



SIDLEY AUSTIN LLP  
701 FIFTH AVENUE, SUITE 4200  
SEATTLE, WA 98104

AMERICA • ASIA PACIFIC • EUROPE

SBERMAN@SIDLEY.COM  
+1 206 262 7681

July 9, 2018

**Via eTariff Filing**

Kimberly D. Bose  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, NE  
Washington, DC 20426

Re: **Potomac Electric Power Co.**  
**Docket No. ER18-905-000**

Dear Secretary Bose:

Potomac Electric Power Co. (“Pepco”), submits<sup>1</sup> for filing this Response to Deficiency Letter of April 24, 2018.<sup>2</sup> As directed, we are electronically delivering copies of this filing to Kristin Fleet and Bryan Wheeler in the Office of Energy Market Regulation.

In its February 23, 2018 Application in Docket No. ER18-905, Pepco requested an April 24, 2018 effective date for its proposed modifications to Pepco’s formula transmission rate, contained in PJM Interconnection LLC (“PJM”) Open Access Transmission Tariff, Attachment H-9A (“Formula Rate”) to incorporate measures to more accurately track expenses arising from tax liabilities, and to clarify the timing for

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<sup>1</sup> Pursuant to Order No. 714, this filing is submitted by PJM on behalf of Pepco as part of an XML filing package that conforms with the Commission’s regulations. PJM has agreed to make all filings on behalf of the PJM Transmission Owners in order to retain administrative control over the PJM Tariff. Thus, Pepco has requested PJM submit this filing in the eTariff system as part of PJM’s electronic Intra PJM Tariff.

<sup>2</sup> The deficiency letter grouped together filings in separate dockets by the several Exelon Utilities, including the filing by Pepco in Docket No. ER18-905 as well as *Atlantic City Electric Co.* (“ACE”), Docket No. ER18-904; *Commonwealth Edison Co.*, (“ComEd”), Docket No. ER18-899; and *Delmarva Power and Light Co.* (“Delmarva”), Docket No. ER18-903. Because each docket involves a separate company with separate facts, the various Exelon Utilities are submitting separate responses in each of their respective dockets.

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recovery of various accrued tax liabilities and adjustments to those tax liabilities (“FAS 109 Amounts”). Pepco renews its request for an April 24, 2018 effective date. Good cause exists to grant Pepco’s request for an April 24, 2018 effective date. The Commission permits applicants to retain their original requested effective date when a filing is amended in good faith to cure a deficiency.<sup>3</sup> Pepco’s original filings and this filing have been submitted in good faith in order to clarify the timing under which deferred tax liabilities and assets in the company’s accounts will be recovered from customers. Because the filing does not change the amount that customers will ultimately be required to pay over time, or that the company will ultimately receive over time, and instead merely provides clarity and certainty to customers as to when various tax liabilities will be recovered, and ensures in each instance that the proper amounts will be recovered over time, customers will not be prejudiced by adoption of the originally requested effective date. Additionally, a purpose of Pepco’s filing was to ensure prompt and complete flowthrough to customers of all FAS 109 amounts, including the impacts of the federal corporate tax cuts arising from the Tax Cuts and Jobs Act of 2017 (“TCJA”). Allowing the earliest possible effective date will help ensure that such prompt and complete flowthrough occurs.<sup>4</sup>

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<sup>3</sup> *Duquesne Light Co.*, 118 FERC ¶ 61,087 (2007); *Milford Power Company, LLC*, 110 FERC ¶ 61,299 at PP 18, 23, 26 (2005); *Midwest Independent Trans. Sys. Oper., Inc.*, 110 FERC ¶ 61,164 at PP 5-14 (2005) (granting requested effective date following response to deficiency notice that included a notice of withdrawal of proposed tariff changes included in the original application); *Conectiv Bethlehem, LLC*, 106 FERC ¶ 61,272 at PP 9-11 (2004) (granting requested effective date following supplemental filing in response to deficiency letter and ordering Conectiv to refile its tariff sheets to correct any computational errors present in its original filing); *Midwest Independent Trans. Sys. Oper., Inc.*, 105 FERC ¶ 61,076 (2003) (granting requested effective date following supplemental filing in response to deficiency letter); *Illinois Power Company*, 103 FERC ¶ 61,032 (2002) (same); *Niagara Mohawk Power Corp.*, 75 FERC ¶ 61,087 at 61,263 (1996) (“We have explained that the Commission will grant waiver of notice if a good faith initial filing was made at least 60 days prior to the proposed effective date and subsequently was amended to cure a Commission-identified deficiency”).

