I. Introduction

The Maryland Public Service Commission (“PSC” or “Commission”) acted unreasonably when setting rates for Baltimore Gas and Electric Company (“BGE” or “Company”) because short-term debt was excluded from the capital structure used to determine the return to BGE investors. This action by the PSC results in
an unwarranted subsidy to BGE shareholders of $3.3 million at the expense of BGE ratepayers.

The Office of People's Counsel ("OPC") on reply here addresses BGE’s assertion that both the Commission and the Circuit Court “erroneously” state that the capital structure adopted by the order is “that of BGE’s parent.” BGE Brief, p. 4 including footnote 1. BGE claims that the PSC’s erroneous statement¹ is a misreading of the record evidence. Id.

BGE states that the record evidence on the issues is “undisputed” in spite of the PSC’s erroneous statements and argues in support of the use of BGE’s proposed capital structure for rate setting purposes. BGE Brief, p. 4. The apparent confusion in the record and in the PSC’s conclusion adopting BGE’s proposed capital structure, only adds support to OPC’s arguments that the PSC misread and mischaracterized the record evidence in this proceeding in an improper attempt to favor BGE’s parent, Constellation Energy, to the detriment of ratepayers.

The PSC focused on the profitability of Constellation, instead of relying upon a traditional ratemaking analysis required for a regulated gas distribution company like BGE. The PSC inquiry also stopped short of an analysis of the impact of the parent/subsidiary relationship on the appropriate capital structure.

¹ The PSC stated “BGE’s requested capital structure is the actual capital structure of its parent corporation, Constellation Energy.” E.51. The statement was repeated later in the Order with the PSC indicating “the capital structure proposed by the Company herein is that of BGE’s parent.” E. 76. The structure, ultimately adopted by the PSC Order, of 45.70 percent long-term debt, preferred stock of 5.90 percent and 48.40 percent common equity was identified as “BGE’s proposed capital structure.” E. 79.
The “erroneous” conclusion regarding the “actual” capital structure adopted for BGE only highlights the unreasonableness of the PSC action.

The PSC failed to undertake the required analysis of the capital structure necessary to demonstrate the reasoned decision making required by law for a state agency. BGE’s assertion regarding the use of the wrong language by the PSC to identify the selected capital structure supports OPC’s position that the flawed PSC decision must be rejected as unlawful. A remand to the PSC is necessary to correct the unjust result of the Order.

II. Argument

A. The Action Of The PSC Was Arbitrary And Against Long Standing PSC Practice And Precedent

The position of BGE and the Maryland Public Service Commission can be summed up as “defer to the agency.” BGE Brief, p. 19 and PSC Brief, p. 9; E. 120, 124. BGE and the PSC seek to restrict the Court’s inquiry into the PSC’s decision not to look at an alternative to BGE’s proposed capital structure, absent imprudence. Apparently, BGE and the PSC believe that further inquiry is not required as long as the prudence of BGE’s management choices is not challenged.

Whether BGE acted prudently, however, is irrelevant. Ratepayers are not required to “foot the bill” for an unnecessarily burdensome capital structure resulting from management actions, prudent or otherwise. If that capital structure unfairly penalizes ratepayers, the case law is clear that an alternate or hypothetical

Unnecessary harm was created for ratepayers as a consequence of the PSC majority decision. E. 119-120. The PSC majority’s arbitrary action reversed long standing case precedent and regulatory practice, which preclude use of an “actual” capital structure to set rates when the structure places an unnecessary burden on the ratepayers of a regulated utility. Such a capital structure may create windfall profits for shareholders inconsistent with established principles of utility ratemaking which require an appropriate balance of ratepayer and investor interests. See *In Re Permian Area Rate Cases*, 390 U.S. 747, 770 and 796-797 (1968) and *C&P Telephone v. PSC*, 230 Md. PSC 395, 412 (1963).

The imputation of short-term debt is needed to effectively balance the concerns of consumers and investors in the public interest. OPC Brief, p. 11. In *C&P Telephone*, 230 Md. PSC 395, 413 (1963) the PSC outlined the inquiry required to determine the appropriate capital structure upon which to establish the return to investors. See also OPC Brief, pp. 17-18; pp. 21-22. The Dissent in this proceeding also relied on *Federal Power Commission v. Hope Natural Gas* 320 U.S. 591 (1944) to explain the appropriate ratemaking approach which requires the PSC to determine in this case a capital structure that includes short-term debt
for BGE as a regulated gas distribution utility. See also *Comsat v. FCC*, 611 F. 2d 883, 904 (1977), citing *Hope Natural Gas* 320 U.S. at 603.

