

ORDER NO. 89026

IN THE MATTER OF THE APPLICATION OF ELKTON GAS COMPANY (FORMERLY PIVOTAL UTILITY HOLDINGS, INC. D/B/A ELKTON GAS) FOR AUTHORITY TO INCREASE RATES AND CHARGES _____	* * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND _____ CASE NO. 9488 _____
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Issued: January 7, 2019

PROPOSED ORDER OF PUBLIC UTILITY LAW JUDGE

I. Introduction

On June 29, 2018, Pivotal Holdings, Inc. d/b/a Elkton Gas ("Elkton Gas" or the "Company")¹ filed an application with the Public Service Commission of Maryland (the "Commission"), pursuant to §4-203 of the Public Utilities Article of the *Annotated Code of Maryland* ("PUA"), for an increase in its base rates for gas distribution service ("Application"). In its Application, Elkton Gas stated three reasons for the requested revenue increase: (1) the Company is experiencing a revenue deficiency as a result of an increased rate base that has arisen primarily due to investment in the Company's distribution system since its base rates were last adjusted in 2008; (2) because that last base rate case was nearly 11 years ago, an updating of the expenses, rate base, and other elements of the Company's base rates is appropriate; and (3) a condition of the Commission's approval of the Southern/AGL Resources merger in Case No. 9404 was that Elkton Gas was to file a base rate case on or before June 30, 2018. The rates, as originally proposed, were designed to increase the Company's overall revenues by \$82,521. On September 21, 2018, Elkton Gas revised its filing, proposing that its overall revenues

¹ Effective July 1, 2018, Elkton Gas became Elkton Gas Company, a wholly-owned subsidiary of SJI Utilities, Inc., a New Jersey holding company that, in turn, is directly owned by South Jersey Industries, Inc.

increase by \$265,865. The Parties ultimately reached a settlement that encompasses a revenue increase of \$90,507.

II. Procedural History

Elkton Gas submitted with the Application² the testimony of Brian MacLean, President of Elkton Gas, who explained the reasons for the filing and the key elements of the case;³ Thomas Kaufmann, Manager of Rates and Tariffs, who testified in support of the proposed revenue increase, rates, and tariff modifications;⁴ and Kevin S. Bassler, an analyst employed by Southern Company Services, who testified regarding Elkton Gas' cost of equity and made a recommendation for a fair rate of return on equity.⁵

The Office of People's Counsel (OPC) presented the testimony of Kevin W. O'Donnell, an independent consultant specializing in utility regulation, who testified regarding the requested revenue requirement of Elkton Gas and cost of capital.⁶

The Technical Staff of the Commission ("Staff") presented the testimony of Joanne Hernandez, a Public Utility Auditor in the Accounting Investigations Division, who testified regarding revenue requirement;⁷ Kevin D. Mosier, an Assistant Director in the Energy Analysis and Planning Division, who testified regarding cost of equity and rate of return;⁸ and Margaret

² The Application was entered into evidence at the December 11, 2018 hearing as Elkton Exhibit ("Ex.") 2.

³ Elkton Ex. 3, Direct Testimony of Brian MacLean ("MacLean Direct").

⁴ Elkton Ex. 4, Direct Testimony of Thomas Kaufmann ("Kaufmann Direct"); Elkton Ex. 7, Rebuttal Testimony of Thomas Kaufmann ("Kaufmann Rebuttal").

⁵ Elkton Ex. 5, Direct Testimony of Kevin S. Bassler ("Bassler Direct"); Elkton Ex. 8, Rebuttal Testimony of Kevin S. Bassler ("Bassler Rebuttal").

⁶ OPC Ex. 1, Direct Testimony of Kevin W. O'Donnell ("O'Donnell Direct"); OPC Ex. 2, Surrebuttal Testimony of Kevin W. O'Donnell ("O'Donnell Surrebuttal").

⁷ Staff Ex. 1, Direct Testimony and Exhibits of Joanne Hernandez ("Hernandez Direct").

⁸ Staff Ex. 3, Direct Testimony of Kevin D. Mosier ("Mosier Direct"), Staff Ex. 6, Surrebuttal Testimony of Kevin D. Mosier ("Mosier Surrebuttal").

Tubridy, a Regulatory Economist in the Telecommunications, Gas and Water Division, who testified regarding rate design and Elkton Gas' proposed tariff modifications.⁹ David L. Valcarenghi adopted Ms. Hernandez' testimony in his surrebuttal.¹⁰

An evening hearing for public comments was held on September 17, 2018 in Elkton, Maryland.¹¹ Because of the significant change in revenue requirement in the Company's updated filing, a second evening hearing for public comments was held on October 29, 2018 at the same location.¹²

On November 21, 2018, Elkton Gas informed the Public Utility Law Judge Division that the Parties had reached an agreement in principle that settled all of the issues in this proceeding. By Notice issued November 27, 2018, the procedural schedule was further modified to accommodate a hearing on the settlement, and contingent dates in the event the settlement was not approved. A Joint Motion for Approval of Unanimous Stipulation and Settlement ("Settlement") was filed on November 28, 2018, and testimony in support of the Settlement was filed on December 5 and 6, 2018. A hearing was held on December 11, 2018 at which time all pre-filed testimony was admitted into the Record, as well as the Settlement with attachments,¹³ and testimony in support of the Settlement.¹⁴

⁹ Staff Ex. 2, Direct Testimony and Exhibits of Margaret Tubridy ("Tubridy Direct"); Staff Ex. 5, Surrebuttal Testimony and Exhibits of Margaret Tubridy ("Tubridy Surrebuttal").

¹⁰ Staff Ex. 4, Surrebuttal Testimony of David L. Valcarenghi ("Valcarenghi Surrebuttal").

¹¹ A certificate of publication for the first hearing was entered into evidence as Elkton Ex. 6.

¹² A certificate of publication for the second hearing was entered into evidence as Elkton Ex. 9.

¹³ The Settlement with attachments was entered into evidence as Staff Ex. 8, and is attached hereto as Appendix A.