<sup>4</sup> In its Application, Pepco proposed, in addition to annual formulaic flowthrough of FAS 109 amounts, an “Early Tax Rebate.” The Early Tax Rebate estimated the 2018 deferred tax savings arising from the TCJA and flowed through those amounts in the rate update that went into effect June 2018, rather than waiting for the effects to flow through in the June 2019 true-up. Because the June 2018 update has now passed, it will not be possible to implement the Early Tax Rebate. Indeed, the Pepco Protocols specifically provide that there will not be mid-year rate adjustments – and that adjustments arising mid year will instead be addressed in the next annual true-up. Pepco Protocols, PJM Tariff Attachment H-9B, Section 5(a). The prohibition on mid-year rate

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## I. RESPONSES TO SPECIFIC DEFICIENCY LETTER QUESTIONS

### STAFF REQUEST 1:

The following questions relate to the adjustment for Flow-Through Items:

- i. Provide the date each of the Exelon Companies changed to full tax normalization from the flow-through method, and identify the gross amount of any tax benefits flowed through retail rates and the unfunded tax liability determination, along with the amortization period and annual amount of amortization. Additionally, provide citations to the retail rate order(s) for each Exelon Company approving full tax normalization and any catchup provision similar to the *South Georgia* catchup provision.<sup>5</sup>
- ii. With respect to the adjustment for Flow-Through Items, for each of the Exelon Companies, provide the amount of plant that has not been depreciated or retired for the plant additions made prior to the adoption of full tax normalization.

### RESPONSE TO STAFF REQUEST 1:

- i. As discussed in the Application, prior to its formula rate filing, Pepco had a history of black box settlements. Those black box settlements made it impossible to determine whether the rates, prior to the formula, incorporated full tax normalization. In 2005, Pepco submitted its formula rate, in Docket No. ER05-515.<sup>6</sup> This was made effective

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adjustments avoids complications at PJM, which otherwise might have to constantly alter and adjust rate levels. The Pepco formula rate provides that interest at the FERC rate will be applied to true-up amounts. Pepco Formula Rate, PJM Tariff, Attachment H-9A, Attachment 6, line 9 of Reconciliation Details, providing for interest pursuant to 18 C.F.R. § 35.19a for true-up amounts. So while customers would have preferred receiving the tax benefits in 2018, they will not be harmed in waiting to receive those benefits until the true-up effective with the June 2019 update.

<sup>5</sup> See *South Georgia Natural Gas Co.*, Docket No. RP77-32 (May 5, 1978) (delegated letter order) (*South Georgia*). Under the *South Georgia* method, a calculation is taken of the difference between the amount actually in the deferred account and the amount that would have been in the account had normalization continuously been followed. This difference is collected from ratepayers over the remaining depreciable life of the plant that caused the difference. When the deferred account is fully funded at the end of this transition period, the annual increment ceases. *Memphis Light, Gas and Water Div. v. FERC*, 707 F.2d 565, 569 (D.C. Cir. 1983).

<sup>6</sup> *Baltimore Gas and Electric Co. and Pepco Holdings, Inc.*, Docket No. ER05-515 (Application

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June 1, 2005.<sup>7</sup> The formula rate filing resulted in a settlement<sup>8</sup> accepted on April 19, 2006.<sup>9</sup>

In Docket No. ER05-515, with the adoption of the formula rate, Pepco was effectively approved to implement full tax normalization except for amounts related to AFUDC equity and excess / deficient deferrals arising from tax rate changes.

As of December 31, 2004, the gross tax benefits flowed through retail rates and the unfunded balance was \$31,986,241 inclusive of excess deferred taxes. Please refer to Exhibit C, Tab 1a from the February 23, 2018 Application in this docket. The proposed amortization for those pre-2005 amounts is the same as for remaining pre-2005 AFUDC Equity amounts, described below in the response to Question 2(iii).

- ii. With respect to the adjustment for Flow-Through items, the amount of plant that was not depreciated or retired related to plant additions made prior to the adoption of full tax normalization in 2005 was \$41,926,623.

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of January 31, 2005) (Docket No. ER05-515 was jointly submitted by BGE and the PHI companies because the Commission had encouraged joint filings by the PJM utilities. BGE and the PHI companies were unaffiliated at the time, and did not become affiliates until the 2016 closing of the Exelon/PHI merger).

