

**PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265**

Public Meeting held January 16, 2004

Commissioners Present:

Terrance J. Fitzpatrick, Chairman
Robert K. Bloom, Vice Chairman
Glen R. Thomas
Kim Pizzingrilli
Wendell F. Holland

Pennsylvania Public Utility Commission	:	R-00038304
Gary D. A. Lewis	:	R-00038304C0001
Richard Sanderman	:	R-00038304C0002
John Ross	:	R-00038304C0003
Brian Carr	:	R-00038304C0004
Elaine Ziegler	:	R-00038304C0005
Irwin A. Popowsky, Consumer Advocate	:	R-00038304C0006
Randy and Bonnie Reich	:	R-00038304C0007
Cecil J. Hartman	:	R-00038304C0008
Natalie Kerr	:	R-00038304C0009
Thomas B. Aunkst	:	R-00038304C0010
Jeannie Weaver	:	R-00038304C0011
John D. Eisenhard	:	R-00038304C0012
Kevin M. Aldrich	:	R-00038304C0013
David R. Erali	:	R-00038304C0014
Jamie Denunzio	:	R-00038304C0015
Steven Maga	:	R-00038304C0016
Gary E. Pickel	:	R-00038304C0017
Richard Dewees	:	R-00038304C0018
Randy Piersol	:	R-00038304C0019
Laurence Wagner	:	R-00038304C0020
Ann Katcavage	:	R-00038304C0021
William D. and Loretta J. Hawkins	:	R-00038304C0022
Emmanuel Cooper	:	R-00038304C0023
Frank Lesnefsky	:	R-00038304C0024
Robert M. East, Jr.	:	R-00038304C0025
Peter Nahrgang	:	R-00038304C0026

Dirk Maurer	:	R-00038304C0027
David H. Lower	:	R-00038304C0028
Dale L. Szarejko	:	R-00038304C0029
Jennifer Ottinger	:	R-00038304C0030
Robert J. Cunnane	:	R-00038304C0031
Carolyn Marinelli	:	R-00038304C0032
Douglas George	:	R-00038304C0033
Timothy G. Long	:	R-00038304C0034
Joseph and Deborah Saracino	:	R-00038304C0035
James P. Trunzo, Jr.	:	R-00038304C0036
Michael Blevins	:	R-00038304C0037
Rosemary Smith	:	R-00038304C0038
Andrew Kozemko	:	R-00038304C0039
Mildred McDonald	:	R-00038304C0040
Andrew Moletress	:	R-00038304C0041
A. P. Casciano	:	R-00038304C0042
Patricia Termine	:	R-00038304C0043
Michael J. Zuber	:	R-00038304C0044
Bernard J. Lease	:	R-00038304C0045
Edmund Leizens	:	R-00038304C0046
Garry Detwiler	:	R-00038304C0047
Pamela Burnisky	:	R-00038304C0048
Gail Shannon	:	R-00038304C0049
Debbie and Gregg Templin	:	R-00038304C0050
Fern L. and John P. Gedman	:	R-00038304C0051
Gary A. Lunardini	:	R-00038304C0052
Kathleen Cotton	:	R-00038304C0053
William R. Cora	:	R-00038304C0054
George B. Smith	:	R-00038304C0055
Louise E. and Anthony S. Cisek	:	R-00038304C0056
Patricia A. Eyer	:	R-00038304C0057
Joseph A. Grudzinski	:	R-00038304C0059
Andrew L. and Dorris K. Gerfin	:	R-00038304C0060
Davis Haldeman	:	R-00038304C0061
Werner H. Frank	:	R-00038304C0062
Isabelle Martinez VanDapel	:	R-00038304C0063
Barbara L. Elia	:	R-00038304C0064
Donald E. Weston, III	:	R-00038304C0065
Paul Allen	:	R-00038304C0066
Alberta Murphy	:	R-00038304C0067
Robert T. Heist	:	R-00038304C0068
Lois K. Fink	:	R-00038304C0069
Susan and James Irwin	:	R-00038304C0070

Richard and Helene Dorr	:	R-00038304C0071
Carol F. Pennington,	:	
Acting Small Business Advocate	:	R-00038304C0072
Pennsylvania-American Water Large Users Group:	:	R-00038304C0073
Paul and Miriam Fligleman	:	R-00038304C0074
Clare Kashuba	:	R-00038304C0075
Madeline Metro	:	R-00038304C0076
Charles Fortescue	:	R-00038304C0077
Eugene Rutkoski	:	R-00038304C0078
Joanne Ross-MacLeod	:	R-00038304C0079
John G. Patrick	:	R-00038304C0080
Rebecca Hafer	:	R-00038304C0081
Angelo Greek	:	R-00038304C0082
Josephine R. Kwiatkowski	:	R-00038304C0083
Joseph F. and Anna B. Marshalek	:	R-00038304C0084
William Rinker	:	R-00038304C0085
Anna M. Sealer	:	R-00038304C0086
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Razvan Andrei	:	R-00038304C0089
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Angus D. MacLeod	:	R-00038304C0092
Michael and Matilda Gagliardi	:	R-00038304C0093
George H. Gantert, Jr.	:	R-00038304C0094
Frank Smith	:	R-00038304C0095
Jean Popp	:	R-00038304C0096
David Armanini	:	R-00038304C0097
Cathie Pally	:	R-00038304C0098
Arthur Karten	:	R-00038304C0099
Patrick A. Brown	:	R-00038304C0100
Bill and Suzanne Patz	:	R-00038304C0101
James Schafer	:	R-00038304C0102
Ann F. Miller	:	R-00038304C0103
Kenneth Booth	:	R-00038304C0104
Otto and Winifred Forster	:	R-00038304C0106
Deletta Mastrangelo	:	R-00038304C0107
June Marie Preston	:	R-00038304C0108
Peter J. Mundell	:	R-00038304C0109
Regis P. Zapata	:	R-00038304C0110
D. Wintermyer	:	R-00038304C0111
Robert K. Alico	:	R-00038304C0112
Vittoria McEntee	:	R-00038304C0113

Robert S. Schaeffer	:	R-00038304C0114
Alice Yamrick	:	R-00038304C0115
Duerr Packaging Company, Inc.	:	R-00038304C0116
Jerome Greene	:	R-00038304C0117
Ronald J. Funk	:	R-00038304C0118
Robert Redinger, Jr.	:	R-00038304C0119
Dorothy E. Farrell	:	R-00038304C0120
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Winifred Jennings	:	R-00038304C0123
William J. Becker	:	R-00038304C0124
Kenneth J. Depro	:	R-00038304C0125
Bryan M. Maldony	:	R-00038304C0126
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Peter Digiacomio	:	R-00038304C0128
Nancy Svitak	:	R-00038304C0129
John J. Hafferty	:	R-00038304C0130
Kari Suter	:	R-00038304C0131
Cheryl and Thomas H. Dalton, Sr.	:	R-00038304C0132
Fred M. Woy	:	R-00038304C0133
Bill Gaffey	:	R-00038304C0134
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Deborah Destefano	:	R-00038304C0136
West Brownsville Borough, Washington Co.	:	R-00038304C0137
Robert K. and Diane M. Tuttle	:	R-00038304C0138
George Ondra	:	R-00038304C0139
Spring Township, Berks Co.	:	R-00038304C0140
Upper Providence Township, Montgomery Co.	:	R-00038304C0141
Robert Megatulski	:	R-00038304C0142
Elizabeth Kozlowski	:	R-00038304C0143
Thomas J. Hallyburton	:	R-00038304C0144
Colleen Sosnowy	:	R-00038304C0145
Fred J. and Ursula B. Pledger	:	R-00038304C0146
John M. and Terry D. Stockton	:	R-00038304C0147
Victoria Marie DeBarbieri	:	R-00038304C0148
William Glaser	:	R-00038304C0149
Dominick S. Vassallo	:	R-00038304C0150
Community Central Energy Corporation	:	R-00038304C0151
Eat 'N Park Hospitality Group, Inc.	:	R-00038304C0152
Joanne G. Kramer	:	R-00038304C0153
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Rice Enterprises LLC	:	R-00038304C0155
The Exeter Library Association	:	R-00038304C0156
Dorothy Reilly	:	R-00038304C0157

L. Louise Kellerman	:	R-00038304C0158
Joseph Merces	:	R-00038304C0159
Michelle P. Kircher	:	R-00038304C0160
Rosalia DiGrazia	:	R-00038304C0161
Susan M. Chelston	:	R-00038304C0162
Lois Schmoyer	:	R-00038304C0163
Mr. and Mrs. Robert R. Gross	:	R-00038304C0164
Jose A. and Helen Vega	:	R-00038304C0165
Dorothy K. Billing	:	R-00038304C0166
Bonnie and Bill Cochran	:	R-00038304C0167
Laurence Boucher	:	R-00038304C0168
Wesley J. Egleberger	:	R-00038304C0169
Samuel T. Orlando	:	R-00038304C0170
Kathleen A. Tini	:	R-00038304C0171

v.

Pennsylvania-American Water Company

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OPINION AND ORDER

BY THE COMMISSION:

Before the Commission for consideration and disposition is the Recommended Decision of Administrative Law Judge (ALJ) Wayne L. Weismandel, issued on December 2, 2003, relative to the above-captioned proceedings, and the Exceptions and Replies filed with respect thereto.

Exceptions to the Recommended Decision were filed by Pennsylvania-American Water Company (PAWC) and by the Office of Consumer Advocate (OCA) on December 17, 2003. Letters were received from the following Parties indicating that they would not be filing Exceptions: the Office of Small Business Advocate (OSBA), on December 16, 2003; the Commission's Office of Trial Staff (OTS), and Pennsylvania-American Water Large Users Group (PAWLUG), on December 17, 2003.

Reply Exceptions were filed by PAWC, the OTS and the OCA on December 24, 2003. The OSBA and PAWLUG filed Letters indicating that they would not be filing Reply Exceptions on December 23, 2003.

I. History of the Proceeding¹

On March 31, 2003, PAWC filed with the Commission a Petition for Permission to Depart From the Requirements of 52 Pa. Code § 53.52(B)(2) and to File Supporting Data that Conform to the Proposed Amendments to the Data Filing Requirements for Water Utilities Published at 33 *Pennsylvania Bulletin* 1106 (Petition). That Petition was granted per Secretarial Letter issued on April 23, 2003.

¹ We have extracted liberally from the Recommended Decision in setting forth the History of the Proceedings and the positions of the Parties as presented during the evidentiary phase of this matter.

On April 30, 2003, PAWC filed with the Commission Supplement No. 141 to Tariff Water - Pa. P.U.C. No. 4, to become effective June 29, 2003, containing proposed changes in rates, rules, and regulations calculated to produce \$64,946,533 (18.2%) in additional annual revenues based on a future test year ending December 31, 2003.

On May 5, 2003, the OCA filed a Formal Complaint,² as did AK Steel on May 7, 2003. By Order adopted and entered May 22, 2003, we suspended the filing until January 29, 2004, unless permitted by Commission Order to become effective at an earlier date. Our May 22, 2003 Order also directed an investigation into the lawfulness, justness, and reasonableness of the proposed rates, rules and regulations, with hearings to be held by the Office of Administrative Law Judge (OALJ).

Pursuant to the Settlement Guidelines and Procedures for Major Rate Cases - Statement of Policy,³ by Notice dated May 28, 2003, an Initial Prehearing Conference was scheduled for June 17, 2003, and ALJ Weismandel was assigned as the Presiding Officer. By Initial Prehearing Conference Order dated May 28, 2003, the participants were ordered to prepare memoranda to be filed and served by June 10, 2003, and advised that active participants would be limited to attendees at the scheduled Initial Prehearing Conference on June 17, 2003, unless granted active participant status upon the filing of Petitions to Intervene. On June 3, 2003, the OSBA filed a Formal Complaint, as did PAWLUG on June 9, 2003.⁴ On June 10, 2003, the OTS filed a Notice of Appearance.

² During the course of this proceeding a total of 171 Formal Complaints were filed. The overwhelming majority of the Complainants became inactive participants. Three of the Formal Complaints (Docket Numbers R-00038304C0058, R-00038304C0105 and R-00038304C0122) were withdrawn by the respective Complainants and closed by Secretarial Letters (respectively dated July 23, 2003, August 14, 2003, and August 14, 2003).

³ 52 Pa. Code §§ 69.401-69.406.

⁴ PAWLUG consists of GlaxoSmithKline, H. Warshow & Sons, Inc. and USX Corporation – U.S. Steel.

By letter dated June 16, 2003, PAWC advised that it would be relying on the provisions of 52 Pa. Code § 5.61(d) which provide that, for complaints which are docketed with Commission-instituted rate proceedings, no answer is generally required. PAWC, the OTS, the OCA, the OSBA, AK Steel, PAWLUG, the Commission on Economic Opportunity of Luzerne County (CEO), and the City of Pittsburgh (Pittsburgh) timely submitted Memoranda in accordance with the Initial Prehearing Conference Order. The Prehearing Conference occurred as scheduled on June 17, 2003, and was attended (either in-person or by telephone) by representatives of PAWC, the OTS, the OCA, the OSBA, AK Steel, PAWLUG, CEO, and Pittsburgh. A transcript of the proceeding containing 52 pages was produced.

As a result of the Prehearing Conference, ALJ Weismandel issued a Scheduling and Briefing Order dated June 18, 2003, which, *inter alia*, provided a schedule for the hearing and for Public Input Hearing sessions, and scheduled a Second Prehearing Conference for September 5, 2003. By Hearing Notice dated June 18, 2003, an initial and further hearing were scheduled for September 15-19, 2003, and September 22-26, 2003, in Harrisburg. A Further Prehearing Conference was also scheduled for September 5, 2003.

By Hearing Notice dated June 27, 2003, Public Input Hearing sessions were scheduled for the period of August 11-21, 2003. By Order Scheduling Public Input Hearing dated June 30, 2003, a Public Input Hearing in sixteen sessions at nine locations in Pennsylvania was scheduled for the period of August 11-21, 2003. By Order Granting Permission to Intervene dated July 30, 2003, the Petition to Intervene jointly filed on July 29, 2003, by

A Pocono County Place Property Owners Association (APCPPOA) and by Saw Creek Estates Community Association, Inc. (SCECA) was granted.⁵

By Second Prehearing Conference Order dated August 4, 2003, the active participants were ordered to prepare Memoranda to be filed and served by August 29, 2003. Among other things, the Memoranda were to include the Party's litigation position summary and final witness information for the scheduled initial and further hearing. By Order Scheduling Additional Public Input Hearing Sessions dated August 7, 2003, two additional sessions at another location were scheduled.

During the period of August 11-27, 2003, a Public Input Hearing, in eighteen sessions, was held in Pennsylvania. Sessions were held in ten of the thirty-five Counties in which PAWC provides public water service. At these Public Input Hearing sessions, a total of ninety-six witnesses presented sworn testimony, and six exhibits were admitted into evidence. Transcripts of the proceedings containing 833 pages were produced.

By Order Granting Motion for Leave to File Testimony Pursuant to the Commission's July 24, 2003 Order, at Docket No. R-00027983, dated August 20, 2003, PAWC was permitted to submit testimony and other evidence on the issue of the prudence and reasonableness of increased security costs incurred after September 11, 2001. PAWC had filed a Motion seeking this permission on August 7, 2003, which Motion was opposed by the OCA.

⁵ The fourteen active participants which litigated this case are PAWC, the OCA, AK Steel, the OSBA, PAWLUG, the OTS, CEO, Pittsburgh, APCPPOA, SCECA, Quarryville Borough, Lancaster County, Atglen Borough, Chester County, Christiana Borough Lancaster County, and Parkesburg Borough, Chester County.

PAWC, the OTS, the OCA, the OSBA, AK Steel, PAWLUG, CEO, Pittsburgh, and Quarryville, Atglen, Christiana, Parkesburg, APCPPOA and SCECA (jointly) timely submitted Memoranda in accordance with the Second Prehearing Conference Order. The Second Prehearing Conference occurred as scheduled on September 5, 2003, attended (either in-person or by telephone) by representatives of PAWC, the OTS, the OCA, the OSBA, AK Steel, PAWLUG, CEO, Pittsburgh, Quarryville, Atglen, Christiana, Parkesburg, APCPPOA, and SCECA. A transcript of the proceeding containing 29 pages was produced. As a result of agreements reached by the active participants at the Second Prehearing Conference, the initial and further hearing was rescheduled to begin on September 19, 2003, rather than on September 15, 2003.

Based upon further agreements of the active participants, and due in part to the temporary unavailability of an OCA witness due to a family emergency, the initial and further hearing ultimately convened on Tuesday, September 23, 2003. That hearing continued on consecutive work days through Monday, September 29, 2003. PAWC, the OCA, the OTS, the OSBA, PAWLUG, Quarryville, Atglen, Christiana, Parkesburg, APCPPOA and SCECA each presented written direct testimony that was admitted as evidence. PAWC, the OCA, the OSBA, PAWLUG, and AK Steel each presented written rebuttal testimony that was admitted as evidence.

