

DIRECT TESTIMONY  
OF  
PHILLIP S. BARNETT

DOCKET NO. R-2008-2028394

Explaining PECO's Need For Rate Relief;  
Providing An Overview of PECO's Principal Accounting  
**Exhibits And Budgeting Process; and**  
Describing The Nature And Allocation Of The Cost Of Services  
That PECO Receives From Affiliated Entities

**Date: March 31, 2008**



1 recently as Senior Vice President of Corporate Financial Planning, before assuming  
2 my current position in September 2007.

3 4. **Q. What is the purpose of your direct testimony?**

4 mo The purpose of my direct testimony is as follows: (1) to briefly explain PECO's need  
5 for rate relief; (2) to provide an overview of PECO's principal accounting exhibits, as  
6 well as its planning process; and (3) to describe the nature and allocation of costs of  
7 services that PECO receives from the Exelon Business Services Company.

8 **II. NEED FOR RATE RELIEF**

9 so **Q. Why is PECO seeking a rate increase at this time?**

10 mo As noted by Mr. Mark F. Alden in his testimony (PECO Statement No. 1), it has been  
11 twenty-one years since PECO last requested a base rate increase for its gas  
12 operations. Over that period, PECO has invested approximately \$1.2 billion in new  
13 and replacement gas plant; has granted its employees annual wage and salary  
14 adjustments; and has incurred substantial increases in the costs of providing  
15 healthcare and retiree benefits to its workforce. Despite concerted efforts to attract  
16 new customers and to hold the line on expenses, those factors, coupled with a  
17 reduction in average per customer consumption, have severely compromised our  
18 ability to earn a fair return on our investment.

19 m **Q. Please elaborate.**

20 mo On a pro forma basis, PECO's gas operations are projected to produce an overall  
21 return on invested capital of 3.73%, and a return on common equity of only 2.05%,

1 during the twelve months ending December 31, 2008. Those return levels are clearly  
2 inadequate, as Mr. Paul R. Moul points out in his testimony (PECO Statement No. 4).  
3 Needless to say, absent rate relief, PECO Gas's financial results would deteriorate  
4 even further in 2009 and jeopardize PECO's ability to appropriately invest in the  
5 infrastructure needed to maintain and improve our reliability and customer service  
6 levels. It would also have an adverse impact on our credit coverage ratios and  
7 negative implications to maintaining our investment grade credit ratings.

8 III. OVERVIEW OF PECO'S PRINCIPAL ACCOUNTING EXHIBITS AND  
9 BUDGETING PROCESS

10 **7. Q. Please provide an overview of PECO's principal accounting exhibits.**

11 PECO's principal accounting exhibits are Exhibits RLO-1 and RLO-2 and are  
12 sponsored, for the most part, by Mr. Robert L. O'Brien (PECO Statement No. 3).  
13 Exhibit RLO-1, entitled "Revenues, Expenses, Income & Measures Of Value, Twelve  
14 Months Ended December 31, 2008," presents PECO's revenue requirement for the  
15 future test year and comprises four sections, as follows:

16 **Section A** consists of a summary schedule setting forth PECO's claimed  
17 Measures of Value (Rate Base) and the derivation of its requested rate  
18 increase.

19 **Section B** contains basic accounting data, largely extracted from the  
20 Company's financial records, including a test year end balance sheet;  
21 statements of net operating income and test year revenues; a schedule of  
22 expense items by primary account; and a calculation of PECO's tax expenses.  
23 Also included are schedules developing PECO's embedded costs of debt and  
24 preferred stock; its test year end capital structure; and its overall claimed rate  
25 of return.

26 **Section C** provides the detailed development of the major components that  
27 make up the Company's rate base claim. Included therein are summaries of  
28 the original cost and accrued depreciation at test year end of the various

1 categories of utility plant, including allocated common plant; and calculations  
2 of PECO's working capital, gas inventory, customer deposits and advances,  
3 materials and supplies, and accumulated deferred income tax claims.

4 **Section D** contains the detailed adjustments required to place test year  
5 revenues and expenses on a ratemaking basis. These adjustments are  
6 summarized on Schedules D-3, D-4, and D-5, and, together with certain tax  
7 adjustments, are carried forward to Schedule D-1 to derive PECO's pro forma  
8 operating income at present and proposed rates.

9  
10 As explained by Mr. O'Brien, adjustments were made to budgeted data, where  
11 necessary, to ensure that PECO's claimed revenue, expenses and taxes are  
12 representative of the levels that the Company expects to experience on a normalized,  
13 ongoing basis and to comply with established Commission ratemaking precedent.  
14 Because PECO is basing its requested rate increase on future test year data, Exhibit  
15 RLO- 1 is key to understanding and evaluating the derivation of the Company' s  
16 claimed revenue requirement. For that reason, Mr. O'Brien devotes most of his  
17 testimony to a discussion of Exhibit RLO-1.