OPC notes that in support of the majority decision certain irrelevant information was provided by BGE regarding the Federal Energy Regulatory Commission (FERC) oversight of the money pool where the cash supplied by BGE ratepayers was borrowed by the parent and subsidiary affiliates. BGE appears to cite this information to support the lawfulness of the money pool arrangement. BGE Brief, p. 7. However, no one in this case has disputed the details or legality of the operation of the money pool regulated by FERC. In fact, the record establishes correctly that BGE has had only limited borrowings, 26 loans from the pool as opposed to 521 by affiliates, during the period at issue in this case. OPC Brief, p. 12; E. 122, 483-484.

Both BGE and the PSC argue that this case is a mere disagreement over facts. BGE Brief, p. 23; PSC Brief, p. 5. They are wrong. The facts are not in dispute. Rather, the PSC has overturned significant ratemaking principles without cause or a foundation in the record. The PSC’s decision not to impute short-term debt to set rates serves only to support BGE’s role as a contributor to the corporate profits of the parent, Constellation Energy, at ratepayers’ expense. This arbitrary and capricious result should be avoided by a remand of this case for further consideration and a full inquiry to establish the appropriate capital structure in support of reasonable rates for BGE.
B. The Commission Decision is Unsupported By The Record Evidence In This Case

BGE asserts that BGE management incurred long-term debt to supply BGE’s short-term operating needs, not to benefit shareholders, but to take advantage of opportunities to lock in low cost long-term debt in a period of rising short-term rates. BGE Brief pp. 17-18. However, the evidentiary record shows that short-term debt was still less expensive than long-term obligations or permanent equity capital for which BGE ratepayers are paying under the capital structure adopted by the PSC. OPC Brief, p. 11; E. 469.

BGE presents the case of a home mortgage buyer who chooses a fixed rate loan as comparable to the actions of BGE’s management to lock in long-term rates. BGE Brief, p.6; p. 18. OPC prefers a more accurate comparison. In this case, the buyer has not simply locked in a higher interest rate than necessary to secure his mortgage. More significantly, this buyer (i.e., BGE) is paying higher rates for a house that he needs only seasonally and which he rents out in other months at a below market rate to renters. One might investigate why the home owner (or BGE) has entered into this uneconomic arrangement. In this case no investigation by the PSC was provided on the record for the subsidy received by BGE shareholders at BGE ratepayers’ expense.

In summary, BGE affiliates benefit from the use of funds available in a money pool which includes the contributions of BGE ratepayers. BGE, as a gas distribution company, has certain short-term requirements for capital, for example,
to purchase seasonal gas inventories for BGE’s customers. Money borrowed by management and paid for by ratepayers as long-term debt or permanent capital in rates may not be needed by BGE for many months out of a 12-month or more (long-term) period of the debt obligation. Instead these funds are borrowed at below market rates by BGE affiliates. These funds, if lent to BGE non-affiliated entities at market rates, would provide benefits to ratepayers in the form of a reduced cost of capital and ultimately lower rates. Since this was not done, BGE’s ratepayers suffer economic harm to the extent such an arrangement is reflected in rates. A revised capital structure, to be used to establish rates, will provide a reasonable return on investment for BGE investors with appropriate components of long and short-term debt, preferred stock and equity capital, and avoid economic harm to ratepayers. OPC Brief, pp. 11-12.

Since the record lacked support for an increased return for BGE, the PSC sought to establish rates based on intangible benefits to ratepayers. The PSC allowed the capital structure proposed by BGE to improperly inflate the return to investors at ratepayer expense. OPC Brief, p. 25; E. 78. There was no offset for the detriment to ratepayers established on the record as a whole, because the PSC simply disregarded the facts of a subsidy and the unnecessary burden to ratepayers in favor of windfall profits for BGE and its sole shareholder, Constellation Energy.