In accordance with the requirements of the Special Instructions for Briefs and Exceptions in Major General Rate Increase Proceedings, Paragraph 3.a., the test year to be used in this case was established on the record as the future test year ended December 31, 2003. (Tr. at 1571). Also in accordance with the requirements of the Special Instructions, Paragraph 4.a., at the conclusion of the hearing, PAWC was directed to file and serve, identified as ALJ Exhibit 1, its final *pro forma* showing at present rates. ALJ Exhibit 1 would be the starting point from which all active participants would make adjustments based upon evidence admitted in the case. (Tr. at 1572 – 1574).

Finally, at the conclusion of the hearing, the ALJ directed that the record would close on October 6, 2003. (Tr. at 1578). On October 7, 2003, PAWC late-filed ALJ Exhibit 1. PAWC, the OTS, the OCA, PAWLUG, and CEO timely submitted Main Briefs in accordance with the Scheduling and Briefing Order. PAWC, the OTS, the OCA, and APCPPOA and SCECA (jointly) timely submitted Reply Briefs in accordance with the Scheduling and Briefing Order.

On October 28, 2003, all of the active participants in this case, outlined above, filed a Stipulation Concerning Rate Structure and Rate Design (Stipulation) to resolve the issues concerning the structure and design of rates and the distribution among customer classes of any revenue increase allowed in this proceeding. The Stipulation requested that its terms be adopted in the final Order in this case. The Stipulation as filed remained unsigned on behalf of APCPPOA, SCECA, Quarryville, Atglen, Christiana, and Parkesburg due to the need for their respective Boards to meet and formally authorize their attorney to execute the Stipulation on their behalf.

By Order Reopening Record and Admitting Exhibits dated October 31, 2003, the record was reopened for the limited purpose of admitting, as part of the record, both ALJ Exhibit 1 filed October 7, 2003, and the Stipulation filed October 28, 2003. On November 13, 2003, counsel for APCPPOA, SCECA, Quarryville, Atglen, Christiana, and Parkesburg filed an executed signature page evidencing that all six of his clients joined in the Stipulation. On November 18, 2003, original signature pages for the Stipulation on behalf of the OTS and Pittsburgh were filed (the filed Stipulation contained faxed signature pages on behalf of these two active participants). In accordance with the Order Reopening Record And Admitting Exhibits dated October 31, 2003, the record was closed on November 21, 2003.

ALJ Weisman's Recommended Decision was issued on December 2, 2003. In his Recommended Decision the ALJ found, *inter alia*, that PAWC's proposed

Supplement No. 141 to Tariff Water - Pa. P.U.C. No. 4 proposing an annual increase of \$64,946,533, should be rejected. The ALJ stated that the rates contained in that Supplement were not just and reasonable, or otherwise in accordance with the Pennsylvania Public Utility Code (Code) and the Commission's Regulations. The ALJ further recommended that the Commission issue an Opinion and Order directing PAWC to file a tariff allowing recovery of no more than \$26,174,845 in additional base rate revenue. (R.D. at 81).

Exceptions and Reply Exceptions to the Recommended Decision were filed as above noted. As duly noted in our determinations herein, we are adopting the ALJ's Recommended Decision, modified (1) to permit deferred security costs as further adjusted herein; and (2) to increase the cost of common equity to 10.6%. Incorporating these modifications into our determinations herein, results in a grant of additional annual operating revenues not to exceed \$34,314,157.

II. Description of The Company and General Principles

PAWC is a regulated Pennsylvania public utility that furnishes water service to approximately 609,110 customers in a service territory covering portions of 35 counties across the Commonwealth. It was formed by the merger of the former Pennsylvania-American Water Company with Western Pennsylvania Water Company (WPW) on February 1, 1989.

The former WPW was originally established in 1972, when sixteen separate water companies in Western Pennsylvania were merged. The former Pennsylvania-American Water Company was initially formed in 1987, when Riverton Consolidated Water Company (Riverton) merged with Keystone Water Company (Keystone). Keystone itself had been established in 1973, when fourteen separate companies located in Eastern and Central Pennsylvania were merged. Similarly, Riverton was the combined derivative of many small independent water companies, all serving the area in the Harrisburg vicinity known as “The West Shore.”

On February 16, 1996, PAWC acquired all of the water utility assets of the former Pennsylvania Gas and Water Company (PG&W) and began providing water service in the former PG&W service territory located in Lackawanna, Luzerne, Susquehanna and Wayne Counties. Since January 1, 1996, PAWC has acquired the assets of a number of smaller municipal and investor-owned water systems. On March 22, 2001, it acquired the water system owned and operated by the City of Coatesville Authority, which furnished service to approximately 8,300 residential, commercial, industrial and sale for resale customers located in the City of Coatesville and all or portions of fifteen other municipalities. Additionally, on January 15, 2002, PAWC acquired the utility assets of Citizens Utilities Water Company of Pennsylvania (Citizens), which furnished service to approximately 33,550 residential, commercial, and industrial customers located in all or portions of 36 municipalities.

PAWC utilizes various sources of water supply to meet its customers' requirements. In addition, it owns and operates water treatment facilities, distribution storage facilities, booster pumping stations, and transmission and distribution mains for furnishing water service to customers. PAWC is a subsidiary of American Water Works Company, Inc. (American).⁶ Another subsidiary of American, the American Water Works Service Company, Inc. (Service Company), provides certain technical and administrative services to American and its subsidiaries. Such services, which include engineering, water quality and procurement, are provided at cost, with no element of profit to the Service Company. In addition, through an initiative that began in 2001, certain customer call center and corporate service functions were consolidated at the Service Company level in the National Customer Call Center and the Shared Services Center.

In deciding this, or any other, general rate increase case brought under Section 1308(d) of the Code, 66 Pa. C.S. § 101 *et seq.*, certain general principles always apply. A public utility is entitled to an opportunity to earn a fair rate of return on the value of the property dedicated to public service. *Pennsylvania Gas and Water Company v. Pennsylvania Public Utility Commission*, 341 A.2d 239 (Pa. Commw. Ct. 1975) [Emphasis added].

In determining a fair rate of return the Commission must be guided by the criteria provided by the United States Supreme Court in the landmark cases of *Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944). In *Bluefield*, the Court stated, in pertinent part, that:

⁶ On January 10, 2003, American was acquired by Thames Water Aqua US Holdings, Inc. (Thames), the water division of RWE Aktiengesellschaft (RWE). Prior to its acquisition by Thames, American's common stock was publicly held.

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

Bluefield, 262 U.S. 679, 692-3 (1923).

The burden of proof to establish the justness and reasonableness of every element of a public utility's rate increase request rests solely upon the public utility in all proceedings under Section 1308(d) of the Code. The standard to be met by the public utility is set forth at Section 315(a) of the Code which provides that:

Reasonableness of rates. –In any proceeding upon the motion of the Commission, involving any proposed or existing rate of any public utility, or in any proceeding upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility.

66 Pa. C.S. § 315(a).

The Pennsylvania Commonwealth Court, in reviewing Section 315(a) of the Code, interpreted the utility's burden of proof in a rate proceeding as follows:

Section 315(a) of the [Code], 66 Pa. C.S. Section 315(a), places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the public utility. It is well-established that the evidence adduced by a utility to meet this burden must be substantial. [Emphasis added].

Lower Frederick Township Water Company v. Pennsylvania Public Utility Commission, 409 A.2d 505, 507 (Pa. Commw. Ct. 1980) (Emphasis added). *See also, Brockway Glass Company v. Pennsylvania Public Utility Commission*, 437 A.2d 1067 (Pa. Commw. Ct. 1981). Substantial evidence is such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. *Smalley v. Zoning Hearing Board of Middleton Township*, 2003 Pa. LEXIS 1950 (Pa., 2003) (citation omitted).

It is well-established that in general rate increase proceedings, the burden of proof does not shift to parties challenging a requested rate increase. Rather, the utility's burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one and that burden remains with the public utility throughout the course of the rate proceeding. It has been held that there is no similar burden placed on other parties to justify a proposed adjustment to the utility's filing. The Pennsylvania Supreme Court has held that:

[T]he appellants did not have the burden of proving that the plant additions were improper, unnecessary or too costly; on the contrary, that burden is, by statute, on the utility to demonstrate the reasonable necessity and cost of the installations, and that is the burden which the utility patently failed to carry.

Berner v. Pennsylvania Public Utility Commission, 382 Pa. 622, 631, 116 A.2d 738, 744 (1955).

This does not mean, however, that in proving that its proposed rates are just and reasonable a public utility must affirmatively defend every claim it has made in its

filing, even those which no other party has questioned. As the Pennsylvania Commonwealth Court has held:

While it is axiomatic that a utility has the burden of proving the justness and reasonableness of its proposed rates, it cannot be called upon to account for every action absent prior notice that such action is to be challenged.

Allegheny Center Assocs. v. Pennsylvania Public Utility Commission, 570 A.2d 149, 153 (Pa. Commw. Ct. 1990) (citation omitted). *See; also, Pa Public Utility Commission v. Equitable Gas Co.*, 73 Pa. P.U.C. 310, 359 – 360 (1990). It is also noted that the mere rejection of evidence, contrary to that adduced by the public utility, is not an impermissible shifting of the evidentiary burden. *United States Steel Corp. v. Pennsylvania Public Utility Commission*, 456 A.2d 686 (Pa. Commw. Ct. 1983).

Discussion

In analyzing a proposed general rate increase, the Commission basically determines a rate of return to be applied to a rate base measured by the aggregate value of all the utility's property used and useful in the public service. At its most fundamental level, the determination of a proper rate of return requires calculation of the utility's capital structure (either actual or hypothetical) and, with respect to the different types of capital, the cost of that type of capital during the period in issue. The Commission is granted wide discretion, because of its administrative expertise, in determining the cost of capital. *Equitable Gas Company v. Pennsylvania Public Utility Commission*, 405 A.2d 1055 (Pa. Commw. Ct. 1979) (determination of cost of capital is basically a matter of judgment which should be left to the regulatory agency and not disturbed absent an abuse of discretion). It is well settled that when the parties have been ordered to file Briefs and fail to include all the issues they wish to have reviewed, the unbriefed issues may properly be viewed as having

been waived. *Jackson v. Kassab*, 2002 Pa. Super. 570, 812 A.2d 1233 (2002) appeal denied, *Jackson v. Kassab*, 885 A.2d 1261, 2003 Pa. LEXIS 1128 (Pa. 2003).

As we proceed in our review of the various positions espoused in this proceeding, we are reminded that we are not required to consider expressly or at great length each and every contention raised by a party to our proceedings. (*University of Pennsylvania, et al. v. Pennsylvania Public Utility Commission*, 485 A.2d 1217, 1222 (Pa. Commw. Ct. 1984)). Moreover, any exception or argument that is not specifically addressed herein shall be deemed to have been duly considered and denied without further discussion.

III. Rate Base

PAWC's claim for rate relief in this proceeding is based upon data for the future test year ending December 31, 2003. (PAWC Initial Brief, Appendix A, PAWC Exhibit 3-B-1). PAWC's final claimed rate base of \$1,549,769,797 consists of the depreciated original cost of its utility plant in service as of December 31, 2002, together with rate base additions and deductions.

A. Original Cost Utility Plant in Service

To develop the future test year year-end level of plant in service, the original cost of plant to be constructed or acquired during the twelve months ended December 31, 2003, was added to the original cost of plant recorded on PAWC's books at December 31, 2002, and the original cost of plant to be retired during the twelve months ending December 31, 2003, was subtracted. (PAWC Statement 3, at 5-6). PAWC's final claim for the original cost of utility plant in service as of December 31, 2003, is \$2,069,597,830 (PAWC Exhibit 3A Revised, at 23R). From this amount, PAWC deducted contributions in aid of construction, customer advances for construction, and the original cost of certain utility property excluded from rate base to derive net utility plant in service of \$1,938,013,782. (PAWC Exhibit 3A Revised, at 23R). After deducting Accrued Depreciation of \$367,431,008, and adding/deducting various other rate base elements that result in a net deduction of \$20,812,977, the final claimed rate base of \$1,549,769,797 is determined. (PAWC Initial Brief, Appendix A, at 23R). None of the active participants disputed any of these claims.

B. Accrued Depreciation

1. Positions of the Parties

PAWC's claim for accrued depreciation related to its utility plant in service that was developed and presented by Mr. John J. Spanos, Vice-President of the Valuation and Rate Division of Gannett Fleming, Inc. The details underlying the methodology employed by Mr. Spanos, together with all supporting calculations and documentation, are set forth in two separately bound documents placed in the record as PAWC Exhibit Nos. 10-A and 10-B. PAWC's claim for accrued depreciation related to utility plant in service at December 31, 2003, is \$367,431,008. (PAWC Exhibit 3A Revised, at 23R).

PAWC's accrued depreciation is its book reserve, as established by Commission Orders entered January 24, 1985, at 59 PA P.U.C. 178 (WPW), March 21, 1985, at 59 PA P.U.C. 286 (Riverton) and March 29, 1985, at Docket No. R-842755 (Keystone). Mr. Spanos computed the accrued depreciation related to PAWC's plant in service as of December 31, 2003, by reflecting all appropriate entries required to establish what PAWC's book reserve would be at that point in time (PAWC Statement 10, at 6-7). The OTS was the only active participant that disputed any element of PAWC's claim for accrued depreciation.

The OTS recommended that \$21,506,211 be added to PAWC's accumulated depreciation reserve, which adjustment, if made, would serve to decrease PAWC's rate base by the same amount. The OTS argued that PAWC improperly deducted its annual net negative salvage expense from its accrued depreciation, thereby overstating its rate base by inflating its depreciation book reserve.

2. ALJ's Recommendation

The ALJ noted that in *Penn Sheraton Hotel v. Pennsylvania Public Utility Commission*, 184 A.2d 324 (Pa. Super. Ct. 1962), the Pennsylvania Superior Court defined the term “negative salvage” as follows:

Negative salvage is the loss a utility suffers upon the retirement of property resulting from the necessity to expend funds in excess of the salvage value in order to remove the property.

Penn Sheraton, 184 A.2d at 327.

The Court went on to describe how *actual* negative salvage should be treated in a general rate increase case.

[T]he negative salvage actually incurred by the utility either upon the actual retirement of a property without replacement or upon the replacement of an item of property is of course entitled to consideration in a rate proceeding. It is then no longer prospective but actual. If the utility retires and removes a property without replacing it or replaces it after removal and incurs actual negative salvage in doing so, the expenditure should be capitalized and amortized by some reasonable method and for and over a reasonable length of time.

Penn Sheraton, 184 A.2d at 329 [Emphasis added].

The ALJ furthermore cited *PA Public Utility Commission v. Pennsylvania-American Water Company*, 1994 PA P.U.C. LEXIS 120, which was PAWC's 1993 general rate increase case. Therein, the Commission rejected the OTS' arguments on this issue, which were nearly identical to those offered here. The Commission held there as follows:

We do not view the time honored treatment of net salvage as implicating the prohibitions of the “used and useful” concept, and neither does it produce the unfavorable result of permitting The Company a return on and return of its costs. The booking of net salvage to accrued depreciation acts as a

reduction to the book reserve and an increase to rate base with the historic annual five-year amortization of the depreciation expense appropriately recognizing the on-going nature of plant additions and plant retirements. On the basis of the foregoing, we shall deny the OTS Exception on this issue.

Id., 1994 PA P.U.C. LEXIS 120, 45-46 (footnote omitted).

Additionally, the ALJ averred that PAWC's capitalizing net salvage is directed by the most recent *Uniform System of Accounts for Class A Water Utilities* prescribed by the National Association of Regulatory Utility Commissioners (NARUC). The ALJ also noted that PAWC is required, by Commission regulation, to keep its accounts in conformity with this NARUC prescript. 52 Pa. Code § 65.16(a). The ALJ concluded that a Pennsylvania appellate court and the Commission itself, repeatedly, have determined that PAWC's treatment of net negative salvage is proper. Consequently, the ALJ recommended that the OTS' proposed adjustment should be rejected. (R.D. at 16).

3. Disposition

No Party excepts to the ALJ's recommendation on this issue. Finding the ALJ's recommendation to be reasonable, appropriate and otherwise in accord with the record evidence, it is adopted.

C. Citizens Acquisition Adjustment

1. Positions of the Parties

PAWC requested that it be allowed to include in rate base, and thereby earn a return on, the approximate \$46.0 million acquisition adjustment that it recorded upon its acquisition, in January 2002, of the water utility assets of Citizens. In this regard, PAWC averred that it has satisfied all of the criteria for rate base inclusion set forth in Section

1327(a) of the Code, 66 Pa. C. S. § 1327(a) (Section 1327(a)). In addition, PAWC requested that it be permitted a return of its Citizens acquisition adjustment through a 40-year amortization. The amount included in PAWC's rate base claim is \$44,878,275, which reflects a reduction for one year's amortization of \$1,150,725. (PAWC Exhibit 3-A at 33, 64). The OCA recommended that both requests be rejected. No other active participant has made a recommendation.

The OCA recommended that PAWC not be allowed to include the approximate \$46.0 million acquisition adjustment in its rate base on the basis that it does not qualify for such treatment under Section 1327(a). Additionally, the OCA recommended that PAWC not be permitted to amortize the approximate \$46.0 million acquisition adjustment independent of its inclusion in rate base.

