COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF KENTUCKY UTILITIES COMPANY FOR AN ADJUSTMENT OF ITS ELECTRIC RATES	)))	CASE No. 2018-00294

-and-

ELECTRONIC APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ADJUSTMENT OF ITS ELECTRIC AND GAS RATES	))))	CASE No. 2018-00295

ATTORNEY GENERAL'S RESPONSES TO DATA REQUESTS OF KENTUCKY UTILITIES COMPANY AND LOUISVILLE GAS AND ELECTRIC COMPANY

Comes now the intervenor, the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention, and submits the following responses to data requests of Kentucky Utilities Company ["KU"] and Louisville Gas & Electric Company ["LG&E"] in the above-styled matters.

Respectfully submitted,

ANDY BESHEAR
ATTORNEY GENERAL

KENT A. CHANDLER
REBECCA W. GOODMAN
JUSTIN M. MCNEIL
LAWRENCE W. COOK
ASSISTANT ATTORNEYS GENERAL
700 CAPITAL AVE., SUITE 20
FRANKFORT KY 40601-8204
(502) 696-5453
Kent.Chandler@ky.gov
Rebecca.Goodman@ky.gov
Justin.McNeil@ky.gov
Larry.Cook@ky.gov

Certificate of Service and Filing

Counsel certifies that the foregoing is a true and accurate copy of the same document being filed in paper medium with the Commission within two business days; that the electronic filing has been transmitted to the Commission on February 14, 2019; that there are currently no parties that the Commission has excused from participation by electronic means in this proceeding.

This 14th day of February, 2019

Assistant Attorney General

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WITNESS/RESPONDENT RESPONSIBLE:
Counsel

QUESTION No. 1
Page 1 of 1

Provide a copy of any agreement between the AG, Lou Metro and LFUCG regarding their joint participation in this proceeding.

RESPONSE:

Objection. This request seeks information or documents that are privileged and further, are irrelevant to the proceeding. The documentation sought by LG&E/KU have no relevancy to or bearing on the underlying applications in these matters and are thus not discoverable. Without waiving this objection, see attached.

From: David Barberie <dbarberi@lexingtonky.gov>
Sent: Tuesday, December 18, 2018 1:23 PM
To: 'Chandler, Kent A (KYOAG)'; Jim Gardner; Todd Osterloh
Cc: Goodman, Rebecca (KYOAG); Napier, Heather (KYOAG); Keith Horn
Subject: RE: Case No. 2018-00294 Agreement between AG and LFUCG

Kent –

This is acceptable to LFUCG. Thanks

DAVID J. BARBERIE
Managing Attorney
Department of Law
(859)258-3500
dbarberi@lexingtonky.gov

LEXINGTON

From: Chandler, Kent A (KYOAG) [mailto:Kent.Chandler@ky.gov]
Sent: Tuesday, December 18, 2018 9:58 AM
To: David Barberie; Jim Gardner; Todd Osterloh
Cc: Goodman, Rebecca (KYOAG); Napier, Heather (KYOAG)
Subject: Case No. 2018-00294 Agreement between AG and LFUCG

[EXTERNAL] Use caution before clicking links and/or opening attachments.

Counsel,

This email, and subsequent confirmation and approval of the substance, shall memorialize and confirm the separate agreements between the Office of the Attorney General ("OAG") and LFUCG and the OAG and Louisville Metro with respect to the base rate cases, 2018-00294 and 2018-00295, respectively.

1. In order to defray the cost of the OAG's revenue requirement expert in these matters, namely the $99,292.50 contract with Blueridge consulting ("BRC"), which all parties have reviewed, LFUCG agrees to provide $20,000 and Louisville Metro $25,000.
2. Based upon a thorough review of the base rate applications, the expectation is that BRC's work will be approximately split between the two matters as so: 55% for the LG&E matter and 45% for the KU matter. The LG&E matter inherently includes more work because of the need to perform two revenue requirement models,

for both gas and electric. Nevertheless, due to the unique circumstances and significant revenue request in the KU matter, primarily driven by the withdrawal of several wholesale customers, the KU matter will require substantial effort.

3. Upon receipt of invoices from BRC, the OAG will send separate invoices to counsel for LFUCG and Louisville Metro representing their pro rata and proportional share. These amounts will be calculated by using the percentages provided above (55% and 45%) to separate the invoice by case, and then broken out by the pro rata share represented by each city's pledged amount. The KU portion of the BRC contract is $44,682 ($99,292.50 x .45), and LFUCG has pledged $20,000 in support of the witness. Therefore, upon receipt of an invoice from BRC, the OAG will invoice LFUCG 44.8% ($20,000 / $44,682) of the KU portion of the invoice. For instance, if the OAG receives an invoice for $10,000, the KU portion is $4,500. The portion of this BRC invoice that the OAG will invoice LFUCG would be $2,016 ($4,500 x .448). The Louisville portion is $54,610.88 ($99,292.50 x .55), Louisville pledged $25,000 so Louisville would be invoiced 45.8% of the LG&E portion ($25,000/$54,610.88). Thus in the example given – a $10,000 invoice – Louisville would pay $2,519 ($5,500 x .458), Lexington would pay the $2,016 figured above, and the OAG would pay $5,465. Invoicing in this matter ensures that if BRC comes under budget, each city receives their pro rata savings in the form of a percentage reflecting the amount of funding pledged at the outset of the proceedings.
4. In consideration of the aforementioned monetary support, the OAG will allow LFUCG, Louisville Metro and its attorneys, at their option, to: review the testimony of the OAG's revenue requirement expert and revenue requirement discovery prior to filing, contact and discuss relevant issues with the OAG's expert provided that said subject matter is not contradictory to a position of the OAG on that issue, and adopt any or all of the OAG's experts' testimony in its entirety or any portion thereof at any time including an appeal.
5. In connection with LFUCG's, Louisville Metro's and OAG's efforts concerning the rate cases, these parties and their counsel have concluded that information known to one party may assist the other. These parties therefore acknowledge and agree that they share certain common interests and that their interests will be best served if they and their counsel can exchange information subject to the continued protection of the attorney/client, work product and other applicable privileges.

Please respond and confirm that LFUCG agrees.

Thanks,

Kent

Kent A. Chandler
Assistant Attorney General
Office of Rate Intervention
Office of the Attorney General
700 Capital Avenue, Suite 20
Frankfort, Kentucky 40601
(502) 696-5456
Kent.Chandler@ky.gov

From:	Derouen, Jeff <Jeff.Derouen@louisvilleky.gov>
Sent:	Tuesday, December 18, 2018 11:13 AM
To:	Chandler, Kent A (KYOAG); Todd Osterloh; Jim Gardner
Cc:	Goodman, Rebecca (KYOAG); Napier, Heather (KYOAG)
Subject:	RE: Case No. 2018-00295 Agreement between AG and Louisville Metro

Yes, this is what we understand the agreement to be.

JEFF DEROUEN
OFFICE OF MIKE O'CONNELL
JEFFERSON COUNTY ATTORNEY
531 Fiscal Court Place, 9th Floor
Louisville, Kentucky 40202
502-574-6333 (main)
502-574-2313 (direct)
502-574-0009 (fax)
Jeff.derouen@louisvilleky.gov

From: Chandler, Kent A (KYOAG) <Kent.Chandler@ky.gov>
Sent: Tuesday, December 18, 2018 9:57 AM
To: Derouen, Jeff <Jeff.Derouen@louisvilleky.gov>; Todd Osterloh <tosterloh@sturgillturner.com>; Jim Gardner <jgardner@sturgillturner.com>
Cc: Goodman, Rebecca (KYOAG) <Rebecca.Goodman@ky.gov>; Napier, Heather (KYOAG) <Heather.Napier@ky.gov>
Subject: Case No. 2018-00295 Agreement between AG and Louisville Metro

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Please respond and confirm that Louisville Metro agrees.

Thanks,

Kent

Kent A. Chandler
Assistant Attorney General
Office of Rate Intervention
Office of the Attorney General
700 Capital Avenue, Suite 20
Frankfort, Kentucky 40601
(502) 696-5456
Kent.Chandler@ky.gov

WITNESS/RESPONDENT RESPONSIBLE:
Donna Mullinax

QUESTION No. 2
Page 1 of 1

Provide copies of all electronic files in native format with formulas intact used in your analysis. This includes copies of all work papers supporting your testimony, analyses, and conclusions.