¹⁴ Elkton Gas' panel testimony of Ann Anthony and Thomas Kaufmann in support of the Settlement was entered into evidence as Elkton Ex. 10; OPC's settlement testimony was admitted as OPC Ex. 3; and the Joint Testimony of Juan Alvarado and David Valcarenghi in support of the Settlement was admitted as Staff Ex. 7.

III. Public Comments

No member of the public attended either public comment hearing held in Elkton. No written comments were received.

IV. Stipulation and Settlement Agreement

The Settlement is a full settlement of all issues in this proceeding. The rates the Parties agreed to will be effective with bills rendered beginning with the Company's March 2019 billing cycle, and will reflect an increase in the annual revenue requirement of \$90,507. The revenue requirement will be allocated among customer classes based on test-year revenues per class derived from test-year determinants and current rates. The monthly customer charge will increase from \$5.75 to \$6.00 per month for residential customers; from \$11.00 to \$11.50 for commercial customers; and from \$60.00 to \$62.50 for interruptible and large-volume industrial customers. Elkton Gas' capital structure will reflect a rolling 12-month average annual equity ratio of at least 48%, however, for ratemaking purposes, a 50% debt to equity ratio will be assumed. Elkton Gas' return on equity will be set at 9.8% with its overall rate of return based on the 50%/50% debt to equity ratio equal to 6.98%.¹⁵

The positions advanced by the Parties on each of these issues are discussed below, followed by the compromise position reached.

V. Discussion

A. Adjustments to Rate Base and Operating Income

Rate base represents the investment a company makes in plant and equipment to provide safe and reliable service to its customers. Operating income is derived from the revenues a company receives for gas service less the prudently incurred costs of providing service to

¹⁵ Staff Ex. 8, Settlement, p. 3-4.

customers. Adjustments to the Company's rate base and operating income were offered, and accepted or disputed by the Parties.

1. Elkton Gas

The Application used an entirely historical 12-month test year ending December 31, 2017. The Company included adjustments to normalize revenues and to include the recent reduction in base rates resulting from the Tax Cuts and Jobs Act (TCJA).¹⁶ The Company also included adjustments to normalize certain expenses and to include an allocated portion of the net assets of AGS Services Company that are used in part by Elkton Gas in providing service to its customers.¹⁷ The Company made five adjustments to the 2017 operating expenses accounting results. The Company removed \$85,374 in outside legal expenses because they were non-recurring and related to the Company's intervention in a FERC matter.¹⁸ The Company also removed approximately \$5,600 associated with Marketing and Civic Participation expenses as they represent non-recoverable expenses for regulatory purposes.¹⁹ The Company added \$50,000 in Rate Case expenses to the test year based on an assumption that, if litigated, this rate case would result in \$200,000 in rate case expenses that would be amortized over four years.²⁰ The Company also normalized Property Taxes for an adjustment recorded in 2017 not associated with the 2017 property taxes, which resulted in an \$85,000 reduction to Taxes Other Than Income Taxes.²¹

¹⁶ Elkton Ex. 4, Kaufmann Direct, p. 4.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 4-5.

²⁰ *Id.* at 5.

²¹ *Id.*

2. OPC

OPC's witness Kevin W. O'Donnell agreed that the reduction in marketing expenses of \$4,273 and the elimination of \$1,330 in civic expenses were appropriate.²²

Mr. O'Donnell recommended two adjustments to employee salaries and bonuses. He reduced salaries for Administrative and General (A&G) to the three-year average, resulting in a decrease in O&M expenses of \$25,242.²³ He also reduced the annual incentive plan (AIP) bonus to reflect the three-year average of this expense.²⁴

Next, Mr. O'Donnell made an adjustment to remove additional legal expenses, again based on the past three years.²⁵ Mr. O'Donnell recognized the high jump in medical expenses in 2017, but normalized this cost as well, based on an average of health care costs for 2015 through 2017.²⁶ He reduced rate case expenses from the \$200,000 sought to \$80,000 and amortized the expense over four years.²⁷

Mr. O'Donnell made an adjustment to operating income related to the TCJA. Elkton Gas proposed to return over-recovery of taxes using the average rate assumption method (ARAM), under which the excess deferred income taxes (EDIT) would be returned over the life of the remaining assets which would be in excess of 30 years. Mr. O'Donnell recommended a five-year amortization of the EDIT and an accompanying adjustment of (\$175,995).²⁸

²² OPC Ex. 1, O'Donnell Direct, p. 7.

²³ *Id.*

²⁴ *Id.* at 8.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.* at 9.

²⁸ *Id.* at 9-10.

Lastly, Mr. O'Donnell recommended eliminating construction work in progress (CWIP), in the amount of \$42,626, from rate base.²⁹

3. Staff

Staff recommended adjustments to Elkton's operating income adjustment in the areas of salary expenses, medical expenses, AIP compensation, and rate case expenses.³⁰ Staff also does not believe that the test-year level of A&G salary should be used to set rates in this proceeding.³¹ Staff Witness Hernandez pointed out an excessive increase in salaries over the past five years for which Elkton Gas has provided no justification.³² Ms. Hernandez recommended that the average A&G salary over the past five years be used in the development of adjusted operating income, and developed an adjustment that is reflected in Exhibit JH-6.³³

Ms. Hernandez testified that during the test year, Elkton incurred \$120,358 in medical expenses that it proposes to include in setting rates in this proceeding.³⁴ She noted that medical expenses have also increased significantly over the period 2013 through 2017, for which Elkton Gas has provided insufficient explanation.³⁵ Accordingly, Staff recommended that the five-year average of \$25,415 be used in the development of operating income (a proposed adjustment of \$94,943).³⁶

²⁹ *Id.* at 10.

³⁰ Staff Ex. 1, Hernandez Direct, p. 4

³¹ *Id.*

³² *Id.* at 4-5.

³³ *Id.* at 5.

³⁴ *Id.* at 6.

³⁵ *Id.*

³⁶ *Id.* at 6-7.

