. 33-34; WGL R. Br. 62; Tr. 1209 (WGL witness White). WGL states that the only exception was "structures and improvements" – a category of plant generally covering one or two buildings (and lacking the retirement dispersion of mains or services mass accounts) – where the service life was shortened by 10 years in the 2010 Study.

212 WGL R. Br. 63-69; WGL (2E) at 4-5, 6-9, 11-12 (White).

213 WGL argues that OPC presents no reason why it now proposes increases in service lives ranging from 7 to 24 years for some plant accounts. WGL found it "inconceivable" that within 48 months, the mean service life of steel mains increased from 70 years to 80 years and the mean service life of plastic services increased from 45 years to 55 years when no retirement forces changed during this time. WGL R. Br. 70.

214 WGL R. Br. 44-46, 63, 69-71; WGL (2E) at 9, 10 (White).

215 WGL and OPC agree that net salvage value means "the salvage value of property retired less the cost of removal." WGL (2E) at 14 (White); OPC R. Br. 15; WGL Br. 35-37. WGL states "future net salvage is the estimated cost of removing facilities following the end of their useful lives, reduced by an amount for any gross salvage that may be derived from them." For Washington Gas, the future net salvage is generally negative, which indicates that in the aggregate, the cost of removal of facilities at the end of their useful lives exceeds the salvage that the Company can reasonably expect from such facilities." *Id.* at 35.

216 WGL Br. 37-41. "Regulation has for decades employed the straight-line method to allocate both the initial

90. WGL acknowledges that in a recent Pepco case (*Formal Case No. 1076*) the Commission rejected a depreciation method that charges current customers for future inflation. WGL also acknowledges that this Commission's recent Pepco decision supports a SFAS 143 method for calculating net salvage value. Moreover, WGL acknowledges that the Maryland PSC recently directed it to use SFAS 143 to calculate future net salvage accruals.[217] Washington Gas criticizes the appropriateness of SFAS 143,[218] but nevertheless offers a SFAS 143 formulation that it says properly recognizes retirement dispersion in the computation of discounted net salvage accrual rates.

91. WGL's SFAS 143 formulation is different, however, than what this Commission approved in *Formal Case No. 1076*. There this Commission adopted the SFAS-143 method using formulas from Maryland *Case No. 9092*, with the rate of inflation rate used as the discount factor.[219] The Company submits what it claims is a new, updated and corrected formulation of net salvage value based on SFAS 143 proposals that the Maryland Commission accepted (after modifications suggested by WGL witness White) in its later Maryland *Case No. 9096*.[220] WGL indicates that, under its new SFAS 143 calculation of net salvage rates, WGL's composite depreciation rate is 2.71%, and its annual depreciation expense would be reduced by an additional $1.3 million over and beyond the ($810,020) reduction proposed by Foster Associates'

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cost of an asset and estimated future net salvage over the estimated service lives of plant categories." While this results in higher depreciation rates in earlier years (and lower in later years) relative to other methods reflecting time value of money in accounting for depreciation, WGL states that any issues of fairness are addressed by group depreciation accounting, making it inappropriate to introduce time value of money in accruing for net salvage under WGL's approach. WGL R. Br. 55-56. WGL also submits that the present value of revenue requirements for return and depreciation (including accruals for net salvage) will be identical regardless of how inflation is recognized in estimating future net salvage rates. "The issue is not inflation. The issue that regulators must decide is a policy decision of who should pay for future cost of removal (and when)." WGL Br. 39-40.

[217] WGL R. Br. 56-57. According to WGL, the Maryland Commission found that "a straight-line method is appropriate when net salvage is positive (thereby reducing depreciation expense) but is inappropriate when net salvage is negative (thereby increasing depreciation expense). Stated differently, the Commission found, as a policy matter, that shifting the burden of cost recovery to future customers was in the public interest and a FAS 143 model would achieve that objective." WGL R. Br. 57.

[218] WGL Br. 37 n.116; WGL (2E) at 19 (White). WGL argues that SFAS 143 is an accounting standard that does not dictate how non-legal asset retirement obligations ("non-legal AROs"), such as the future cost of removal, should be treated for ratemaking purposes. WGL Br. 41–43. WGL acknowledges, however, that "who should pay for future cost of removal (and when) is a policy decision" for the Commission. WGL (2E) at 18 (White). WGL states that in *Formal Case No. 1076* this Commission "rejected OPC's modified 'present value' formulas and adopted a 'SFAS 143 method, using the formulas from Maryland Case No. 9092, with the rate of inflation used as the discount factor.'" *Id*. at 18-19, citing *Formal Case No. 1076,* Order No. 15710, ¶¶ 251-252 (March 2, 2010).

[219] *See Formal Case No. 1076*, Order No. 15710, ¶¶ 251-252 (March 2, 2010).

[220] WGL Br. 43-47; WGL R. Br. 58-61; WGL (2E) at 20 (White). WGL states that the "improvement" it made "resulted in an increase in depreciation expense of over $10.3 million" from the Maryland Staff's initial proposal in the more recent *Maryland Public Service Commission, Case No. 9096, In the Matter of the Application of Baltimore Gas & Electric Company for Approval of changes in Depreciation Rates ("Maryland Case No. 9096"),* Order No. 83310 (May 4, 2010).. *Id. see* WGL Br. 37-38, 42, 44; Tr. 414 (WGL witness White).

2010 Depreciation Study.[221] Were this alternative to be taken, it would result in a total reduction of $2.1 million in depreciation expense, reducing WGL's current annualized depreciation expense of $17.49 million to $15.38 million.[222]

92. *(C)* *Whole-Life vs. Remaining-Life Depreciation.* Washington Gas notes that in *Formal Case No. 1076* the Commission ruled that it "will continue to use remaining-life depreciation rates which are designed to have an investment fully depreciated by the time of its expected retirement." The Commission also stated in that case that "adjusting for the amount in accumulated depreciation reserve occurs in the remaining-life technique but does not occur in the whole-life technique." According to WGL, OPC has not presented any compelling reason for the Commission to depart from this precedent.[223]

93. *(D)* *Non-Legal Removal Cost Reserve*. The Company submits that money it collected in advance from ratepayers to pay for the costs of removal should be held in WGL's depreciation reserve for future removal costs.[224] Objecting to OPC's proposed refund of these sums, the Company states that these monies were part of the costs to provide services that ratepayers already have received. While OPC invokes accounting standards to characterize WGL's prior excess collections as regulatory liabilities owed to ratepayers, WGL submits that generally accepted accounting principles ("GAAPs") permit differences between financial and regulatory accounting.[225] According to WGL, "[t]here is no compelling reason to reclassify a portion of the recorded reserve to a 'regulatory liability' account when the so-called 'liability' is created and controlled in the depreciation reserve."[226] WGL witness Tuoriniemi states that no other Commission has adopted OPC's recommendation to flow back existing non-legal asset retirement obligations ("AROs") to ratepayers.[227]

94. WGL states that there is no realistic possibility that it would move its reserve imbalance (the amount of which is disputed) into "income" for its shareholders, since that could happen only if this Commission allowed it, and only in the highly unlikely event that the retail natural gas delivery business was deregulated.[228] WGL criticizes OPC's position for pushing the

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221 WGL Br. 44.

222 *See* WGL (2G)-1 at 6 (White).

223 *See* WGL Br. 45-48; WGL R. Br. 71-74; WGL (3D) at 43 (Tuoriniemi); WGL (2E) at 29 (White).

224 WGL Br. 49-50.

225 WGL (3D) at 44-46 (Tuoriniemi); WGL (2E) at 29 (White).

226 WGL (2E) at 31 (White); *see* WGL Br. 48.

227 This is because WGL "will ultimately be required to expend the money it has accumulated to cover the AROs, both legal and non-legal, as part of the costs of removal for the retired assets. In addition, there is no sound regulatory accounting approach that would suggest that current and future customers are entitled to a refund of amounts collected from previous generations of customers under rates approved by previous commissions. Adoption of this proposal would guarantee a future crisis in rate making that would occur when the Company expends money in the future to retire the assets." WGL (3D) at 48 (Tuoriniemi).

228 WGL (3D) at 49-50, 51, 53-54 (Tuoriniemi). WGL claims that its reserve imbalance is $37 million, which

recovery of removal costs well into the future, "thereby relieving current ratepayers who benefit from the plant serving them today from any responsibility of costs associated with the retirement and removal of such plant." The Company argues that delaying the recovery of removal costs until after an asset's retirement creates generational inequities and is contrary to the principles in NARUC's manual on Utility Depreciation Practices.[229] WGL urges the Commission to follow its recent ruling in *Formal Case 1076*, where it denied OPC's identical proposal to transfer a portion of the utility's recorded depreciation reserves (the component associated with cost of removal) to a regulatory liability, and then to refund the transferred amount to ratepayers.[230]

95. **OPC**. OPC would reduce WGL's proposed annual depreciation expense by at least $7.3 million, lowering it to $10.6 million based on WGL's September 30, 2011 balances. OPC advances four specific arguments, noted below, to support its position.[231]

96. *(A)* *Service Lives.* OPC presents independently-calculated estimated equipment service lives and retirement rates that differ from WGL's figures. According to OPC, WGL's service lives are too short for six of the accounts.[232] They fail to consider WGL's stretched-out future pipeline replacement plans. Moreover, OPC argues, WGL's past estimates of service lives (in its 2006 Depreciation Study) were also too short.[233] OPC argues that its recommended service

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it proposes to amortize over an average 29-year period. WGL R. Br. 74. OPC, by contrast, computed WGL's reserve imbalance as $122 million, and proposes to amortize $97.7 million of that sum (representing OPC's proposed "regulatory liability" for WGL's non-legal ARO reserve) over the same 29-year period. *See* OPC Br. 64, 96; WGL R. Br. 75-76.

229 NARUC's Manual on Utility Depreciation Practices (August 1996) states: "[P]roperty ownership includes the responsibility for the property's ultimate abandonment or removal. Hence, if current users benefit from its use, they should pay their pro rata share of the costs involved in the abandonment of the property and also receive their pro rata share of the benefits of the proceeds realized. This treatment of net salvage is in harmony with GAAP and tends to remove from the income statement any fluctuations caused by erratic, although necessary, abandonment and removal operations. It also has the advantage that current customers pay or receive a fair share of costs associated with the property devoted to their service, even though the costs may be estimated." WGL (3D) at 51-52 (Tuoriniemi).

230 WGL R. Br. 76-80, citing *Formal Case No. 1076,* Order No. 15710 ¶ 239 (March 2, 2010). *See* OPC (2E) at 31-32 (White); OPC (3D) at 55 (Tuoriniemi). WGL also claims that technical errors and inconsistencies plague OPC's testimony on depreciation issues. WGL R. Br. 50-51; WGL (2E) at 32 (White).

231 OPC also attacks WGL's depreciation study more generally as overly detached from WGL's current operations (OPC Br. 66-67) and failing to use informed judgment to deal with anomalous service life figures (*id*. 89-90).

232 *Service Lives*. Relying on industry statistics and the retirement-rate method (using "Iowa Curves" to find the best fit), OPC examined plant turnover rates and concluded that WGL's service lives are "too short" for six accounts. These are: (1) account 367.1 (transmission mains – steel) (OPC argues for a 80 year service life, as opposed to WGL's 60 years); (2) account 376.1 (distribution mains – steel) (OPC urges a 80 year service life, as opposed to WGL's 70 years); (3) account 380.2 (services-plastic) (OPC recommends a 55 year service life, as opposed to WGL's 45 years); (4) account 381.5 (meters – electronic demand recorders) (OPC says a 22 year service life is most reasonable, as opposed to WGL's 15 years); (5) account 382 (meter installations) (OPC advocates a 63 year service life, as opposed to WGL's 45 years); and (6) account 384 (house regulators installations) (OPC argues for a 54 year service life, as opposed to WGL's 30 years). OPC Br. 82-90; OPC (C) at 31-39 (Majoros).

233 OPC Br. 63-65; OPC R. Br. 10-14, citing the growth in WGL's positive reserve imbalance between 2006

lives should be accepted because they "better fit the data" and because its method is more transparent than WGL's.[234]

97. *(B)* <u>*Net Salvage Value.*</u> OPC argues that WGL's net salvage values should be recalculated (specifically, the future costs of removing retired plant), using a method that eliminates the Company's procedure of charging current ratepayers for future inflation.[235] This OPC argument mirrors one that OPC earlier used successfully to lower Pepco's depreciation rates.[236] OPC relies on that Pepco precedent, as well as the Maryland PSC's recent rulings on WGL's net salvage accruals.[237] OPC also asserts that the record does not justify adoption of

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and year-end 2009 as evidence that WGL's existing reserves exceed its needs.

[234] OPC Br. 90. OPC also argues that, contrary to WGL's claims, OPC used geometric mean turnover studies only to corroborate the service lives that OPC developed based on survivor curves. *Id*. at 88.

[235] *Net Salvage Value*. OPC claims that WGL "uses a front-loaded approach that increases the current estimate of future costs of removal by including future inflation into that estimate. WGL * * * charges current ratepayers for future inflation, an expense that has not yet been incurred, which is why this approach is specifically precluded by generally accepted accounting principles (GAAP*)*." OPC (C) at 40 (Majoros); *see* OPC Br. 69-74. "The proper future cost of removal estimates are measured on a present value basis." OPC (C) at 46 (Majoros). OPC states that both its "present-value approach" and WGL's "straight-line method" will accrue sufficient dollars to retire assets at the end of their useful service lives. OPC argues that its present-value approach is superior, however, because it charges current ratepayers only for the present value of future net removal cost estimates, accreting inflation costs and other changes in the present value of the liability over time. OPC claims that its present-value approach therefore does a better job of matching inflation costs to the period in which they are incurred, and ensures intergenerational equity by charging current and future ratepayers on a comparable economic basis. OPC Br. 74; OPC R. Br. 17. OPC argues that WGL's system of crediting excess accruals to the depreciation reserve only mitigates slightly the harm to current ratepayers from WGL's straight-line method. OPC R. Br. 18.

Taking a SFAS 143 approach to calculating net salvage value, OPC argues that the record does not contain sufficient evidence to justify departing from the formulas that the Commission approved in *Formal Case No. 1076 – i.e.*, the formulas used in *Maryland Case No. 9092*. OPC claims that WGL misrepresents the Maryland PSC's depreciation rulings in the later *Maryland Case No. 9096*, which followed the views of Maryland PSC staff and only to an unexplained minor extent the views of WGL witness White. OPC acknowledges that WGL followed a proper SFAS 143 approach in calculating the future cost of removals that are legally required to occur ("legal AROs"). OPC (C) at 45-46. Not so for non-legal AROs however. Following the procedures approved by this Commission in *Formal Case No. 1076*, OPC recalculated the future net salvage ratios and depreciation rates for non-legal AROs. OPC Br. 79; OPC R. Br. 21-22. According to OPC, WGL's conclusion, that it has $37 million in excess depreciation collections, is "understated" and the correct "reserve excess" is $122 million. OPC (C) at 47-49 (Majoros); OPC R. Br. 9, 15-22.

[236] In *Formal Case No. 1076,* this Commission agreed with OPC that Pepco's "net salvage" method created "intergenerational inequity by charging current customers more in 'real' dollars than future customers," so it ordered Pepco to adopt "a net salvage method that minimizes the collection of future inflation from current customers." *Formal Case No. 1076,* Order No. 15710, ¶¶ 248-250 (March 2, 2010). Other Commission rulings addressed the impact of the Maryland PSC's depreciation rulings on the correct calculation of net salvage value. The Commission rejected OPC's modified "present value" formulas modifying SFAS 143, but it ruled that "the formulas from Maryland Case No. 9092, using inflation based discount rates, produce an annual accrual for D.C. distribution net salvage of $7.0 million that is both fair and reasonable." The Commission adopted "the SFAS 143 method, using the formulas from Maryland Case No. 9092, with the rate of inflation rate used as the discount factor." *Formal Case No. 1076,* Order No. 15710, ¶¶ 251-252 (March 2, 2010). *See* OPC R. Br. 19.

[237] OPC Br. 65; OPC R. Br. 16-19. OPC states that the Maryland PSC's most recent decisions hold that Maryland PSC Case No. 9092 formulas continue to be appropriate and that, when used with inflation-based discount

WGL's proposed "corrections" to the net salvage accrual formulas approved in *Formal Case No. 1076*. Moreover, OPC states, the Maryland PSC in *Case No. 9096* largely accepted its own staff's recommendations on depreciation, and only to a limited, minor, unexplained extent, the corrections now proposed by WGL witness White.[238]

98. *(C) Whole-Life vs. Remaining-Life Depreciation.* OPC urges adoption of the whole-life method, instead of the remaining-life technique.[239] OPC advances the same arguments that it made before this Commission in the recent Pepco rate case.[240]

99. *(D) Non-Legal Removal Cost Reserve.* OPC claims that WGL has over-collected from ratepayers for many years to cover its asset-removal obligations, wrongly charging current customers for future inflation, so that today WGL owes a $97.7 million ("large and growing") regulatory liability to its D.C. ratepayers.[241] OPC argues that WGL should put this $97.7 million into a regulatory liability account and flow it back to ratepayers over a 29-year period. This would result in a $3.37 million annual reduction in WGL's depreciation expense.[242] OPC

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rates, they yield "fair and reasonable" net salvage accruals. OPC Br. 77-78.

238 OPC R. Br. 20-22.

239 *See* OPC Br. 65, 90-96; OPC R. Br. 22-23; OPC (C) at 50-57 (Majoros). A switch to whole-life rates, OPC states, calls for acceptance of OPC's recommended amortization proposal. OPC Br. 96-98.

240 In *Formal Case No. 1076*, the Commission found that "OPC has not shown that it would be advantageous to change from the use of remaining-life to whole-life in determining depreciation reserve." *Formal Case No. 1076*, Order No. 15710, ¶ 235 (March 2, 2010). OPC challenges that ruling in the present case and urges adoption of the whole-life approach for WGL. OPC Br. 90-96; OPC (C) at 55-57 (Majoros).

241 With respect to WGL's non-legal removal cost reserve, OPC argues that accounting standard SFAS 143 requires regulated utilities to report "prior excess collections" as "regulatory liabilities owed to ratepayers," if the requirements of SFAS 71 are met. OPC (C) at 60 (Majoros), citing SFAS 143 ¶ B.73. OPC states that, because of SFAS 143 and SFAS 71, "WGL has created a regulatory liability for GAAP financial reporting purposes." *Id.* at 61, 67. According to OPC, WGL thinks that the Company's "D.C. jurisdiction book reserve, including its past over-collections, exceeds WGL Witness White's calculated theoretical reserve by $37 million." *Id.* at 62. OPC quarrels with WGL witness White's theoretical reserve ("understated service lives and future inflated cost of removal ratios") and submits that "WGL's actual positive reserve imbalance is approximately $122 million." *Id.* at 47-49, 63, 76; OPC R. Br. 9.

OPC claims that the problem is that, while WGL has recognized its non-legal ARO reserve as a "regulatory liability" for accounting purposes, it has not done so for ratemaking purposes. OPC (C) at 64 (Majoros). OPC claims that, unless the Commission specifically designates the $97.7 million as a regulatory liability to be returned to customers -- or follows its decision in *Formal Case No. 1076* and orders WGL not to transfer any money out of Account 108 (Accumulated Provision for Depreciation) to income without prior Commission permission -- there is a risk that WGL will take that money instead of returning it to WGL's D.C. ratepayers. *See* OPC R. Br. 24 ("WGL Witness White's treatment fails to ensure that money collected from ratepayers to pay for asset removal will be held and used only for that purpose."); OPC (C) at 65-72 (Majoros); OPC (C)-9 (OPC witness Majoros' November 2005 Public Utilities Fortnightly article on this subject).

242 Alternatively, OPC submits, the Commission could allow the $97.7 million regulatory liability to remain as a permanent rate base deduction "to be used solely for actual cost of removal expenditures." OPC (C) at 76-78 (Majoros); OPC Br. 65; OPC R. Br. 9.

recognizes that this argument was not accepted in *Formal Case No. 1076*. There, this Commission refused to order any flow-back to ratepayers, but it ordered Pepco not to transfer any money from accumulated depreciation reserves to income without prior Commission approval.[243] OPC would accept this same outcome in the present WGL case.[244]

100. **AOBA.** AOBA states that, for depreciation purposes, Washington Gas assumes an average expected life for cast iron pipe of 83.56 years and an average remaining life of 16.44 years. By contrast, AOBA asserts that the average age of WGL's cast iron pipe is already 94.62 years. Moreover, AOBA claims that the Company's pipeline replacement plans indicate that WGL will still have more than 100 miles of cast iron mains in service 50 years from now, while the cast iron pipe covered by WGL's accelerated pipeline replacement program ("APRP") will on average remain in place at least another 25 years. Thus, AOBA submits that the Company's pipeline replacement planning relies on long service lives for its existing cast iron mains, well in excess of the shorter lives which WGL proposes to use for depreciation purposes. AOBA suggests that such large disparities are unwarranted, and it questions whether WGL's depreciation study reflects unreasonably short depreciation lives.[245]

DECISION

101. The Commission's decisions on WGL's depreciation rates are guided by the depreciation principles we recently announced in *Formal Case No. 1076*.[246] Washington Gas's attempt to assert that this Commission and OPC have somehow accepted the methodology of its 2010 Depreciation Study because of its similarities to the 2006 Depreciation Study presented in *Formal Case No. 1054* are misguided because that case ended in a Commission approved settlement agreement, not an Order ruling on the merits of its study.[247]

102. *(A) Service Lives*. Both WGL and OPC presented expert witnesses on the issue of the Company's asset service lives. WGL witness White and OPC witness Majoros disagreed, however, over the appropriate service lives for six disputed asset accounts.[248] WGL claims that its depreciation proposals are reasonable and appropriate and are not invalidated by the fact that

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243 *Formal Case No. 1076,* Order No. 15710, ¶ 239 (March 2, 2010).

244 OPC Br. 101-102.

245 AOBA R. Br. 14-15.

246 *See Formal Case No. 1076,* Order No. 15710, ¶¶ 234-236, 239, 248-252, 254 (March 2, 2010).

247 *See* WGL R. Br. 44, 69; *Formal Case No. 1054, In the Matter of the Application of Washington Gas Light Company for Authority to Increase Existing Rates and Charges for Gas Service* ("*Formal Case No. 1054*"), Order No. 14694, ¶ 31 (December 28, 2007). We also note that OPC did not sign onto that settlement agreement.

248 The specific asset accounts were listed in footnote 231 (These are account 367.1 (transmission mains – steel) (80 year service life); account 376.1 (distribution mains – steel) (80 year service life,). account 380.2 (services-plastic) (55 year service life); account 381.5 (meters – electronic demand recorders) (22 year service life); account 382 (meter regulators installations) (63 year service life); and account 384 (house regulators installations) (54 year service life).

"differences of opinion" have led OPC to propose "a different standard of acceptability" (*i.e.*, reduced depreciation expense)."[249] The selection of service lives is not a simple mathematical exercise in which there is only one right answer. We have used our discretion to choose the appropriate service lives for WGL's assets, taking all the relevant policy considerations into account as part of our responsibility to ensure just and reasonable rates. The service lives for all but six of WGL's asset accounts are not disputed. The Commission has reviewed the uncontested accounts and accepts WGL's proposed service lives and survivor curve shapes for those uncontested accounts as reasonable.

103. Regarding the six WGL asset accounts that are disputed here, we find that OPC's longer service lives and curve shapes are generally better than WGL's as a predictor of the Company's actual historical life data because OPC's recommended lives and curves fit the actual data better than WGL's proposed lives and curves. While the Commission recognizes that service lives and depreciation lives are established for different reasons and therefore will not be identical, we think there should be some consistency between the two. Service lives that are too long might discourage WGL's prompt replacement of older pipe, or undercut the Company's ability to fully recover the cost of older pipe through its depreciation rates before replacement is needed. On the other hand, depreciation lives that are too short and result in a faster recovery of the Company's cost before replacement is necessary, place an unfair financial burden on the ratepayers while making larger reserves available to the Company. Weighing these considerations, and balancing them in the public interest, the Commission has decided to accept OPC's proposed longer service lives for the six WGL asset accounts where service life is disputed.

104. For the six contested accounts, we find that OPC's recommended lives and curves fit the actual data better than WGL's proposed lives and curves. An example, which is representative of the six accounts in issue here, demonstrates why OPC's recommended service lives fit the actual data better than WGL's. For account 382 (meter regulators installations), the actual data shows that at age 60 over 60% of the investment is surviving. However, the life and curve that WGL recommends assumes that at age 60 less than 10% of the investment would be surviving leading us to conclude that OPC's proposed life and curve of 63 years for this account is much closer to the actual data than is WGL's proposal.[250] The record shows the same pattern for the other five asset accounts in dispute here. We gave special consideration to the dispute regarding the two accounts for mains, i.e. account 367.1 (transmission mains – steel) and account 376.1 (distribution mains – steel) where WGL recommended a service life of 70 years while OPC recommended a service life of 80 years. In these two instances, we again find that the service lives recommended by OPC a better fit to the actual data. Thus, our decision to lengthen WGL's depreciation service lives better aligns them with the actual service life data in this record. At the same time, the actual data regarding the replacement of these mains make it most unlikely that WGL would under-recover depreciation on these assets before it actually replaced these pipes in the District. That said, we want to make sure that our decision to approve the longer service lives for these two accounts is not construed as support for delaying the

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249 WGL R. Br. 45-46; *see* WGL R. Br. 44-46, 63, 69-71.

250 *See* OPC (C)-4 at p.40 (Majoros).

replacement of older pipe more quickly, especially where the record shows that the pipe has far exceeded its service life and there has been full recovery of its cost through depreciation.

105. *(B)* Net Salvage Value. With respect to net salvage value, the Commission finds that OPC's proposal to eliminate WGL's method of charging current ratepayers for future inflation is more consistent with our rulings on this issue in *Formal Case No. 1076*. We reaffirm these depreciation rulings, and we find that they are appropriate for WGL for the reasons we stated in *Formal Case No. 1076*.[251]

106. The Commission finds that "inflation expectations" are part of WGL's net salvage analysis. Including inflation expectations in the net salvage analysis effectively calculates the inflated dollar amount of the future net cost of removal in lower-value future dollars, but collects that number of dollars in more valuable current dollars. Moreover, expressing future net salvage costs in future dollars over-charges current Washington Gas customers. The Commission recently addressed this concern in *Formal Case No. 1076*, Order No. 15710 where it directed Pepco to use the present value method in SFAS 143 (recodified in ASC 410) for collecting its future net removal costs using the formulas from Maryland *Case No. 9092*.

107. The Commission directs WGL to use the present value method in SFAS 143 (recodified in ASC 410) for collecting its future net removal costs using the formulas ordered by the Commission in *Formal Case No. 1076*, Order No. 15710, which are the formulas from Maryland *Case No. 9092*. WGL witness White testified that Maryland *Case No. 9096* (rather than Maryland Case *No. 9092*) provides the proper starting point for recalculating net salvage value under a SFAS 143 approach.[252] According to WGL, the Maryland PSC's later decision in Maryland *Case No. 9096* corrected some mathematical errors in the SFAS 143 approach adopted in the earlier Maryland *Case No. 9092*. OPC answers, however, that WGL has misstated the Maryland PSC's depreciation rulings in Maryland *Case No. 9096*, which relied primarily on Maryland PSC Staff and only secondarily, to an unexplained extent, on WGL witness White's latest views.[253] In addition, OPC points out that WGL witness White did not explain the alleged errors in the Maryland *Case No. 9092* formula or the changes to correct them in Exhibit WG (2E)-1.[254] The Commission has reviewed the Maryland PSC's depreciation rulings in Maryland *Case No. 9096*, and we agree with OPC's reading.[255]

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251 *See Formal Case No. 1076,* Order No. 15710, ¶ 252 (March 2, 2010) (finding that "[f]airness and equity require that the Commission adopt a methodology that, to the extent possible, balances the interest of current and future ratepayers" and that "Pepco should not be allowed to charge current customers future inflation, nor should Pepco be allowed to charge current customers in higher-value current dollars for a future cost of removal amount that is calculated in lower-value future dollars.").

252 WGL (2E) at 20 (White).

253 OPC R. Br. 20-22.

254 OPC R. Br. 20.

255 *See Maryland Case No. 9096,* Order No. 83310, pp. 7-8 (May 4, 2010).

108. The Commission approves the use of an inflation-based discount rate as recommended by WGL and OPC and as directed by the Commission in *Formal Case No. 1076*, Order No. 15710.[256]

109. *(C)* *Whole-Life vs. Remaining-Life Depreciation*. In *Formal Case No. 1076*, the Commission recently considered whether to continue its practice of setting depreciation policies using the remaining-life depreciation method or switch to the whole-life depreciation method. In that proceeding, OPC advanced the same arguments for the use of the whole-life depreciation method that it advances in this case. We hold that WGL should continue to use remaining life depreciation rates, for the same reasons that the Commission stated in *Formal Case No. 1076*.[257] Additionally, because remaining-life depreciation rates automatically adjust for any reserve imbalance, OPC's recommended amortization of the reserve imbalance in this proceeding is unnecessary and we decline to make that additional adjustment.

110. *(D)* *Non-Legal Removal Cost Reserve*. OPC maintains that WGL has over-collected from ratepayers the amounts needed to cover its asset-removal obligations resulting in a large and growing $97.7 million regulatory liability that should be flowed back to ratepayers over a 29-year period, resulting in a $3.37 million annual reduction in WGL's depreciation expenses. WGL argues against the creation of a regulatory liability and a refund of these sums to ratepayers because the funds in questioned are in the depreciation reserve. The Commission addressed a similar concern raised by OPC in *Formal Case No. 1076* where we declined to issue a ratepayer refund of any excess funds in a "non-legal removal cost reserve" and conditioned the transfer of monies out of this depreciation reserve into income upon prior Commission approval. WGL and OPC have both agreed that the practice that we put in place in *Formal Case No. 1076* is appropriate for WGL; therefore, WGL may retain all of its funds associated with the cost of removal in a "non-legal removal cost reserve" and shall not transfer monies out of this depreciation reserve into income without prior Commission approval.

VI. TEST YEAR REVENUES [Issue e][258]

111. WGL presents per book test-year revenues of $246,335,260 to which it proposes two revenue adjustments to reduce revenues by $38,574,526 resulting in ratemaking test-year revenues of $207,760,735.[259] WGL originally proposed rates that would result in test year revenues of $236.7 million. WGL presents two major categories of revenues: (1) Sales and Deliveries of Gas; and (2) Other Operating Revenues. The major revenue-related disputes in this

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256 *See Formal Case No. 1076*, Order No. 15710, ¶¶ 251, 252 (March 2, 2010). *See also Formal Case No. 1093*, Tr. 905 (admitting into evidence PSC Exhibit 13).

257 *See Formal Case No. 1076*, Order No. 15710, ¶ 235 (March 2, 2010) (commenting that, among other things, remaining-life depreciation rates are designed to have an investment fully depreciated by the time of its expected retirement).

258 Designated Issue e asks: "Are WGL's test-year revenues, sales, and any proposed adjustments reasonable, including, but not limited to, weather normalization and the repression adjustment?"

259 The two adjustments are RMA No. 1, Revenue Study, and RMA No. 21, East Station Revenue Sharing.

proceeding are the weather normalization adjustment[260] and the repression adjustment. Additionally, in this section are discussed Other Revenue Issues that were raised by parties during the course of this case.

A. Weather Normalization

112. **WGL.** In WGL RMA No. 1, the Company is proposing to reduce test year revenues by $38.5 million to reflect, among other things, colder-than-normal weather during the test period and the currently lower cost of gas for sales customers.[261] The Company states that it followed Commission-approved procedures for calculating its weather-normalized revenues.[262]

113. WGL describes its weather normalization model as a "linear trend" model, approved by this Commission in *Formal Case No. 686*, which better accounts for the trend toward warmer temperatures than models based on simple averages.[263] According to WGL, its model is more accurate than OPC's weather normalization model or the National Oceanographic and Atmospheric Administration's ("NOAA's") historical 30-year average model based on data from 1981– 2010. WGL also claims that its model is more appropriate than Pepco's approach in predicting what the weather is likely to be during the rate effective period.[264] WGL claims that its linear trend model is supported by dozens of articles and studies including NOAA's own research.

114. The Company used a 3-year period (as opposed to OPC's proposed longer period of time) to predict the normalized level of consumption in the rate effective period. WGL argues that the main driver of weather-related natural gas consumption is the stock of appliances that are connected to WGL's system; that 5% to 10% of that stock is replaced every year; and that, consequently, a shorter, rather than a longer, period will provide a better prediction of normalized consumption in the rate effective period.[265] With respect to weather sensitivity

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260 WGL's weather normalization adjustment is made to eliminate the effect that warmer-than-normal or colder-than-normal test year weather would have on its revenues. WGL Br. 51. *See Formal Case No. 686, In the Matter of the Application of Washington Gas Light Company for Authority to Increase Existing Rates and Charges for Gas Service* ("*Formal Case No. 686*"), Order No. 6051, pp. 39-41 (February 13, 1979) (standards for establishing a weather normalization adjustment).

261 WGL (D) at 22-23 (Tuoriniemi); WGL (D)-2, p.2.

262 WGL Br. 53-54. There is one change: WGL now calculates the variation per heating degree day using 36 months of data, instead of 12 months of data. WGL states that this is a minor change that simply results in more data points for analysis. *Id.*

263 *See* WGL R. Br. 84, 85; WGL (2K) at 36-37 (Raab); Tr. 1466-1471 (WGL witness Raab); Tr. 723-727, 733 (WGL witness Wagner); *Formal Case No. 686*, Order No. 6051, p. 40 (February 13, 1979).

264 WGL R. Br. 85-86. WGL claims that there is no reason for it to adopt Pepco's weather normalization model, because Pepco and other electric utilities have a bias toward, and would be benefitted financially by, a "cooler" definition of normal weather for the rate effective period than is likely to occur. WGL R. Br. 86, 87-88; WGL (2K) at 41, 49-51, 54 (Raab); Tr. 1477-1480 (WGL witness Raab).

265 *See* WGL R. Br. 90; WGL (2K) at 35-61 (Raab) (rebutting OPC on WGL's weather normalization method).

analysis, WGL states that it has used the same Commission-approved "structural specification regression analysis in "all of its jurisdictions for at least the last 30 years."[266]

115. WGL claims that OPC's weather normalization model is technically flawed (insufficient coefficients, theoretically incorrect signs, inclusion of irrelevant or meaningless variables) and is therefore unusable.[267] According to WGL, OPC's approach overstates test year revenues and understates the deficiency. Were the Commission to accept OPC's views on weather normalization, WGL argues, then the Company would have to recalculate and increase the District's jurisdictional cost of service (reflecting greater volumes and colder weather for the District), and then it would have to redesign rates from the revised cost of service study based on a new set of billing determinants that reflect a different distribution of weather normalized consumption by each customer class.[268] WGL also argues that, contrary to OPC's claims, the Company's rates are based on the normal weather predicted for the year in which those rates will be effective (not the year after that). WGL states that this will not uniformly produce a warmer estimate of normal weather.[269]

116. **OPC.** OPC criticizes WGL's weather normalization on the ground that WGL calculated normal temperature using a linear regression based on 140 years of its own data (dating back to 1871) rather than using a 30 year average of data from an independent entity such as NOAA. OPC also argues that WGL used inappropriate statistical estimation methods, including a single temperature sensitivity coefficient for all months, to compute "weather sensitivity coefficients" and that WGL used only 3 years of monthly data (instead of 5 years of monthly data) to compute "weather sensitivity" (the relationship between gas consumption and temperature).[270] OPC argues that WGL improperly used estimated normal temperatures for the year after the test year, which "sways its weather adjustment in favor of a warmer test year."[271] OPC also claims that WGL's weather normalization model did not include the price of natural gas. OPC points out that this is contrary to the way WGL calculated its proposed repression adjustment.[272]

117. OPC argues that Pepco and WGL should be directed to use the same weather normalization method to avoid having them both obtain rate increases through "weather

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266 *See* WGL (2K) at 55-58 (Raab) (rebutting OPC on WGL's equations used to quantify weather sensitivity).

267 *See* WGL (2K) at 56-58 (Raab).

268 *See* WGL R. Br. 89-92.

269 *See* WGL R. Br. 86-87; Tr. 1475 (WGL witness Raab); *see also* Tr. 736 (WGL witness Wagner) (WGL used its regression for the year after the test year to calculate weather normalized therm sales for the test year).

270 *See* OPC Br. 103; OPC (D) at 29-30, 36-55 (Mariam).

271 OPC Br. 103-104.

272 OPC Br. 107-108.

normalization." OPC reasons that, if temperatures are warmer than normal, for example, D.C. residents presumably will consume less gas but more electricity.[273]

118. OPC reports that its weather normalization method results in normalized sales and delivery volumes of 310,120,645 therms for the test year, compared with test year actual sales and delivery volumes of 312,991,504 therms and WGL's normalized sales and delivery volumes of 303,424,819 therms.[274] OPC calculated that, for the 30-year period from 1981-2010, there were 4,031 heating degree days ("HDDs") in a normal year, while the number of HDDs actually experienced in the test year was 3,989. OPC's proposed normal weather HDDs for the test year were thus only 42 HDDs (about 1.1%) higher than the actual HDDs. In contrast, WGL's normal weather calculations yielded 3,777 HDDs in a normal year – a difference of 212 HDDs or about 5.3% lower than the actual number of HDDs experienced in the test year.[275]

119. OPC states that: (1) its weather normalization model is based on a comparison between test year temperatures and the most recent 30-year (1981-2010) NOAA normal temperatures; (2) it uses different temperature sensitivity coefficients for each month; (3) it proposes to use at least 5 years of consumption and temperature data; and (4) it uses a "robust estimation method." OPC states that it "incorporated non-weather related variables (*e.g.*, prior consumption, seasons, month, etc., where necessary and statistically valid) that may affect natural gas consumption." OPC's model would increase WGL's D.C. revenues for the test year by $4.3 million.[276]

DECISION

120. The Commission finds that OPC's approach to determine normal weather using 30 years of weather data independently generated by NOAA and third parties provides a better assessment of what the weather is likely to be during the rate effective period than WGL's use of weather data dating back to 1871. Test year HDDs determined by the parties fell along a spectrum. While the test year actual number was 3,989 HDDs, OPC's approach resulted in 4,031 HDDs (only 42 HDDs or 1.1% higher than the actual number) while WGL's approach yielded 3,777 HDDs (212 HDDs or about 5.3% lower than the actual number). While we understand that WGL has used its method in past cases and has made modifications to that method pursuant to an agreement made in a recent Virginia rate case, the results in this case demonstrate the difference between these two techniques and convince us that it is appropriate to change the way that weather studies should be conducted for ratemaking purposes beginning with this proceeding and continuing on a going forward basis. We think the use of more current data that

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273 OPC Br. 104-107.

274 OPC (D) at 53-54 (Mariam).

275 *See* OPC (D) at 32-33, 39-40 (Mariam) (OPC calculated that there are 4,031 HDDs in a normal year in D.C., 254 more than estimated by WGL); Tr. 787–788 (colloquy between Commissioner Fort and WGL witness Wagner) (3,989 is the actual number of HDDs in the test year on a cycle basis, while 3,777 was WGL's estimate of the number of HDDs in the test year).

276 OPC R. Br. 25; OPC Br. 102; OPC (D) at 41-53, 54-55 (Mariam).

is independently generated will better reflect the effects of climate change that are impacting our current weather patterns. Thus, the Commission will use OPC's proposed adjustment to determine its weather normalization adjustment in the present case. OPC's adjustment results in a $4,257,859 increase to WGL's sales and delivery revenues.

121. In future cases, WGL shall use the most recent 30 years to determine normal weather. We are not adopting the use of the end-of-decade 30 year normal data published by the NOAA, as that data may be computed only once every ten (10) years. This is consistent with our prior decisions and reflects the Commission's desire for more recent, stable data.[277] The Commission is not adopting OPC's weather normalization approach or Pepco's weather normalization methodology for use in WGL proceedings. We will remain open to the use of other approaches that are based on the most recent 30 years to determine normal weather in future cases. Consequently, WGL is free to use its best judgment to refine and improve aspects of its weather normalization adjustment provided that the resulting approach uses the most recent 30 years for determining normal weather. Finally, the Commission is interested in, and encourages, "the continual refinement and improvement of the analyses that goes into determining normal weather."[278] To ensure that the Company's weatherization adjustment is fully transparent, WGL is directed to file in all future rate cases all of its work papers related to weather normalization, identify the sources of data it relies upon, explain any statistical models, and provide clearer step-by-step descriptions of how it calculates its weather normalization adjustment.