2. ALJ's Recommendation

The ALJ noted that Section 1327(a) of the Code was added in 1990, and was designed to carve out an exception to the general rule, set forth in Section 1311(b), 66 Pa. C.S. § 1311(b), that utility property shall be valued, for rate base purposes, at the original cost of such property when first devoted to public service, less applicable accrued depreciation, as such depreciation is determined by the Commission. Section 1327(a) initially applied only to the acquisition of small systems, *viz.*, those of 1,200 or fewer customer connections. However, in 1995, the statute was amended to redefine the limit of a small system as 3,300 or fewer customer connections and to also encompass systems that were "nonviable" in the absence of the acquisition.

The ALJ continued that Section 1327(a) creates a rebuttable presumption that amounts paid by a public utility, in excess of original cost less accrued depreciation, are reasonable and entitled to be included in rate base if nine criteria are satisfied. Those criteria are set forth as (1) through (9) of Section 1327(a), as follows:

- (1) the property is used and useful in providing water or sewer service;
- (2) the public utility acquired the property from another public utility, a municipal corporation or a person which had 3,300 or fewer customer connections or which was nonviable in the absence of the acquisition;
- (3) the public utility, municipal corporation or person from which the property was acquired was not, at the time of acquisition, furnishing and maintaining adequate, efficient, safe and reasonable service and facilities, evidence of which shall include, but not be limited to, any one or more of the following:
 - (i) violation of statutory or regulatory requirements of the Department of Environmental Resources or the commission concerning the safety, adequacy, efficiency or reasonableness of service and facilities;
 - (ii) a finding by the commission of inadequate financial, managerial or technical ability of the small water or sewer utility;
 - (iii) a finding by the commission that there is a present deficiency concerning the availability of water, the palatability of water or the provision of water at adequate volume and pressure;
 - (iv) a finding by the commission that the small water or sewer utility, because of necessary improvements to its plant or distribution system, cannot reasonably be expected to furnish and maintain adequate service to its customers in the future at rates equal to or less than those of the acquiring public utility; or
 - (v) any other facts, as the commission may determine, that evidence the inability of the small water or sewer utility to furnish or maintain adequate, efficient, safe and reasonable service and facilities;

- (4) reasonable and prudent investments will be made to assure that the customers served by the property will receive adequate, efficient, safe and reasonable service;
- (5) the public utility, municipal corporation or person whose property is being acquired is in agreement with the acquisition and the negotiations which led to the acquisition were conducted at arm's length;
- (6) the actual purchase price is reasonable;
- (7) neither the acquiring nor the selling public utility, municipal corporation or person is an affiliated interest of the other;
- (8) the rates charged by the acquiring public utility to its preacquisition customers will not increase unreasonably because of the acquisition; and
- (9) the excess of the acquisition cost over the depreciated original cost will be added to the rate base to be amortized as an addition to expense over a reasonable period of time with corresponding reductions in the rate base.

66 Pa. C.S. § 1327(a).

The ALJ noted that, in this case, there is no dispute that the property in question is “used and useful” in providing water service (Criterion No. 1); that the acquisition was the result of arm's length negotiations (Criterion No. 5); that PAWC and Citizens were not affiliated (Criterion No. 7); and that a 40-year amortization period would be reasonable (Criterion No. 9). As such, the ALJ concluded that the debate herein centered on whether PAWC has met its burden with respect to Criteria Nos. 2, 3, 4, 6, and 8. (R.D. at 18-19).

The ALJ continued that it is essential to note that the nine criteria of Section 1327(a) were written by the General Assembly in the conjunctive, not the disjunctive. That is, all nine criteria must be met or the acquiring public utility is not entitled to include in rate base the amounts paid in excess of original cost less accrued depreciation (the so-called “acquisition adjustment”). The ALJ then went on to examine each of the relevant criteria *seriatim*. (R.D. at 19-25).

a. Criterion No. 2

With respect to Criterion No. 2, PAWC and the OCA disagreed as to whether or not Citizens was “nonviable in the absence of the acquisition” (both active participants recognizing that Citizens had in excess of 3,300 customer connections). The ALJ noted that neither the Code nor any applicable Commission Regulation provides a definition of “nonviable.” PAWC argued that “nonviable” should be defined as a company which lacks the financial capacity to exist as a stand-alone entity apart from its parent and in the absence of extraordinary rate relief. The OCA, analogizing from the Commission’s Small Drinking Water System – Statement Of Policy, Viability of small water systems, 52 Pa. Code § 69.701, advocated that a “nonviable” public utility is one that is not “viable” as that term is defined in 52 Pa. Code § 69.701(a)(2).⁷

The ALJ concluded that neither of these proposed definitions was satisfactory. He found PAWC’s proposed definition to be too narrow in that it would only apply to a public utility that was not a “stand-alone” entity, and, in that limited

⁷ “A viable water system is one which is self-sustaining and has the commitment and financial, managerial and technical capabilities to reliably meet Commission and Department of Environmental Resources . . . requirements on a long-term basis.” 52 Pa. Code § 69.701(a)(2).

circumstance, it would only evaluate financial capacity and a probable need for “extraordinary rate relief”. Managerial or technical capability would not enter into PAWC’s proposed definition, nor would the adequacy or safety of the service being rendered by the acquired utility. The ALJ stated that, while that may be a definition that PAWC would like to use in this case regarding Citizens,⁸ it clearly would not apply to other troubled public utilities that Section 1327(a)(2) was intended to address.

The ALJ further asserted that the OCA’s proposed definition is also not altogether satisfactory, in that it is too vague. The OCA, however, is correct in its attempt to arrive at a satisfactory definition of “nonviable” by analogizing from a Commission policy statement. The ALJ noted that in the Commission’s Small Nonviable Water and Wastewater Systems – Statement Of Policy, Acquisition incentives, 52 Pa. Code § 69.711, the Commission provided a definition that he found superior to either of those offered by the active participants in this case. 52 Pa. Code § 69.711(a)(3) provides, by analogy, a workable definition for not only this case, but also for cases involving “stand-alone” public utility companies. The ALJ noted that such definition takes into consideration more than just financial capability. That definition is as follows:

[T]he acquired system is not viable [when] it is in violation of statutory or regulatory standards concerning the safety, adequacy, efficiency or reasonableness of service and facilities; and . . . it has failed to comply, within a reasonable period of time, with any order of the Department of Environmental Protection or the Commission.

52 Pa. Code § 69.711(a)(3).

The first prong of this definition requires an evaluation of standards regarding safety, adequacy, efficiency or reasonableness of both service and facilities. That, stated the

⁸ There is no dispute in the evidentiary record that Citizens was a subsidiary of Citizens Communications Corporation (CCC) and, consequently, not a “stand-alone” entity.

ALJ, is obviously a much more encompassing evaluation than the sole criterion of financial capacity to exist as a stand-alone entity apart from its parent and in the absence of extraordinary rate relief. The second prong of the definition requires that an Order has been issued either by the Department of Environmental Protection (DEP) or the Commission, and that the acquired public utility has failed to comply with that Order within a reasonable period of time. The ALJ noted that the requirement that there has been a prior Order eliminates uncertainty and debate about whether the public utility has been advised of its deficiencies and has also been afforded an opportunity to correct them. The ALJ concluded that the above-outlined definition, derived from the Commission's policy statement concerning an "acquisition adjustment," 52 Pa. Code § 69.711(b)(2), is the definition best suited for use in instances where the very issue in dispute is the statutory qualification for an acquisition adjustment.⁹ Accordingly, the ALJ adopted that definition for use in his Recommended Decision. (R.D. at 20).

The ALJ concluded that PAWC failed to satisfy Criterion No. 2 of Section 1327(a) because it adduced no evidence that Citizens (the acquired public utility) had been issued an Order either by DEP or the Commission and, within a reasonable period of time, failed to comply with that Order. The ALJ noted that, while PAWC did provide evidence that Citizens had, at some time, not met DEP secondary standards, or Environmental Protection Agency (EPA) proposed regulations, or even DEP reporting regulations, no evidence was introduced that Citizens had ever been issued an Order by DEP or the Commission to which it failed to comply. (Tr. at 1471, 1482, 1484, 1486, 1488, 1503). As the party with the burden of proof, it was incumbent upon PAWC to introduce such evidence if it was to successfully establish that Citizens was a nonviable public utility. (R.D. at 21).

⁹ The only reason this definition cannot be said to directly apply, is because of its limitation to situations where the "acquired system has less than 3,300 customer connections". 52 Pa. Code § 69.711(a)(3).

b. Criterion No. 3

The ALJ stated that, for purposes of this case, the “time of acquisition” (the only relevant time for evaluation with respect to Criterion No. 3) was determined to be the period from the date that the acquisition was announced, October 15, 1999, to the date that it was reported to the Commission that the sale had been consummated, *viz.* January 15, 2002. (Tr. 1090 – 1091). None of the active participants, including PAWC, disagreed with this determination.

The ALJ noted that Criterion No. 3 requires PAWC to prove that Citizens “was not, [during the above-outlined period], furnishing and maintaining adequate, efficient, safe and reasonable service and facilities”. Additionally, while similar to Criterion No. 2, Criterion No. 3 does not require that Citizens had been subject to either a DEP or Commission order during the time of acquisition. Merely being in violation of either DEP or Commission Regulations concerning the safety, adequacy, efficiency or reasonableness of service and facilities during the applicable time period may provide evidence of Criterion No. 3. (66 Pa. C.S. § 1327(a)(3)(i)).

The ALJ stated that, as discussed above, regarding Criterion No. 2, PAWC adduced evidence that Citizens was in violation of DEP, but not of Commission, regulations. (Tr. at 1491, 1498 – 1500, 1503). The ALJ concluded that the amount of evidence adduced by PAWC was not sufficiently substantial to establish that Citizens as

a whole was not “furnishing and maintaining adequate, efficient, safe and reasonable service and facilities” during the applicable time period.¹⁰ (R.D. at 21-22).

The ALJ also pointed out that, given the fact that Glen Alsace, Blue Mountain, and Home are each discrete (not interconnected) parts of the overall Citizens’ system (as are Penn and Lake Heritage), the deficiencies in only fractional portions of parts of these system segments did not constitute substantial evidence that Citizens’ overall system was not providing or maintaining adequate, efficient, safe and reasonable service and facilities during the relevant period. Accordingly, the ALJ concluded that PAWC failed to prove that “the public utility”, *i.e.*, Citizens’ entire system, was not furnishing and maintaining adequate, efficient, safe and reasonable service and facilities during the relevant period. Consequently, the ALJ concluded that PAWC failed to satisfy Criterion No. 3 of Section 1327(a). (R.D. at 22).

c. Criterion No. 4

The OCA asserted that it has produced uncontradicted evidence that PAWC’s cost to address the problems it had identified in the former Citizens’ territory totaled approximately \$613,560. (OCA Statement 7-S, at 5, 7, 11, 14). The OCA further argued that such amount was insubstantial in a system comprised of total net assets of \$141.1 million.

¹⁰ As the Company’s own witness testified, no agency, including DEP and the Commission, determined that Citizens’ system overall was not providing or maintaining adequate, efficient, safe and reasonable service and facilities during the period from October 15, 1999, to January 15, 2002. (Tr. at 1480, 1485, 1485 – 1486, 1489 – 1490). On cross-examination of the Company’s witness it was established that the Citizens’ deficiencies occurred in only fractional portions of parts of its overall system. (Tr. at 1475-1478, 1483-1484, 1485, 1487).

The ALJ noted that, while it is true that the total relevant cost amounted to only four-tenths of one percent of PAWC's total net assets, Criterion No. 4 does not address the size of the investments that will be made to assure that customers being served by the acquired property will receive adequate, efficient, safe and reasonable service. The ALJ pointed out that what Criterion No. 4 does address is that the investments will be "reasonable and prudent." In fact, the ALJ asserted that if PAWC can solve the problems it has identified in the former Citizens' system for only four-tenths of one percent of its total net assets, then that investment would be both reasonable and prudent. Accordingly, the ALJ concluded that PAWC has established that Criterion No. 4 is satisfied. (R.D. at 22-23).

d. Criterion No. 6

The ALJ noted that Criterion No. 6 requires PAWC to prove that the actual purchase price for Citizens is reasonable. The ALJ opined that PAWC's expert witness lacked credibility on this issue. The ALJ also noted in this regard that PAWC's witness did not calculate or introduce evidence relative to "the actual purchase price," but rather relative to what he referred to as the "transaction price." (Tr. at 1338, 1339).

The ALJ noted that at no time did PAWC offer any evidence that the "transaction price" is synonymous with the statutory term "actual purchase price." Finally, as a result of the striking of PAWC's Exhibit 11C and portions of witness Patterson's testimony based thereon, the remaining evidence fails to be sufficiently persuasive as to the reasonableness of witness Patterson's "transaction price." Accordingly, concluded the ALJ, since PAWC failed to prove both that its "transaction price" is reasonable and that its "transaction price" is the same thing as the "actual purchase price" required by the controlling statute, it has failed to satisfy Criterion No. 6. (R.D. at 23-24).

e. **Criterion No. 8**

The ALJ noted that the OCA's witness Kraus provided evidence that the requested rate base addition relating to the acquisition of Citizens is \$44,878,275 at the end of the future test year, or 35% of the total *pro forma* net plant additions claimed by PAWC. The annual amortization expense associated with the acquisition adjustment alone is \$1,150,725. (OCA Statement 3, at 14; Company Exhibit 3A at 23A, 33). Using PAWC's requested pre-tax rate of return of 12.11%, applied to the rate base addition, yields a revenue requirement of \$5,434,759. Adding that amount to the annual amortization totals \$6,585,484, or approximately 10% of the total increase originally requested by PAWC.

The ALJ stated that, as the revised revenue request was \$59,246,159 at that point, the total revenue requirement associated with the Citizens acquisition adjustment comprised over 11% of the requested increase. As was pointed out by another OCA witness, PAWC made a business decision to acquire Citizens with no assurance that an acquisition adjustment would ever be allowed. The ALJ opined that, if the allowance of an acquisition adjustment was crucial, from a business perspective, PAWC could have, and should have, sought prior approval. (66 Pa. C.S. § 1327(b) and (c)).

The ALJ further opined that PAWC's argument regarding the alleged savings that would offset the admitted rate increases that would be experienced by its pre-Citizens acquisition customers fails for a number of reasons. In the first place, as the OCA correctly pointed out, in evaluating a claim for allowance of an acquisition adjustment, the General Assembly prescribed nine criteria which the acquiring public utility must meet. Supposed savings to be experienced as a result of the acquisition is not among those criteria, and the Commission is without authority to add it.

Secondly, the ALJ noted that accepting PAWC's calculations of "savings" associated with labor, benefits, payroll taxes, affiliate charges, rate case expense and eliminated services of \$2,426,487 annually, and adding PAWC's witness Patterson's estimated capital cost savings of \$1 million, the revenue requirement associated with the acquisition adjustment in the first year would be nearly twice the supposed savings. Thirdly, as PAWC's witness Diskin acknowledged, on cross-examination, since the conclusion of PAWC's last general rate increase case and the consummation of its acquisition of Citizens, events which occurred within a few days of each other, ratepayers have been paying rates as though the acquisition never occurred. (Tr. at 1174 1176).

In other words, for nearly two years, any supposed savings have not been obtained by ratepayers, but rather by PAWC itself in increased retained earnings. Those earnings are available, should PAWC choose to so use them, to increase dividends. Finally, PAWC's witness Diskin agreed that if PAWC had acquired Citizens for \$46 million less, or even for \$34 million more, the claimed savings would be the same. (Tr. at 1177). That is, the so-called "savings" are not attributable to the acquisition adjustment.

PAWC argued that pre-Citizens acquisition customers will bear less of the increased revenue requirement which would result from allowance of the acquisition adjustment than would former Citizens' customers. The ALJ stated that, while that argument is interesting, PAWC has nevertheless failed to establish that the increase which the pre-Citizens acquisition customers will experience is reasonable. It was PAWC's burden, according to Criterion No. 8, to prove that the rates of pre-Citizens acquisition customers will not increase unreasonably. The ALJ concluded that it failed to do so. (R.D. at 24-25).

In sum, the ALJ concluded that PAWC failed to satisfy four of the criteria (Nos. 2, 3, 6 and 8) of the nine statutorily required criteria to be entitled to allowance of an

acquisition adjustment. Accordingly, the ALJ opined that its claim should be denied in its entirety,¹¹ and he also recommended that the Commission adopt the OCA's adjustment as contained on Schedule LKM-4. That adjustment would decrease PAWC's claimed rate base by \$42,729,181. The related adjustments would serve to decrease amortization expense by \$1,150,725, increase Pennsylvania Income Tax by \$340,469 and decrease Federal Income Tax by \$119,164. (R.D. at 25).

3. Exceptions and Replies

PAWC excepts to the ALJ's recommendation on this issue, and it addresses each of the outlined Criteria *seriatim*.