<sup>7</sup> *Allegheny Power System Operating Companies*, 111 FERC ¶ 61,308 (2005).

<sup>8</sup> *Baltimore Gas and Electric Co., et al.*, Offer of Settlement and Settlement Agreement, Docket No. ER05-15 (Mar. 20, 2006) (“2006 BGE/PHI Offer of Settlement”).

<sup>9</sup> *Baltimore Gas and Electric Co.*, 115 FERC ¶ 61,066 (2006) (“BGE/PHI Settlement Order”).

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## STAFF REQUEST 2:

The following questions relate to the tax adjustment for AFUDC Equity:

- i. Explain whether the tax adjustment proposed for AFUDC Equity includes any amounts for prior years' (before the requested effective date of April 24, 2018) depreciation expense.
- ii. If the tax adjustment proposed for AFUDC Equity includes amounts for prior years' depreciation expense, explain why Exelon Companies proposed a *South Georgia* catchup provision to address AFUDC Equity, rather than a mechanism related to just the current year's depreciation expense.
- iii. Explain whether and how the Exelon Companies will adjust their *South Georgia* catchup provisions to reflect depreciation rate changes and retirements of transmission assets.

## RESPONSE TO STAFF REQUEST 2:

- i. Pepco is proposing to include a *South Georgia* catch-up provision to recover all unrecovered FAS 109 amounts associated with AFUDC Equity. The formulaic provision will recover all such FAS 109 amounts, and thus will recover both amounts arising from new AFUDC Equity originations, as well as unfunded deferred tax amounts relating to prior year tax originations. As explained in the Application, Pepco's accounting assumes that the deferred taxes associated with AFUDC Equity were recovered in wholesale and retail rates through the date of adoption of the Pepco formula rate, accepted by the Commission in Docket No. ER05-515, and put into effect on June 1, 2005. But the Formula Rate did not recover the deferred taxes associated with AFUDC Equity from June 1, 2005 forward. Thus the *South Georgia* catch up provision would include deferred taxes associated with the AFUDC Equity amounts that were recorded in depreciation expense from June 1, 2005 through the effective date of the Application. That would include amounts associated with AFUDC Equity originating both prior to and after 2005.

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- ii. As discussed in the Application, Pepco's formula rate was the result of a settlement in Docket No. ER05-515 in which parties agreed to exclude all FAS 109 amounts from rate base, but the issue of recovery of deferred income taxes that had been recorded under FAS 109 was deferred.<sup>10</sup> Because the FAS 109 amounts were not reflected in rates as of the 2005 implementation of the formula rate, any new FAS 109 amounts arising from AFUDC Equity since 2005 and the unamortized portion of pre-2005 AFUDC Equity FAS 109 amounts remain unrecovered as an asset subject to later collection in rates once authorized by the Commission.

Regulatory asset treatment specific to the deferred taxes associated with the AFUDC Equity component of depreciation expense is required by Commission precedent. The tax timing difference associated with AFUDC Equity was explained in *Panhandle*.<sup>11</sup> Likewise, Commission Order No. 144-A identified AFUDC equity as among the tax timing differences at issue in Order No. 144.<sup>12</sup> As explained in the Commission's recent *Ameren* order, the deferred tax effect arising from AFUDC equity is a permanent tax difference – but the Commission has held that it should be “treated as a temporary timing difference” and thus treated like other amounts addressed in the Commission's normalization policies.<sup>13</sup>

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<sup>10</sup> By leaving the regulatory asset in place, the settlement was deferring the issue of when and how the asset would actually be recovered in rates. The settling parties did not agree to any level of recovery, or when it would occur, but the settlement recognized the existence of the FAS 109 regulatory asset (which was excluded from rate base) and did not provide for reduction or alteration of the regulatory asset. The very nature of a regulatory asset is that the costs are recorded by the utility in one period, but “such items will be included in a different period(s) for purposes of developing rates that the utility is authorized to charge for its utility services.” See Instructions to Account 182.3 (Other Regulatory Assets) at 18 CFR 101 (2017). By recognizing the existence of a regulatory asset, and leaving the regulatory asset in place, the settlement necessarily left for a later proceeding the issue of recovery in “a different period” of the asset amounts.

<sup>11</sup> *Panhandle Eastern Pipe Line Co.*, 12 FERC 63,034, at 65,094 (1980), *aff'd in relevant part*, 16 FERC 61,037 (1981).