B. WGL's Requested Repression Adjustment[279]

122. **WGL**. Although this issue is listed under test year revenues, WGL argues that its repression adjustment is not seeking any additional D.C. revenues; rather it is an adjustment to test year billing determinants that are used in the Company's rate design. Specifically, WGL asserts that there will be a 3,400,465 therm reduction in sales in the rate effective period due to repression, which equates to a reduction in sales of $1,802,465 based on the Company's full

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277 *See Formal Case No. 1076,* Order No. 15710, ¶ 40 (March 2, 2010) (Commission approves Pepco's use of the most recent 30 year data to determine weather normalization, rejecting OPC's proposed end-of-decade 30 year normal data). The opinion in that case explained that the most recent 30-year data was the "more recent and stable data," while "using the 30-year period (1971-2000) suggested by OPC would lead to weather normals that drop 10 years of data at a time as a result of moving from one decade to the next." In *Formal Case No. 686,* Order No. 6051, pp. 38-40 (February 13, 1979), the Commission also declined to determine weather normalization based on outdated end-of-decade 30 year data. Instead, the Commission determined weather normalization and HDDs for WGL based on WGL's statistical analysis using a least-squares method, rejecting OPC's 20 year moving average that was not supported by the evidence.

278 *Formal Case No. 1076,* Order No. 15710, ¶ 39 (March 2, 2010).

279 This Commission has defined a repression adjustment as "an adjustment [to test year levels] to reflect the price elasticity of demand." *See, e.g., Formal Case No. 1016,* Order No. 13063, ¶ 15 (February 6, 2004); *Formal Case No. 989,* Order No. 12589, p.32 n.210 (October 29, 2002); *Formal Case No. 729, In the Matter of the Application of the Chesapeake and Potomac Telephone Company for Authority to Increase and Restructure its Schedule of Rates and Tariffs* ("*Formal Case No. 729*"), Order No. 7323, pp. 101-102 (May 28, 1981) (standards for recognizing a repression adjustment).

requested rate increase.[280] WGL argues that the repression adjustment should be used to reflect the repression computation in the derivation of therms in WGL's proposed rate design and in distributing WGL's revenue increase among the customer classes.[281] The Company argues that its proposed repression adjustment meets the criteria established in *Formal Case No. 729* for reviewing repression adjustments in future cases.[282] Specifically, WGL argues that it has presented an econometric model that is free of any significant statistical impairment and it has disaggregated data by service categories in order to determine price elasticity of demand. In response to the requirement that it calculate the dollar amounts needed for the repression adjustment, WGL notes that the adjustment would only change the natural gas costs that are billed through the Purchase Gas Cost ("PGC") and would result in no change to the test year's costs that are billed as part of base rates. Therefore, the Company has provided no calculation of a dollar amount needed for this adjustment; and it has presented the data in the format requested by the Commission. WGL offered two options for its repression adjustment: an adjustment in the form of a uniform reduction to test year quantities using a system-wide elasticity value or a repression adjustment in the form of a uniform per therm change applied equally to all customer classes. WGL's preferred adjustment would apply separate repression adjustment to various customer classes to minimize the interclass subsidies.

123. **OPC.** OPC opposes this adjustment, asserting that WGL's methodology is statistically unsound and based upon unrealistic price elasticity studies that yield imprecise and unreliable results. OPC also argues that WGL's repression adjustment methodology suffers from significant statistical impairment because it omits household income levels and the price of gas substitutes such as electricity.[283] OPC also criticizes WGL's use of the PGC prices to estimate the price elasticity for base rate prices and notes that WGL's witness admitted that he had done no study of how customers respond to changes in base rates.

124. **AOBA.** AOBA argues WGL's price elasticity studies are unrealistic. They are presumed to measure the impact on consumption from comparatively small changes in total customer bills resulting from WGL rate increases. AOBA notes, however, that these studies fail to reflect the fact there have been dramatic swings in gas prices over the last six or seven years which did not result in large variations in WGL customers' natural gas usage.[284] For this reason, AOBA argues the repression adjustment should be rejected.

[280] WGL Br. 54-55.

[281] WGL R. Br. 81-82; WGL (3D) at 56-57 (Tuoriniemi).

[282] *See* WGL Br. 54-57 (citing *Formal Case No. 729*, Order No. 7323, p. 98, 101-102 (May 28, 1981), and recommending separate repression adjustments for all Residential customers, all Non-Residential customers, and all Group Metered Apartment customers, to minimize the interclass subsidies that likely would occur when applying a common elasticity estimate); WGL R. Br. 92-103; WGL (K) at 8-12 (Raab); WGL (2B) at 3-34 (Raab).

[283] *See* OPC Br. 109-116; OPC R. Br. 25-26.

[284] AOBA Br. 94; AOBA R. Br. 16-19; *see also* AOBA (A) at 76 (Oliver) (price elasticities for utility services are a useful conceptual construct, but their practical application in ratemaking determinations is fraught with problems and generally yields imprecise and unreliable results); AOBA R. Br. 17 (commenting that delayed customer reaction to price changes creates difficult questions for any repression adjustment).

DECISION

125. The issue of repression adjustments is as contentious today as it was over 30 years ago when the Commission, by Order No. 7323, prescribed the parameters whereby a utility could, through econometric models, propose a repression adjustment to address the potential effect of higher rates on a utility's sales.[285] The Commission has defined a repression adjustment as "an adjustment [to test year levels] to reflect the price elasticity of demand."[286] The idea is that, per the law of demand, consumers tend to respond to higher prices by cutting back on the purchases when the price increases. The greater the response to price changes, the more "price elastic" the demand for the good. Historically, the Commission has recognized the economic phenomenon of price elasticity[287] and theoretically accepted that, all things being equal, an increase in rates may tend to "repress" volumes consumed by ratepayers. While other local utilities appear to have abandoned requests for a repression adjustment as part of their base rate cases, WGL has continued to request repression adjustments in its base rate case application in the District of Columbia – although not in neighboring jurisdictions. This Commission approved a repression adjustment for WGL in *Formal Case No. 1016* in a split decision.[288] In the current proceeding, as was the situation in past WGL proceedings, there have been technical econometric disputes mainly surrounding the issue of a proper price elasticity study that is devoid of any statistical impairment.[289]

126. After careful review of the parties' submissions and the policies underlying the repression adjustment, the Commission has decided to reject WGL's repression adjustment. The complex calculations supporting WGL's proposed repression adjustment have been challenged by OPC and AOBA with a variety of both theoretical and practical objections. As AOBA noted, the theoretical basis for WGL's proposed repression adjustment is highly questionable, since the dramatic swings in gas prices over the last six or seven years did not result in large variations in WGL customers' natural gas usage. OPC noted that WGL conducted no customer studies to

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285 *Formal Case No. 729,* Order No. 7323, p. 101-102 (May 28, 1981). First, all econometric models must be shown to be free of any significant statistical impairment; second, service categories are to be disaggregated for purposes of determining the price elasticity of demand and for calculating the dollar amounts of the repression adjustment required; and third, the company must submit a description of the methodology used to estimate the changes in test-year costs which are expected to have resulted from the effects of repression.

286 *See, e.g.*, *Formal Case No. 1016*, Order No. 13063, ¶ 15 (February 6, 2004); *Formal Case No. 989,* Order No. 12589, p. 32 n.210 (October 29, 2002); *Formal Case No. 729,* Order No. 7323, pp. 101-102 (May 28, 1981) (standards for recognizing a repression adjustment).

287 *Formal Case No. 729,* Order No. 7323, p. 101 (May 28, 1981).

288 *See Formal Case No. 1016,* Order No. 12986, ¶¶ 74-84 (November 10, 2003) (Commission splits 2-1 in accepting WGL's repression adjustment to weather-normalized test year data), reconsideration denied, *Formal Case No. 1016,* Order No. 13063, ¶¶ 14-41 (February 6, 2004). Given that the Commission has approved a repression adjustment for WGL only once in its history, we believe it fair to say that no serious reliance interests are affected by the Commission's decision today ceasing to recognize this controversial adjustment.

289 *See Formal Case No. 989*, Order No. 12589, ¶¶ 78-96 (October 29, 2002); *Formal Case No. 922*, Order No. 10307 at 196-197 (October 8, 1993); *Formal Case No. 729,* Order No. 7323, pp. 98-102 (May 28, 1981).

measure how the changes in gas prices impacted their usage. We have previously required a utility to identify and distinguish with precision the various different causes of its repressed demand. The precise basis for the proposed repression adjustment is especially important in a restructured market in order to ensure that we do not compensate a utility for purely competition-related losses (such as when gas customers switch to electric appliances) and to ensure that the proposed adjustment does not give a utility a competitive advantage over other suppliers. WGL is before us in this proceeding in its role as a natural gas distribution company operating in the competitive market that now exists for the sale of natural gas in the District of Columbia.[290] Indeed, after our decision to grant a repression adjustment in *Formal Case No. 1016*, significant new supplies of natural gas have been developed and have come into the market. Yet, the Company provided no demonstration in the present case that the repression adjustment the Company received in 2003-2004 accurately predicted the impact of WGL's rate increase on natural gas consumption by District ratepayers. Also notable, is the fact that in this case, WGL did not provide a test year revenue requirement impact for its adjustment and instead seeks to adjust the test year billing determinants. That change seems at odds with a rate design that the Company proposes that moves towards a higher customer charge. In light of these concerns, and the concerns we identify in the following paragraph, we do not see a need to further analyze the various academic arguments that the parties have raised about each other's price elasticity studies. Suffice it to say, WGL's affirmative case, and its responses to the challenges raised by OPC and AOBA do not persuade us that a repression adjustment through test year billing determinants should be approved for in this proceeding.

127. We have also decided that it is time for us to eliminate repression adjustments as an appropriate ratemaking adjustment in future rate proceedings for utilities under our jurisdiction as a matter of regulatory policy. In our view, a repression adjustment has no continuing viability in a restructured environment. Recently there also have been significant changes in the District's regulatory environment, including the creation of a Sustainable Energy Utility ("SEU"), that affect gas consumption and cast further doubt on the continued validity of repression adjustments generally in this jurisdiction. Indeed our research has not uncovered any other jurisdictions in a restructured market that recognizes repression adjustments today.[291] Our judgment is that all these factors weigh against continuing to recognize a repression adjustment for WGL and any other local distribution company.[292]

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290 *See Formal Case No. 1016*, Order No. 12986, Chairman Yates' Dissent pp. 1-2 (November 10, 2003).

291 It should be noted that WGL did not request a repression adjustment in the Company's last rate cases in our neighboring jurisdictions. *See Maryland PSC Case No. 9267*, Order No. 84475 (November 14, 2011) and *Virginia SCC Case No. PUE-2010-00139*, Order (July 2, 2012).

292 Our ruling eliminating repression adjustments as a matter of regulatory policy is explained by the "reasoned analysis" set out in the text above (¶ 126), which shows that, for good reason based on changed circumstances, our prior policy is being "deliberately changed, not casually ignored." *See Watergate East v. Public Service Commission*, 665 A.2d 943 (D.C. 1995) (court upholds this Commission's change of policy – approving a change in Watergate rate design from a test year method to a pass-through method – since the Commission provided a "reasoned analysis" indicating that the prior policy was being "deliberately changed, not casually ignored.") *and see Federal Communications Commission v. Fox Television*, 556 U.S. 502, 515-516, 523, 525 (2009) (when an agency changes position, it ordinarily must indicate its awareness that it is changing position and that there are good reasons for the new policy, but it need not demonstrate to the satisfaction of a reviewing court that the reasons for the new policy are better than the reasons for the old one). *See also id.* (Agency action is not subject to a "heightened" or

C. Other Revenue Issues

128. **WGL.** WGL includes in its "Other Operating Revenue" category, items such as late payment fees, asset optimization revenues, third-party balancing charges, Watergate revenues, and transportation revenues. With respect to transportation revenues, which are the only revenues that are disputed in this category in this proceeding, the Company explains that it has eliminated $64.5 million of per book transportation revenues from the miscellaneous category in its Company financial statements to avoid double-counting because WGL performs its normal weather study using the volumes of gas transported for sales customers and delivery service customers and its level of revenues for ratemaking purposes reflect the anticipated revenues from both types of customers.[293] In response to AOBA's proposed revenue adjustment for omitted Interruptible Revenues, WGL argues that pursuant to its long-standing practice, the Company accounts separately for Interruptible Revenues, outside the context of base rates and rate cases.[294] WGL responded that the AOBA proposed adjustment shows a lack of understanding of the Commission's practice of how Interruptible Service customer revenues are returned to firm customers through the Distribution Charge Adjustment ("DCA") mechanism, which is not a base rate mechanism. WGL disputes AOBA's suggestion that the Company calculated Peak Usage Charge revenue in a manner inconsistent with its tariff and argues that the suggestion, which was first raised on brief, is untimely, lacks clarity, and is incorrect because the Company's weather normalized revenues are correctly and consistently computed. Additionally, the Company urges the Commission to reject AOBA's suggestion that the Commission require additional information about Transportation Service Revenues and therms by rate classification in base rate case filings, arguing that the information was included in electronic workpapers

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more searching standard of court review simply because it represents a change in administrative policy). *Fox Television* was decided under the federal Administrative Procedure Act ("APA"), 5 U.S.C. § 551 *et seq*., especially 5 U.S.C. § 706(2) (judicial review), which is analogous to the relevant parts of the D.C. Administrative Procedure Act ("DCAPA"), D.C. Code § 2-501 *et seq.,* especially D.C. Code § 2-510(a)(3) (judicial review). Consequently, *Fox Television* is persuasive authority for construing the meaning of the DCAPA on these issues. *See Pendleton v. D.C. Board of Elections and Ethics*, 449 A.2d 301, 305 (D.C. 1982). The Commission's ruling in this case, eliminating repression adjustments for WGL, satisfies the standards of DCAPA as interpreted in both *Watergate East* and (by analogy) *Fox Television*.

293 WGL Br 52-53.

294 WGL responded that AOBA's claim reflects unfamiliarity with the way that Interruptible customer service rates are set, or their effect on other Firm customer rates. WGL states that: (1) Interruptible gas sales service customers are charged rates based on value-of-service pricing, which changes monthly; (2) accordingly, the amount that WGL collects from its Interruptible customers cannot be known in advance; and (3) this makes it impossible to include Interruptible revenues in the Company's CCOSS. To account for this practice, WGL collects revenues from Interruptible customers and then credits them to WGL firm customers through the Company's Distribution Charge Adjustment ("DCA"), which operates outside the context of base rates and rate cases. WGL argues that its system accounts for Interruptible revenues and shows that there is no basis for AOBA's claim that WGL "omitted" or neglected to account for $19.2 million in Interruptible customer revenues. *See* WGL R. Br. 81; WGL (2J) at 5 (Wagner). *See also Formal Case No. 1016,* Order No. 12986, ¶ 336 (November 10, 2003) (explaining calculation of Interruptible rates and stating that revenues from the Interruptible class are shared with other WGL firm customers through WGL's DCA).

provided in response to data requests and could have been found with a due diligence review by AOBA.[295]

129. **AOBA.** AOBA claims that the manner in which WGL has developed and presented its test year revenues at present rates undermines the credibility of the Company's overall assessment of its test year revenues and raises four specific issues for the Commission to consider.[296] First, AOBA witness Oliver's direct testimony proposes that that WGL's test year revenues should be increased by $19.2 million to incorporate "omitted" Interruptible Service revenues.[297] Second, in its brief, AOBA looks at the revenues associated with the Company's core business of the delivery of gas to make sure that it has properly accounted for gas that is delivered to customers that purchase it directly from the Company and for the gas that WGL is paid to transport to customers for third-party suppliers. AOBA claims that the Company did not provide adequate detail regarding its actual test year revenues and therms for Transportation Service customers by rate class and therefore it is impossible for the Commission to certify that all test year Transportation Service revenues and therms have been properly included.[298] AOBA contends that WGL at first reflected all of its Transportation Service revenue on Line 20 of "Other Miscellaneous Revenue" but subsequently removed the Transportation Service revenue and did not re-assign that revenue directly to rate classes.[299] AOBA argues that the continued classification of more than $64.5 million of Transportation Service revenue (an amount equal to 25% of the Company's core business) as "Other Miscellaneous Revenue" does not properly reflect the unbundled nature of the Company's rates and is no longer reasonable or appropriate.[300] AOBA argues the Commission cannot verify that the Company has properly identified and re-assigned test year Transportation Service revenue and therms by rate classification. AOBA suggests that in future base rate filings, the Commission direct the Company to include detail about its actual test year Transportation Service revenue and its Non-Gas Sales Service revenue by rate class prior to applying its ratemaking adjustments for normal weather.

130. Third, AOBA argues that the Company understated the appropriate computed Peak Usage Charge revenue for non-residential customers because it was calculated in a manner that is inconsistent with the Company's tariff. According to AOBA, WGL witness Tuoriniemi conceded on cross-examination that although the tariff requires that the Peak Usage Charge revenue be calculated using each customer's maximum average daily consumption in the prior November through April period (i.e. the "maximum billing month"), the Company conceded that

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295 WG R. Br. 83. *See* WGL R. Br. 62-63.

296 AOBA Br. 59-65.

297 *See* AOBA (A) at 70-74 (Oliver); (and AOBA Br. 64-65, n.63 (claiming WGL provided insufficient "breakdown" of information on therms and revenues for Interruptible customers and that WGL under-reported its normal weather test year revenues by $389,368).

298 *See* AOBA Br. 60, n.71.

299 See WGL (D)-3, Adjustment 1 of 41, Line 20 and Tr. 326.

300 AOBA Br. 61, n.73 and Tr. 326-327.

it made its calculations using the assessment of Peak Usage under normal weather conditions for the test year, i.e. for January 2011 which is not the "maximum billing demand" as defined in the Company's tariff. AOBA argues that a more detailed and accurate assessment of the Company's application of its tariff provisions to normal weather usage is required if WGL is going to rely on estimates of Peak Usage Charge revenue under normal weather conditions as part of its development of test year revenues for its base rate proceedings.

131. Finally, AOBA argues that the record of this case contains discrepancies in the delivery volumes for the Company's Interruptible Service customers that result in a significant understatement of the Company's normal weather therms for Interruptible Service customers and leads to an understatement of Normal Weather Test Year Revenues for both WGL's Interruptible Service and for the Company's District of Columbia jurisdiction. AOBA submits that WGL's Normal Weather Study shows that actual test year volumes for the Company's Interruptible Service were 109,263,189 terms while the Normal Weather volumes for that class is shown to be 107,408,650 therms.[301] AOBA maintains that a 2,489,564 therm difference is never explained and yields a $389,368 under-reporting of Normal Weather Test Year revenues at both present and proposed rate levels, assuming it would be priced at the Company's tail block rate for Interruptible Transportation Service.[302] AOBA also argued that, in future cases, WGL should be required to provide more detail regarding actual test year Transportation Service revenues and therms by rate classification.[303]

DECISION

132. WGL has correctly stated that the Commission does not include Interruptible Service revenues as part of the test year revenues in a base rate case.[304] Therefore, we are rejecting the proposed AOBA adjustment to WGL's test year revenues to include Interruptible revenues. AOBA does, however, raise valid concerns about how Transportation Service revenues are reflected in base rate filings and how Interruptible Service revenues are being tracked, recorded and reflected. With respect to AOBA's suggestion concerning Transportation Service revenues, we think it is both reasonable and appropriate under our restructured market for the Company's Transportation Service revenues, which now reflect around 25% of the Company's revenues, to be isolated from the "Other Miscellaneous Revenues" category. Therefore, we are directing the Company in future base rate filings, to include detail about its actual test year Transportation Service revenue and its Non-Gas Sales Service revenue by rate class prior to applying its ratemaking adjustments for normal weather. Furthermore, we are concerned that WGL has not clearly explained how it collects, uses, and accounts for Interruptible Service

301 AOBA Br. 64.

302 AOBA Br. 64-65.

303 AOBA Br. 60-61.

304 *See, e.g., Formal Case No. 1016,* Order No. 12986, ¶ 336 (November 10, 2003); *Formal Case No. 840, In the Matter of the Application of District of Columbia Natural Gas, A Division of Washington Gas Light Company for Authority to Increase Existing Rates and Charges for Gas Service* ("*Formal Case No. 840*"), Order No. 8569, p. 84 (September 5, 1986).

revenues, which raises several issues, such as: (1) what are the current numbers, types and usage patterns of the customers now in WGL's Interruptible Sales and Interruptible Delivery Service classes; and (2) what principles explain how WGL splits up the revenues it collects from the Interruptible Service class, using some of this money to fund the Residential Essential Service program,[305] while sharing other Interruptible Service revenues with WGL's firm customers through the Company's DCA. These are issues that need to be resolved outside of a base rate case proceeding; therefore, the Commission is opening a separate investigative proceeding to collect more information on these issues. With that information, and comments from all interested parties about the best way to deal with WGL's Interruptible Service classes in the future, the Commission may then assess whether WGL's value-of-service Interruptible Sales Service should be terminated (as the Maryland PSC has done), whether WGL's margin sharing of Interruptible Service distribution revenues should be adjusted or ended, and whether revenues from the Interruptible Service and Watergate classes should be included in WGL's class cost of service studies in the future.[306]

133. We decline to decide the two remaining issues that AOBA raised for the first time in its Reply Brief. Although we have verified that AOBA correctly stated the Peak Usage Charge language in WGL's tariff, there is insufficient evidence for us to decide whether the Company has improperly calculated the Peak Usage Charge revenues according to the tariff in a manner that has impacted the test year revenues for this proceeding. Similarly, AOBA has not presented sufficient detail for us to adopt the revenue adjustment that it proposed in its Reply Brief for the first time to correct what it alleges to be a $389,368 under-reporting of Normal Weather Test Year Revenues in this proceeding. AOBA or any other party is welcome to raise both of these issues in a future proceeding for the Commission's consideration.

VII. TEST YEAR EXPENSES [Issue f][307]

134. Test year expenses include what a company spends to operate and maintain its distribution system; to pay employee wages and benefits; to purchase materials and supplies; to pay interest on the company's debt; to pay federal, state and local taxes; and the costs of other direct business expenses adjusted for known and measurable changes to make it reflective of the rate-effective period. WGL presents per book test-year expenses of $219,669,714 and proposes to reduce these expenses by $13,546,270 resulting in ratemaking expenses of $206,123,444.[308]

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305 *See* Tr. 1414-1419 (WGL witness Wagner) (explaining the sources of funding for the RES program).

306 AOBA submits that terminating WGL's current margin sharing arrangement would simplify WGL's determination of cost-based rates for Interruptible service in future cases. According to AOBA, it also would increase the amount of revenue recognized as contributing to WGL's overall rate base requirement, raise WGL's resulting rates of return, and lower the Company's revenue requirements. AOBA Br. 82-83.

307 Designated Issue f asks: "Are WGL's test year expenses and any proposed adjustments reasonable, including but not limited to, pension and OPEB, executive compensation, outsourcing and uncollectibles?"

308 WGL (D)-1 at 1. WGL's Updated Revenue Requirement, October 31, 2012, proposes to reduce expenses by $13,757,092, resulting in ratemaking expenses of $205,912,623.

A. Uncontested Adjustments

135. The following expense adjustments are either unopposed, or are agreed to by the parties: RMA No. 2, Uncollectible Gas Accounts; RMA No. 3, Purchased Gas Costs;[309] RMA No. 4, D.C Delivery Tax; RMA No. 5, D.C. Rights-of-Way Fees;[310] RMA No. 6, D.C. Income Taxes; RMA No. 7, Federal Income Taxes;[311] RMA No. 12, Employee Benefits Expense;[312] RMA No. 13, FICA/Medicare Taxes;[313] RMA No. 15, Trade Association Dues, Business and Civic Memberships and Support Payments; RMA No. 16, AGA Dues; RMA No. 17, General Advertising; RMA No. 18, Community Affairs; RMA No. 20, Environmental Costs; RMA No. 24, Tax Depreciation; RMA No. 25, Interest on Debt (Interest Synchronization);[314] RMA No. 29, Regulatory Commission Expense; RMA No. 31, Property Taxes;[315] RMA No. 32, Postage Costs; RMA No. 33, Insurance; RMA No. 34, Fuel Costs; RMA No. 35, Interest on Customer Deposits; RMA No. 39, Safety Initiatives; RMA No. 40, Affiliated Allocations; and RMA No. 41, Sustainable Energy and Energy Assistance Trust Funds. In addition, the Company has accepted

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309 Although none of the parties oppose the methodology WGL uses to compute RMA Nos. 2 and 3, WGL and OPC differ on the synchronization adjustments to be applied to these adjustments, which reflect their respective proposed weather normalization adjustment discussed in Issue e. The Company's final adjustment will reflect the Commission's approved weather-normalization adjustment.

310 WGL RMA Nos. 4 and 5 represent pass-through taxes. WGL is required by District of Columbia law to collect the funds and remit them to the District of Columbia Government. They are reflected as a surcharge on customer bills. No party contests the methodology used to calculate these charges. WGL's and OPC's recommended adjustments reflect their proposed weather-normalization adjustments in Issue e. The Company's final adjustments will reflect the Commission's approved weather-normalization adjustment.

311 None of the parties challenges the methodology used to compute D.C. and Federal income taxes. Both WGL and OPC compute District and Federal income taxes at the D.C. tax rate of 9.975% and Federal tax rate of 35%, respectively. Each party's adjusted District and Federal incomes tax amounts reflect the impact of the parties' recommended adjustments to the revenue requirement.

312 None of the parties challenges WGL's employee benefits expense adjustment. However, OPC does challenge the Company's proposed adjustments to wages and salaries related to WGL's employee gross-up factor (head count) (OPC Adjustment No. 10) which affects this adjustment. The final employee benefits expense adjustment will reflect the Commission's decision as to the appropriate employee head count.

313 None of the parties filed testimony directly in response to WGL's proposed FICA/Medicare adjustment. However, OPC's proposes adjustments related to the employee gross-up factor and at-risk compensation (WGL's proposed Adjustment No. 9) which affect this adjustment. WGL's FICA/Medicare Taxes adjustment will be revised to reflect the Commission's decision on the Company's appropriate employee head count used in calculating at-risk pay.

314 Interest synchronization is a flow-through calculation based on the interest on debt. No party challenges the methodology used to calculate interest synchronization. The final flow-through interest synchronization adjustment will be calculated based on the weighted cost of debt and the adjusted rate base.

315 None of the parties contests the methodology the Company uses to calculate property taxes. Both WGL's and OPC's proposed adjustments reflect their respective proposed test-year plant-in-service balances. Since property taxes are a flow-through item, it will be calculated based upon the Commission's final authorized plant-in-service balance.

two expense adjustments that were made by OPC: OPC RMA No. 1, Removal of Non-Existent Meters; and OPC RMA No. 2, Correction to ENSCAN Meter Depreciation Expense.[316]

DECISION

136. The Commission has reviewed the adjustments and independently finds them to be just and reasonable. Therefore, we approve the above ratemaking adjustments for this proceeding subject to our determination of the final revenue requirement.

B. Ratemaking Adjustments

1. Purchase Gas Costs (RMA No. 3)

137. **WGL**. The Company is proposing to decrease operating expenses by $19.8 million to reflect a decrease in the Purchase Gas Cost ("PGC") which includes both the capacity costs and the commodity costs.[317] The Company has not adjusted the transportation and storage cost components of the capacity costs but it has adjusted the commodity component to reflect normal weather and the most recent projections of future gas prices. WGL notes that it followed the same methodology as it has used in the past to calculate the PGC, therefore the adjustment should be approved. Although no party challenged the methodology used to compute this adjustment, the Company recognizes that its test-year expense would need to be adjusted in the event that the Commission accepted OPC's synchronization adjustments to test-year revenues.[318] Additionally, based on the colloquy between Chairperson Kane and the Company during the hearings, WGL updated its revenue requirement to include a new adjustment, Bench 1, which removes gas purchase costs from the revenue requirement.[319] According to WGL, a similar issue was raised by the Maryland Public Service Commission and WGL made an adjustment to move these costs out of the costs of service and to include them in the purchase gas cost.[320]

DECISION

138. Based upon information elicited from the Company during the hearings and on an evaluation of the testimony presented in this proceeding, we have determined that purchase gas administrative expenses in the amount of $113,960 for non-distribution PGC related expenses, *i.e.*, hedging, purchasing, and billing costs, should be removed from the Company's revenue

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316 WGL and OPC agree on the ENSCAN Meter Depreciation Expense adjustment but not the applicable deprecation rate. The depreciation rate to be applied in this adjustment will be determined by the Commission's decision in Issue d.

317 WGL Br at 60 and WGL (D) at 25-26.

318 *See* WGL (C)-3, page 2 of 3 (Hanley); OPC (B)-5, page 1of 3 (Wooldridge). WGL R. Br. 103-104.

319 *See* WGL Updated Revenue Requirement, Adjustment Bench I (October 11, 2012).

320 Tr. 372-373 (WGL witness Tuoriniemi).

requirement.[321] These costs were not segregated in the costs of service as originally filed in this rate proceeding.[322] With these costs removed and with the synchronization adjustments proposed by OPC, we accept the Company's proposed PGC adjustment to decrease operating test year expenses in the amount of $113,960. WGL is also directed to revise its tariff such that these PGC administrative costs that we have removed will now be recovered through the gas administrative charge.

139. In this proceeding, we noted that the Company's filings included items that are not under the jurisdiction of this Commission. Since the Commission is mandated to set rates for distribution only, we direct Washington Gas to submit future rate case filings in such a manner that distribution-only rate base, revenue, and expenses (and any adjustments thereto) are easily discernable from the Company's other regulated matters, such as purchased gas and transmission rate base, revenues, and expenses. In other words, Washington Gas may continue to present its adjustments as it has in this case, but it must prepare a separate schedule that starts with the District's totals, and then it must remove all non-distribution items. The Company shall also provide the adjustments made to derive the distribution items, along with all associated work papers.

2. Deferred Income Taxes / Medicare Part D (RMA No. 8)

140. **WGL.** WGL proposes to amortize over five years the District's share of the $16.1 million Medicare Part D regulatory asset totaling $2.670 million that was created when the recent changes in the tax law repealed the Medicare Part D tax credits that the Company previously received.[323] Because WGL provides prescription drug benefits equal to or greater than those provided under Medicare Part D, it had qualified for a non-taxable subsidy from the federal government, which had the effect of lowering other post-retirement employee benefit expense ("OPEB") and WGL's effective tax rate. However, as a result of the Patient Protection and Affordable Care Act[324] and the Health Care and Education Reconciliation Act[325], effective March 23 and March 30, 2010, respectively, (collectively referred to as the "ACA"), future Medicare Part D tax benefits are eliminated. The elimination of the Medicare Part D tax benefit is expected to increase WGL's effective tax rate by 1%. Therefore, the Company included the District's amortized share of the Medicare Part D regulatory asset in the amount of $294,148 in the reconciliation of the effective tax rates. The Company alleges that the establishment of the Medicare Part D regulatory asset is consistent with the Non-Unanimous Agreement of Stipulation and Full Settlement ("Settlement Agreement") and Order on Settlement[326] in *Formal*

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321 Tr. 1155-1164 (Colloquy between Chairperson Kane and WGL witness Tuoriniemi).

322 *See* WGL Updated Revenue Requirement, Adjustment Bench I (October 11, 2012).

323 WGL Br. 104.

324 Public Law 111-148, 124 Stat. 119.

325 Public Law 111-152, 124 Stat. 1029.

326 *Formal Case No. 1054*, Order No. 14694, ¶ 11 (December 28, 2007).

Case No. 1054 and the Commission's traditional treatment of changes in the tax law.[327] WGL notes that the Commission historically incorporates the impact of changes in the tax laws when those changes affect the amount of taxes paid in the future, citing to *Formal Case No. 1087*, Pepco's recent base rate case, where the Commission approved the amortization of Medicare Part D.[328]

141. WGL argues that to require it to write off this expense would preclude WGL from collecting from customers a benefit they received in the past to which they were never entitled. "Customers should not be enriched under the presumptions of one set of tax regulations, while the Company is penalized when that presumption is modified by subsequent tax law changes."[329] Addressing OPC's opposition to this change, the Company submits that OPC confuses the effect on taxes for regulatory purposes due to changes in the laws related to temporary tax differences with a permanent change in the taxability, such as Medicare Part D.[330] The Company contends that the Commission has historically reflected the effect of changes in taxation in the determination of income tax for ratemaking purposes, a fact that OPC does not dispute.[331]

142. In response to OPC's allegation that ratepayers have not fully benefited from Medicare Part D because a portion of this asset comes from amounts accumulated before the tax benefit was passed onto ratepayers, WGL counters by stating that the amount was reflected in *Formal Case No. 1054*'s test year and therefore the benefit was passed on to ratepayers in the rates from that proceeding.[332] WGL states that OPC's argument is essentially the same as the one made and rejected by the Commission in *Formal Case No. 1087*.[333]

143. **OPC.** OPC contends that, instead of writing off Medicare Part D to expense in March 2010, as required by Generally Accepted Accounting Principles ("GAAP"), WGL inappropriately recorded it as a regulatory asset.[334] OPC claims that WGL did not meet the criteria for establishing a regulatory asset because in order to establish a regulatory asset, there must be probable future revenues in the amount being capitalized and the revenues must be tied to the specific item being deferred.[335] OPC asserts that neither the Settlement Agreement nor the

[327] WGL (D) at 31-32 (Tuoriniemi).

[328] WGL Br. 105, citing *Formal Case No. 1087*, Order No. 16930, ¶ 254 (September 27, 2012).

[329] WGL (3D) at 69-70 (Tuoriniemi).

[330] WGL (3D) at 67 (Tuoriniemi).

[331] WGL (3D) at 70 (Tuoriniemi); WGL R. Br. 105.

[332] Tr. 240-241(WGL witness Tuoriniemi); *see also* OPC Cross Examination Ex. No. 9 (A WGL response identifying that "[t]he favorable tax benefit of Medicare Part D was reflected in rates effective December 31, 2007 in Formal Case No. 1054").

[333] WGL R. Br. 104-106; WGL (3D) at 63-70 (Tuoriniemi); Tr. 239-246.

[334] OPC Br. 132; OPC (A) at 78 (Ramas).

[335] OPC Br. 133; OPC (A) at 79 (Ramas).

Commission's Order on Settlement mentions the Medicare Part D benefit in that they both reference either new taxes or changes in the current income tax rates. OPC argues that the provision in the ACA, removing the deductibility related to prescription drug benefits, is not a "new tax" and is not a change in the current tax rates,[336] but rather it is a future change in the deductibility of an item that was previously deductible. Additionally, OPC argues that ratepayers have not fully benefited from the deferred tax asset because a substantial portion of the deferred tax asset pertains to amounts accumulated before the tax benefit was passed on to ratepayers.[337] OPC also argues that numerous other tax law changes that resulted in bonus depreciation and accounting changes for the Company have not resulted in deferrals as regulatory liabilities.[338] Based on the above, OPC requests that the amortization of the regulatory asset be disallowed and that WGL be required to treat it as an expense. OPC submits that deferred income tax expense be reduced by $115,349 to remove the impact of the Company's proposed $249,148 amortization of the Medicare Part D regulatory asset.[339]

DECISION

144. The Commission finds that WGL's treatment of the increase in Medicare Part D expenses that occurred due to changes in the tax law is reasonable. The Commission previously approved a similar adjustment in *Formal Case No. 1087.* When tax deductions are eliminated, it increases costs to the Company and, by extension, to ratepayers. Ratepayers received the benefit of the Medicare Part D tax deduction in the past, and it is only fair that they bear their responsibility for costs resulting from subsequent changes in the tax law. The courts and the Commission have long recognized that, as between shareholders and ratepayers, burdens should be borne by the group that received the benefit giving rise to the burden.[340] We again choose to apply this principle in the present case. In this instance, ratepayers who received the tax-saving benefits in the early years should be responsible for the later years' costs associated with the disallowance of the benefits. The Commission approves the Medicare Part D regulatory asset in the amount of $2.670 million, which will be recovered over a five-year period as requested by the Company. WGL shall file specific testimony in subsequent rate cases to demonstrate that it has "trued up" for ratemaking purposes its initial estimates of the adjustment approved by the Commission for taxes on Medicare Part D expense.

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336 OPC (A) at 82 (Ramas).

337 OPC Br. 133-134.

338 OPC (A) at 82-85 (Ramas).

339 OPC Br. 131-136; OPC (A) at 76-85; OPC (A)-4, Schedule 15 (Ramas).

340 *See, e.g., Washington Public Interest Organization v. Public Service Commission*, 393 A.2d 71 (D.C. 1978)*; Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission*, 158 U.S. App. D.C. 7, 485 F.2d 786 (1073); *Formal Case No. 647*, Order No.7411, p. 3 (October 6, 1981).

3. Wages and Salaries (RMA No. 9)

145. **WGL.** WGL proposes a labor expense adjustment of $535,342[341] which reflects: (1) annualized basic payroll[342] for all test year employees on the Company's payroll as of September 30, 2011; (2) wage increases for union employees pursuant to current contracts and estimated upcoming contract renewals; (3) wage increases granted to all non-union employees in October and December of 2011; and (4) at-risk pay for all employees.[343]

146. Consistent with *Formal Case No. 1016*, the Company includes scheduled wage increases for: (1) Teamster Union Local No. 96 (effective June 1, 2012) to reflect a 2.25% general wage increase and a $500 per employee signing bonus amortized over the three year life of the contract; (2) Office and Professional Employee Local No. 2 (effective April 1, 2012) to reflect a 2.50% base wage increase; (3) Production and Maintenance Unit of Local Union No. 1900 (effective August 1, 2012) to reflect a 2.00% general wage increase; (4) Clerical Unit of Local No. 1900 (effective August 1, 2012) to reflect a 2.00% general wage increase; and (5) Shenandoah Gas Division International Brotherhood of Teamsters Local 96, which will expire prior to the rate effective period in July 2012. No additional wage data was provided for this contract.[344]

147. WGL further states that, to retain its existing workforce and attract new employees, the Company has historically granted performance-based increases for management and executive employees, in December and October, respectively, of each year. As basic payroll was annualized using September 30, 2011 information, the merit increases for management and executive employees paid in 2011 (for fiscal year 2010 performance) were included. The increases for fiscal year 2011 were awarded and reflected in pay in October 2011 and December 2011, one month and three months after the close of the test year respectively. The total system at-risk pay for executives is $7.9 million ($3.8 million for short-term incentives and $4.1 for long-term incentives). Of this total, $6.7 million was attributed to WGL and of that, 18.92% or $1.3 million was charged to the District. The Company then charged 80.70% to O&M.[345]

148. The Company calculates a labor expense of $18.5 million. The test year labor expense was $18.0 million, to which the Company adds a ratemaking level adjustment of $0.5

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341 WGL Br. 63-64. Originally, the Company had proposed a labor expense adjustment of $552,080. It conceded that it double counted the amortized portion of the Teamsters Contract Signing Bonus and reduced this adjustment by $16,618 to $535,342. WGL (3D) at 71 (Tuoriniemi).

342 The Company calculates basic payroll for the test year by first determining total monthly base wages and salary (excluding overtime, shift bonus, etc.) for the Company's workforce as of September 30, 2011, then multiplying that sum by 12 to get an annual wage, which is adjusted for overtime, part-time employees, shift bonuses, and other compensation paid during the test year. WGL (D) at 36 (Tuoriniemi).