RESPONSE:

All work papers supporting Mrs. Mullinax's testimony, analysis, and conclusions were filed contemporaneously with her direct testimony. Other information relied upon was included within her exhibits or identified in footnotes and are already of record as filed by LG&E/KU.

WITNESS/RESPONDENT RESPONSIBLE:
Donna Mullinax

QUESTION No. 3
Page 1 of 1

Reference Mullinax Testimony, p. 28. Provide any studies or analyses relied upon by you that support the contention that employees and employers consider various components of compensation and benefits in isolation rather than considering them holistically or in the aggregate when making employment decisions.

RESPONSE:

Although it may be a valid contention that employees and employers consider various components of compensation and benefits in isolation rather than considering them holistically or in the aggregate when making employment decisions, Mrs. Mullinax did not make such a contention in her testimony and therefore has not collected any studies or analyses supporting it. Her contention in testimony was that "***[f]rom a regulatory point of view***, unfair and/or unreasonable practices cannot be overlooked or disregarded in any one area simply because the overall result balances out. Each area of concern should be examined separately and, if reasonable objections to it are identified, regulatory response should address it" (Mullinax Testimony, p. 28, lines 7–11; emphasis added).

WITNESS/RESPONDENT RESPONSIBLE:
Donna Mullinax

QUESTION No. 4
Page 1 of 1

Reference Mullinax Testimony, pp. 28–29. Provide detailed characteristics and parameters that should be used to form a proxy group by which a utility's compensation and benefits may be compared. The answer should include all characteristics that you think should be included (including company size, location, area of business, etc.) and define those parameters of any such characteristic.

RESPONSE:

Since Mrs. Mullinax's profession is not that of a benchmarking research analyst, she does not have a fully vetted list of all possible characteristics by which a proper comparison study should be conducted. However, as suggested in her testimony, similarities of geographic location, company size, and operation are certainly minimum starting points. Disparity of geographic location might skew results based on factors such as regional economies; disparity of company size might skew results based on factors such as overhead levels; and disparity of operation might skew results based on factors such as focus of expertise and skill levels. Her contention included in her testimony was that the Mercer Benefits Study did not take into account even these minimum factors that might skew results.

WITNESS/RESPONDENT RESPONSIBLE:
Donna Mullinax

QUESTION No. 5
Page 1 of 2

Reference Mullinax Testimony, pp. 30–31. Please state whether Ms. Mullinax is aware of the Commission's decision in the recent Duke Energy case (Case No. 2017-00321) on the issue of the recovery of matching 401(k) contributions made to those participating in a pension plan. If so, describe why the Commission should not reach the same conclusion in the Companies' cases as it reached in Case No. 2017-00321 on this issue.

RESPONSE:

Assuming the request is referring to the Commission order dated April 13, 2018, in Case No. 2017-00321, Mrs. Mullinax has reviewed the Commission decision in that case. As noted in the order, the Commission was in only partial agreement with Duke Kentucky based on other specifics of that particular case. In regard to the instant cases, as noted in her testimony, the Commission's prior orders in KU's and LG&E's last rate cases characterized such duplicative payments as "not reasonable" and "excessive." Her point in testimony was that based on the Commission decision, the Companies had the opportunity to end those not reasonable and excessive payments. However, the Companies seemingly chose to disregard the order in favor of continuing to pay the characterized "not reasonable" and "excessive" costs.

Furthermore, and of profound significance, Mrs. Mullinax has also reviewed the more recent decision in the Inter-County Energy Cooperative Corporation case (Case No. 2018-00129) in which the Commission claims strict consistency in finding payment to a defined benefits retirement plan while simultaneously contributing to a 401(k) retirement savings plan to be unreasonable. In its January 25, 2019, order, the Commission made the following pertinent statements:

1. "The Commission has held that it is unreasonable for utilities to pay the full contribution to a defined benefits retirement plan while simultaneously contributing to 401(k) retirement savings plans for its employees" (page 9, internal citations omitted).
2. "[I]t is difficult to see any circumstance under which the payment . . . for both a defined benefit and 401(k) plan for the same employees could be justified and the Commission questions why . . . utilities continue to propose recovering the costs of such plans." (pages 9–10, internal citations omitted).

QUESTION No. 5
Page 2 of 2

3. "Thus, the Commission is not able to find that it is necessary for Inter-County Energy to pay . . . for both a 401(k) and defined benefit retirement plan in order to compete with other companies for employees" (page 12).
4. "The Commission also observes that Inter-County Energy represented that it 'aggressively sought' to manage expenses. Yet, it continued to pay . . . for two retirement plans for certain employees in a manner contrary to national trends and inconsistent with the recent orders of this Commission" (pages 12–13).
5. "[T]he Commission finds that it would be unreasonable for Inter-County Energy to continue to pay for the entire RS defined benefit retirement plan while simultaneously contributing to a 401(k) retirement savings plan for the same employees" (page 14).

WITNESS/RESPONDENT RESPONSIBLE:
Glenn A. Watkins

QUESTION No. 6
Page 1 of 1

Provide copies of all electronic files in native format with formulas intact used in your analysis. This includes copies of all work papers supporting your testimony, analyses, and conclusions.

RESPONSE:

All work papers supporting Mr. Watkins' testimony, analysis, and conclusions were filed contemporaneously with his direct testimony. Other information relied upon was included within his exhibits or identified in footnotes and are already of record as filed by LG&E/KU.

WITNESS/RESPONDENT RESPONSIBLE:
Glenn A. Watkins

QUESTION No. 7
Page 1 of 1

Watkins Testimony, footnote 7, p. 6: Why were Trimble County Units 5 and 6 and Brown Units 5, 6, and 7 considered "intermediate" units, while other similar combustion turbines were considered "peakers?"

RESPONSE:

Refer to Schedule GAW-3. These units were considered intermediate in nature due to an examination of these units' order of dispatch, forecasted fuel cost per MWH and capacity factors relative to the other KU/LG&E generating units.

WITNESS/RESPONDENT RESPONSIBLE:
Glenn A. Watkins

QUESTION No. 8
Page 1 of 1

Refer to Schedule GAW-3.

a. Explain the "(1)" noted for Dix Dam 1 and Ohio Falls 1.
b. Explain how Dix Dam 1 can have a capacity factor of 83.13%.
c. Explain how Ohio Falls 1 can have a capacity factor of 263.03%.

RESPONSE:

a. This amount was intended to be a separate footnote that was inadvertently omitted. This note refers to the gross investment and forecasted net generation in that for Dix Dam and Ohio Falls, the investments and forecasted KWH relate to Dix Dam and Ohio Falls units on a combined basis as reported by LG&E in response to AG-1-145 and AG-1-146.
b. The stated capacity for Dix Dam 1 of 83.13% is an error. This is because the reported net generation of 81,780 MW is for all Dix Dam units on a combined basis. The capacity factor for all of Dix Dam units on a combined basis is 28.21%.
c. The stated capacity for Ohio Falls 1 of 263.03% is an error. This is because the reported net generation of 300,360 MW is for all Ohio Falls units on a combined basis. The capacity factor for all of Ohio Falls units on a combined basis is 32.88%.

WITNESS/RESPONDENT RESPONSIBLE:
Glenn A. Watkins

QUESTION No. 9
Page 1 of 1

Refer to page 22, lines 7-11. Provide specific citations to the referenced testimony supporting the statement "that the primary objective of the Companies residential rate design is to guarantee revenue collection and profitability."

RESPONSE:

This statement is Mr. Watkins' conclusion based on the entirety of Messrs. Conroy and Seelye's testimony in this case. See for example, Mr. Watkins' direct testimony, page 22, line 19 through page 30, line 17 and page 33, line 11 through page 36, line 38.

WITNESS/RESPONDENT RESPONSIBLE:
Glenn A. Watkins / Counsel as to objection

QUESTION No. 10
Page 1 of 1

Refer to page 32. Provide all Commission orders in any jurisdiction where Mr. Watkins' "direct customer cost analysis" has been specifically accepted in setting customer charges for residential customers.