Criterion No. 2 concerns viability. As amended in 1995, Section 1327(a)(2) requires a showing that "the public utility acquired the property from another public utility which was nonviable in the absence of the acquisition. With respect to that Criterion, PAWC contends that it has presented extensive evidence establishing that Citizens was not viable as a stand-alone entity and that its parent, Citizens Communications Corporation (CCC), lacked the commitment to provide Citizens the financial, technical and managerial support it needed to become viable and to provide adequate, efficient, safe and reasonable service. (PAWC Initial Brief at 12-22; PAWC Reply Brief at 2-6). PAWC furthermore asserts that, applying the Commission-approved definitions, Citizens was not "viable" at the time of the acquisition. (PAWC Exc. at 26-28).

Criterion No. 3 concerns the adequacy and reasonableness of service and facilities. PAWC contends that while the ALJ seemed to acknowledge that Citizens was operating in violation of DEP regulations at the time of its acquisition (R.D. at 21), he

¹¹ The ALJ noted with approval, and adopted, the OCA's position that the issue of amortization does not exist if there is no acquisition adjustment to amortize. (R.D. at 25, Footnote 12).

nonetheless concluded that Citizens' deficiencies occurred only in "fractional" areas of its service territory and that, in order to satisfy Criterion No. 3, PAWC had to establish that Citizens' entire system was not furnishing adequate, efficient, safe and reasonable service. (R.D. at 22). PAWC argues, to the contrary, that the ALJ's "entire system" test is not supported by the applicable statutory language, would impose an evidentiary standard which would be virtually impossible to meet and, as a consequence, would diminish the Commission's ability to promote the acquisition of marginal water systems. (PAWC Exc. at 28-30).

Criterion No. 6 concerns the reasonableness of the purchase price. The ALJ granted a motion to strike a substantial portion of the testimony and accompanying exhibit of PAWC's expert witness on this issue, William Patterson, who opined that the purchase price for the acquisition was reasonable. PAWC excepts to both the ALJ's evidentiary ruling on the motion, and to the ALJ's recommended finding.

PAWC argues that the stricken evidence consisted of data from comparable water utility acquisition which had been compiled by Merrill Lynch from public documents filed with the SEC.¹² It is the same kind of valuation analysis which Mr. Patterson has submitted in other regulatory proceedings both in Pennsylvania and elsewhere. (PAWC Statements 11 and 11-R; PAWC Exhibits 11-C and 11-D). According to PAWC, the ALJ's ruling that that evidence should be stricken because it was based on impermissible hearsay is incorrect. (R.D. at 23). PAWC continues that Rule 703 of the Pennsylvania Rules of Evidence specifically permits expert witnesses to rely upon exactly the kind of data used by Mr. Patterson. Furthermore, PAWC posits that the evidence which was not stricken herein fully supports the reasonableness of PAWC's purchase price. (PAWC Initial Brief at 25-26). Finally, the ALJ's statement that Mr. Patterson's opinion was based on a

¹² "Securities Exchange Commission"

“transaction price” that is not synonymous with “actual purchase price” is incorrect, according to PAWC. (PAWC Exc. at 30-33).

Criterion No. 8 concerns the effect of the acquisition on the rates of pre-acquisition customers. Section 1327(a)(8) requires a demonstration that “the rates charged by the acquiring public utility to its preacquisition customers will not increase unreasonably because of the acquisition.” PAWC contends that the ALJ, relying extensively on OCA witness Ms. Kraus’ testimony, concluded that PAWC failed to satisfy this criteria for the following reasons: (1) it improperly included acquisition-related savings in its analysis; (2) the alleged savings are less than the revenue requirement of the proposed acquisition adjustment; and (3) PAWC purportedly has been able to retain the savings for the past two years. (R.D. at 24-25).

PAWC argues, to the contrary, that Ms. Kraus’ contentions are wrong in a number of respects. (PAWC Initial Brief at 28-29; PAWC Reply Brief at 8-9). First, Ms. Kraus erred in asserting that acquisition-related savings were irrelevant because they are not specifically mentioned in Section 1327. Second, it is not relevant that the annual savings of \$3.4 million are less than the revenue requirement of PAWC’s claim of \$6.6 million. The relevant issue is whether the net rate impact (43.2 million), when spread over PAWC’s 600,000 pre-existing customers, is unreasonable. Finally, Ms. Kraus’ contention that PAWC padded its bottom line with acquisition savings since January 2002, is fanciful, and should be given no serious consideration. After it was granted its last rate relief in 1995, Citizens continued to add plant, continued to incur increased expenses, and its revenue requirement continued to grow over time. (Tr. at 1184). None of those additional costs are currently being recovered from customers. (PAWC Exc. at 33-34).

The OCA rejoins that the ALJ correctly rejected PAWC’s claim due to PAWC’s failure to prove four of the statutory criteria. (OCA R.Exc. at 16-21).

4. Disposition

Based on our review of the record evidence, we conclude that the ALJ correctly rejected PAWC's claim for an acquisition adjustment related to the purchase of Citizens in the amount of \$44,878,275 in rate base, and the associated amortization of \$1,150,725 per year for forty years. (R.D. at 16-25). PAWC attempted to portray the acquisition adjustment as two distinct claims. One was for the rate base increment associated with the portion of the purchase price in excess of the depreciated original cost of Citizen's assets, and the other was an expense amortization which PAWC argued was justified by acquisition-related savings. (PAWC Exc. at 25-35). However, the ALJ correctly concluded that "the amortization does not exist if there is no acquisition adjustment to amortize." (R.D. at 25 n12). In other words, the rate base addition and the amortization are statutorily, inextricably intertwined, and cannot, therefore, be viewed as two discrete claims. (OCA Reply Brief at 1-4).

We have carefully reviewed the ALJ's extensive discussion of the applicable criteria for inclusion of an acquisition in a utility's rate base, according to Section 1327(c) of the Code. Without reiterating that discussion, we find that PAWC has not met its burden of proving that the inclusion of Citizens in its rate base as an acquisition adjustment would be proper, based on PAWC's failure to prove four of the nine statutory criteria. (R.D. at 18-25). We note that the nine criteria of Section 1327(a) of the Code were written by the General Assembly in the conjunctive, not the disjunctive. Accordingly, we conclude that all nine criteria must be met by the acquiring public utility or else it is not entitled to include, in rate base, the amounts paid in excess of original cost less accrued depreciation. (R.D. at 16-25). Finding that PAWC has failed to satisfy the requisite burden of proof, its Exception on this issue is denied.

However, as a final note, we wish to commend PAWC for its acquisition of Citizens. We believe that these types of acquisitions are essential to provide smaller water

companies with the opportunity to take advantage of needed economies of scale. Prior to its acquisition, Citizens was an example of a water company clearly headed for trouble, as outlined by PAWC in its list of cited problems, including diminished capital investment and serious water quality issues. (PAWC Initial Brief at 17-19).

IV. Revenues

PAWC's final claim for an increase in annual operating revenue is \$59,246,157, which amount represents a decrease of \$5,700,376 from its originally filed claim. Only one issue remained in dispute before the ALJ regarding this claim.

A. Forfeited Discounts

1. Positions of the Parties

Initially, the ALJ objected to the use of the term "Forfeited Discounts," stating that he was disturbed by the use of this "misnomer" for what is commonly referred to as late payment charges. The ALJ advised PAWC to abandon the use of this term. (R.D. at 26, Footnote 11). PAWC's claim for the penalties that customers pay for the late payment of their bills (1.5 percent of the delinquent bill) is based upon the annualized effect of the ratio of the penalties to water sales as of December 31, 2002. The ratio developed from the figures for the historic test year was then applied to annualized future test year water sales revenue to develop the claimed "forfeited discounts" revenue component of the total claimed revenue requirement.

The OCA recommended that PAWC's late payment charge revenue claim be reduced by \$106,373, which proposed adjustment resulted from normalization of PAWC's late payment charge revenue for the last three calendar years as opposed to its projection based solely on results for 2002.

2. ALJ's Recommendation

The ALJ noted that normalization is a rate making technique used to smooth out the effects of an item of revenue or expense that occurs at regular intervals but in

irregular amounts. Clearly, customer late payment charges, arrived at by imposing a constant 1.5 percent charge, fluctuate from year to year based upon, among other things, overall water usage, billing frequency, and the state of the economy. As such, noted the ALJ, it is appropriate to apply normalization in this instance. Furthermore, a pattern of late payment is closely linked to uncollectible expense, in that customers who ultimately do not pay at all frequently begin their downward slide by paying late.

The ALJ noted that normalizing both brings some symmetry to the treatment of “payment troubled” customers to the benefit of PAWC’s other ratepayers. (R.D. at 26). As such, the ALJ concluded that, because late payment charge revenues are received every year, but in amounts that fluctuate due to various external factors, the OCA’s proposal that the Commission approve normalization, using the most recent three year history is sound. Accordingly, the ALJ recommended that the Commission approve the OCA’s proposed \$106,373 decrease in PAWC’s late payment charge revenue claim. (R.D. at 27).

3. Exceptions and Replies

PAWC excepts to the ALJ’s recommendation on this issue. PAWC avers that the use of a three-year average to calculate forfeited discount revenue is improper for all of the same reasons set forth in its Exception on the issue of uncollectible accounts, *infra*. PAWC further notes the ALJ’s criticism of the use of the term “forfeited discounts.” In Footnote 13, found on page 27 of the Recommended Decision, the ALJ stated that “forfeited discounts” is a term which “serves only to obscure and confuse,” and the ALJ furthermore advises PAWC to “abandon this term.” PAWC notes in this regard that it did not itself devise the term “forfeited discounts,” but that the term originated in the title given to the applicable revenue account by the NARUC in its *Uniform System of Accounts for Class A Water Utilities*, at 135.

The OCA rejoins that the ALJ correctly rejected PAWC's forfeited discounts claim as unreliable. (OCA R.Exc. at 24-25).

4. Disposition

Our review of the record evidence leads us to conclude that the ALJ's recommendation relative to this issue is reasonable and consistent with Commission precedent. It is well settled that normalization is a ratemaking technique used to smooth out the effects of an item or revenue or expense that occurs at regular intervals, but in irregular amounts. (R.D. at 53). Clearly, customer late payment charges, or forfeited discounts, arrived at by imposing a constant 1.5 percent charge fluctuate from year to year based upon, among other things, overall water usage, billing frequency, and the state of the economy. As such, normalization is properly employed for items such as late payment charges. Accordingly, for the above-outlined reasons, PAWC's Exception on this issue is denied.

V. Expenses

A. Security Costs

1. Positions of the Parties

PAWC's claim for security costs is divided into two parts. Based upon the deployment of security guards, the anticipated contract rates that will be in place by the end of the future test year, and the annual cost for security firm ADT's monitoring and related services, PAWC's claim for current security costs is \$3,536,179 per year. (PAWC Exhibit 3A Revised, at 48R). No active participant disputes this part of PAWC's claim.

PAWC's final claim for deferred security costs is in the amount of \$16,789,349, to be amortized over five years at the rate of \$3,357,870 per year. The deferred security costs were incurred during the period after September 11, 2001, through August, 2003. PAWC's treatment of these costs was addressed by this Commission in our Opinion and Order entered on July 24, 2003, in *Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Facility Protection Charge and to Use Deferred Accounting for Certain Security-Related Costs*, Docket Number R-00027983 (FPC Order).¹³ In the FPC Order, we ordered as follows:

5. That the Petition of Pennsylvania-American Water Company at Docket No. R-00027983 for approval to use deferred accounting for certain incremental security-related costs incurred between September 11, 2001, and the resolution of its next general base rate case at Docket No. R-00038304, is granted subject to the following conditions:

¹³ The OCA has appealed the FPC Order to the Pennsylvania Commonwealth Court, and PAWC has cross-appealed.

- a. That approval of deferred accounting treatment is not an assurance of future rate recovery of the claimed incremental security costs.
- b. That approval of deferred accounting treatment does not create a regulatory asset.
- c. That the issue of Pennsylvania-American Water Company's right to rate recovery of the claimed incremental security costs plus the issue of the reasonableness or prudent incurrence of the claimed incremental security costs shall be decided in Pennsylvania-American Water Company's general base rate case at Docket No. R-00038304.

(FPC Order Paragraph 5, at 9 10).

PAWLUG proposed that the entire \$16,789,349 claim for deferred security costs be denied, and it contended that approving this claim would constitute impermissible retroactive ratemaking. PAWLUG further argued that PAWC failed to prove that the deferred costs were prudently incurred. However, PAWLUG's Main Brief merely stated its position, and provided minimal supporting argument.

The OTS proposed that the entire \$16,789,349 claim for deferred security costs be denied. It contended that the approval of this claim would constitute impermissible retroactive ratemaking, and that PAWC has failed to prove that the deferred costs were prudently incurred.

The OCA also proposed that the entire \$16,789,349 claim for deferred security costs be denied. It argued that approval of this claim would constitute impermissible retroactive ratemaking. As a part of this argument, the OCA averred that the Commonwealth Court decision in *Philadelphia Electric Company v. Pennsylvania Public Utility Commission*, 502 A.2d 722 (Pa. Commw. Ct. 1985) (*PECO*) should control the

outcome herein. The OCA further argued that PAWC has failed to prove that the deferred costs were prudently incurred.

Additionally, the OCA argued that: (1) the relevant effects of the disaster of September 11, 2001, were already taken into account in PAWC's last general rate increase case; (2) PAWC "assumed the risk" of increased operations and maintenance expense by its actions in its last general rate increase case; (3) that allowing PAWC to recover the deferred expenses would negate the promised savings resulting from American's acquisition by Thames; and (4) that the proceeding that resulted in the FPC Order should control.

2. ALJ's Recommendation

The ALJ noted initially that, because of the prospective nature of rates, a rule against retroactive ratemaking has long been in force in the ratemaking arena. The rule against retroactive ratemaking generally prohibits a public utility commission from setting future rates to allow a utility to recoup past losses or to refund to consumers excess utility profits. *Popowsky v. Pennsylvania Public Utility Commission*, 642 A.2d 648 (Pa. Commw. Ct. 1994), *appeal denied*, *Popowsky v. Pennsylvania Public Utility Commission*, 673 A.2d 338 (Pa. Commw. Ct. 1996). However, the ALJ also noted that an exception to the rule against retroactive ratemaking has also been recognized where the expenses are extraordinary and nonrecurring. *Philadelphia Electric Company v. Pennsylvania Public Utility Commission*, 502 A.2d 722 (Pa. Commw. Ct.1985).

The ALJ further noted that, to qualify for the exception to the rule against retroactive ratemaking, the expense being considered must be unanticipated, extraordinary and nonrecurring. The tragic events of September 11, 2001, he opined, were unanticipated, but, he went on to say, if so, that lack of anticipation may have more to do with national hubris than with any legitimate basis for believing "it can't happen here". Because, in fact, the events of September 11, 2001, were unanticipated it does not follow

that they should have been, opined the ALJ, especially with respect to a company whose product is one of the very necessities of human life. The ALJ averred that it should be remembered that one of PAWC's responsibilities as a certificated public utility is to furnish and maintain safe service and facilities. This statutory obligation existed before September 11, 2001, and continues today. (R.D. at 31).

As to PAWC's claim for \$16,789,349 in deferred security costs, the ALJ concluded, for the above-outlined reasons, that allowance of recovery for that claim would constitute impermissible retroactive ratemaking. Consequently, the ALJ recommended that the claim be rejected in its entirety. Alternatively, the ALJ stated that he found that PAWC had not proven that the deferred security costs were reasonable, nor that they were prudently incurred. Therefore, on that alternate basis, the ALJ stated that PAWC's entire claim for deferred security costs should be rejected as unreasonable and imprudently incurred. (R.D. at 37).

3. Exceptions and Replies

PAWC excepts to the ALJ's recommendation on this issue, stating that the recommendation should be rejected because it does not comport with either the relevant law or the record evidence. As outlined above, PAWC's expense claim herein includes a request to amortize, over five years, security costs totaling \$16,789,349 (or \$3,357,870 per year) which were incurred during the period after September 11, 2001, through August 2003, and were deferred on PAWC's books pursuant to the Commission's FPC Order, *supra*. (PAWC Exc. at 11). PAWC further argues that, contrary to the ALJ's recommendation, its deferred security costs are precisely the kind of expense "result[ing] from an extraordinary and nonrecurring one-time event" that the Commission, with the agreement of the Commonwealth Court, has ruled is not impermissible retroactive or single issue ratemaking. *Popowsky v. Pennsylvania Public Utility Commission*, 695 A.2d 448 (Pa. Commw. Ct. 1997) (*PPL II*). (PAWC Exc. at 13-17).

PAWC contends that the Commission ruled, in the FPC Order, that PAWC should defer, for accounting purposes, its post 9/11 security expenses with the expectation that a final decision on the recovery of deferred and current security costs would be decided in the instant proceeding. (FPC Order at 10; R.D. at 37). In so doing, the Commission authorized and directed PAWC to present additional evidence on the issues which concerned it, namely, the “prudence and reasonableness of the pertinent expenditures, including what the expenses would have been if a competitive bidding procedure had been used.” (FPC Order at 7-8). PAWC argues that, in compliance with the FPC Order, it issued a state-wide RFP for security guards, identified the lowest qualified bidder, and calculated its security guard costs if the RFP contract rate were applied to those positions which had been filled by private contractors. (PAWC Statement 1-R at 8-10; PAWC Exhibit 1-A, Schedule 3). In addition, argues PAWC, it has submitted extensive evidence concerning the prudence of its actions and decisions to implement the security measures put in place after September 11, 2001. (PAWC Exc. at 18-21).