343 WGL (D) at 33 (Tuoriniemi).

344 WGL (D) at 37-39 (Tuoriniemi).

345 WGL (D) at 37-42 (Tuoriniemi).

million.[346] The total annualized payroll was based on the employee level for September 2011. WGL calculates the average employee level for the test year to be 1,268 employees, which was higher than the September 2011 level of 1,259 at the end of the test year. Therefore, WGL makes a corresponding adjustment to increase the total payroll by 100.72%.[347] WGL asserts that OPC's focus on the employee level for only the first three months of the year in determining the appropriate head count is inappropriate, since employee levels are consistently lower during this time period due to retirements. WGL reiterates that the Commission precedent is to use the average test year employee levels as opposed to end-of-year employee levels.[348]

149. **OPC.** OPC opposes the Company's 100.72% employee gross-up factor because it overstates the number of employees in comparison to WGL's September 2011 employee head count and its employee head count for the rate-effective period. OPC argues that the Company's D.C. employee count has actually decreased from both the test year average of 1,268 and the September 2011 level of 1,259 to a March 2012 level of 1,241.4, which is 17.6% less than the September 2011 level and 26.6% less than the average test year level. OPC points outs that the decrease continued from April to August 2012. It contends that as of August 2012, there were 1,224.4 employees, which is 43.6% fewer than the average test year number, and 34.6% fewer than September 2011. OPC proposes to reduce labor costs by $132,570, employee benefit expense by $21,029, and payroll tax expense by $18,402.[349]

DECISION

150. The parties agree that WGL included the amortized portion of Teamsters Contract Ratification Signing Bonus twice in this adjustment.[350] The Commission accepts the revised adjustment and will reduce test year labor costs by $16,618 (D.C. portion) to remove the Company's double counting as agreed upon, as it provides the correct dollar amount of the signing bonus that should be reflected in the wages and salary adjustment. With respect to the remainder of the union wage increases, "[i]t has been the Commission's policy to include collectively bargained union wage increases that are known and measurable in rates in order to more accurately reflect costs in the rate-effective period."[351] In keeping with its practice, the Commission will authorize all of WGL's union wage increases with the exception of the Shenandoah Teamsters Union Local 96 contract for which WGL has failed to provide any updated contractual information as to its ratification.[352]

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346 WGL (D) at 42 (Tuoriniemi).

347 WGL R. Br 106.

348 WGL (3D) at 72-73 (Tuoriniemi).

349 OPC Br. 118-120; OPC (A) at 57-58 (Ramas); Tr. 1098-110; *see* WGL Compliance Filing § 206.9 Workpaper, "Adjustment No. 9 – Labor Expense," at 1, 3 and 29 of 29.

350 OPC Br. 117, WGL (3D) at 17 (Tuoriniemi).

351 *Formal Case No. 1076,* Order No. 15710, ¶ 167 (March 2, 2010).

352 OPC (D) at 37, 39 (Tuoriniemi).

151. Turning to the appropriate employee level to be used during the rate-effective period, we note that WGL does not dispute that its employee head count as of August 2012 has fallen 34.6% below its September 2011 level and 43.6% below its average test year level.[353] While we acknowledge that the number of employees is usually lower in the first quarter of the year due to the impact of retirements, we are not convinced that the continuing decline in the number of employees post-test year is an aberration. WGL has failed to provide any evidence as to its prospective employee level in the rate-effective period nor has it demonstrated that its declining employee level would stabilize within the rate-effective period. Although in its Reply Brief, WGL suggests that the Company will need to make a corresponding increase in contractor costs to perform needed work if the employee count is reduced; the Company was unable to provide any evidence to support this assertion during cross-examination.[354] In fact, WGL offers no evidence of the Company's future projected employee staffing and budgeting levels. Instead, WGL merely asserts that OPC only relies on a few months of data to support its argument that employee levels are declining, while emphasizing that the Commission's preference is to use the average test year employee level.[355]

152. The Commission's long-standing policy has been to use average test year employee levels for labor-related expenses of employees rather than end-of-test year employee levels to insulate the cost of service from any variances in a company's workforce and to produce employee levels that are less likely to produce abnormal figures.[356] However, this policy, like all policies of the Commission, can be modified in special circumstances. OPC has argued that it has met its burden of showing why the Commission's general policy should not be followed in this case. Specifically, OPC has argued that the use of average test year employee levels on this record will produce abnormal figures that will burden ratepayers with an extra $172,001 in expenses for WGL employees who do not exist. OPC argues that the record is clear that, as of August 2012, the employee count at WGL was 1,224.4, which is 43.6 fewer employees than the average test year number advanced by the Company, and 34.6 fewer employees than the count as of the last month of the test year, *i.e.,* September 2011. At the same time, the Company has given us no indication that this drop in its employee count is an aberration (such as the drop in employees that the Company says happens at the beginning of the year for retirements before the employees are replaced). We are persuaded by OPC's argument that a departure from our policy of using the average test year employee count is appropriate for this case. WGL has not refuted OPC's evidence nor provided a credible explanation to convince us that the declining employee level is just an anomaly. We agree with OPC that the evidence

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353 OPC (A)-24 (Ramas) (Headcount FTE Data Source: October 2010 through September 2011, Compliance Workpapers for Adjustment No. 6 at 29 and OPC Cross-examination Exhibit No. 46 (April through August 2012).

354 Tr. 1099-1100.

355 WGL R. Br. 107.

356 *See, e.g., Formal Case No. 989*, Order No. 12589, ¶ 145 (October 29, 2002) ("The Commission's long-standing policy is to use average test year employee levels as opposed to end-of-test year employee levels. The use of average test year numbers insulate the cost of service from any variances in WGL's workforce. The Commission also finds that average employee levels are less likely to produce abnormal figures.")

shows that use of the Company's average test year employee level will substantially overstate WGL's likely workforce during the rate-effective period resulting in an unwarranted recovery based on abnormal employee levels.[357] Under these circumstances, departure from our normal practice of using the average test year is clearly warranted. To address this significant reduction, we accept OPC's post-test year employee levels as more known and measurable than WGL's post-test year levels.[358] Although we will not adopt OPC's recommendation to use the end-of-test year employee head count of 1,259, the Commission finds that WGL's Wages and Salaries Adjustment should be based on 1,249 employees, which represent the average employee level for the 12 month period from September 2011 to August 2012. In addition, we recognize that the employee gross-up factor also applies to employee benefits expense and payroll taxes expense. The result of this Commission adjustment would be to reduce test year labor costs by $275,216, employee benefits expense by $40,464, and payroll tax expense by $19,099. We believe that these adjustments will ensure that ratepayers are paying employee-related expenses that are more reflective of the employee level for the rate-effective period.

a. Executive Incentive Compensation

i. Short-Term Incentive Compensation

153. **WGL.** Washington Gas's compensation program for executives consists of base salary and "at-risk" pay. The "at-risk" pay consists of an annual short-term incentive plan ("STIP") and a long-term incentive plan ("LTIP"). All Company employees, including union and executive personnel, are eligible to receive short-term incentive compensation.[359] WGL explained that it undertook a benchmarking analysis to evaluate the design and level of the Company's pay for non-union employees relative to other comparable utility and energy companies. This analysis concluded that WGL's pay values and pay mix were consistent and competitive with the practices of other utilities and energy companies. WGL explained further that it targets its executive compensation at the 50th percentile of other similarly sized energy and utility companies.[360] As a result of the study, WGL concluded that it was a common practice for utility companies to use "pay at risk" incentive plans because these arrangements, in its opinion, compensate employees in a cost effective manner while motivating employees to achieve organizational goals and objectives.[361]

154. According to WGL, under the terms of the STIP, employees, including executives, are assigned a target payout level, which is a percentage of their base salary. The actual payout depends upon the attainment of annual goals set forth in the WGL Corporate

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[357] OPC R. Br. 119-120.

[358] This approach is consistent with the Commission's treatment in *Formal Case No. 1053*, where it used known and measurable workforce levels as compared to average test-year levels in setting employee-related costs. *See Formal Case No. 1053*, Order No. 14712, ¶ 184.

[359] WGL (H) at 5 (McGee).

[360] WGL (H) at 3, 5 (McGee).

[361] WGL (H) at 12 (McGee).

Scorecard and individual goals.[362] The Corporate Scorecard is a set of operational and financial goals that provide a framework for managing WGL's corporate performance.[363] WGL submits that while payment of employee incentive compensation is dependent on WGL meeting a threshold level of return on equity, whether an incentive is paid and how much incentive is paid is determined by the totality of WGL's performance against a "balanced set of operational and financial measures."[364]

155. The Company states that the short-term incentive compensation that is paid to executives and other employees is linked to the achievement of Corporate Scorecard goals, which include the following areas: (1) Safe Delivery; (2) Performance Improvement; (3) Customer Value; (4) Supplier Diversity; (5) Reliable Supply; and (6) Financial Performance. These scorecard goals are given equal weight by WGL and are designed to produce strong employee results for customers, investors, and the community.[365] WGL claims that the Corporate Scorecard is focused on activities that directly impact the Company's overall performance and that the majority of these goals directly relate to safe, reliable, and cost-effective natural gas service. Some examples include a reduction in third-party damage to distribution pipes, improved system reliability, and increased customer satisfaction.[366] The Company notes that the determination of whether a short-term incentive is paid to employees first depends on whether the Company meets a threshold return on equity target and then on obtaining the Corporate Scorecard goals.[367]

156. According to the Company, the Corporate Scorecard, which includes 13 utility goals covering six categories, supports its contention that ratepayers benefit from the achievement of these goals. WGL seeks to show that each of these goals, including the financial goal, benefits ratepayers. WGL believes that OPC's recommendation to exclude 58.33% of the STIP costs is arbitrary and unsubstantiated because it fails to provide any data or analysis to show that the STIP amounts are unreasonable. In addition, WGL asserts that its return on equity goal in the Corporate Scorecard benefits shareholders and ratepayers alike because it demonstrates to investors that WGL has effectively controlled costs, while providing safe and reliable service.[368] WGL also claims that OPC has failed to challenge the reasonableness or prudence of the Company's incentive compensation plan because it does not dispute that WGL's incentive compensation is market based and is in line with the costs and practices of comparable utility and energy companies.[369]

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362 WGL (H) at 15 (McGee).

363 WGL (A) at 1 (Sims).

364 WGL (H) at 15 (McGee).

365 WGL (A) at11, 12 (Sims).

366 WGL (A) at 16, 18 (Sims).

367 WGL Br. 65.

368 WGL (2A) at 7, 9 (Sims).

157. WGL argues further that the rate customers pay for service is based upon the cost-of-service standard. Since employee compensation is a component of the operating cost of providing utility service, ratepayers should not be able to pick and choose which elements of the cost of service they want to pay for, as if the cost of service were a "buffet."[370]

158. WGL believes that market factors determine whether the Company's incentive compensation is in fact reasonable. Because executive incentive compensation is a normal cost of providing utility services, WGL's incentive compensation program is based upon the market costs necessary to hire and retain qualified executives. Therefore, WGL submits, the incentive compensation that WGL pays to its executives is the normal market based compensation necessary to provide utility service and, consequently, it should be included in the cost of service.[371]

159. WGL asserts that it has met the Commission's standards for the inclusion of executive incentive compensation costs in WGL's rates. The Company believes that it has shown these costs to be known, measurable, reasonable, and prudent. Moreover, the Company asserts that it has met the Commission's standards set forth in *Formal Case 989* that: (1) the executive incentive compensation programs provide "some tangible benefit to ratepayers;" (2) they are necessary to ensure the provision of quality service; and (3) the costs are reasonable or consistent with comparable companies in the region.[372]

160. **OPC.** OPC argues that the Commission should reduce the amount WGL should recover for short-term incentive executive compensation by 58.33% because the main driver of the STIP is the return on equity for shareholders.[373] OPC relies upon the testimony of WGL witness Halloran who stated that the payment of incentive compensation to employees is dependent on the Company meeting a threshold level of return on equity and the Company's proxy statement, which indicated that a failure to reach the return on equity threshold would lead to a zero payout of the corporate portion of the STIP.[374]

161. In addition, OPC seeks to show that, although the Corporate Scorecard includes various goals that would benefit ratepayers, the amount of any particular payout is not

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369 WGL (3D) at 74 (Tuoriniemi).

370 WGL (3D) at 74-75 (Tuoriniemi).

371 WGL (3D) at 74-75 (Tuoriniemi). WGL points out that the Commission has never previously excluded incentive compensation costs for non-supervisory managers and union members in rates. WGL challenges OPC witness Ramas' interpretation of *Formal Case No. 989*, Order 12589 (October 28, 2002), saying that it "excluded only executive incentive costs," not union and non-supervisory personnel costs. WGL asserts that the payout of incentive compensation to non-supervisory management is based exclusively on the performance of the employee; not the achievement of corporate goals.

372 WGL (3D) at 75-76 (Tuoriniemi).

373 OPC (A) at 71 (Ramas).

374 OPC (A) at 70-71 (Ramas).

specifically tied to the achievement of individual Scorecard factors. OPC states that, as described by WGL, the determination of the individual executive payout is based upon a "holistic view of the Company's performance" and the discretionary decision of the Human Resource Committee of the Board of Directors.[375] This leads OPC to conclude that there is no direct link between the goals that benefit ratepayers and the payout amounts to executives.

162. For these reasons, OPC recommends that the first 50% of the STIP costs be funded by WGL's shareholders. OPC then recommends that the Commission not allow WGL to recover one-sixth of the remaining balance of expenses because one of the six categories of corporate goals contained in the Corporate Scorecard is entitled "Reward Investors" and relates to achieving a prescribed return on equity. OPC concludes that the purpose of the "Reward Investors" goal in the Corporate Scorecard is to benefit shareholders and not ratepayers.[376]

163. **AOBA.** AOBA asserts that WGL's Corporate Scorecard does not provide a reasonable justification for the Company's inclusion of costs associated with its incentive compensation plans in rates for District customers. AOBA argues that it has demonstrated that WGL's Corporate Scorecard is not relevant to the Commission's decision regarding whether WGL's incentive compensation plans' costs should be recovered in rates. AOBA asserts that its cross-examination of WGL witness Sims shows that the measures of WGL's company-wide performance that are displayed in the Corporate Scorecard do not address the significant variations in the Company's actual performance by jurisdiction.[377]

164. In addition, AOBA contends that the Commission did not have input into the establishment of the performance targets and has not been granted the opportunity by WGL to review or approve the targets in advance of their use. Because of the significant variation in WGL's achievement of the Scorecard goals in the various jurisdictions and the Commission's lack of advance input or review of the establishment of the Scorecard goals, AOBA concludes that Washington Gas has failed to establish a reasonable basis for the Commission to assess the appropriateness of the incentive compensation costs that WGL seeks to recover in District rates.[378]

DECISION

165. Washington Gas seeks to recover the costs of its STIP applicable to union, non-supervisory management employees and its executive personnel. In *Formal Case 989*, the Commission indicated that the legal standard it would apply to determine whether to allow a utility to recover corporate executive incentive compensation is whether the incentive plan provides benefit to the ratepayers. We said that some of the factors to be considered in assessing the benefit to the ratepayers are whether the incentive compensation was necessary to provide

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375 OPC (A) at 71-72 (Ramas).

376 OPC (A) at 72 (Ramas).

377 AOBA R. Br. 20-21.

378 AOBA R. Br. 20-21.

quality service, and whether the costs were consistent with comparable companies in the region.[379]

166. WGL undertook a benchmarking analysis to evaluate the design and level of the Company's pay for non-union employees to show that the utilization of STIP is common in the industry, and that WGL's pay values and pay mix are consistent and competitive with the practices of other similar utilities. Under WGL's system, non-supervisory management STIP payments are not dependent on achieving corporate financial goals, "the payout amount is only based on the performance of the individual employee."[380] As set forth above, the Company also maintains that the payment of STIP for supervisory managers is linked to the achievement of Corporate Scorecard goals, which the Company contends provide direct ratepayer benefits through six areas, including (1) safe delivery; (2) performance improvement; (3) customer value; (4) supplier diversity; (5) reliable supply; and (6) financial performance.[381] WGL also maintains that "safe delivery" includes such areas of Company performance as worker safety, safe work environment, worker safety education, and minimizing damage to the Company's pipelines by third parties and the Company's employees. The Company's performance improvement includes the improvement of operating costs on a per customer basis, reducing or minimizing the unit cost of major construction projects, and maintaining business outsourcing service costs within budget. Other Corporate Scorecard efforts include meeting supplier diversity goals, meeting a goal related to the number of outages per 100,000 meters, and meeting a weighted average of the Company's return on equity goals.[382]

167. The Commission concludes that WGL has demonstrated that ratepayers benefit to some degree from the operation of the STIP because the great majority of the Corporate Scorecard goals used in awarding STIP are based on activities that benefit ratepayers. Of note are the Corporate Scorecard goals that encourage and produce enhanced customer satisfaction, that focus on safer and more reliable gas distribution service, and more efficient Company operations. The Commission is persuaded by WGL's evidence that supervisory managers receive STIP compensation based upon WGL's evaluation of the employees' achievement of the goals in the Corporate Scorecard. Even OPC's recommendation that would permit WGL to recover 42.66% of its STIP in rates inherently acknowledges that some of the Corporate Scorecard goals benefit ratepayers.

168. Both OPC and AOBA encourage the Commission to reduce the amount of STIP that is included in the test year expenses. AOBA urges us to deny the full STIP adjustment because WGL's Corporate Scorecard goals are insufficiently linked to its employees' performance in the District. OPC urges us to reduce the amount of STIP in rates by 58.33% because the STIP payments are driven by the achievement of WGL's corporate financial goals,

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379 *Formal Case No. 989*, Order No. 12589, ¶ 149 (October 29, 2002).

380 WGL (3D) at 77 (Tuoriniemi).

381 WGL (A) at 11 (Sims).

382 WGL (A) at 12, 15 (Sims)

which benefit shareholders, not ratepayers. WGL has shown that the STIP payments to non-supervisory managers are not linked to the achievement of corporate financial goals, but instead are linked to the achievement of individual goals, many of which benefit ratepayers. With respect to the supervisory managers and executives, the evidence shows that the achievement of a threshold rate of return is a prerequisite for STIP, which is then determined by the items in the Corporate Scorecard. We accept the Company's argument that achieving a certain return on equity is a prerequisite to ensure the ability to have the funds to pay for the STIP.[383] We have evaluated STIP as a component of overall compensation, and find that the majority of the Corporate Scorecard goals benefit ratepayers. We have not set as a requirement for STIP that each and every goal within an incentive plan must only benefit ratepayers. We recognize that a financially healthy utility company that provides quality service is beneficial to ratepayers and shareholders alike. As long as the STIP is structured to provide significant benefits to ratepayers, it can also contain a financial performance goal that benefits shareholders. For that reason, we decline to accept OPC's recommendation to reduce the STIP cost recovery by one-sixth because of the existence of the return on equity goal.

169. The Commission finds that the compensation paid under STIP to union and non-supervisory managers, and to supervisory executives is reasonable, competitive, and benefits ratepayers by providing incentives for Company personnel to achieve the many customer-related goals that are set forth in the Corporate Scorecard. Consequently, we approve the Company's adjustment that increased test year expenses by $809,883 to fund the Company's at-risk STIP.

ii. Long-Term Incentive Compensation

170. **WGL.** As part of its compensation to executives in the test year, WGL paid long-term incentive compensation and seeks full recovery of the $678,427 costs as reasonable incentive compensation. The Company' long-term incentive executive compensation is paid at the Director level and above to establish, in WGL's view, a link between compensation for senior level employees and the value of the Company over the long term. The long-term incentive payments are made through a mix of Performance Shares (Company stock) and Performance Units (cash). Both forms of long-term incentive pay are earned by senior level executives based upon WGL's total shareholder return compared to a peer group of companies over a three year period. WGL argues that the LTIP encourages eligible executives to undertake long-term initiatives and projects that improve the operational efficiency and business processes of the Company.[384] In addition, WGL argues that it showed that the LTIP for senior executives are widely used in the utility industry, that the WGL pay levels are comparable with similar utilities, and are consistent with industry practices for executive compensation. Further, the Company asserts that none of the parties to this proceeding has disputed the fact that its long-term incentive compensation is market-based and is consistent with compensation practices in the utility industry.

383 *See* WGL (2A) at 9-10 (Sims); and WGL (2H) at 5 (Halloran).

384 WGL (H) at 17-20 (McGee).

171. WGL contends that long-term incentive compensation is necessary to hire and retain the qualified senior executives that are required to provide safe and reliable gas service to ratepayers. Therefore, the Company maintains, all components of labor, including executive incentive compensation should be included in its cost of service. WGL states that, for senior professionals, compensation is viewed as a three-legged stool comprised of base pay, STIP and LTIP, and that if any one of these components is eliminated, one or both of the other components would have to be increased in order to have a market competitive compensation package.

172. WGL also argues that whether the incentive compensation benefits ratepayers or shareholders should not be a factor that is considered because attracting and retaining critical talent benefits shareholders and ratepayers alike. WGL submits further that strong stock performance also benefits ratepayers because it provides access to equity capital, which the Company uses to invest in plant that supports safe and reliable gas distribution.[385] Thus, WGL concludes that market factors should determine whether WGL's LTIP is reasonable, and since its incentive compensation is based upon the market costs necessary to hire and retain qualified executives to provide utility services, the LTIP should be included in the cost of service.[386]

173. **OPC.** OPC opposes any recovery by WGL for executive compensation paid as a result of the LTIP because the LTIP awards are determined exclusively on the total shareholder return for WGL Holdings relative to a peer group of utilities during a three year performance period. OPC maintains that the total shareholder return is calculated as the change in stock price and dividends paid divided by the stock price at the beginning of the performance period, and therefore, the receipt of LTIP benefits depends entirely on achieving shareholder goals. Thus, OPC concludes, since the LTIP is driven by the returns to shareholders, the shareholders should bear the full cost of funding this plan's expenses.[387] OPC also cites to the Commission's prior decisions that have rejected the inclusion of long-term incentive compensation pay for WGL and Pepco. In those cases, inclusion of the LTIP in test-year revenues depended on whether the Commission found any benefits to ratepayers included in the performance measures of the plan or whether the plans only provided incentives to management to increase profitability of the Company.[388]

DECISION

174. The standard this Commission has set for a utility to receive cost recovery for LTIP in rates, requires WGL to show that LTIP provides a tangible benefit to ratepayers. Unlike the evidence WGL submitted to support its request for STIP cost recovery, its evidence in support of LTIP does not establish that ratepayer benefits are part of the equation for determining LTIP benefits for senior executives. On the contrary, we are persuaded by the evidence that the LTIP awards to executives are determined exclusively by the total shareholder return to WGL

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385 WGL (2H) at 2-4 (Halloran).

386 WGL Br. 66.

387 OPC (A) at 65 (Ramas).

388 OPC Br. 123-124, OPC (A) at 66-67 (Ramas).

Holdings based upon a comparison of returns to a WGL peer group over a three-year period. As was the case in *Formal Case Nos. 989* and *929,*[389] we find that the LTIP in this case only provides incentives to increase the profitability of the Company and does not provide a benefit to the Company's ratepayers.

175. While comparability of pay levels and the wide-spread use of executive incentive compensation programs are important, these factors alone are not determinative. The critical element for cost recovery in rates is that WGL must show that such expenditure benefits ratepayers. The District of Columbia Court of Appeals has stated:

> The purpose of Commission oversight is to protect the consuming public against monopolistic exploitation . . . in part by assuring that the utility customers are compelled to pay only for expenses that accrue to their benefit.[390]

176. WGL asserts that the achievement of its financial goals provides benefit to ratepayers by attracting capital and investment. However, WGL's witness support statements are phrased in generalized, conclusory language that fail to provide specific, identifiable, and quantifiable evidence to support their contentions of ratepayer benefit. Company witnesses Halloran and Sims fail to provide a direct nexus between the achievement of WGL's corporate financial goals and the factors that are determinative in investors' decision-making. WGL introduced the idea that good corporate financial performance may prove useful in some minor or major way in attracting capital to WGL. However, this assertion was insufficiently developed, supported, or proven. Without more details of specific benefits, the Commission finds that WGL failed to meet its burden of proof that LTIP expenditures provide a direct benefit to ratepayers. Accordingly, the Commission accepts OPC's adjustment that excludes all LTIP expenditures from ratepayer recovery and we will reduce WGL's test-year expenses by $678,427 to remove all of the costs associated with LTIP.

iii. Supplemental Executive Retirement Plan and Restoration Plan[391]

177. **WGL.** WGL's Supplemental Executive Retirement Plan ("SERP") is a non-qualified, unfunded defined benefit plan. The purpose of SERP is to provide an incentive to attract and retain executive officers of the Company. WGL asserts that SERPs are common benefits in the utility industry and is a critical compensation component that supports its ability to attract talented officers to run the Company. Therefore, WGL believes SERP costs and

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389 *Formal Case No. 989*, Order No. 12589, ¶ 150 (October 29, 2002); *Formal Case No. 929*, Order No. 10387, p. 93 (March 4, 1994).

390 *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1229 (D.C. 1982).

391 WGL Br. 71. The Company also has a Restoration Plan, which is a non-qualified, unfunded defined benefit plan that provides pension and pension-related benefits to a select group of management employees. WGL has two executives who are eligible to receive benefits under the Restoration Plan. *See* OPC (A) at 60 (Ramas).

Restoration Plan costs are reasonable and necessary for providing utility service that benefits ratepayers and should be recoverable in rates.[392]

178. WGL submits that the proper standard for determining whether the Company can recover these costs from ratepayers is whether the costs are reasonable and prudently incurred. The fact that tax regulation by the IRS encourages different types of benefit plans does not determine whether those plans are unreasonable. The Company contends that the primary considerations regarding whether SERP costs are reasonable and prudent are whether SERP costs are market-based compensation, and whether they result in the attraction and retention of talent at the organization.[393] WGL asserts that it has shown SERP costs to be reasonable and prudent by demonstrating that SERP programs are prevalent in the utility industry and in the general business environment. Because SERP programs are market-based and are, in WGL's opinion, required to attract talent, the cost of the Company's SERP and Restoration Plan should be included in the cost of service.[394]

179. **OPC.** OPC requests adoption of its RMA No. 11, which rejects recovery of WGL's proposed SERP costs and decreases the Company's test year expenses by $873,531. It argues that the SERP and the Restoration Plan provide pension benefits to select executives that are above and beyond the level of benefits they already receive from the WGL qualified defined benefit plan. OPC claims that the benefits dispensed under these plans go to executives whose compensation is in excess of the limits allowed by the IRS in the Company's qualified pension plan.[395] OPC avers that the Commission has previously excluded SERP costs from rates in *Formal Case No. 939*, and more recently in *Formal Case No. 1053*, on the grounds that, if the utility wishes to compensate its executives over and above its qualified pension plan, then the costs are properly borne by the shareholders, not the ratepayers. OPC argues that in the current case WGL has not provided any basis for the Commission to overturn its previous decisions denying recovery in rates for these types of costs.[396]

DECISION

180. The Commission accepts OPC's recommendation that we reject WGL's proposed expense recovery for the SERP and the Restoration Plan. This results in a reduction to WGL's operating expenses of $873,531. This Commission has held previously, in Order No. 10646 in *Formal Case No.939*, and more recently in Order No. 14712 in *Formal Case No. 1053*, that it

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392 WGL Br. 71.

393 WGL (3D) at 81-83 (Tuoriniemi).

394 WGL R. Br. 116-118.

395 OPC (A) at 60-61 (Ramas).

396 OPC (A) at 61-62 (Ramas).

would be improper to approve ratepayer funding for SERP and other extraordinary retirement benefits that compensate executives over and above the utility's qualified pension plan.[397]

181. WGL has failed to prove that not including these costs in rates would substantially impact its ability to hire and retain qualified executives. WGL's evidence shows that SERP plans are prevalent in the market, but it falls short of demonstrating that the absence of ratepayer funded SERP plans will make it inordinately difficult to recruit or retain qualified senior executive talent. In short, WGL has failed to provide a sufficient evidentiary basis for the Commission to overturn its previous determination of policy that the cost of supplemental retirement benefit plans in excess of the pension benefits that are contained in the IRS qualified retirement plans should not be borne by the ratepayers.

iv. Miscellaneous Executive Benefits

182. **WGL.** Washington Gas also seeks to recover in rates costs for executive physicals and executive estate planning services. The Company argues that these costs are part of the Company's general executive compensation package and are reasonable and consistent with industry practice. WGL maintains that the costs associated with these employee benefits are a necessary component of reasonable compensation and these costs are a benefit to ratepayers because they attract skilled and talented employees to manage the Company. Accordingly, the Company requests that the $6,339 costs of these employee benefits be included in the Company's cost of service and be recovered from ratepayers.[398]

183. **OPC.** OPC opposes the recovery in rates of these two specific components of executive compensation. First, OPC claims that the payment by the Company for executive physical exams is a payment that is above and beyond the services that are received under the Company's health care plan in which these executives and other employees participate. Second, OPC asserts that the estate planning services provided to executives are services that are not provided to less senior employees. OPC therefore recommends that the costs associated with these "extra perks" provided to select executives should be funded by shareholders and not passed on to ratepayers. The implementation of OPC's recommendation regarding these two components of executive compensation would result in a $6,339 reduction to test year expenses for the Company on a District basis.[399]

DECISION

184. As we have explained previously, we will review the various components of executive compensation individually to determine their reasonableness and whether it is appropriate for ratepayers to bear the burden of these costs. As with LTIP, Washington Gas has failed to establish by sufficient evidence that these costs inure to the benefit of ratepayers or that

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397 *Formal Case No. 939*, Order No. 10646, pp. 127-128 (June 30, 1995); *Formal Case No. 1053,* Order No. 14712, ¶ 190 (January 30, 2008).

398 WGL R. Br. 115-116.

399 OPC Br. 130-131.

ratepayer funding of these costs are such an essential tool to recruit or maintain executive talent that the absence of such funding by ratepayers would create an essential hardship for the Company.[400]

185. As pointed out by OPC, these physical exams are for a select group of executives and the costs incurred are over and above the costs for the health plan the Company already provides for these same executives and other employees. The estate planning services are also additional benefits the Company provides to a select group of executives. If the Company wishes to provide extra benefits to select executives, which costs have not been proven to be beneficial to ratepayers, then these costs are properly borne by the shareholders who also benefit from the executive talent that is being retained. For these reasons, we accept OPC's recommendation that the Company's costs for these extraordinary executive physical exams and estate planning services should not be recovered in rates. Therefore, WGL's test year expenses will be reduced by $6,339 to exclude these specific costs from recovery in rates in this proceeding.

4. Revolver & Lines of Credit Fees (RMA No. 36)

186. **WGL.** The Company eliminates the per book Revolver and Lines of Credit Fees in the amount of $20,241 from the cost of service since the fees are reflected in the cost of short-term debt.[401] Because the fees that accompany the lines of credit do not vary with the amounts borrowed, the Company has included those fees in the cost of short-term debt.[402] This is the approach WGL used in *Formal Case No. 1016* without dispute.[403] WGL concedes that with the inclusion of the fixed fees in the cost rate of short-term debt, a potential for over-recovery does exist; however, it adds that interest rates are variable so that it could also lead to an under-collection as well.[404]

187. **AOBA.** AOBA argues that the inclusion of fixed fees associated with maintaining the Company's line of credit for short-term borrowing in the cost of short-term debt overstates the incremental cost of short-term debt. AOBA contends that the cost rate for short-term debt should just reflect its average cost rate for the test year without rolling in costs for revolving credit or other fees that do not vary directly with the amount borrowed. AOBA recommends that the Commission adopt the same policy it approved in *Formal Case No. 1076* where Pepco was allowed to recover fixed fees associated with its credit facility costs through an adjustment to the Company's test year expense.[405]

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[400] *US West Communications, Inc. v. Public Service Commission of Utah*, 901 P.2d 270, 277; *In re GASCO, Inc.*, 132 P.U.R. 4th 352, 368 (Hawaii Public Utilities Commission, 1992); *In re Illinois Power Co.*, 131 P.U.R. 4th 1, 62-63 (Illinois Commerce Commission, 1992).

[401] WGL (D) at 81; WGL (D)-2 (Tuoriniemi).

[402] Tr. 1036-1307 (WGL witness Nee).

[403] WGL Br. 73.

[404] Tr. 1037 (WGL witness Nee).

[405] AOBA (A) at 68-69 (Oliver).

DECISION

188. The Commission finds that these fees are appropriately included in the cost of short-term debt. Because the costs are reflected in the cost of short-term debt, \$20,241 should be eliminated from test year expense. We reject AOBA's recommendation for the reasons discussed in Issue b. *See* Section III. B. 1. Cost of Debt and Preferred Stock, ¶¶ 19-20.

5. Fee-Free Credit/Debit Card Payments (RMA No. 38)

189. **WGL.** Washington Gas proposes an adjustment of \$70,370 to reflect the costs associated with a proposed tariff revision to offer residential and small commercial customers access to Fee-Free Credit/Debit Card payments. The proposed adjustment is based on customers anticipated usage of credit/debit cards for payments and the fees expected to be charged by credit card companies. The Company's proposed adjustment also reflects savings anticipated from a reduction in processing fees related to checks that would be paid by credit or debit card as a result of the elimination of the charge. WGL maintains that there are benefits to providing customers with another payment option. The Company contends that the cost related to this adjustment is an appropriate business expense.[406]

190. According to WGL, the costs are economical and consistent with cost-based ratemaking concepts. It states that, while the \$1.00 transaction fee for residential customers is higher than some payment options (e.g., the processing of mailed checks), it is cheaper than any other payment option, such as cash payments, checks, or money orders that are brought in-person to a payment office. WGL counters AOBA's challenge to the underlying assumption that credit card users are not being assessed a separate charge for using the payment option by asserting that a customer who pays in cash is not assessed a separate fee even though the costs of processing that form of payment are much higher. WGL notes that both the Maryland and Virginia Commissions have found the program beneficial and approved the program over the same objections made by AOBA in this proceeding.[407]

191. **AOBA.** AOBA opposes the adoption of WGL's proposed Fee-Free Credit/Debit Card program and the associated costs being recognized in the cost of service. AOBA argues that WGL's proposed adjustment is based on assumptions with a high degree of uncertainty regarding the actual level of costs to be incurred under the program. The assumptions include: (1) transaction costs will be approximately \$1.00 for residential credit/debit card bill payments and approximately \$2.00 for small commercial credit/debit customers; (2) the number of credit/debit card transactions will increase 260% over the number of actual credit/debit card payments that took place during the test year; and (3) that there will be an equal number of residential and small commercial transactions. AOBA asserts that based on the foregoing, the cost estimates upon which this adjustment is based are not "known and measurable."[408]

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406 WGL Br. 74.

407 WGL R. Br. 140-143.

408 AOBA Br. 65-73.

192. AOBA also asserts that the estimated number of transactions that will be processed is speculative and does not constitute a reasonable or appropriate basis upon which to base a proposed adjustment. Although WGL alleges that there will be increased customer usage of credit/debit card transactions based on the experiences of one utility, Atmos Energy, and other unnamed entities of its bank partner, Wells, Fargo Bank, N.A, AOBA contends that WGL provides no documentation supporting its claim. Further, AOBA maintains that WGL provides no support for its contention that, among other things, the program will enable the Company to avoid the cost of processing a mailed check and that it benefits customers who currently pay by cash or money order. AOBA further argues that while customers will individually save $4.55 per transaction, the Company will incur roughly $1.00 per transaction for each transaction processed. Thus, AOBA claims that the vast majority of customers would experience no savings and would be exposed to potential increases in customer-related costs in future rate cases. WGL provides no compelling evidence that its proposed program would provide any benefits to customers who use more expensive payment options such as in-person cash or money order payments. Finally, as it pertains to cost-based ratemaking, AOBA challenges the underlying assumption that a credit/debit card user should not be separately charged for using the payment option.[409]

DECISION

193. The Commission is not opposed to WGL implementing a Fee-Free Credit/Debit Card payment tariff. However, the Commission finds that the Company's proposed expense adjustment has not been adequately supported. Although the proposed costs are relatively small, the costs are not known and measureable and appear speculative at best. Additionally, WGL's volume estimates are thinly supported. WGL alleges that there will be increased customer usage of credit/debit card transactions based on the experiences of other entities. However, WGL provides no documentation supporting this claim. Therefore, we reject WGL's proposed $70,370 expense adjustment to implement its Fee-Free Credit/Debit Card payment plan. Nevertheless, WGL is free to implement its Fee-Free Credit/Debit Card payment plan on its own. The data it obtains may be useful in developing the basis for its proposal in a future rate case. Until such time, any costs and risks associated with this adjustment shall be borne solely by the Company.

6. Business Process Outsourcing Costs/Costs to Achieve

194. **WGL.** Washington Gas seeks to recover in the Company's test year Operations and Maintenance ("O&M") expenses the District of Columbia's portion of the annual amortization of the Company's Cost to Achieve in the amount of $370,862.[410] The Cost to Achieve are the costs WGL incurred with implementing the 2007 Master Services Agreement ("MSA") with Accenture, LLC for the operation of certain Company functions as part of WGL's Business Processing Outsourcing ("BPO") program. In 2007, WGL entered into an agreement with Accenture that outsourced various business functions necessary for the operation of the Company, including Consumer Services, Finance, Human Resources, Information Technology

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[409] AOBA Br. 65-73.

[410] WGL (D) at 96:18-20 (Tuoriniemi).

Services, and Supply Chain areas of the Company.[411] In addition to recovering the actual expenses associated with performing the functions outsourced under the MSA, WGL also seeks to recover in its test year O&M, the D.C. portion of the amortization of the Company's Costs to Achieve.

195. WGL asserts that the test period costs related to the MSA are reasonable and appropriate for recovery in this proceeding. It states that performance under the MSA has resulted in reduced operational costs for the Company and increased customer satisfaction. WGL has managed the costs incurred under the contract and the quality of service delivered.[412] The Company also proposes that the test year amortization of the Costs to Achieve that were necessary to deliver the quality of service and improved operational efficiency under the MSA are reasonable and appropriate for recovery from District customers as part of the cost of service in this proceeding.[413]

196. WGL claims that District customers have benefited from the MSA in many ways and that the outsourcing contract provided a mechanism to better set targets, quantify and measure outcomes, and provide insight into how to improve results. WGL contends that its District customers have in general benefited from receiving better service at a reasonable cost. Specific areas of improved performance include customer contact areas, customer billing, and the credit and collections area, among others.[414] Moreover, WGL maintains that the MSA helped the Company in controlling the growth of Administrative & General ("A&G") costs. From Fiscal Year 2002 to Fiscal Year 2007, total A&G costs increased by 39.32%, i.e., 6.86% per year. However, from Fiscal Year 2007, the year of inception of the BPO contract, to Fiscal Year 2011, total A&G costs increased by 10.78%, or 2.59% per year, which represents a substantial reduction in A&G costs.[415]

197. WGL also submits that the Company provided appropriate oversight and management of the service provider's contract performance, which resulted in meeting the contract's objectives in the various functional areas and in meeting overall cost parameters. The Company claims that it was successful in managing the contract within its budgetary limits and that the Company's management of the contract led to the provision of reasonable services to customers at reasonable costs.[416] Washington Gas asserts that none of the parties to this proceeding has challenged the reasonableness of the costs associated with performing the operational functions of the MSA, and it has shown that the test year O&M costs associated with

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411 WGL Br. 74-75.

412 WGL (I) at 19-20 (Akari).

413 WGL (I) at 2 (Akari).

414 WGL (I) at 4-6 (Akari).

415 WGL (I) at 5-6 (Akari).

416 WGL (I) at 7-14 (Akari)

performing the operational functions of the MSA have been prudently incurred and are reasonable.[417]

198. The Costs to Achieve include advisory costs to parties that identified cost savings, severance costs to employees terminated as part of the plan to reduce costs, transition costs to move existing processes to different providers, and costs expended to upgrade processes. WGL contends that the savings would not have been realized by the Company but for the expenditure of these Costs to Achieve and the implementation of the MSA.[418] The Company states that these costs have not been reflected in the rates that are currently being collected from customers, nor have the amounts been reflected in the determination of rate base. The Company claims that, as a result, it has financed these costs throughout the period they have been incurred. WGL also contends that its decision to reflect the impact of this amortization in cash working capital, as contrasted with including the unamortized balance in rate base, results in a lower cost to ratepayers.[419]

199. The Company contends that these expenses are known and measurable and represent reasonable expenses to include in the Company's cost of service. Therefore, the Company is seeking to reflect the annual amount of the remaining amortization consistent with the accounting treatment the Commission approved in Order No. 14694.[420] WGL asserts that the Company has demonstrated that it incurred the totality of these costs prior to periods the BPO improvements occurred in order to generate savings and efficiencies over the entire ten-year term of the outsourcing contract. WGL believes that the categories of costs, taken as a package, are not ordinary expenses.[421] The Company asserts that it did not write-off its Costs to Achieve in Virginia, but instead amortized the costs over a four year period. The Company admits that it was denied recovery of its Cost to Achieve in Maryland, but indicates that that case is currently under appeal.[422]

200. **OPC.** OPC asserts that WGL should not be permitted to include out-of period Costs to Achieve in rates in this proceeding. Therefore, OPC would remove $370,864 from WGL's O&M costs. OPC acknowledges that in order to implement the MSA WGL incurred Costs to Achieve. However, OPC believes that WGL's Costs to Achieve are ordinary costs that are routinely expensed in the year in which they were incurred. Because these costs were incurred prior to the test year, OPC submits that they are out-of-period expenses that should not

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417 WGL Br. 75, n.243.