RESPONSE:

Objection. This request, insofar as it seeks "all Commission orders in any jurisdiction," is overbroad and unduly burdensome. Without waving this objection, over the course of 38 years, Mr. Watkins has conducted hundreds of rate design studies. In this regard, Mr. Watkins' does not maintain a list of all Commission orders or instances wherein his recommendations were or were not adopted by a Commission. However, in an attempt to fairly respond to this request, Mr. Watkins recalls the following Commission Orders that have adopted a direct customer cost analysis for establishing residential customer charges:

a. Virginia State Corporation Commission, Case No. PUE-2014-00020, Columbia Gas of Virginia (Hearing Examiner's Report and Order provided).
b. Washington Utilities and Transportation Commission, Docket No. UE-140762, Pacific Power & Light Company, Order 08 (Order provided).
c. Washington Utilities and Transportation Commission, Docket Nos. UE-170033 and UG-170034, Puget Sound Energy, Order 08 (Order provided).
d. Pennsylvania Public Utility Commission, Docket No. R-00061398, PPL Gas Company, Final Order (Order provided).
e. Pennsylvania Public Utility Commission, Docket No. R-00932670, Pennsylvania-American Water Company, Final Order (Order provided).
f. Pennsylvania Public Utility Commission, Docket No. R-00942991, National Fuel Gas Distribution Company, Final Order (Order provided).

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

APPLICATION OF

COLUMBIA GAS OF VIRGINIA, INC. **CASE NO. PUE-2014-00020**

For authority to increase rates and charges and to revise the terms and conditions applicable to gas service

REPORT ON REMAND OF MICHAEL D. THOMAS, HEARING EXAMINER

June 30, 2015

HISTORY OF THE CASE

On April 30, 2014, Columbia Gas of Virginia, Inc. ("CGV" or "Company"), filed an application with the State Corporation Commission ("Commission") pursuant to Chapter 10 of Title 56 (§ 56-232 *et seq.*) of the Code of Virginia ("Code") requesting authority to increase its rates and charges, effective for the first billing unit of October 2014, and to revise other terms and conditions applicable to its gas service ("Application"). The proposed rates and charges are designed to increase the Company's annual non-gas base revenues by approximately $31.8 million, which includes $6.9 million currently being collected by the Company outside of base rates in a surcharge associated with its Steps to Advance Virginia's Energy ("SAVE") Plan pursuant to § 56-603 *et seq.* of the Code ("SAVE Act").[1] The Company states that its requested increase in annual non-gas base revenues reflects its costs and revenues for the test year ending December 31, 2013; an increase in its rate base since its last base rate case in 2011;[2] an updated capital structure and requested return on equity ("ROE") of 10.9%; and certain rate year adjustments that are "reasonably predicted to occur" during the twelve months ending September 30, 2015 ("Rate Year"), as permitted by § 56-235.2 of the Code.[3]

On May 28, 2014, the Commission issued an Order for Notice and Hearing in which it, among other things, docketed the Application; scheduled an evidentiary hearing on the Application; established a procedural schedule; directed the Company to provide public notice of its Application; and appointed a hearing examiner to conduct all further proceedings on behalf of the Commission and file a final report.

Notices of Participation were filed timely by the Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel"); County of Fairfax, Virginia ("Fairfax County"); Virginia Industrial Gas Users Association ("VIGUA"); Stand Energy Corporation ("Stand Energy"); and Chaparral (Virginia) Inc. ("Chaparral").

[1] Application at 1.

[2] *See Application of Columbia Gas of Virginia, Inc., For authority to increase rates and charges and to revise the terms and conditions applicable to gas service,* Case No. PUE-2010-00017, 2010 S.C.C. Ann. Rep. 475 ("2010 Rate Case").

[3] Application at 4.

The evidentiary hearing was convened as scheduled on December 9, 2014. Eight public witnesses appeared at the hearing.[4] The evidentiary hearing was continued until the following day to permit the parties, the Staff, and the Company to finalize a stipulation that resolved all the disputed issues among the stipulating parties. The Stipulation was submitted into the record for the Commission's consideration.[5] Stand Energy noted its objection to the Stipulation.[6]

The Stipulation resolved all of the outstanding issues in this case among the stipulating parties, which excluded Stand Energy. The key provisions of the Stipulation provided:

- The stipulating parties agreed to an increase in the Company's jurisdictional non-gas base revenue requirement of $25.2 million, which represented a decrease of $6.6 million in the Company's requested revenue increase.
- The Company agreed to an authorized ROE range of 9.00% to 10.00%, and a ROE of 9.75% for the purpose of determining its revenue requirement in this case. The Company's overall weighted average cost of capital was set at 7.35%.
- Rates would be calculated using a revenue apportionment of the $25.2 million non-gas base revenue requirement increase in the manner presented in Company witness Balmert's testimony and as agreed upon by Staff witness Tufaro. Staff witness Tufaro's proposed rate design for the Residential ("RS/RTS"), Small General Service ("SGS"), and Large General Service ("LGS") customer classes would be implemented, except that (i) the respective customer charges would be increased as specified in Company witness Balmert's testimony, and (ii) the rates applicable to the LGS2 and Transportation Service ("TS") 2 classes would be designed in a manner that resulted in every billing block receiving the same percentage increase. The rate design reflected three separate SGS classes.
- The Company would implement thermal (Dth) billing consistent with the methodology presented in Company witness Horner's testimony to be effective no later than meter readings on and after January 1, 2016.[7] The Company agreed to provide a schedule of monthly BTU values from each of the five pipeline scheduling points for the preceding calendar year in its Annual Informational Filings ("AIFs") submitted to the Commission.
- The 9.75% ROE used to establish rates in this case would be used for calculating rates under the Company's SAVE Plan and would be the Company's authorized ROE prior to any change in the ROE adopted by the Commission. The stipulating parties agreed that, until changed by the Commission, the midpoint of the ROE range of 9.0% to 10.0% would be used for its earnings tests.
- The stipulating parties agreed to the following concerning the treatment for Eligible Safety Activity Costs ("ESAC") deferred prior to the Rate Year, amortized over a five-year basis, and incurred during and after the Rate Year: (1) the $25.2 million revenue requirement included $7.72 million of ESAC, as reflected on Line 23 in Attachment IV to the Stipulation; (2) the Company would calculate and record the over/under collection

[4] The public witnesses included Northwest Hardwoods, Virginia Poultry Federation, Shenandoah Processing Limited and Shenandoah Organic Poultry, Mary Baldwin College, Staunton Steam Laundry, Bridgewater College, Centra Health, Inc., and McKee Foods Corporation.

[5] Ex. 31.

[6] Tr. at 61-63.

[7] The Company currently procures all of its wholesale gas supplies based on Dth billing.

of ESAC on its books by comparing (i) ESAC recoveries determined using an ESAC recovery factor of $2.54/bill as reflected on Line 30 in Attachment IV to the Stipulation, to (ii) actual ESAC; (3) for purposes of calculating the ESAC deferral for periods preceding the Rate Year, the Company would calculate a baseline of ESAC using 2012 pipeline safety costs following the methodology used to develop the 2009 baseline study submitted in this proceeding, as revised by Staff witness McLeod. The results of the 2012 study would be filed for Commission review with the Company's next AIF, and the Commission-approved 2012 baseline study would be used to adjust the calculation of pre-rate year ESAC deferrals; and (4) the ESAC deferral balance would be included as a component of rate base in future AIFs.

- The Company would conduct a Class Cost of Service study based on the Customer/Demand methodology, adjusted to allocate seven-twelfths (7/12) of demand-related costs to interruptible customer classes. The Company would file the results of the study for informational purposes with its next non-gas base rate case. However, the Company would not be obligated to utilize the results of the study.
- The Company would refund, with interest and pursuant to such terms and conditions as specified by the Commission, the increased revenues collected under the interim rates implemented for service rendered on and after September 29, 2014.

