

PECO ENERGY COMPANY

STATEMENT OF SPECIFIC REASONS FOR PROPOSED INCREASE IN ELECTRIC RATES

PECO Energy Company (“PECO” or the “Company”) is filing to increase its electric delivery rates by \$316.4 million, or 7% of its total electric operating revenues, effective May 30, 2010. The reasons for the proposed increase are summarized below.

Rate Increase

PECO last filed for an increase in electric base rates in July 1989. During the intervening 21 years, PECO has invested \$2.9 billion in new and replacement electric-distribution plant; incurred inflation on material and contracting costs; invested in its workforce by granting its employees annual wage and salary adjustments; and incurred substantial increases in the costs of providing healthcare, pensions and other benefits to its workforce.

During this period, PECO has also made concerted efforts to control discretionary spending through the deployment of new technologies, the management of the size of its workforce, the realization of merger-related synergies and the implementation of process improvements, and competitive-procurement policies and benchmarking. Indeed, since the Company’s electric restructuring case nearly fourteen years ago,¹ PECO’s operating costs (exclusive of required energy-efficiency and smart-meter spending) have increased by a compound annual growth rate of only 1.3% - well below the rate of inflation during that period. Notwithstanding PECO’s aggressive cost-containment and management efforts, after 21 years, based on PECO’s review of current and projected financial results, an increase in electric-

¹ *Application of PECO Energy Company for Approval of Its Restructuring Plan under Section 2805 of the Public Utility Code*, Docket No. R-00973953, December 23, 1997, 181 PUR 4th 517 (Pa. P.U.C. 1997)

delivery revenues is needed and cannot be achieved without an increase in rates. In fact, the Company's revenues declined in 2009 and are projected to decline in 2010.

Absent rate relief, the Company's overall rate of return at present rates is projected to be only 3.64% 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 only 1.77%, which is inadequate by any reasonable standard and far less than required to provide the Company with a reasonable opportunity to attract capital.

Without the requested rate relief, PECO's financial results would deteriorate even further in 2011. This would jeopardize the Company's ability to appropriately invest in the infrastructure needed to maintain and improve its safety, reliability and customer-service levels. It would also have an adverse impact on PECO's credit-coverage ratios and negative implications with respect to maintaining the Company's investment-grade credit ratings, which would increase its financing costs.

The requested rates produce an 8.95% return on the Company's claimed rate base and a return on its common equity of 11.75%. These return levels are recommended by Mr. Paul R. Moul (PECO Statement No. 5), 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> |
|-----------------|---------------|------------------|----------------------|
| Long-Term Debt | 45.19% | 5.81% | 2.63% |
| Preferred Stock | 1.63% | 4.38% | 0.07% |
| Common Equity | <u>53.18%</u> | 11.75% | <u>6.25%</u> |
| Total | 100% | | 8.95% |

Mr. Moul proposes an 11.75% return on common equity for this case based on his analysis of the Company and its superior performance, as described in the testimony of Mr. Craig Adams, PECO's Senior Vice President and Chief Operating Officer (PECO Statement No. 1).

Supporting Data

PECO is filing all of the supporting data required by the Commission's regulations, both for the historic test year ended December 31, 2009, and the future test year ending December 31, 2010. Because the Company is basing its claim principally on the level of operations for the future test year, the discussion that follows will address future test year data.

The revenue and expense claims for the future test year have been prepared in accordance with accepted practices of the Commission. Operating revenues at present rates were derived from budgeted revenues for PECO's electric operations for the year ended December 31, 2010, adjusted in the manner shown on Schedule D-5 of PECO Exhibit RLO-1. Principal revenue adjustments include decreased revenues resulting from the implementation of Act 129 energy efficiency programs and changes in the Company's Customer Assistance Program ("CAP"), which were previously approved in the Company's Default Service proceeding. These adjustments are shown on Schedules D3 and D5 of Exhibit RLO-1.

Pro forma future test year operating expenses were developed from PECO's 2010 budget for electric 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 2009 distribution. The budget data, as distributed to FERC accounts, were annualized or normalized in accordance with established Commission ratemaking practices. Adjustments to the budget data are shown in specific expense-related schedules included in

Section D of PECO Exhibit RLO-1. The estimated annualized depreciation accrual related to plant in service at December 31, 2010 was calculated using the remaining life method, which the Commission had previously approved for PECO's electric operations. PECO's claim for the estimated annualized depreciation accrual is set forth in PECO Exhibit JA-2 and is described in PECO Statement No. 4.

