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-2018-3000164

DIRECT TESTIMONY

WITNESS: PHILLIP S. BARNETT

SUBJECT: EXPLAINING PECO'S NEED FOR RATE RELIEF; DISCUSSING PECO'S EFFORTS TO CONTROL OPERATING AND MAINTENANCE COSTS; 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 THE EXELON BUSINESS SERVICES COMPANY

DATED: MARCH 29, 2018

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DIRECT TESTIMONY
OF
PHILLIP S. BARNETT

I. INTRODUCTION AND PURPOSE OF TESTIMONY

1. Q. Please state your name and business address.

A. My name is Phillip S. Barnett, and my business address is PECO Energy Company, 2301 Market Street, Philadelphia, Pennsylvania 19103.

2. Q. By whom are you employed and in what capacity?

A. I am employed by PECO Energy Company ("PECO" or the "Company") as Senior Vice President, Chief Financial Officer and Treasurer. In that capacity, I am responsible for PECO's financial function, including budgeting, long range financial planning, financial analysis and reporting, project evaluation and financings. In addition, I have oversight and coordination responsibilities for PECO's accounting, tax, treasury, investor relations and risk management activities. I also ensure that PECO performs with strong financial management discipline and solid financial internal controls.

3. Q. Please briefly describe your educational background and professional experience.

A. I received a bachelor's degree in business administration with a concentration in accounting from Marquette University and a master's degree in management from Northwestern University. I began my professional career as an auditor at Arthur Andersen; worked at Itel Corporation in various financial planning and reporting roles; and was then employed at GE Capital for approximately eleven years, rising through the ranks to the position of chief financial officer of three of GE Capital's business units. I have worked for the Exelon organization for the past fifteen years, most recently as Senior Vice President of Corporate Financial Planning, and assumed my current position in March 2008.

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

A. The purpose of my direct testimony is as follows: (1) to briefly explain PECO's need for rate relief; (2) to summarize PECO's efforts to control operating and maintenance ("O&M") costs since its last approved base rate increase in 2015; (3) to provide an overview of PECO's principal accounting exhibits, as well as its planning process; and (4) to describe the nature and allocation of costs for services that PECO receives from the Exelon Business Services Company ("EBSC").

II. PECO'S NEED FOR RATE RELIEF

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

A. As explained by Mr. Michael A. Innocenzo in his testimony (PECO Statement No. 1), PECO last requested a base rate increase for its electric operations three years ago. Since the Company's current base rates became effective on January 1, 2016, PECO has invested approximately $0.9 billion in new and replacement electric distribution plant and is planning to invest approximately an additional $1.0 billion in new and replacement electric distribution plant in years 2018 through 2019. As explained by Mr. Innocenzo, the projected expenditures are designed to maintain and/or enhance the safety and reliability of our backbone electric delivery system, strengthen system resiliency and maintain and/or enhance physical security and cybersecurity.

During the same period, PECO has granted its employees annual wage and salary adjustments and has experienced the effects of inflation on material and contracting costs.

Significantly, PECO has not experienced increases in sales that would offset these costs. In fact, load growth from 2016 to 2017 has declined by 0.5%, notwithstanding the fact that the number of customers has increased by 0.8% during the same period.[1] Load growth from 2017-2019 is expected to remain relatively flat with a compound annual growth rate of 0.1% notwithstanding customer growth of 0.8%.

The growth in number of customers that has occurred and is continuing has been more than offset by a decline in usage per customer that is due, in significant part, to PECO's successful implementation of energy efficiency and conservation ("EE&C") mandates under Act 129 of 2008 ("Act 129"). PECO is a strong supporter of energy efficiency, and its award-winning programs have saved customers more than $600 million dollars over the last eight years, but the net effect for PECO is a continuing reduction in revenue (with potentially significant additional penalties for any failure to meet required reductions in usage by designated milestone dates). As reflected in our projected load growth, PECO's

[1] The Company's load growth data is weather normalized.

current Phase III EE&C program is designed to reduce customer consumption by 1,962,659 MWh over the June 1, 2016-May 31, 2021 period.

Despite efforts to attract new customers and to contain expenses, the factors I described above have compromised the Company's ability to earn a fair return on its investment.

6. Q. Please elaborate.

A. Absent an increase in revenues, PECO's electric distribution operations are projected to produce an overall return on invested capital of 5.84%, and an indicated return on common equity of only 7.30%, during the twelve months ending December 31, 2019.