The stipulating parties agreed that the Stipulation represented a compromise for the purposes of settlement of this case. None of the signatories to the Stipulation necessarily agreed with the treatment of any particular item, any procedure followed, or the resolution of any particular issue in agreeing to the Stipulation, other than as specified in the Stipulation, except that the stipulating parties agreed that the resolution of the issues in this case, taken as a whole, and the disposition of all the other matters set forth in the Stipulation are in the public interest. The Stipulation was conditioned upon and subject to acceptance by the Commission and was non-severable and of no force or effect and may not be used for any other purpose unless accepted in its entirety by the Commission.[8]

On January 13, 2015, the Hearing Examiner filed his Report, which recommended that the Commission adopt the Stipulation. On January 23, 2015, the Company and VIGUA filed comments in support of the Hearing Examiner's recommendation, and the Staff filed a letter notifying the Commission that it would not file comments on the Hearing Examiner's Report. On January 28, 2015, Fairfax County also filed comments in support of the Hearing Examiner's Report. Stand Energy filed comments and exceptions to the Hearing Examiner's Report on January 29, 2015.

On March 30, 2015, the Commission entered an Order Remanding for Further Action ("Remand Order"). In its Remand Order, the Commission found that the total revenue requirement and the customer class allocation of that revenue requirement as set forth in the Stipulation are supported by the evidence, are reasonable, and meet the requirements of the statute.[9] However, the Commission found the proposed rate design within each customer class to be unreasonable. Specifically, the Commission found that the amount of revenue assigned to the fixed customer charges is unreasonably high. The Commission noted that a significant portion of the revenue increase is caused by the Company's Distribution Integrity Management Program ("DIMP") and

[8] Ex. 31.

[9] Remand Order at 4.

SAVE Plan, and that it is unreasonable to assign such a large percentage of these costs to fixed charges as set forth in the Stipulation.[10] The Commission remanded the case to the Hearing Examiner to conduct further proceedings, receive additional evidence, and to issue a report with findings and recommendations on establishing a reasonable rate design for each customer class to recover the revenue requirement assigned to that class pursuant to the Stipulation.[11]

The remand hearing was convened as scheduled on June 3, 2015. Vishwa B. Link, Esquire; Elaine S. Ryan, Esquire; and T. Borden Ellis, Esquire, appeared on behalf of the Company. Mary Beth Adams, Esquire; Andrea B. Macgill, Esquire; and Garland S. Carr, Esquire, appeared on behalf of the Commission Staff. Kiva Bland Pierce, Esquire, appeared on behalf of Consumer Counsel. James G. Ritter, Esquire, appeared on behalf of VIGUA. Susan E. Cooke, Esquire, appeared on behalf of Fairfax County. Stand Energy did not participate in the remand case.

SUMMARY OF THE RECORD

The Company

The Company presented the testimony of Mark P. Balmert, director of Rate and Regulatory Services for NiSource Corporate Services Company. He addressed the reasonableness of the intra-class rate design for each rate class to recover the revenue requirement assigned to that class, pursuant to the Stipulation. In Part I of his testimony, Mr. Balmert presented the rate design principles the Company used to develop customer rates, including the appropriate allocation of revenue between volumetric and fixed charges. In Part II, he presented two options for the Commission's consideration as alternatives to the stipulated customer charges, along with two other rate designs to aid the Commission's consideration of the two options proposed by the Company. Ex. 33, at 1-2.

Mr. Balmert included the following schedules with his testimony:

- Remand Schedule MPB-1: Rate Design Comparison
- Remand Schedule MPB-2: Minimum System Study
- Remand Schedule MPB-3: Across the Board Increase Calculation
- Remand Schedule MPB-4: Current Customer Charge Rate Design
- Remand Schedule MPB-5: Remand Option 2 Rate Design
- Remand Schedule MPB-6: Remand Option 1 Rate Design (Recommended)
- Remand Schedule MPB-7: Across the Board Rate Design
- Remand Schedule MPB-8: Stipulated Rate Design.

Ex. 33, at 2.

Mr. Balmert discussed the criteria the Company considers in designing rates. First, the rates must be just and reasonable and not unduly discriminatory. Second, where rates require adjustment to achieve proper cost recovery, customer impact considerations, such as rate stability and

[10] *Id.*
[11] *Id.*

gradualism, are factored into the rate design process. Finally, for purposes of this proceeding, the Company believes it is appropriate to recover a portion of its revenue requirement increase through the fixed customer charge. Ex. 33, at 3.

Mr. Balmert identified the major drivers of the fixed cost increases since the Company's last rate case: (i) the Company increased its investment in the customer component of mains by approximately $42 million; (ii) the Company increased the customer component of services by approximately $51 million; (iii) the Company has $6,042,205 of ongoing and $1,681,444 of amortized ESAC; and (iv) the Company has installed additional automatic meter reading devices amounting to an additional $8.6 million in customer-based investment. Ex. 33, at 3-4.

Mr. Balmert discussed the Company's Minimum System Study, and how it shows the costs incurred by the Company to connect a customer to its distribution system and bill the customer, regardless of usage, based on the customer's rate class. Mr. Balmert believes a customer charge should, over time, recover the fixed costs identified in the Minimum System Study to minimize the possibility of intra-class subsidization. The Minimum System Study indicates that the monthly customer charge for the RS/RTS class should be $24.17. Ex. 33, at 4.

Mr. Balmert explained how intra-class subsidies occur. Based on the Company's annual bill frequency for its residential customers and an analysis of its minimum system, the minimum size main (two-inch) will serve virtually all of its residential customers. On average, it costs the Company the same to serve all residential customers regardless of consumption. Charging volumetric rates to recover fixed costs creates an intra-class subsidy that does not reflect the actual cost of service. Based on cost causation, residential customers would be charged a flat monthly rate for their distribution services, as it most accurately reflects the manner in which the Company incurs costs to serve residential customers. A departure from cost causation creates subsidies within the residential class because it causes high volume customers to pay more than their fair share of the Company's distribution service, and causes those customers who use less than the average residential class customer to pay less than the cost to provide them distribution service. Ex. 33, at 4-5.

Mr. Balmert described the benefits of increasing the proportion of fixed non-gas costs covered by the fixed monthly charge. Those benefits include: increased stability and predictability of customers' bills; simpler and more understandable customer bills; and a reduction of the magnitude of annual true-ups for customers participating in the Company's Budget Billing Plan. Ex. 33, at 5-6.

Mr. Balmert explained that rate stability and gradualism keep the Company from setting its customer charge at the amount shown in its Minimum System Study. However, the Company will continue to move toward recovering a greater percentage of its fixed costs through a fixed rate recovery mechanism, and will gradually increase its customer charge over time. Ex. 33, at 6.

Mr. Balmert described the Company's progress at minimizing intra-class subsidies in its rates by increasing the percentage of its costs recovered through its customer charge. Presently, the Company recovers 52.7% of an average monthly bill for the RS/RTS class through its monthly customer charge. The $18.00 customer charge in the Stipulation would have reduced the amount recovered to 48.2%, the lowest percentage since 2010. For comparison purposes, Mr. Balmert prepared an example of "across the board" rates in Remand Schedule MPB-3. In that Schedule, the RS/RTS calculation shows that 49.664635% of current base revenue is recovered through the $14.25 residential customer charge. Applying 49.664635% to the $99,077,330 base revenue found reasonable by the Commission in this case produces $49,206,394 of revenue to be recovered through the customer charge. Mr. Balmert divided $49,206,394 by the number of residential bills to arrive at a $17.62 customer charge ($49,206,394 / 2,792,834 bills = $17.62). Mr. Balmert believes that any customer charge less than $17.62 for the RS/RTS class creates greater intra-class subsidies. The Company is not proposing an "across the board" rate for the customer charge in this proceeding. Ex. 33, at 6-8.

Mr. Balmert provided an overview of his Remand Schedule MPB-1, which summarizes the Company's Option 1 (Recommended) and Option 2 (Alternative) customer charge proposals. In Option 1, the current customer charge for the RS/RTS class of $14.25 is added to the current SAVE Rider of $1.83, resulting in a new customer charge of $16.08. The Company's ESAC and its non-SAVE incremental costs (since the 2010 rate case) included in the Minimum System Study, would be recovered through the Company's volumetric rate. The advantage with Option 1 is that residential customers would pay the same total fixed charge as they are paying today. Under Option 1, the Company would recover approximately 43.1% of its revenues through its customer charge. Ex. 33, at 8-10.