Ms. Hernandez testified that in order for Elkton Gas to recover the costs of its AIP program, the bonus payments must provide a direct benefit to ratepayers.³⁷ Because no evidence of benefit to ratepayers has been shown, Ms. Hernandez recommended an adjustment to remove the AIP compensation of \$55,931.³⁸

Staff agreed that rate case expense is an appropriate item to be reflected in rates, however, Staff disagreed with the proposed level of costs to be recovered by Elkton Gas.³⁹ Staff explained that the Company should be authorized to recover actual rate case expenses that are known and measurable and that result in a reasonable level of costs.⁴⁰ Staff recommended that rates be developed based on the actual, prudently incurred costs that can be supported with documentation through the rebuttal phase of this proceeding.⁴¹ Staff agreed that a four-year amortization period is an appropriate period over which to recover these expenses, but recommended a reduction in the costs of legal services based on limiting recovery to a fee of \$300 per hour.⁴² Staff's recommended adjustment in rate case expenses is a reduction of \$44,332.⁴³

Lastly, Ms. Hernandez prepared an adjustment for interest synchronization based on Staff's recommended rate base and recommended cost of debt of \$5,157.⁴⁴ Exhibit JH-5 contains a summary of Staff's recommended adjustments to operating income. Staff recommended that Elkton Gas be authorized to implement revised gas distribution rates that produce a decrease in

³⁷ *Id.* at 7.

³⁸ *Id.* at 8.

³⁹ *Id.* at 9.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* at 9-10.

⁴³ *Id.* at 10.

⁴⁴ *Id.*

annual revenues of \$291,505, based on an adjusted rate base of \$9,175,315, net operating income of \$820,501, and a 6.71% rate of return.

4. Elkton Gas Rebuttal/August 28, 2018 Revision to Proposed Revenue Increase and Rates

Mr. Kauffmann submitted rebuttal testimony to (1) submit, explain, and support an August 28, 2018 revision to Elkton Gas' proposed revenue increase and rates; (2) rebut certain recommendations made by Staff and OPC; and (3) update the Company's revenue requirement and summarize the Company's rate design and customer charge.⁴⁵

Mr. Kauffmann stated that in preparing its response to Data Request MDPSC 1-16, the Company noted that the industrial distribution therms in its proof of revenues were materially higher in comparison to 2017 actual industrial therm usages on the volumes tab of MDPSC 1-16.1.⁴⁶ He testified that the Company later confirmed that a modeling function inadvertently caused the industrial therms volumes of one of its larger customer's facilities to be counted three times, replacing two of its smaller usages at its other locations.⁴⁷ Further review showed that this occurred for two other industrial facilities, and when these over-counts and replacements were corrected, the result was a decrease in industrial therms.⁴⁸ The Company discovered that this issue also occurred with a commercial customer with multiple facilities, resulting in an increase in commercial therms.⁴⁹ Mr. Kaufmann testified that the net result is a deficiency increase of (\$237,882) which when run through the case model for changes in

⁴⁵ Elkton Gas Ex. 7, Kaufmann Rebuttal, p. 1.

⁴⁶ *Id.* at 2.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 3.

working capital, uncollectibles, and taxes, together with the initially filed revenue deficiency of (\$82,517), totals (\$327,300).⁵⁰

The Company did not agree that, although there is no specific evidence of fixed cost increases, such costs have not increased.⁵¹ Given Elkton Gas' customer charges in comparison to other Maryland gas utilities, the Company believes that any increase in this case should include a modest increase in the customer charge.⁵²

With respect to A&G salaries, Mr. Kaufmann testified that fluctuations in payroll accounts are connected to how employees enter their time (A&G salaries is the default account to charge to if hours are not charged to a specific job function or activity) and not an indication of increases or decreases to total employee salaries and wages.⁵³ Mr. Kaufmann opined that the most effective way to review the Company's effectiveness at managing employee wages is to analyze total fixed compensation, which increased year over year from 2013 - 2017 by an average of 3.46%.⁵⁴ Mr. Kaufmann opined that the Company has been prudent in managing its fixed compensation and therefore should be allowed to recover the total cost to compensate its employees.⁵⁵

Mr. Kaufmann did not agree with Staff's recommendation that the Company use the average from 2013 - 2017 to determine medical expenses because in years 2013 and 2014, the medical expenses figure was a negative number.⁵⁶ He instead accepted OPC's method of

⁵⁰ *Id.*

⁵¹ *Id.* at 4.

⁵² *Id.* at 5.

⁵³ *Id.* at 6.

⁵⁴ *Id.*

⁵⁵ *Id.* at 7.

⁵⁶ *Id.*

averaging the period 2015 - 2017 and subtracting the average from the 2017 booked costs, resulting in \$69,826 being included in the Company's test-year revenue requirement.⁵⁷

Mr. Kaufmann did not agree with Staff's recommendation that all of the Company's variable compensation (AIP compensation) be removed from revenue requirement. He stated that the Company considers variable compensation an integral component of its total compensation program and contends that it benefits customers.⁵⁸ Mr. Kaufmann proposed that the Company accept OPC's method of normalizing AIP compensation from 2015 to 2017, resulting in \$46,775 being included in revenue requirement.⁵⁹

Mr. Kaufmann did not agree with OPC's recommendation that legal expenses need to be normalized because the Company already adjusted the test-year legal expenses for all non-regulatory and non-recurring events.⁶⁰

Mr. Kaufmann did not agree with OPC's proposal to accelerate the amortization of EDIT to five years instead of using the ARAM. Mr. Kaufmann testified that the TCJA retained the normalization method of accounting generally used for excess tax reserves associated with public utility property, and that utilities are generally not permitted to reduce excess reserves more rapidly than the reductions permitted by the ARAM.⁶¹ Mr. Kaufmann opined that OPC's proposal would be a direct violation of IRS tax normalization rules. He further stated that the Commission approved the amortization methodologies and periods the Company has used in this proceeding in Case No. 9473 (March 28, 2018 Letter Order).⁶²

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 8.

⁶⁰ *Id.* at 9.

⁶¹ *Id.*

⁶² *Id.* at 10.