418 WGL Br. 76.

419 WGL Br. 76.

420 WGL Br. 76-77.

421 WGL R. Br. 120.

422 WGL R. Br. 121; *In the Matter of the Application of the Washington Gas Light Company for Authority to Increase Existing Rates and Charges and to Revise its Terms and Conditions for Gas Service, Case No. 9267, appeal taken to the Circuit Court for Baltimore City, Civil Action No. 24-C-12-002607 (Filed April 30, 2012).*

be included in rates.[423] OPC notes that the Commission does permit out-of period expenses to be deferred and amortized in a future rate case if the utility has first sought approval of the deferral. However, OPC asserts that the Commission has not given prior approval to the Company to include these costs for rate recovery purposes. OPC maintains that in Order No. 14694, the Commission permitted WGL to defer and amortize its expenses incurred to facilitate the transition to the MSA "for accounting purposes only" and stated that those costs did not constitute a "regulatory asset." Consequently, OPC asserts, the Commission did not approve recovery of those costs in rates. OPC further contends that neither the Maryland or Virginia Commissions have approved the recovery in rates of WGL's Costs to Achieve related to the BPO contract.[424]

201. OPC believes that removing these out-of-period expenses from rates will not impose an unfair burden on WGL because WGL has already experienced savings under the MSA in excess of the expenses it incurred to make the transition to the contract provider. OPC notes that, on cross-examination, WGL witness Akari did not disagree with OPC witness Ramas' assessment that WGL had already achieved savings in excess of the expenses incurred to transition to the BPO contract.[425] OPC concludes that the Commission should not permit WGL to amortize out-of period expenses associated with the transition to the MSA because these expenses are not capitalized and excluding them is consistent with the fact that ratepayers do not receive a benefit from the out-of period savings WGL received because of the BPO contract. OPC concludes that disallowance of these costs is especially appropriate because WGL has amassed savings from the outsourcing program that are greater than the Costs to Achieve.[426]

DECISION

202. WGL is seeking to recover as part of the cost of service a year's worth of Costs to Achieve its 2007 MSA that WGL chose to amortize over a ten-year period. WGL claims that these are known and measurable expenses that the Company is currently incurring; that these expenses were prudently incurred for the benefit of ratepayers; and that these are costs for which the Commission approved recovery in Order No. 14694 in *Formal Case No. 1054*.

203. OPC argues that two threshold legal issues must be addressed in order to determine whether these expenses are recoverable: (1) are these out-of-period expenses? and (2) if so, did WGL receive that requisite prior approval from the Commission for their recovery in later years and therefore in this test year. OPC asserts that without this approval, these costs should not be recovered in the test year even if they are known and measurable and were prudently incurred.

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423 OPC Br. 136-37.

424 OPC Br. 137 (citing *Formal Case No. 1054*, Order No. 14694, ¶ 10 (December 28, 2007)).

425 OPC Br. 138, OPC (A) at 90 (Ramas).

426 OPC Br. 138.

204. In Order No. 14694, approving a Non-Unanimous Settlement Agreement, the Commission determined that "Washington Gas, for accounting purposes only, may defer and amortize the costs to achieve its outsourcing agreement identified in the MSA between Washington Gas and Accenture over a 10-year period. However, approval of the Company's proposed accounting treatment for these costs shall not constitute either express or implicit approval of their inclusion in customer rates or agreement that these cost constitute a 'regulatory asset' for ratemaking purposes."[427] In addition, the Commission determined that the Settlement Agreement "resolve[d] the issues surrounding the outsourcing arrangement under the MSA, i.e., Issues Nos. 7(c) and 15.[428] For a 6-month period following the approval of the Settlement Agreement, no effort to readdress Issue Nos. 7(c) and 15, or elements thereof, will be initiated by the Settling Parties, with the exception of individual customer complaints."[429] We also approved a moratorium on the filing of base rate change applications until January 1, 2011.[430]

205. There is no dispute that the O&M expenses associated with the D.C. portion of the amortization of Costs to Achieve are out-of-period expenses. However, the Cost to Achieve issue was not ripe for review until the next base rate case because the Settlement Agreement in *Formal Case No. 1054* and Order No. 14694 allowed WGL to defer and amortize the Costs to Achieve for accounting purposes only, prohibited the parties from initiating any action to readdress the Cost to Achieve until at least 6 months from settlement, and placed a moratorium on initiating a rate case until 2011.

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427 *Formal Case No. 1054*, Order No. 14694, ¶ 40 (December 28, 2007). *See also* ¶ 10, quoting Section 5 (Deferral and Amortization of Costs to Achieve) of the Non-Unanimous Agreement of Stipulation and Full Settlement dated December 13, 2007, which states:

> Washington Gas, for accounting purposes only, may defer and amortize the costs to achieve the outsourcing arrangement identified in the Master Services Agreement ("MSA") between the Company and Accenture on the Company's books of account over a 10 year period. However, approval of the Company's proposed accounting treatment for these costs shall not constitute either express or implicit approval of their inclusion in customer rates, or express or implicit agreement that these costs constitute a "regulatory asset" for ratemaking purposes. The Settling Parties retain their full rights to review (and challenge, if applicable) the recovery of those costs in rates in a future proceeding, the timing of which is subject to the moratorium provisions of the Settlement Agreement, and which otherwise be pursued consistent with the Settlement Agreement.

428 *See Formal Case No. 1054,* Order No. 14233 (March 20, 2007). Designated Issue 7(c) asked the questions: Should WGL be provided funding through rates at this time for its proposed program to outsource Administrative and General (A&G) functions? Is the level of WGL's proposed costs related to the outsourcing of A&G costs reasonable and appropriate? Designated Issues 15 asked: Are the components of WGL's proposed PBR plan that relate to the outsourcing of its call center and/or other customer service functions reasonably designed to provide a benefit to ratepayers without jeopardizing the quality of service provided to those ratepayers?

429 *Formal Case No. 1054,* Order No. 14694, ¶ 46 (December 28, 2007).

430 *Formal Case No. 1054*, Order No. 14694, ¶ 37 (December 28, 2007).

206. Although the Settlement Agreement barred WGL from filing a rate case during a specified period it also preserved the Company's rights to present this cost for recovery in a future proceeding and the parties' rights to challenge the recovery. This case is the first full natural gas rate case since the Settlement Agreement in *Formal Case No. 1054*. Therefore, this is the first opportunity that WGL has had to seek recovery of the deferred Costs to Achieve. Moreover, both the Order and Settlement Agreement allow WGL to defer and amortize the MSA's costs over the 10 year life of the MSA. It is not uncommon for regulatory commissions to defer the inclusion of some costs in a utility's rate base.[431] Likewise, when some operating test year expenditures are found to be extraordinary (i.e. infrequently recurring), commissions have amortized the recovery of those expenses over an appropriate number of years.[432] This type of rate treatment is recognized as an aspect of the "more basic principle of economics and regulation [that] costs which benefit future ratepayers should be capitalized and expensed in the future [citations omitted]."[433]

207. No party challenges that the costs in question were incurred. Nor does any party deny that these costs are not reflected in the rates currently being collected from customers. In addition, there is no question that, as required by the Order and Settlement Agreement, WGL has deferred and amortized these costs over the 10-year life of the MSA, and has chosen to only include approximately one tenth of the deferred balance in cost of service in this proceeding.

208. We are persuaded by WGL's argument that in order for the Company to generate the efficiencies and customer service improvements under the MSA, WGL incurred costs to achieve those benefits and that these cost were an integral part of the initiative that caused the improvements. The Commission finds that, although WGL did not get pre-approval to recover these costs in later years as would normally be required, the extraordinary circumstances as presented in this case warrant recovery of the Costs to Achieve. More specifically: (1) the MSA contract was not thoroughly investigated by the Commission in the prior rate case because the matter was settled and, by regulation,[434] the Commission's only review was limited to a determination of whether the settlement was in the public interest; (2) WGL was constrained by the Settlement Agreement and Order from recovering the Costs to Achieve until 2011; (3) review of the MSA expenses was not ripe until the filing of a base rate case; (4) the instant proceeding is the first fully litigated natural gas base rate case since the Settlement Agreement; (5) WGL has amortized the Cost to Achieve over the 10 year life of the MSA and has only included approximately one tenth of the deferred balance in the cost of service; and (6) the parties do not argue that the expenses and savings resulting from the Company's MSA are unreasonable. Therefore, because of the unusual circumstances of this case (i.e., the non-recurring Settlement Agreement), the Commission believes that an exception should be made to allow these out-of-period expenses to be recoverable because they are known and measurable and properly match

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[431] *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1236 (D.C. 1982).

[432] *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1236-1237 (D.C. 1982).

[433] *Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1237 (D.C. 1982).

[434] 15 D.C.M.R. § 130.11 (1998) (a full settlement presented in a base rate change application shall only be accepted after a public interest hearing).

costs with benefits. Consequently, we do not accept OPC's argument that the Cost to Achieve expenses should be removed because it is an out-of-period expense and OPC's Adjustment No. 16 (Remove Amortization of Costs to Achieve) is rejected.

209. The Company argued that the costs were incurred to generate savings and efficiencies over the entire ten year term of the outsourcing contract. We share the view expressed by OPC that ratepayers who pay a portion of the Cost to Achieve should also receive a portion of the benefits. We understand that the savings related to the MSA are both variable and on-going. Thus, the Commission finds that due to the variable nature of projected savings, WGL should continue to track the actual costs and savings that result from the MSA. WGL is hereby required to continue filing the annual reports outlined in Order No. 14694, ¶ 17. We are, however, directing that one change be made in the report that shows the updated costs and savings. Currently that report shows the actual costs when those figures become final but continues to show the original projected costs and savings in the future years. In the reports that have been submitted to date, the projected costs and savings in future years on the updated reports have not changed from the original projections. Therefore, it is not clear to us whether the costs and savings that are reflected for the future years reflect the impacts of the costs and savings in earlier years as they have actually occurred. Going forward, the annual reports that show the updated costs and savings should not only continue to clearly show actual costs and savings as they occur but the report should also provide revisions to the projected costs and savings, as appropriate, that flow from the costs and savings that have already occurred so a more accurate picture of the actual and projected costs and savings of the MSA can be ascertained. WGL is put on notice that, in the next rate case, the Commission will thoroughly review the cost and savings resulting from the MSA and will determine whether the MSA expenses reflected in rates are reasonable.

VIII. PENSION & OTHER POST-RETIREMENT EMPLOYEE BENEFITS ("OPEB") [Issue g][435]

210. The Commission approved a change to accrual method accounting[436] for pension expense and OPEB expense and authorized the Company to establish trackers in *Formal Case Nos. 870* and *922*, respectively.[437] The tracker mechanisms enabled the Company to track the difference between per book expenses and the amount of that expense actually recovered through rates. The Commission permitted WGL to phase-in the implementation of the accounting change by way of a five-year ramp-up period and twenty-year phase-in period.[438]

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435 Designated Issue g asks: "Are WGL's proposed recovery of costs associated with deferred pension expense reasonable in this case? Are there alternatives that should be considered to address cost recovery? Are the pension and OPEB trackers appropriate and should they be continued?"

436 Under accrual accounting, transactions are recorded when made or when the service occurs regardless of when the money for the transaction or service is actually paid or received. Under cash accounting where the income is not counted until the cash or check is received, and expenses are not counted until they are actually paid.

437 *Formal Case No. 870*, Order No. 9146, pp. 39-40 (October 18, 1988); *Formal Case No. 922*, Order No. 10307, pp. 98-99 (October 8, 1993).

438 *See Formal Case No. 922*, Order Nos. 10307, pp. 98-99 (October 8, 1993) and 11246, p. 6 (September 8, 1998).

211. **WGL.** WGL proposes to continue to use the tracker to reconcile fluctuations in pension and OPEB expenses.[439] WGL explains that the system pension expense has changed from a credit of $8.4 million to $21.5 million expense since *Formal Case No. 1016*. The Company attributes this increase to the results of the 2008 recession. To mitigate the rising pension costs, the Company closed the pension program in 2009 for most employees and for the IBEW Local 1900 employees, effective January 1, 2010. WGL claims that the OPEB expense grew after *Formal Case No. 1016* but was reduced by workforce reductions related to the outsourcing agreement and a plan change that required retirees to contribute to the plan. WGL contends that these cost controls have kept the OPEB expense close to the expense level established in *Formal Case No. 1016* but have resulted in an over-collection of these expenses.

212. In regard to OPEB expense adjustment (RMA No. 10), the Company proposes to: (1) adjust the per book amount included in the test year related to OPEB to the amounts expected in the rate effective period; (2) amortize the over-collected balance in the OPEB tracker account the Company anticipates at the beginning of the rate effective period; and (3) amortize carrying costs on the balance over three years.[440] The sum of the three proposed adjustments results in a total ratemaking adjustment of $676,049. As it relates to pension expense, RMA No. 11, the Company, using the same methodology it used to develop its OPEB expense, adjusts the per book amount included in the test year to reflect the amounts expected in the rate effective period. The sum of the Company's three proposed adjustments results in a total ratemaking adjustment of $29.5 million.[441]

213. At the end of the three-year period, the Company proposes ending the proposed amortization built into rates and adjusting distribution rates outside of a base rate proceeding if significant over-recovery occurs. The Company states that it would welcome suggestions that would allow for periodic true-ups of the tracker balance outside of rate cases.[442] WGL maintains that the amount of pension and OPEB expenses reflected in rates has not changed since *Formal Case No. 1016* because, as part of the Stipulation and Settlement in *Formal Case No. 1054*, the expenses were held constant at the *Formal Case No. 1016* levels. Because the Order and Settlement were silent on this issue, WGL argues that it was reasonable to refer to the last adjudicated case, *Formal Case No. 1016* where the Commission specified these amounts.[443]

214. WGL argues that the change in pension and OPEB expense related to the MSA is appropriately included in the trackers because the deferred amount represents a change in the

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439 WGL (D) at 50, 57 (Tuoriniemi).

440 WGL (D) at 46 (Tuoriniemi).

441 WGL (D) at 58-59 (Tuoriniemi). In order to properly synchronize the tax effect of the carrying costs, a carrying costs adjustment to reflect the debt portion of the overall cost of capital must be included. This will decrease taxable income by $1.865 million.

442 WGL (D) at 45-46 (Tuoriniemi).

443 WGL (D) at 43, WGL (3D) at 95-97 (Tuoriniemi).

actuarial calculation, which is the purpose of the tracker. Because this represents the difference between GAAP pension and OPEB expenses, and the pension and OPEB expenses recovered in rates, the Company contends that this is an appropriate amount to defer as established by Commission orders. Moreover, according to WGL, GAAP requires that the Company "recognize a loss 'when it is probable that a curtailment will occur and the effects described are reasonably estimable.'"[444] WGL contends that these costs were not special terminated employee benefit costs, which the employees were not otherwise entitled, but costs that the Company would have incurred whether it outsourced or not.[445] Regarding enhanced saving plan benefits, WGL argues that these are legitimate costs associated with achieving cost reductions in the pension plan. Therefore, WGL submits that it is appropriate to match these costs with the associated costs that they are intended to control.[446]

215. WGL opposes carrying costs being based on the weighted costs of debt, without compounding. WGL argues that the Company has not abused the tracker (the basis for OPC's recommendation that the Commission use the weighted cost of debt) and notes that it was OPC who proposed the compounding of carrying costs in *Formal Case No. 1016*. As it relates to a five year amortization period, WGL maintains that historical precedent supports the use of a three year period, however, it would not object to a longer amortization period if the Commission so desires.[447] WGL opposes the surcharge proposed by OPC because it presumes that the trackers are discontinued. Nevertheless, the Company says it is not opposed in concept to a surcharge with annual true-ups.[448]

216. Regarding AOBA's contention that WGL applied the wrong carrying cost rate, WGL states that it misspoke during the hearings and that a review of Revised Compliance Filings filed in *Formal Case No. 1054* shows that the Company used the authorized *Formal Case No. 1054* carrying cost rate of 8.12% (11.80%, pre-tax). Thus, WGL claims that no modification is necessary to the Company's calculations of pension and OPEB expense or the resulting revenue requirement in this proceeding. WGL further states it uses its proposed overall cost of capital from this proceeding to calculate pension and OPEB carrying costs for the rate-effective period.[449]

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444 WGL (3D) at 89-91 (Tuoriniemi); WGL R. Br. 123. *See Formal Case No. 870*, Order No. 9146, pp. 39-40 (October 18, 1988); *Formal Case No. 922*, Order 10307, p. 99 (October 8, 1993); *see* GAAP ASC 715-30-20 (for Pensions) and ASC-715-60-20 (for OPEB) which outlines how curtailments should be accounted. A curtailment occurs when a significant number of employees in the plan are eliminated from the plan or there is a significant change in the expected years of future service of current employees.

445 Tr. 1165-1166.

446 WGL (3D) at 93-94 (Tuoriniemi).

447 WGL R. Br. 122-133.

448 WGL (3D) at 100-104 (Tuoriniemi).

449 WGL (4D) at 2-4 (Tuoriniemi).

217. **OPC.** OPC argues that the amounts of pension and OPEB expenses included in the pension and OPEB trackers are overstated because it includes inappropriate deferred amounts. Further, OPC asserts that when the new rates go into effect, the recovery period should be extended to five years with carrying costs based on the weighted costs of debt, without compounding and not on the weighted cost of capital. OPC submits that WGL has failed to establish the reasonableness of the continuation of either the pension or OPEB trackers, and recommend that they be discontinued.[450]

218. OPC contends that costs associated with a change in pension expense related to the BPO and with the Company's enhanced savings plan benefits that resulted from the closure of the pension plan to new employees should not be included in the pension and OPEB trackers.[451] OPC avers that the pension expense associated with BPO costs are special employee benefits that should be recovered through "Costs to Achieve" which are being amortized over 10 years. OPC claims that WGL is providing terminated employees pension benefits to which those employees would not otherwise be entitled.[452] Similarly, OPC argues that the employee savings plan should be removed from pension expense.[453]

219. OPC further argues that the pension and OPEB expense levels in the trackers should have been based on the expense levels included in WGL's filing in *Formal Case No. 1054*.[454] Due to the abuse OPC alleges WGL committed in administering the trackers (*i.e.*, inclusion of BPO and enhanced saving plan costs), OPC proposes that carrying costs be based on the weighted cost of debt (as opposed to the cost of capital), without compounding.[455] OPC proposes as an alternative to the three year amortization period a five-year period due to the unique circumstances that resulted from the adoption of the Settlement Agreement coupled with the substantial growth in pension costs. OPC asserts that this would mitigate the impact on ratepayers from the recovery of these substantial balances.[456] OPC proposes that the Commission discontinue the pension and OPEB trackers and establish a surcharge to recover net pension and OPEB costs with carrying costs being reflected at the weighted cost of debt (as opposed to the cost of capital) over five years, with the surcharge ending when the authorized amounts are fully recovered.[457] Should the Commission not be inclined to discontinue the use of trackers, OPC

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450 OPC Br. 140.

451 OPC Br. 143-149; OPC (A) at 94 (Ramas).

452 OPC Br. 144; OPC (A) at 101 (Ramas).

453 OPC Br. 148.

454 OPC Br. 151.

455 OPC (A) at 117 (Ramas).

456 OPC Br. 155.

457 OPC (A) at 95, 120-122 (Ramas).

urges the Commission to have all costs recovered through base rates and not through a surcharge.[458]

220. **AOBA.** AOBA contends that WGL's pension and OPEB costs are overstated because WGL did not apply the correct carrying cost rate. AOBA also claims that WGL testified that it applied the pre-tax rate of return of approximately 16%; not the carrying cost rate of 11.80% authorized by the Commission in *Formal Case No. 1054*. AOBA also challenges the Company's inclusion of preferred stock in its pre-tax return on debt.[459]

DECISION

221. The Company's pension and OPEB adjustments (RMA Nos. 11 and 10 respectively) consist of three components: (1) adjustments of $7.4 million and $658,482 for pension and OPEB expenses, respectively, to reflect the annual test year expenses as computed by Towers Watson; (2) the amortization of the deferred tracker account amounts of $11.9 million and ($382,104), respectively, over three years; and (3) the amortization of carrying costs of $10.2 million and $399,671, respectively, over three years; all of which results in ratemaking adjustments of $29.5 million for pension expense and $676,049 for OPEB expense.

222. Before addressing the merits of the Company's arguments, we feel compelled to comment that the Commission was required to spend an inordinate amount of time and effort in determining whether the calculation of RMA No. 11, pension expense, was mathematically correct and consistent with the formulas provided by WGL. The Commission is troubled by the imprecision and the careless manner in which the Company presented the calculation and its underlying support for this significant cost adjustment. Because of the manner in which the Company calculated RMA 11, the Commission had to reopen the evidentiary record to ensure that it was calculated consistent with the methodology provided by WGL, which in turn resulted in the unnecessary delay in the resolution of the Company's rate application and the issuance of this Order. We expect WGL to be more precise and take greater care in future proceedings in submitting testimony and exhibits, particularly underlying methodologies, which are clearly identified and explained in detail to ensure that all parties, and the Commission, can easily determine, for example, the components of formulas and how the calculations were performed. Any future confusion caused by the Company's carelessness may be resolved against the Company.

223. Turning to the test year pension and OPEB expenses, OPC requests that the costs associated with the curtailment of terminated employees related to the MSA be removed from the pension and OPEB tracker balances because these are special employee benefits to which the employees were not entitled, and they should be reflected as part of WGL's Cost to Achieve costs. WGL asserts that the BPO resulted in terminations that had an actuarially computed expense and that consistent with GAAP, this curtailment required that all amortization

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[458] OPC Br. 156. OPC (A) at 114-119 (Ramas); *see also* OPC (A)-4, Schedules 17 (pension tracker amortization expense); 18 (OPEB tracker amortization expense) (Ramas).

[459] AOBA R. Br. 22-23; AOBA (3A) at 3-5 (Oliver).

components that were included in net periodic pension and OPEB expenses be immediately accelerated and reflected on the Company's books. OPC's objection appears to be two-fold. First, OPC claims that these curtailment costs are really special employee benefits that were granted as part of the outsourcing program and the MSA and therefore should not have been treated as curtailment expenses under GAAP. Upon review of the record and arguments, we are not persuaded that the pension expenses related to the terminations were special employee benefits. These benefits were previously earned by the employees who were terminated. We accept the argument that the costs at issue represent an actuarially computed expense representing the difference between the GAAP pension and OPEB expenses, and the pension and OPEB expenses recovered in rates. As such, these are costs that GAAP requires the Company to recognize as a loss "when it is probable that a curtailment will occur and the effects described are reasonably estimable."[460] OPC next raises the question of whether these costs should be recovered through the Costs to Achieve adjustment rather than through the pension tracker balances because the costs were generated to achieve the MSA. WGL responds that these costs are properly in the tracker because these were costs that were the result of the BPO – not costs that were expended to bring about the BPO and the MSA in the first place.[461] Because these are costs that the Company was obligated to pay when it terminated its employees, we consider them to be costs incurred as the result of the BPO and not costs to achieve the MSA. The Commission finds that WGL's treatment of these curtailment costs for terminated employees is consistent with GAAP and were the result of the BPO process; therefore, the Commission rejects OPC's recommendation to remove these costs from the deferred pension and OPEB balances and to treat them as part of the Cost to Achieve adjustment that includes the upfront costs of making the MSA a reality.

224. OPC also recommends that the enhanced savings plan benefits be removed from the pension tracker because "enhanced employee savings plan benefits do not qualify as pension expenses . . . WGL's employee savings plan, i.e., the thrift savings plan for management/executive employees and capital appreciation plan for union employees, are not included in the calculation of the balances to be included in the pension balancing account, nor should the new enhanced employee savings plan that was implemented in January 2010."[462] The Company maintains that these are legitimate costs incurred to achieve cost savings in the Company's Pension Plan. While these may be costs that WGL incurred to achieve reductions in its Pension Plan, it does not guarantee their inclusion into the OPEB and Pension tracker. WGL must still prove to the Commission that these are reasonable costs that may be placed on District ratepayers; and we are not persuaded to accept these costs on this record. WGL merely asserts that the enhanced saving plans are legitimate expenses but did not offer any testimony or credible evidence to show that the Company's plan is a qualified plan in accordance with the IRS

460 WGL (3D) at 89-91 (Tuoriniemi) (quoting ASC 715-30-35-94 and ASC 715-60-35-171); WGL R. Br. 123. *See Formal Case No. 870*, Order No. 9146, pp. 39-40 (October 18, 1988); *Formal Case No. 922*, Order 10307, p. 99 (October 8, 1993); *see* GAAP ASC 715-30-20 (for Pensions) and ASC-715-60-20 (for OPEB) which outlines how curtailments should be accounted. A curtailment occurs when a significant number of employees in the plan are eliminated from the plan or there is a significant change in the expected years of future service of current employees.

461 WGL Br. 124.

462 OPC Br. 147. OPC (A) at 104, line 19 – p. 105, line 1.

provisions. This is a significant omission because the Commission has consistently disallowed non-qualified plans, such as the Company's Supplemental Executive Retirement Plan.[463] The Commission finds that WGL's enhanced employee savings plan is not a qualified plan, but a supplemental benefit that should be excluded from the tracker just as the Company's existing employee savings plans are excluded. Based on this finding, we find that the costs for the enhanced saving plans do not qualify as a pension expense to be recovered from District ratepayers and should not be included in the pension tracker. Therefore, we direct that the expenses that represent the costs of the enhanced employee savings plan be removed from the test-year pension expense, the accumulated tracker balance subject to recovery, and the related carrying charges, resulting in a reduction of test-year pension expenses by $563,581. We also direct that the estimated expense through November 30, 2012, of $14,341 be removed, along with the related carrying charges. Further, we direct the Company, as part of the true-up, to review the amounts included in the tracker balance to ensure that there are no costs related to the enhanced savings costs from prior years. If enhanced savings costs are in the historic balances, we direct the Company to remove those costs from the balance and to remove the carrying costs associated with those amounts.

225. OPC also recommends that the Commission use the pension and OPEB expense levels established in *Formal Case No. 1054* rather than the amounts from *Formal Case No. 1016*. The parties acknowledge that the Settlement Agreement and the Commission's Order on Settlement are silent on this issue. Because there is no specific pension and OPEB costs stated in the Settlement Agreement and Order on Settlement, we find it reasonable to use the specific ratemaking amounts last approved by the Commission in *Formal Case No. 1016* and, therefore, we reject OPC's recommendation.

226. In the past, pension expense and OPEB expense, including tracker and carrying costs were recovered over a three-year period.[464] OPC recommends that the under-recovery of pension and the over-recovery of OPEB tracker balances be amortized over five years in light of the substantial amounts involved. The Company is not opposed to amortizing the pension and OPEB tracker balances over five years to minimize the impact on ratepayers. We determine that it would be appropriate to amortize these expenses over five years in that it will, as OPC says, mitigate the impact on ratepayers of these substantial balances, and, therefore, we direct WGL to amortize these balances over a five year period.

227. OPC also recommends, due in part to what it characterizes as abuses by WGL in using the trackers (i.e., by improperly including the MSA contract costs and enhanced saving plans costs in the trackers), that the carrying costs going forward be based on the weighted cost of debt, without compounding. We do not find any merit to OPC's unsubstantiated allegations of abuse. While we agree that the costs of the enhanced savings plans should not be recovered through the tracker, we do not agree that the Company's actions were intentionally abusive nor

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[463] See *infra* ¶¶ 177-178.

[464] *Formal Case No. 1016*, Order No. 12986, ¶¶ 113 and 116-117 and 120 (November 10, 2003) (OPEB and Pension respectively); *Formal Case No. 989*, Order No. 12589, pp. 54 and 57 (October 29, 2002) (OPEB and Pension respectively); *Formal Case No. 922*, Order No. 10307. p. 38 (October 8, 1993) (Pension).

do we think that the Company should be penalized for its actions by denying it the ability to use compounding for its carrying costs. We accept the Company's representation that it made the adjustment that it thought was appropriate given the facts and circumstances that existed when the decision was made. In addition, it was OPC who originally proposed the compounding of carrying costs in *Formal Case No. 1016* to ensure that ratepayers received the benefits of this approach.[465] We therefore authorize the Company to continue the accrual of compounded carrying costs set at the authorized pre-tax rate of return consistent with Commission precedent. Further, the carrying costs shall be amortized over a five year period consistent with the five year recovery period of the tracker balances.

228. AOBA argues that, contrary to the Settlement Agreement and the Commission's Order on Settlement, WGL applied the pre-tax rate of return approved in *Formal Case No. 1016* of 13.61% and not the correct pre-tax rate of 11.80% from *Formal Case No. 1054* in computing carrying costs. WGL states that, despite its testimony otherwise, it calculated pension and OPEB expenses correctly based on the *Formal Case No. 1054* 8.12% (11.80% pre-tax) carrying cost rate.[466] The Commission has reviewed WGL's calculations (not without some confusion and extended effort as previously described) and is satisfied that the actual cost rate used by WGL to compute carrying costs is the *Formal Case No. 1054* cost rate of 8.12% (11.80% pre-tax). AOBA also challenges WGL's inclusion of the pre-tax return on preferred stock as part of the debt component in calculating carrying charges. We note that the pretax carrying cost is the same whether preferred stock is treated as equity or debt. Therefore, AOBA's concern is noted but has no impact on our decision. Going forward, carrying costs for the rate-effective period will be based on the cost of capital approved by the Commission in this proceeding.

229. WGL argues for the continued use of trackers noting the Commission's more than twenty year history of including the pension tracker in base rates. Based on language in Order No. 12589, the Company suggests that the Commission has supported the reexamination of the amortization periods for the trackers and modification of the frequency of the balances to be trued-up in rates and concludes that to do something other than continue the trackers would be "unfair to ratepayers going forward."[467] WGL states that it has taken proactive steps to control pension and OPEB costs, i.e., with introduction of the savings plan and cost sharing for retiree medical insurance. While Washington Gas prefers to maintain the tracker mechanism, it is not opposed to the use of a surcharge with a true-up, if the Commission does not continue the trackers. OPC, on the other hand, recommends that the Commission discontinue the use of trackers going forward, and recommends that no new costs be added to the balancing accounts, and carrying costs should only apply to existing balances. OPC argues that Pepco's pension and OPEB costs are not subject to a tracker mechanism and that WGL does not have trackers in place in either Maryland or Virginia.[468] Additionally, OPC asserts that "the tracker is an unreasonable

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465 *See Formal Case No. 1016*, Order No. 12986, ¶¶ 114, 116, 118, and 120 (November 10, 2003).

466 WGL (4D) at 2-3, WGL (4D)-1, *Formal Case No. 1054*, Revised Compliance Filing, dated July 14, 2008 (Tuoriniemi).

467 WGL (3D) at 102.

468 OPC Br. 156.

disincentive to the pursuit of timely and needed rate relief and its continuation is contrary to the public interest."[469] OPC suggests that with a tracking mechanism in place, WGL had no incentive to control costs and mitigate costs increases and could forgo seeking rate relief even while continuing to carry a balance of $33 million on its books because the tracker allowed the Company to earn a 16 percent return on the dollars in the tracker.[470] Rather than use a tracker, OPC suggests that the balance be recovered from ratepayers in base rates. OPC further suggests that if the Commission is not inclined to discontinue the use of a tracker, that it consider using a surcharge with a true-up instead of a tracker mechanism.

230. WGL's trackers for pension and OPEB expenses were authorized in 1988 and 1993, respectively, to help facilitate the Company's transition from pay-as-you-go accounting to the new Statement of Financial Accounting Standard No.106 accrual accounting method ("SFAS 106"). Because of the enormity of the OPEB-related costs related to the accounting change, the Commission agreed to a phasing-in of the OPEB costs over a twenty year period from 1994 to 2013 and directed WGL to establish a deferred account to track the over-recovery and the under-recovery for the OPEB costs.[471] Although WGL attempts to argue otherwise, there is no evidence that the Commission intended this to be a permanent change for the recovery of these expenses when it was established. During its twenty year existence, the Commission did consider whether to adjust the amortization period in Order No. 12589, as noted by WGL, but the Commission's Order establishing the tracker was clear that this was a special arrangement to achieve a specific purpose over a set time period. That twenty year period has now come to an end and so, too, in our opinion, should the continued use of these trackers. As noted by OPC, Pepco's pension and OPEB costs are not subject to a tracker mechanism, and WGL has no trackers in Maryland and Virginia. Going forward, WGL is not authorized to add any additional costs to the trackers as of the effective date of this Order. WGL is authorized to recover the current balances in the pension and OPEB trackers over five years with carrying costs at the approved rate in this proceeding.

231. If the trackers are discontinued, WGL says it is not opposed in concept to the use of a surcharge with annual true-ups. We do not agree. Twenty years ago, there was a special circumstance that caused us to create the tracker mechanism that we are ending today. No party has presented us with any compelling special circumstances that have convinced us that these funds should be collected in the future by any means other than through base rates. Consistent with our normal practice of disfavoring surcharges unless warranted by special circumstances, the Commission declines to establish a surcharge for the collection of future pension and OPEB costs.[472] Instead, these expenses will be recovered as an expense in base rate proceedings as we have done in our most recent decisions regarding Pepco's rate applications.[473]

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469 OPC Br. 160.

470 OPC Br. 160.

471 See *Formal Case No. 922*, Order 10307, p. 100-101 (October 8, 1993).

472 Traditional Commission policy disfavors the use of surcharges, except in limited circumstances. *See, e.g., Formal Case No. 827, In Matter of the Application of the Chesapeake and Potomac Telephone Company for Authority to Increase and Restructure Its Schedules of Rate and Tariffs ("Formal Case No. 827")*, Order No. 8300, p. 143 (August 9, 1985) ("our traditional policy disfavor[s] the use of surcharges") (surcharge denied to recover C&P revenues lost when AT&T terminated C&P's billing inquiry service, on the ground that those revenues were

IX. WGL'S ACCELERATED PIPELINE REPLACEMENT PROGRAM (Issue l)[474]

232. Washington Gas seeks permission to implement the first five years of a fifty-year Accelerated Pipe Replacement Program ("APRP") at a cost of approximately $119 million. The Company seeks to recover the costs through a surcharge mechanism called the Plant Recovery Adjustment ("PRA") that is billed to customers on a monthly basis. Over its entire 50-year life, WGL's APRP would cost $748 million (as compared to WGL's current rate base of $209 million). WGL states that its APRP would replace 414 miles of main and over 37,000 services, more than doubling the miles of mains and tripling the number of services normally replaced in that time.[475]

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uncertain in amount and indistinguishable from "the loss of other revenues or Company operations in the normal course of business" that are assessed and recovered through traditional rates without a surcharge); *Formal Case No. 1076*, Order No. 15710, ¶¶ 183, 184 (March 2, 2010) (surcharge denied to collect Pepco's pension costs, OPEB and uncollectible expenses, which are "classic, ongoing utility expenses"); *Formal Case No. 722, In the Matter of the Application of Washington Gas Light Company for an Interim Increase in its Rates for Gas Service ("Formal Case No. 722"),* Order No. 7049, p. 7 (November 2, 1979) (surcharge denied to recover WGL's "cost and expense of implementing the Consumer Bill of Rights" since those costs were "no different from any other cost of service" and were not shown to be both certain and reasonable). Where utility surcharges have been approved, they generally have been used to recover externally-imposed costs that are volatile and difficult to control, or in other special circumstance where surcharges were necessary to ensure the utility's reasonable cost recovery. *See, e.g.*, *Formal Case No. 827, supra*, affirmed on reconsideration, Order No. 8329, pp. 22-24 (October 9, 1985) (surcharge granted to recover C&P's "external, uncontrollable costs" imposed by the Federal Communications Commission that were both "measurable and relatively certain"); *Formal Case No. 917*, Order No. 10155 (February 1, 1993) (surcharge authorized to collect Pepco's carrying costs on pollution control equipment, which were "non-revenue producing, governmental-mandated costs" that could not otherwise be recovered through traditional ratemaking). In more recent years, the Commission has indicated that it has discretion, on a case-by-case basis, to approve a surcharge to encourage expedited utility activity and expenditures for specific, targeted projects serving important public interest purposes. *See also Formal Case No. 1087*, Order No. 16930 ¶¶ 475-485 (September 27, 2012) (surcharge denied to recover Pepco's accelerated RIM construction costs, which were not narrowly defined.).

473 *See Formal Case No. 1076*, Order No. 15710, ¶¶ 183-184 (March 3, 2010); *Formal Case No. 1087*, Order No. 16930, ¶¶ 28-32 (September 27, 2012).

474 Designated Issue l asks: "Is WGL's accelerated pipeline replacement program reasonable and appropriate? Is WGL's proposed recovery of costs associated with the accelerated replacement of higher risk pipes warranted in this case?"

475 *See, e.g.*, WGL Br. 87-91; WGL R. Br. 146-147, 154, 183-184; WGL (A) at 5-7 (Sims); WGL (L) at 3-15 (Buckley); WGL (2L) at 18 (Buckley); WGL (G) at 3-18 (Townsend); WGL (2G) at 29 (Townsend). WGL's APRP is based upon risk and other factors identified through WGL's federally-mandated Distribution Integrity Management Program ("DIMP") (effective August 10, 2011). After the initial five year period, WGL proposes $25 million per year for pipe replacement, as compared to what WGL states is its $7 million per year average in earlier years (excluding the costs of pipe replacements under *Formal Case No. 1027*). *Id.* at 7, 24; WGL R. Br. 153. WGL witness Townsend stated that a 50 year accelerated program is needed for the District (as opposed to WGL's 30-year accelerated plan for Maryland) because WGL's system is larger and has more cast iron in the District than in Maryland. Tr. 660 (WGL witness Townsend).

A. WGL's Pipe Replacement Programs

233. **WGL.** Targeting pipe with the highest risk and leak rates, WGL states that its proposed APRP consists of five specific programs. Program 1 covers the replacement of bare and coated steel services unprotected from corrosion. Program 2 addresses the replacement of bare and coated steel mains unprotected from corrosion. Program 3 focuses on the remaining mechanically coupled pipe that was selected for replacement or remediation action in *Formal Case No. 1027*. Program 4 targets the replacement of cast iron pipe and associated services. Program 5 covers the cost of ENVISTA, web-based software that assists WGL in reducing right-of-way issues and third-party construction damage.[476] The Company plans to replace bare/unprotected steel services and mains, as well as cast iron pipe, with modern polyethylene pipe with a life expectancy of over 100 years that should have zero leaks immediately after installation.[477]

234. *(a) Accelerated Pipe Replacement.* WGL explains that it wants to embark upon its proactive program for accelerated pipe replacement in the District, in part, because of its concern over some recent catastrophic accidents in the natural gas industry.[478] While traditional rate cases would limit WGL's pipe replacement activities to the minimum necessary to provide safe and adequate service, the Company states that its APRP and surcharge will cost more (three times the current budgeted amount), but provide more safety and reliability.[479] WGL maintains that its APRP will benefit District customers,[480] and, if implemented, it will make Washington, D.C. one of the nation's leading cities in addressing aging infrastructure.[481]

235. *(b) Risk Assessment.* The Company looks at historic average leak rates to identify which pipe replacement programs to include in its APRP (the strategic approach), while it utilizes its Optimain risk assessment tool (combined with other planning considerations) to select individual pipe replacement projects each year (the tactical approach).[482] The Company states

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476 *See* WGL Br. 88-93; WGL (G) at 4-7 (Townsend). Each program specifies the capital expenditures that WGL proposes for each category of pipe over the 50-year life of the APRP. WGL R. Br. 152.

477 WGL Br. 93; WGL R. Br. 149, 172.

478 *See, e.g.*, Tr. 1280-1281 (WGL witness Townsend). Other factors that motivated WGL to propose its APRP include a recent White Paper issued by the federal government that raises safety concerns about the District as a major urban area that still uses cast iron pipe. *See, e.g.*, WGL Br. 102-103; WGL R. Br.170.

479 *See* WGL R. Br. 148; WGL (2G) at 6, 10, 20-22, 26-27 (Townsend).

