

**PECO ENERGY COMPANY  
STATEMENT NO. 2**

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

PECO ENERGY COMPANY – ELECTRIC DIVISION

DOCKET NO. R-2010-2161575

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DIRECT TESTIMONY

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WITNESS: PHILLIP S. BARNETT

SUBJECT: EXPLAINING PECO'S NEED FOR RATE  
RELIEF; PROVIDING AN OVERVIEW OF  
PECO'S PRINCIPAL ACCOUNTING EXHIBITS  
AND BUDGETING PROCESS; AND  
DESCRIBING THE NATURE AND LOCATION  
OF THE COST OF SERVICES THAT PECO  
RECEIVES FROM AFFILIATED ENTITIES

DATED: MARCH 31, 2010

## TABLE OF CONTENTS

		Page
1	I. INTRODUCTION AND PURPOSE OF TESTIMONY .....	1
2	II. PECO'S NEED FOR RATE RELIEF .....	2
3	III. OVERVIEW OF PECO'S PRINCIPAL ACCOUNTING EXHIBITS AND	
4	BUDGETING PROCESS .....	6
5	IV. AFFILIATED SERVICES .....	11
6	V. CONCLUSION.....	15



1 through the ranks to the position of chief financial officer of three of GE Capital's  
2 business units. I have worked for the Exelon organization for the past seven years,  
3 most recently as Senior Vice President of Corporate Financial Planning, and assumed  
4 my current position in September 2007.

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

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

10 **II. PECO'S NEED FOR RATE RELIEF**

11 **5. Q. Why is PECO seeking a rate increase at this time?**

12 A. As noted by Mr. Craig L. Adams in his testimony (PECO Statement No. 1), it has  
13 been twenty-one years since PECO last requested a base rate increase for its electric  
14 operations. Over that period, PECO has invested approximately \$2.9 billion in new  
15 and replacement electric distribution plant; has granted its employees annual wage  
16 and salary adjustments; has incurred increases in the costs of providing healthcare,  
17 pension and other benefits to its workforce and has incurred inflation on material and  
18 contracting costs. Despite concerted efforts to attract new customers and to hold the  
19 line on expenses, those factors have severely compromised the Company's ability to  
20 earn a fair return on its investment.

1 **6. Q. Please elaborate.**

2 A. On a pro forma basis, PECO's electric distribution operations are projected to  
3 produce an overall return on invested capital of 3.64%, and a return on common  
4 equity of only 1.77%, during the twelve months ending December 31, 2010. Those  
5 return levels are clearly inadequate, as Mr. Paul R. Moul points out in his testimony  
6 (PECO Statement No. 5). Absent rate relief, PECO's financial results would  
7 deteriorate even further in 2011 and jeopardize its ability to appropriately invest in  
8 the infrastructure needed to maintain and improve its safety, reliability and customer  
9 service levels. It would also have an adverse impact on PECO's credit-coverage  
10 ratios and negative implications to maintaining the Company's investment-grade  
11 credit ratings, which would increase our financing costs.

12 **7. Q. Why is it important that PECO maintain and/or possibly improve its credit**  
13 **ratings?**

14 A. The electric distribution business, like other forms of regulated utility service, is  
15 extremely capital-intensive. In fact, and as illustrated by the following table, PECO  
16 projects that it will need to invest approximately \$1.7 billion in new and replacement  
17 electric delivery plant over the next five years:

18

19

20

21

	Year	Capital Expenditures (in million \$\$\$)
1		
2	2010	\$343.97
3	2011	\$371.97
4	2012	\$349.29
5	2013	\$338.81
6	2014	\$333.56

7 While some portion of this investment presumably will come from internally  
8 generated funds, a meaningful amount will undoubtedly have to be externally  
9 financed by either issuing debt or other more expensive forms of capital. The  
10 Company's financial health, as reflected in its credit ratings, will determine how  
11 much it has to pay to attract such capital. And, ultimately, those capital costs will get  
12 passed along to PECO's electric customers.