As explained by Mr. Paul R. Moul (PECO Statement No. 5), such return levels are inadequate under any reasonable standard. These return levels would deteriorate even further in 2020 and thereafter, jeopardizing PECO's ability to make investments necessary to maintain and enhance the provision of safe, reliable, and resilient service to customers. Inadequate returns would also adversely impact PECO's credit coverage ratios and its ability to maintain or improve its investment-grade credit ratings, which, in turn, would increase the Company's financing costs.

7. Q. Why is it important that PECO maintain or possibly improve its credit ratings?

A. Credit ratings matter because PECO projects that it will need to invest $2.5 billion in new and replacement electric distribution plant over the next five years (2018-2022). Capital costs ultimately are borne by customers and, therefore, maintaining strong credit metrics helps to reduce the costs customers bear.

8. Q. What steps, if any, has PECO taken to minimize its costs of borrowing?

A. PECO has leveraged the low interest rate environment and its strong credit rating in order to reduce its weighted average long-term debt rate of 4.43% in 2017 to approximately 4.16% as projected for 2019.

III. PECO'S EFFORTS TO CONTROL OPERATING AND MAINTENANCE COSTS

9. Q. Mr. Barnett, please describe PECO's efforts to control O&M expenses since its current base rates became effective on January 1, 2016.

A. When adjusted for major storms, PECO projects a 0.4% compound annual growth rate in O&M expense from 2016 through the end of the fully projected future test year (2019) ("FPFTY"). These annual increases are well below the expected rate of inflation for the same period. The projected compound annual growth rate would increase to 1.7% if the variable expenses associated with major storms (using PECO's five-year average of historic storm damage expense) were included.

PECO has taken a variety of significant steps to control O&M expenditures. These steps include but are not limited to:

- ***Bad Debt.*** PECO reduced bad debt expense from $28.4 million in 2016 to $24.4 million in 2017, and projects $25.0 million and $25.1 million of bad debt expense in 2018 and 2019, respectively. PECO is achieving these reductions through a variety of initiatives, including increasing oversight of high balance accounts, requiring down payments for most types of payment arrangements, mandating deposits for delinquent accounts and continued use of advanced metering infrastructure ("AMI") remote connect/disconnect functionality.
- ***Other Post-Employment Benefits ("OPEB")***. PECO's overall employee benefits costs have decreased, even though underlying retiree medical expenses have generally increased at approximately 5% annually in recent years. PECO actively manages its employee benefit costs by evaluating trends in benefits and identifying and implementing cost reduction measures while maintaining a competitive compensation package. PECO's projected 2019 OPEB expense is approximately a $0.5 million credit (negative expense) due to the continued amortization of a prior service credit resulting from a prior OPEB plan design change, higher than expected asset returns in 2017 and a reduction in eligibility of new hires for OPEB. The 2019 OPEB credit of $0.5 million is approximately $1.1 million lower than the actual 2016 OPEB expense of $0.6 million.

- ***EBSC Services.*** PECO's allocated EBSC costs declined from $107.1 million in 2016 to $105.5 million in 2017, and are projected to be $98.8 million in 2018 and $90.0 million in 2019. This decline reflects reduced allocations to PECO which are primarily due to the merger of Pepco Holdings and Exelon and other cost management activities.

IV. OVERVIEW OF PECO'S PRINCIPAL ACCOUNTING EXHIBITS AND BUDGETING PROCESS

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

A. PECO's principal accounting exhibits are PECO Exhibits BSY-1, BSY-2 and BSY-3 and are sponsored by Mr. Benjamin S. Yin (PECO Statement No. 3), based, in part, on data provided by other PECO witnesses. PECO Exhibit BSY-1 presents PECO's revenue requirement for the FPFTY and comprises four sections, as follows:

> **Section A** consists of a summary schedule setting forth PECO's claimed measures of value (i.e., rate base) and the derivation of the Company's requested rate increase.
>
> **Section B** contains basic accounting data from the Company's books and records, including a FPFTY-end balance sheet; statements of net utility operating income and FPFTY revenues, with the separation of Pennsylvania jurisdictional and non-jurisdictional amounts; a schedule of O&M expense items; and a calculation of PECO's taxes other than income. Also included are schedules developing PECO's embedded cost of debt, its FPFTY capital structure; and its overall claimed rate of return.
>
> **Section C** provides a detailed development of the major components of the Company's rate base claim. Included therein are summaries of the original cost and accrued depreciation at the end of the FPFTY of the various categories of utility plant, including allocated common plant; and calculations of PECO's working capital, materials and supplies, accumulated deferred income taxes, customer deposits and advances, the unamortized balance of Automated Meter Reading

investment related to legacy meters that are being retired and replaced with AMI and a pension-related asset.