480 WGL states that, for all District of Columbia residential services replaced under the APRP, it will install an Excess Flow Value ("EFV") between the gas main and the customer's premise, which will protect against sudden natural gas releases from accidents. It also will reduce "water related outages" by upgrading its system from low pressure to medium pressure, where feasible, when replacing low pressure cast iron pipe. Furthermore, it will move inside meters to the outside when feasible, to eliminate the need for the customer to be present for routine maintenance and to allow for a quicker shut-off of gas to the property in case of an emergency. WGL Br. 99-100; WGL R. Br. 149.

481 *See* WGL (L) at 5 (Buckley); WGL R. Br. 148-149.

482 WGL R. Br. 155, 165. WGL advises that, whereas the strategic selection of pipe replacement programs for

that, because of "lower relative leak rates," it systematically excludes larger diameter cast iron pipe from its immediate action accelerated pipe replacement projects.[483] Moreover, while WGL utilized its Optimain risk assessment model to identify the 100 highest priority District pipe replacement projects, in terms of risk, the Company does not propose to give the highest priority to that list of projects (which includes many larger diameter, medium pressure, cast iron pipe).[484] Instead, WGL states that the projects in the first five years of the APRP will concentrate on completing *Formal Case No. 1027* work on mechanically coupled pipe (Program 3), addressing bare steel that has the highest relative leak and risk rates (Programs 1 and 2), and possibly including some cast iron work (Program 4). WGL's selection of bare steel and cast iron projects would be based on their relative leak rates and a prioritization utilizing the Company's Optimain risk assessment tool that also considers operational efficiencies.[485] Washington Gas also states that a recent White Paper issued by the federal government, and OPC's own engineering consultants, identified each category of pipe covered by the APRP as "high risk."[486]

236. Washington Gas states that "the various items/parameters that may be part of the Optimain risk scoring, to measure risk, include both the probability and consequence of an incident – factors that were identified as critical to an appropriate risk ranking. These factors include risk of injury to people or buildings, location, proximity to a building, ability for migration, and being under a hard surface."[487]

237. *(c) Cast Iron Pipe.* While cast iron pipe is covered by the APRP, WGL advises that its risk analysis does not, at this time, call for cast iron pipes to be replaced in advance of bare/unprotected steel pipes. The Company states that it has not decided exactly how much cast iron pipe it will replace during the first 5 years of the APRP, and that it will make that "tactical decision" each year, based on its most up-to-date risk analysis.[488]

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inclusion in the APRP was based on relative average leak rates among pipe categories, Optimain is the major tool for selecting specific projects each year. Optimain is a complex dynamic tool, focused on WGL's operations, continuously updated, and using over 80 input factors to calculate a relative risk score for each segment of pipe "based on the probability and consequence of a leak." WGL R. Br. 155 citing Tr. 531, 656 (WGL witness Townsend). WGL states that Optimain analysis includes all the criteria identified by OPC for determining probability and consequences (for measuring risk). Confidential WGL (2G)-4 is a copy of the entire Optimain manual. WGL R. Br. 156-157, 165.

[483] WGL (2G) at 21-22, 33 (Townsend).

[484] *See* WGL (2G) at 11-12 (Townsend) and WGL (2G)-3 (confidential) (listing WGL's 100 highest priority pipe replacement projects in D.C.).

[485] WGL Br. 94. WGL witness Townsend stated that "small diameter cast iron is a higher-risk pipe" and that "bare and/or unprotected steel mains and services have experienced the highest leak rates of all material types." WGL (2G) at 13, 32 (Townsend).

[486] WGL Br. 93. In particular, WGL's Program 4 (for replacement of cast iron mains) is the largest program, accounting for 68% of all APRP expenditures and targeting what OPC called WGL's most vulnerable cast iron pipe — the smallest diameter cast iron main. WGL R. Br. 153-154; WGL (2G) at 33 (Townsend).

[487] WGL Br. 95, citing Tr. 655-656 (WGL witness Townsend). *See* WGL (2G) at 11-12 (Townsend).

[488] WGL R. Br. 162-163; WGL (2G) at 32-33 (Townsend).

238. The Company argues that OPC and AOBA have overstated their concerns about the amount of cast iron in the District, the age of the cast iron pipe, and the fact that more than 66% of the cast iron in the District is older than its expected life. WGL contends that "expected life" is a concept used for depreciation purposes, not for operational decision-making. It does not measure operational life. WGL asserts that it may be operationally safe to continue to have cast iron pipe in service after the end of its depreciation life. For example, if cast iron pipe is not disturbed by construction or paving, and has not experienced leak rates that justify its replacement, then the Company states that it would not have to replace it, and it could still have cast iron pipe in service 50 years from now.[489]

239. *(d) Mechanically Coupled Pipe*. WGL seeks to continue its work under the settlement reached in *Formal Case No. 1027* to replace all vintage mechanically coupled pipe in the District by 2016. The Company submits that Program 3 would complete this work without changing its scope or timetable for an additional $22 million. WGL argues that this program to replace vintage mechanically coupled pipe has been successful in reducing leaks and that discontinuing it before it is completed, as AOBA urges, would undermine a key component of WGL's accelerated pipe replacement plan.[490]

240. *(e) Operational Design of the APRP*. The Company claims that it prioritizes pipeline replacement projects annually based on risk profiles determined by Optimain.[491] WGL plans one year at a time, stating that it needs "flexibility to select and prioritize specific projects within approved program categories and costs," to obtain the biggest "bang for the buck," compared to having a prescriptive program tied to pre-selected projects and metrics for measuring progress. WGL argues that, by not specifying targets for miles of main or services replaced in any one year, the Company is allowed to focus on safety in light of changing risk profiles. It also will facilitate the Company's response to other changing circumstances about paving costs and construction efficiencies.[492]

241. Essentially, WGL submits that it will spell out its detailed pipeline replacement programs and projects, with "specific targets and within specific budgets," in the Company's detailed annual reports to the Commission, which will cover both the prior year's pipeline replacement activities and future planned projects.[493] WGL argues that this will ensure adequate

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[489] WGL R. Br. 163-165. *See also* WGL (2G) at 13-19, 32-33 (Townsend).

[490] WGL R. Br. 165-166, 184, 192. WGL insists that its need for an extra $22 million is not caused by any cost overruns or unanticipated costs, but instead represents updated costs based on actual experience and the inclusion of overhead construction costs that had previously been omitted. *See* Tr. 1287-1294 (WGL witness Townsend).

[491] WGL R. Br. 172.

[492] WGL Br. 95; WGL R. Br. 158.

[493] *See* WGL R. Br. 161, 177. WGL "fully anticipates a 'best practices' level of transparency that will provide the Commission with detailed information on a project level, including costs, amount of pipe, and material type, sufficient for a prudence review of completed replacement, and to review forecast replacements. This track record of accountability relating to the [APRP] was established in Formal Case No. 1027, and has been used successfully to monitor the Company's progress." WGL R. Br. 177.

Commission oversight of the APRP. WGL asserts that determining the appropriate amount of high-risk pipe to replace is a management decision.[494] The Company submits that this Commission should follow the example of the Virginia Commission, which recently approved a flexible plan allowing WGL to select specific pipeline replacement projects annually, in response to changing risk profiles and construction efficiencies, under an approved master plan.[495]

242. *(f) Hexane Costs*. Washington Gas vigorously defends its cost recovery for continuing hexane injections to mitigate gas leaks. The Company states that its supplies continue to include leak-prone natural gas with low levels of heavy hydrocarbons ("HHCs");[496] that it injects hexane at three of its gate stations when incoming gas supplies have low levels of HHCs; that both the Maryland and Virginia Commissions have ruled that injecting hexane into low HHC natural gas can mitigate gas leaks; that the settlement in *Formal Case No. 1027* provides for leak remediation through hexane injections and accelerated replacement of vintage mechanically coupled pipe; and that eliminating hexane injections in the District could compromise the safety of WGL's distribution system.[497]

243. **OPC.** OPC objects to the Company's proposed APRP contending it would shift the risk of cost and safety to ratepayers, especially since WGL has not committed to a specific budget or schedule of pipe replacement. OPC criticizes: (1) the design of WGL's pipe replacement plan, including WGL's failure to identify the specific projects included in its initial five-year APRP; (2) WGL's request for flexibility to include transmission system remediation within the APRP; (3) the APRP's failure to define and target only the most vulnerable "truly leak prone pipe"; (4) the absence of clear priorities in WGL's APRP, including WGL's failure to focus on high-risk small diameter cast iron pipe and cast iron mains; (5) WGL's failure to classify leaks by grade; (6) WGL's failure to distinguish between cast iron leaks and breaks; and (7) WGL's failure to track trends in leak data. OPC also criticizes WGL's "risk assessments" for not looking beyond leak rates and its failure to consider the consequences of pipe failure (*e.g.*, the consequences of major cracks in cast iron pipes vs. leaks of a smaller volume of gas at a pipe joint; and the impact of leaks in service lines that are closer to structures than a main). While

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494 WGL R. Br. 158-160.

495 WGL R. Br. 161-162. WGL submits that the measure of success is simply enhanced safety, under a flexible approach that is not constrained by "rigid" standards of the kind sought by OPC and AOBA, involving metrics to measure leak levels, "specific levels of reductions," or progress toward an "acceptable level" of leaks. The Company would, however, expect to see a downward trend in the number of leaks over time, which will continue to trend downwards as more high risk pipe is replaced. *See* WGL R. Br. 169-172.

496 WGL points out that its 2011 SEC Form 10-K stated that, while it had reduced supplies of leak-prone natural gas from Cove Point, "Other sources of low HHC gas entering the interstate pipeline that serve Washington Gas could pose similar risks. * * * * Washington Gas continues to mitigate the impact of low HHC gas from whatever source through accelerating the replacement of mechanically coupled pipeline and the operation of three HHC injection facilities." WGL R. Br. 192-193.

497 WGL R. Br. 190-194. WGL also argues that, procedurally, the issue of the reasonableness of continued hexane injections was not accepted and is not properly before the Commission in *Formal Case No. 1093*. WGL R. Br. 188-189 (citing Order No. 16896 and Order No. 16919).

acknowledging that WGL's claims that its risk assessment also considers other factors, OPC claims that "how this will be accomplished still lacks details."[498]

244. Overall, OPC claims that Washington Gas's APRP lacks specific goals, plans, accountability measures, cost control incentives, and measures of success. Given the complete lack of specificity by WGL with respect to targets, metrics and applicability, OPC argues that a Phase II of this case should be convened to address these issues if the Commission approves WGL's proposal for accelerated pipeline replacement and surcharge cost recovery. OPC asserts that WGL should be required to commit to "a detailed replacement program with specific targets and within specific budgets, but be afforded an opportunity to justify needed variations from that plan for good cause."[499]

245. **AOBA.** Opposing an accelerated schedule for normal course of business pipeline replacements like Programs 1 and 2 (steel services and mains respectively), AOBA argues that tighter year-to-year planning and review of WGL's pipe replacement activities is preferable. AOBA states that WGL's normal activities have produced more actual pipe replacement in some past years than the seven miles a year envisioned by WGL's APRP. According to AOBA, WGL's past pipeline maintenance and replacement activities were inadequate, and WGL has failed to account for how it spent the depreciation allowances it received in past years to aid the replacement of pipeline mains.[500] AOBA argues that the Company has delayed pipe replacements and accepted increased leak rates for years; that much of the APRP represents "make-up for insufficient pipe replacement activity" in the past; that WGL's professed need for an accelerated pipeline replacement program is contrived; and that WGL's APRP proposal is advanced primarily to obtain a surcharge.[501] Overall, AOBA submits, WGL has failed to demonstrate that the APRP is "proactive" or that it will accomplish anything that the Commission would not expect of WGL without the APRP.[502]

246. AOBA contends that WGL's APRP is vague and unstructured, in that: (1) timetables are wholly absent, as are any commitments for WGL to undertake any specific pipe replacement activity; (2) any metrics by which to measure reasonable costs or success in improving safety or service reliability are missing; and (3) WGL does not commit to any specific

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498 OPC Br. 169-177, 184-185; OPC (F) at 6-16 (Gawronski); Tr. 915-918 (OPC witness Gawronski).

499 OPC Br. 177-179, 184, 185; OPC R. Br. 36; OPC (G) at 21 (Radigan).

500 *See, e.g.*, AOBA Br. 31-34; AOBA R. Br. 33; AOBA (A) at 15-35 (Oliver). The spike in WGL leaks during 2010-2011 suggests to AOBA that WGL neglected earlier maintenance, which leads AOBA to ask the Commission to make sure that WGL spends its pipeline replacement monies for that purpose and not for "supporting system growth, enhanced profitability, or greater financial flexibility." *See* AOBA (A) at 18, 24-25, 31-32 (Oliver). Over the 15 year period between 1986 and 2001, AOBA states, WGL installed an average of 15.67 miles of mains per year. AOBA R. Br. 33.

501 *See* AOBA Br. 11, 32-33; AOBA R. Br. 38.

502 AOBA R. Br. 34, 38.

reductions in leak rates, or suggest a timetable, or even an accelerated rate of pipe replacement,[503] for completing even the highest priority projects.[504]

247. Turning to the future, AOBA argues that WGL's pipe replacement activities should focus on the 329 miles of old mains in the District (mostly very old cast iron mains) that have exceeded their useful lives. AOBA points out that WGL's 100 highest priority projects call for replacement of about 12.7 miles of primarily cast iron mains, which AOBA claims could be replaced by WGL within 2 to 3 years.[505] AOBA submits that the Commission should conclude that WGL Programs 1 and 2 represent comparatively low priority activities, which are more consistent with normal on-going business than special projects. Given the current low level of mechanical coupling-related leaks in mains and services, AOBA argues that Program 3 is simply not among WGL's highest priority projects at this time.[506] On the other hand, AOBA argues that the replacement of cast iron mains under Program 4 should be among WGL's highest priorities. According to AOBA, the Commission also should encourage the Company to address cast iron mains that are included among WGL's 100 highest priority pipe replacement projects. Moreover, AOBA suggests that the vast majority of WGL's older cast iron mains should be replaced in less than the 50 years proposed by WGL. AOBA claims that Program 5 does not belong in WGL's requested APRP funding.[507] WGL's proposed APRP is not a well-focused or "proactive" program, AOBA argues, because it does not envision replacing the majority of these very old mains for at least another 20 years, and many miles of them will not be replaced for another 30 or 40 years.[508]

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503 According to AOBA, WGL is misleading in suggesting that replacing seven miles of cast iron mains a year represents a "doubling" of its recent rate of replacements. This is only true in comparison with WGL's scaled-back 2010 schedule (five miles of mains per year). It is false in comparison with WGL's 2005-2009 activity, which replaced nine miles of mains each year. AOBA Br. 31; AOBA R. Br. 38.

504 AOBA Br. 29-30; AOBA R. Br. 33-34, 36, 38.

505 AOBA (A) at 33, n.8 (Oliver).

506 AOBA argues that, in light of new changed circumstances, the Commission should terminate both the surcharge and the accelerated program approved in *Formal Case No. 1027* for replacing/encapsulating mechanically coupled mains (Program 3). According to AOBA, WGL has reduced its use of leak-prone vaporized LNG from Cove Point; it replaced or encapsulated a number of mechanical couplings; and it continues to use hexane injections. These new changed circumstances, AOBA claims, should greatly lower the priority of Program 3. AOBA Br. 11, 25-26, 30, 38-40; AOBA R. Br. 34.

507 AOBA (A) at 32-33 (Oliver).

508 AOBA R. Br. 35-36. AOBA thus objects to the inclusion of vintage mechanically coupled pipe in the APRP, and the relative priorities of WGL's five programs under the APRP. While Program 4 (replacement of cast iron mains) is properly a high priority for WGL, AOBA argues that is not the case for WGL Programs 1 and 2 (replacement of steel services and mains) and Program 3 (mechanical couplings). According to AOBA, WGL is now using less low heavy hydrocarbon gas (prone to leak) and should therefore concentrate on fixing leaks associated with cast iron mains, which accounted for 67% of all main leaks in recent years (2005-2010), rather than Program 3 mechanical couplings that accounted for only four (4) leaks/year (or only 2.5% of all main leaks from all causes) over the same period. AOBA Br. 18-22.

248. AOBA's supplemental testimony criticizes the priorities of WGL's recent pipeline replacement activities. AOBA argues that WGL recently focused on replacement/ encapsulation of mechanical couplings (for which WGL obtains accelerated cost recovery under the surcharge approved in *Formal Case No. 1027*), while the Company cut back significantly on its replacement of risky cast iron mains (for which cost recovery is obtained through traditional rate cases).[509] According to AOBA, the settlement in *Formal Case No. 1027* did not authorize this "redirection" of replacement activities, which the Commission should find imprudent.[510] AOBA claims that any reduction in leaks resulting from the Company's replacement/encapsulation of mechanically coupled mains has been overwhelmed by increased leaks from other types of pipe.[511] To remedy this situation AOBA proposes: (1) termination of the *Formal Case No. 1027* surcharge covering replacement and encapsulation costs for mechanical couplings; (2) a Commission ruling that WGL should not have curtailed its replacement of cast iron and other types of non-mechanically coupled mains; (3) denial of "the discretion that WGL seeks to amend its pipe replacement plans on a year-to-year basis";[512] (4) a better accounting from WGL that differentiates its "accelerated" pipe replacement activities from "its on-going pipe replacement activities and its need to compensate or 'catch-up' for less than adequate levels of pipe replacement activity" in the past; and (5) denial of WGL's requested surcharge for accelerated pipeline replacement.[513]

DECISION

249. There are significant problems with WGL's proposed APRP, which require the Commission to reject the APRP as submitted. We are directing WGL to reassess its risk assessments and priorities for pipeline replacement in the District of Columbia. WGL's original program for replacement/encapsulation of vintage mechanical couplings will continue in *Formal Case No. 1027* with no additional funding, the same completion date, and an increased focus on

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509 *See* AOBA Br. 27-28; AOBA (4A) at 4-9 (Oliver). AOBA submits that only 139 miles or 29.4% of WGL's total cast iron mains were installed between 1920 and 1930. Nearly half (*i.e.*, 48.8%) of WGL's cast iron mains were installed before 1920. According to AOBA, WGL has over 77 miles of cast iron mains that were installed before 1900 and are now more than 112 years old (including over 12 miles of cast iron mains that were installed in the 1870s). AOBA Br. 29.

510 AOBA Br. 9, 25, 27-29.

511 AOBA Br. 7-8; AOBA R. Br. 34. According to AOBA, WGL's leak history from 2004 through the present shows that WGL's leak rates for mains in the District have increased in the last two years (2010 and 2011).

512 AOBA submits that the degree of flexibility that WGL has requested in terms of the activities it will accomplish and the costs it will incur in any future period would make it virtually impossible to challenge the prudence of the Company's APRP expenditures in the future. AOBA R. Br. 37-38.

513 AOBA (4A) at 18-19 (Oliver). AOBA also complains about WGL's continuing cost recovery for high levels of hexane injections. WGL stated that, while it cut back its use of leak-prone gas from Cove Point, it is still using leak-prone gas from other new sources that call for its continuing use of hexane. Nonetheless, AOBA opposes WGL's continued pass-through of hexane costs to District ratepayers on the ground that WGL presented no evidence that is has tried to reduce its use of increasingly expensive hexane, or that other utilities have found new gas supplies to be leak-prone. According to AOBA, WGL also failed to account for the impact of the decreasing number of vintage mechanical couplings. *See* AOBA Br. 26, 40-43; AOBA (4A) at 13-18 (Oliver).

cost control and schedule. Our reasoning explaining these rulings is set out below in ¶¶ 270 to 271and in a separate order to be issued in *Formal Case No. 1027*.

250. WGL's daily operations, including pipeline replacements, have important public safety implications. To meet its safety obligations, the Company must speed up its pipeline replacement activities in the District while it refines its risk assessments and pipeline replacement priorities. Today's decision underlines the need for speedier pipeline replacement in the District, and WGL should not for any reason slow down its District pipeline replacement activities while it is reassessing risks and priorities.

1. WGL's Accelerated Natural Gas Pipeline Replacement Programs

251. We find WGL's current pace of pipeline replacement in the District of Columbia to be unacceptable. It has proceeded far too slowly in recent years. In 2010, the Company replaced only 5 miles of cast iron and steel main. This is less than its 9 miles per year average in 2005-2009 and far below the average of 15.67 miles per year of mains that WGL installed in the District during the years 1986 through 2001.[514] Equally disappointing is WGL's proposed "accelerated" APRP for the future. Despite its name, the APRP is not an "accelerated" program. To the contrary, under WGL's proposed "accelerated" APRP, WGL would replace only 7 miles of mains per year, which is less than half of the average of 15.67 miles per year of mains that WGL installed in the years 1986 through 2001.

252. WGL's slow pace in replacing aging pipe in the District gives credence to the serious question posed by AOBA about whether WGL's APRP is merely an attempt to make up for its slow District pipeline replacement activity in recent years. We agree with AOBA that WGL has failed to explain why the depreciation allowances it received in past years (approximately $14 million a year) were not used by WGL to replace aging gas pipelines at a faster pace in the District. AOBA's concern is that the Company may have taken the money intended for pipeline replacement and used it, instead for stockholder dividends, while neglecting normal pipeline replacement. To address these concerns and to provide the Commission with a baseline to distinguish between normal pipeline replacement and other replacement activities, we direct WGL to explain more fully to the Commission and to the public, in a filing to be made with the Commission within three months of today's order, (1) exactly what constitutes a "normal" pace of D.C. pipeline replacement; (2) how and why WGL defines "normal" the way it does, both in terms of miles of pipe installed each year[515] and in terms of retirement dollars expended each year on pipeline replacement; and (3) why the depreciation allowances it received in past years (approximately $14 million a year) were not used by WGL to replace aging gas pipelines at a faster pace in the District through the normal replacement process.[516] We will

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[514] *See* Tr. 621-622 (WGL witness Townsend); AOBA Br. 31, explaining AOBA (2A)-2 (Oliver); AOBA R. Br. 33.

[515] As noted in the text above, WGL installed an average of 15.67 miles of pipe each year in the District during the years 1986 through 2001. Using miles of pipe installed per year as the measure raises the issue that the same length of a larger diameter pipe costs more to replace than a smaller diameter pipe.

[516] An average of approximately $400,000 of cast iron mains (Account 376.30) would have to be retired each year to be consistent with the 70-year average service life that WGL used in its depreciation calculations. *See*

carefully review WGL's filings directed herein and will closely examine how the depreciation funds are being used.

253. With that background, the Commission has decided to continue Program 3 (mechanical couplings) in *Formal Case No. 1027*, for now, with an increased focus on cost control and schedule. However, no additional funding will be provided. Nor will the originally scheduled completion date in 2016 be changed. We find that the need to address mechanical couplings has not abated sufficiently to end this program now. A separate order to be issued in *Formal Case No. 1027* will explain this in more detail. The Commission also agrees with OPC and AOBA that Program 5, leasing of ENVISTA software, should be the subject of normal WGL cost recovery and not a part of any special surcharge for "accelerated" pipeline replacement.[517]

254. We share WGL's view that the District would benefit from a pipeline replacement program that targets the pipe with the highest risk and the highest leak rates. Like WGL, the Commission is focused on making certain that the pipeline system in the District, as a densely populated high consequence area, is both safe and reliable. We remain open to approving a program to perform necessary replacement in an accelerated fashion and with an alternative funding mechanism. However, for the reasons that are set out below, we have concluded that the information that WGL has presented to us regarding the remaining three parts of WGL's APRP -- Program 1 (steel services), Program 2 (steel mains), and Program 4 (small diameter cast iron pipe)[518] –is inadequate. We are, therefore, directing WGL to reassess and revise its APRP consistent with the directives in this Order and Opinion.

2. WGL's Risk Assessments and Pipe Replacement Priorities

255. As we discuss below, OPC and AOBA have raised serious doubts, which WGL has not satisfactorily dispelled,[519] about WGL's risk assessments and pipeline replacement priorities, which guide not only WGL's proposed "accelerated" APRP, but also its normal day-to-day pipeline replacement activities. We share their concerns and we need more information

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Commission Cross-Examination Exhibit 4. In fact, however, WGL retired only $25,000 of cast iron mains each year, on average, during the years 2005-2009. *See* Commission Cross-Examination Exhibit 3, p. 69. The retirement amount per year is affected by the original cost of the pipe. A pipe of a certain length and size installed in 1920 has a lower original cost than a pipe of the same length and size installed 10 years ago.

[517] WGL Program 5 is not a pipe replacement program *per se*, although it may support WGL's pipe replacement activities by improving coordination between utilities and reducing construction damage caused by third-party contractors (a leading cause of leaks and breaks in both mains and services). WGL would have leased this software program anyway, in the normal course of its business, as shown by the Company's current leasing of the software.

[518] WGL's Program 4 appears to cover only small diameter cast iron pipes and services (which have exhibited higher leak rates in the past) without covering any of WGL's 86 miles of cast iron piping in the District that is 8-inch or larger in diameter.

[519] *See, e.g.*, *Potomac Electric Power Co. v. Public Service Commission*, 661 A.2d 131, 139-140 (D.C. 1995) (when objectors raise "serious doubts" about some aspect of a utility program, the burden shifts to the utility to dispel these doubts and prove that the questioned activity is prudent).

about how WGL is assessing pipeline risks and pipe replacement priorities under its proposed APRP.

256. WGL claims that it considers "risk of injury to people or buildings," as well as leak rates, in prioritizing pipe replacements in the District.[520] Exactly how WGL weighs risk of injury to people or buildings is unclear, however, as it relates to WGL's year-by-year selection of specific projects where it will actually undertake immediate pipeline replacement. WGL states that it utilized its Optimain risk assessment model to identify the 100 highest priority District pipe replacement projects in terms of risk, and those 100 projects include many larger diameter, medium pressure, cast iron pipe.[521] At the same time, WGL's own description of its risk assessment system indicates that, at the outset, it effectively excludes from serious consideration for priority pipeline replacement action all larger diameter pipes because of those pipes' lower relative leak rates.[522]

257. Washington Gas has not adequately explained these inconsistent statements, or why its pipeline replacement priorities for "accelerated" action – which WGL states in terms of completing *Formal Case No. 1027* work on mechanically coupled pipe (Program 3), addressing bare steel that has the highest relative leak and risk rates (Programs 1 and 2) and possibly including some work on small diameter cast iron pipe (Program 4)[523] -- are not more closely linked to its list of the 100 riskiest, highest priority pipe replacement projects in the District. WGL did not respond to AOBA's assertion that WGL's 100 highest priority projects would

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520 *See, e.g.*, WGL (2G) at 12 (Townsend) (WGL's risk priority scoring considers more than "leak rates" and includes consideration of "the consequences of a leak" as well as other factors); Tr. 654-656 (colloquy between Commissioner Fort and WGL witness Townsend) (WGL's "tactical approach" on pipe replacement considers "the probability as well as the consequence" – the "risk of injury to people or buildings or consequences from particular events" – considering factors including "location," "proximity to a building," "ability for migration," "being under hard surfaces"); Tr. 552-553 (WGL witness Townsend) (Optimain is not used to model risk, but WGL does a "similar risk calculation" that considers "probability" and "consequence" of a failure); Tr. 603-605 (WGL witness Townsend) (WGL uses Optimain scores to prioritize pipe replacement "and leaks is just one of the inputs in calculating the Optimain risk score." For example, cast iron mains can fail through "brittle fracture" in an unpredictable manner – which WGL models by considering "the consequence and the probability of that failure." WGL considers such pipe failures to pose a "high level of risk" of particular concern "in highly populated and paved areas" that experience heavy traffic). *Cf.* WGL R. Br. 163-165 (WGL argues that it considers the consequences of a leak – such as the likelihood of injury to persons or property – taking into account all the factors that OPC identified as relevant). *But see also* Tr. 1331-1333 (WGL witness Townsend) (WGL considers leak rates, pipe materials, and aging in prioritizing pipe replacements) (omitting any mention of the impact of leaks on humans and buildings).

521 *See* WGL (2G) at 11-12 (Townsend) and WGL (2G)-3 (confidential) (listing 100 highest priority pipe replacement projects in D.C., in terms of risk, as identified by Optimain).

522 *See* WGL (2G) at 21-22, 32-33 (Townsend).

523 WGL states that its selection of bare steel and cast iron projects would be based on their relative leak rates and a prioritization utilizing WGL's Optimain risk assessment tool that includes consideration of operational efficiencies. WGL Br. 94. WGL witness Townsend stated that "small diameter cast iron is a higher-risk pipe" and that "bare and/or unprotected steel mains and services have experienced the highest leak rates of all material types." WGL (2G) at 13, 32 (Townsend). WGL witness Townsend stated on the stand that, in addition to WGL's Program 4 targeting 342 miles of low-pressure cast iron mains, there would be additional replacement of medium pressure pipe. Tr. 1298 (WGL witness Townsend).

involve replacing about 12.7 miles of primarily cast iron mains, which might be replaced within 2 to 3 years.[524] As OPC witness Gawronski testified, "[t]he consequences of a crack in a cast iron facility are much greater because of the volume [of natural gas] generally that would escape from a crack versus a leak at a joint."[525] WGL states that it embarked upon "accelerated" pipeline replacement in part because of some recent catastrophic events in the natural gas industry,[526] which involved larger diameter, elevated pressure gas pipes. Those accidents triggered recent federal legislation and regulations emphasizing the importance of improving gas pipeline safety in densely populated high consequence areas.[527] WGL's 100 highest priority projects, as identified by Optimain, often involve larger diameter, medium pressure cast iron pipe. Yet, WGL's selection criteria for immediate pipeline replacement action, in actual operation, appear to exclude all larger diameter pipe from consideration.

258. All this makes it clear that the Company needs to re-evaluate its risk assessments and pipeline replacement priorities and report back to the Commission. WGL should more clearly explain how its stated pipeline replacement priorities (for Programs 1, 2, 3, and 4) fit together with the Optimain-generated list of the 100 highest priority pipe replacement projects in the District, many of which involve larger diameter pipe and medium pressure. WGL should be able to answer more clearly the questions raised about its pipeline replacement priorities. For example, under a proper risk assessment, should replacing WGL's larger diameter/elevated pressure cast iron pipes in the heavily populated areas of the District be given priority over steel pipe replacements in Programs 1 and 2?[528] Should WGL's pipeline replacement activities focus primarily on projects that address high-risks to public safety and the avoidance of catastrophic consequences? WGL's current descriptions of its proposed "accelerated" programs raise serious concerns that in actual operation WGL may overemphasize "leak rates" and slight the

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524 *See* AOBA (A) at 33, n.8 (Oliver).

525 Tr. 916 (OPC witness Gawronski).

526 *See, e.g.*, Tr. 1280-1282 (WGL witness Townsend).

527 In response to high profile explosions of natural gas pipelines in California and Pennsylvania in 2010, and an earlier oil pipeline leak in Michigan, the United States Congress passed the Pipeline Safety, Regulatory Certainty, and Job Creation Act of 2011, Public Law 112-90 (January 3, 2012), 49 U.S.C. 60101 *et seq.* The statute imposes new obligations on interstate pipeline operators. It requires the Pipeline and Hazardous Materials Safety Administration ("PHMSA") to study regulatory approaches to address safety concerns raised by these accidents, particularly as they may affect high consequence areas where a pipeline release could have significant consequences for health and safety. Over the past 18 months, PHMSA has been holding meetings to collect information on how to improve pipeline safety, focusing on improving (a) pipeline risk assessment and record-keeping, (b) pipeline emergency response, and (c) leak detection systems and automatic/remote control valves. These on-going studies, meetings and activities of PHMSA on interstate pipeline safety may provide useful information for WGL as it reassesses its risk assessments and pipeline replacement priorities for intrastate pipe located in the District of Columbia.

528 Thus, for example, AOBA recommends that WGL's proposed replacement Program 1 (steel services) and Program 2 (steel mains) be treated as normal on-going business, that Program 3 (mechanical couplings) be deemphasized in WGL's pipe replacement programs, and that WGL's highest priorities should be the replacement of cast iron mains (Program 4) and the cast iron mains included among WGL's 100 highest priority pipe replacement projects. AOBA (A) at 32-33 (Oliver).

consideration of consequences and safety concerns about the risk of injury to people and buildings from gas leaks.[529]

259. The Commission, therefore, directs WGL to reconsider its risk assessments (including large diameter/elevated pressure pipe) and to report back promptly to the Commission, in a filing to be made within three months from the date of this Order, on its revised risk assessments and pipe replacement priorities. This is consistent with WGL's system in which, each year, the Company recalculates its risk assessments and prepares a new priority listing for District pipeline replacement work. When WGL reports back to the Commission on its revised risk assessments and priorities, it should take into account the responses that it will be providing to the Commission regarding the definition of a "normal" pace of pipeline replacement for the District. *See* ¶ 252.

260. Gas pipeline remediation and replacement is an evolving field.[530] Washington Gas should be constantly developing and improving its expertise in assessing risks and priorities for gas pipeline remediation and replacement.[531] There are on-going developments in the field of risk assessment, and the prioritization of risks, concerning gas pipelines. Old subjective standards are gradually being replaced by more objective, systematic, quantitative criteria. The Commission encourages the continual refinement and improvement of WGL's analyses for assessing natural gas pipeline risks and the proper prioritization of its gas pipeline replacement and remediation activities.

B. Reporting Requirements

261. **WGL.** Washington Gas states that, as part of the APRP, it will file annual reports with the Commission describing the pipe replacement projects it completed in the year, and detailing the cost, location, start and completion dates of those projects, as well as the extent to which project costs are eligible for surcharge recovery. The Company also offers to provide detailed information on the specific pipeline replacement projects it is planning for the next upcoming year.[532] WGL maintains that its detailed annual reports will provide transparency and facilitate Commission oversight. According to WGL, these annual reports, covering both prior

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529 WGL witness Townsend's testimony raises the concern that, possibly without adequately considering the possible consequences and risk to human safety, the "Company's approach is to exclude large diameter cast iron pipe from the [APRP's] scope due to lower leak rates." WGL (2G) at 32-33 (Townsend); WGL (2G) at 21-22 ("The 66 miles of larger diameter cast iron has not been included in the Plan, again directly as a result of lower relative leak rates.").

530 Though risk assessment varies according to the subject matter, modern regulatory analysis often assesses proposed actions in a regulated field in terms of the dollars spent to save one statistical life. *See, e.g.*, Stephen Breyer, Breaking the Vicious Circle: Toward Effective Risk Regulation (Harv. Univ. Press 1993).

531 Federal regulations on interstate gas transmission pipeline safety define "risk," "risk assessment" and "risk management." American Society of Mechanical Engineers B31.8S, incorporated into federal regulations by 49 C.F.R. 192.7 and 49 C.F.R. 192.907(b) (October 1, 2012).

532 WGL Br. 89, 94, 97-98; WGL R. Br. 173, 174.

year and forecasted projects, will commit the Company to a detailed replacement program with specific targets and within specific budgets.[533]

DECISION

262. Though the Commission is denying the APRP, the Commission accepts WGL's offer to provide more detailed information about the specific pipeline replacement projects that it is planning for the upcoming years. We expect these normal pipe replacement activities to proceed at a faster pace than they have occurred during the past few years. To ensure that these normal replacement activities are occurring, we will require WGL to file quarterly reports describing its pipe replacement projects, similar to the reports that WGL will be required to file in *Formal Case No. 1027*.[534] WGL's reports shall describe the pipe replacement projects it has completed within each three-month period, and detail the cost, location, start and completion dates of those projects. In these reports, WGL shall also provide detailed information on the specific pipeline replacement projects it is planning for the upcoming year, with specific targets, timetables, and budgets.

263. In a separate confidential part of these reports, available to the Commission and all parties of record in this proceeding that have signed an appropriate Confidentiality Agreement, WGL shall also provide its most recent up-to-date list of the 100 highest priority main and/or service pipeline replacement projects in the District. This list shall be set out in the same format that is used in WGL (2G)-3 (confidential). Together with this updated list of its 100 highest priority projects, WGL shall provide a written explanation of how, and on what schedule, its pipeline replacement plans, including any plans under a revised APRP, are addressing its updated list of the 100 highest priority projects in the District.

C. WGL's Proposed Expedited Surcharge Recovery[535]

264. **WGL**. Washington Gas proposed to recover the costs of the APRP on an expedited basis with a surcharge referred to as the Plant Recovery Adjustment ("PRA").[536] The Company argues that a surcharge will save the regulatory costs of an increasing number of traditional rate cases, and that it will enhance Commission oversight by allowing an upfront Commission determination of the categories of pipe that will be covered by the APRP. The Company contends that WGL's annual reporting on the APRP surcharge will ensure transparency, facilitate streamlined Commission review (using fewer resources than a full rate case), and ensure that WGL's surcharge recovery is not "automatic." WGL also asserts that the surcharge will better align cost recovery with the Company's incurrence of pipeline replacement

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533 WGL R. Br. 146-147, 161.

534 The Commission directs WGL to file these reports in *Formal Case No. 1027* starting July 1, 2013.

535 Because we are rejecting WGL's proposed APRP as submitted, there is really no need to discuss WGL's proposed rate recovery for the APRP. However, in the interest of providing full and complete information concerning this matter, we will briefly summarize the primary arguments of the parties on the rate recovery issue.

536 WGL Br. 102.

costs, which under the APRP will be three times the level of WGL's "business-as-normal" expenditures.[537] WGL argues that the size, monetary commitment, and "proactive" nature of its APRP, going beyond normal operations to ensure safety, fully justify a surcharge (as opposed to traditional ratemaking) for timely cost recovery. According to WGL, surcharges are commonly used to recover the costs of major infrastructure replacement, and are utilized in 30 states in a growing national trend.[538]

265. The Company's PRA would extend the scope of the surcharge approved in *Formal Case No. 1027* (which covered only vintage mechanically coupled pipe) so that it covers all the categories of high risk pipe in WGL's APRP. WGL explains and defends the design of its proposed PRA as follows: First, the surcharge would recover, not the amount of WGL's $119 million investment for the first 5 years, but instead the lower amount representing the specific costs related to the annual level of replacement plant. WGL asserts that these are the same kinds of costs that the Commission approved for surcharge recovery in *Formal Case No. 1027*.[539] For example, for the $19 million investment in the first year of the APRP, the surcharge would be only $1 million for all of WGL's D.C. customers (or $5.00 a year – less than 50¢ a month -- for the average-gas-consuming D.C. residential customer of WGL).[540] Second, the surcharge is limited to actual costs.[541] It would be adjusted annually for any under or over collection. In WGL's next rate case, plant costs recovered through the surcharge will be moved out of the surcharge and into rate base. The surcharge would continue the Commission-approved process for review of costs that was adopted in *Formal Case No. 1027*.[542] Third, the PRA is calculated

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537 *See* WGL Br. 101-102, 105-106, 110-111; WGL R. Br. 147, 173-175, 194-195; WGL (2A) at 11 (Sims); WGL (2L) at 14-19 (Buckley). WGL (L)-4 sets out WGL's proposed surcharge.

538 WGL Br. 102-103; WGL R. Br. 167-168, 178-179, 182-183, 194-195. WGL argues that its proposed surcharge is very different from Pepco's RIM surcharge that the Commission recently rejected in *Formal Case No. 1087*, Order No. 16930, ¶¶ 182, 475 (September 27, 2012). WGL claims its surcharge is specific and detailed, focusing on "particular categories of high risk pipe" and their costs; it expands on the Commission-approved surcharge and reporting protocols in *Formal Case No. 1027*; it is limited to proactive improvements that exceed WGL's statutory obligations for safety and reliability; and it is policed through WGL's detailed annual reports on the APRP. By contrast, Pepco's RIM surcharge was vaguely defined and inadequately explained; it was designed to meet minimum required reliability standards; and it was not limited to projects that improved Pepco's D.C. reliability. Given these differences, WGL argues that the Commission's decision rejecting Pepco's RIM surcharge should not be read broadly as a policy decision to prefer traditional cost recovery over all accelerated surcharge recovery mechanisms. WGL Br. 89-90, 98-99, 106-110; WGL R. Br. 151, 174, 176, 178, 185-187.

539 In response to OPC's criticisms, WGL agrees that its surcharge should recover only the net additions to plant, so the PRA will reflect the addition of the depreciation expense and property taxes for the new plant net of the deprecation and property taxes for the replaced plant. WGL Br. 105; WGL (2L) at 6 (Buckley).

540 *See* WGL R. Br. 167-168, citing WGL (L)-4.