<sup>12</sup> *Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes*, Order No. 144, FERC Stats. & Regs. ¶ 30,254 (1981), *order on reh'g*, Order No. 144-A, FERC Stats. & Regs. ¶ 30,340, at 30,136 (1982); *aff'd sub nom, Public Systems v. FERC*, 709 F.2d 73, 85 (D.C. Cir. 1983) (“*Public Systems II*”)

<sup>13</sup> *Midcontinent Independent System Operator*, 163 FERC ¶ 61,163, at P 59 (2018) (*Ameren*).

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The proper accounting for this timing difference was addressed in FAS 109, and in the FERC Chief Accountant's FAS 109 guidance issued in April 1993.<sup>14</sup> The guidance specifically addressed AFUDC Equity with the following explanatory question and answer:

Question: SFAS 109 considers the equity component of AFUDC a temporary timing difference for which deferred income taxes must be provided. How should an entity record the deferred tax liability for the equity component of AFUDC and the related regulatory asset in its accounts?

Response: An entity shall record the deferred tax liability for the equity component of AFUDC in Account 282, Accumulated Deferred Income Taxes – Other Property, and any corresponding regulatory asset in Account 182.3, Other Regulatory Assets. The regulatory asset is itself a temporary difference for which deferred incomes taxes shall be recognized and recorded in Account 283, Accumulated Deferred Income Taxes – Other. This accounting shall be followed for the adjustments required upon initial application of the statement and for all amounts of equity AFUDC capitalized in subsequent periods”.<sup>15</sup>

The Commission requires adherence to this accounting. For example, in *Florida Gas*,<sup>16</sup> the Commission explained: “Equity AFUDC is not deductible for income tax purposes. Therefore, revenues are provided to allow for both the recovery of the equity AFUDC capitalized and the related income taxes that must be paid on those revenues. Under the FERC's accounting requirements, pipelines record as a

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<sup>14</sup> Financial Accounting Standards Board Statement No. 109 (“FAS 109”); *Accounting for Income Taxes*, Docket No. AI93-5, April 23, 1993 Letter (“1993 FAS 109 Guidance Letter”)

<sup>15</sup> 1993 FAS 109 Guidance Letter at. 6., cited in *Ameren*, in P 59 and n. 72.

<sup>16</sup> *Florida Gas Transmission Co.*, 74 FERC 62,243, at n.1 (1995).

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regulatory asset the present value of the revenues needed to meet the tax liability associated with equity AFUDC.”

In accordance with FAS 109 and the 1993 FAS 109 Guidance Letter, Pepco appropriately recognized a regulatory asset equal to the FAS 109 deferred tax liability for AFUDC Equity upon initial adoption and for all amounts of AFUDC Equity capitalized in subsequent periods. Also, since its adoption of FAS 109, Pepco began amortizing its AFUDC equity-related regulatory asset to tax expense as its deferred tax liability unwound over the estimated useful life of the underlying assets. However, consistent with the 2014 Staff Guidance on Formula Rates, which provides for separate treatment of FAS 109 amounts absent express Commission authorization,<sup>17</sup> the formula rate in Docket No. ER05-515 does not recover FAS 109 amounts including AFUDC Equity. Thus there has been no such recovery since June 1, 2005, and Pepco is proposing a *South Georgia* catch-up provision to recover these costs going forward.

It would not have been appropriate for Pepco to continue unwinding AFUDC Equity amounts from its regulatory asset after June 1, 2005. This can be seen in *Transcontinental Gas*.<sup>18</sup> In that case, the Commission found that FERC’s accounting instructions required that the regulatory asset associated with AFUDC Equity deferred tax amounts should be reduced “concurrently with the recovery of the amounts in rates.” And required that the company revise its accounting to ensure that the reductions to its deferred tax regulatory asset matched recovery in rates. Because Pepco did not recover FAS 109 amounts associated with AFUDC Equity after June 1, 2005, it would violate FERC accounting rules to charge the regulatory asset as if the amounts were being recovered.

The accrued FAS 109 amounts related to AFUDC Equity are real amounts that are properly recovered from ratepayers. The Commission addressed this issue in *PJM*,<sup>19</sup> where certain facilities were transferred to PJM by various PJM transmission owners (including Pepco), and the transfers included the FAS 109 regulatory assets associated with the tax effects of AFUDC Equity. The Commission found the transfer of the

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<sup>17</sup> *Staff Guidance on Formula Rate Updates*, issued July 17, 2014, at page 2 of 5 (“2014 Staff Guidance on Formula Rate Updates”).