Section D contains the detailed adjustments to place FPFTY revenues and expenses on a ratemaking basis. These adjustments are summarized on Schedules D-3 to D-17, and, together with certain tax adjustments, are carried forward to Schedule D-1 to derive PECO's pro forma operating income at present and proposed rates.

As explained by Mr. Yin, adjustments were made to budgeted data, where necessary, to ensure that PECO's claimed revenue, expenses and taxes are representative of the levels that the Company expects to experience on a normalized, ongoing basis, and in accordance with established Pennsylvania Public Utility Commission ("Commission") ratemaking precedent. Because PECO is basing its requested rate increase on FPFTY data, PECO Exhibit BSY-1 is key to understanding and evaluating the derivation of the Company's claimed revenue requirement. For that reason, Mr. Yin devotes most of his testimony to a discussion of PECO Exhibit BSY-1.

11. Q. What is contained in PECO Exhibit BSY-2?

A. PECO Exhibit BSY-2 mirrors PECO Exhibit BSY-1 in format, but presents information for the future test year ending December 31, 2018.

12. Q. What is contained in PECO Exhibit BSY-3?

A. PECO Exhibit BSY-3 mirrors PECO Exhibit BSY-1 and BSY-2 in format, but presents information for the historic test year ended December 31, 2017. This information is being furnished in accordance with the Commission's filing requirements and provides a basis for comparing PECO's FPFTY claims to actual historic results of operations, adjusted for rate making purposes for the historic test year.

13. Q. What are the sources of the data contained in PECO Exhibits BSY-1, BSY-2 and BSY-3?

A. The base data set forth in PECO Exhibits BSY-1 and BSY-2 were derived, for the most part, from PECO's 2018 and 2019 capital and operating budgets, respectively, while the corresponding base data in PECO Exhibit BSY-3 were taken from PECO's 2017 books and records.

14. Q. Please briefly describe PECO's budgeting process.

A. One of the key goals of the annual planning process is to integrate and align PECO's operational, regulatory, and financial plans. The operational plan includes goals focused on achieving best in class safety performance at top decile and first quartile performance for both reliability and customer satisfaction, as explained in Mr. Innocenzo's testimony. The operational plan is also consistent with statutory and Commission-imposed regulatory requirements. In terms of the financial plan, spending targets are set in order to achieve operational goals and comply with regulatory requirements and to ensure that O&M expense increases are lower than the rate of inflation.

The planning process starts with a review and update of PECO's operational and regulatory goals and initiatives to determine if changes are required for the future. Any significant changes in such goals and initiatives are taken into consideration when updating our financial Long Range Plan ("LRP"). The LRP is also a five-year view and is updated with key assumptions (e.g., inflation rates, interest rates) and with detailed input provided by "responsibility areas." Each "responsibility area" reviews its historic expense levels, current and anticipated employee staffing levels, performance assessments, regulatory requirements, operational goals, specific projects, and a myriad of other factors. The individual "responsibility area" LRPs are typically submitted to finance in June of each year and are carefully analyzed for consistency, completeness and appropriateness. The "responsibility area" LRPs are then consolidated and delivered to PECO's senior management (i.e., the Chief Executive Officer, Chief Operating Officer and Chief Financial Officer) for review and approval in September.

Once the LRP has been updated and approved, data is thoroughly scrutinized to formulate a detailed two-year budget. The two-year budget is "built up" by "responsibility area," similar to the LRP process described above. The financing plan is then developed to ensure PECO can maintain investment grade credit ratings. Based on that plan, PECO determines the amount it can borrow to fund its spending plans and the dividend levels that will achieve its targeted capital structure. The consolidated budget is then submitted to PECO senior management for review and approval. The budgeted spending (i.e., O&M and capital) plan and financing plan (i.e., borrowing) are also approved by PECO's Board of Directors thereafter. Quarterly dividends are approved each quarter by the PECO Board.

15. Q. How does the Company budget for gross tax repair deductions?

A. First, PECO takes the capital expenditures plan and converts it to a capital additions plan based on in-service dates. The capital additions are then unitized by applying a 6-month lag factor (reflecting the average time it takes to take a project from in-service to closure). Next, the Company identifies the tax repair eligible categories of work within that plan, such as Corrective Maintenance, and pinpoints specific projects expected to be eligible for tax repairs. Finally, PECO applies a qualifying factor to the identified categories and projects to reflect the Company's experience regarding the amount of tax repair benefit it expects to receive. In 2017, the Company's tax repairs gross deduction was $96.3 million, and PECO forecasts $94.9 million of tax repairs gross deduction in 2018 and $96.9 million in 2019.