Under Option 1, the Company's SGS1/SGTS1 customers would pay $20.08 to reflect the higher cost to serve SGS1/SGTS1 customers compared to the residential rate class. For SGS2/SGTS2 customers, the current $5.47 SAVE Rider would be added to their current monthly charge of $25.00, resulting in a new customer charge of $30.47. For the SGS3/SGTS3 class, the Company added $10.00 to the SGS2/SGTS2 customer charge to reflect the higher cost to serve the SGS3/SGTS3 class, resulting in a new customer charge of $40.47. Ex. 33, at 10-11.

The Company's alternative customer charge, Option 2, is computed by taking the current customer charge and adding 52.61% of the currently approved SAVE Rider. For the SGS classes, their customer charge was calculated in a manner similar to Option 1, by adding only 52.61% of the SAVE Rider. The remaining authorized revenue increase, by rate class, would be recovered through an increase in the volumetric base rates. The Company determined that the customer component of mains was 52.61% and included that cost in its Minimum System Study, Remand Schedule MPB-2. Ex. 33, at 11-14.

Mr. Balmert prepared a table comparing the recovery of the authorized residential revenue increase of $18,944,084 under Options 1 and 2 and the Stipulation:

Rate Design	Customer Charge Revenues	Volumetric Charge Revenues	Customer Charge Recovery %	Volumetric Charge Recovery %
Stipulation	$10,473,128	$8,470,956	55.3%	44.7%
Option 1	$5,110,887	$13,833,197	27.0%	73.0%
Option 2	$2,681,121	$16,262,963	14.2%	85.8%

Ex. 33, at 14-15.

Option 1 is the Company's recommended rate design because it simply adds the SAVE Rider to the Commission-approved customer charge, which is same fixed monthly charge customers are now paying. Option 1 also decreases the likelihood of customers' over- or under-payments for delivery service as compared to Option 2. Both Options 1 and 2 satisfy the rate design principle of rate stability because both rate designs produce reasonably stable and predictable prices. Option 2 produces greater intra-class subsidization because it results in a lower percentage of fixed cost recovery than Option 1. Option 2 only minimally contributes to the recovery of SAVE costs, ESAC costs, meters, automatic meter reading devices, house regulators, and industrial M&R stations since the Company's last rate case. Ex. 33, at 15-16.

Mr. Balmert confirmed that the rate class customer charges proposed in this case are mutually exclusive. Each rate class's rate design is based on the revenue requirement apportioned to that rate class. However, Mr. Balmert believes there should be a consistent rate design among the various rate classes. The Company favors Option 1 for all rate classes. Ex. 33, at 16-17.

Finally, Mr. Balmert confirmed that the Company will provide an updated Base Monthly Normalized Non-Gas Revenue ("BMNR") to be used to calculate the Company's Revenue Normalization Adjustment ("RNA"). Additionally, the Company will file rate sheets after the Commission approves its final rates that are based on dekatherm ("Dth") billing, rather than volumetric billing ("Mcf"). Ex. 33, at 17.

At the hearing, Mr. Balmert explained how the 52.61% customer component of mains was calculated in the Minimum System Study.[12] Tr. at 91-94.

On rebuttal, Mr. Balmert responded to the rate design positions taken by Consumer Counsel witness Watkins, VIGUA witness Collins, and Staff witness Tufaro. Mr. Balmert included the following schedules in his testimony:

- Revised Remand Schedule MPB-2: Minimum System Study (Revised)
- Remand Rebuttal Schedule MPB-9: Schedule 29 Page 4 of Original Filing
- Remand Rebuttal Schedule MPB-10: Peer Company Comparison
- Remand Rebuttal Schedule MPB-11: Schedule GAW-2 (Corrected)
- Remand Rebuttal Schedule MPB-12: 2" Main Detailed Calculation.

Ex. 37, at 1-2.

Mr. Balmert confirmed that the Company continues to support its Option 1 rate design with one exception. After considering Mr. Collins' remand testimony, the Company now recommends that the Commission approve the stipulated $2,700.00 customer charge for the LGS2 and TS2 classes. Ex. 37, at 2-3.

Mr. Balmert explained that the Company pursued three objectives in establishing the amount of revenue to be recovered through its customer charge. First, the Company is seeking to at least recover the same percentage of total base revenue that it recovers from the currently approved customer charge. Second, the Company prepared its Minimum System Study and its goal is to

[12] *See* Ex. 33, at 12-13.

progress towards a customer charge that would recover the cost of its minimum system. Third, any increase in the proposed customer charge must be gradual to avoid rate shock. Ex. 37, at 3-4.

Mr. Balmert believes Mr. Tufaro misinterpreted what the Company's Option 1 rate design was intended to recover. The Commission remanded the case because the stipulated customer charge included the recovery of SAVE costs and a portion of the Company's ESAC costs. Option 1 keeps the Company's fixed recovery at the same level that residential customers were paying prior to the implementation of interim rates. Proposed residential customer charge Option 1 recovers only 39.8% of the combined SAVE and ESAC costs included in the Company's total cost of service. Under Option 1, the remaining 60.2% of SAVE and ESAC costs would be recovered through the Company's volumetric rate. Ex. 37, at 5-6.

Mr. Balmert confirmed that the Company does not object to either of Mr. Collins' recommendations. It will adopt the stipulated $2,700.00 customer charge for the LGS2 and TS2 classes, or adopt the $2,654.00 Option 1 customer charge for those classes. Ex. 37, at 6.

Mr. Balmert noted that certain corrections must be made to Mr. Watkins' analysis, including uncollectible expense, interest expense, equity return, and income tax corrections. Mr. Balmert calculated a residential customer charge of $15.07 using Mr. Watkins' proposed methodology, as shown in Remand Rebuttal Schedule MPB-11: Schedule GAW-2 (Corrected). The Company does not support Mr. Watkins' methodology; however, since the customer charge is close to the Company's Option 2 customer charge of $15.21, the Company does not object to a residential customer charge of $15.07 as another option for the Commission's consideration. Mr. Balmert's changes resulted in the following revised customer charges in Schedule GAW-2 (Corrected): RS/RTS - $15.07 instead of $14.78; SGS1/SGTS1 - $15.29 instead of $14.38; SGS2/SGTS2 - $23.92 instead of $23.73; SGS3/SGTS3 - $46.60 instead of $46.38. Ex. 37, at 3 and 7.

Based on criticism from Mr. Watkins, Mr. Balmert corrected the ROE used in his Minimum System Study.[13] Mr. Balmert noted that the change lowers the indicated customer charges; however, those charges continue to exceed the charges proposed in this case. Ex. 37, at 7-8.

Mr. Balmert responded to Mr. Watkins' criticism that rate structures that recover fixed costs in volumetric rates create intra-class subsidies. First, the cost to provide a distribution system for residential customers is fixed regardless of the amount of gas consumed by a customer. On average, since it costs essentially the same to serve all residential customers, Mr. Balmert believes it is logical and reasonable to gradually include the recovery of fixed costs through the customer charge, thereby matching revenue with cost. Second, Mr. Balmert is unaware of any natural gas distribution company that recovers 100% of its fixed delivery costs through a volumetric rate as in Mr. Watkins' gas station example; therefore, he could not see the relevance of Mr. Watkins' analogy. Third, Mr. Balmert noted that most small usage customers connect to existing mains and do not pay to have a main extended for service. Therefore, those customers would not be paying twice for the same infrastructure. Ex. 37, at 8-11.

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[13] Revised Remand Schedule MPB-2: Minimum System Study (Revised).

Regarding Mr. Watkins' comparison of the Company's customer charges to those of the other gas distribution companies in Virginia, Mr. Balmert stated that the rate design for each of the other companies could have an impact on the customer charge. Rather than looking only at the customer charge, Mr. Balmert believes a more reasonable approach would be to include a customer's base load usage along with the customer charge. Mr. Balmert prepared an illustration making his point. Remand Rebuttal Schedule 10 compares the Company's recovery of costs to the other gas companies, under the Company's existing customer charge and Options 1 and 2. In calculating the cost recovery, Mr. Balmert used the Company's sales volume and customer count from this case, the Company's average base load usage of 1.2 Mcf, and the customer bills and volume levels through each rate schedule. Based on his analysis, Mr. Balmert concluded that the Company's percentage of fixed cost recovery through the customer charge and base load usage is consistent with the other gas distribution companies, even though the Company has the highest customer charge. Ex. 37, at 11-14.