<sup>18</sup> *Transcontinental Gas Pipe Line Corp.*, 78 FERC 62,128, at 64,496 (1997).

<sup>19</sup> *PJM Interconnection LLC*, 93 FERC 61,056 (2000)



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regulatory asset appropriate, and likewise found it appropriate for PJM to recover the regulatory asset amounts in rates.

Recovery of a tax component for AFUDC Equity amounts in rates is lawful and proper – indeed, the Commission recently addressed and explained this in the *Ameren* order.<sup>20</sup> Recovery of catch-up amounts is also appropriate. For example, *PPL*<sup>21</sup> and *Duquesne*<sup>22</sup> permitted recovery of the unamortized portion of the FAS 109 amounts that had accumulated through the time that the formula rates for those companies went into effect. While *PPL* and *Duquesne* did not expressly address AFUDC Equity, their catchup provisions were calculated based on their entire FAS 109 balances, and thus would have reflected AFUDC Equity among other things.<sup>23</sup> *ITC*<sup>24</sup> and *VEPCO*<sup>25</sup> likewise had recovery provisions that explicitly incorporate the cumulative AFUDC Equity balances through the applicable rate year.

- iii. For post-2005 originations, Pepco intends to track the relevant assets and their remaining lives and depreciation rates using its PowerTax and PowerPlant software, which track each plant item and associated tax expense, and thus will allow an amortization that properly adjusts each year based on the remaining lives of the relevant assets. Interested parties will be able to pursue discovery about the calculations in the annual update process, if they do not find adequate support in the workpapers provided with each annual update. As discussed in the Application, for

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<sup>20</sup> *Ameren*, at PP 57-63.

<sup>21</sup> *PPL Electric Utilities Corp.*, Docket No. ER12-1397-000 (“PPL March 30, 2012 Application”) and May 23, 2012 Letter Order.

<sup>22</sup> *Duquesne Light Co.*, Docket No. ER13-1220 (*Duquesne* April 1, 2013 Application) and April 26, 2013 Letter Order.

<sup>23</sup> See PPL March 30, 2012 Application at Exhibit PPL-101 and explanation of inputs in Exhibit PPL-100 (computing amount to be amortized based on entire FAS 109 balance as of the date PPL adopted formula rate); *Duquesne* April 1, 2013 Application at Exhibit DLC-101 and explanation of inputs at pages 9-10 of that application and in Exhibit DLC-100 (computing amount to be amortized based on entire FAS 109 balances as of the date *Duquesne* adopted formula rate).

<sup>24</sup> *Midcontinent Indep. System Operator*, Docket No. ER16-208 (*ITC* October 30, 2015 Application), approved at *Midcontinent Indep. System Operator*, 153 FERC ¶ 61,374 (2015) (“*ITC*”).

<sup>25</sup> *Virginia Electric and Power Co.*, Docket No. ER16-2116 (*VEPCO* July 1, 2016 Application) approved at *Virginia Electric and Power Co.*, Docket No. ER16-2116 (“*VEPCO*”) (August 2, 2016 Letter Order).

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pre-2005 originations, consistent with the methodology proposed and accepted in *PPL* and *Duquesne*, Pepco has proposed an amortization based on its average remaining life of all of its transmission assets as of 2005 – 27 years.<sup>26</sup> This is a fixed period that would not vary with asset retirements or depreciation rate changes. Pepco would not object to a shorter amortization for those amounts – but the proposed amortization leads to a reduced annual rate impact and thus benefits customers.

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<sup>26</sup> Application at n. 84.

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## **STAFF REQUEST 3:**

Each of the Exelon Companies appear to use a net plant allocation method to determine the transmission-related component of the FAS 109 regulatory asset.<sup>27</sup>

- i. Explain whether each Exelon Company records AFUDC and overheads by project and applies transmission depreciation rate(s) that differ by plant function or primary plant account.
- ii. Explain and address how the FAS 109 amounts relate to transmission depreciation expense. Specifically, identify how each Exelon company determines depreciation expense and whether the monthly gross accumulated AFUDC Debt and Equity (adjusted for additions and retirements during the month) is multiplied by the monthly depreciation rate.
- iii. In order to determine ADIT related to AFUDC Debt and Equity, do the Exelon Companies multiply the AFUDC Debt and Equity in depreciation expense by the applicable composite income tax rate?
- iv. Further, do the Exelon Companies adjust for salvage and cost of removal?

