

PECO ENERGY COMPANY
**STATEMENT OF SPECIFIC REASONS FOR
PROPOSED INCREASE IN RATES**

PECO Energy Company (PECO or the Company) is filing Supplement No. 71 to Tariff Gas-Pa. P.U.C. No. 2, which bears a proposed effective date of May 30, 2008. The rates set forth in Supplement No. 71 would increase PECO's annual gas distribution revenues by \$98.3 million. This represents an increase of 11.2 % in total gas operating revenues anticipated for the future test year ending December 31, 2008. The reasons for the proposed increase are summarized below.

Rate Increase

PECO last filed for an increase in base rates in April 1987. During the intervening twenty-one years, PECO has made concerted efforts to control discretionary spending. In fact, since PECO's last gas base rate case, its operating costs have grown by approximately 1.8% on an annual compound basis, which is well below the rate of inflation experienced over that period. For many years, PECO's aggressive cost containment has allowed it to offset both increases in revenue requirement, which were caused principally by its investment of \$1.2 billion in new and replacement gas plant since its last rate case, and a large decrease in operating income, which was caused by an approximate 13% decline in annual per-customer usage since 1992. However, based on PECO's review of current and projected financial results, an increase in gas distribution revenues is needed and cannot be achieved without an increase in gas distribution rates.

As previously noted, a major factor driving PECO's need for rate relief is its substantial investment in new and replacement utility plant. In its final order in PECO's last gas base rate case, the Commission approved a rate base of \$408.9 million. By contrast, PECO's rate base

claim in this case is \$1.104 billion. As also previously noted, the decline in per capita gas consumption is another major factor driving the need for rate relief. Although PECO has expanded its customer base over the last twenty-one years, customers are using less gas due, in large part, to improved appliance efficiency and more energy-efficient building materials. Additionally, despite its cost containment efforts, PECO has experienced unavoidable increases in various operating and maintenance expenses, including wages, salaries and the cost of providing employee healthcare and retirement benefits.

Absent rate relief, the Company's overall rate of return at present rates is projected to be only 3.73% for the future test year, as shown on Schedule A-1 of PECO Exhibit RLO-1. More importantly, the indicated return on common equity under present rates is anticipated to be 2.05%, which is inadequate by any reasonable standard and far less than required to provide the Company with a reasonable opportunity to attract the additional capital needed to finance future plant additions and improvements.

The requested rates would produce an 8.87% return on the Company's claimed rate base and an 11.5% return on its common equity. These return levels are consistent with those recommended by Mr. Paul R. Moul, the Company's cost of capital consultant and an expert on the subject of rate of return. Mr. Moul's rate of return recommendations are set forth in PECO Exhibit PRM-1 and are summarized in the following table:

	<u>Ratio</u>	<u>Cost Rate</u>	<u>Weighted Cost</u>
Debt	43.95%	5.79%	2.54%
Preferred Stock	1.71%	4.76%	0.08%
Common Equity	<u>54.34%</u>	<u>11.50%</u>	<u>6.25%</u>
	100.00%		<u>8.87%</u>

PECO is filing all of the supporting data required by the Commission's regulations, both for the historic test year ended December 31, 2007, and the future test year ending December 31, 2008. Because the Company is basing its claim principally on the level of operations for the future test year, the discussion that follows will address the future test year data.

The revenue and expense claims for the future test year have been prepared in accordance with accepted practices of this Commission. Operating revenues at present rates were derived from budgeted revenues for PECO's gas operations for the year ended December 31, 2008, adjusted in the manner shown on Schedule D-5 of PECO Exhibit RLO-1. Principal revenue adjustments include annualizing the effect of changes in the number of customers, removing non-jurisdictional revenues and reflecting changes in the Company's Customer Assistance Programs (CAP).

Pro forma future test year operating expenses were developed from PECO's 2008 budget for gas operations. Budgeted expenses, which were prepared based on corporate activities and related cost categories (e.g., payroll), were distributed to FERC accounts based on the Company's actual 2007 distribution. The budget data, as distributed to FERC accounts, were annualized or normalized in accordance with established Commission ratemaking practices. These and other appropriate adjustments that were made to the budget data are shown in specific expense-related schedules included in Section D of PECO Exhibit RLO-1. The annual accrual for depreciation related to plant in service at December 31, 2008 was calculated using the straight-line remaining life method, which the Commission had previously approved for PECO's gas operations. PECO's claim for annual depreciation expense is set forth in PECO Exhibits MRG-1 and MRG-2 and is described in PECO Statement No. 4.

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Income taxes were calculated using procedures accepted by the Commission. Interest deductions were synchronized to the Company's rate base and the weighted cost of debt included in its overall rate of return. Book-tax timing differences related to PECO's use of accelerated depreciation for Federal income tax purposes were normalized, and all other book-tax timing differences were flowed-through for ratemaking purposes. The unamortized balance of investment tax credits were amortized to income in accordance with the method selected by the Company. The Company's claim for Federal income taxes also reflects a consolidated tax adjustment that was calculated using the Modified Effective Tax Rate method, which the Commission has adopted to comply with Pennsylvania appellate court decisions.