Both the OTS and the OCA rejoin that the ALJ properly determined that PAWC’s attempt to recover deferred security expenses must be disallowed as impermissible retroactive ratemaking. The OTS furthermore contends that PAWC’s reliance on *Popowsky* is misguided, because the facts in that case are readily distinguishable from the facts in the instant proceeding. (OTS R.Exc. at 4-7; OCA R.Exc. at 7-15).

4. Disposition

Initially, we commend PAWC for taking the comprehensive actions it implemented in response to the tragic events of September 11, 2001. The record evidence demonstrates that PAWC’s actions and costs incurred, with some exceptions as noted *infra*, were prudent and reasonable in light of the significance and ramifications of the event

which marked a unique moment in time and one which will forever change this country's view of what it considers necessary and appropriate security measures.

As outlined above, the ALJ recommended disallowance of PAWC's claim for \$16,789,349 (\$3,357,870 annually, amortized over five years) based on his belief that the costs constituted impermissible retroactive ratemaking and that PAWC had not demonstrated in the record that the security costs were reasonable or prudently incurred. We disagree.

The record is clear that PAWC took immediate and responsive action to seek timely recovery of its costs. Immediately following the events of September 11, 2001, PAWC did not seek to include the increased costs within its then pending rate case since the record was closed on September 20, 2001. Instead, PAWC chose to pursue those costs with the FPC proceeding. In that proceeding, the Commission determined, *inter alia*, that those costs should be deferred to the present rate case.

An exception to the rule governing retroactive ratemaking is that the expenses are extraordinary and nonrecurring. (*PECO, supra*, at 727-728; PAWC Initial Brief at 71). The ALJ found the costs to be extraordinary, but he did not conclude that the costs were nonrecurring. However, in our view, those costs do not constitute retroactive ratemaking because the circumstances arose from an extraordinary and nonrecurring event, namely, the terrorist attacks of September 11, 2001. That event was similar to those within the case law cited by PAWC, referred to as *PPL II, supra*.

In that case, the Commonwealth Court allowed the deferred Statement of Financial Accounting Standards No. 106 (SFAS 106) costs although they also had an ongoing component (similar to the ongoing nature of some of PAWC's security costs). In *PPL II*, the event triggering the changed circumstances was the change from cash to accrual accounting. In the same case, the Court also allowed deferred costs associated with nuclear

plant construction. There the utility's deferred "early window" costs, consisting of O&M expenses, depreciation and capital costs, incurred after the date of commercial operation but prior to recognition of the nuclear plant in the utility's rate base, were allowed in rates through an amortization even though these deferred costs also had an ongoing component in the test year. Accordingly, we agree with PAWC that *PPL II* controls and also that allowance of the deferred security costs, as adjusted below, is permissible.

We are convinced that the deferred costs do not connote retroactive ratemaking and that the costs were reasonable and prudently incurred. However, we find that the following adjustments are appropriate.

The first adjustment is for later competitive bidding. According to this adjustment, \$1,021,416 should be removed from PAWC's \$16,789,349 claim to reflect savings that would have been realized had PAWC put a competitively-bid contract into place six months after September 11, 2001. (PAWC Exc. at 23). Accordingly, PAWC's claim will be reduced to \$15,767,933.

The second adjustment is for not seeking federal grants. According to this adjustment, \$230,000 should be deducted from PAWC's claim because PAWC could have sought federal grants to defray the cost of U.S. Environmental Protection Agency-required Vulnerability Assessments. Accordingly, PAWC's claim will be reduced to \$15,537,933.

The third adjustment is to amortize over a longer period. The five-year amortization period should be expanded to ten years in order to mitigate the impact on customers' rates. Therefore, the amortization expense allowed annually will be \$1,553,793 over ten years.

Accordingly, PAWC's Exceptions on this issue are granted to the extent outlined above, and the recommended disposition of the ALJ is modified accordingly.

B. Salaries and Wages

1. Positions of the Parties

PAWC's claim for salaries and wages is \$44,320,416. (PAWC Exhibit 3A Revised at 41R, line 4). This figure was developed based upon its authorized employee positions for the future test year of 1,013. (PAWC Statement 6, at 5). Wage rates and salaries were annualized to reflect the effect of wage and salary increases granted or to be granted through June 30, 2004. Wage rates used in calculating the annualization adjustment are set forth in union contracts that are currently in effect and will remain in effect through June 30, 2004. (PAWC Statement 6, at 5-6). For salaried and non-union employees, PAWC projected increases of 3.5%, to become effective in April 2004, which are in line with the level of increases established by collective bargaining agreements with unionized employees. (PAWC Statement 6, at 6). Finally, to determine the portion of wage and salary costs charged to expense, PAWC deducted 19.05%, which is the proportion of direct labor costs charged to capital accounts during the historic test year (PAWC Statement 6, at 6).

The OCA recommended that PAWC's claim for salaries and wages be decreased by \$1,280,714. The OCA based its recommendation on a "vacancy rate" adjustment that reduces the employee complement to 1,006, which was the actual complement on December 31, 2002, and on an adjustment that completely eliminates the annualization of salary and wage increases that will become effective within six months after the end of the future test year, *i.e.*, by June 30, 2004.

2. ALJ's Recommendation

The ALJ noted that, as to the proposed "vacancy rate" adjustment, PAWC's witness Gilbert presented uncontradicted evidence that the seven vacant positions either had been or would be filled by December 31, 2003. (PAWC Statement 6R at 4, Tr. 1135-1138). The ALJ stated that, at any point in time, PAWC could have its full 1,013 complement, or some lesser figure such as the OCA's "vacancy rate" adjusted figure of 1,006. However, the uncontradicted evidence establishes that PAWC intends to, and will, staff at the full complement level. The ALJ opined that, with this evidence, it would be unjustifiable micromanaging of a privately owned company for the Commission to accept the OCA's proposed "vacancy rate" adjustment.

The ALJ furthermore noted that the Commission has previously approved claims which involve the annualization of salary and wage increases that will become effective within six months after the end of the future test year. The Commission has done this both in the case of PAWC, and for other utility companies. (R.D. at 38-39). The ALJ noted that, for unionized employees, the annualization includes changes resulting from collective bargaining agreements that will become effective between January 1 and June 30, 2004. (PAWC Statement 6, at 5-6). These expenses are, therefore, known and measurable. For non-union employees, PAWC included a 3.5% increase to become effective in April 2004, to track that of unionized employees. The Commission has previously held such a procedure reasonable, and allowed the expense.

Based on the above consideration, the ALJ recommended that the OCA's proposed adjustments to PAWC's claim for salaries and wages should be rejected. Therefore, according to the ALJ, the OCA's proposed adjustment, to decrease PAWC's claim for salaries and wages by \$1,280,714, should be rejected, and its claim for salaries and wages in the amount of \$44,320,416 should be allowed. (R.D. at 39).

3. Disposition

No Party excepts to the ALJ's recommendation on this issue. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

C. Service Company Charges

1. Positions of the Parties

PAWC's claim for Service Company charges, as initially presented, was based upon its historic test year expense level, increased by \$686,435 to reflect the transfer from PAWC to the Service Company of ten employees who, after the transfer, would provide service primarily to PAWC. (PAWC Exhibit 3A, at 54; PAWC Statement 4R at 4). Subsequently, PAWC revised its claim for Service Company charges to \$17,111,977, based upon more recent actual and budgeted information for the future test year. (PAWC Statement 4R, at 5; PAWC Exhibit 3A Revised, at 54R).

The OCA proposed three adjustments to PAWC's claim for Service Company charges. The first adjustment of \$1,015,673, would reduce PAWC's claim to the level of Service Company charges for the historic test year, on the grounds that it did not explain in detail the nature of the projected increase. The OCA's two additional proposed adjustments, of \$80,118 and \$58,409, were based on the use of 2003 allocation factors to allocate historic test year expense for the Call Center and Shared Services functions, respectively. (R.D. at 40).

2. ALJ's Recommendation

The ALJ referenced Section 2101 of the Code, 66 Pa. C.S. § 2101, as the standard for evaluating affiliated interest transactions in a rate case, as follows:

If the commission shall determine that the amounts paid or payable under a contract or arrangement filed in accordance with this section are in excess of the reasonable price for furnishing the services provided for in the contract, or that such services are not reasonably necessary and proper, it shall disallow such amounts, insofar as found excessive, in any proceeding involving the rates or practices of the public utility. In any proceeding involving such amounts, the burden of proof to show that such amounts are not in excess of the reasonable price for furnishing such services, and that such services are reasonable and proper, shall be on the utility.

66 Pa. C.S. § 2102(c).

The ALJ further noted that the standard for evaluating transactions with affiliated interests has long been held to require strict application. *Solar Electric Company v. Pennsylvania Public Utility Commission*, 9 A.2d 447 (Pa. Super. Ct. 1939).

The ALJ was of the opinion that PAWC never adequately explained the specific components underlying calculation of the \$686,435 claim related to the transfer of ten of its employees to the Service Company, nor its claim that \$329,238 of its increase reflects the costs that the Service Company incurs primarily for salaries and adding employees. The ALJ concluded that PAWC did not introduce sufficient evidence to support this claim when evaluated under a strict scrutiny standard, as is required. Therefore, he recommended that the OCA's proposed adjustments on this item should be adopted by the Commission, resulting in the Company's claim for this item being decreased by a total of \$1,154,200, and the allowance of the amount of \$15,957,777. (R.D. at 43).

3. Exceptions and Replies

PAWC excepts to the ALJ's recommendation on this issue, arguing that it is contrary to the evidence, and should be rejected. First, PAWC contends that the ALJ's criticism does not apply to the increase of \$686,435 to reflect the transfer of employees from PAWC to the Service Company. The salary amounts for those employees and the nature of their work before and after the transfer were well documented. Second, as to the additional increment of \$329,238, the ALJ's criticism is also misplaced. As PAWC has previously made clear, that figure is an estimate of the increase in Service Company fees from 2002 to 2003 based on anticipated increases in the Service Company's costs, which are predominantly payroll and payroll related expenses.

Third and finally, PAWC asserts that the OCA's proposed adjustment (\$138,527) to reduce Service Company charges below the historic test year level is particularly inappropriate. That adjustment was based on the use of 2003 allocation factors to allocate historic test year expenses for the Call Center and Shared Services functions, respectively. (OCA Statement 1, Schedule LKM-22, at 2). The mismatch is obvious. Using the changed allocation factor without recognition of the associated increase in the expenses being allocated would unfairly and improperly understate the actual costs. (PAWC Exc. at 36-37).

The OCA rejoins that, under the strict scrutiny and statutory standard which applies to all affiliated transactions, the ALJ correctly concluded that PAWC failed to prove its full claim of \$17,111,977 in Service Company charges. (OCA R.Exc. at 22-24).

4. Disposition

On review of this issue, we conclude that the ALJ correctly determined that under the strict scrutiny and statutory standards applicable to this type of transaction, PAWC has failed to prove its full claim of \$17,111,977. Section 2101 of the Code and *Solar, supra*. The ALJ concluded that as a result of PAWC's lack of support for its estimate of future test year Service Company expenses, the OCA was justified in using actual expense numbers from the historic test year. (R.D. at 42).

Additionally, we find that the evidentiary record reveals that PAWC failed: (1) to respond adequately to the discovery request for data underlying its claim for this item; (2) to substantiate its statement of "actual underlying data" to support its claim; and (3) to justify its Service Company expenses through any "reliable documentation." (R.D. at 42). We note that, in allowing the OCA's proposed adjustment for this item, we are still permitting PAWC to recover Service Company expenses in the amount of \$15,957,777. (R.D. at 43). Accordingly, for the above reasons, PAWC's Exception on this issue is denied.

D. Postage and Forms Expense

1. Positions of the Parties

In accordance with affiliated interest agreements approved by the Commission, PAWC provides services to American Water Resources (AWR) in connection with the Water Line Protection Program (WLPP) offered by AWR. Under that program, a customer pays a monthly fee to AWR and, in exchange, AWR will repair or replace the customer's service line if it is damaged or leaks. (PAWC Statement 7R at 5, OCA Exhibit Cross-examination 1).

The principal service provided by PAWC is billing and collection of AWR's monthly service fees, coordinating repair service when and if necessary, and coordinating AWR promotional mailings with an outside mailing house. For the services it provides, PAWC is compensated at rates scaled to the number of bills that contain AWR charges. The contract charges to AWR range from a maximum of \$0.55 cents per bill to a minimum of not less than \$0.10 per bill and are subject to annual increases. (OCA Exhibit Cross-examination 1).

PAWC increased its revenues by \$114,524 to reflect the amounts paid or to be paid by AWR. That amount is based on a projection of compensation from AWR for 2003 annualized at the level of monthly compensation for December 2003. (PAWC Statement 7R at 5; PAWC Exhibit 3A Revised, at 17A). Those charges cover not only the cost incurred by PAWC, but also include its profit. (PAWC Statement 4R at 2, Tr. 1221).

The OCA proposed an adjustment to reduce PAWC's expenses by \$320,427, to remove postage, forms and "advertising" expenses it alleges are associated with PAWC's "promotion" of the WLPP. (OCA Statement 1, at 14-16, Schedule LKM-12). The OCA's proposed adjustment consisted of 10% of PAWC postage and forms expense for all customer billing (\$211,414) plus an adder of (\$109,013) to represent a so-called "advertising" expense.

2. ALJ's Recommendation

The ALJ opined that the OCA's proposed adjustment, representing less than one-half of one percent of PAWC's original claim of approximately \$65 million in additional revenue, is both logically and legally flawed. The ALJ stated that, assuming, for the sake of argument, that the costs of printing one line regarding the WLPP on PAWC's bills were more than a few hundred dollars per year, the OCA nevertheless

adduced no evidence that it would, therefore, be logical to assume that an appropriate charge would be 10% of PAWC's postage and forms expense for all customer billing (\$211,414). The ALJ also stated that the OCA's proposal also ignored established precedent that any additional charges in situations such as this must be arrived at by determining the incremental cost to arrive at a reasonable number. (R.D. at 44).

The ALJ further noted that the OCA had similarly failed to produce persuasive evidence that PAWC President Ross' letter is an "advertisement" for AWR, as opposed to a public service message for PAWC's customers. (OCA Exhibit Cross-Examination 2). The ALJ also stated that, even assuming that the letter is an advertisement, the OCA has ignored Section 1316(a) of the Code, which deals with the recovery of advertising expenses. That Section provides, in pertinent part, is as follows:

- (a) **General rule.**—For purposes of rate determinations, no public utility may charge to its consumers as a permissible operating expense for ratemaking purposes any direct or indirect expenditure by the utility for political advertising. The commission shall also disallow as operating expense for ratemaking purposes expenditures for other advertising, unless and only to the extent that the commission finds that such advertising is reasonable and meets one or more of the following criteria:
- (1) Is required by law or regulation
 - (2) Is in support of the issuance, marketing or acquisition of securities or other forms of financing.
 - (3) Encourages energy independence by promoting the wise development and use of domestic sources of coal, oil or natural gas and does not promote one method of generating electricity.
 - (4) Provides important information to the public regarding safety, rate changes, means of

reducing usage or bills, load management or energy conservation.

- (5) Provides a direct benefit to ratepayers.
- (6) Is for the promotion of community service or economic development.

[Emphasis added].

President Ross' letter advises PAWC's ratepayers that "you own the water line that runs through your property between the street and your home." The ALJ stated that, doubtless, that information is news to many ratepayers. At Public Input Hearing sessions herein, a number of ratepayers expressed surprise and concern about this "new information."

The letter also advised PAWC's ratepayers of one way in which they could protect themselves from a potentially large expense if their service line¹⁴ should need repair. The ALJ opined that providing both of these pieces of information is a direct benefit to ratepayers. Therefore, the ALJ found that even if the pertinent letter were to be classified as an "advertisement," the associated reasonable costs would be recoverable by PAWC in its rates. The ALJ further found that the OCA's proposal to impose an adder of \$109,013 for this item was held to be unjustified. For those reasons, ALJ Weismandel concluded that the OCA's proposed adjustment to reduce PAWC's expenses by \$320,427 is contrary to both logic and the law, and, accordingly, should be rejected. (R.D. at 44-45).

3. Exceptions and Replies

The OCA excepts to the ALJ's recommendation on this issue, stating that that recommendation is based on two errors. The first error is the ALJ's failure to

¹⁴ "The service line extending from the curb, property line or utility connection to a point of consumption." (52 Pa. Code § 65.1).

properly apply the standards of Section 2101 of the Code, *supra*, and the second error is the wrongful application of Section 1316 of the Code, *supra*. With regard to Section 2102, the OCA argues that the ALJ erroneously failed to recognize this issue as associated with an affiliated transaction, thus requiring “strict scrutiny” pursuant to Chapter 21 of the Code, as he clearly and correctly did with respect to the Service Company charges, discussed *supra*. (R.D. at 40-41, 43-45). The OCA contends that the relevant activities are without question gratuitous services provided by PAWC on behalf of its for-profit affiliate AWR, pursuant to an affiliated interest agreement. As such, the costs of those activities require “strict scrutiny” by the Commission. (OCA Exc. at 17-19).