## **RESPONSE TO STAFF REQUEST 3:**

- i. Pepco records AFUDC to each applicable capital project on a monthly basis. Overhead costs that are attributable to the asset are allocated to those capital projects through allocation processes that occur on a monthly basis. Consistent with longstanding industry practice for regulated utilities, Pepco applies the group and composite methods of depreciation to most of its fixed assets. Under these approaches, assets are aggregated and depreciated by applying a rate based on the weighted average expected service lives of the corresponding component assets. Pepco calculates depreciation for transmission assets based on group depreciation rates by utility account on a monthly basis.
- ii. For transmission assets, depreciation is calculated each month by taking the depreciable base of the combined transmission assets in the utility account and multiplying that base by the monthly depreciation rate of the utility account. AFUDC

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<sup>27</sup> See, e.g., ComEd's FAS 109 Transmission Regulatory Asset Analysis, Attachment 1 and Attachment 1b, which states, "The FAS 109 Regulatory Asset is allocated to Transmission using the Transmission net plant allocator."

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is included in the depreciable base of the combined transmission assets. However, depreciation specifically related to AFUDC is not separately tracked.

- iii.** For income tax purposes, AFUDC debt and equity is immediately expensed and not capitalized to plant. Due to the immediate expensing, income tax rules do not permit the deduction for the AFUDC debt and equity that is capitalized to plant and included in depreciation expense for financial reporting purposes. Thus, over time, the financial statement reporting of depreciation expense, which includes a component of AFUDC debt and equity, will be different from the related amount deducted on the income tax return that does not include AFUDC debt and equity.

The immediate expensing for income tax purposes gives rise to the origination of an ADIT liability. The ADIT balance reverses as the amount capitalized for financial reporting purposes is depreciated. The ADIT reversal is calculated by multiplying the AFUDC debt and equity components in depreciation expense by the applicable composite income tax.

- iv.** Salvage is recorded as a credit to the salvage account within accumulated depreciation. Pepco does not have cost of removal in its transmission depreciation rates.

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## **STAFF REQUEST 4:**

Exelon Companies state that their FAS 109 amortizations are assumed to have been collected in rates prior to the effectiveness of their Formula Rates.

- i.** Explain and quantify the Commission-jurisdictional amounts of FAS 109 amounts that were accrued, recorded and accumulated on each of the Exelon Companies' books prior to the effectiveness of their Formula Rates.
- ii.** Clarify whether the amortized amount that Exelon Companies assumes has been collected represents only amortization incurred between the establishment of stated rates and the establishment of Formula Rates, or all amortization incurred between the initial establishment of the deferred tax amounts and the establishment of Formula Rates.
- iii.** Explain how Exelon Companies propose to reduce their regulatory assets and liabilities for any amounts that have been assumed to have been collected or refunded prior to the effectiveness of their Formula Rates.
- iv.** Further, explain whether each of the Exelon Companies have been adjusting rate base to reflect the accumulated collections of excess or deficient deferred income taxes.

## **RESPONSE TO REQUEST 4:**

- i.** The FAS 109 amounts accrued, recorded, and accumulated on Pepco's books prior to the effectiveness of Pepco's formula rates are shown in Tab 1a to Exhibit C of the Application, broken down by category. The first column shows the amounts as of December 31, 2004 – the year end prior to the formula rate. Other columns in that spreadsheet show the FAS 109 amounts over the following years. The derivation of the amounts on Tab 1a can be seen in the following tabs in Exhibit C.
- ii.** The amounts shown in Tab 1 of Exhibit C reflect amortization of FAS 109 amounts from the origination of the deferred tax amounts until the establishment of the Formula Rates in 2005. Implicit in that amortization is that Pepco rates (either at the retail level or at FERC) were recovering those amortizations each year – until establishment of the Formula Rates.

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- iii.** Pepco has already reduced the FAS 109 amounts at issue to reflect amortization through the inception of its Formula Rate. No further reduction is necessary.
- iv.** As can be seen at Line 40 of the Pepco Formula Rate, PJM Tariff, Attachment H-9A, Pepco's rate base adjustment for ADIT is net of FAS 109 amounts. The FAS 109 amounts have thus not impacted the rate base calculation.