Mr. Kaufmann did not agree with OPC's adjustment to remove AGL Service Company CWIP from rate base, because Elkton Gas does not accrue/record AFUDC on capital projects while they are in progress.⁶³ Mr. Kaufmann explained that assets on AGL Service Company books include assets that are used by employees of AGL Services Company and Elkton Gas. He stated that although these shared assets are not on Elkton Gas' books, they are included in the calculation of Elkton Gas' revenue requirement to properly present the costs to provide safe and reliable service.⁶⁴

The Company's revenue requirement was updated to \$265,865 to reflect the increase due to the therm usage recalculations, correct the billing determinates, and include the adjustments made to medical expenses and AIP compensation discussed above, as well as the Company's rate of return position discussed by Mr. Basler. In addition, rate base changed slightly as the adjustments flowed through lead lag and interest synchronization.

5. OPC and Staff Surrebuttal

Mr. O'Donnell responded in surrebuttal to the Company's updated revenue requirement. He testified that as a result of the change, all revenue requirement changes needed to be adjusted upwards by \$237,882.⁶⁵ In addition to adjusting the starting revenues, he made two additional adjustments. He accepted the Company's and Staff's position on protected excess deferred income taxes and amortized the balance over a longer time period than his previous five-year amortization.⁶⁶ He stated that in so doing he was recognizing the IRS normalization rules in

⁶³ *Id.*

⁶⁴ *Id.* at 11.

⁶⁵ OPC Ex. 2, O'Donnell Surrebuttal, p. 2.

⁶⁶ *Id.* at 3.

which the EDIT is to be refunded over the life of the underlying assets.⁶⁷ In his opinion, however, the amortization of unprotected EDIT should be amortized over five years.⁶⁸ Second, Mr. O'Donnell accepted Staff's position with regard to the AIP bonus and eliminated bonuses entirely from the revenue requirements. Mr. O'Donnell's final recommended revenue requirement was that the Commission lower Elkton Gas' revenues by \$231.

David L. Valcarengi testified that Staff verified data provided by Elkton Gas and concurs that an error was made in the Company's original statement of its test-year operating revenue.⁶⁹ Staff recommended that the additional revenues associated with the identified errors be reflected in the development of the revenue requirement. After reviewing the Company's rebuttal testimony, Staff is no longer recommending an adjustment to salaries and wages. Although Elkton Gas proposed that it would accept OPC's proposed adjustment to medical expenses (three-year average level of expenses deducted from amount booked in 2017), Staff maintains that a five-year average level of medical expenses is reasonable and appropriate.⁷⁰ With regard to AIP compensation, Staff first noted that in rebuttal the Company elected to adopt the proposed adjustment proffered by OPC to include \$46,775 of expenses, representing the average level of bonuses disbursed during the period 2015 through 2017. Mr. Valcarengi testified that Staff recognizes the motivating factor that can be created through the disbursement of bonuses, and thus now proposes recovery of 50% of the bonuses incurred as a proxy level of bonuses that do not relate to the attainment of financial goals.⁷¹ Based on additional invoices provided by the Company, Staff updated its recommended adjustment for rate case expenses to

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ Staff Ex. 7, Valcarengi Surrebuttal, p. 5.

⁷⁰ *Id.* at 7.

⁷¹ *Id.* at 8.

\$11,276.⁷² In summary, Staff recommended that Elkton Gas be authorized to implement revised tariff pages with rates that afford it the opportunity to collect \$90,507 in additional annual gas base revenues.⁷³

6. Settlement

The Settlement embraces Staff's compromise position on surrebuttal as to revenue requirement. The rates the Parties agreed to will be effective with bills rendered beginning with the Company's March 2019 billing cycle, and will reflect an increase in the annual revenue requirement of \$90,507.⁷⁴

B. Cost of Capital

The cost of capital is a utility's overall rate of return (ROR), which is the sum of the weighted returns on the utility's common equity and short-term and long-term debt.

1. Capital Structure

Elkton Gas proposed a capital structure based on the consolidated capital structure of Southern Company Gas as of December 31, 2017. Elkton Gas proposed a 55.18% to 44.82% ratio of debt to equity. Elkton Gas' debt is comprised of 7.8% short-term debt and 47.38% long-term debt. OPC Witness O'Donnell testified that the Company's capital structure is reasonable.⁷⁵ Staff Witness Kevin D. Mosier testified that the Company's proposed capital structure is overly

⁷² *Id.* at 9.

⁷³ *Id.* at 4.

⁷⁴ Staff Ex. 8, Settlement, p. 3.

⁷⁵ OPC Ex. 1, O'Donnell Direct, p. 16.

leveraged, however, it should not result in unduly burdensome rates to end users and should be approved for rate making purposes.⁷⁶

2. Return on Equity

The allowed return on equity (ROE) is the amount determined to be appropriate for a utility's common stockholders to earn on the capital they invest in the utility when they purchase its stock. The Supreme Court set forth the fundamental elements for determining a fair return on the investments of a regulated utility in the cases *Bluefield Waterworks* and *Hope Natural Gas*.⁷⁷ In those cases, the Supreme Court found that a return on equity should be: (i) comparable to returns investors expect to earn on investments of similar risk; (ii) sufficient to assure confidence in the company's financial integrity; and (iii) adequate to maintain and support the company's credit and to attract capital.⁷⁸ Thus, in this case, Elkton Gas is entitled to a return that is sufficient to attract capital on reasonable terms, maintain its financial integrity, and provide an opportunity to achieve a level of revenue commensurate with that available in other investments of similar risk.

a. Elkton Gas

The Company requested an ROE of 11.50%. Company Witness Bassler estimated the cost of equity by applying multiple standard cost of equity methods to market data for a proxy

⁷⁶ Staff Ex. 3, Mosier Direct, p. 6.

⁷⁷ *Bluefield Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 693 (1923) ("The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties."); and *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("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.").