13 **8. Q. What steps, if any, has PECO taken to minimize its capital costs?**

14 **A.** As a result of strong operating performance and aggressive debt-reduction initiatives  
15 since its last electric base rate case in 1989-90, coupled with an overall decline in  
16 capital costs, PECO has been able to reduce its weighted average long-term debt rate  
17 from over 10% to less than 6%. Also, in addition to establishing its spending goals to  
18 meet safety and reliability requirements, PECO strategically sets its capital spending  
19 target to limit the amount of borrowing necessary, which lowers its capital costs.  
20 Finally, and as the Commission is well aware, PECO was one of only six utilities in  
21 the United States designated to receive major funding under the American Recovery  
22 and Reinvestment ("Stimulus") Act. The \$200 million Stimulus Grant that PECO

1 was awarded obviously reduces the aggregate amount of capital the Company will  
2 have to raise over the next five years.

3 **9. Q. In addition to capital costs, you mentioned that pension costs are contributing to**  
4 **PECO's need for rate relief. Please elaborate.**

5 A. PECO is a participant in the Exelon employer-sponsored pension funds. As of  
6 December 31, 2007, Exelon had funded 92% of its pension obligation. As of  
7 December 31, 2009, the funding level had declined to 68%, primarily due to the  
8 significant decline in the value of the plan assets in 2008, driven by disruptions in the  
9 broader capital markets. PECO's unfunded obligation as of December 31, 2009 (for  
10 actuarial purposes, not for financial reporting purposes) was approximately \$372  
11 million.

12 **10. Q. What is PECO's plan to fund the pension obligation and what is reflected in the**  
13 **revenue requirement request?**

14 A. ERISA guidelines (as amended by the Pension Protection Act of 2006) require  
15 companies to maintain certain minimum funding thresholds and, generally, to fund  
16 their pension obligations over a seven-year period. Exelon and PECO are currently  
17 evaluating different pension contribution options to reduce the unfunded obligation.  
18 The strategy management is currently proposing is expected to substantially fund the  
19 obligation (achieving a 97% funded status) by 2016, subject to market conditions  
20 aligning with our forecast. The current revenue requirement claim is \$31 million,  
21 which is based on a \$71 million funding contribution in 2010 adjusted for 67%

1 allocated to PECO's electric distribution business and 64% allocated to O&M  
2 expense.

3 **11. Q. Why is PECO making this funding contribution at this time?**

4 A. Exelon and PECO are reviewing their funding strategy to determine the most prudent  
5 and efficient means to meet the pension funding obligation. The obligation will have  
6 to be funded over an approximately seven-year timeframe, and contributing \$71  
7 million in 2010 has identifiable benefits. Factors being considered include a credit  
8 environment that allows for access to funding at favorable rates. Additionally,  
9 contributing funds in 2010 provides more stability in future funding requirements and  
10 reduces the potential volatility associated with having a significant obligation.

11 **III. OVERVIEW OF PECO'S PRINCIPAL ACCOUNTING EXHIBITS AND**  
12 **BUDGETING PROCESS**

13 **12. Q. Please provide an overview of PECO's principal accounting exhibits.**

14 A. PECO's principal accounting exhibits are Exhibits RLO-1 and RLO-2 and are  
15 sponsored, for the most part, by Mr. Robert L. O'Brien (PECO St. No. 3). Exhibit  
16 RLO-1, presents PECO's revenue requirement for the future test year and comprises  
17 four sections, as follows:

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

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

1           **Section C** provides the detailed development of the major components that make up  
2 the Company's rate base claim. Included therein are summaries of the original cost  
3 and accrued depreciation at test year end of the various categories of utility plant,  
4 including allocated common plant; and calculations of PECO's working capital,  
5 materials and supplies, accumulated deferred income taxes, and customer deposits  
6 and advances.

7           **Section D** contains the detailed adjustments required to place test year revenues and  
8 expenses on a ratemaking basis. These adjustments are summarized on Schedules D-  
9 3, D-4, and D-5, and, together with certain tax adjustments, are carried forward to  
10 Schedule D-1 to derive PECO's pro forma operating income at present and proposed  
11 rates.

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

20 **13. Q. What is contained in Exhibit RLO-2?**

21           A. Exhibit RLO-2 mirrors Exhibit RLO-1 in format, but presents information for the  
22 historic test year ended December 31, 2009. This information is being furnished in  
23 accordance with the Commission's filing requirements and provides a basis for  
24 comparing PECO's future test year claims with actual book results for the historic test  
25 year.