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

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

17. Q. Has PECO's budgeting process been reviewed by the Commission?

A. Yes. PECO's budgeting process was reviewed by the Commission during its Focused Management and Operations Audit of PECO in 2014 ("2014 Audit").[2] The Commission's auditors found no deficiencies or weaknesses in the way PECO prepares its budgets.

18. Q. Do the personnel in each of the "responsibility areas" develop their budget*s* by FERC account?

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

19. Q. Schedules B-2, B-3 and B-4 of PECO Exhibit BSY-1 present the 2019 budgeted data on a FERC account basis. How were those figures derived?

A. As Mr. Yin describes more fully in his testimony, he analyzed the recorded 2017 FERC account balances to determine their composition (e.g., payroll, benefits, rent) and then distributed the 2019 budgeted cost elements based on his findings. The results of Mr. Yin's proposed distribution of costs were then reviewed and confirmed with members of my staff.

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[2] *See* Focused Management and Operations Audit of PECO Energy Company, Docket No. D-2013-2370921 (issued September 2014).

20. Q. Do PECO Exhibits BSY-1, BSY-2 and BSY-3 contain all of the data needed to evaluate PECO's claimed revenue requirement?

A. No. While PECO Exhibits BSY-1, BSY-2 and BSY-3 present, in considerable detail, PECO's rate base, revenue, expense and tax claims, much of the supporting data are provided in the separately-bound volumes comprising the Company's responses to the Commission's standard rate case filing requirements at 52 Pa. Code §§ 53.53, 53.62 and 53.64 and supplemental data requests issued by the Commission's staff.

In addition, other PECO witnesses are sponsoring testimony and specific exhibits in the areas of depreciation (Mr. Scott Bailey), and rate of return (Mr. Paul R. Moul).

21. Q. In Paragraph 21 of the Joint Petition for Settlement of PECO's 2015 electric base rate case, PECO agreed that it would provide comparisons of its actual expenditures in certain areas with projections made in its 2015 base rate case. Has PECO provided these comparisons?

A. Yes. First, on March 28, 2016, PECO provided the Commission's Bureau of Technical Utility Services ("TUS"), the Commission's Bureau of Investigation and Enforcement ("I&E"), the Office of Consumer Advocate ("OCA"), and the Office of Small Business Advocate ("OSBA") with an update on its electric division's actual capital expenditures, plant additions, and plant retirements by month for the twelve months ending December 31, 2015. A copy of the filing is provided as Exhibit PSB-1.

Second, on March 31, 2017, the Company provided a similar update regarding actual capital expenditures, plant additions, and plant retirements by month for the twelve months ending December 31, 2016. A copy of the filing is provided as Exhibit PSB-2.

Taken together, these filings show that over the 2015-2016 period, the Company's actual capital expenditures, capital additions and retirements were greater than its projections in the 2015 electric base rate proceeding.

With respect to O&M expense, PECO spent $545.7 million in 2016 in comparison to the 2016 budget of $579.3 million in the 2015 base rate case. The variance is primarily due to lower storm costs in 2016 with no major events and lower bad debt. Please see the Company's response to SDR-OM-1 for more detailed information.

22. Q. Has PECO accounted for the effects of the recent changes to federal tax law in 2017?

A. Yes. On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") became law. As a result of this legislation, the Federal corporate tax rate was reduced from 35% to 21% effective January 1, 2018, and bonus depreciation was eliminated. Additionally, PECO is proposing to flow back "excess" differences in its accumulated deferred income tax ("ADIT") liabilities resulting from the reduction in the Federal corporate income tax rate. The effects of the TCJA on PECO's revenue requirement, including the flow-back of "excess ADIT," are discussed in the direct testimony of Mr. Yin. Mr. Schlesinger discusses the Federal Tax

Adjustment Credit that PECO is proposing to return to customers the reduction in the Company's 2018 revenue requirement attributable to the TCJA.