Mr. Balmert disagreed with Mr. Watkins' assertion that high fixed charge rate structures promote additional consumption. He noted that the Company has seen a decline in usage for its residential customers since it increased its customer charge from $12.25 to $14.24 in 2011. Since 2011, including increases in the SAVE Rider, average residential usage has declined from 69.2 Mcf to 68.6 Mcf. Mr. Balmert provided an example in which Columbia Gas of Ohio implemented a straight fixed variable rate design for its small general service customer class in 2009, which includes 99.5% of its residential customers. Since then, average customer usage has declined from 86.6 Mcf/year to 83.3 Mcf/year. Mr. Balmert observed that if Mr. Watkins' assertion were true, the opposite should have occurred. Ex. 37, at 14-16.

In response to Mr. Watkins' reliance on Professor Bonbright's Principles of Public Utility Rates, Mr. Balmert stated that the National Association of Regulatory Utility Commissioners ("NARUC") Gas Distribution Rate Design Manual recognizes the validity of using a minimum size distribution system analysis to determine customer costs. Ex. 37, at 16-17.

Mr. Balmert disagreed with Mr. Watkins' argument that pricing for a regulated utility should mirror competitive firms to the greatest extent practicable. He believes the fundamental differences in the businesses create a distinctly different pricing structure for public utilities compared to industries operating in a competitive market. Ex. 37, at 17-19.

Mr. Balmert disagreed with Mr. Watkins' argument that the Company's Weather Normalization Adjustment ("WNA") and RNA "guarantee" the Company stable revenues. Mr. Balmert stated that these mechanisms do not "guarantee" revenue recovery, do not minimize the difference between winter and summer gas bills, do not create more stable gas bills, and do not correct for intra-class subsidies. Ex. 37, at 19-20.

Mr. Balmert responded to Mr. Watkins' recommendation that the Commission redesign the Company's Infrastructure Reliability and Replacement Adjustment ("IRRA") so that the costs could be recovered on a volumetric basis. Mr. Balmert stated that the design of the IRRA is not an issue before the Commission in this proceeding. Ex. 37, at 20-21.

Finally, Mr. Balmert summarized the Company's position. The Company recommends that: (i) the Commission select the Option 1 rate design for all rate classes except the LGS2 and TS2 classes; and (ii) the Commission approve the stipulated $2,700.00 customer charge for the LGS2 and TS2 classes. The Company has no objection to a residential customer charge of $15.07, calculated using Mr. Watkins' methodology as another option for the Commission's consideration. Ex. 37, at 21.

At the hearing, Mr. Balmert explained the difference between the $15.07 residential customer charge he calculated using Mr. Watkins' methodology and Mr. Watkins' residential customer charge of $15.00. Mr. Balmert believes that when Mr. Watkins adjusted the amount of uncollectible expense, he should have also adjusted his income tax expense. Mr. Balmert restated that the Company has no objection to a $15.07 residential customer charge. Tr. at 109-110.

Mr. Balmert clarified that under Option 1, which adds the current SAVE Rider to the current customer charge resulting in a $16.08 residential customer charge, the Company recovers only 39% of eligible SAVE and DIMP costs through the customer charge. Mr. Balmert believes the Company's proposed Option 1 residential customer charge addresses the Commission's concern that the $18.00 stipulated customer charge collected too high a percentage of fixed costs related to SAVE and DIMP. Mr. Balmert noted that SAVE and DIMP costs added to the current customer charge would have resulted in a customer charge of $18.85. He noted the $18.00 customer charge proposed in the Stipulation was not intended to collect 100% of the Company's SAVE and DIMP costs. Tr. at 111-116.

On cross-examination, Mr. Balmert was unsure whether the $0.07 difference between his and Mr. Watkins' analysis related solely to income taxes. He agreed generally that both analyses produced numbers that were very close. Tr. at 117-119.

Finally, Mr. Balmert confirmed that if the Company included the 52.61% of the customer-related portion of mains in the customer charge, the customer charge would be approximately $23.14, the amount indicated in its Minimum System Study. Tr. at 119-123.

Staff

Marc A. Tufaro, a principal utilities analyst with the Commission's Division of Energy Regulation, testified on behalf of the Staff. Mr. Tufaro addressed the remand direct testimony of Company witness Balmert and the Company's Option 1 (Recommended) and Option 2 (Alternative) rate designs. In addition, Mr. Tufaro addressed the testimony of Mr. Watkins and Mr. Collins. Ex. 36, at 2.

Mr. Tufaro began his testimony with a comparison of the fixed residential customer charges of all Virginia natural gas distribution companies from the lowest (Appalachian Natural Gas Distribution Company – Bluefield at $7.00 per month) to the highest (Columbia Gas of Virginia at its current $14.25 per month). Ex. 36, at 2-3.

Mr. Tufaro explained the Company has a CARE Plan that was approved by the Commission in Case No. PUE-2012-00013[14] and was amended in Case No. PUE-2013-00114.[15] A key component of the CARE Plan that impacts this case is the RNA decoupling mechanism. The RNA applies to the RS/RTS, SGS1/SGTS1, and SGS2/SGTS2 rate classes. The RNA is designed to align the Company's annual actual billed non-gas distribution revenue with a pre-established level of Annual Distribution Revenue ("ADR") approved in the Company's last rate case. Each month, an Authorized Monthly Normalization Non-Gas Revenue ("AMNR") is computed separately for the residential and small general service customer classes by multiplying the BMNR per bill by the number of customer bills for each customer class. The RNA decouples the recovery of fixed costs from the actual sales volumes consumed in a given month. With the RNA in place, Mr. Tufaro believes the Company is guaranteed to recover its BMNR per bill for the RS/RTS, SGS1/SGTS1, and SGS2/SGTS2 classes, regardless of the actual gas volumes consumed by the class and regardless of the customer charge that is in effect. Ex. 36, at 3-4.

Mr. Tufaro explained that with the exception of the small general service classes, the proposed rates in Option 1 are the sum of the SAVE Rider and the fixed customer charge in effect at the time the Application was filed. For the RS/RTS class, the $1.83 SAVE Rider was added to the current customer charge of $14.25, which results in an Option 1 proposed customer charge of $16.08. This is the same amount residential customers were paying prior to the implementation of interim rates. For the SGS1/SGTS1 class, the Company added $4.00 to the RS/RTS class for a proposed customer charge of $20.08. For the SGS2/SGTS2 class, the Company added the SAVE Rider of $5.47 to the $25.00 current customer charge resulting in a proposed customer charge of $30.47. For the SGS3/SGTS3 class, the Company proposed a fixed customer charge of $40.47 to reflect that this rate class has a higher minimum cost of service. Ex. 36, at 4-5.

Mr. Tufaro explained that with Option 2 the Company added 52.61% of the current SAVE Rider to the currently approved customer charge. This resulted in proposed Option 2 customer charges of: RS/RTS - $15.21; SGS1/SGTS1 - $18.88; SGS2/SGTS2 - $27.88; SGS3/SGTS3 - $30.47. For the remaining rate classes, the Company used the same methodology to compute the monthly fixed customer charge. Ex. 36, at 5-6.

Mr. Tufaro provided an overview of the Staff's position on customer costs. The Staff views customer costs as the operating and capital costs found to vary directly with the number of customers served rather than with the amount of utility service supplied. These costs include meter reading, billing, collecting, and accounting, as well as those costs associated with the capital investment in metering equipment and customer service connections. Mr. Tufaro noted that depending on the philosophy of the cost analyst, the analyst may include a portion of the costs associated with the distribution system in customer costs. However, the inclusion of such costs is controversial. The argument against including these costs as customer charges is that mains are installed to deliver gas and, as such, their cost should be allocated based on throughput and demand, and recovered through volumetric charges. The Company's cost of service study indicated that the

[14] *Application of Columbia Gas of Virginia, Inc., For approval to extend and amend its natural gas conservation and ratemaking efficiency plan,* Case No. PUE-2012-00013, 2012 S.C.C. Ann. Rep. 395.