18 <sup>go</sup> **Q. What is contained in Exhibit RLO-2?**

19 <sup>ao</sup> Exhibit RLO-2 mirrors Exhibit RLO-1 in format, but presents information for the  
20 historic test year ended December 31, 2007. This information is being furnished in  
21 accordance with the Commission's filing requirements and provides a basis for  
22 comparing PECO's future test year claims with actual book results for the historic test  
23 year.

24 **Q. What are the sources of the data contained in Exhibits RLO-1 and RLO-2?**

1           Ao     The base data set forth in Exhibit RLO-1 were derived, for the most part, from  
2                   PECO's 2008 capital and operating budgets, while the corresponding base data in  
3                   Exhibit RLO-2 were taken from PECO's 2007 books and records.

4 10.    **Q.   With regard to the data set forth in Exhibit RLO-1, please briefly describe  
          PECO's budgeting process.**

6           Ao     One of the key goals of the planning process is to have integrated and aligned  
7                   regulatory, operational and financial plans. The planning process starts in the second  
8                   quarter of the year with a review and update of PECO's existing five year regulatory  
9                   and operational goals and initiatives to ensure they are still appropriate. Any  
10                  significant changes in such goals and initiatives are taken into consideration when  
11                  updating our financial Long Range Plan (LRP). The LRP is a five-year view and is  
12                  updated with key assumptions (e.g., inflation rates, interest rates) and with detailed  
13                  input provided by "responsibility areas." Each "responsibility area" reviews its  
14                  historic expense levels; current and anticipated employee staffing levels; performance  
15                  assessments; operational goals; specific projects; and a myriad of other factors. The  
16                  individual "responsibility area" LRPs are typically submitted in May; are carefully  
17                  analyzed for consistency, completeness and appropriateness; and are consolidated and  
18                  delivered to senior management for its review and approval in June.

19                         Once the LRP has been updated and approved, data for the first two years of  
20                         the LRP become the budget and are thoroughly scrutinized. As the budget process  
21                         progresses, significant assumptions are updated and operational and financial goals  
22                         revisited. The two-year budget is then "built up" through a bottom's-up approach by

1 "responsibility area" in much the same fashion as the LRP is developed. The  
2 financing plan is then developed to ensure PECO can maintain investment grade  
3 credit ratings, determine the amount of borrowings required to fund spending plans,  
4 and determine dividend levels to achieve the targeted capital structure. The  
5 consolidated budget is then submitted for management review and approval in the  
6 fourth quarter of the year. The budgeted spending (i.e., O&M and capital) plan and  
7 financing plan (i.e., borrowing) are approved by PECO's Board of Directors in  
8 January. Quarterly dividends are approved each quarter by the PECO Board.

11. **Q. Is that the end of the process?**

10 <sup>Ao</sup> Absolutely not. Although the budget, as approved, remains in place throughout the  
11 year and is not formally amended, it is reviewed and updated on a monthly basis to  
12 reflect the latest estimates. Actual results are then compared to both the original  
13 budget and the latest estimates, and significant variances are thoroughly investigated  
14 and actions are taken as appropriate.

15 12. **Q. Did Schumaker & Company review PECO's budgeting process as part of its**  
16 **recent PUC-mandated management audit?**

17 <sup>Ao</sup> Yes, it did. Schumaker concluded that PECO's budget function and process are  
18 "complete and well documented" and that its financial planning and forecasting  
19 function is "comprehensive and timely," "integrated with PECO's business  
20 functions," and "effectively support[s] both the budget and long-range plan  
21 development process" (Vol. I, pp. 80-81).

**1 13. Q. Do the "responsibility areas" budget by FERC account?**

2       <sup>ao</sup>     No, they do not. Instead, the "responsibility area" budgets are prepared on the basis  
3             of corporate activities and related cost elements, such as payroll, employee benefits,  
4             outside services etc.

5 14.   **Q. Schedules D-4 and D-5 of Exhibit RLO-1 present the 2008 budgeted data on a**  
6             **FERC account basis. How were those figures derived?**

7       <sup>ao</sup>     As Mr. O'Brien describes more fully in his testimony, he analyzed the recorded 2007  
8             FERC account balances to determine their composition (e.g., payroll, benefits, rent)  
9             and then distributed the 2008 budgeted cost elements based on his findings. The  
10            results of Mr. O'Brien's proposed distribution of costs were then reviewed and  
11            confirmed with members of my staff.