541 WGL acknowledges that O&M expenses will be less for new pipe (as opposed to older replaced pipe), but argues that its net O&M savings will be "negligible" in the first 5 years of the APRP because only 8% of the system's pipes will be replaced during that time. WGL R. Br. 179-180. The surcharge does not recognize lower overheads, WGL explains, because most of the pipe replacement work is done by contractors, which would not impact WGL's labor capitalization ratios. WGL R. Br. 181-182.

542 *See* WGL Br. 101-102, 104-105; WGL R. Br. 175.

separately for the Residential, Non-Residential, and Interruptible Service customer classes. While AOBA is concerned that the surcharge would add disproportionately to the bills of Commercial and Group Metered Apartment customers, WGL states that in fact the surcharge per therm charge for Non-Residential customers would be less than half that for Residential customers.[543]

266. **OPC.** OPC opposes a surcharge on the grounds that traditional rate cases provide adequate cost recovery, while a surcharge diminishes the Commission's oversight and may result in excessive WGL earnings. Typically, OPC states, surcharges are limited to cases where (unlike WGL's situation) the costs covered are a significant portion of operating expenses, highly volatile, and difficult to control. According to OPC, there is no national trend toward accepting surcharges. OPC argues that WGL's surcharge should be rejected, and traditional ratemaking reaffirmed, for the same policy reasons that were recently stated by this Commission in *Formal Case No. 1087*, to wit: (1) traditional ratemaking with regulatory lag creates incentives for efficient utility operations; (2) it involves a holistic look at a utility's finances and operations rather than piecemeal consideration of only a few issues; and (3) a surcharge offers no savings or efficiency in the regulatory review process.[544]

267. **AOBA.** Opposing WGL's proposed new PRA, as well as the old surcharge in *Formal Case No. 1027*, AOBA argues that surcharges insulate shareholders from normal risks and avoid full regulatory scrutiny of WGL's pipeline replacement activities. AOBA points out that the White Paper issued by the federal government in late 2011 (encouraging accelerated rehabilitation, repair, and replacement of high risk pipeline infrastructure) does not mandate or favor a surcharge recovery mechanism.[545]

268. AOBA also asserts that WGL has not shown that a PRA is needed to finance its "accelerated" pipeline replacement program, or that needed pipe replacements would not take place without the surcharge. According to AOBA, the PRA improperly rewards the Company recovery for projected budgeted amounts for replacement plant to cover the costs of make-up pipe replacement work that should have been, but was not, performed by WGL in the past.[546] AOBA complains that there has been no showing that the surcharge would reduce costs, nor is there any limit on the amount of cost recovery through this surcharge. AOBA fears that the surcharge would be imposed on a uniform cents per therm basis across-the-board on all classes and, as a result, it would add to the existing unfair disparities in class rate of returns.[547] Additionally, AOBA argues that WGL offers no specifics to describe the APRP to which the

[543] WGL R. Br. 184, citing WGL (L)-4.

[544] *See* OPC R. Br. 37; OPC Br. 180-181.

[545] AOBA Br. 10, 15-22, 26-27, 35.

[546] AOBA R. Br. 37-38; AOBA (2A) at 19.

[547] AOBA Br. 15, 34-35; AOBA R. Br. 37-38.

surcharge is attached. For all these reasons, AOBA opposes WGL's requested surcharge for pipeline replacement.[548]

DECISION

269. Because the Commission rejects WGL's proposed APRP as submitted, the issue of the PRA to fund the proposed APRP is no longer ripe for a decision. We will revisit the issue, if requested to do so, when WGL refiles its revised APRP. For now, we expect Washington Gas to move forward with its pipeline replacement activities in the District, in accordance with the testimony of WGL representative Roberta W. Sims.[549]

270. Turning to WGL's program for replacement/encapsulation of mechanical couplings in *Formal Case No. 1027*, we find that WGL's continued use of hexane gas injections is reasonable, since it is still using significant quantities of leak-prone natural gas, and it has not completed its replacement/encapsulation of mechanically coupled mains.[550] We also find that the risks we perceived earlier in *Formal Case No.1027* have not been so substantially abated that accelerated pipe replacement or remediation is no longer appropriate for WGL's mechanically coupled pipe.

271. The Commission concludes that WGL's program to replace or remediate mechanically coupled pipe should be continued in *Formal Case No. 1027* with an increased focus on cost control and schedule. This safety improvement program has proceeded at a slower pace and higher cost than originally estimated. The original $28 million funding level for this program will remain unchanged.[551] WGL's request in this case for $7 million in additional funding for this project is denied. The surcharge that was originally approved in *Formal Case No. 1027*, to recover the cost of remediating mechanically coupled pipe, will be continued. To be sure, surcharge mechanisms are not generally favored.[552] The surcharge approved in *Formal*

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548 AOBA argues that, in light of new changed circumstances, including WGL's use of lower volumes of leak-prone gas and WGL's recent activities in replacing/encapsulating mechanically coupled mains, the old surcharge approved in *Formal Case No. 1027* should also be discontinued.

549 *See* Tr. 57 (WGL witness Sims) ("[W]GL would move forward to continue to make [its] system safe" irrespective of the outcome of its request for approval of a surcharge cost recovery mechanism).

550 WGL persuasively defends its continuing use of hexane injections, on the ground that it is using new sources of natural gas, from the Marcellus Shale formation in the Eastern United States, that have lower levels of heavy hydrocarbons, which calls for WGL to continue to use hexane injections to prevent gas leaks. WGL (2L) at 21 (Buckley); *see* Tr. 1308-1309 (WGL witness Townsend) (WGL will continue to need hexane injections in the District until the remaining level of mechanically coupled seals is reduced).

551 *Formal Case No. 1027, In the Matter of the Emergency Petition of the Office of People's Counsel for an Expedited Investigation of the Distribution System of Washington Gas Light Company ("Formal Case No. 1027")*, Order No. 15627, ¶¶ 9, 18 (December 16, 2009).

552 Traditional Commission policy disfavors the use of surcharges, except in limited circumstances. *See, e.g., Formal Case No. 827*, Order No. 8300, p. 143 (August 9, 1985) ("our traditional policy disfavor[s] the use of surcharges") (surcharge denied to recover C&P revenues lost when AT&T terminated C&P's billing inquiry service, on the ground that those revenues were uncertain in amount and indistinguishable from "the loss of other revenues or Company operations in the normal course of business" that are assessed and recovered through traditional rates

Case No. 1027,[553] however, was part of a settlement that addressed an important issue of public safety by calling for prompt WGL remedial action to prevent an accident like the explosion and fire caused by leaking mechanical couplings in District Heights, Maryland.[554] The settlement provided that the surcharge could be ended and the costs included in base rates if a base rate case was filed before the remediation program was completed. Although AOBA has urged us to end the surcharge, we decline to do so. The Commission finds that the continuing need for prompt remediation of mechanical couplings in the District of Columbia, as a matter of public safety, together with the success of this program so far in reducing leaks, justifies continuing the incentives for expedited remediation that are provided by continuing the surcharge.[555] The original schedule for completing the program in 2016 will remain unchanged, but we expect WGL to speed up its remediation of mechanically coupled pipe in the District and to better manage the costs for its work so District ratepayers are not unduly burdened by these remediation efforts.

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without a surcharge); *Formal Case No. 1076, Potomac Electric Power Company*, Order No. 15710, ¶¶ 183-184 (March 2, 2010) (surcharge denied to collect Pepco's pension costs, OPEB and uncollectible expenses, which are "classic, ongoing utility expenses"); *Formal Case No. 722*, Order No. 7049, p. 7 (November 2, 1979) (surcharge denied to recover WGL's "cost and expense of implementing the Consumer Bill of Rights" since those costs were "no different from any other cost of service" and were not shown to be both certain and reasonable). Where utility surcharges have been approved, they generally have been used to recover externally-imposed costs that are volatile and difficult to control, or in other special circumstance where surcharges were necessary to ensure the utility's reasonable cost recovery. *See, e.g., Formal Case No. 827, supra*, affirmed on reconsideration, Order No. 8329, p. 22 (October 9, 1985) (surcharge granted to recover C&P's "external, uncontrollable costs" imposed by the Federal Communications Commission that were both "measurable and relatively certain"); In more recent years, the Commission has indicated that it has discretion, on a case-by-case basis, to approve a surcharge to encourage expedited utility activity and expenditures for specific, targeted projects serving important public interest purposes. *See also Formal Case No. 1087,* Order No. 16930 ¶¶ 475-485 (September 27, 2012) (surcharge denied to recover Pepco's accelerated RIM construction costs, which were not narrowly defined.).

[553] The Commission stated in *Formal Case No. 1027*: "There are two proposed expiration periods for the surcharge, depending on the timing of the next rate case. If no rate case is filed during the duration of the Program, then the surcharge will end upon the implementation of new base rates after the conclusion of the Program [in 2016]. The plant balance remaining upon the expiration of the surcharge will be reflected in rate base at that time. If WGL files for and receives a change in base rates before the conclusion of the Program, the surcharge will end upon the implementation of these new base rates. The rate base included in this application will include the latest balance of unrecovered mechanical coupling replacement work. The parties also agree that WGL would not be precluded from seeking a continuation of the surcharge in this new rate application." *Formal Case No. 1027,* Order No. 15627, ¶ 10 (December 16, 2009).

[554] *See Formal Case No. 1027,* Order No. 15627, ¶¶ 2, 10-11 (December 16, 2009).

[555] The surcharge granted in *Formal Case No. 1027, that we are extending today,* encourages a targeted public safety pipeline remediation program. The program was created in response to an unexpected public safety emergency and is still needed, as a matter of public safety, to prevent an explosion and fire like the explosion and fire that occurred recently in Maryland. Our earlier precedents do not block this Commission action. To the extent that any "change in policy" is involved in our decision today, we are consciously making it and not "casually ignoring" our prior policies on surcharges. *See Watergate East v. Public Service Commission*, 665 A.2d 943 (D.C. 1995); *Federal Communications Commission v. Fox Television*, 556 U.S. 502, 515-516, 523, 525 (2009). We are extending the old *1027* surcharge, to recover the cost of mechanical couplings, in the interest of public safety. A separate order to be issued in *Formal Case No. 1027* will further address WGL's program to remediate mechanical couplings.

X. JURISDICTIONAL COST ALLOCATION[556]

272. **WGL.** WGL states that its Jurisdictional Cost Allocation Study – allocating rate base, operating revenues and operating expenses among the three local jurisdictions in which the Company operates – is reasonable and consistent with the methodology approved by the Commission in its last rate case.[557] Concerning the weather normalization issue, WGL argues that, if the Commission accepts OPC's views on weather normalization, then WGL's jurisdictional cost study "must be revised to reflect somewhat greater volumes [of natural gas] and cost responsibility for the District" and greater resource requirements for the District relative to Maryland and Virginia.[558]

273. **AOBA.** In its post-hearing reply brief, AOBA asserts for the first time that WGL obtained $3.9 million from D.C. sources (for Asset Optimization Revenue Sharing and WGL's share of Interruptible Margin revenue) "without any associated income tax responsibility."[559]

DECISION

274. Other than an issue raised by WGL about weather normalization, and a claim raised by AOBA about the allocation of D.C. taxes, no party has opposed or offered suggested changes to the Company's jurisdictional cost allocations.[560] The Commission has examined the Company's jurisdictional cost allocations and approves them as reasonable. The Commission has accepted OPC's adjustment on weather normalization. *See* ¶ 120 to 121, *supra*. However, we reject WGL's unsupported claim that the acceptance of OPC's position on weather normalization requires recalculation of its jurisdictional cost allocations. Although the Company suggested that a recalculation of jurisdictional cost allocations would be required, it provided no data to substantiate the purported risk that WGL might over-collect from its combined three jurisdictions. The Commission has considered the issue raised by AOBA for the first time in its post-reply brief; but we reject this claim on two grounds. First, it was not timely raised by AOBA so WGL had no opportunity to respond to it. Due process and our rules dictate that parties who raise new issues during the reply briefing phase of our proceedings do so at their peril. Second, AOBA has not carried its burden of proof to establish a specific rate adjustment based on this claim. We find no basis in the record to persuasively support this out-of-time claim belatedly submitted by AOBA.

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556 Designated Issue h: "Is the jurisdictional cost allocation for WGL's customers in the District of Columbia reasonable and consistent with the Commission's approved methodology and does the Company's methodology produce allocation results that are reasonable and appropriate for setting rates in the District of Columbia?"

557 WGL Br. 81. *See* WGL (D)-4 (Tuoriniemi) (WGL's jurisdictional cost allocation study) and *Formal Case No. 1016, Washington Gas Light Co.*, Order No. 12986, ¶ 262 (November 10, 2003).

558 *See* WGL (2K) at 60 (Raab).

559 AOBA R. Br. 24-25. *See also* AOBA Br. 52-53 (WGL's risk is low for D.C. service, and its cost of equity is overstated, AOBA argues, because WGL received $3.9 million of pre-tax earnings during the test year, *i.e.*, $2.3 million of net asset optimization revenue and $1.6 million for WGL's share of Interruptible revenue margins).

560 OPC took no position on this issue. OPC Br. 161.

XI. WGL'S REVENUE REQUIREMENT

275. The Commission concludes that, as a result of the findings and conclusions set forth in this Opinion and Order, WGL's District of Columbia test period rate base is $201,569,048 upon which the Company is authorized to earn a 7.93% rate of return, or $15,984,426 annually. The Company's net test-year operating income is $11,157,313, which is deficient by the amount of $4,827,113. When tax payments are accounted for, the Commission finds that an $8,381,089 revenue increase is appropriate for WGL and will still allow the Company to earn its authorized rate of return. WGL's revenue increase is on an annual basis.

XII. CUSTOMER CLASS DISTRIBUTION OF THE RATE INCREASE AND RATE DESIGN [Issues i, j, and k][561]

276. The Commission must determine how to distribute Washington Gas's $8,381,089 revenue increase for the District among the Company's customer classes and then a rate design to charge each class member.

A. WGL's Class Cost of Service Study

277. **WGL**. Washington Gas has presented a class cost of service study ("CCOSS") that Company asserts is reasonable, that accurately reflects the proper cost allocations among various customer classes, and uses an allocation methodology that is consistently used in the industry and has previously been approved by the Commission.[562] The Company's CCOSS shows that while its District of Columbia jurisdictional average ROR is 0.94%, the residential classes are currently earning much lower, negative class RORs.[563] These range from negative 13.89% (Residential Non-heating and Non-cooling/Individually Metered Apartments) to negative 7.06% (Residential Non-heating and Non-cooling/Other) and negative 0.93% (Residential Heating and/or Cooling).[564] On the other hand, WGL's non-residential classes, particularly the non-heating and non-cooling classes, are earning class RORs well above the system average. These include class RORs of: 1) +29.53% (Commercial and Industrial (C&I)/non-heating and non-cooling); 2) +21.50% (Group Metered Apartments (GMA)/non-heating and non-cooling); 3)+18.50% (C&I/3,075 therms or more); 4) +18.11% (GMA/3,075 therms or more); 5) 12.91% (GMA/less than 3,075 therms); and 6) +7.89% (C&I/less than 3,075

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561 Designated Issue i asks: "Are the data and allocation methods used in WGL's class cost of service study reasonable and appropriate? (1) What are the reasonable and appropriate approaches to allocating WGL's revenue requirement among customer classes and is the allocation of revenues among customer classes reasonable and appropriate?" Designated Issue j asks: "Are the proposed rate design and tariff changes, including but not limited to the proposed Fee-Free Credit/Debit Card Bill Payment Program, reasonable in this case." Designated Issue k asks: "Are the proposed changes to Residential Essential Service reasonable and appropriate?"

562 WGL R. Br. 139.

563 WGL (J)-4 (Wagner).

564 WGL (J)-4 (Wagner).

therms).[565] WGL's updated CCOSS calculations include Interruptible Service Distribution Charge revenues and show a +9.91% class ROR for the Interruptible Service class.[566] The Company submits that it is appropriate to use its CCOSS as a basis for moving these widely varying class RORs gradually toward more equalized class RORs.[567]

278. Washington Gas dismisses OPC's complaints about the CCOSS' allocation of distribution main costs, citing both NARUC's Manual on Gas Rate Design and the Commission's decision in *Formal Case No. 989* as support for the Company's allocation methodology.[568] WGL disagrees with AOBA's assertion that the Company's calculated rate of return for Interruptible service customers is not accurate because the CCOSS did not factor in Interruptible Distribution Charge revenue.[569] WGL acknowledges that the Company's CCOSS does not include Interruptible Service class revenues because Interruptible Sales Service customers' rates are based on value of service pricing, which changes monthly, and the Company evaluates rates of return on a total customer class basis; thus, the amount of all revenue that is to be collected from the Interruptible customer class is not known in advance.[570] WGL also argues that the revenues received from Interruptible customers are shared with Firm customers through the Distribution Charge Adjustment ("DCA").[571] WGL opposes AOBA's recommendation to terminate Interruptible Service revenue sharing.[572] WGL argues that from a procedural standpoint, it is improper for AOBA to present arguments on a new issue at this point as the question of whether Interruptible revenue sharing should be continued is not included among the designated issues to be considered in this case.[573] WGL also maintains that this is the first time AOBA has made the recommendation to end the Interruptible revenue sharing mechanism and AOBA has provided no record evidence that supports its arguments on this issue.[574] Turning to

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565 WGL (J)-4 (Wagner).

566 *See* Tr. 1379-1381 (WGL witness Wagner); WGL (2J) at 7; WGL (2J)-2 (Wagner). The class ROR for the Interruptible Service class is relevant to setting the proper Customer Charge for the Interruptible Service class. *See, e.g.,* WGL (2J) at 7 (Wagner) ("Based on this return, the Company has only proposed an increase to the Customer Charges for [the Interruptible] class.").

567 WGL Br. 81-82; WGL (J)-4 (Wagner).

568 WGL (2J) at 32-4 (Wagner), citing *Formal Case No. 989,* Order No. 12589, ¶ 364 (October 29, 2002); WGL R. Br. 134.

569 WGL R. Br. 137.

570 WGL R. Br. 137.

571 WGL R. Br. 137.

572 WGL R. Br. 137-138.

573 WGL R. Br. 138.

574 WGL R. Br. 137-138. Over many years, WGL explains, its District Interruptible Service customers' revenues have been returned to firm customers through WGL's Distribution Charge Adjustment ("DCA") mechanism under GSP No. 16 tariff. In 2011, District firm customers received a credit of $14.3 million through the DCA mechanism, thereby reducing their distribution charges on their customer bills. "In addition, interruptible customers in the District of Columbia have the option of obtaining gas service as sales service or delivery service

AOBA's proposal that class rate base be used to allocate class responsibility for paying federal income taxes, WGL counters that the Company's methodology is commonly used throughout the utility industry and has been approved by this Commission in WGL's rate case filings for decades.[575] Moreover, WGL argues, class rate base is not an appropriate allocator for federal income taxes, because ultimately net income, not rate base, determines the amount of federal income tax expense.[576]

279. **OPC.** OPC asserts that WGL's CCOSS has been improperly performed and understates the contribution of residential ratepayers to the Company's earned return. OPC quarrels with the way WGL's CCOSS allocates the cost of mains, arguing that the CCOSS is sensitive to the assumptions used in the study regarding the allocation of mains.[577] OPC argues that WGL's usage of the minimum size main methodology underestimates the demand-related component of mains, biasing the results of the Company's class cost of service study.[578] OPC proffers two alternative methodologies to allocate the cost of mains – the "Basic Customer" model and the "Throughput" model – showing the class ROR for the Residential Heating and Cooling class moving from WGL's figure of negative 0.93% to +2.53% and +5.19% respectively.[579] OPC argues that WGL's CCOSS fails to show that there are inter-class subsidies because there is no marginal cost study in the case and WGL has not shown "that any class is paying less than the incremental cost of providing service to it."[580]

280. **AOBA.** To a large extent, AOBA agrees with the outcome of WGL's CCOSS which shows wide disparities in class RORs, with WGL's Non-Residential firm service customers paying an 18.12% ROR (compared to WGL's requested District of Columbia jurisdictional 8.91% ROR), while total Residential customers currently have a negative ROR and even have portions of their allocated operating expense responsibilities subsidized.[581] Yet AOBA attacks the Company's original CCOSS to the extent that it shows a negative class ROR for the Interruptible (Non-Firm) class.[582] Two major defects stand out in WGL's original CCOSS,

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customers. The sales service customers are charged rates based on value-of-service pricing, which changes monthly. Therefore, the amount of revenue to be collected from all interruptible customers is not known in advance, thereby prohibiting the inclusion of interruptible revenues in the CCOSS." WGL (2J) at 5 (Wagner).

575 WGL R. Br. 138-139.

576 WGL (2J) at 6 (Wagner); WGL R. Br. 138-139.

577 OPC Br. 164.

578 OPC Br. 164.

579 OPC Br.164. *See* OPC Exhibits (E)-1 and (E)-2 (Briden).

580 OPC Br. 165.

581 AOBA Br. 74.

582 AOBA Br. 74-75. AOBA suggests separating use and cost responsibilities for separate "Special Contract" customers from Interruptible customers. AOBA notes that "WG[L]'s class cost of service and rate design analyses frequently do not segregate usage and cost responsibilities for Special Contract customers and Sales service customers from measures of use and cost responsibility for Interruptible Transportation Service customers. As a

according to AOBA. First, AOBA argues that WGL's original CCOSS failed to recognize $19 million in distribution charges that the Company collected from Interruptible Service customers.[583] AOBA discounts the Company's claim that Interruptible Service revenues should only count monies from Interruptible Transportation Service customers, and (according to WGL) should exclude revenue from Watergate customers and "value of service" Interruptible Sales Service customers.[584] AOBA notes that while WGL filed a revised rate of return of 9.91% for Interruptible Service class, WGL's updated CCOSS continues to understate the Company's reported actual test year Interruptible Revenue by more than $4 million.[585] The core problem, AOBA states, is that "due to the present sharing of interruptible distribution service margins between the Company and its firm service customers, the interruptible margin revenue that WG[L] shares with firm customers is left out of the [CCOSS] as are the substantial margin revenue credits that flow to firm customers through the [Purchased Gas Cost]."[586] AOBA also urges the Commission to terminate WGL's sharing of Interruptible margin revenues arguing that it would simplify the determination of cost-based rates for Interruptible service in future cases.[587] AOBA contends that the termination of WGL's sharing of Interruptible margin revenues would increase the amount of revenue recognized as contributing the WGL's overall base rate requirement, raise WGL's resulting rates of return, and lower the Company's base rate revenue requirements.[588] Second, AOBA claims that WGL's CCOSS improperly allocates taxes (including ratemaking tax credits or "negative taxes") to low paying customer classes generally,[589] and it improperly allocates excessive tax responsibility to the Interruptible Service class.[590]

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result, rate concessions made to Special Contract customers may distort the actual rate of return that WG[L] derives from Interruptible Transportation Service customers for which the Commission does establish rates and charges as part of the Company's base rate proceedings." *Id.* 75 n.98.

583 AOBA Br. 76.

584 AOBA Br. 75-77.

585 AOBA Br. 79-80.

586 AOBA Br. 82.

587 AOBA explained that, years ago, the Commission ordered "margin sharing," allowing WGL to take 10% of its annual Interruptible Service revenues (which are not considered when computing WGL's earned returns for ratemaking purposes), as an incentive for WGL to maximize its Interruptible Service. This occurred at a time when Interruptible Service was believed to be threatened by competitive fuel oil prices, and revenue from Interruptible Service was deemed unreliable. AOBA advises, that today, over 98.5% of WGL's Interruptible Service in the District is subject to fixed rates, its future existence seems more secure, and there is no longer any basis for sharing Interruptible Service revenue margins. AOBA Br. 81-83.

588 AOBA Br. 82-83.

589 Initially, AOBA claims that WGL's CCOSS improperly rewards customer classes with very low or negative class RORs by giving them tax credits (or "negative taxes") that unjustifiably lower their class cost responsibilities. AOBA Br. 75, 83-87. While acknowledging that WGL's methodology is "fairly common in utility cost of service studies," AOBA states that "that methodology does not perform well and does not produce reasonable results" where, as in WGL's present circumstances, there are wide disparities in customer class rates of return. *Id.* at 84. AOBA submits that "no class that has a zero or negative contribution to the Company's return requirements should be rewarded for its poor performance." *Id.* at 85. To correct these inequities, AOBA

281. In AOBA's view, the Commission should require that any future CCOSS recognize all Interruptible Service revenue.[591] This is an essential step that AOBA urges as part of the transition that Interruptible Service rates are making from a variable rate (based on value-of-service) to a fixed rate (based on class cost-of-service). AOBA claims that, in the settlement in *Formal Case No. 1054*, WGL changed its pricing of Interruptible Transportation Service from value-of-service pricing (under which rates could fluctuate monthly with changes in the relative costs of natural gas and fuel oil alternatives) to fixed rates.[592] This switch reflects the fact, AOBA states, that in many circumstances fuel oil is no longer price competitive with interruptible gas service.[593] Given the changes in the marketplace, and the manner in which Interruptible Service customers now contract for gas supply services, AOBA argues that "the rationales for value-of-service pricing for interruptible transportation service are no longer applicable."[594] AOBA also requests that the Commission consider directing WGL to eliminate its Interruptible Sales Service in the District of Columbia or place a freeze on service for new customers under the current rate option.[595] AOBA argues that Interruptible Sales Service now represents the last vestige of value-of-service pricing in the District of Columbia, and the numbers of customers and throughput volumes utilizing WGL's Interruptible Sales Service have declined sharply in recent year.[596] According to AOBA, the numbers of Interruptible Service customers and the magnitude of the volumes presently served by competitive suppliers over the

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recommends that Federal Income Tax responsibilities be distributed among rate classes in proportion to each class's allocated rate base costs. AOBA Br. 84argues AOBA contends that such treatment would be consistent with the way that WGL already allocates Other Income Taxes (*i.e.*, District of Columbia Income Taxes), and with the limitations in federal income tax law on the use of tax credits or "negative taxes." *Id*. at 85-86. Further, AOBA states that while the tax code does recognize negative taxable income, no where does it provide tax credits that exceed the amount of an entity's negative taxable income. AOBA Br. 86.

590 AOBA also complains about a different "tax defect" in WGL's CCOSS for Interruptible customers: "The Company's original filing allocated Other Income Taxes among rate classes using a 'Net Rate Base' allocation methodology. Under that methodology, Interruptible Service customers received an allocation of ($272,199). However, witness Wagner's Updated Non-Firm analysis computes an incremental income tax of $1,504,397, and does not allocate that amount among rate classes in a manner consistent with the Company's original filing. Rather, WG[L] assigns the entire amount to Non-Firm service customers. Thus, there can be little question that the actual rate of return for the Company's Non-Firm Service classes is significantly above the 9.91% rate of return suggested by witness Wagner's revised Non-Firm rate of return analysis." *Id*. at 80-81.

591 AOBA Br. 81.

592 AOBA Br. 81

593 AOBA Br. 81.

594 AOBA Br. 81-8283.

595 AOBA Br. 89. AOBA notes that "WGL eliminated its Sales Service in Maryland several years ago without any significant problems or customer complaints." AOBA Br. 89.

596 AOBA Br. 89.

last several years offer strong demonstration of the viability of the competitive market for interruptible gas supply service in the District.[597]

DECISION

282. The Commission approves Washington Gas's updated CCOSS as reasonable. WGL presents testimony that its embedded CCOSS was developed utilizing well-established methodologies that the Commission has approved in past WGL rate cases. Though improvements can be made in the future, we find that the data and allocation methods used in the Company's CCOSS provides a reasonable basis for allocating WGL's revenues requirements among customer classes. OPC continues to challenge the way WGL's CCOSS allocates the costs of mains; however, its challenges are not new and they do not persuade us to change the views that we expressed on the same issue in WGL's last two rate cases.[598] Nor are we persuaded to direct WGL to change the allocation methodology for Federal Income Tax expenses that it uses in its CCOSS and use the customer's allocated rate base as an alternative cost allocator as AOBA urges us to do. While we understand AOBA's argument that the current allocator that focuses on the funds paid by customers has a negative effect on customer classes that pay the larger share of WGL's revenues, the Company's allocation methodology is consistent with other utility cost allocation studies and with the Commission's past practice and we see no reason to change our existing policy.[599]

283. WGL's CCOSS allows us to compare the class rates of return with the overall return to determine which customer classes are providing higher and lower than system average rates of return. It shows that the residential classes are continuing to earn rates of return that are lower than the system average while non-residential classes are earning rates of return that are significant above the system average. Even OPC's proposed CCOSS shows that significant disparities now exist in class RORs, with WGL's Commercial classes paying higher class RORs than the Residential classes. With the exception of the situation of the Interruptible class, as discussed in more detail below, the Commission finds that no party showed changed

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597 AOBA Br. 89.

598 *See, e.g., Formal Case No. 1016*, Order No. 12986, ¶ 283 (November 10, 2003) ("The Commission accepts the validity of WGL's embedded CCOS. WGL presented essentially uncontradicted testimony that it developed its CCOS study by utilizing the same methodology that was approved by the Commission in *Formal Case No. 989*. [citation omitted]. We agree with the Company that, contrary to some of AOBA's claims, the Company's CCOS study does not attempt to depict a 'class cost of service' for Interruptible customers, whose revenue contributions to WGL are determined under a 'value of service' approach that includes revenue sharing with other customer classes. We conclude [ ] that WGL's embedded CCOS study is reasonable and valid.").

599 Our ruling here for WGL mirrors the similar ruling we entered in Pepco's recent rate case. *See Formal Case No. 1087*, Order No. 16930, ¶ 306 (September 27, 2012) ("Taxes are levied on the sums of money paid by customers for electric service, not on the basis of class rate base or some underlying "costs" of the seller to provide the service. We agree with AOBA, however, that the Company's CCOSS (and even OPC's CCOSS) shows that severe disparities now exist between customer class RORs"); *id.*, Order No. 17027 ¶ 32 n.103 (December 26, 2012) ("while we reject AOBA's 'tax allocation' argument for adjusting the Company's CCOSS, AOBA's submission about taxes illustrates the distortions that arise when severe disparities in class ROR are allowed to persist. Other customer classes are significantly burdened by the subsidy now flowing to the residential class.").

circumstances or set forth any good reason warranting a change to the established *status quo* methodology that the Company used to develop its CCOSS study in the present case.[600]

284. As noted by AOBA in its testimony, the treatment of Washington Gas's Interruptible Service class in its CCOSS presents special issues. AOBA has argued that WGL has failed to include within its study a majority of the distribution revenues from Interruptible Service customers and therefore fails to recognize more than $19 million of revenues that Interruptible Sales and Delivery (Transportation) service customers made to the Company's test year cost of services. WGL admits that its study in Exhibit WG (J)-4 does not include actual revenues for interruptible customers, but claims that it has determined the rate of return and the appropriate rate adjustments for Interruptible customers using a separate class cost of service study which it did not make a part of this record.[601] This cloak of secrecy that WGL draws around the revenues picture related to its Interruptible customers further underscores our reason for opening a separate proceeding on this topic. We will add to the list of topics the issues the class cost of service issues raised by AOBA, including how WGL's CCOSS accounts for the Interruptible Service and Watergate classes in its various class cost of service studies and how those studies calculate the costs and class RORs for Interruptible Service and Watergate customers.

B. Customer Class Revenue Requirements

285. **WGL**. To move the class ROR for each customer class closer to WGL's proposed District of Columbia jurisdictional average ROR of 8.91%, WGL proposes to assign 63% of its revenue increase to the Residential class, 24.5% to its Commercial and Industrial class of customers, and 12.2% to Group Metered customers, with a small amount to Interruptible Service customers.[602] The Company argues that these class revenue targets address the disparities in class RORs shown by its CCOSS, move gradually toward more equalized class RORs, and reflect how its costs are incurred.[603]

286. **OPC**. OPC recommends that any rate increase be allocated proportionately among the classes through a pro rata increase across-the-board among the customer classes.[604] OPC urges the Commission to recognize the flaws in WGL's CCOSS; to assign little weight to the CCOSS in determining how to allocate the proposed rate increase among the various customer classes; to consider other valid factors such as rate continuity, historic patterns of rate change, equity, the value of service to the customer, and other factors including the need to

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600 *See, e.g., Formal Case No. 989*, Order No. 12589, ¶¶ 363, 364 (October 29, 2002) (party challenging one of the Commission's established rate making methodologies bears a significant burden to show changed circumstances or persuasive good new reasons for overthrowing the *status quo*).

601 WGL Br. 84 and WGL (J) at 16.

602 *See* WGL (J) at 9-10 (Wagner); WGL (J)-1, Schedule C (Wagner), as calculated by staff.

603 *See* WGL (J) at 9-10 (Wagner);

604 OPC Br. 166.

conserve energy resources.[605] OPC argues that it is "more equitable to maintain the current allocation of revenue among the classes rather than apply a disproportionate rate increase that penalizes those classes that can least afford it.[606]

287. **AOBA.** AOBA urges the Commission to move more forcefully to reduce the disparities in the class ROR. According to AOBA, WGL's CCOSS results indicate that WGL's Residential customers provide no contribution to the Company's return requirements and even have portions of their allocated operating expense responsibilities subsidized.[607] While recognizing that there are limits on the percentage increases that can be reasonably be imposed on any class of service, AOBA argues that there should be limits on the magnitude of rates of return that are expected from any class of service.[608] Finally, AOBA argues that any overall reduction in the Company's revenue requirement be assigned to those classes having rates of return in excess of the overall rate of return that the Commission finds to be just and reasonable for WGL in this proceeding.[609]

DECISION

288. The Commission enjoys wide discretion in setting customer class revenue requirements.[610] Traditionally, in setting class revenue requirements for WGL, we have considered the class cost of service for each class, as well as a broad range of other factors.[611] WGL's customer class rates of return need not be equal considering only class cost of service.[612] The options submitted by the parties for setting class revenue targets in the present case cover a wide spectrum and include: (1) OPC's across-the-board approach, which would recover WGL's revenue increase primarily through increases in the Company's distribution and peak usage charges; (2) WGL's proposal to move gradually toward more equal class RORs, which would allocate approximately 63% of WGL's proposed rate increase to the Residential classes, while increasing WGL's Customer Charges by 25% or 30%, among other things; and (3) AOBA's proposal to move more forcefully to reduce disparities in class RORs. In *Formal Case No. 1016*, the Commission announced that its policy is to move gradually toward more equal class RORs

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605 OPC Br. 166.

606 OPC Br. 167.

607 AOBA Br. 74.

608 AOBA Br. 87

609 AOBA Br. 88

610 *See, e.g., Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187 (D.C. 1982).

611 *See, e.g., Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1202-1208 (D.C. 1982).

612 *See, e.g., Washington Gas Light Co. v. Public Service Commission*, 450 A.2d 1187, 1207; *Apartment House Council of Metropolitan Washington, Inc. v. Public Service Commission*, 332 A.2d 53, 57 (D.C. 1975) ("equal return from customer classes is not required").

and to eliminate any negative class RORs.[613] The Company's CCOSS shows that wide disparities now exist in customer class RORs, including some negative class RORs for WGL's Residential customers. Weighing these considerations and the Commission's policy to move toward greater parity in class RORs,[614] we cannot accept OPC's across-the-board proposal, which would simply increase disparities in class RORs. WGL's approach, on the other hand, is in line with the Commission's policy. To move gradually toward more equal class RORs, the Commission assigns more than an across-the-board amount of responsibility for WGL's $8,381,089 rate increase to those classes with negative or low class RORs below the District's jurisdictional average ROR. With these principles in mind, the Commission approves the Company's proposal for the collection of 63% of its revenue increase from the Residential class, 24.5% from its Commercial and Industrial class of customers, and 12.2% from Group Metered customers, with a small amount from Interruptible Service customers. As a matter of policy, however, we will limit the allocation to the low-earning Residential class so its share of the revenue requirement will not fall below its present level (i.e., approximately 55%) as a result of our decision today.[615] The impact of these rulings moves all customer classes gradually toward greater parity in class RORs, consistent with our stated policies.

289. While we assign more than an across-the-board amount of responsibility for WGL's $8,381,089 rate increase to those classes with negative or low class RORs below the District's jurisdictional average ROR, the Commission believes that WGL's volumetric charges should, in general, be spread on a uniform basis to the extent necessary to cover the remainder of the class revenue targets for the Residential, Commercial and Industrial, and Group Metered classes.[616]

C. Customer Class Rate Designs [Issue j][617]

290. Washington Gas presented a rate design proposal that it describes as seeking to establish rates that more accurately reflect how the Company incurs its costs, thereby sending a proper price signal to customers and implementing a modest movement towards parity among all customers.[618] The Company's proposal maintains its two-part rate structure for Residential customers (consisting of a fixed monthly Customer Charge and a Distribution Charge) and a three-part structure for Non-Residential Firm customers (consisting of a Customer Charge, a

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613 *See Formal Case No. 1016,* Order No. 12986, ¶¶ 306-308 (November 10, 2003) (noting "the interest in moving in the direction of having [Washington Gas's low-earning] subclasses pay their costs of service and avoid earning a negative class rate of return").

614 *See Formal Case No. 1016,* Order No. 12986, ¶ 329 (November 10, 2003).

615 WGL (J)-1, Schedule B, p. 2 of 5.

616 The Commission addresses, in subsequent discussion, WGL's request to create a separate distribution charge for non-residential non-heating and non-cooling customers.

617 Designated Issue j asks: "Are the proposed rate design and tariff changes, including but not limited to the proposed fee-free credit/debit card bill payment program, reasonable in this case?"

618 WGL. Br. 83.

Distribution Charge, and a Peak Usage Charge). WGL proposes to increase the Customer Charge of its Firm Service Customers by 25%, except for the Residential Non-heating/Non-cooling and small Non-Residential classes, which it will increase by 30% and increase the Customer Charge for the Interruptible Class by 25%. The Company proposed to collect the remainder of its revenue increase through the application of an uniform percentage increase in its Distribution Charges and the Peak Usage Charges of Non-Residential customers of each customer class, adjusted slightly to continue a movement toward parity of return, based upon weather normalized data and application of WGL's proposed repression adjustment.[619] WGL proposes a 25% increase in the Customer Charge for the Interruptible Service class, but no increase in the Interruptible Service Distribution Charge because they are shown to be close to the system average in a class cost of service study which includes the actual revenues received from Interruptible customers.[620] WGL also proposes to create a separate Distribution Charge for Non-Residential Non-heating and Non-cooling customers to allow a continued movement towards parity of return.[621] Finally, WGL recommends that the Commission assign any variation in the requested revenue requirement to the residential Distribution Charges and non-residential Distribution and Peak Usage Charges.[622]

291. **OPC.** OPC argues that if the Commission approves a revenue increase, there should be an across-the-board distribution of WGL's revenue increase.[623] OPC contends that WGL's recommendation to impose a disproportionately greater rate increase on the residential customer classes appears to be based almost entirely upon the results of its class cost of service study.[624] According to OPC, "because of the flaws implicit in the Company's class cost of service study, it is unclear that a disproportionate rate increase is even necessary to match class costs with class revenues."[625] OPC claims that the flawed CCOSS should not be given substantial weight in determining how to allocate the proposed rate increase among the various customer classes.[626] OPC claims its across-the-board approach is supported by the presumptive validity of the Commission's earlier class cost allocation decisions, by equity, and by the interests in maintaining rate continuity and historic patterns of rate change.[627] Opposing increased Customer Charges, OPC recommends instead that "the rate increase be implemented entirely through higher distribution charges" for those classes not subject to a peak usage charge;

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619 *See* WGL R. Br. 136; WGL (J) at 8-14 (Wagner).

620 WGL (J) at 16 (Wagner).

621 WGL Br. 83. *See* WGL (J) at 12-13. (Wagner).

622 *See* WGL (J) at 16 (Wagner)

623 OPC Br. 166.

624 OPC Br. 166.

625 OPC Br. 166.

626 OPC Br. 166.

627 *See* OPC Br. 166-167; OPC R. Br. 35.

and, for the remaining classes, OPC suggests increasing the peak usage charge by a percentage equal to the overall cost of service increase for those classes.[628] OPC argues that increasing the distribution charge rather than the customer charge signals to customers the "real marginal cost of peaking."[629] OPC claims that increasing the distribution charge will send better cost signals to customers and will encourage energy conservation more than increases in WGL's Customer Charges.[630]

292. **AOBA.** Observing that there are wide disparities in WGL's class RORs, with Non-Residential customers paying far higher RORs than Residential customers, AOBA submits that WGL's proposed rates for Commercial and Group Metered Apartments are excessive.[631] To correct this, AOBA urges that any reduction in WGL's requested revenue increase should be distributed "primarily to those Commercial and Group Metered Apartments classes with the highest computed post-increase rates of return."[632] While it supports increasing fixed Customer Charges for most Non-Firm customers, AOBA opposes any increase in the Customer Charge for Interruptible Service customers.