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## **STAFF REQUEST 5:**

The Tax Reform Act of 1986 (Tax Reform Act) decreased the tax rate from 46 percent to 34 percent, and then the tax rate increased to 35 percent in 1993. Explain whether each of the Exelon Companies have been refunding or recovering, as appropriate, any ADIT excesses or deficiencies related to the Tax Reform Act. If so, explain which customers have been receiving refunds or charges related to the Tax Reform Act, and what mechanism the Exelon Companies have been using to provide these refunds or charges. If not, explain whether and how the instant filings address ADIT excesses or deficiencies related to the Tax Reform Act. For example, will ADIT excesses and deficiencies related to the Tax Reform Act have a different amortization period than ADIT excesses and deficiencies related to the Tax Cuts and Jobs Act?

## **RESPONSE TO REQUEST 5:**

Pepco followed the accounting required by FAS 109 and Commission policy, properly accounting for any ADIT excess or deficiencies related to the Tax Reform Act of 1986. Pepco's accounts assume that an annual amortization of FAS 109 amounts were amortized each year until 2005 using the average rate assumption method ("ARAM") as required by Section 203(e) of the Tax Reform Act of 1986. Up until 2005, Pepco assumes that it had been refunding or recovering such amounts from its customers through its stated rates (either retail or FERC rates). However, because its rates prior to 2005 were black box settlement rates, there is no rate order that expressly spells out that such recovery is occurring.

In 2005 Pepco proposed a formula rate, which resulted in a settlement, and the settlement adopted a rate structure that deferred recovery of FAS 109 amounts. This filing requests a mechanism to allow for the pass through to customers of the FAS 109 amounts that would have been amortized from that period forward. This includes the unamortized pre-2005 FAS 109 amounts related to the Tax Reform Act which will be amortized using the average rate assumption method ("ARAM"). (There may have been non-property amounts impacted by the Tax Reform Act, but any such amounts have already been fully amortized.) The ADIT excesses and deficiencies related to the Tax Cuts and Jobs Act (TCJA) will generally use the ARAM methodology, which relies on the remaining life of the property at issue. There are certain deferred tax effects of the TCJA that are not associated with property items; for those amounts, Pepco proposes to use a 10-year amortization period based on analysis of average period of time to eliminate the book to

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tax basis difference for that group of non-property items.



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## **STAFF REQUEST 6:**

Please explain why each of the Exelon Companies decided to exclude FAS 109 recovery in their respective Formula Rates, when they intended to seek FAS 109 recovery in their Formula Rates, and the reason(s) for the delay in seeking FAS 109 recovery in their Formula Rates.

## **RESPONSE TO REQUEST 6:**

The Pepco Formula Rate and its exclusion of FAS 109 amounts was the product of a settlement, approved by the Commission on April 19, 2006.<sup>28</sup> The settlement expressly provides that: “The discussions among the Settling Parties have been conducted with the explicit understanding and agreement, pursuant to Rule 602(e) of the Commission’s Rules of Practice and Procedure, that all offers of settlement and discussions relating thereto are and shall be privileged, shall be without prejudice to the positions of any Settling Party or participant presenting any such offer or participating in any such discussion, and are not to be used in any manner in connection with this proceeding or otherwise.”<sup>29</sup> Accordingly, the discussion among the parties that led to the exclusion of these amounts is privileged and cannot be revealed.

While the underlying discussion is privileged, we note that exclusion of FAS 109 amounts, to be addressed at some later date, was reasonable in light of the Commission’s accounting policies, which generally provided that recovery of FAS 109 amounts could only happen pursuant to a FERC rate filing addressing those amounts.<sup>30</sup> While it is clear today that recovery of such amounts can occur formulaically, and the Commission has approved many formula rates that automatically flow these amounts through, it was not clear at all in 2007 that such automatic flow through would be acceptable. Leaving the issue to be addressed at some later time was thus a sensible approach that parties might understandably agree to in settlement.

It is illustrative to look at the example of a similar item: Post-Retirement Benefits other than Pensions (PBOP) amounts, recorded pursuant to FAS 106. For that item, the settlement result was that a PBOP amount would be reflected in rates, but the amount

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<sup>28</sup> BGE/PHI Settlement Order.

<sup>29</sup> 2006 BGE/PHI Offer of Settlement at Section 6.7.

<sup>30</sup> E.g., Order No. 144; 1993 *FAS 109 Guidance Letter*.