V. EXELON BUSINESS SERVICES COMPANY

23. Q. Does PECO procure certain shared services from an affiliated service company?

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

24. Q. What types of services does the EBSC make available and to whom?

A. The EBSC is designed to provide a range of what would typically be regarded as in-house services in the case of a stand-alone utility. In broad terms, those services fall into the following categories: information technology ("IT"); supply; commercial operations; finance; human resources; government and external affairs and public policy; legal; corporate governance; strategy; and communications. The EBSC offers its services to PECO and other affiliated members of the Exelon family of companies, including Atlantic City Electric Company, Baltimore Gas and Electric Company, Commonwealth Edison Company, Delmarva Power & Light Company and Potomac Electric Power Company.

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

A. No, it is not. Under the terms of the General Services Agreement ("GSA") between PECO and the EBSC, which was approved in the PECO/Unicom merger proceeding at Docket No. A-110550F0147, PECO has the discretion to determine whether and to what extent to utilize the EBSC's services in all areas except corporate governance.

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

A. PECO's overall approach is to use its own personnel or independent contractors to staff the day-to-day operations of its electric delivery system, as well as its customer-service functions (e.g., call taking, billing). Other services, such as employee-benefits administration, mass purchasing, insurance and treasury, to name a few, are provided by the EBSC.

27. **Q.** **What is the principal advantage of the service company structure?**

A. The EBSC enables PECO to realize economies of scale and scope that, in my judgment, could be very difficult to achieve on an individual company basis. Indeed, if PECO were to try to maintain comparably qualified personnel on its own payroll, the total cost PECO would incur to obtain the same level and quality of service it receives from the EBSC likely would be considerably higher.

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

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

29. Q. How is the cost of those services determined?

A. Direct charges are made for services where possible. Otherwise, costs are allocated on the basis of the allocation factors/methodologies identified in the attachment to the GSA, which were previously reviewed and approved by the SEC. These allocations and methodologies were also reviewed as part of the Commission's 2014 Audit and the Commission's auditors found no issues with respect to PECO's allocations and methodologies.

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

A. PECO obtains that assurance in several ways. First, PECO and the management of EBSC work together to identify PECO's needs and to define service priorities and major new initiatives. As a consequence, PECO has meaningful input into the development of the EBSC's budget for the upcoming year, and PECO's Chief Financial Officer ultimately approves the service level arrangements ("SLAs").

SLAs are annual agreements between the EBSC and Exelon's operating companies (including PECO) entered into under the express authority of the Commission-approved GSA that detail the specific services that the EBSC will provide during the following year, including the scope of services, unit cost expectations and performance measures. Services are grouped by function so that budgeted and actual costs can be tracked. Second, the EBSC's monthly billings are carefully scrutinized by PECO personnel. Variances between actual and budgeted charges are reviewed by PECO personnel with their EBSC counterparts to ensure that all costs are properly justified.

In addition, for functions that are not already outsourced, PECO obtains extensive information regarding the composition of the EBSC's costs, which PECO can then review for reasonableness. This "Market Testing Analysis" – developed in conjunction with the Commission's management auditors – is a formal approach for evaluating the cost-effectiveness of using the EBSC's shared services. This analysis is performed on an annual basis, which, along with the allocation factors and methodologies used for EBSC costs, was reviewed as part of the 2014 Audit. In 2017, the Commission conducted a Management Efficiency Investigation to evaluate PECO's implementation of recommendations from the 2014 Audit.[3] The Commission again examined PECO's affiliated interest and cost allocations processes and concluded that PECO (and EBSC) had taken steps to verify that "shared services are being provided in an efficient and cost-effective manner

[3] *See* PECO Energy Company Management Efficiency Investigation Evaluating the Implementation of Selected Management Audit Recommendations from the 2014 Focused Management and Operations Audit, Docket No. D-2016-2562303 (issued August 2017).

and/or improvement opportunities are identified to ensure service offerings are fair and reasonable."

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

A. PECO has included $90.0 million in its FPFTY expense claim for charges from EBSC. A breakdown of those costs is attached as PECO Exhibit PSB-3.

Because of the merger of Pepco Holdings and Exelon that occurred in 2016, EBSC costs for shared services across the Exelon companies that are allocated or assigned to PECO are materially lower than they otherwise would have been absent the merger. Some costs were incurred to achieve these savings, which are set forth in PECO Exhibit BSY-1 and discussed in Mr. Yin's direct testimony. PECO's revenue requirement in this case includes a three-year amortization of the costs to achieve the merger savings that were allocated to PECO. Recovery of these costs is appropriate since the costs had to be incurred to achieve the benefits of merger savings, and PECO's share of merger-related savings substantially outweighs PECO's share of the costs to achieve.

VI. CONCLUSION

32. Q. Does this complete your direct testimony at this time?

A. Yes, it does.