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

2 A. The base data set forth in Exhibit RLO-1 were derived, for the most part, from  
3 PECO's 2010 capital and operating budgets, while the corresponding base data in  
4 Exhibit RLO-2 were taken from PECO's 2009 books and records.

5 15. Q. Please briefly describe PECO's budgeting process.

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

20 Once the LRP has been updated and approved, data for the first two years of the LRP  
21 become the budget and are thoroughly scrutinized. As the budget process progresses,

1 significant assumptions are updated and operational and financial goals revisited.  
2 The two-year budget is then “built up” through a bottom’s-up approach by  
3 “responsibility area.” Each “responsibility area” again reviews its historic expense  
4 levels, current and anticipated employee staffing levels, performance assessments,  
5 operational goals, specific projects, and a myriad of other factors. The financing plan  
6 is then developed to ensure PECO can maintain investment grade credit ratings,  
7 determine the amount of borrowings required to fund spending plans, and determine  
8 dividend levels to achieve the targeted capital structure. The consolidated budget is  
9 then submitted for management review and approval in the fourth quarter of the year.  
10 The budgeted spending (i.e., O&M and capital) plan and financing plan (i.e.,  
11 borrowing) are approved by PECO’s Board of Directors in December. Quarterly  
12 dividends are approved each quarter by the PECO Board.

13 **16. Q. Is that the end of the process?**

14 A. No. Although the budget, as approved, remains in place throughout the year and is  
15 not formally amended, it is reviewed and updated on a monthly basis to reflect the  
16 latest estimates. Actual results are then compared to both the original budget and the  
17 latest estimates and significant variances are thoroughly investigated and actions  
18 taken as appropriate.

19 **17. Q. Has PECO’s budgeting process been reviewed by the Commission?**

20 A. Yes it has. In a 2007 PUC-mandated management audit, Schumaker & Company  
21 concluded that PECO’s budget function and processes were “complete and well  
22 documented” and that its financial planning and forecasting was “comprehensive and

1           timely”, “integrated with PECO’s business functions,” and “effectively supported  
2           both the budget and long-range plan development process” (Vol. I, pp. 80-81).

3 **18. Q. Do the “responsibility areas” budget by FERC account?**

4           A. No, they do not. Instead, the “responsibility areas” budgets are prepared on the basis  
5           of business activities and related cost elements, such as payroll, employee benefits,  
6           outside services, etc.

7 **19. Q. Schedules D-4 and D-5 of Exhibit RLO-1 present the 2010 budgeted data on a  
8           FERC account basis. How were those figures derived?**

9           A. As Mr. O’Brien describes more fully in his testimony, he analyzed the recorded 2009  
10          FERC account balances to determine their composition (e.g., payroll, benefits, rent)  
11          and then distributed the 2010 budgeted cost elements based on his findings. The  
12          results of Mr. O’Brien’s proposed distribution of costs were then reviewed and  
13          confirmed with members of my staff.

14 **20. Q. Do Exhibits RLO-1 and RLO-2 contain all of the data needed to evaluate  
15          PECO’s claimed revenue requirement?**

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

1 In addition, other PECO witnesses are sponsoring testimony and specific exhibits in  
2 the areas of depreciation (Mr. Jorge Acevedo), rate of return (Mr. Paul R. Moul),  
3 universal-service programs (Ms. Lauren B. Feldhake), energy-efficiency programs  
4 (Mr. Frank J. Jiruska), cost-of-service allocation (Mr. Howard S. Gorman), and the  
5 unbundling of certain costs (Mr. Alan B. Cohn).

#### 6 IV. AFFILIATED SERVICES

7 **21. Q. Mr. Adams, in his testimony (PECO Statement No. 1), notes that PECO**  
8 **procures certain services from the Exelon Business Services Company**  
9 **("EBSC"). Please elaborate.**

10 A. Like many other energy holding-company systems, Exelon created a service  
11 company, the EBSC, following the merger of PECO and the former Unicom  
12 Corporation to house specific support functions that it believed could be staffed more  
13 efficiently and economically on a centralized basis.