With regard to Section 1316(a), the OCA argues that the ALJ erroneously cited Section 1316(a)(5) as a basis for denying the OCA’s proposed adjustment to postage and forms expense, concluding that the promotional letters from Mr. Ross contain information which may be helpful to ratepayers and, as such, “provide a direct benefit to ratepayers.” (R.D. at 44-45). The OCA argues, on the other hand, that Section 1316 is not applicable to the instant issues, as it addresses “direct or indirect [advertising] expenditures *by the utility*,” not by the utility’s affiliate, as is the case here. The information provided in the promotional mailings, while it may be incidentally helpful to some ratepayers, relates 100% to the sale of an unregulated service, the WLPP. As such, it is not related to utility service, and Section 1316 does not apply. (OCA Exc. at 19-20).

PAWC rejoins that the ALJ correctly rejected the OCA’s proposed adjustment for this item, as “both logically and legally flawed.” (R.D. at 44). (PAWC R. Exc. at 9-12).

4. Disposition

We note that the OCA in its Exception relative to this issue offers no objection or response to the ALJ's principal finding that the magnitude of the proposed adjustment bears no conceivable relationship to the costs, if any, of the "promotional activities" in which PAWC is alleged to have engaged. As PAWC witness Freeston noted, such costs likely do not exceed a few hundred dollars per year, if that. (Tr. at 1222-1223). Moreover, PAWC is fully compensated for the services it provides to AWR under affiliated interest agreements approved by the Commission, which set forth rates of compensation scaled to the number of water bills issued by PAWC which contain AWR charges. (PAWC Statement 4-R, at 2; Tr. at 1221).

Also, what the OCA characterized as PAWC's "promotion" of the WLPP was described by the OCA's own witness as "a one-line message on the residential customers' bills informing them that the WLPP is available." (OCA Statement 1, at 15). Accordingly, for the above reasons, as well as those articulated by the ALJ, the OCA's Exception on this issue is denied.

E. Fuel Expense

1. Positions of the Parties

PAWC annualized the cost of fuel used to operate its fleet of vehicles based on fuel usage experienced during the historic test year and the latest available cost per gallon for each category of fuel. For retail gasoline purchases, which comprise approximately 70% of all its fuel, the fuel price used in the annualization was \$1.636 per gallon, based on data as of March 27, 2003. (PAWC Statement 6, at 11, PAWC Statement 6R at 8). The resulting figure was reduced by 19.05%, to reflect the portion of fuel

expense chargeable to capital accounts. PAWC's claim for the fuel cost chargeable to operating expense is \$1,057,621. (PAWC Exhibit 3A, at 55).

The OTS calculated PAWC's fuel expense in the future test year as \$1,144,463. It then proposed that, of this amount, \$926,443 should be allocated to future test year Operation and Maintenance (O&M) expenses, and the remaining \$218,020 to the corresponding Capital account. That represented a \$131,178 reduction to O&M expense, and a \$30,870 reduction to Capital. (OTS Statement Number 2, at 26., OTS Exhibit Number 2, Schedule 2, at 1 of 2). The OTS also recommended that PAWC utilize a three-year, normalized cost of gasoline and diesel fuel. (R.D. at 46).

The OCA proposed the use of a three-year average of fuel consumption in lieu of PAWC's actual historic test year consumption. Similar to the OTS, the OCA also recalculated PAWC's fuel expense by using average fuel prices specific to its areas of operations. The use of the OCA's methodology would result in a proposed adjustment decreasing PAWC's O&M expense for fuel by \$170,486. The OCA also recommended that PAWC utilize a three-year, normalized cost of fuel. (R.D. at 47).

2. ALJ's Recommendation

The ALJ opined that both the OTS and the OCA presented persuasive evidence that PAWC's calculation of fuel expense was flawed, and both correctly argued that fuel prices fluctuate widely and frequently. Consequently, the ALJ stated that PAWC utilized an improper methodology by focusing on the price on one date, March 27, 2003, in order to calculate fuel expense for the future. The better, and more realistic, method is to use some average price to account for the fluctuating nature of the price over time.

The OTS averaged fuel prices incurred by PAWC in 2000, 2001 and 2002. The OCA, on the other hand, used an average of only two data points, July 29, 2002, and July 29, 2003, for retail fuel prices and a spot price for bulk purchases. The resulting prices are as follows:

	OTS	OCA
Retail Purchases		
Gasoline	\$1.44	\$1.450
Diesel	1.62	1.520
 Bulk Purchases		
Pittsburgh – Gasoline	1.33	1.420
Pittsburgh – Diesel	1.45	1.540
Hershey – Gasoline	1.48	1.520
Hershey – Diesel	1.45	1.590

The ALJ noted that both the OTS and the OCA arrive at prices significantly lower than PAWC’s \$1.636 per gallon for retail gasoline, but within \$.01 per gallon of each other. The ALJ opined that the OTS’ use of a three-year normalized price of gasoline and diesel better accounts for the volatility in fuel prices than does the OCA’s two data points method. The ALJ stated that the OTS’ proposed adjustment to PAWC’s fuel expense, a \$131,178 reduction, is a better use of the concept of normalization than is the OCA’s proposed adjustment. Accordingly, the ALJ concluded that the OCA proposal to use a three-year average of fuel consumption in lieu of PAWC’s actual historic test year consumption should be rejected. The ALJ concluded that the OTS’ proposed adjustment of a decrease in PAWC’s fuel expense claim of \$131,178 should be adopted by the Commission. (R.D. at 47-48).

3. Disposition

No Party excepts to the ALJ's recommendation on this issue. Finding the ALJ's recommendation to be reasonable, appropriate and in accord with the record evidence, it is adopted.

F. Inflation Adjustment Expense

1. Positions of the Parties

PAWC claimed \$1,431,804 as an inflation adjustment expense. An inflation factor was applied to O&M expenses booked during the historic test year for which specific future test year adjustments were not made. (PAWC Statement 6R at 11-12, PAWC Exhibit 3A, at 56). PAWC used an inflation factor of 3.49%, based upon changes during the historic test year in three major inflation indices: the Consumer Price Index (CPI), the Producer Price Index (PPI), and the Gross Domestic Product Price Index (GDPPI). (Statement 6, at 12, Tr. at 1116-1117).

The OCA proposed that PAWC's entire inflation adjustment expense claim be denied, arguing that PAWC did not present specific evidence that each of the myriad O&M expenses that were not specifically adjusted actually increased at its calculated inflation rate of 3.49%. The ALJ noted that the Commission has addressed, and rejected, this argument in the past, and that it still makes no sense to argue that each of the unadjusted O&M expenses should be, or could be in a cost-efficient manner, analyzed separately. *Pennsylvania Public Utility Commission v. Pennsylvania-American Water Company*, 68 Pa. PUC 343 (1988). The ALJ concluded that the OCA's position remains untenable and that it should be rejected. (R.D. at 50).

The ALJ noted that the OTS, on the other hand, makes an excellent argument that recognizes the legitimacy of an inflation adjustment expense, but reduces the PAWC claim for this item. The ALJ concluded that the claim for inflation of \$1,431,804 is overstated, and should be rejected, and its inflation rate as used in this proceeding is stale and results in an inappropriate calculation of the projected expense. As presented in the OTS' witness Keim's testimony, an inflation rate of 1.43% is more representative of the expected future test year rate.

The OTS used the most current average Blue Chip Financial Forecasts to calculate a 1.43% GDPPI inflation rate for the future test year. Consequently, the OTS proposed a reduction in PAWC's claim for inflation expense of \$845,133, leaving an allowable claim of \$586,671. The OCA, however, proposed that PAWC's entire claim of \$1,431,804 for inflation expense be rejected.

2. ALJ's Recommendation

The ALJ noted that, to arrive at its inflation adjustment expense claim, PAWC deducted \$97,558,029 of specifically adjusted O&M expenses from the total historic test year O&M expenses of \$138,583,943, to arrive at \$41,025,914 of unadjusted expenses. It then calculated its inflation factor based on the average of the 2001 to 2002 increases in CPI, PPI, and GDPPI, arriving at an inflation factor of 3.49%. It then applied its inflation factor of 3.49% to its unadjusted O&M expenses of \$41,025,914 to reach its claimed inflation adjustment expense of \$1,431,804. (R.D. at 49).

The ALJ found that, at a time when the Wall Street Journal Prime Rate is 4.00%, the Federal Discount Rate is 2.00%, and the Federal Funds Rate is 1.00%, the Company's claimed inflation factor of 3.49% should not be accepted. Rather, the OTS' inflation factor of 1.43% is the proper factor to apply to the Company's unadjusted O&M expenses. Accordingly, the ALJ concluded that the OTS' proposed adjustment to the

Company's inflation adjustment expense claim should be accepted and its claim reduced by \$845,133, leaving an allowable claim of \$586,671. (R.D. at 51-52).

3. Disposition

No Party excepts to the ALJ's recommendation on this issue. Finding the ALJ's recommendation to be reasonable, appropriate and in accord with the record evidence, it is adopted.

G. Uncollectibles Expense

1. Positions of the Parties

To calculate uncollectible accounts expense, PAWC applied the ratio of actual historic test year write-offs to actual historic test year water sales revenue to the *pro forma* levels of water sales revenue under present rates. (PAWC Statement 6, at 13, PAWC Exhibit 3A Revised, at 61R). That calculation produced a claimed amount of \$4,789,698 in future projected uncollectible expense at current rates.

The OTS averred that, assuming that PAWC was granted its entire requested rate increase, its uncollectible expense would be \$5,669,575. The OTS proposed an adjustment to this figure by reducing it by \$1,341,387 to \$4,328,188. The OTS based its proposed adjustment on normalizing PAWC's uncollectible expense, using a three year historic analysis.

The OCA, on the other hand, used PAWC's uncollectible expense claim at present rates, \$4,789,698, but proposed a decrease of \$1,119,572, to arrive at \$3,670,126. Like the OTS, the OCA based its proposed adjustment on normalizing the Company's uncollectible expense, using a three year historic analysis.

2. ALJ's Recommendation

Both the OTS and the OCA argued that PAWC's claim for this item should be normalized, using a three year historic analysis. The ALJ stated that he agreed with that position. Specifically, the ALJ noted that PAWC's claim is based on data from only one year, the historic test year ending December 31, 2002. In opposition to the OTS' and the OCA's proposals to use a three year normalization, PAWC argued that this method "simply masks an upward trend in uncollectible expense." (PAWC Statement Number 6R at 13). The ALJ observed, however, that one year's numbers do not constitute a trend. A review of the years 2002, 2001, and 2000 reveals that this item, as a percent of revenues, fluctuated. (OCA Statement Number 1S, at 20, Tr. 1123-1124). (R.D. at 53).

The ALJ's review of the OTS and OCA testimony revealed that the OTS determined its adjustment based on a factor of 0.010377542 (OTS Exhibit No. 2-SR, Schedule 3) and that the OCA determined its adjustment based on a factor of 0.010402 (OCA Main Brief, Schedule LKM-11, Page 2 of 2). The OTS and the OCA relied upon data provided by PAWC to determine their three year average factors.

The ALJ accepted the OTS factor of 0.010377542, and he also stated that an adjustment to decrease the *pro forma* Uncollectible Expense by \$1,132,543 is necessary. That adjustment was determined by applying the uncollectible factor of 0.010377542 (OTS Exhibit No. 2-SR, Schedule 3) to the Water Sales of \$352,137,711 (PAWC Exhibit 3-A Revised, at 61R) yielding an uncollectible expense of \$3,654,324. Deducting PAWC's claim of \$4,786,867 (PAWC Exhibit 3-A Revised, at 61R) results in an adjustment to decrease PAWC's annualized expense by \$1,132,543. In addition, PAWC's claimed Uncollectible Factor of 0.013593737 (PAWC Exhibit 3-A Revised, at 61R) shall be rejected

in favor of the three year normalized factor of 0.010377542 for determining the revenue requirement. (R.D. at 53-54).

3. Exceptions and Replies

PAWC excepts to the ALJ's recommendation on this issue, arguing that adoption of the ALJ's recommended use of a three-year average would actually serve to introduce an anomaly. That is because only PAWC's 2002 experience fully captures the payment patterns of customers added through acquisitions which took place over that three-year period, particularly the acquisitions of the Coatesville and Citizens systems in 2001 and 2002, respectively. Also, PAWC contends that the use of an historic three-year average understates the current level of uncollectible expense, which has been increasing. (PAWC Statement 6-R, at 14; Tr. at 1134). The ALJ's rationale, namely, that PAWC's 2002 experience was anomalous and that the future test year level would be in line with an historic three-year average, is refuted by actual 2003 data, according to PAWC. (PAWC Exc. at 37-38).

On this issue, the OTS rejoins that the ALJ correctly determined that PAWC's uncollectible expense claim must be normalized, using a three-year historic analysis. (R.D. at 54). (OTS R.Exc. at 7-8). The OCA also responds on this issue, averring that the ALJ's determination thereon is reasonable, consistent with past Commission rulings, and should be adopted. (OCA R.Exc. at 24-25).

4. Disposition

We note that the ALJ adopted a three-year normalization for this item, because use of that normalization "smooth[es] out the effects of an item of revenue or expense that occurs at regular intervals but in irregular amounts." (R.D. at 53). This is precisely the case in the instant proceeding. A review of the record indicates that PAWC's

own data shows that its write-off ratio has varied from year to year. (PAWC Statement 1 at 8). The use of a three year historic analysis is sufficiently current to reflect present customer payment tendencies while providing enough historical information to account for any aberrations in PAWC's write-off activity. It also avoids the use of stale data. Accordingly, PAWC's Exception on this issue is denied.

H. Depreciation Expense

1. Positions of the Parties

PAWC claimed an annual depreciation expense allowance of \$56,053,431 based on depreciation calculations performed by its witness Spanos (PAWC Statement Number 10, PAWC Exhibit 10-B). In calculating PAWC's annual accrual, witness Spanos employed the straight-line remaining life method, which had been approved for use by PAWC and its corporate predecessors since 1985. Witness Spanos used depreciation techniques and methods of life estimation that are the same as those used to determine PAWC's annual accrual for ratemaking purposes for over a decade.

In addition, pursuant to the Commission's Regulations at 52 Pa. Code §§ 73.1-73.9, PAWC has filed Annual Depreciation Reports with the Commission since 1995 that provide detailed information about, among other things, the derivation of its depreciation rates, the determination of service lives, and the specific depreciation methods and techniques it employs. Based upon these reports, the Commission approved the depreciation rates used by the utility to record depreciation for accounting purposes. PAWC's last Annual Depreciation Report was filed in July, 2003. (R.D. at 55).

The OTS proposed an adjustment to reduce PAWC's claim for amortization of net salvage by \$2,008,255 (OTS Statement 4, at 4 - 5). The OTS calculated that amount based on a five-year average of salvage and cost for removal for the five-year

period 1998 through 2002 and, thereby, eliminated the future test year from the average and substituted data for the year 1998.

The OCA proposed an adjustment to reduce PAWC's claim for annual depreciation expense by \$1,893,601. The OCA relied on the application of a statistical formula to the Company's historical retirement data to obtain a statistical prediction of the survivor characteristics and expected life of each account.

2. ALJ's Recommendation

OTS witness Gruber explained the basis for the OTS' proposed adjustment, which eliminated the future test year from the five-year average of salvage and cost for removal, and substituted the five-year period of 1998 through 2002 as follows:

I have been advised by counsel that the Penn Sheraton Hotel v. Pennsylvania Public Utility Commission, 198 Pa. Superior Ct. 618 (sic) 184 A.2d 324 (1962) decision does not permit the reflection of the cost of net salvage in rates until it has actually been expended. The use of a projected amount would violate this principle.

(OTS Statement Number 4, at 5).

The ALJ opined that the OTS' interpretation of *Penn Sheraton* is erroneous, as evidenced by the fact that the Commission has, for many years, approved the use of projected future test year retirement data in calculating the five-year average of net salvage. (*Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Co.*, 71 PA. P.U.C. 593, 599 (1989)). The ALJ further noted that the *Penn Sheraton* decision predated the Commission's Regulations which allow the use of future test year data in rate proceedings and, therefore, that case did not address the use of data for a future test year. The ALJ, therefore, concluded that including the estimated net salvage related to

actual future test year retirements in the amortization of net salvage as of December 31, 2003, does not represent the kind of accrual prohibited by *Penn Sheraton*. Accordingly, the ALJ concluded that the OTS' proposed adjustment should be rejected. (R.D. at 57).