12 15.   **Do Exhibits RLO-1 and RLO-2 contain all of the data needed to evaluate PECO's**  
13             **claimed revenue requirement?**

14       <sup>ao</sup>     No. While Exhibits RLO-1 and RLO-2 present, in considerable detail, PECO's rate  
15             base, revenue, expense and tax claims, much of the supporting data is provided in the  
16             following separately-bound volumes, comprising the Company's responses to the  
17             PUC's standard rate case filing requirements at 52 Pa. Code §53.53, 53.62 and 53.64  
18             and supplemental data requests issued by the Commission's staff:

19             **Volume VII       Valuation**  
20             **Volume VIII     Rate of Return**  
21             **Volume IX-A    Balance Sheet and Operating Statement**



1           <sup>ao</sup>    The EBSC is designed to provide a range of what would typically be regarded as in-  
2                   house services in the case of a stand-alone utility. In broad terms, those services fall  
3                   into the following categories: information technology; supply; commercial  
4                   operations; finance; human resources; government and environmental affairs and  
5                   public policy; general counsel/legal; corporate secretary; strategy; and  
6                   communications. The EBSC offers its services to PECO and other affiliated  
7                   members of the Exelon family of companies, including Commonwealth Edison  
8                   Company (CornEd) and Exelon Generation Company, LLC (ExGen).

9 **18.   Q.   Is PECO required to utilize the EBSC's services?**

10           <sup>ao</sup>    No, it is not. Under the terms of the General Services Agreement (GSA) between  
11                   PECO and the EBSC, as approved in the PECO/Unicom merger proceeding at Docket  
12                   No. A-110550F0147, PECO has the discretion to determine whether and to what  
13                   extent to utilize the EBSC's services. The only exception to this general policy fails  
14                   in the area of "corporate governance."

15 **19.   Q.   What role then does the EBSC play in PECO's gas operations?**

16           <sup>ao</sup>    PECO's overall approach is to use its own personnel or independent contractors to  
17                   staff the day-to-day operations of its gas system, as well as its customer service  
18                   functions (e.g., call taking, billing). Other services, such as employee benefits  
19                   administration, mass purchasing, insurance and financing to name a few, are provided  
20                   by the EBSC. Finally, certain highly specialized services, for which it would not be  
21                   cost-effective to maintain the required expertise at either PECO or the EBSC, are  
22                   obtained through contracting with outside firms (e.g., meter reading).

**1 20. Q. What, in your view, is the principal advantage of the service company structure?**

2       <sup>AO</sup>     The EBSC enables PECO to realize economies of scale and scope that, in my  
3             judgment, could be very difficult to achieve on an individual company basis. Indeed,  
4             if PECO were to try to replicate the expertise of the EBSC by maintaining  
5             comparably qualified personnel on its own payroll, the cost to staff those positions  
6             would likely be considerably higher.

**21. Q. How does the EBSC price out the services it provides to PECO?**

8       <sup>AO</sup>     The GSA provides that the services furnished by the EBSC to PECO be billed out at  
9             the EBSC's cost. Prior to enactment of the Energy Policy Act of 2005, the Exelon  
10            system companies were subject to the affiliate transaction and cost allocation rules  
11            prescribed by the Securities and Exchange Commission (SEC) under the Public  
12            Utility Holding Company Act of 1935 (PUHCA), which generally mandated that  
13            service companies, such as the EBSC, offer their services to affiliates at fully  
14            distributed cost. The "at cost" rules were incorporated into the GSA and their  
15            continued use in the provision of non-power goods and services has been approved by  
16            the FERC, which assumed some of the SEC's oversight responsibilities when  
17            PUHCA was repealed, in part, several years ago.

**18 22. Q. How is the cost of those services determined?**

19       <sup>AO</sup>     Direct charges are made for services where possible. Otherwise, costs are allocated  
20             on the basis of the allocation factors/methodologies identified in the attachment to the  
21             GSA, which were previously reviewed and approved by the SEC.

1 23. **Q. What is the approximate breakdown between directly assigned and allocated**  
2 **costs?**

3 <sup>AO</sup> This relationship obviously varies from year to year depending upon the nature of the  
4 work undertaken. However, for PECO during 2007, roughly 40% of its EBSC  
5 billings comprised directly assigned charges and 60% represented allocated costs.

6 24. **Q. How does PECO satisfy itself that the services it procures from the EBSC are**  
7 **provided at a competitive price?**

8 <sup>AO</sup> In several ways. First, PECO and EBSC management work together when it comes  
9 to identifying PECO's needs and defining service priorities and major new initiatives.  
10 As a consequence, PECO has meaningful input into the development of the EBSC's  
11 budget for the upcoming year and ultimately approves the service level arrangements  
12 (SLAs) and budgeted costs. Second, EBSC monthly billings are carefully scrutinized  
13 by PECO personnel, variances between actual and budgeted charges are reviewed  
14 with their EBSC counterparts and actions are taken as appropriate. Through this  
15 detailed budgeting and cost control process, PECO obtains extensive information  
16 regarding the composition of the EBSC's costs, which PECO can then measure  
17 against the results of benchmarking studies and/or price quotes received from third  
18 party vendors. Third, studies are conducted periodically to assess the comparability  
19 of the EBSC's costs to the cost of services available externally.

20 25. **Q. What is PECO's claim in this proceeding for EBSC services?**

1           Ao     PECO has requested an annual allowance for EBSC services of \$13.7 million. A  
2                   breakdown of those costs is attached as Exhibit PSB-1.

**3 26. Q. Does that conclude your direct testimony at this time?**

4           A. Yes, it does.