⁷⁸ See *Bluefield*, 262 U.S. 679 at 692-693; *Hope Natural Gas*, 320 U.S. 591 at 603.

group of natural gas utility companies of comparable business risk.⁷⁹ He used the single-stage Discounted Cash Flow (DCF) model, a two-stage DCF model, and the Capital Asset Pricing Model (CAPM) in his ROE analysis. Mr. Bassler found that the cost of equity for his comparable sample group to be 9.4%.⁸⁰ He adjusted this figure to reflect the higher financial risk associated with Elkton Gas' book-based ratemaking capital structure compared to the financial risk associated with the average market-value capital structure of the comparable sample group and arrived at a cost of equity of 11.8%.⁸¹ He concluded that a fair rate of return on equity for Elkton Gas is approximately 11.5%.⁸²

b. OPC

OPC Witness O'Donnell found the Company's requested ROE of 11.5% to be inflated and unjustified.⁸³ Mr. O'Donnell testified that the requested ROE is almost 200 basis points higher than what other gas utilities around the country are receiving, at a time when financial costs have been falling.⁸⁴ He testified that the current interest rate environment is expected to remain relatively stable for many years to come.⁸⁵

Though he prefers the DCF model, Mr. O'Donnell used the CAPM and the Comparable Earnings Model as checks for his DCF results.⁸⁶ Mr. O'Donnell used most of the same companies as Mr. Bassler for his proxy group; the difference in their results is based on the

⁷⁹ Elkton Ex. 5, Bassler Direct, p. 4.

⁸⁰ *Id.* at 5.

⁸¹ *Id.* at 5-6.

⁸² *Id.* at 6.

⁸³ OPC Ex. 1, O'Donnell Direct, p. 19.

⁸⁴ *Id.*

⁸⁵ *Id.* at 20.

⁸⁶ *Id.* at 25.

application of the various cost of capital methodologies.⁸⁷ Mr. O'Donnell arrived at a forecasted dividend yield range of 2.5% to 2.6%, and an expected growth rate range of 5.0% to 6.0%, producing a DCF range of 7.5% to 8.6%.⁸⁸ He adjusted this range to 8.0% to 9.0% to account for the strong movement in the United States to more gas infrastructure.⁸⁹

Mr. O'Donnell performed a comparative earnings analysis noting that in 2017 the overall allowed ROE for gas utilities was 9.72%, which was up slightly from the 9.54% allowed by states regulators for gas utilities in 2016.⁹⁰ He concluded that the proper rate of return using a comparable earnings analysis is in the range of 9.25% to 10.25%.⁹¹ Lastly, Mr. O'Donnell used the CAPM arriving at a range of 4.9% to 7.3%.

Mr. O'Donnell's ultimate recommendation was a return on equity of 9.25%, giving weight to the fact that Elkton Gas has a lower equity ratio and therefore slightly higher financial risk than companies in the comparable group.⁹² Mr. O'Donnell noted that with interest rates remaining at historically low levels, utility stock prices have increased greatly, causing dividend yields to decrease, leading to a low cost of capital environment.⁹³ Using Elkton Gas' capital structure, the overall rate of return he recommended was 6.46%.⁹⁴

Next, Mr. O'Donnell reviewed the cost of equity analysis performed by Mr. Bassler. Mr. O'Donnell stated that Mr. Bassler used forecasted earnings growth values as the source of dividend growth in his DCF model, whereas Mr. O'Donnell used data that included historical and

⁸⁷ *Id.* at 26.

⁸⁸ *Id.* at 34-35.

⁸⁹ *Id.* at 35.

⁹⁰ *Id.* at 36-38.

⁹¹ *Id.* at 38.

⁹² *Id.* at 43-44.

⁹³ *Id.* at 44.

⁹⁴ *Id.* at 47.

forecasted growth in earnings, dividends, and book value.⁹⁵ Mr. O'Donnell disagreed with Mr. Bassler's inclusion of a flotation adjustment since there was no indication as to whether Elkton Gas incurred any flotation costs.⁹⁶ Without the flotation adjustment, the result of Mr. Bassler's single-stage DCF model was 9.59%.⁹⁷

Mr. O'Donnell stated that Mr. Bassler's use of an inaccurate GDP growth estimate of 5.02% in his two-stage DCF model renders his results essentially useless.⁹⁸ Mr. O'Donnell also criticized Mr. Bassler's CAPM analysis because of the high risk-free rate used.⁹⁹

Mr. O'Donnell noted that Mr. Bassler's estimated ROEs are all less than 10%, yet he recommended an ROE of 11.5% based on Elkton Gas' greater financial risk due to its lower equity ratio than the average equity ratio of the comparable group.¹⁰⁰ Mr. O'Donnell asserted that Mr. Bassler's analysis is flawed because in his adjustment he compared the market equity of the companies in his comparable group to the book equity in Elkton Gas, an "apples-to-oranges" comparison that "contradicts basic financial sense."¹⁰¹

c. Staff

Staff Witness Kevin Mosier recommended an ROE of 9.8%. Mr. Mosier used a traditional DCF analysis to calculate an average ROE of 9.98%, which he found to be the high end of the range of reasonableness.¹⁰² Second, he used the build-up method risk premium (RP) analysis that uses the risk free rate of return, equity risk premium, and industry adjustment to

⁹⁵ *Id.* at 48.

⁹⁶ *Id.* at 49.

⁹⁷ *Id.*

⁹⁸ *Id.* at 50.

⁹⁹ *Id.* at 51.

¹⁰⁰ *Id.* at 52-53.

¹⁰¹ *Id.* at 53.