293. AOBA argues that WGL's CCOSS does not accurately show the cost of serving Interruptible customers, and "any adjustment to WG[L]'s charges for Interruptible Service must await the Company's presentation of a more accurate portrayal of its Interruptible (Non-Firm) costs of service in the Company's next base rate proceeding." If the Interruptible Service class Customer Charge is increased, AOBA argues, it should be fully offset by a decrease in the distribution charges for the Interruptible Service class.[633] In the absence of a COSS that more reasonably and accurately assesses the Company's Non-Firm costs of service, AOBA maintains that it cannot support WGL's proposed increase in the Customer Charge for Interruptible Service customers.[634] AOBA suggests, however that WGL's Interruptible Service should be thoroughly revamped. To begin with, AOBA argues that the old historical rationale is outdated and no longer supports WGL's practice of sharing Interruptible margin revenues.[635] AOBA also argues that the Commission should terminate WGL's Interruptible Sales Service – "the last vestige of value-of-service pricing in the District of Columbia" – which accounts for only 1.5% of WGL's total annual Interruptible volumes. AOBA says that the volumes now served by competitive suppliers demonstrate that there is a viable competitive market for interruptible gas supply service in the District. AOBA notes that the Company eliminated its Interruptible Sales Service

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628 OPC Br. 167; OPC R. Br. 35.

629 OPC Br. 167.

630 OPC Br. 165-168; OPC R. Br. 35.

631 AOBA Br. 87-88; AOBA R. Br. 30-31.

632 AOBA Br. 87-88; AOBA R. Br. 30-31. *See* AOBA (A) 101-102 (Oliver).

633 AOBA R. Br. 31-32.

634 AOBA Br. 88-89.

635 *See* n.587 *supra* and AOBA Br. 81-83.

in Maryland several years ago without any significant problems or customer complaints, and AOBA submits that this Commission should take similar action "or at least place a freeze on service for new customers under that rate option, and thereby remove any pretense that value-of-service pricing is still a meaningful approach to pricing non-firm gas service in the District of Columbia."[636]

DECISION

294. Washington Gas argues that its revenue increase should be recovered in significant measure through increased Customer Charges,[637] and not solely through higher distribution charges and increases to the peak usage charge as OPC urges.[638] WGL's proposal is consistent with this Commission's actions in the prior WGL rate case that allowed WGL to recover slightly more of its fixed costs in Customer Charges.[639] After restructuring, Washington Gas is primarily a natural gas distribution company whose major costs are fixed costs that should be recovered through fixed charges like the fixed monthly Customer Charge. The Company showed that its current Customer Charges are well below the actual fixed costs of serving each customer class.[640] Increasing WGL's Customer Charges will better match the Company's revenues with its costs and will reduce the volatility of customers' bills. Accordingly, we agree with WGL's proposal to collect its District of Columbia revenue increase in significant measure through increases in the Customer Charge and we approve the Company's proposed 25% increase in the Customer Charge for the Residential and the Non-Residential Firm Customers (including for the Interruptible Service class), with a 30% increase in the Customer Charge for the low-earning Residential Non-heating and Non-cooling and small Non-Residential classes.[641]

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[636] AOBA Br. 89-90.

[637] WGL's approach includes some volumetric elements. OPC maintains that WGL proposes to increase peak usage charges by a percentage equal to the overall cost of service increase for those classes that have peak usage charges. S*ee* OPC Br. 167.

[638] OPC's proposal for increased volumetric rates is supported by energy efficiency and conservation rationales, which, as we stated previously, are factors for this Commission to consider. The Maryland PSC embraced these rationales in its WGL decision last year, ordering WGL to collect its revenue increase through increased volumetric rates. *Maryland PSC Case No. 9267,* Order No. 84475 p.94 (November 14, 2011). We have considered these factors, but approve increased Customer Charges for WGL for the reasons stated in the text above.

[639] *See, e.g., Formal Case No.1016,* Order No. 12986, ¶¶ 309-333 (November 10, 2003) (opinion considers OPC's objections to increased Customer Charges (*see* ¶ 315) but approves increased Customer Charges as the most appropriate means both to collect WGL's revenue increase and to recover a greater proportion of WGL's fixed costs through fixed price charges).

[640] *See* WGL (2J)-1 p.1 (Wagner) (WGL's current Customer Charges listed on line 40, while its calculated monthly cost per customer, for each customer class, appears on line 39). The chart shows, for example, that $21.91/month is the current fixed actual cost of serving WGL's D.C. Residential Heating or Cooling customers (WGL's largest class of residential customers), while WGL's current Customer Charge for these customers is only $7.95/month.

[641] *See* WGL (J) at 16 (Wagner) (if the Commission grants less than WGL's requested rate increase, then WGL recommends the same increases to Customer Charges, with any variation in revenue requirements assigned to the residential Distribution Charges and non-residential Distribution and Peak Usage Charges).

To better reflect WGL's actual costs, the Company's peak usage charge shall be increased by a uniform percentage increase for those classes that have peak usage charges.

295. We accept WGL's proposal that the Interruptible Service class rates should be raised only by the 25% increase in the Interruptible Service Customer Charge and that no change should be made to the Distribution Charge for this customer class. But we do so with a great deal of reluctance because there is a suggestion in the record that the cost to serve this customer class is significantly higher.[642] We also note that AOBA urged the Commission to make no change to the Interruptible customer's Customer Charge and instead adjust the Distribution Charge if an increase needed to be made for this customer. WGL argued for no change to the Interruptible Distribution Charge based on the results of a separate class cost of service study; however it did not provide that study to us. As we have recognized throughout this Order and Opinion, there are numerous issues that need to be resolved about the Interruptible Service customers. The correct rate design and cost to serve the Interruptible class of customers are two more issues to add to the list of issues we have already identified for the new proceeding that we will open soon. The Commission has elected to make no increase in the distribution charge, for Interruptible Service customers at this time.

296. With respect to the Company's request to change the rate design for Non-Residential, Non-heating, Non-cooling customers to allow a separate Distribution Charge, we find the request to be reasonable. It will allow the Company to set a rate for this customer class that is different from the rate for its non-residential heating and cooling customer and will facilitate a move to parity. No other party has objected to the change. Therefore, WGL may adjust the distribution charge similar to Exhibit WG (J)-1, Schedule A.

297. Based on the policies and principles discussed in this Order and Opinion, the class revenues allocations and the Customer Charges from the rate design discussed above are set out in the chart below:[643]

WGL Customer Class	Class Revenue Present Rates ($000's)	Class ROR in WGL CCOSS	Increase Amount ($000's)	Increase % Excluding Gas Cost	Customer Charge Increase
Residential					
Heating and/or Cooling	$57,774	(-0.93%)	$4,926	8.5%	$7.95→$9.90
Non-heating/Non-cooling					
Individual Metered Apts	$965	(-13.89%)	$185	19.1%	$4.10→$5.30
Other	$961	(-7.06%)	$97	10.1%	$4.85→$6.30

[642] See WGL (2J)-1 that suggests the monthly costs to serve this customer class is $1,595.

[643] These outcomes reflect WGL's updated CCOSS, including its class ROR for the Interruptible Service class. *See* WGL (J) at 16, WGL (J)-1, Schedule B p.2, line 43 less line 26 (class revenue), p.3 and Schedule C, and WGL (J)-4 (class RORs in WGL's CCOSS) (Wagner); WGL Exhibits (2J)-1 and (2J)-2 (Wagner); Tr. 1379-1381 (WGL witness Wagner). "Increase Amount" does not include late payment charges of $97,000.

WGL Customer Class	Class Revenue Present Rates ($000's)	Class ROR in WGL CCOSS	Increase Amount ($000's)	Increase % Excluding Gas Cost	Customer Charge Increase
Commercial and Industrial					
Heating and/or Cooling					
Less than 3,075 therms	$4,321	7.89%	$368	8.5%	$13.15→$17.10
3,075 therms or more	$25,200	18.50%	$1,327	5.3%	$26.40→$33.00
Non-heating/Non-cooling	$6,080	29.53%	$334	5.5%	$11.20→$14.00
Group Metered Apartments					
Heating and/or Cooling					
Less than 3,075 therms	$527	12.91%	$49	9.4%	$13.15→$17.10
3,075 therms or more	$12,962	18.11%	$823	6.4%	$26.40→$33.00
Non-heating/Non-cooling	$2,116	21.50%	$138	6.5%	$11.20→$14.00
Total Firm	$110,906				
Interruptible	$11,515	9.91%	$37	0.3%	$63.55→$80.00
D.C. Total Sales/Delivery	$122,421	--	$8,284	6.8%	--

D. Residential Essential Service [Issue k][644]

298. **WGL**. Washington Gas proposes two changes to provide further assistance to the Company's low-income customers with their gas bills during the winter heating season under the Residential Essential Services ("RES") Program. First, WGL proposes to increase RES credits by the overall percentage increase that is assigned to the Residential class in this case. WGL has proposed a volumetric change that would use the per therm increase to the Residential Distribution Rate and add to it the effective rate per therm increase for the Residential heating Customer Charge during the winter months when the RES is in effect, dividing that amount by the related therm throughput.[645] This would result in a proposed $0.1731 increase in the RES credit. WGL calculates that the impact of this for the 5,920 eligible RES customers who were participating in the program as of the close of the test year in September 2011, would be to

644 Designated Issue k asks: "Are the proposed changes to Residential Essential Service reasonable and appropriate?"

645 WGL (J) at 17 (Wagner).

increase the average RES credit per therm from the current rate of $0.2186 to $0.3917 ($0.2186 + $0.1731 = $0.3917). Second, the Company proposes a change to the Purchase Gas Charge ("PGC") paid by RES customers. The basis for the PGC charged to RES customers would move from the current PGC threshold that uses a three-year average based on the period 1997-1999 to an average monthly PGC based on six months of actual PGC data for the year 2012.[646] The Company asserts that this change would better reflect gas costs in the current pricing environment.

299. **OPC.** OPC takes no position on this Issue.[647]

300. **AOBA**. AOBA is not opposed to a limited program designed to facilitate bill payment by low-income customers. However, AOBA also states that a broad offering of that program is not justified on the basis of the record of this proceeding.[648]

301. **District Government.** The District Government agrees with WGL's change updating the PGC charge in RES rates to reflect current, lower gas prices and agrees that the RES credit should be increased; however it opposes the WGL proposal to increase the RES credit through the use of a volumetric method to offset the increase in the customer charge.[649] The District Government points out that the Company's proposal fails to reduce its reliance on volumetric revenues to support this program, and it puts RES customers who consume fewer than 108 therms per month (including customers who are conserving use in an attempt to lower their bills and all RES customers in the months of November and April) at risk of not recouping the full amount of the RES credit for the Customer Charge increase. At the same time, RES customers who consume more than 108 therms due to a colder-than-normal weather or higher usage may recover higher-than-normal credits.[650] The District Government supports a RES credit that would offset the increase in the Customer Charge that would rise from $7.95 per month for the heating season (November through April) to $9.90 per month. As an alternative to a flat credit that offsets any increase in the Customer Charge, the District Government recommends no increase to the Customer Charge for RES customers.[651]

302. The District Government recognizes that the manner in which this issue is decided will affect the District Department of the Environment's Energy Office ("DDOE") because it is the District agency that administers the low-income utility discount programs in the District of Columbia, including RES.[652] The District Government also recognizes that the RES program, as

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646 WGL Br. 86-87; WGL (J) at 17 (Wagner).

647 OPC Br. 168.

648 AOBA Br. 13.

649 District Government (A) at 5, 9 (Mathur).

650 District Government Br 11.

651 District Government Br. 11.

652 District Government Br. 1. Tr. 952-964 (colloquy between Chairman Kane and District Government witness Mathur).

it exists today, is the product of a series of actions by the Commission over a 26 year period (since RES was created in a final rate order in Formal Case No. 840 on September 5, 1986, along with a series of actions taken by the Council of the District of Columbia ("the Council")).[653] These actions have culminated with the passage of the Clean and Affordable Energy Act of 2008 ("CAEA") that transferred the RES program to DDOE and created the Energy Assistance Trust Fund ("EATF") for low income utility programs that is funded, in part, by a new $0.006 per therm surcharge on all WGL customers except RES customers.[654] Nevertheless, according to the District Government, the Commission's jurisdiction to set WGL's rates encompasses the jurisdiction to set the RES rate level and determine the reasonableness of the RES rate design for the program's funding received from WGL's base rates.[655]

DECISION

303. The Commission has grown increasingly concerned about the impact of the changes in the RES Program, as outlined in the District Government's brief, and the effects of those changes on the program's operations, the costs that are paid by District ratepayers, and the Commission's jurisdiction to ensure that the resulting rates are just and reasonable. We have concluded that, as a matter of policy, the approval of additional ratepayer funds to the RES Program under its current formulation is neither reasonable nor appropriate. Therefore, the Commission is only approving one of the two RES changes proposed by WGL, one that, at least in the short term, will likely not require additional ratepayer funds and may even result in ratepayer savings.

304. We are concerned, for reasons that we explain below, that the funding level of the subsidy that we had previously authorized for the RES Program, when combined with the surcharge funding that has been established for RES, is placing an undue burden on the District firm ratepayers. They are now paying for the RES Program under two different funding mechanisms and the amounts that are being paid may not be aligned with program costs. Therefore to minimize the potential for unreasonable rates, we are retaining the amount of ratepayer funding that WGL is authorized to include in base rates at its current level of $511,032. Furthermore, we are not allowing WGL to collect additional funding through the Distribution Charge Adjustment for the RES Program. This action will ensure that the primary funding for the RES Program will come from the CAEA EATF surcharge that has been placed on the bills of District ratepayer for the RES and other low-income programs, as the City Council has directed. Moreover, our consideration of the RES program in this case has led us to conclude that a

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653 District Government Br. 2-7 (summarizing the creation of the RES program in *Formal Case No. 840*, Order No. 8569, pp. 84-90 (September 5, 1986); and various D.C. Council actions including Omnibus Utility Amendment Act of 2004 § 101, D.C. Law 15-342, Act 15-760 (effective April 12, 2005) (enacting old D.C. Official Code § 34-1651 (now repealed); the Clean and Affordable Energy Act of 2008, D.C. Law 178-0250 ("CAEA") (October 22, 2008). the Residential Aid Discount Subsidy Stabilization Act of 2010, Bill 18-493, D.C. Law 18-195, 57 DCR 4519 (effective July 23, 2010) especially D.C. Code § 8-1774.11(d), § 8-1774(c), § 8-1773.01(6).

654 CAEA, D.C. Law 178-0250 (October 22, 2008).

655 *See* District Government Br. 1-9.

legislative change is needed to transfer the RES Program back to the Commission. This will allow for a better alignment of responsibility for both designing and funding the RES program. We will be urging the Mayor and the Council to make that change as soon as possible.

305. A partial description of the Commission's involvement in the RES program may be helpful in understanding our decision. This Commission last considered proposed changes to the RES program in a base rate proceeding in 2003 in *Formal Case No. 1016.*[656] At the start of that case, the RES Program made available to RES customers during a heating season, from November through April, was 750 discounted therms per heating season with two tiers of credits – one for a higher level of consumption to protect RES customers in the event of unusually cold winter weather and funding to cover 50 percent of the cost of purchase gas for RES customers in the event that the cost of gas increased 50 percent or more from a three-year base line average for 1997-1999. The second tier of credits in the event of a colder winter plus the contribution towards 50% of the cost of gas were RES enhancements that were added in *Formal Case No. 989* at the cost of $511,032 for the 7,148 RES customers.[657] The Commission included this cost in WGL's base rates. In *Formal Case No. 1016*, we approved a proposal by WGL to increase the existing credit for RES customers by the same overall percent increase that was approved for the Residential Class revenue requirements to cover increases in both the Company's Distribution Charge and Customer Charge. In addition, we modified WGL's tariffs (Purchased Gas Charge, General Provision No. 16) to eliminate the then current cap of $1.08 million a year on RES credits to allow maximum benefits to be paid to RES customers and to approve the use of the Distribution Charge Adjustment ("DCA") to track the cost needed to cover the RES credits and provide additional funding to the RES Program in the event that the costs exceeded $511,032.

306. Between our decision in *Formal Case No*. 1016 and today, the RES Program has undergone a series of changes as a result of actions taken by the Council. These changes have included the passage of the Omnibus Utility Amendment Act of 2004 ("Gas Act of 2004")[658] that created the National Gas Trust Fund ("NGTF") to be used for programs to promote energy efficiency and provide financial assistance to low-income gas customers. The NGTF was funded by a new per therm surcharge on all WGL customers except RES customers. The Gas Act of 2004 required the Commission to establish a universal service program to assist low-income natural gas customers and DDOE was assigned the task of administering the program. In response to the legislative directive, the Commission created the Residential Essential Service Expansion and Awareness Program ("RESEAP") that had the goal to "increase participation in the RES program and to make natural gas more affordable for low-income customers."[659] The objectives of the RESEAP were to increase the existing RES credit to customers already in the

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[656] *Formal Case No. 1016*, Order No. 12986, ¶¶ 359-371 (November 10, 2003).

[657] *Formal Case No. 989*, Order No. 12589, ¶ 461 (October 29, 2002).

[658] *See* Omnibus Utility Amendment Act of 2004 ("Gas Act of 2004"), D.C. Law 17-20, D.C. Official Code § 34-1651 *et. seq.* (2008 Supp.).

[659] *Formal Case No. 1037*, *In the Matter of the Investigation Into the Omnibus Utility Emergency Amendment Act of 2005, Specifically Regarding the Establishment of the Natural Gas Trust Fund Programs* ("*Formal Case 1037*"), Order No. 14608, pp.13-14 (October 23, 2007).

program and to provide sufficient RES funding to cover the cost of an additional 2,200 customers for the RES program in each of the following two years through an aggressive outreach program. To provide the additional funding, the Commission ordered the RESEAP to contribute 20% over the existing RES credits, raising the average assistance to a typical RES customer from $211.43 to $253.74 over the course of the heating season.[660] Additionally, the Commission directed that an additional $422,900 be available for the first year of the program and $515,938 for the second year of the program to support the projected participation of 10,000 RES customers and 12,200 RES customers respectively in addition to supporting the 7,800 customers who were already in the program.[661]

307. During the first year of the RESEAP, the Council passed the Clean and Affordable Energy Act of 2008 ("CAEA") that repealed the NGTF and replaced it with the Energy Assistance Trust Fund ("EATF") that is funded, in part, by a new $0.006 per therm surcharge on all WGL customers except RES customers. The CAEA funded the existing low-income programs that were defined as the RESEAP and the Low Income Home Energy Assistance Program Expansion and Energy Education program ("LIHEAP Expansion"), which provided funding for electric customers when federal LIHEAP funding was not available to eligible households. The CAEA tasked the Mayor with issuing rules to modify the EATF assessment and the programs that EATF funds. The current annual funding through the CAEA is $2.6 million.[662]

308. Although responsibility for the administration of the RES program now rests with DDOE, WGL and the District Government, along with other parties, continue to look to the Commission to fund the RES program as part of its duty to set fair, just, and reasonable rates for District ratepayers. Through pre-filed testimony, discovery and testimony during the course of the evidentiary hearing in this proceeding, the Commission was able to obtain some additional details about the costs and the funding of the RES Program that DDOE is now administering. According to WGL, it recovers the funds for the RES Program first from the $511,032 in its base rates, as authorized by the Commission in *Formal Case No. 989* and confirmed in *Formal Case No. 1016*; next from DDOE from the CAEA EATF, and any remaining amount is recovered through the DCA. To illustrate, we know the number of test year RES customers is 5,920. Assuming a credit of $253.74 per customer, the total credit would be about $1.5 million. After taking out the base rate amount of $511,032 and the EATF amount of $81,546 for FY2011, the remaining amount to be paid through DCA would be roughly $909,563.[663] It concerns us that in 2011 the major burden fell on the DCA, despite the fact that there was additional funding available in the EATF.

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660 *Formal Case No. 1037,* Order No. 14608, p. 14 (October 23, 2007).

661 District Government Response to Commission Bench Request No. 3; and District Government Br. at 6.

662 The Fiscal Year 2011 Supplemental Budget Support Act of 2010 ("BSA"), D.C. Law 18-370 (April 8, 2011). The pertinent part of the BSA is Section 612 (c), which reads: "The Energy Assistance Trust Fund shall be used solely to fund the existing low-income programs in the amount of $2.409 million in fiscal year 2011, and $2.6 million annually thereafter."

663 This is an example that serves to illustrate the funding in FY 2011, however, the Commission believes there is sufficient EATF funding to cover the DCA portion.

309. The Commission has considered whether it should adopt as reasonable and appropriate the two changes that WGL has proposed for the RES Program. Based on the record before us, we are convinced that we should only approve one of the two proposed changes - the change in the calculation that would raise the PGC threshold. There is a two-prong basis for our decision. First, the record in this proceeding has convinced us that there is now a misalignment between the funding of the RES and the spending on the program and that the current structure is placing an unfair burden on firm ratepayers. The Commission has the authority to decide what amount of funding, if any, should be contributed to the RES Program from District ratepayers, separate and apart from the RES funding that is now being generated through the CAEA EATF surcharge; however, we have no authority over the administration of the program. Based on the current record, it appears that District ratepayers are now paying $511,032 through WGL base rates plus a varying amount through the DCA plus the EATF surcharge to support RES and the other programs for low-income consumers. Additionally, the record in this proceeding shows that DDOE's EATF allocation to the RES expansion program has declined significantly in recent years and it appears that funds that are collected by WGL through the EATF are not being used by DDOE to fully fund the RES. As a result of the funding shortfall by the EATF, District firm ratepayers have to pay extra funds through the DCA for the RES. Given our fiduciary duty to the firm ratepayers contributing to the RES Program as well as our duty to ensure just, and reasonable rates for all District ratepayers, we are not persuaded that we should increase funding for the RES through base rates. Second, the record shows that WGL's recommendation to increase the RES credits through a volumetric change in the rate design of the RES Program and the District Government's alternative proposal to increase the RES credits through a flat fee would further increase the costs of the program and place an additional financial burden on District ratepayers. Our obligation to ensure that the rates that are paid by District ratepayers are just, fair and reasonable prevents us from approving any change to the RES Program that would place financial burdens on District ratepayers. We are, therefore, capping the amount of funding that WGL is authorized to use from base rates at the present level of $511,032 and we are directing that WGL shall no longer use funds from the DCA to further subsidize the RES Program that DDOE is administering. Our decision does not limit the amount of funds that WGL may request or receive under the EATF that DDOE is administering. There is sufficient funding in the EATF to support the existing RES program without burdening the ratepayer beyond the $511,032 contribution. Indeed, we believe the EATF is sufficient for DDOE to cover the increase in the credits to offset the minimum increase in rates we permit in this proceeding.

310. We conclude that WGL's second recommended change is reasonable and should be approved. WGL's second recommended change would move the PGC rate from the current PGC target that uses a three-year average based on the period of 1997-1999 to an average monthly PGC based on six months of actual PGC data for the year 2012. The Company asserts, and we agree, that this change would better reflect gas costs in the current pricing environment. This change is not contested by any party. We believe that, at least in the short term, this change will reduce the amount of the subsidy required to support the RES program.

311. An additional Commission concern about the RES program is the fact that RES participation appears to be declining, despite several years of economic hardship for many District citizens. The number of RES customers during this test year period was 5,920 which is

substantially lower than the 20,000 customers that the Commission targeted for support in our decision in *Formal Case No. 1016* and lower than the 7,148 RES customers that were enrolled during *Formal Case No. 989* when we established the level of RES subsidy. The more recent program participation numbers of 8,866 toward the end of 2012 are more encouraging but still substantially below the numbers that the Commission had targeted for the RES Program a decade ago. This drop in the level of participation along with the multiple sources of uncoordinated funding for the RES Program has convinced us that the RES Program needs to be reviewed to ensure that it is reaching the intended population of low-income customers and that the funding is being done in a manner that is fair to RES customers and to the District ratepayers who pay for the cost of the program. Historically, this was a task that the Commission could undertake; however, the CAEA moved the administration of the RES Program to DDOE. Our decision today is the most that we can do at this time to ensure that District ratepayers, who are the ultimate source of all RES Program funding, are being charged rates that are fair, just, and reasonable while also providing a reasonable amount of funding to support the program that DDOE now administers through the EATF.

312. Like RES, the electric support program, known as the Residential Aid Discount ("RAD") was originally the responsibility of the Commission. However, program administration was moved to the D.C. Energy Office in 2000 after the passage of the Retail Electric Competition and Consumer Protection Act of 1999, D.C. Official Code § 34-1514 *et. seq.* (2008 Supp.);[664] and later transferred to DDOE in 2008 under the CAEA. In 2009, when a concern arose about the RAD program and it became clear that the Commission no longer had the jurisdiction to resolve the program concern, the Council enacted the Residential Aid Discount Subsidy Stabilization Emergency Act ("RAD Emergency Act") (D.C. Act 18-398), effective May 10, 2010, which amended the CAEA and returned jurisdiction and responsibility over the RAD Program to the Commission. The legislation also proportionally reduced the EATF surcharge on electric distribution customers and returned funding authority to the Commission. The RAD Emergency Act was followed by the Residential Aid Discount Subsidy Stabilization Amendment Act of 2010, ("the Act of 2010") (D.C. Law 18-195), enacted May 19, 2010, that permanently enacted the emergency measures.[665] We believe that the RES Program should receive the same treatment as the RAD Program. If authority for the RES Program is returned to the Commission (a legislative action that we welcome and are prepared to actively support), we are prepared to conduct a major review of the RES Program in order to establish a reasonable subsidy for low-income customers, similar to our current efforts with the Residential Aid Discount ("RAD") Program for electric customers.

E. Tariff Changes and Additions

313. **WGL.** Tariff changes are proposed by the Company to its General Service Provisions ("GSP"), including GSP No. 4 (affecting customer payments), GSP No. 25

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664 *See* Retail Electric Competition and Consumer Protection Act of 1999 ("Electric Act of 1999"), D.C. Law 13-107, D.C. Official Code § 34-1514 *et. seq.* (2008 Supp.).

665 *See* the Residential Aid Discount Subsidy Stabilization Amendment Act of 2010, ("the Act of 2010") (D.C. Law 18-195), enacted May 19, 2010.

(facilitating customer sign-ups for WGL's automated payment plan), and GSP No. 26 "Plant Recovery Adjustment" (expanding this surcharge mechanism to cover additional aspects of WGL's pipeline replacement program).[666] WGL also proposes to create a new GSP No. 27 ("Balancing for Natural Gas-Fired Generating Stations") that would affect operators of electric generating stations.[667]

314. **AOBA.** AOBA objects to two adjustments that are related to two of WGL's proposed tariff changes. The first objection relates to WGL's implementation of its "Fee-Free" Credit/Debit Card Bill Program and the related tariff. The second objection is to the PRA mechanism that WGL seeks to use to recover cost associated with its APRP and implement with a new surcharge.[668] AOBA argues that surcharges insulate shareholders from normal risks and avoid full regulatory scrutiny of WGL's pipeline replacement activities.[669]

DECISION

315. The Commission's ruling on Washington Gas's Fee-Free Credit/Debit Card payments plan will require a change to the proposed GSP No. 4 if WGL elects to offer its proposed Fee-Free Credit/Debit Card bill payment option under the condition that no costs related to the plan be recovered from ratepayers. *See* ¶¶ 193 *supra*. WGL is directed to file a revised GSP No. 4 if it elects to present the program under the conditions set by the Commission. We have rejected WGL's proposal for an expanded APRP surcharge mechanism to cover additional aspects of its pipeline replacement program; therefore, we do not approve GSP No. 26. *See* ¶ 269 *supra*. AOBA's objection to the Fee-Free Credit/Debit Card bill payment option was previously considered in Test Year Expenses (Issue f) wherein we rejected WGL's proposed payment option. We also rejected the Company's proposed PRA earlier in this decision. Therefore, AOBA's objections to these tariff changes here are moot. WGL's proposed tariff changes for GSP. No 25 and GSP No. 27 are not disputed by any party. The Commission approves these undisputed tariff changes as reasonable. The company shall include any tariff changes as part of its compliance filing.

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666 WGL's proposed changes to GSP No. 4 would "(1) change the time by which payments must be received to be processed on the same day, (2) eliminate the fee paid by customers to a third-party processor for credit/debit card bill payments, and (3) initiate the Automatic Name Change Program to automatically transfer service in the name of the property manager or landlord without interruption of service or the payment of a service initiation fee when a tenant moves out." WGL's proposed changes to GSP No. 25 would permit customers to sign up for the automated payment plan via the Company's website. WGL's proposed changes to GSP No. 26 would expand its Plant Recovery Adjustment/cost recovery mechanism "to include additional risk-based components to the existing pipe replacement program." WGL Application 6-7; WGL Br. 85; WGL (L) at 16-19, 24 (Buckley).

667 WGL states that its proposed new GSP No. 27 ("Balancing for Natural Gas-Fired Generating Stations") is intended "to encourage operators of electric generating stations to balance daily gas deliveries with daily gas usage, within a reasonable tolerance." WGL Application 7.

668 AOBA R. Br. 23.

669 AOBA Br. 10, 15-22, 26-27, 35.

316. The Commission's ruling on the requests related to the RES Program will also require changes to WGL's tariff. *See* ¶¶ 303-312 *supra*. First, the Residential Essential Service Rider ("RES Rider") will need to be changed to reflect our new directive that, to the extent that any billing credits for RES exceed the $511,032 authorized in this proceeding from base rates, the funding shall come exclusively from the EATF administered by DDOE. Additionally, the Rider will need to be adjusted to reflect the change in the calculation of the PGC that is used to calculate the amount of the gas credits when the PGC charges exceed the 150% threshold. Finally, since we are not approving the volumetric tariff changes that WGL has proposed to credit classifications shown in the RES Rider, WGL's proposed changes to the tariff are not approved. Second, GSP 16. PURCHASED GAS CHARGE, subsection IV.A will need to be changed to reflect our decision that the DCA will no longer be used to fund any RES discount billing credits in excess of the $511,032 approved in this case. Any shortfall will now be funded exclusively through the EATF surcharge that DDOE is administering. In the event that the RES billing credits are less than the approved $511,032, the remainder will be added to the DCA and returned to District ratepayers through the DCA mechanism.

317. The Commission's decision to remove the purchase gas administrative expenses from non-distribution purchase gas charge-related expenses will also require that WGL amend its Purchase Gas Charge tariff so that the removed costs will now be recovered through the gas administrative charge.

318. Although this issue was not raised by any party in this proceeding, the Commission has noticed that GSP 16 subsection V.B.5 provides that carrying costs for the Actual Cost Adjustment ("ACA") for the PGC will be accrued at the Company's short-term debt rate, as approved in *Formal Case No. 989*. Since we are approving a new short-term debt rate of 1.21% in this proceeding, we direct WGL to amend this portion of its tariff to reflect the updated short-term debt rates for the carrying cost on the ACA amount.

XIII. RESEARCH AND DEVELOPMENT INITIATIVES [Issue m][670]

319. **WGL.** WGL proposes to increase its ratepayer-financed research and development ("R&D") activities by participating in two programs sponsored by the Gas Technology Institute ("GTI").[671] WGL proposes a $176,821 increase in test year revenues to fund its participation in two GTI-managed consortia: the Operations Technology Development ("OTD") program for $76,821 and the Utilization Technology Development ("UTD") program

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[670] Designated Issue m asks: "Are WGL's proposed research and development Initiatives for gas customers reasonable and appropriate?"

[671] Beginning in 1998, funding for gas industry R&D shifted from FERC to local gas distribution and pipeline companies. This shift in funding for R&D has meant that these costs now must be approved by the local gas company and the local public utility commission. WGL's participation in the OTD and UTD is thus contingent upon Commission approval in this rate case, and would not begin until the rate effective period. *See* WGL (F) at 5, 24 (Edelstein); WGL (G) at 27 (Townsend). WGL currently participates in GTI's Sustaining Membership Program (applied research projects) and Keyhole Technology Program (maintenance activities performed through a small diameter cut). GTI is an organization that conducts and manages gas industry research and development projects. *See* WGL (G) at 19 (Townsend).

for $100,000.[672] According to WGL and GTI, OTD funds R&D that seeks to develop technologies and products that increase the safety and reduce the costs of gas transmission and distribution systems. UTD funds R&D that seeks to benefit end users of natural gas by increasing the efficiency and lowering the cost of gas-using equipment.[673] Twenty-three natural gas local distribution companies ("LDCs") located throughout the United States are members of OTD, and 16 gas LDCs are members of UTD.

320. WGL has identified four (4) R&D projects in which it would participate in the District of Columbia under the OTD program. These initiatives include: (1) GPS Consortium, which facilitates the sharing of information related to the use of GPS technology for utility operations; (2) Evaluation of Lightweight Jackhammers; (3) Breakaway Disconnect Shutoff for Meter Risers; and (4) GPS-Enabled Leak Surveying and Pinpointing. WGL has also selected five projects under the UTD program in which it would participate: (1) Residential and Commercial Gas-Fired Clothes Dryer Opportunity Assessment and Technology Development; (2) Low-Cost, High Efficiency Condensing Unit Heater; (3) High Efficiency Steam Driven CHP System; (4) Next Generation Water Heating Components Development; and (5) GTI Emerging Technology Program membership.[674] According to WGL, the specific projects selected are "representative of the types of projects that the Company will participate in, but the Company will re-evaluate its selection once funding is approved."[675]

321. WGL asserts that the UTD program funds R&D that will benefit consumers of natural gas by increasing the efficiency and lowering the cost of gas using equipment. According to WGL, successful past examples of UTD projects include residential/commercial space heating and water heating equipment, boilers, cooking equipment and venting safety. After the initial period, WGL's participation is voluntary and gives WGL the flexibility to select to use the approved R&D funding for efforts it believes will benefit customers of the District of Columbia.[676]

322. WGL argues that it is reasonable for R&D funding to be included in the cost of service in this proceeding because District customers have benefited in the past and will continue to benefit from GTI's R&D projects.[677] The Company claims that, although investments in R&D may not all be successful, when benefits are realized, they benefit the public good. WGL states that it will direct the approved amount to fund R&D projects that will most benefit D.C. customers. Company witness Edelstein identified several technologies that may benefit

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672 WGL (D) at 82 (Tuoriniemi).

673 WGL (F) at 7 (Edelstein).

674 WGL (G) at 22 (Townsend).

675 WGL (G) at 27 (Townsend).

676 WGL Br. 114.

677 WGL Br. 11.

consumers in the District under UTD research, including venting and safety technologies, rooftop heating systems and high efficiency water heaters.[678]

323. WGL contends that the record shows that customers in the District of Columbia will receive benefits from GTI research in excess of known costs. WGL asserts that District of Columbia customers have realized and continue to realize cost savings from the sale and installation of high efficiency furnaces.[679] The Company points to witness Edelstein's analysis, which shows a benefit-to-cost ratio of 4.8 to 1 based on prior gas costs and 4.1 to 1 ratio based on current gas prices and submits that these District of Columbia results are in line with national results that show an 8 to 1 benefit-to-cost ratio.[680]

324. While R&D investment cannot be predicted with certainty, WGL asserts that the results of R&D research can be found in good public benefits such as safety, system integrity, and deliverability, which cannot be quantified by a dollar amount. The Company also maintains that, although manufacturers might benefit economically from GTI's UTD R&D, the benefits of such research accrue directly to customers who use the technology.[681] For end use R&D, WGL states that direct benefits to consumers include low-cost equipment and purchasing less gas. WGL also asserts that there is an indirect benefit for customers who do not purchase high-efficiency equipment in the form of overall reduced demand for gas, which results in reduced prices for natural gas.[682]

325. Replying to OPC's criticism that the benefits of this research is primarily for manufacturers with the exclusive licenses to manufacture and market the products that are developed, WGL argues that, to the extent R&D creates cost savings or increased sales or reduced operating costs for shareholders, utility regulators will see to it that those savings or benefits are shared with the utility's customers as part of the utility's next rate case.[683]

326. **OPC.** OPC states that it is neither just nor reasonable for District ratepayers to pay for WGL's participation in the OTD and UTD R&D initiatives WGL proposes. Therefore, OPC requests that the Commission deny WGL's request to participate in these R&D projects. OPC asserts that WGL has failed to demonstrate that the proposed UTD research would provide benefits to D.C. ratepayers sufficient to justify the costs that ratepayers would incur. OPC argues that the only District of Columbia-specific study offered by WGL to support the proposed UTD charges relates to the fully condensing pulse combustion furnace, which was first introduced for commercial sales more than 25 years ago.[684]

678 WGL R. Br. 196.

679 WGL R. Br. 197.

680 WGL R. Br. 197.

681 WGL R. Br. 199

682 WGL R. Br. 200.

683 WGL R. Br. 201.

684 OPC Br. 186.

327. OPC points out that UTD research involves developing end-user appliances and products that must be purchased separately by consumers from the manufacturers. Therefore, OPC claims that the benefits of UTD research primarily go to manufacturers who are granted exclusive licenses by GTI to manufacture and market the resulting products, possibly at premium prices. It is for these reasons, OPC asserts, that the Maryland Public Service Commission denied WGL the opportunity to recover UTD R&D costs, *i.e.*, on the grounds that the benefits of UTD programs are more in the nature of R&D for manufacturers, which do not directly benefit ratepayers. OPC also argues that, since R&D programs potentially benefit WGL shareholders and the Company's corporate image, it is neither just nor reasonable for ratepayers to fund 100% of WGL's participation in the R&D programs. If the Commission decides to approve rate recovery of R&D funding, OPC proposes that the recovery be restricted to funds used for OTD research.[685]

328. **AOBA.** Opposing WGL's effort to impose additional costs for R&D on District ratepayers, AOBA states that WGL's arguments in the current rate case are similar to WGL's arguments that FERC rejected in 2004 when it denied mandatory FERC funding of GTI research and cost recovery for WGL's participation in GTI R&D projects. AOBA notes that FERC rejected WGL's arguments in support of mandatory funding of GTI R&D because FERC was not convinced that there was inadequate private capital devoted to R&D efforts. Moreover, AOBA states, FERC found no benefit to ratepayers of continuing mandatory funding of GTI's R&D ventures and cost recovery by natural gas distribution companies of GTI membership expenses.

329. AOBA believes that WGL should not impose on ratepayers the obligation to fund speculative ventures through GTI.[686] In support of this conclusion, AOBA points to WGL witness Edelstein's testimony before the Michigan Public Service Commission, where he stated that investing in GTI is a speculative undertaking with no guarantee of a return on the investment, "let alone the availability of products and services" of use to local gas distribution companies. AOBA also claims that private sector and government supported R&D is available to Washington Gas without the need to impose additional costs on District ratepayers. AOBA points to programs run by the U.S. Department of Transportation and the U.S. Department of Commerce under mandate of federal law, which, AOBA contends, conduct research and development regarding the type of topics about which WGL contends it has an interest.[687] AOBA submits further that WGL's investment in GTI should be done by WGL's shareholders, not its ratepayers.

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685 OPC Br. 186, 188.

686 AOBA R. Br. 44.

687 AOBA R. Br. 44-45. AOBA points out that District ratepayers are already funding R&D through taxpayer-funded programs administered and coordinated by federal and state governmental agencies, often in concert with the private sector, to improve the safety and environmental operation of the natural gas pipeline distribution infrastructure. The District of Columbia participates in the U.S. Department of Transportation federal/state cooperative gas and hazardous liquid pipeline safety programs. *Id.* at 47.

DECISION

330. After reviewing all of the evidence presented in this case regarding OTD and UTD R&D for the District of Columbia, the Commission denies WGL's request to include in rates costs for both OTD and UTD research and development.