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would not adjust formulaicly, and would instead have to be adjusted from time to time in single-issue PBOP adjustment filings (with an exception allowing formulaic changes if the PBOP adjustment was small).<sup>31</sup> The settled treatment of FAS 109 (excluding it and leaving it to be dealt with later) is different than the settlement treatment of FAS 106 (including a fixed amount, that would have to be adjusted in later filings) but reflects the common concern that the settling parties were attempting to construct a formula rate settlement that would pass muster under long-standing precedent concerning specific rate items, developed when most utilities had stated rather than formula rates.

What is very clear is that Commission policy permits resolution by settlement of the treatment of FAS 109 amount. In the Commission's Order No. 144, the Commission explained that applicants would be required to address the ratemaking treatment in "the applicant's next rate case," but then says in the following sentence: "The rule, of course, leaves undisturbed the ability of the parties to reach a settlement on any of the issues covered by the rule."<sup>32</sup> Further, the rule text adopted in Order No. 144 was modified to ensure that settlements would be honored. The Commission explained that it wanted to ensure that: "agreement by the parties not to litigate the issue in future rate cases is preserved and encouraged."<sup>33</sup> Thus, the seminal order on this issue recognizes that parties may reach settlements that would defer litigation relating to the timing of deferred tax recoveries.

Having agreed by settlement to defer flowthrough of FAS 109 amounts, Pepco was obligated under Order No. 144 to address the issue in its "next rate case." But that next rate case is this proceeding. And thus there has been no delay in making this filing. Other than a variety of single-issue rate filings, since its 2006 rate settlement and until today, Pepco has not submitted a Section 205 rate filing to modify its transmission formula rates that could have addressed the FAS 109 issue. (Customers or the Commission could have initiated a Section 206 proceeding to address the issue – but customers, and the Commission, like Pepco, apparently saw no need to make a rate filing to address this issue during those years.)<sup>34</sup> While Pepco had no applicable rate filings in the intervening years – it had been watching the rate filings by others and has seen that

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<sup>31</sup> Attachment H-9B, Section 1(h) in 2006 BGE/PHI Offer of Settlement.

<sup>32</sup> Order No. 144 at 31,519.

<sup>33</sup> Order No. 144 at 31,561.

<sup>34</sup> Neither Pepco nor its customers could have made such a filing prior to June 1, 2009, because the settlement included a moratorium on such rate changes. 2006 BGE/PHI Offer of Settlement at Section 4.2(d).

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the Commission now permits formulaic FAS 109 adjustments. Accordingly, Pepco decided that it was appropriate to make a Section 205 rate filing to address this issue in this proceeding. Making a filing now had the benefit of both providing a mechanism to address this issue generally, and providing a mechanism to address the deferred tax impacts of the TCJA. By clarifying the timing of the flowthrough of these amounts, both customers and Pepco benefit.

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## II. CONCLUSION

For the reasons explained above, Pepco respectfully requests that the Commission accept this Response to Deficiency Letter of April 24, 2018, and that it accept the tariff amendments proposed in this docket, effective April 24, 2018, or otherwise on the earliest date permitted.

Respectfully submitted,

/s/ Christopher A. Wilson

Christopher A. Wilson  
Director, Federal Regulatory Affairs  
Exelon Corporation  
101 Constitution Ave., N.W., Suite 400 East  
Washington, DC 20001  
202-347-7500  
[FERCe-Filings@exeloncorp.com](mailto:FERCe-Filings@exeloncorp.com)

/s/ Stan Berman

Stan Berman  
Eric Todderud  
Sidley Austin LLP  
701 Fifth Ave., Suite 4200  
Seattle, WA 98104  
206-262-7681  
[sberman@sidley.com](mailto:sberman@sidley.com)

/s/ Amy L. Blauman

Amy L. Blauman  
Assistant General Counsel  
Exelon Corporation  
701 Ninth St. N.W.  
Washington, DC 20001  
202-872-2122  
[alblauman@pepcoholdings.com](mailto:alblauman@pepcoholdings.com)

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**CERTIFICATE OF SERVICE**

I hereby certify that I have this day served an electronic copy of the foregoing document upon each person designated on the official service list established in Docket No. ER18-905.

Dated this 9th day of July 2018 at San Francisco, CA.

*/s/ Lauren C. Freeman*  
Sidley Austin LLP  
555 California Street  
San Francisco, CA 94104  
(415) 772-1253  
lfreeman@sidley.com