¹⁰² Staff Ex. 3, Mosier Direct, p. 4, 8.

calculate an ROE of 9.78%. Lastly, he performed a CAPM analysis, which uses the risk of the company's stock relative to a well-diversified portfolio, to calculate an ROE of 9.66%; this was the low end of his range of reasonableness.¹⁰³

For his proxy group, Mr. Mosier used the full list of gas utilities in Value Line that have paid dividends in each of the previous four quarters, excluding One Gas, Inc. because it lacks five years of historic data, and South Jersey Industries because it is the parent company of Elkton Gas.¹⁰⁴ Mr. Mosier's recommended ROE of 9.80% is the average of the ROEs resulting from the three methodologies he used.¹⁰⁵

Mr. Mosier had one major concern with Mr. Bassler's ROE analysis, namely Mr. Bassler's 210 basis point adjustment to his ROE calculation of 9.4% to arrive at an ROE of 11.5%. Mr. Mosier noted that Elkton Gas' capital structure is determined by the Company, and he strongly disfavors granting a 210 basis point increase in ROE because the Company chooses to have a limited amount of common equity in its capital structure.¹⁰⁶ He recommended that the Commission disregard Mr. Bassler's ROE adjustment.¹⁰⁷

d. Elkton Gas Rebuttal

Mr. Bassler reviewed Staff Witness Mosier's testimony and continues to recommend an ROE of 11.5%.¹⁰⁸ Mr. Bassler did not agree with Mr. Mosier's application of the DCF model. He testified that Mr. Mosier deviated from accepted practice by (1) relying on a single source, Value Line, for his growth assumption calculations; (2) using growth rates other than the

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 9.

¹⁰⁵ *Id.* at 15.

¹⁰⁶ *Id.* at 18.

¹⁰⁷ *Id.*

¹⁰⁸ Elkton Ex. 8, Bassler Rebuttal, p. 1.

expected growth in earnings to estimate future growth expected by investors; and (3) using prices that are tied to 90 days prior to the issuance of the Value Line report.¹⁰⁹

Mr. Bassler had no issues with Mr. Mosier's risk premium or CAPM methodologies. However, he did not agree with Mr. Mosier's position on adjusting the ROE for capital structure. Mr. Bassler defended his adjustment to his calculated ROE in order to apply a market based value to a book value basis.¹¹⁰

e. OPC and Staff Surrebuttal

Mr. O'Donnell found Staff Witness Mosier's recommended ROE of 9.80% excessive and unreasonable in today's lower capital cost markets.¹¹¹ Specifically, he testified in surrebuttal that Mr. Mosier erred in the application of the DCF model by examining only forecasted growth rates, ignoring all historical growth rates for his comparable group. Mr. O'Donnell stated that this caused Mr. Mosier's results to be high.¹¹² Mr. O'Donnell testified that another error was examining cash flow growth rates instead of book value growth which he believes represents the true investment growth of a company.¹¹³ He also disagreed with Mr. Mosier's decision to eliminate the 30.5% growth rate of Northwest Natural Gas but to retain the 18.0% earnings growth rate of NiSource, Inc.; if both were eliminated Mr. Mosier's DCF result would have been 9.57% and not 9.98%.¹¹⁴ Given the difference, Mr. O'Donnell stated that Mr. Mosier should have conducted further analysis and provided an explanation for his decision.¹¹⁵

¹⁰⁹ Elkton Ex. 8, Bassler Rebuttal, p. 2.

¹¹⁰ *Id.* at 4-6.

¹¹¹ OPC Ex. 2, O'Donnell Surrebuttal, p. 4.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.* at 5.

¹¹⁵ *Id.*

Mr. O'Donnell commented on Mr. Mosier's build-up method risk premium (RP) analysis, testifying that Mr. Mosier's risk premium was too high, and adjusted incorrectly, resulting in flawed results.¹¹⁶ He recommended that the Commission give no weight to this methodology as used by Mr. Mosier.¹¹⁷

Mr. O'Donnell also disagreed with Mr. Mosier's application of the CAPM because of the unrealistically high return on the market he used, resulting in an unbelievable CAPM return.¹¹⁸ He recommended that the Commission give no weight to Mr. Mosier's CAPM results. In conclusion, Mr. O'Donnell testified that if Mr. Mosier were to correct mistakes in his analyses, his recommended ROE would be lower.¹¹⁹

Staff Witness Mosier filed surrebuttal testimony in response to Company Witness Bassler's rebuttal testimony. Mr. Mosier testified that his use of Value Line for growth assumptions is consistent with Staff's long-standing practice.¹²⁰ With regard to the use of cash flow and dividend growth rates, Mr. Mosier stated that in Staff's opinion, a wider range of growth rates leads to a more robust forecast.¹²¹ However, Staff had no objection to using the Company's DCF methodologies and estimates, which resulted in an average DCF ROE of 9.5%, and would lower Staff's recommended ROE from 9.8% to 9.65%.¹²² Lastly, Mr. Mosier stated that Elkton Gas' overly leveraged capital structure should not be used to artificially inflate its ROE because capital structure is within the control of the Company.¹²³

¹¹⁶ *Id.* at 5-6.

¹¹⁷ *Id.* at 6.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 7.

¹²⁰ Staff Ex. 6, Mosier Surrebuttal, p. 4.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

f. Settlement

Pursuant to the Settlement, Elkton Gas' capital structure will reflect a rolling 12-month average annual equity ratio of at least 48%, however, for ratemaking purposes, a 50% debt to 50% equity ratio will be assumed. Elkton Gas' return on equity will be set at 9.8% with its overall rate of return based on the 50%/50% debt to equity ratio equal to 6.98%.

C. Rate Design

1. Elkton Gas

In his rebuttal testimony Mr. Kaufmann explained that the newly calculated revenue deficiency of \$265,865 was allocated to rate classes based on test-year revenues per class derived from test-year determinants and current rates.¹²⁴ The Company proposed a 4.3% increase in the customer charge and a 9.6% increase in distribution charges for residential customers.¹²⁵

2. Staff

Ms. Tubridy agreed with Elkton Gas' proportional revenue allocation methodology and therefore recommended that Staff Witness Hernandez' adjusted revenue reduction be allocated using the same methodology.¹²⁶

Ms. Tubridy did not agree with Elkton Gas' proposed increase to the customer charge in part because it was not supported by the evidence of a recent Cost of Service Study (COSS).¹²⁷ Ms. Tubridy clarified in her surrebuttal testimony that she had proposed to capture the allocated revenue decrease from the Company's distribution charges primarily because Staff's

¹²⁴ Elkton Ex. 7, Kaufmann Rebuttal, p. 12.