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 was amortized to income. 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 electric plant at December 31, 2009, including common plant used in, and appropriately allocated to, electric operations, as shown in Section C of PECO Exhibit RLO-1. The estimated original cost of gross plant at December 31, 2010 was developed by taking the original cost of gross plant at January 1, 2010, and adding the 2010 estimated plant additions and subtracting the 2010 estimated plant retirements. The estimated accumulated book reserve at December 31, 2010 was calculated in similar fashion. Specifically, the accumulated book reserve at January 1, 2010 was brought forward to December 31, 2010 by adding the 2010 estimated annual depreciation accrual; subtracting the 2010 estimated plant retirements; and adding 2010 estimated salvage or

subtracting estimated removal costs that are closed to the accumulated book reserve.

Accumulated deferred Federal income taxes, customer advances, and a 13-month average of customer deposits were deducted from rate base.

As is evident from the foregoing, and the extensive 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 that is used and useful in the public service and to maintain the integrity of its existing capital and to attract new capital.

Rate Structure

As Mr. Alan B. Cohn (PECO Statement No. 9) 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 (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 the system average rate of return.

PECO proposes certain changes in rate design including: (1) aligning fixed distribution/customer charges with, or closer to, customer-classified costs; (2) eliminating certain rates that are legacies of PECO's "bundled" rates (*i.e.*, rates that recovered generation costs as well as distribution costs); and (3) implementing a Transmission Service Charge ("TSC") Rider to remove PJM-related transmission charges from base rates, thereby assuring competitive neutrality between default service and service offered by Electric Generation Suppliers.

PECO is also proposing to unbundle the working capital revenue requirement associated with a portion of PECO's default-generation supply and transmission-service costs by recovering that revenue requirement in the Generation Supply Adjustment ("GSA") and the TSC, which apply only to default-service customers, rather than in base rates, which are charged to all (shopping and non-shopping) customers.

Finally, PECO proposes to recover all existing meter and meter-reading costs through the Smart Meter Cost Recovery Rider ("SMCR") the Company proposed in its Smart Meter Technology Procurement and Installation Plan proceeding at Docket No. M-2009-2123944. By doing so, the savings that arise from replacing PECO's existing metering systems with a "Smart Meter" network will flow to customers automatically.

Customer-Assistance Program

As part of its electric default-service proceeding at Docket No. P-2008-2062739, PECO agreed to a number of Customer Assistance Program ("CAP") affordability enhancements, as well as cost-containment measures to minimize the impact of increased costs on non-CAP customers. These enhancements include increasing the discount levels that PECO offers to CAP customers so that approximately 90% of each tier of CAP customers will meet the Commission's affordability targets, and implementing new cost-containment design criteria that limit maximum CAP benefits on a system-wide basis. PECO's case includes a \$59 million adjustment to roll the cost of the CAP programs into base rates. The CAP measures are discussed by Ms. Lauren Feldhake, PECO's Director of Customer Financial Operations, in PECO Statement No. 6.

Energy-Efficiency Programs

Consistent with the spirit and letter of Act 129's energy-efficiency provisions, PECO, in collaboration with multiple parties and stakeholders, developed a comprehensive Energy

Efficiency and Conservation Plan (“EE&C Plan”) that received final Commission approval in February 2010.² The Plan contains numerous robust programs to meet the Act’s consumption and demand-reduction requirements and to help consumers in PECO’s service territory save energy. As discussed in the testimony of PECO witness Mr. Frank J. Jiruska (PECO Statement No. 7), the EE&C Plan offers a wide variety of tools that can help customers achieve significant financial savings. In fact, by using fairly simple measures such as Compact Fluorescent Lamps and adjusting their thermostats, customers can achieve savings that will offset PECO’s estimated bill increase, and can achieve even greater savings by taking advantage of additional opportunities under the EE&C Plan.

Capital Infrastructure and Community Investment

PECO makes significant capital and infrastructure investments in its service territory every year. As noted above, since its last base rate case, PECO has invested \$2.9 billion in its electric distribution plant. This helps to maintain and create thousands of jobs in the region.

PECO also has a strong and continuing tradition of community involvement. The Company’s corporate citizenship efforts are designed to improve the quality of life for the people who live and work in PECO’s service territory, and includes support for education and the environment, sponsorships, employee volunteer activities, and executive involvement on outside nonprofit boards.

Summary

The requested increase in revenues is the minimum necessary to enable the Company to appropriately invest in the infrastructure needed to maintain and improve its safety, reliability

² *Petition of PECO Energy Company for Approval of its Act 129 Energy Efficiency and Conservation Plan and Expedited Approval of its Compact Fluorescent Lamp Program*, Docket No. M-2009-2093215 (Order Entered February 17, 2010).

and customer-service levels; to maintain the integrity of PECO's existing capital; to attract additional capital at reasonable costs; and to have an opportunity to 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 Company's proposed rates, rules and terms of service should be permitted to become effective as filed.