[15] *Application of Columbia Gas of Virginia, Inc., For authority to amend its natural gas conservation and ratemaking efficiency plan,* Case No. PUE-2013-00114, 2014 S.C.C. Ann. Rep. 326.

customer component of mains was 52.61%. Mr. Tufaro further noted that determining the appropriate customer charge involves a considerable amount of judgment and balancing the interests of the various customers within the same customer class, such as heating and non-heating customers and low usage and high usage customers. Finally, Mr. Tufaro noted that the Company's RNA is intended to promote revenue stability as customers reduce their energy consumption and is designed to assure recovery of an average level of revenue per customer. Although the RNA mechanism is complicated and potentially confusing to customers, Mr. Tufaro observed that higher customer charges would reduce and potentially limit the need for such a mechanism. Ex. 36, at 7-9.

Mr. Tufaro provided the Staff's recommendations. Since the Commission is concerned with the SAVE Rider being fully included in the fixed customer charge, Staff is unable to recommend approval of the Company's proposed Option 1. The Staff is comfortable with both Option 2 and Consumer Counsel's recommended fixed monthly charge for the RS/RTS class. For the SGS1/SGTS1 class, the Staff recommends that the Commission adopt the fixed customer charge proposed in Option 2, since the customer cost analysis conducted by Mr. Watkins shows a charge well below the $25.00 fixed charge he is recommending. For the SGS2/SGST2 class and the LGS1 and TS1 classes, Staff recommends following Option 2. For the SGS3/SGTS3 class, Staff recommends that the Commission adopt the $40.00 charge recommended by Mr. Watkins. Finally, Mr. Tufaro noted that Mr. Collins recommended that the LGS2 and TS2 class customer charge be kept at the stipulated amount of $2,700.00. Ex. 36, at 9-10.

Finally, Mr. Tufaro stated even after considering all the various options, the Commission may still determine that the "amount of fixed customer charge is unreasonably high." The Commission could keep the currently approved customer charges, since the RNA decoupling mechanism ensures that the Company will recover its BMNR per bill regardless of the actual volumes consumed and regardless of the customer charge that is in effect for the RS/RTS, SGS1/SGTS1, and SGS2/SGTS2 classes, which comprise the vast majority of the Company's customers. Ex. 36, at 10.

Consumer Counsel

Glenn A. Watkins, a principal and senior economist with Technical Associates, Inc., testified on behalf of Consumer Counsel. His testimony focused on the fixed monthly charges applicable to the residential and small general service classes. Based on his analysis, Mr. Watkins recommended a fixed monthly customer charge of $15.00 for the RS/RTS class, $25.00 for the SGS1/SGTS1 and SGS2/SGTS2 classes, and $40.00 for the SGS3/SGTS3 class. With regard to the Company's SAVE Rider, Mr. Watkins recommends that these costs be recovered through the Company's volumetric rate. Ex. 35, at 1-4.

Mr. Watkins disagreed with Mr. Balmert's reasoning supporting higher fixed monthly customer charges. He believes Mr. Balmert's philosophy and resulting opinions are contrary to accepted economic principles, at odds with economic and public policy issues relating to efficiency and conservation, and would result in an unfair and inefficient pricing structure. Ex. 35, at 4-5.

Mr. Watkins responded to Mr. Balmert's assertion that the Company's non-gas distribution revenues should be collected from fixed monthly charges, and no distribution charges should be collected in volumetric rates.[16] Mr. Watkins believes Mr. Balmert's position is based on a misguided understanding of accepted economic principles. Mr. Balmert mistakenly believes "fixed" costs should only be recovered from fixed charges. Mr. Watkins took issue with the Company's Minimum System Study, particularly the inclusion of a portion of the cost of mains and other expense items that are not properly considered "customer costs." Additionally, Mr. Watkins took issue with Mr. Balmert's use of a ROE of 10.90%, when the Stipulation in this case allows the Company a ROE of 9.74%. Ex. 35, at 5-6.

Mr. Watkins disagreed with the Company's Minimum System Study that 52.61% of the Company's distribution main costs are "customer-related" and 47.39% are "demand-related." He believes the distribution mains exist to move natural gas from the interstate pipelines to the individual natural gas end-users throughout the year. Mr. Watkins believes 100% of the cost of distribution mains should be considered demand-related. Mr. Watkins described the various methodologies for allocating mains among customer classes for class cost allocation purposes, but he stated that at no time should mains be considered a "customer cost." Ex. 35, at 6-8.

Mr. Watkins cited Professor James C. Bonbright's treatise, Principles of Public Utility Rates, as support for his position that distribution mains should not be included in customer costs. Professor Bonbright believes that distribution mains are an "unallocable portion of total costs" that is properly excluded from demand-related costs and customer-related costs.[17] In addition, Mr. Watkins also cited basic economic theory for his position that "fixed costs" do not have to be collected through "fixed charges." Mr. Watkins referenced other industries with short-run "fixed costs" similar to the Company's that recover those costs almost exclusively under volumetric pricing structures. Ex. 35, at 9-11.

Mr. Watkins explained that a rate structure with a high fixed charge promotes additional consumption because a consumer's price of incremental consumption is less than that of an efficient price structure. As an example, Mr. Watkins cited Federal Energy Regulatory Commission ("FERC") Order 636 that adopted a "Straight-Fixed Variable" ("SFV") pricing method to encourage increased use of domestic natural gas by promoting additional interruptible (and incremental firm) gas usage. Mr. Watkins explained that the price signal that results from SFV pricing is meant to promote additional natural gas consumption, not reduce consumption. He believes a rate structure that is heavily based on a fixed monthly customer charge sends an even stronger price signal to consumers to use more energy. Ex. 35, at 11-13.

Mr. Watkins observed there have been no changes in the Company's business risk that would warrant a move from volumetric pricing to recover its costs to a fixed-cost recovery methodology. Mr. Watkins believes to do so would run counter to years of established utility ratemaking. Ex. 35, at 13.

Mr. Watkins advocated for a pricing structure that promotes cost-effective conservation and the efficient utilization of resources. As consumption increases, consumers should incur more cost. As an economist, the concept of fixed-charge pricing completely escapes Mr. Watkins. He believes the Company's customer charge should be limited to the costs to connect and maintain a customer's

[16] Mr. Watkins referred to this pricing approach as "Straight-Fixed Variable Pricing."
[17] James C. Bonbright, Principles of Public Utility Rates at 492 (2nd ed. 1988).

account and the remainder of the Company's revenues should be collected through its volumetric rates. Ex. 35, at 13-15.

Mr. Watkins explained his direct customer cost analysis, which is included as Schedule GAW-2 (Revised) to his testimony. In his analysis, he did not consider the Company's investment in distribution mains, only those costs that vary as a result of connecting a new customer and are required to maintain that customer's account. He explained that under FERC's Uniform System of Accounts, "Customer Accounts" expenses include: Supervision (Account 901), Meter Reading (Account 902), Customer Records & Collections (Account 903), Uncollectible Expenses (Account 904), and Miscellaneous Customer Accounts Expenses (Account 905). Mr. Watkins excluded uncollectible expenses from his analysis because the Company's RNA ensures a dollar-for-dollar recovery of gas cost expense, including the uncollectibility of gas cost revenues. In his analysis, Mr. Watkins utilized the capital structure, cost of debt, and 9.75% cost of equity contained in the Stipulation, as well as a provision for State and Federal income taxes at the statutory rates of 6.00% and 35.00%, respectively. Mr. Watkins did not include Accumulated Deferred Income Taxes (deductions from rate base) associated with services, meters, and meter reading equipment. As shown in his Schedule GAW-2 (Revised), his customer cost analysis results in monthly costs of $14.78 for the RS/RTS class, and $14.38 for SGS1/SGTS1, $23.73 for SGS2/SGTS2, and $46.38 for the SGS3/SGTS3 classes.[18] Ex. 35, at 15-17.