With respect to the OCA's proposed adjustment for this item, the ALJ noted that the mere application of a statistical formula to PAWC's historical retirement data to obtain a statistical prediction of the survivor characteristics and expected life of each account, without the application of informed engineering judgment, is not the Commission's preferred methodology. In the Commission's most recently litigated water utility general rate increase case, *Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company*, 219 PUR 4th 272 (2002), the Commission accepted the utility's life estimates, which were developed in the same manner and by the same expert witness as PAWC's in this case, and rejected the OCA's reliance on statistical analysis. (R.D. at 58). The ALJ rejected both the OTS' and the OCA's proposed adjustments to PAWC's annual depreciation expense claim as unjustified, and recommended that PAWC's entire claim should be allowed. (R.D. at 57-58).

3. Exceptions and Replies

The OCA excepts to the ALJ's recommendation on this issue, arguing that the ALJ should have accepted its proposed \$1.8 million adjustment to reduce the Company's claim for annual depreciation expense. The OCA argues that the ALJ has misapprehended the OCA's position on this issue. It does not dispute that the use of engineering judgment is appropriate, however, it disagrees that the engineering judgment applied by PAWC's witness was "informed" because the record evidence on PAWC's actual retirement experience and future plans, and the experience of comparable utilities, do not support those judgments. The OCA also disagrees with the ALJ's failure to recognize that the OCA's expert witness applied informed judgment, which is supported by the record evidence. (OCA Exc. at 2-8).

PAWC rejoins that the ALJ properly rejected the OCA's proposed adjustment for this item, based on Commission precedent. (PAWC R.Exc. at 1-4).

4. Disposition

The ALJ rejected the OCA's proposed adjustment for this item. The crux of the OCA's disagreement with the ALJ's recommendation here lies with the decision of PAWC's witness¹⁵ to consider only actuarially significant retirement experience in the statistical studies he performed. In contrast, Mr. Majoros, the OCA's witness, applied a statistical formula to all of the historical data, regardless of its actuarial significance.

We note that in the 2002 *Philadelphia Suburban* rate case, *supra*, we rejected an identical adjustment. (R.D. at 58). In that case, the utility's service life estimates were developed in the same manner, using the same methodology, and by the same expert witness, as PAWC's life estimates in this case. In short, the OCA's proposed adjustment is simply an attempt to re-open and re-litigate an issue which was conclusively decided against it less than two years ago. Our review of the issue in the context of the present case leads us to concur with the ALJ's determination that the OCA's proposed adjustment is unjustified and, as such, should be rejected. Accordingly, the OCA's Exception on this issue is denied.

¹⁵ Mr. John J. Spanos, Vice President of the Valuation and Rate Division of Gannett Fleming, Inc.

VI. Taxes

The ALJ noted that none of the active participants raised any issue directly regarding taxes. Consequently, the only changes to PAWC's original filing are a result of various adjustments in other areas of the filing, *e.g.*, revenues, expenses, return. PAWC's claims for State and Federal income taxes are set forth in PAWC Exhibit 3A Revised, at 69R-72R, as further revised in Appendix A. As shown on PAWC's Exhibit 3A Revised (at 70R, line 29) and Appendix A, PAWC's Federal income tax claim incorporates a reduction of \$2,639,000 for "consolidated tax savings." That amount was calculated using the same computation method proposed by the OTS in PAWC's 1991 rate case, and approved by the Commission in that and all subsequent cases (PAWC Statement 3 at 12). (R.D. at 59).

VII. Rate of Return

It is well settled that a public utility is entitled to an opportunity to earn a fair rate of return on the value of its property which is dedicated to public service. *Pennsylvania Gas & Water Company v. Pennsylvania Public Utility Commission*, 341 A.2d 239 (Pa. Cmwlth. 1975). This is consistent with longstanding decisions by the United States Supreme Court, including *Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 690-93 (1923), and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

A utility's rate of return has been defined as follows:

[t]he *rate of return* is the amount of money a utility earns, over and above operating expenses, depreciation expense and taxes, expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the 'return' is interest on long-term debt, dividends on preferred stock, and earnings on common stock equity. In other words, the return is that money earned from operations which is available for distribution among the capital. In the case of common stockholders, part of their share may be retained as surplus. The rate-of-return concept merely converts the dollars earned on the rate base into a percentage figure, thus making the item more easily comparable with that in other companies or industries.

(P. Garfield and W. Lovejoy, *Public Utility Economics*, (1964), at 116).

In determining what is a fair rate of return, we have traditionally considered the utility's capital structure in conjunction with its costs of debt, preferred stock, and common equity, as will be discussed below.

A. Capital Structure

The following is a summary of the Parties' positions regarding PAWC's capital structure:

Capital Structure	Company(1)	OTS(2)	OCA(3)
	%	%	%
Long-term Debt	56.82	56.82	52.15
Short-term Debt			4.67
Preferred Stock	.98	.98	.98
Common Equity	<u>42.20</u>	<u>42.20</u>	<u>42.20</u>
Total Capital	<u>100.00</u>	<u>100.00</u>	<u>100.00</u>

- (1) PAWC Exhibit 9-A, Schedule 1, at 1.
- (2) OTS Exhibit No.1, Schedule 1.
- (3) OCA Statement 5, Schedule JRW-1, at 1.

PAWC's position is based on the use of a capital structure at the end of the future test year, December 31, 2003. PAWC chose the capitalization ratios tabulated above because these ratios are indicative of those that it will maintain to finance its claimed rate base during the period that new rates will be in effect. The OTS accepts the capital structure proposed by PAWC because, according to the OTS, it protects the interests of all Parties to the instant proceeding and is, therefore, acceptable for ratemaking purposes.

The OCA alleges that PAWC's proposed capital structure does not accurately represent the source of its capital. Specifically, the OCA maintains that the record evidence as developed in this proceeding shows a consistent and ongoing pattern of short-term debt usage by PAWC to finance projects other than Construction Work in

Progress (CWIP), so that short-term debt must comprise a portion of PAWC's capital structure. (OCA Main Brief at 108).

The ALJ, noting that the Commission in prior cases rejected the identical arguments raised by the OCA, recommended the adoption of PAWC's proposed capital structure anticipated at the end of the future test year. Specifically, the ALJ indicated that, although PAWC utilizes short-term debt on an on-going basis, it has used, and will continue to use, short-term debt to support construction activities (CWIP as well as plant placed in service between rate cases), the acquisition of other water and wastewater systems, and other short-term borrowing needs. (R.D. at 61). It is the ALJ's position that the capital structure to be employed in this proceeding consists of 56.82% long-term debt, .98% preferred stock and 42.20% common equity. This is the capital structure that PAWC will employ at the end of the future test year, December 31, 2003, and comports with the position of the OTS.

We note that no Party excepted to the recommendation of ALJ Weismandel on the capital structure issue. We are persuaded that PAWC has demonstrated in the record that it uses its non-CWIP short-term debt for a number of purposes other than to finance its rate base, such as the support of plant placed in service between rate cases and to finance the acquisition of other water and wastewater systems and to meet other short-term borrowing needs. Moreover, in *Pennsylvania Public Utility Commission v. Pennsylvania Suburban Water Company*, 219 PUR4th.272 (2002), we rejected a virtually identical proposal by the OCA to include short-term debt in the capital structure. We, therefore, adopt the recommendation of the ALJ regarding capital structure.

B. Cost of Debt

Regarding its cost of debt, PAWC's claimed cost of long-term debt for this proceeding is 6.15 percent. (PAWC Exh. 9-A at 1). No Party contested this cost rate.

(OTS Statement 1 at 8; OCA Statement 5, Schedule JRW-1 at 1). As a result, and finding it reasonable, appropriate and in accord with the evidentiary record, we will adopt the ALJ's recommendation of the 6.15 percent cost of long-term debt proposed by PAWC. Since we recommend the exclusion of short-term debt from our recommended capital structure, we shall accordingly exclude the 1.42 percent cost of short-term debt recommended by the OCA.

C. Cost of Preferred Stock

PAWC's claimed cost of preferred stock for this proceeding is 8.08 percent. (PAWC Exh. 9-A at 1). No Party contested this cost rate. (OTS Exh. 1, Schedule No. 1; OCA Statement 5, Schedule JRW-1 at 1). As a result, we will adopt the ALJ's recommendation to adopt the 8.08 percent cost of preferred stock proposed by PAWC since it is reasonable and in accord with the evidence.

D. Cost of Common Equity

The following table summarizes the cost of common equity claims made, and methodologies used, by the Parties in this proceeding:

<u>Methodology</u>	<u>Company(1)</u>	<u>OTS(2)</u> %	<u>OCA(3)</u> %
Discounted Cash Flow Range (DCF)	10.53-12.09	9.25-10.03	8.4
Risk Premium Model (RPM)	11.75-12.00		6.7
Capital Asset Pricing Model (CAPM)	14.69-15.39		
Comparable Earnings Method (CEM)	14.20		
Recommendation	<u>11.75</u>	<u>10.00</u>	<u>8.40</u>

- (1) Company Statement 9, at 4
- (2) OTS Statement 1, at 19
- (3) OCA Statement 5, at 29

1. Positions of the Parties

PAWC, after applying four of the above cited and widely recognized market-based models to market data for its barometer group of water utilities, and its barometer group of gas distribution utilities, arrived at an 11.75 percent cost of common equity recommendation. PAWC’s water barometer group consists of three water utilities with actively traded common stock. These water utilities appear in the Water Utility Industry section of the *Value Line Investment Survey*. (PAWC Exh. 9-A, Schedule 3 at 2). PAWC’s gas barometer group consists of ten gas distribution utilities with actively traded common stock which engage in similar business lines. These gas distribution utilities appear in the Gas Distribution Utility Industry section of the *Value Line Investment Survey*. (PAWC Exh. 9-A, Schedule 3 at 7).

PAWC contended that the above cited common equity cost rate models, used *in tandem*, are based on the premise that no one method or model of the cost of equity can be applied in an isolated manner. According to PAWC, informed judgment must be used to take into consideration the relative risk traits of the firm. It is for this

reason that PAWC uses more than one method to measure its cost of common equity. (PAWC Statement 9 at 22). It should be noted that PAWC's recommended range of DCF common equity cost rates of 10.53 to 12.09 percent, calculated from its water and gas groups, include 78 and 83 basis point upward adjustments respectively, to *reconcile* the divergence between the market and book value of the common equity. (PAWC Statement 9 at 36).

Specifically, PAWC calculated recent six-month average dividend yields of its barometer groups which it basically increased by (1+.5) the respective growth rates to reach a 3.75 percent dividend yield for its water group and a dividend yield of 5.01 percent for its gas distribution group. The 3.75 percent dividend yield + 6.00 percent growth rate = 9.75 percent DCF result is subsequently increased by 78 basis points to 10.53 percent for its water group. The 5.01 percent dividend yield + 6.25 percent growth rate = 11.26 percent DCF result is subsequently increased by 83 basis points to 12.09 percent for its gas distribution group.

The average of PAWC's DCF results (10.53 percent + 12.09 percent/2 = 11.31 percent) and its risk premium results (11.75 percent + 12.00 percent/2 = 11.88 percent) approximates PAWC's recommended 11.25 percent to 11.75 range of market based cost rates of common equity, excluding comparable earnings which is not market based. We note that PAWC also excludes its CAPM calculation in formulating its recommendation. From this range, PAWC chooses 11.75 percent, which recognizes the alleged exemplary performance of PAWC's management. (PAWC Statement 9 at 4-5).

The OTS relied solely on the DCF method to arrive at its 10.00 percent recommended cost rate of common equity. The OTS applied the DCF method to its barometer group of water utilities whose stock is actively traded. The OTS' barometer group consists of seven publicly traded water utilities that have at least two sources of analysts' forecasts of earnings growth, and are not the announced subject of an

acquisition. (OTS Statement 1 at 11). Specifically, the OTS averaged the spot dividend yield and the 52-week average dividend yield of its barometer group to reach a 3.28 percent composite dividend yield. It then added its 6.75 percent growth rate recommendation to the 3.28 percent dividend yield to reach a 10.03 percent DCF recommendation for its barometer group.

Next, the OTS averaged the spot dividend yield and the 52-week average dividend yield of PAWC's three water utility barometer group, which is a subset of the aforementioned OTS group, to reach a 3.45 percent composite dividend yield. The OTS then added its 5.75 percent growth rate recommendation to the 3.45 percent dividend yield to reach a 9.20 percent DCF recommendation for PAWC's barometer group. The OTS chose 10.00 percent as its recommended cost rate of common equity from its recommended range of 9.25 percent to 10.00 percent. OTS reasoned that since PAWC's common equity ratio is estimated at only 42.20 percent as of December 31, 2003, as opposed to the 46.70 percent and 44.96 percent common equity ratios of its barometer groups, PAWC faces more financial risk than either of the groups. (OTS Statement 1 at 19.).

The OCA relied upon the DCF method and the Risk Premium method to produce common equity cost rates of 8.4 percent and 6.7 percent, respectively. The OCA then chose 8.4 percent as its common equity cost rate recommendation because it primarily employs the DCF model to estimate its common equity cost rate. (OCA Statement 5 at 29). Specifically, the OCA employed the latest 2-month composite dividend yield of 3.3 percent to develop the DCF dividend yield for its barometer group. Next, in order to account for dividend growth in the period in which rates will be in effect, the OCA adjusted the 3.3 percent dividend yield by one-half the expected dividend growth rate of 5.00 percent or 2.50 percent. The OCA's DCF result is thereby 3.3 percent x 1.025 + 5.00 percent = 8.4 percent. (OCA Statement 5 at 24).

To develop its Risk Premium result, the OCA used the risk-free Treasury securities over an 18-month period to arrive at a rate of 4.0 percent as the risk-free rate. The OCA then derived a risk premium range from the data of its barometer group, which ranged from 1.96 percent to 4.10 percent. Using the average of 2.69 percent, the OCA concluded that the indicated rate of return of its risk premium approach is 4.0 percent + 2.69 percent = 6.7 percent. As cited above, the OCA subsequently recommended an 8.4 percent common equity rate of return based on its DCF methodology. (OCA Statement 3 at 29).

2. ALJ's Recommendation

Based on his review, evaluation and analysis of the record, regarding the cost of common equity, the ALJ recommended that we afford PAWC the opportunity to earn a rate of return on common equity of 10.0 percent. The ALJ was of the view that PAWC has not met its burden of proof that a 78 basis point adjustment is appropriate to compensate PAWC for a market price per share to book value per share ratio (M/B) in excess of 1.0. Additionally, the ALJ did not agree with PAWC's proposal for a positive adjustment factor in recognition of the exemplary performance of its management.

3. Exceptions

PAWC excepts to the ALJ's recommended 10.0 percent common equity cost rate, contending that such a recommendation is exclusively based upon the 10.0 percent DCF result of the OTS. As such, PAWC argues that PAWC's cost rate for common equity is substantially understated for primarily three reasons.

First, PAWC argues that we have been considering other common equity methodologies in the quarterly earnings reports submitted by Pennsylvania's

jurisdictional utilities and in establishing the cost of equity for Distribution System Improvement Charge (DSIC) purposes. (PAWC Exc. at 5).

Second, PAWC contends that the ALJ erred in rejecting the previously Commission-approved leverage adjustment. PAWC pointed out that we approved the leverage adjustment in *Pennsylvania Suburban, supra*. Specifically, the leverage adjustment adjusts the calculated common equity cost rate in order to compensate PAWC for the application of a market based cost rate of common equity to a book value common equity ratio. PAWC argues that since its book value common equity ratio of 42.20 percent is significantly less than its 62 percent market based common equity ratio, which reflects a market based common equity cost rate such as 10.00 percent, the equity return rate should be increased when applied to the 42.20 percent book value common equity ratio. The ensuing basis point premium compensates PAWC for the financial risk differential between the book value and the market based common equity ratios. (PAWC Exc. at 5-9).

Finally, PAWC argues that the ALJ erred by declining to adopt a positive adjustment factor to reflect its exemplary management performance. PAWC disagrees with the ALJ's characterization of its management as being inefficient because of the frequency of its rate filings. PAWC has filed eleven general rate increases in sixteen years, but it notes that in an attempt to stem the tide of base rate filings, it pioneered the development of the DSIC. PAWC continues that since the implementation of the DSIC in 1996, it has only filed one rate case every two years which, it alleges, comports with other Pennsylvania major water utilities. Finally, PAWC cites its acquisition of troubled systems, its low income customer assistance, and its responsiveness to customer concerns as reasons that it should be awarded an equity premium for exemplary management performance.

In its Reply Exceptions, the OTS rejoins that the Commission has relied upon the DCF analysis and informed judgment as the appropriate means of measuring the cost of common equity. *See e.g., Pennsylvania Public Utility Commission v. Pennsylvania-American Water Company*, Docket No. R-00016339, Order entered January 25, 2002, *Pennsylvania Public Utility Commission v. City of Lancaster*, 197 P.U.R.4th 156 (1999), *Pennsylvania Public Utility Commission v. Consumers Pennsylvania Water Company-Roaring Creek Division (Roaring Creek)*, 87 Pa. P.U.C. 826 (1997), *Pennsylvania Public Utility Commission v. PECO Energy Company*, 87 Pa. P.U.C. 184, 212-213 (1997). (OTS R.Exc. at 4).