BGE attempts to identify some limited benefits to the “money pool” to ratepayers including the fact that there is some return on the funds borrowed, as well as availability of funds for investment in capital improvements. BGE Brief,
p. 18. Yet, these limited examples, which were not the focus of the PSC majority ruling, are already reflected in rates and are hardly an offset to the benefits provided by ratepayers to shareholders in the money pool. OPC Brief, p. 12; p. 24. Further, the Commission focused not on ratepayer related capital investments but on the need to support the corporate parent’s profitability to protect BGE’s credit ratings in order to avoid any negative affect on the cost of capital. E. 78.

The PSC stated

The adjustment that the Dissenting opinion would accept also does not take into account the real but indefinable benefits to customers of having a financially sound utility company…. One need not look very far to find utility companies with poor credit ratings, and to note that increased borrowing costs and other consequences attend those poor credit ratings. Id.

However, the record failed to support the requirement of an excessive contribution in the amount of $3.3 million in order to sustain BGE’s credit rating. In fact, the PSC acknowledged that the 11.0 percent return generously granted to BGE focused on “indefinable” benefits provided to ratepayers as a result of BGE’s relationship with the parent, Constellation Energy. PSC Brief, p. 14-15; OPC Brief, p. 5. The incorrect conclusion that there was a benefit rather than harm to BGE ratepayers is unsupported by the record.

The PSC points to a conclusory statement by a Staff attorney on brief, not to the evidence of record, to support its “no harm” finding. PSC Brief, p. 10. OPC submits that attorney arguments are not “evidence.” The PSC also avers that the testimony of a staff witness, Mr. Vanderheyden, was persuasive. PSC Brief, p.
8. Yet, Mr. Vanderheyden, the PSC’s rate of return witness, did not specifically address whether the imputation of short-term debt was needed. He merely adopted BGE’s proposed structure as “reasonable.” E. 500-503. The PSC majority disregarded the testimony of Mr. Lee, a different Staff witness, and OPC’s rate of return witness, Mr. Charles King. As the Dissent made clear, the undisputed testimony of these witnesses supports the imputation of short-term debt in BGE’s proposed capital structure, for purposes of setting the return for the utility and establishing just and reasonable rates. E. 121,125.

The PSC argues that the record, viewed in its entirety, shows that a reasonable rate decision was made regardless of the details of OPC’s contentions and the arguments of the Dissent. PSC Brief, p. 3. However, if no adjustment is made to the capital structure, then BGE essentially receives a return greater than the 11.0 percent return on equity and the overall return of 8.49 percent authorized to BGE by the Order. E. 89. Thus, the PSC’s failure to consider the relationship of BGE’s proposed capital structure for the determination of final rates and the return to shareholders results in excessive rates.

BGE attempts to factually distinguish a case relied on by OPC and the Dissent, Re Columbia Gas, 72 Md. PSC 575 (1981). The PSC in the Columbia rate case utilized the actual capital structure of Columbia’s parent to set rates. BGE Brief, p. 21. BGE indicates that this rate case is different because BGE has its own capital structure and has issued no short-term debt. This attempt to
factually distinguish the Columbia case disregards the clear similarities of the two rate case determinations.

Like BGE, Columbia was a wholly owned subsidiary of the parent, Columbia Gas System Inc., and received all of its financing from the parent. 72 Md. PSC 575, 590 (1981); E. 128. In Re Columbia Gas the Commission imputed short-term debt consistent with the parent’s actual capital structure in spite of Columbia’s request that the Commission accept the Company’s projected capital structure which did not include short-term debt. Id. In Re Columbia Gas the appropriate capital structure was developed with consideration of the details of the parent/subsidiary relationship. That type of assessment was not done in this case. If the PSC in the current matter properly had explored the parent/affiliate relationship a correct decision may have resulted. The PSC’s limited inquiry into the capital structure was inadequate and resulted in an arbitrary decision which must be reversed.

OPC urges the Court to reject the majority’s improper decision, which failed to address the requirement for a short-term debt component in the BGE capital structure used to set rates. If the Commission is permitted to set rates which authorize a capital structure for BGE without regard to the impact of the underlying parent/subsidiary relationship, and in favor of shareholders at ratepayers’ expense, unreasonable rates may be adopted not just in this case but for other similarly situated utilities in Maryland. Such a result is contrary to sound ratemaking policy and must be rejected.
CONCLUSION

For all of the above reasons, OPC asks that the Court remand PSC Order No. 80460 for revision of the capital structure used to establish rates as set forth by OPC on reply herein and on brief.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

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