¹²⁵ *Id.* at 13

¹²⁶ Staff Ex. 2, Tubridy Direct, p. 5.

¹²⁷ *Id.* at 6.

recommended adjustment revenue requirement did not support an increase in rates.¹²⁸ She stated that it would be inappropriate to recommend an overall revenue decrease and a rate component increase at the same time.¹²⁹

Once Elkton Gas revised its revenue requirement request as part of its rebuttal testimony, necessitating that Staff revise its recommended revenue requirement, Ms. Tubridy performed necessary revisions to her proposed rate design. Since Staff was now recommending a revenue requirement increase, Ms. Tubridy proposed an increase to both the Company's distribution charges and customer charges, across all rate schedules.¹³⁰ She recommended a more modest increase in the customer charge than Elkton Gas recommended; for residential customers, the customer charge would increase from the current charge of \$5.75 to \$5.90, instead of the \$6.00 proposed by the Company.¹³¹ Ms. Tubridy defended her proposed rate design on the basis that it would bring the proportion of each rate component's increase closer to parity while also bringing the Company's customer charges closer to the levels supported by the Company's 2007 COSS.¹³² Ms. Tubridy testified that the average residential customer using 40 therms per month would have a total bill impact of \$0.49, or a 1.13% increase.¹³³

3. Settlement

There was no dispute among the Parties as to allocation of the rate increase. Accordingly, pursuant to the Settlement, the revenue requirement will be allocated among customer classes based on test-year revenues per class derived from test-year determinants and

¹²⁸ Staff Ex. 5, Tubridy Surrebuttal, p. 4.

¹²⁹ *Id.*

¹³⁰ *Id.* at 5.

¹³¹ *Id.* at 5-6.

¹³² *Id.*

¹³³ *Id.* at 7.

current rates. As part of the Settlement, the Parties agreed that the monthly customer charge will increase from \$5.75 to \$6.00 per month for residential customers; from \$11.00 to \$11.50 for commercial customers; and from \$60.00 to \$62.50 for interruptible and large-volume industrial customers.¹³⁴

VI. Analysis and Findings

The Commission has considered and approved settlements proposed by adverse parties representing divergent interests in previous rate case proceedings. Historically, a settlement submitted by parties who normally have adverse interests is an indication that the overall agreement reached is a reasonable one. *See, e.g., In the Matter of the Application of Delmarva Power & Light Company for Adjustments to Its Retail Rates for the Distribution of Electric Energy*, 2018 WL 864147 (Md. P.S.C.) *slip op.* (February 9, 2018). However, the Commission must carefully evaluate the settlement to ensure that the outcome is in fact reasonable, and in a rate case, that the resulting rates are just and reasonable.

PUA § 4-101 defines "just and reasonable rate" as:

a rate that (1) does not violate any provision of this article; (2) fully considers and is consistent with the public good; and (3) except for rates of a common carrier, will result in an operating income to the public service company that yields, after reasonable deduction for depreciation and other necessary and proper expenses and reserves, a reasonable return on the fair-value of the public service company's property used and useful in providing service to the public.

In a recent Potomac Electric Power Company ("Pepco") rate case that resulted in a settlement, the Commission approved the settlement because it found that, "under the

¹³⁴ Staff Ex. 8, Settlement, p. 3.

circumstances and the record before us, the Settlement will result in just and reasonable rates for Pepco and its customers and is consistent with the public interest."¹³⁵ Based on the record in these proceedings, and after a thorough review of this Settlement, it is approved.

Elkton Gas' request (after revision due to error) was for a base rate increase of \$265,865. OPC's recommendation was for a small revenue decrease of \$231. Although Staff originally recommended a revenue decrease as well, Staff agreed to several of the Company's proposed adjustments and ultimately compromised its position to the agreed-upon revenue increase of \$90,507. Although in this instance we know the adjustments that led to Staff's figure (which ultimately became the agreed-upon figure), a determination with regard to each individual adjustment is not what is required.¹³⁶ Rather, the question is whether the ultimate revenue requirement increase or decrease is reasonable and results in reasonable rates. In this case, thoughtful negotiations resulted in a significant reduction of the revenue increase, from \$265,865 to \$90,507. I find the compromise revenue requirement reasonable based on the record in this case. The resulting rates will mean a relatively small increase for Elkton Gas' customers, and I find them to be both just and reasonable.

The Commission's preference in rate cases is to use the actual capital structure absent compelling evidence for an alternative capital structure. In this case, the Company originally proposed to use the consolidated capital structure of Southern Company Gas, Elkton Gas' former parent company, as of December 31, 2017. Effective July 1, 2018, however, Elkton Gas became Elkton Gas Company, a wholly owned subsidiary of SJI Utilities, Inc., a New Jersey holding

¹³⁵ *In the Matter of the Application of Potomac Elec. Power Co. for Adjustments to Its Retail Rates for the Distribution of Electric Energy*, Case No. 9472, Order No. 88719, *slip op.* at 1 (dated May 31, 2018).

¹³⁶ And since this case resulted in a settlement, the various adjustments cannot be said to provide any type of precedent.

company that, in turn, is directly owned by South Jersey Industries, Inc.¹³⁷ Pursuant to a stipulation and settlement agreement in Case No. 9475, approved by Order No. 88718, Elkton Gas agreed to maintain a rolling 12-month average annual equity ratio of at least 48%.¹³⁸ In fact, Elkton Gas agreed that there would be no change to its existing ratemaking capital structure ratios of debt and equity in connection with the acquisition, and that Elkton Gas would maintain a rolling 12-month average annual equity ratio of at least 48%. At the December 11, 2018 hearing in this case, Elkton Gas agreed that the foregoing language could reasonably be read to imply that Elkton Gas had an existing equity ratio of 48%. However, Ms. Anthony explained that prior to the July 1 transfer, Elkton Gas was not a separate legal entity having its own capital structure.¹³⁹ As Mr. Kaufmann explained, because Elkton Gas was a subsidiary, the capital structure it agreed to maintain was not formally on its books.¹⁴⁰ When Elkton Gas filed this case, not having its own capital structure on its books, the capital structure of the parent company was used.¹⁴¹ Ms. Anthony testified that Elkton Gas currently has an actual capital structure that is between 90 and 100 percent equity, though the Company contemplates significant capital expenditures which will alter the equity ratio.¹⁴²