PECO's rate base elements reflect the Company's balances of gas plant at December 31, 2007, including common plant used in, and appropriately allocated to, gas operations, as shown in Section C of PECO Exhibit RLO-I. To the year-end 2007 plant balances, the Company added its budgeted capital expenditures that will close to plant in service during 2008 and subtracted the appropriate 2008 retirements. The accumulated depreciation was calculated in similar fashion. Specifically, the accrued depreciation at December 31, 2007 was brought forward to December 31, 2008 using 2008 accrual rates; the anticipated 2008 retirements were deducted; and appropriate entries were made to record net salvage. Accumulated deferred income taxes, customer advances, and a 13-month average of customer deposits were deducted from rate base. The Company's rate base was increased by claims for gas storage inventory, materials and supplies, and cash working capital. The gas storage and materials and supplies claims are based on 13-month averages. The Company's cash working capital claim was determined from a comprehensive lead-lag study and incorporates an offset for the lag in payment of interest on debt, as the Commission requires.

As is evident from the foregoing and the voluminous supporting data filed by the Company, the proposed increase is just and reasonable and is the minimum increase necessary to enable the Company to earn a reasonable return on the fair value of its property used and useful in the public service, to maintain the integrity of its existing capital and to attract new capital.

Rate Structure

The Company's proposed rate structure and rate design are described by Mr. Paul T. Patterson in PECO Statement No. 9. As Mr. Patterson explains, in developing its rate structure proposal, the Company considered the results of a cost of service study performed by Mr. Howard S. Gorman, a principal consultant with Black & Veatch Corporation. The cost of service study is explained by Mr. Gorman in PECO Statement No. 8. While the cost of service study was used as a guide, the Company also considered the principle of gradualism that has traditionally been applied in Pennsylvania. Accordingly, the proposed rates were designed to mitigate the impact on each major rate class, to the extent practicable, while still making meaningful movement toward each class' cost of service. Based on the results of Mr. Gorman's cost of service study, PECO's proposed revenue allocation moves the rates of return for each rate class closer to the system average rate of return.

PECO is also proposing certain changes in rate design including: (1) aligning fixed distribution charges/customer charges with, or closer to, customer-classified costs; (2) establishing a maximum commodity charge for Rate TS-F that is cost-of-service based and, therefore, not differentiated based on whether Pennsylvania or non-Pennsylvania gas is being transported (this change will conform Rate TS-F to Rate TS-I, which, both currently and as

proposed, has a single maximum commodity charge for all gas transported); and (3) eliminating pressure-differentiated fixed distribution/customer charges for Rates GC, MV-I and MV-F.

PECO is also proposing changes to its rules for High Volume Transportation (HVT) service, as explained by Ms. Amy E. Hamilton in PECO's Statement No. 10. More specifically, PECO is proposing revisions that would: (1) require the annual recalculation of transportation customers' Transportation Contract Quantity (Rule 1.5); (2) increase the Balancing Charge and provide for its annual recomputation (Rule 2.3); and (3) eliminate the 50 Mcf minimum allowable variation for daily and monthly receipts of customer-owned gas that exceed PECO's deliveries to a customer (Rules 2.4 and 2.6). Additionally, changes are proposed to Rule 12 of PECO's Rules and Regulations to clarify the permissible scope of System Maintenance Orders and to Rule 3.3 of PECO's Gas Transportation Service General Rules and Regulations to remove the requirement for Standby Sales Service for Priority 1 customers.

Customer Assistance And Energy Efficiency Programs

As part of this case, PECO is proposing changes to improve and materially expand its low income customer assistance program (Gas CAP) and extend its outreach to low income customers. The changes in PECO's Gas CAP are discussed by Mr. Manus J. McHugh, the Company's Director of Revenue Management, in PECO Statement No. 6.

Also as part of this case, PECO is proposing comprehensive energy efficiency and conservation programs for gas customers. These programmatic changes, if approved, will be accompanied by a customer education initiative to raise customer awareness of conservation issues and direct them to the energy efficiency programs offered by the Company. These

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programs are discussed by Ms. Kathy A. Lentini, Manager of PECO's Marketing Department, in PECO Statement No. 7.

Summary

In summary, the proposed increase in revenues is the minimum necessary to permit the Company to continue to provide safe and reliable service, maintain the integrity of its existing capital, attract additional capital at reasonable costs and have an opportunity to actually achieve a fair rate of return on its investment in property dedicated to public service. The Company's proposed revenue allocation and rate design are just, reasonable and non-discriminatory. Accordingly, the rates, rules and terms of service set forth in Supplement No. 71 should be permitted to become effective as filed.

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