331. AOBA and OPC recommend that costs for GTI research be denied because WGL has failed to demonstrate that the programs have quantifiable benefits for District ratepayers that outweigh the expected costs. They urge us to follow the decisions of the Maryland Public Service Commission and FERC that have each denied WGL's request for cost recovery for UTD R&D programs after concluding that these programs have greater benefits for manufacturers and are more appropriately financed by private sector funding.[688] WGL notes, however, that the Maryland Public Service Commission recently approved cost recovery for the OTD program for Washington Gas.[689]

332. Our review of the recent Maryland order confirms that the Maryland Commission approved the recovery of OTD costs after finding that the OTD projects proposed in Maryland were "designed to improve system safety and reliability while reducing system costs" leading the Maryland Commission to conclude that these funds "provide a benefit to ratepayers."[690] On the other hand, the Maryland Commission denied the recovery of UTD expenses because they "focus on research that is aimed at improving end-user products including gas appliances" and as such were "more in the nature of R&D for manufacturers which does not directly benefit ratepayers." Thus, if we were to follow the Maryland precedent, we would deny recovery of UTD expenses entirely and permit recovery of OTD expenses where we find that these expenditures "provide a benefit to ratepayers."

333. WGL suggests that the issue before the Commission with respect to both the OTD and UTD requests is whether consumers in the District of Columbia should have the opportunity to fund research that could lead to the next technological breakthrough that could benefit not only them but the public at large.[691] We think that is the wrong question. The issue before us is whether consumers should be *obligated* to fund this research through their rates if there is no showing on the record that they will receive substantial benefits. Our assessment of that issue, like that of the Maryland Public Service Commission, is that first, ratepayers should not be burdened with the costs associated with the type of R&D that primarily benefits manufacturers (UTD Projects) and second, ratepayers should receive some specific benefit from the projects that they are being asked to support.[692]

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688 *Maryland PSC Case No. 9267*, Order No. 84475, p. 43 (November 14, 2011); AOBA R. Br. 39-41; *Federal Energy Regulatory Commission Order on Application Requesting Advance Approval of a New Gas Industry Collaborative RD&D Program*, 109 F.E.R.C. ¶ 61,164, 61,791-61,793 (November 18 2004).

689 WGL R. Br at 201.

690 *Maryland PSC Case No. 9267*, Order No. 84475, p. 43.

691 WGL R. Br. 195-196.

692 *Maryland PSC Case No. 9267,* Order No. 84475, p. 43 (November 14, 2011) (where the OTD projects

334. This is not a new position for the Commission. We first raised the issue of ratepayer benefits with respect to research programs funded by GTI's predecessor, the Gas Research Institute ("GRI"), in 1982 in *Formal Case No. 874*. In that proceeding, we attempted to establish a policy precluding the recovery from operating expense of more than 25% of costs attributable to GRI's surcharges unless WGL could prove that the surcharges specifically benefited local ratepayers. Our decision was subsequently overturned because at the time, the determination of an appropriate level of GRI spending was an issue that was preempted by FERC which required mandatory funding for GRI research and development and demonstration projects ("RD&D") as part of the wholesale gas charge that it approved – a situation that is no longer the case.[693] As noted by WGL's witness, a 1998 FERC settlement ended the FERC-approved funding mechanism and instituted a voluntary program for R&D funding that was phased in between 1998 and 2004.[694] As AOBA has noted in this proceeding, in 2004 FERC decided that "[m]arket based RD&D would better serve the consuming public" and was preferable to mandatory funding mechanism for GTI.

335. The only example presented by WGL that focused specifically on the benefits to District of Columbia ratepayers was a 2003 report that focused on the benefits to District consumers of high-efficiency furnaces.[695] WGL did not provide any evidence of how the four proposed OTD projects for which it was seeking funding would improve system and public safety, lower O&M costs or enhance reliability for District customers. This is in contrast to the WGL presentation in Maryland where it was able to demonstrate the benefits of its projects. In addition, we note that, not only are the projects proposed for the District different from those proposed in Maryland, they are also only "representative" of projects that WGL might decide to invest in once they have received ratepayer funding.[696] Further, WGL did not demonstrate that its proposed OTD projects would produce a measurable reduction in gas costs or other substantial benefits to consumers. For these reasons, we deny WGL's request for $76,821 of rate recovery for its OTD R&D expenses.

336. The Commission also denies WGL's request for $100,000 of rate recovery of its UTD R&D expenses. The record does not show that ratepayers would receive sufficient benefits to require mandatory ratepayer participation in UTD R&D.[697] UTD projects can be speculative,

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focused upon the benefits of polyethylene ("PE") plastic pipe which increases safety, and costs about one-half of coated steel pipe; the first set of guided horizontal drilling tools, which provides substantial cost savings; and the optical methane detector improves leak detection accuracy while lowering costs and testimony was given that these and other OTD products had improved system and public safety, lowered O&M costs and enhanced reliability).

693 *Washington Gas Light Company v. Public Service Commission, et al*., 508 A2d 930 (D.C. 1986)

694 WGL (F) at 5 (Edelstein).

695 WGL (F)-2 (Edelstein).

696 WGL (G) at 27 (Townsend).

697 OPC Br. 186-188; OPC (D) at 13:11-15: 11 (Mariam); AOBA (A) at 90: 1-5 (Oliver).

can take years of research and development, and may never come to market.[698] In that event, there is no benefit to ratepayers. When UTD products or technology do successfully come to market, the benefits accrue primarily to manufacturers. The manufacturer benefits from the subsidy of R&D dollars, from the receipt of an exclusive license to make and sell the product, and finally from the opportunity to sell the product, perhaps at a premium price, to customers who provided the initial research funding.

337. The free market arguments made by OPC and AOBA provide additional support for our decision to deny WGL's request for rate recovery for UTD R&D funding. OPC shows that, through the use of the patent system, investors can have a significant incentive to provide R&D funding for UTD research because the investors can recoup R&D investments and profits through the cost of the product that will be sold on the open market. Market incentives provide both incentives for investment in the form of profits from the sale of end-use products and incentives for proper safety and installation of such end use products.[699] WGL has failed to establish that available free market mechanisms are insufficient to provide desirable UTD R&D funding.

338. Although WGL produced evidence of customer benefit for the high efficiency furnace based on a study conducted in 1995 through 2000, WGL's evidence is deficient in several respects. First, the benefits are limited to the customers who bought the more efficient product. If there is any benefit to customers, either direct or indirect (as argued by the Company), who did not purchase the product, WGL has failed to quantify or prove it. WGL also failed to provide sufficient evidence to support its allegation that reduced gas costs to customers who purchased a new product resulting from UTD R&D are attributable to the use in the market of the more efficient product as opposed to other factors existing in the marketplace that may cause gas prices to fall. We, therefore, deny the Company's request for cost recovery of its UTD R&D test year expenses.

339. The Commission is not opposed to WGL funding any of the proposed projects through shareholder funds if it still wants to pursue R&D projects. Moreover, the Company is welcome to seek ratepayer funding in future rate cases so long as WGL can demonstrate quantifiable benefits for District of Columbia ratepayers for the projects being funded.

XIV. FINDINGS OF FACT AND CONCLUSIONS OF LAW

340. Based upon the evidence on the record in this proceeding, the Commission makes the following findings of fact and conclusions of law:

(a) That the twelve month period, starting October 1, 2010 and ending September 30, 2011, is the appropriate test year to use in determining WGL's revenue requirement based upon WGL's actual historical data for that period;

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698 AOBA R. Br. 44-45.

699 OPC (D) at 10 (Mariam); AOBA R. Br. 39, 47.

(b) That, although the proportion of common equity in WGL's actual capital structure at 59.30% is at the upper bounds of reasonableness and a hypothetical capital structure may be adopted in future cases if the proportion of common equity remains at the current level or continues to trend upwards, the actual capital structure as proposed by WGL is appropriate for this proceeding;

(c) That WGL's cost of long term debt is 6.16% and its cost of preferred stock is 4.79%;

(d) That WGL's cost of short term debt is 1.21%;

(e) That AOBA's Adjustment #3 that eliminates the revolver credit fees associated with WGL's short term debt is rejected and the fixed costs associated with revolving credit fees are accepted;

(f) That a reasonable return for WGL on common equity is 9.25% (the midpoint of the range of reasonableness from 9.0% to 9.5%);

(g) That a fair rate of return (including capital costs and capital structure) is 7.93%;

(h) That WGL's District of Columbia rate base for the test period is $201,569,048;

(i) That WGL's test-year operating revenues, as adjusted, are $212,018,594;

(j) That WGL's test-year operating expenses, as adjusted, are $201,182,162;

(k) That WGL's test-year revenues less test-year operating expenses, as adjusted, indicate the net operating income for WGL's District of Columbia service territory was $11,157,313;

(l) That the revenue required to produce the authorized level of return when the 7.93% rate of return is applied to the adjusted rate base of $201,569,048 is $15,984,426;

(m) That the Company's adjusted District of Columbia net operating income of $11,157,313 for the test year was deficient by the amount of $4,827,113;

(n) That the appropriate adjustment which would increase test-year revenue to the level of gross revenue requirements computed in accordance with the findings in this Opinion and Order and the schedules attached hereto is $8,381,089, which includes the appropriate allowance for taxes and uncollectibles;

(o) That the following uncontested adjustments to WGL's rate base when calculating the test-year rate base are approved as reasonable:

- WGL Adjustment #20 – East Station Environmental Costs (reduces rate base by $1,035,877)
- WGL Adjustment #26 – Storage Gas Inventory (reduces rate base by $21,661,774)
- WGL Adjustment #27 – Materials and Supplies (reduces rate base by $16,675)
- WGL Adjustment #28 – Supplier Refunds (increases rate base by $12,311);

(p) That OPC Adjustment #6 (Cash Working Capital – Revision to Revenue Lag), that reduces WGL's figures for billing lag in its lead-lag study is rejected with the exception of the flow through adjustments approved by the Commission;

(q) That WGL's Adjustment #19 (Cash Working Capital) based on its lead-lag study is approved as reasonable after adjusting for the adjustments approved by the Commission;

(r) That OPC Adjustment #7 (Cash Working Capital – Impact of OPC Expense Adjustments) is accepted insofar as it reflects the adjustments approved by the Commission;

(s) That the portion of WGL's Adjustment #30 (Gas Plant in Service/Construction Work in Progress) that includes $5,733,318 for the District of Columbia's share of the incremental cost of the new Springfield Service Center as of January 31, 2011 is accepted and OPC Adjustment #4 (Remove Post Test Year Incremental Springfield Office Plant Addition) to remove costs for the new Springfield Service Center is rejected;

(t) That OPC's Adjustment #3 (Remove $1.4 million in Post Test Year "Safety Related" Replacement Plant Additions) is accepted with respect to six (6) work orders totaling $605,068 that had no in-service date and open completion dates and the remainder of the adjustment is rejected and the portion of WGL's Adjustment #30 (Gas Plant in Service/Construction Work in Progress) that includes the remainder of its $1.4 million in Post Test-Year "Safety Related" Replacement Plan Additions is accepted;

(u) That OPC Adjustment #5 (Remove Uncertain Tax Position Offset to ADIT) is accepted (this reduces WGL's rate base by $6,779,007);

(v) That WGL's proposed depreciation expense is too high and should be lowered as specified in this Opinion and Order; that OPC's proposed service lives are more reasonable than WGL's proposed service lives for six (6) WGL asset accounts: account 380.2 (services-plastic), account 381.5 (meters-electronic demand recorders), account 382 (meter regulators installations), account 385 (house regulators installations), account 367.1 (transmission mains – steel), and account 376.1 (distribution mains – steel), and are accepted for those six (6) accounts; however, WGL's proposed service lives are accepted for the other uncontested accounts;

(w) That consistent with our depreciation rulings in *Formal Case No. 1076*, going forward, depreciation rates for WGL shall use the present value method in SFAS-143 (recodified in ASC 410) for collecting for future net removal costs using the formulas ordered by the Commission in Order No. 15710 in *Formal Case No. 1076*, which are the formulas from Maryland *Case No. 9092*; net salvage shall be calculated as described in this Opinion and Order; an inflation-based discount rate and the remaining-life depreciation method shall be used to calculate WGL's depreciation rates going forward and WGL is directed not to transfer monies out of its depreciation reserve into income without prior Commission approval.

(x) That OPC Adjustment #2 (Correction to ENSCAN Meter Depreciation Expense) is accepted concerning the removal of the double-counted balance; but that OPC's depreciation rate of 1.81% is rejected, and WGL's rate of 2.69% shall be used instead for this adjustment;

(y) That WGL's Adjustments #1 and #21 (Revenues and East Station Revenue Sharing, respectively) are accepted subject to the modifications for the weather normalization noted below;

(z) That WGL's Adjustment #2 (Uncollectibles) is accepted subject to the adjustment associated with our acceptance of OPC's weather normalization adjustment;

(aa) That WGL's Adjustment #1 (Weather normalization) is rejected, and OPC's Adjustments #8 and #22 (Weather normalization) that increase net income by $1,643,984, are accepted;

(bb) That in future proceedings, WGL is directed to use the most recent 30 years of data from an independent source to determine normal weather, but is otherwise free to use its best judgment in refining and improving its weather normalization adjustment, provided that it files a complete set of work papers and provides a clearer step-by-step explanation of how it calculates its weather normalization adjustment as outlined in this Opinion and Order;

(cc) That WGL's Repression Adjustment for test year billing determinants is rejected for reasons set forth in this Opinion and Order;

(dd) That going forward, the Commission will no longer consider the adoption of a repression adjustment in a base ratemaking case for the reasons set forth in this Opinion and Order;

(ee) That AOBA's Adjustment #1 (Interruptible Revenues) is rejected;

(ff) That a separate proceeding to collect more information about: WGL's Interruptible Service customer class, the operation of WGL's distribution charge adjustment ("DCA"), how WGL's CCOSS might account for revenues from the Interruptible and Watergate classes, and the proper design of Interruptible Service rates will be opened in the near future;

(gg) That the Commission approves as reasonable the following uncontested adjustments to WGL's test year expenses:

- WGL Adjustment #15 – Trade Dues, Business Memberships, and Support Payments (increases net income by $12,459)
- WGL Adjustment #16 – AGA Dues (increases net income by $50,670)
- WGL Adjustment #17 – General Advertising (increases net income by $34,257)
- WGL Adjustment #18 – Community Affairs (increases net income by $13,267)
- WGL Adjustment #20 – East Station Environmental Costs (reduces net income by $11,905)
- WGL Adjustments #24 – Tax Depreciation (reduces net income by $1,906,945)
- WGL Adjustment #26 – Storage Gas Inventory (reduces net income by $212,543)
- WGL Adjustment #27 – Materials and Supplies (reduces net income by $164)
- WGL Adjustment #28 – Supplier Refunds (increases net income by $121)
- WGL Adjustment #29 – Regulatory Commission Expense (increases net income by $136,501)
- WGL Adjustment #32 – Postage Expense (reduces net income by $6,687)
- WGL Adjustment #33 – Insurance Expense (reduces net income by $21,773)
- WGL Adjustment #34 – Fuel Expense (reduces net income by $15,148)
- WGL Adjustment #35 – Interest on Customer Deposits (reduces net income by $8,085)
- WGL Adjustment #39 – Safety Initiatives (reduces net income by $114,150)

- WGL Adjustment #40 – Affiliate Allocations/Officer Time (increases net income by $34,419)
- WGL Adjustment #41 – Sustainable Energy Trust Fund and Energy Assistance Trust Fund (increases net income by $3,592,705)
- OPC Adjustment #1- Remove Non-Existent Meters (increases net income by $143,120)
- OPC Adjustment #9 – Remove Double Count of Signing Bonus Amortization (increases net income by $9,724)
- Commission Adjustment – Gas Purchase Expense (increases net income by $66,685);

(hh) That WGL's Adjustment #6 (D.C. Income Taxes) and WGL Adjustment #7 (Federal Income Taxes) involve flow-through accounting and shall be adjusted by WGL to reflect the adjustments adopted in this Opinion and Order as appropriate;

(ii) That WGL's Adjustment #8 (Deferred Income Taxes), related to differences between book and tax accounting) is accepted;

(jj) That WGL's revised Adjustment #9 (Wages and Salaries), consistent with OPC's Adjustment #9, which contains an adjustment to annualize payroll for salary increases which reduces test year expenses by $16,618 is accepted;

(kk) That OPC Adjustment #10 (Remove Impacts of Employee Gross-Up Factor) that reduces the employee gross-up factor used in labor costs, benefits, and payroll taxes; and uses an average period headcount of 1,249 employees based on the most recent head count data on the record (12 months ended August 2012) is accepted, as set forth in this Opinion and Order;

(ll) OPC Adjustment #11 (Remove SERP and Restoration Expense), which increases WGL's net income by $511,157, is accepted;

(mm) That OPC Adjustment #12 (Remove Executive Long Term Compensation Expense) which increases WGL's net income by $396,990 is accepted;

(nn) That OPC Adjustment #13 (Reduction to Short Term Incentive Compensation Expense) is rejected;

(oo) That OPC adjustment #14 (Remove Executive Physicals and Estate Planning Costs), which increased WGL's net income by $3,710 is accepted;

(pp) That OPC's Adjustment #15 (Removing Medicare Part D Amortization Adjustment for Deferred Income Tax) is rejected, and WGL is allowed to recover this expense over its requested five-year period;

(qq) That WGL's Adjustment #10 (OPEB) shall be treated in the following manner:

(1) *Component 1: Test Year Expense ($658,482).* The uncontested test year expense figure of $658,482 representing the OPEB amount to be incurred in the rate effective period, based upon actuarial studies, is accepted as reasonable;

(2) *Component 2: Amortize Deferred Tracker Account ($382,104)* OPC's adjustment to remove the OPEB curtailment losses of $262,720 is rejected; WGL's OPEB expense amount of ($382,104) in the OPEB deferred tracker account will be amortized over five (5) years and WGL shall use the specific expense amounts last approved by the Commission in *Formal Case No. 1016* until the effective date of this Order at which time WGL will use the OPEB expense approved in this proceeding;

(3) *Component 3: Amortize Carrying Costs.* The recovery of WGL's carrying costs for the OPEB Tracker shall be amortized over five (5) years; the carrying charge proposed by WGL in this proceeding to calculate the recovery of over recovered carrying charges is approved; OPC's recommendations to penalize WGL for requiring carrying costs to be based upon the weighted cost of debt only, without compounding, is rejected; and WGL's request to use a surcharge mechanism to recover WGL's OPEB carrying costs is rejected; carrying costs will be based on the weighted cost of capital with compounding as approved in this proceeding;

(rr) That WGL's Adjustment #11 (Pension Costs) is accepted but is modified in the following manner for the following reasons:

(1) *Component 1: Test Year Expense ($7,436,323).* The uncontested $7,436,323 pension amount expected to be incurred in the rate effective period based on actuarial studies is accepted; however, WGL's addition of the employee enhanced savings plan in the test year expense is rejected;

(2) *Component 2: Amortize Deferred Tracker Account ($11,867,459).* OPC's adjustment concerning the removal of enhanced employee savings plan from the deferred tracker account is accepted; OPC's recommendation to remove the pension curtailment losses is rejected; WGL is directed to use the specific pension expense amounts last approved by the Commission in *Formal Case No. 1016* until the effective date of this Order, at which time WGL will use the pension expense approved in this proceeding; and the under-recovery of WGL's pension tracker shall be amortized over five years instead of three years;

(3) *Component 3: Amortize Carrying Costs ($10,154,395).* OPC's adjustment to remove carrying charges associated with the employee enhanced savings from the carrying charge calculations is accepted; WGL's proposal to use a carrying cost based on the weighted cost of capital with compounding as approved in this proceeding to calculate the recovery of under-recovered carrying charges is accepted; and OPC's recommendation to penalize WGL for alleged abuses by requiring carrying costs to be based upon the weighted cost of debt only, without compounding is rejected; and the carrying costs shall be amortized over five (5) years;

(ss) That WGL's pension and OPEB trackers shall be discontinued upon the effective date of this order at which time WGL's pension and OPEB expenses shall be recovered through base rates;

(tt) That WGL Adjustment #12 (Employee Benefits Expense) which reduces WGL's net income by $86,826 is accepted (uncontested with the exception of employee gross-up factor earlier addressed);

(uu) That WGL Adjustment #13 (FICA/Medicare Taxes) which is a flow-through adjustment to FICA and Medicare taxes, dependent on labor costs that reduces WGL's net income by $34,046 is accepted (uncontested with the exception of employee gross-up factor earlier addressed);

(vv) That WGL Adjustment #14 (Supplemental Executive Retirement Plan ("SERP") and Restoration Expense) is rejected and OPC Adjustment #11 is accepted, increasing WGL's net income by $511,157;

(ww) OPC Adjustment #16 (Remove Amortization of Cost to Achieve) to reject the ten (10) year amortization of WGL's cost to achieve the Master Service Agreement with Accenture Business Outsourcing services in the amount $370,862 is rejected;

(xx) That WGL's Adjustment #31 (Property Taxes) and OPC Adjustment #19 (Reduction to Property Tax Expense) methodologies are uncontested and accepted as consistent with past precedent. The actual expense will be adjusted to reflect their respective proposed test year plant-in-service balances;

(yy) That WGL's Adjustment #37 (R&D Funding) to increase test year expenses in the amount of $176,821 to join the Utilization Technology Development ("UTD") program and the Operations Technology Development ("OTD") program is rejected because WGL did not make a convincing showing that either program benefits District ratepayers; and AOBA Adjustment #4 and OPC Adjustment #23 that eliminate all funding for R&D are accepted;

(zz) That WGL Adjustment #38 (Fee-Free Credit/Debit Card Payment Plan) which increases WGL's net income by $70,370 is rejected; however WGL may, at its option, offer its proposed Fee-Free Credit/Debit Card Payment Plan to customers provided WGL does not recover any additional monies from ratepayers for providing this option;

(aaa) That WGL's proposed Accelerated Pipeline Replacement Plan ("APRP") is rejected as submitted because it does not adequately assess WGL's risk assessments and pipe replacement priorities and a decision on WGL's request to recover the costs of the Company's Accelerated Pipeline Replacement Program in a Plant Recovery Adjustment is deferred until it is ripe for decision;

(bbb) That WGL should reassess and report back within three (3) months to the Commission with an update on the Company's risk assessments and pipe replacement priorities; and a better explanation of the Company's priorities, including the priority actually given to its "100 highest priority projects," and explain whether and why the Company's pipeline replacement activities do or do not give highest priority to projects that address high risks to public safety and the avoidance of catastrophic consequences, such as replacing cast iron, bare steel or unprotected steel mains that carry the highest pressures, have the largest diameters, are the oldest mains, and are closest to buildings where large numbers of people congregate or live;

(ccc) That WGL should accelerate the pace of the Company's pipeline replacement in the District and is directed to explain more fully, within three (3) months of the date of this Order, exactly what constitutes a "normal" pace of D.C. pipeline replacement; how and why WGL defines "normal," both in terms of miles of pipe installed per year and in terms of retirement dollars expended each year on pipeline replacement, consistent with this Opinion and Order; and why the depreciation allowances it received in past years (approximately $14 million a year) were not used by WGL to replace aging gas pipelines at a faster pace in the District through the normal replacement process;

(ddd) That WGL's continued use of hexane gas injections is reasonable; that WGL's program to replace or remediate mechanically coupled pipe should be continued in *Formal Case No. 1027* with an increased focus on cost control and schedule; and that the continuing need for prompt remediation of mechanical couplings in the District of Columbia, as a matter of public safety, together with the success of this program so far in reducing leaks, justifies continuing the surcharge as an incentive for expedited remediation;

(eee) That the Company's jurisdictional cost allocation study is reasonable; and that the Commission rejects WGL's proposal to recalculate its jurisdictional cost allocations in light of the new weather normalization adjustments that are being ordered by the Commission;

(fff) That WGL's embedded Class Cost of Service Study shows the relative positions of WGL's customer classes, and provides a reasonable basis upon which the Commission can allocate class revenue responsibilities, and set class rate of returns and rate designs in this case;

(ggg) That WGL's jurisdictional revenue increase should be distributed to WGL's customer classes in a manner that will reduce the wide disparities that now exist in the rate of return of WGL's customer class, assigning more revenue responsibility to those classes with negative or low (below D.C. jurisdictional average) class rates of return, and recovering WGL's $8.38 million D.C. revenue increase in significant part through increased Customer Charges, as described in this Opinion and Order;

(hhh) That WGL's tariffs for the Residential Essential Service Rider ("RES") as well as Section 16, PURCHASED GAS CHARGE ("PGC"), Subsection IV. A., regarding the Distribution Charge Adjustment ("DCA"), shall be amended to reflect that WGL shall no longer use funds from the DCA to further subsidize the RES Program, and the amount of funding that WGL is authorized to use from base rates is capped at the present level of $511,032 and the PGC rates used in determining the RES credits shall be amended to reflect the use of an average monthly PGC based on six months of actual PGC data for year 2012 to reflect more current gas prices;

(iii) That WGL is permitted to amend its tariff GSP No. 4 to allow WGL to offer its proposed new Fee-Free Credit/Debit Card bill option, while barring WGL from recovering any additional monies for providing this option upon condition that no costs related to the plan be recovered from ratepayers;

(jjj) That WGL's proposed tariff containing an expanded PRA surcharge to cover additional aspects of its pipeline replacement programs is rejected;

(kkk) That WGL's other miscellaneous tariff proposals, which are undisputed, are approved as reasonable;

(lll) That, because the Commission is mandated to set rates for distribution only, WGL is directed to submit future rate case filings in such a manner that distribution-only rate base, revenue, and expenses (and any adjustments thereto) are easily discernable from the Company's other regulated matters, such as purchased gas and transmission rate base, revenues, and expenses. WGL may continue to present its adjustments as the Company has in this case, but it must prepare a separate schedule that starts with the District's totals, and then it must remove all non-distribution items and provide the adjustments made to derive the distribution rate items, along with all associated work papers.

THEREFORE, IT IS ORDERED THAT:

341. That the Application of the Washington Gas Light Company filed February 29, 2012, seeking to increase rates for gas distribution service by $28,969,570 is hereby denied;

342. That a rate increase in the amount of $8,381,089 based on a rate of return of 7.93% on WGL's jurisdictional test year rate base of $201,569,048 and a net operating income of $11,157,313 is hereby granted;

343. That WGL is authorized to file revised tariffs that increase gas distribution rates by no more than $8,381,089 pursuant to a rate design that shall be consistent with the findings of this Order;

344. That WGL is directed to file revised rate schedules, together with supporting exhibits in compliance with our directives in this Opinion and Order and the schedules attached hereto, no later than May 28, 2013. Rates authorized in this Order shall be effective on or after June 4, 2013, at 12:01 A.M.;

345. That, at this time, for the reasons set out in this Order and Opinion, WGL's request to implement the initial five (5) year phase of its Accelerated Pipeline Replacement Program is hereby denied and a decision on WGL's request to recover the costs of its Accelerated Pipeline Replacement Program in a Plant Recovery Adjustment is hereby deferred until it is ripe for decision;

346. That WGL is directed to report back to the Commission, within three (3) months from the date of this Order, the information pertaining to its risk assessments and pipeline priorities and to its definition and practice regarding normal pipeline replacement that are outlined in Paragraphs 340 (bbb) of this order;

347. That WGL is directed to file quarterly reports starting July 1, 2013, describing the pipe replacement projects it has completed within each six (6) month period, as well as the projects it is planning for the next upcoming year, as specified in this Opinion and Order;

348. That WGL is permitted to continue the surcharge cost recovery for the remediation/replacement of mechanical couplings pursuant to the directives set out in *Formal Case No. 1027*; and

349. WGL is directed to submit future rate case filings in such a manner that distribution-only rate base, revenue, and expenses (and any adjustments thereto) are easily discernable from the Company's other regulated matters, such as purchased gas and transmission

rate base, revenues, and expenses. WGL may continue to present its adjustments as the Company has in this case, but it must prepare a separate schedule that starts with the District's totals, and then it must remove all non-distribution items and provide the adjustments made to derive the distribution rate items, along with all associated work papers.

350. That WGL shall comply with all other directives included in this Order in the manner and time periods set forth herein.

A TRUE COPY

BY DIRECTION OF THE COMMISSION:

CHIEF CLERK:

BRINDA WESTBROOK-SEDGWICK
COMMISSION SECRETARY

ATTACHMENT: SCHEDULES

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

Docket No. FC 1093
Schedule 1

Washington Gas Light Company
Twelve Months Ending September 30, 2011
Revenue Requirements

Line	Description (A)	WGL Application (B)	WGL Revised (C)	Adjustments (D)	Approved Total (E)
1	**Rate Base**				
2	Gas Plant in Service	$ 605,478,638	$ 599,109,305	$ (605,068)	$ 598,504,237
3	Gas Plant Held for Future Use	1,457,204	1,457,204	-	1,457,204
4	Construction Work in Progress	-	-	-	-
5	Unamortized LCP Cost (net of deferred taxes)	(2)	(2)	-	(2)
6	Unamortized Environmental Cost (net of deferred taxes)	134,292	134,292	-	134,292
7	Materials and Supplies	3,577,949	3,577,949	-	3,577,949
8	Cash Working Capital	18,367,972	15,655,129	(438,732)	15,216,397
9	Reserve for Depreciation	(322,293,794)	(315,664,237)	2,533,593	(313,130,644)
10	Accumulated Deferred Income Taxes	(83,449,884)	(83,449,884)	(6,779,007)	(90,228,891)
11	Gains/Losses on Reacquired Debt	(527,242)	(527,242)	-	(527,242)
12	Customer Deposits	(13,040,618)	(13,040,618)	-	(13,040,618)
13	Deferred Tenant Allowance	(393,634)	(393,634)	-	(393,634)
14	Total Rate Base	$ 209,310,881	$ 206,858,262	$ (5,289,214)	$ 201,569,048
15	**Rate of Return**	8.91%	8.91%		7.93%
16	**Return Requirement**	$ 18,643,283	$ 18,424,829	$ (2,440,403)	$ 15,984,426
17	**Operating Revenues**				
18	Revenues	$ 207,760,735	$ 207,760,735	4,257,859	$ 212,018,594
19	Total Operating Revenues	$ 207,760,735	$ 207,760,735	$ 4,257,859	$ 212,018,594
20	**Operating Expenses**				
21	Operation	$ 145,024,985	$ 144,898,186	$ (9,008,449)	$ 135,889,737
22	Maintenance	9,184,649	9,180,750	-	9,180,750
23	Depreciation	15,822,683	15,562,459	(2,533,593)	13,028,866
24	Amortization	2,567,919	2,567,920	-	2,567,920
25	Interest on Customer Deposits	14,345	14,345	-	14,345
26	Interest on Supplier Refunds	319	319	-	319
27	General Taxes	36,258,464	36,247,983	(29,831)	36,218,152
28	Other Income Tax	(2,767,609)	(2,721,783)	1,591,493	(1,130,290)
29	Federal Income Tax	(8,133,915)	(7,989,160)	5,249,919	(2,739,241)
30	Investment Tax Credit Adjustments	(282,254)	(282,254)	-	(282,254)
31	Deferred Income Taxes	8,433,858	8,433,858	-	8,433,858
32	Total Operating Expenses	$ 206,123,444	$ 205,912,623	$ (4,730,461)	$ 201,182,162
33	**Net Operating Income**	$ 1,637,291	$ 1,848,112	$ 8,988,320	$ 10,836,432
34	AFUDC	$ 320,881	$ 320,881		$ 320,881
35	Net Operating Income-Adjusted	$ 1,958,172	$ 2,168,993	$ 8,988,320	$ 11,157,313
36	**Income Deficiency**	$ 16,685,111	$ 16,255,836	$ (11,428,723)	$ 4,827,113
37	Revenue Conversion Factor	1.70893	1.70893		1.70893
38	Revenue Deficiency Before Uncollectibles	$ 28,513,637	$ 27,780,037	$ (19,530,853)	$ 8,249,184
39	Allowance for Uncollectible Accounts	$ 455,933	$ 444,203	$ (312,298)	$ 131,904
40	**Total Revenue Deficiency**	$ 28,969,570	$ 28,224,240	$ (19,843,151)	$ 8,381,089
41	Percent of Original Request				28.93%

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

Docket No. FC 1093
Schedule 2

Washington Gas Light Company
Twelve Months Ending September 30, 2011
Rate of Return Calculation

Line	Description (A)	Capital Structure (B)	Ratio (C)	Cost % (D)	Weighted Cost % (E)
1	Long-Term Debt		38.23%	6.16%	2.36%
2	Short-Term Debt		0.84%	1.21%	0.01%
3	Preferred Stock		1.63%	4.79%	0.08%
4	Common Equity		59.30%	9.25%	5.49%
5	Total		100.00%		7.93%

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

Docket No. FC 1093
Schedule 3
Page 1 of 2

Washington Gas Light Company
Twelve Months Ending September 30, 2011
Ratemaking Adjustments

Line	Description	WGL Revised	Adjustment 1	Adjustment 2	Adjustment 3	Adjustment 4	Adjustment 5	Adjustment 6	Adjustment 7	Adjustment 8	Adjustment Subtotal
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
1	**Rate Base**										
2	Gas Plant in Service	$ 599,109,305		$ (605,068)							$ (605,068)
3	Gas Plant Held for Future Use	1,457,204									-
4	Construction Work in Progress	-									-
5	Unamortized LCP Cost (net of deferred taxes)	(2)									-
6	Unamortized Environmental Cost (net of deferred taxes)	134,292									-
7	Materials and Supplies	3,577,949									-
8	Cash Working Capital	15,655,129	(438,732)								(438,732)
9	Reserve for Depreciation	(315,664,237)		16,276			2,517,317				2,533,593
10	Accumulated Deferred Income Taxes	(83,449,884)			(6,779,007)						(6,779,007)
11	Gains/Losses on Reacquired Debt	(527,242)									-
12	Customer Deposits	(13,040,618)									-
13	Deferred Tenant Allowance	(393,634)									-
14	Total Rate Base	$ 206,858,262	$ (438,732)	$ (588,791)	$ (6,779,007)	$ -	$ 2,517,317	$ -	$ -	$ -	$ (5,289,214)
15	**Rate of Return**	8.91%	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%
16	**Return Requirement**	$ 18,424,829	$ (34,791)	$ (46,691)	$ (537,575)	$ -	$ 199,623	$ -	$ -	$ -	$ (419,435)
17	**Operating Revenues**										
18	Revenues	$ 207,760,735						$ 4,257,859			$ 4,257,859
19	Total Operating Revenues	$ 207,760,735	$ -	$ -	$ -	$ -	$ -	$ 4,257,859	$ -	$ -	$ 4,257,859
20	**Operating Expenses**										
21	Operation	$ 144,898,186						$ 1,067,747	$ (315,680)	$ (668,730)	$ 83,337
22	Maintenance	9,180,750									-
23	Depreciation	15,562,459		(16,276)		(2,517,317)					(2,533,593)
24	Amortization	2,567,920									-
25	Interest on Customer Deposits	14,345									-
26	Interest on Supplier Refunds	319									-
27	General Taxes	36,247,983		(1,035)					(19,099)	(9,697)	(29,831)
28	Other Income Tax	(2,721,783)		1,726		251,102		318,214	33,395	67,673	672,110
29	Federal Income Tax	(7,989,160)		5,455		793,175		1,227,914	105,485	213,764	2,345,793
30	Investment Tax Credit Adjustments	(282,254)									-
31	Deferred Income Taxes	8,433,858									-
32	Total Operating Expenses	$ 205,912,623	$ -	$ (10,131)	$ -	$ (1,473,040)	$ -	$ 2,613,875	$ (195,899)	$ (396,990)	$ 537,816
33	**Net Operating Income**	$ 1,848,112	$ -	$ 10,131	$ -	$ 1,473,040	$ -	$ 1,643,984	$ 195,899	$ 396,990	$ 3,720,043
34	AFUDC	$ 320,881									-
35	Net Operating Income-Adjusted	$ 2,168,993	$ -	$ 10,131	$ -	$ 1,473,040	$ -	$ 1,643,984	$ 195,899	$ 396,990	$ 3,720,043

Adjustment 1	Adjust Cash Working Capital for Expense Adjustments (WGL #19; OPC #7)
Adjustment 2	Remove Not In-Service Replacement Plant from Plant in Service (WGL #30; OPC #3)
Adjustment 3	Eliminate Uncertain Tax Position from ADIT (OPC #5)
Adjustment 4	Impact of Modified Depreciation Rates (WGL #22; OPC #MM-24)
Adjustment 5	Adjustment to Reserve for Modified Depreciation Rates
Adjustment 6	Remove Weather Normalization (OPC Adj. YM and Adj #8)
Adjustment 7	Modify Employee Gross-up Factor (WGL Adj. # 9, 12, and 13; OPC Adj. #10)
Adjustment 8	Eliminate Executive Long Term Incentive Compensation (WGL #9; OPC #12)

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

Docket No. FC 1087
Schedule 3
Page 2 of 2

Washington Gas Light Company
Twelve Months Ending September 30, 2011
Ratemaking Adjustments

(in thousands)

Line	Description	Carry Forward	Adjustment 9	Adjustment 10	Adjustment 11	Adjustment 12	Adjustment 13	Adjustment 14	Adjustment 15	Adjustment Subtotal	Approved Totals
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
1	**Rate Base**										
2	Gas Plant in Service	$ (605,068)								$ (605,068)	$ 598,504,237
3	Gas Plant Held for Future Use	-								-	1,457,204
4	Construction Work in Progress	-								-	-
5	Unamortized LCP Cost (net of deferred taxes)	-								-	(2)
6	Unamortized Environmental Cost (net of deferred taxes)	-								-	134,292
7	Materials and Supplies	-								-	3,577,949
8	Cash Working Capital	(438,732)								(438,732)	15,216,397
9	Reserve for Depreciation	2,533,593								2,533,593	(313,130,644)
10	Accumulated Deferred Income Taxes	(6,779,007)								(6,779,007)	(90,228,891)
11	Gains/Losses on Reacquired Debt	-								-	(527,242)
12	Customer Deposits	-								-	(13,040,618)
13	Deferred Tenant Allowance	-								-	(393,634)
14	Total Rate Base	$ (5,289,214)	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ (5,289,214)	$ 201,569,048
15	**Rate of Return**	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%	7.93%		7.93%
16	**Return Requirement**	$ (419,435)	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 15,984,426
17	**Operating Revenues**										
18	Revenues	$ 4,257,859								$ 4,257,859	$ 212,018,594
19	Total Operating Revenues	$ 4,257,859	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 4,257,859	$ 212,018,594
20	**Operating Expenses**										
21	Operation	$ 83,337	$ (873,531)	$ (6,339)	$ (7,889,528)	$ (75,196)	$ (70,370)	$ (176,821)		$ (9,008,449)	$ 135,889,737
22	Maintenance	-								-	9,180,750
23	Depreciation	(2,533,593)								(2,533,593)	13,028,866
24	Amortization	-								-	2,567,920
25	Interest on Customer Deposits	-								-	14,345
26	Interest on Supplier Refunds	-								-	319
27	General Taxes	(29,831)								(29,831)	36,218,152
28	Other Income Tax	672,110	87,135	632	786,980	7,501	7,019	17,638	12,478	1,591,493	(1,130,290)
29	Federal Income Tax	2,345,793	275,239	1,997	2,485,892	23,693	22,173	55,714	39,418	5,249,919	(2,739,241)
30	Investment Tax Credit Adjustments	-								-	(282,254)
31	Deferred Income Taxes	-								-	8,433,858
32	Total Operating Expenses	$ 537,816	$ (511,157)	$ (3,710)	$ (4,616,656)	$ (44,002)	$ (41,178)	$ (103,469)	$ 51,896	$ (4,730,461)	$ 201,182,162
33	**Net Operating Income**	$ 3,720,043	$ 511,157	$ 3,710	$ 4,616,656	$ 44,002	$ 41,178	$ 103,469	$ (51,896)	$ 8,988,320	$ 10,836,432
34	AFUDC	-								-	320,881
35	Net Operating Income-Adjusted	$ 3,720,043	$ 511,157	$ 3,710	$ 4,616,656	$ 44,002	$ 41,178	$ 103,469	$ (51,896)	$ 8,988,320	$ 11,157,313

Adjustment 9	Eliminate SERP (WGL #14; OPC #11)
Adjustment 10	Remove Executive Physical and Estate Planning (OPC #14)
Adjustment 11	Pension: Remove Enhanced Saving, Use Approved ROR for Carrying Costs, and Change # Years for Recovery (WGL #11; OPC #17)
Adjustment 12	OPEB Expense: Use Approved ROR for Carrying Charges and Change # of Years for Recovery (WGL #10; OPC #18)
Adjustment 13	Eliminate Customer Fee Free Credit/Debit Card Payment (WGL #38; AOBA #5)
Adjustment 14	Eliminate UDT and ODT R&D Funding (WGL #37; OPC #YM-23; AOBA #4)
Adjustment 15	Interest Synchronization (WGL #25; OPC #21)