As Mr. Alvarado testified, the Commission imputes a capital structure when there is not a reliable capital structure available.¹⁴³ In this case, there is no reliable capital structure, either at

¹³⁷ See Case No. 9475, *In the Matter of the Application of South Jersey Industries, Inc., Elkton Acquisition Corp. and Pivotal Utilities Holdings, Inc. d/b/a Elkton Gas for Authority to Sell and Transfer Substantially All Elkton Gas's Assets Including Natural Gas Franchises to Elkton Acquisition Corp. and For All Related Authorizations and Approvals*, Docket Item No. 37.

¹³⁸ The stipulation and settlement agreement is attached to Order No. 88718.

¹³⁹ Transcript of December 11, 2018 hearing ("Tr.") at 24-25. Ms. Anthony testified that her interpretation of the settlement agreement in Case No. 9475 is that Elkton Gas agreed to maintain a certain capital structure in connection with the acquisition, *i.e.*, beginning July 1, 2018.

¹⁴⁰ Tr. at 20.

¹⁴¹ Tr. at 25.

¹⁴² Tr. at 31.

¹⁴³ Tr. at 46-47.

the end of the test year or close in time to the filing of the Application.¹⁴⁴ Given the circumstances in this case, imputing a capital structure is warranted. Mr. Alvarado further testified that traditionally when there is no actual capital structure available, the Commission imputes a 50% debt to 50% equity ratio.¹⁴⁵ An imputed capital structure of 50% equity to 50% debt does not result in unduly burdensome rates and is appropriate for ratemaking purposes.

OPC recommended an ROE of 9.25%, but compromised at 9.8%, which was Staff's original position, and the position Staff maintained at the evidentiary hearing.¹⁴⁶ Elkton Gas' original request for an ROE of 11.5% was supported, in part, by an adjustment the Company acknowledged would decrease.¹⁴⁷ Although perhaps not as much of a change in position as 11.5% to 9.8% would represent, the compromise ROE of 9.8% falls between OPC's recommendation and the Company's likely revised recommendation.¹⁴⁸ Most importantly, an ROE of 9.8% provides a fair and appropriate return to Elkton Gas, in accordance with the *Bluefield* and *Hope* decisions, while resulting in reasonable rates for Elkton Gas customers.

The Settlement incorporates the Company's recommended increases to customer charges. The compromise customer charge for residential customers is \$0.10 higher than Staff's position on surrebuttal, \$0.25 higher for commercial customers than Staff's position, \$1.00 higher for large volume industrial and industrial interruptible customers.¹⁴⁹ The agreed-upon increases to Elkton Gas' customer charges appear reasonable despite the fact that the customer charges are

¹⁴⁴ The extremely high equity ratio as of the date of the hearing on the Settlement would result in unduly burdensome rates, and, as such, would be inappropriate for rate making purposes.

¹⁴⁵ Tr. at 47.

¹⁴⁶ Tr. at 49.

¹⁴⁷ Tr. at 29.

¹⁴⁸ An imputed equity ratio of 50% is closer to the equity ratio of the companies in Mr. Bassler's comparable group than the 44.82% originally used, *see* Elkton Ex. 5, Bassler Direct p. 7-8; thus his adjustment based on degree of difference in financial risk would not be as great.

¹⁴⁹ Staff Ex. 5, Tubridy Surrebuttal at 6.

increasing by a greater percentage than the distribution charges. Customer charges are increasing 4.2 to 4.5%¹⁵⁰ while distribution charges are now increasing 2.0 to 2.7% based on the proposed tariffs filed as part of the Settlement. Ms. Tubridy had recommended something close to parity - an average 2.41% increase in customer charge and an average 2.49% increase in distribution charge. However, she also testified that her proposed rate design would only bring the Company's customer charges closer to the levels supported by the Company's 2007 COSS. Moreover, Elkton Gas claimed that the Company's fixed costs have increased since that time. A higher percentage increase in customer charge, as compared to increase in distribution charge, will not be rejected based on this record.

A percentage increase in customer charge of this magnitude is not unreasonable, rapid or shocking. Mr. Kaufmann of Elkton Gas testified that the new monthly customer charges are still far lower than the monthly customer charges of other gas companies in Maryland. I find the agreed-upon increases to Elkton Gas' customer charges reasonable under the circumstances of this case.

VII. Conclusion

Based on the record in this case, the Settlement will result in just and reasonable rates for Elkton Gas and its customers and is consistent with the public interest. Therefore, the Settlement is approved.

IT IS, THEREFORE, this 7th day of January, in the year Two Thousand Nineteen,

ORDERED: (1) That the Application filed by Pivotal Holdings, Inc. d/b/a Elkton Gas, now known as Elkton Gas Company, on June 29, 2018 is hereby denied.

¹⁵⁰ *Id.*, Table 1.

(2) That the Joint Motion for Approval of Agreement of Unanimous Stipulation and Settlement is hereby granted, and the Stipulation and Settlement Agreement contained therein, and incorporated herein by reference, is approved without modification.

(3) That Elkton Gas Company's tariff pages, filed on November 28, 2018 as part of the Joint Motion, are accepted; once there is a final order of the Commission in this proceeding, Elkton Gas shall file clean tariff pages with an effective date of February 11, 2019.

(4) That pursuant to the terms of the Settlement, the Parties have waived their right to appeal this Proposed Order.

(5) That this Proposed Order will become a final order of the Commission on February 7, 2019, unless the Commission modifies or reverses the Proposed Order or initiates further proceedings in this matter as provided in Section 3-114(c)(2) of the Public Utilities Article.

/s/ Kristin Case Lawrence
Kristin Case Lawrence
Public Utility Law Judge
Public Service Commission of Maryland