14 **22. Q. What types of services does the EBSC make available and to whom?**

15 A. The EBSC is designed to provide a range of what would typically be regarded as in-  
16 house services in the case of a stand-alone utility. In broad terms, those services fall  
17 into the following categories: information technology; supply; commercial  
18 operations; finance; human resources; government and environmental affairs and  
19 public policy; general counsel/legal; corporate secretary; strategy; and  
20 communications. The EBSC offers its services to PECO and other affiliated  
21 members of the Exelon family of companies, including Commonwealth Edison  
22 Company ("ComEd") and Exelon Generation Company, LLC ("ExGen").

1 **23. Q. Is PECO required to utilize the EBSC's services?**

2 A. No, it is not. Under the terms of the General Services Agreement ("GSA") between  
3 PECO and the EBSC, as approved in the PECO/Unicom merger proceeding at Docket  
4 No. A-110550F0147, PECO has the discretion to determine whether and to what  
5 extent to utilize the EBSC's services. The only exception to this general policy falls  
6 in the area of "corporate governance."

7 **24. Q. What role then does the EBSC play in PECO's electric distribution operations?**

8 A. PECO's overall approach is to use its own personnel or independent contractors to  
9 staff the day-to-day operations of its electric delivery system, as well as its customer-  
10 service functions (e.g., call taking, billing). Other services, such as employee-  
11 benefits administration, mass purchasing, insurance and financing, to name a few, are  
12 provided by the EBSC. Finally, certain highly specialized services, for which it  
13 would not be cost-effective to maintain the required expertise at either PECO or the  
14 EBSC, are obtained through contracting with outside firms (e.g., tree trimming).

15 **25. Q. What, in your view, is the principal advantage of the service-company structure?**

16 A. The EBSC enables PECO to realize economies of scale and scope that, in my  
17 judgment, could be very difficult to achieve on an individual-company basis. Indeed,  
18 if PECO were to try to replicate the expertise of the EBSC by maintaining  
19 comparably qualified personnel on its own payroll, the cost to staff those positions  
20 would likely be considerably higher.

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

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

12 **27. Q. How is the cost of those services determined?**

13 A. Direct charges are made for services where possible. Otherwise, costs are allocated  
14 on the basis of the allocation factors/methodologies identified in the attachment to the  
15 GSA, which were previously reviewed and approved by the SEC. These allocation  
16 factors and methodologies were also reviewed as part of the 2007 Management and  
17 Operations audit by the Commission. The audit report concluded that PECO's  
18 affiliate transaction costs were generally reasonable and appropriately based on direct  
19 charges or cost-causation allocation factors. (Vol. II, p.373-374).

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

3 A. This relationship obviously varies from year to year depending upon the nature of the  
4 work undertaken. However, for PECO during 2009, roughly 50% of its EBSC  
5 billings comprised directly assigned charges and 50% represented allocated costs.

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

8 A. 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  
13 scrutinized by PECO personnel, variances between actual and budgeted charges are  
14 reviewed with their EBSC counterparts and actions are taken as appropriate. Third,  
15 for functions that are not already outsourced, PECO obtains extensive information  
16 regarding the composition of the EBSC's costs, which PECO can then measure  
17 against price quotes received from third-party vendors.

18 30. Q. What is PECO's claim in this proceeding for EBSC services?

19 A. PECO has requested an annual allowance for EBSC services of \$71.9 million. A  
20 breakdown of those costs is attached as Exhibit PSB-1.

1 31. Q. How do PECO's 2010 budgeted EBSC charges compare to 2009 actuals?

2 A. PECO's 2010 budgeted EBSC charges are \$1.4 million, or 2.0%, higher than the  
3 2009 actual costs. This is driven by \$8.4 million in Information Technology costs  
4 (including \$3.2 million for Smart Grid) in support of PECO Operations, offset by  
5 lower finance services of \$3.4 million primarily due to implementation of enhanced  
6 financial systems in 2009 and \$3.6 million of lower costs as a result of cost  
7 containment actions at EBSC including a 2009 reorganization and depreciation  
8 transferred to operating companies.

9 V. CONCLUSION

10 32. Q. Does that conclude your direct testimony at this time?

11 A. Yes, it does.