The OTS argues that PAWC's contention that since we review the results of more than one method in establishing the cost of equity for the DSIC, we must therefore, do the same in a base rate case, is entirely without merit. Specifically the OTS reasons that DSIC proceedings merely afford PAWC limited rate relief, based on infrastructure issues, between base rate proceedings. Base rate proceedings, on the other hand, require analytical scrutiny, which is only afforded by the DCF methodology. (OTS R.Exc. at 11-12).

In its Reply Exceptions, the OCA cites *Pennsylvania Public Utility Commission v. Pennsylvania Suburban Water Co.*, 219 PUR4th 272 (2002) to rebut PAWC's contention regarding our prior consideration of other cost of common equity methods. The OCA argues that in *Pennsylvania Suburban, supra*, we continued to endorse the DCF method as the preferred common equity cost rate methodology. (OCA R.Exc. at 2).

The OTS rejoins that the ALJ properly reasoned that no market to book or financial risk adjustment to the DCF findings is necessary to determine an appropriate cost of common equity. Specifically, the OTS submits that any unwarranted financial risk adjustment to compensate PAWC for the application of a market derived common

equity cost rate to a book value common equity ratio will create the need for an even larger proposed adjustment in subsequent proceedings. For example, the OTS notes that in PAWC's last base rate proceeding, it indicated the need for a 60 basis point adjustment while the request in this case is for a 78 basis point adjustment.

Finally, the OTS rejoins that in its attempt to use a market based capital structure for his financial risk adjustment, PAWC's witness neglected to adjust the debt portion of the capital structure to account for the market value of each issue. (OTS R.Exc. at 14.).

The OCA excepts to the ALJ's recommended cost of common equity of 10 percent and, accordingly, submits that the common equity cost rate should be 8.4 percent. The OCA argues that the ALJ's 10.00¹⁶ percent recommendation is excessive in light of current economic conditions. Specifically, the OCA submits that the ALJ erred by adopting a 6.75 percent growth rate for use in the recommended DCF analysis. The OCA alleges that the aforementioned DCF growth rate is excessive because the weight of the evidence favors the much lower growth rate of 5.00 percent proposed by the OCA. The OCA supports its resultant 8.4 percent cost of equity position by arguing that the lower rate is justified because the record shows that capital costs are the lowest in 40 years. For example, the OCA points to record evidence that rates on Treasury bills have dropped previously from 1995 to 2002, from 5.51 percent to 1.62 percent, respectively. (OCA Exc. at 11-12).

PAWC rejoins that the OCA's rejection of the 6.75 percent DCF growth rate recommended by the ALJ is misplaced. PAWC argues that the OCA's 5.00 percent

¹⁶ We note that that the ALJ basically adopted OTS' DCF result of 10.03 percent which is composed of a 3.28 percent dividend yield and a 6.75 percent growth rate. The OCA, on the other hand, recommends an 8.4 percent DCF result which is composed of a 3.38 percent dividend yield and a 5.00 percent growth rate.

recommended growth rate may have been a reasonable estimate several years ago. However, PAWC asserts that investors clearly have bid up the price of water utility stocks, and hence have accepted reduced dividend yields in anticipation of higher future growth. This is why, according to PAWC, there is no merit in the OCA's mixing of current lower dividend yields of water utility stocks with the former low dividend and earnings growth rates which were previously coupled with higher dividend yields. In other words, PAWC submits that investors are less concerned with dividend yields than they are with earnings growth and the associated stock price appreciation. (PAWC R.Exc. at 5-6).

4. Disposition

Historically, we have primarily relied on the DCF methodology in arriving at our determination of the proper cost of common equity. We have, in many recent decisions, determined the cost of common equity primarily based upon the DCF method and informed judgment. *See Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company*, 71 Pa. PUC 593, 623-632 (1989); *Pennsylvania Public Utility Commission v. Western Pennsylvania Water Company*, 67 Pa. PUC 529, 559-570 (1988); *Pennsylvania Public Utility Commission v. Roaring Creek Water Company*, 150 PUR4th 449, 483-488 (1994); *Pennsylvania Public Utility Commission v. York Water Company*, 75 Pa. PUC 134, 153-167 (1991); *Pennsylvania Public Utility Commission v. Equitable Gas Company*, 73 Pa. PUC 345-346 (1990).

We determine that the DCF method is the preferred method of analysis to determine a market based common equity cost rate. Although we agree with the ALJ's adoption of the 10.00 percent market based common equity cost rate as a starting point, we find merit in the financial risk adjustment proposed by PAWC. We note that, in *Lower Paxton Township v. Pennsylvania Public Utility Commission*, 317 A.2d 917 (Pa. Cmwlth. 1974) (*Lower Paxton Township*), the Commonwealth Court recognized that this

Commission may consider such factors that affect the cost of capital such as the utility's financial structure, credit standing, dividends, risks, regulatory lag, wasting assets and any peculiar features of the utility involved.

We are persuaded by PAWC's reasoning that a financial risk adjustment is necessary to compensate PAWC for the application of a market based cost of common equity to a book value common equity ratio. However, we find that PAWC's recommended 78 basis point adjustment is excessive. As we determined in PAWC's prior base rate case, at Docket No. R-00016339 (Order entered January 25, 2002), a 60 basis point adjustment to the market based common equity cost rate will compensate PAWC for the aforementioned application of a market based common equity cost rate to a book value common equity ratio.

PAWC indicates that a preliminary DCF calculation, which is computed using the market price of PAWC's common stock, should be adjusted to reconcile the divergence between market and book values. The indicated cost of common equity of 10 percent, therefore, reflects the barometer group's average *market* capitalization, which includes a common equity ratio of 62 percent as opposed to the recommended common equity ratio of 42.20 percent which reflects significantly more financial risk. PAWC further indicates that, when investors value a company's common stock, they employ actual market capitalization data and not book data although book capitalization is employed for ratemaking purposes.

We agree that a financial risk adjustment is proper. Accordingly, we find that, in order to place the computed DCF result on a consistent basis with the greater financial risk, inherent in PAWC's book value-derived capital structure ratios, a 60 basis point financial risk adjustment above our 10 percent representative DCF common equity cost rate recommendation is warranted.

We further conclude that the record in this proceeding does not support any further upward adjustments. Under the circumstances, we find that the cost of common equity of 10.60 percent is reasonable, appropriate and in accord with the record evidence.

The following table summarizes our determinations concerning PAWC's capital structure, cost of debt, cost of preferred stock, and cost of common equity, as well as the resulting weighted costs and overall rate of return:

<u>Capital Structure</u>	<u>Ratio</u>	<u>Cost Rate</u>	<u>Weighted Cost</u>
Debt	56.82%	6.15%	3.50%
Preferred Stock	0.98%	8.08%	.08%
Common Equity	<u>42.20%</u>	10.60%	<u>4.47%</u>
	<u>100.00%</u>		<u>8.05 %</u>

VIII. Miscellaneous

A. **Low Income Programs**

1. **Positions of the Parties**

PAWC's *H2O-Help to Others Program*® is an integrated three-part program that: (1) helps customers meet current water bills through assistance grants administered by the Dollar Energy Fund; (2) reduces their rates for service through a low-income customer charge discount; and (3) helps reduce their consumption by furnishing, free of charge, conservation devices and installation assistance as well as minor plumbing repairs to stop leaks. (PAWC Statement Number 4, at 17). In this case, PAWC proposed to further expand the benefits available to eligible low-income customers by increasing the low-income customer discount from 20% to 50%. (PAWC Statement Number 4, at 17).

Based on the customer service charge of \$11.50 agreed to in the Stipulation, the savings to an enrolled customer will be \$5.75 per month, or \$69 per year. PAWC also continued to maintain its hardship fund administered by the Dollar Energy Fund at a minimum level of \$120,000.¹⁷ CEO proposed that PAWC be ordered to increase its guaranty of a minimum level of funding for its hardship fund from \$120,000 to \$300,000.

¹⁷ If voluntary customer donations do not reach this level, the Company makes a "below-the-line" charitable contribution sufficient to bring the fund to at least \$120,000.

2. ALJ's Recommendation

The ALJ noted initially that, as a creature of statute, the Commission has only those powers which are expressly conferred upon it by the Legislature and those powers which arise by necessary implication. *Feingold v. Bell of Pennsylvania*, 477 Pa. 1, 383 A.2d 791 (1977), *Rogoff v. Buncher Company*, 395 Pa. 477, 151 A.2d 83 (1959). The ALJ further observed that the Commission is not empowered to act as a super board of directors for the public utility companies of this state. *Metropolitan Edison Company v. Pennsylvania Public Utility Commission*, 437 A.2d 76, 80 (Pa. Commw. Ct. 1981). (R.D. at 77).

Finally, the ALJ observed that, in *United States Steel Corporation v. Pennsylvania Public Utility Commission*, 390 A.2d 865 (Pa. Commw. Ct. 1978), the Court made another observation, which disposes of CEO's proposed adjustment in this case, when it stated as follows:

[T]here is nothing in Pennsylvania law which now empowers the Commission to require one customer simply to pay another's utility bill; and, as we have mentioned, the utility may not and could not for long be required to provide such subsidy out of its capital.

United States Steel, 390 A.2d 871.

The ALJ thus concluded that the implementation of CEO's proposal would require exercise of the legislative powers of taxation and appropriation. These powers are neither expressly conferred upon the Commission by the Legislature nor do they arise by necessary implication. Quite simply, the Commission is without authority to require PAWC, or any public utility, to either make or increase charitable contributions derived solely from shareholder funds and kept entirely "below-the-line" for rate making purposes.

The ALJ recommended that PAWC's voluntary proposal to expand the benefits available to eligible low-income customers by increasing the low-income customer discount from 20% to 50% be approved. He also recommended, based on the above-outlined reasons, that CEO's proposed adjustment be rejected. (R.D. at 77-78).

3. Disposition

No Party excepts to the ALJ's recommendation on this issue. Finding the ALJ's recommendation relative to this issue to be reasonable, appropriate and in accord with the record evidence, it is adopted.

B. Public Input Hearing

The Public Input Hearings conducted in this case were numerous in sessions and also very geographically diverse. Those instances where customers raised concerns about service related issues, viz., Bushkill, Pike County and Tobyhanna, Monroe County; Wyomissing, Berks County; Nazareth, Northampton County, all involved systems recently acquired by PAWC. Those systems had pre-existing problems. However, PAWC has begun to address those problems.

For example, PAWC has begun the designing and permitting process for a centralized treatment facility at the point of interconnection between itself and the Reading system and has also begun to address the water quality issues in Exeter Township raised at the Public Input Hearing sessions in Wyomissing, Berks County. (Company Statement 13-R at 7-8). Similarly, PAWC's witness Kaufman described in detail the extensive work that has been done and will continue to be done to bring the former LP system up to PAWC's standards. (PAWC Statement 14-R at 9 - 10). Although this will be an extensive and long-term project, PAWC has worked diligently to solve the problems that existed at the time of acquisition. (R.D. at 78-79).

PAWC also addressed concerns raised by APCPPOA and SCECA. (PAWC Statement 14-R at 6-7, Tr. at 1440 – 1448). PAWC will continue its regular meetings with APCPPOA and will initiate a similar program of regular meetings with SCECA. When, in the course of the Public Input Hearing sessions, customer-specific problems were raised, PAWC investigated the matter thoroughly and took prompt corrective action where appropriate. (PAWC Statement 1RS, PAWC Statement 13-R, at 10-12, PAWC Statement 14-R at 12-17).

Finally, PAWC agreed to the entry of a Commission Order regarding the continuation of meetings with APCPPOA and the commencement of similar meetings with SCECA. (Tr. at 1449 – 1450). The ALJ recommended that the final Order in this case contain such a provision and, finding that recommendation to be reasonable, appropriate, and in the public interest, we will adopt it. (R.D. at 79).

IX. Rate Structure and Rate Design

The Stipulation concerning Rate Structure and Rate Design is appended to the Recommended Decision of ALJ Weismandel as an Appendix. All fourteen active participants in this general rate case agreed to and were signatories to the Stipulation regarding rate structure and rate design. The ALJ noted that the active participants represented every category of persons or entities that may be affected by the rate structure and rate design adopted in this proceeding. (R.D. at 79). The ALJ determined that the Stipulation is reasonable, appropriate and in the public interest and, therefore, recommended its adoption. (R.D. at 80).

We have carefully reviewed the Stipulation in light of the record evidence. We agree with the ALJ that the adoption and approval of the Stipulation will serve to foster and promote the public interest. We find that the Stipulation provides the basis for a reasonable rate structure for purposes of this proceeding and appropriately balances the interests and concerns of the stipulating Parties as expressed in the testimony and other evidence presented on the record. In addition, we recognize that adoption and approval of the Stipulation will avoid the need for extensive briefing of the numerous and complex issues raised by the Parties with regard to cost of service, rate structure and rate design and will ultimately inure to the benefit of the ratepayers.

Accordingly, the Stipulation concerning Rate Structure and Rate Design is adopted.

X. Conclusion

We have carefully reviewed the record as developed in this proceeding, including the ALJ's Recommended Decision and the Exceptions filed thereto. PAWC initially requested an overall revenue increase of \$64,946,533, or about 18.2%. (PAWC Initial Brief at 3). With adjustments to the cost of debt and in various other areas, PAWC's final claim here, as of its correspondence dated October 20, 2003, and attached tables, was for a revenue increase of \$59,246,159, or about 16.6%. The ALJ recommended an allowable revenue increase in the amount of no more than \$26,174,845. (Table 1 attached to the R. D.). The ALJ also recommended that the increase be spread among the rate classes in accordance with the Stipulation which had been reached thereon, a copy of which was attached to the Recommended Decision.

Based on our review, evaluation, and analysis of the record evidence, we have adopted different conclusions than the ALJ in two key areas by allowing the deferred security costs, as adjusted herein, and by concluding that a cost of common equity of 10.6% is reasonable, appropriate and in accord with the record evidence. The resulting allowable revenue increase is \$34,314,15, or about 9.5%. As such, the Exceptions filed by the various Parties hereto, are granted or denied, as discussed *supra*. Accordingly, the ALJ's Recommended Decision is adopted only to the extent that it is consistent with this Opinion and Order.

XI. ORDER

THEREFORE; IT IS ORDERED:

1. That the Exceptions filed by the Office of Consumer Advocate on December 17, 2003, to the Recommended Decision of Administrative Law Judge Wayne L. Weismandel herein, are denied.
2. That the Exceptions filed by Pennsylvania-American Water Company on December 17, 2003, to the Recommended Decision of Administrative Law Judge Wayne L. Weismandel herein, are granted or denied, consistent with this Opinion and Order.
3. That the Recommended Decision of Administrative Law Judge Wayne L. Weismandel herein, issued on December 2, 2003, is adopted only to the extent that it is consistent with this Opinion and Order, and rejected in other regards.
4. That the Pennsylvania-American Water Company shall not place into effect the rates contained in Supplement 141 to Tariff Water–Pa. P.U.C. No. 4, which have been found to be unjust, unreasonable and, therefore, unlawful.
5. That the Pennsylvania-American Water Company is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing rates, provisions, rules and regulations, consistent with the findings here, to produce revenues not in excess of \$392,181,547.
6. That Pennsylvania-American Water Company's tariffs, tariff supplements, or tariff revisions may be filed upon less than statutory notice, and pursuant

to the provisions of 52 Pa. Code §§ 53.31 and 53.101, may be filed to be effective for service rendered on and after the date of entry of the instant Opinion and Order.

7. That Pennsylvania-American Water Company shall file detailed calculations with its tariff filing, which shall demonstrate to this Commission's satisfaction that the filed rates comply with the proof of revenue, in the form and manner customarily filed in support of compliance tariffs.

8. That Pennsylvania-American Water Company shall comply with all directives, conclusions and recommendations contained in the instant Opinion and Order that are not the subject of individual ordering paragraphs as fully as if they were the subject of specific ordering paragraphs.

9. That the Stipulation Concerning Rate Structure And Rate Design filed in this case on October 28, 2003, be, and hereby is, approved, and incorporated herein by reference as though set forth in full.

10. That Pennsylvania-American Water Company shall allocate the authorized increase in operating revenues to each customer class and rate schedule within each class in accordance with the Stipulation Concerning Rate Structure And Rate Design filed in this case on October 28, 2003, and in the manner prescribed in this Opinion and Order.

11. That Pennsylvania-American Water Company, as it has agreed to do, expand the benefits available to eligible low-income customers by increasing the existing low-income customer discount from 20% to 50%.

12. That Pennsylvania-American Water Company, as it has agreed to do, continue its regular meetings with designated representatives of A Pocono Country Place

Property Owners Association and commence a similar program of regular meetings with designated representatives of Saw Creek Estates Community Association, Inc.

13. That the Complaints filed by the various participants to this proceeding at Docket Numbers R-00038304C0001 through R-00038304C0171, inclusive, are, to the extent they have not been previously marked closed, sustained in part and dismissed in part, consistent with this Opinion and Order.

14. That the Pennsylvania Public Utility Commission's inquiry and investigation in Docket Number R-00038304 is terminated and the record closed.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: January 16, 2004

ORDER ENTERED: January 29, 2004