In response to Mr. Balmert's argument that recovering fixed costs in volumetric rates creates an intra-class subsidy, Mr. Watkins explained that this argument fails for three reasons. First, as a matter of cost causation, the Company must plan and install more capacity for residential heating customers (large volume/low load factor) than for residential non-heating customers (small volume/high load factor). This additional capacity comes at a cost such that the cost to serve a high load factor (low annual volume) customer is significantly less than for a low load factor (high annual volume) customer. Second, goods and services are priced so that a company's fixed costs are recovered in the cost of the goods sold. For example, customers purchasing gasoline at a gas station pay the same price per gallon whether they purchase 5 gallons or 25 gallons. Third, a small volume customer whose expected annual usage and revenues do not justify the cost of extending a main are required under the Company's tariff to make an upfront cash contribution to the Company before service is initiated. Those customers should not have to pay twice, in the form of higher fixed monthly charges, for the same distribution main. Ex. 35, at 17-19.

In response to Mr. Balmert's argument that higher customer charges promote revenue stability, Mr. Watkins stated that the Company has eliminated the risk that it will not collect its authorized revenues through its WNA rider and its RNA rider. Mr. Watkins believes the Company is guaranteed stable revenues regardless of variations in weather, and reductions in per customer usage due to conservation or any other reason. Ex. 35, at 19-20.

In response to Mr. Balmert's argument that higher customer charges will provide greater simplicity and understanding of customers' bills, Mr. Watkins stated that he has practiced public utility rate regulation for 35 years and he has examined thousands of public utility tariffs. He

[18] At the hearing, Mr. Watkins explained that he needed to make a correction to uncollectible expense. This correction resulted in a change in his indicated customer charges. Mr. Watkins prepared Schedule GAW-2 (Revised) reflecting those changes. *See* Tr. at 97-99.

examined the Company's tariff, and because of the number of riders and cost recovery mechanisms included in the tariff and the pages of algebraic formulas needed to make the computations, Mr. Watkins could not understand all aspects of how a customer's bill is determined. Mr. Watkins believes Mr. Balmert's argument in favor of higher customer charges to reduce the magnitude of annual true-ups likewise fails. He stated the annual true-up pales in comparison to all the other adjustments that are already occurring with a customer's bill. Ex. 35, at 20-21.

Mr. Watkins compared the Company's current and recommended customer charge to those of the other gas distribution companies in Virginia: Atmos Energy - $10.98; Virginia Natural Gas - $11.00; Washington Gas Light - $11.25; Roanoke Gas - $13.93; Columbia (Current) - $14.25; and Columbia (Recommended) - $16.08. Ex. 35, at 21-22.

Mr. Watkins provided his recommendations: RS/RTS - $14.75; SGS1/SGTS1 - $25.00; SGS2/SGTS2 - $25.00; SGS3/SGTS3 - $40.00. Although his analysis indicates a lower monthly customer charge for the SGS1/SGTS1 class, Mr. Watkins recommends keeping the current charge because the stipulated revenue requirement and class revenue apportionment results in a revenue increase for SGS1/SGTS1 customers. For rate continuity, Mr. Watkins believes that reducing the customer charge while at the same time increasing the distribution usage charge is not the best regulatory practice. Additionally, his analysis indicates a higher customer charge for the SGS3/SGTS3 class. In the interest of gradualism, Mr. Watkins recommends a customer charge of $40.00, rather than the $46.38 indicated in his analysis. Ex. 35, at 22-23.

Finally, Mr. Watkins recommended that the SAVE Rider costs which relate to the replacement of mains, rather than risers and service lines which are customer-related, should be recovered on a volumetric (per Mcf or Dth) basis because the system infrastructure improvements will benefit those customers that use more natural gas. Ex. 35, at 23-24.

At the hearing, Mr. Watkins explained the difference in results when Mr. Balmert attempted to replicate his customer charge analysis. Mr. Watkins' analysis resulted in a customer charge of $15.00 for the RS/RTS class, and Mr. Balmert's resulted in a customer charge of $15.07. Unlike Mr. Balmert, Mr. Watkins did not include informational sales in his analysis. Mr. Watkins believes that for all intents and purposes the results are the same. Mr. Watkins confirmed that notwithstanding Mr. Balmert's $15.07 result, his customer charge recommendation remained $15.00 for the RS/RTS class. Tr. at 100-101.

On questioning from the bench, Mr. Watkins confirmed that customer-related SAVE costs were included in both his analysis and in Mr. Balmert's alternative analysis. Demand-related SAVE costs were excluded from both. The difference between the two analyses related to the customer portion of mains which Mr. Watkins excluded and Mr. Balmert included. Tr. at 103-106.

Virginia Industrial Gas Users' Association

Brian C. Collins, an associate with the firm of Brubaker & Associates, energy economic, and regulatory consultants, testified on behalf of VIGUA. He stated that VIGUA was a signatory to the Stipulation and continues to support the $2,700.00 customer charge for the LGS2 and TS2 rate classes. Mr. Collins believes this customer charge will provide increased stability and predictability to the Company with respect to the recovery of its fixed non-gas costs. Accordingly, he recommends that the Commission adopt the stipulated rate design for the LGS2 and TS2 classes. Ex. 34, at 1-3.

Mr. Collins responded to Company witness Balmert's remand testimony in which he described other rate design options in the event the Commission rejects the stipulated LGS2 and TS2 rate design. Mr. Collins prepared a comparison of the stipulated rate design and the Company's Options 1 and 2, which is included as Attachment BCC-1R to his remand testimony. If the Commission rejects the stipulated rate design, VIGUA recommends that the Commission select Option 1 for the LGS2 and TS2 classes. Option 1 would allow a similar level of total LGS2 and TS2 class revenue, 16.5% to be collected in the customer charge as compared to the level collected under the current class rate design, 16.2%. The proposed Option 1 rate design would help maintain stability and predictability with respect to the recovery of the stipulated revenue requirement and avoid additional intra-class subsidies. Ex. 34, at 4-5.

Finally, Mr. Collins recommends that the Commission reject the Company's proposed Option 2 rate design for the LGS2 and TS2 classes. As shown in his Attachment BCC-1R, under Option 2, only 14.5% of the LGS2 and TS2 stipulated revenue requirement would be collected via the Company's monthly customer charge of $2,323, which is considerably less than the Company's current rate design. The Company's proposed Option 2 rate design would result in less fixed-cost recovery through the monthly customer charges and, as a result, would introduce more instability and unpredictability into the rate design, with respect to fixed cost recovery. Mr. Collins believes Option 2 is deficient and not a sound rate design because it does not recover an adequate level of fixed costs. Additionally, Option 2 would introduce additional intra-class subsidies among customers in the LGS2 and TS2 rate classes. Ex. 34, at 5.

DISCUSSION

The Company and Consumer Counsel have differing opinions on what costs should be included in the customer charge, and how the SAVE Rider and other ESAC costs should be incorporated into base rates. On one side, the Company believes generally that a percentage of its non-gas fixed costs should be recovered in its fixed monthly customer charges. This includes the customer-related portion of its distribution system, SAVE Rider, and any ESAC costs. The Company believes in gradually increasing its customer charges to those indicated in its Minimum System Study to eliminate any intra-class subsidies. On the other side, Consumer Counsel believes the customer charge should only include the costs necessary to connect the customer to the Company's distribution system, administer the account, and bill the customer. Consumer Counsel believes distribution mains are required to deliver natural gas to the Company's customers and their cost should be recovered in the Company's volumetric rate. Finally, Consumer Counsel believes the SAVE Rider and any ESAC costs should be recovered in the Company's volumetric rate.

The Commission's Remand Order

After finding that the $25.2 million revenue requirement agreed to in the Stipulation was reasonable and after finding that the apportionment of that revenue requirement among the various customer classes was reasonable, the Commission found that the proposed rate design within each customer class was not reasonable. Specifically, the Commission found that the amount of revenue assigned in the Stipulation to the fixed customer charges was unreasonably high. Additionally, the Commission found that the percentage of DIMP and SAVE costs assigned in the Stipulation to the customer charge was unreasonable.[19]

The RS/RTS class customer charge proposed in the Stipulation was $18.00, which was rejected by the Commission for the reasons stated above. The proposed customer charge included the following charges: (i) the current Commission-approved customer charge of $14.25; (ii) the current Commission-approved SAVE Rider of $1.83; and (iii) and a "modest increase" in the amount of the customer charge of $1.92.[20] In his direct testimony, Mr. Balmert did not specify what cost/s the $1.92 was intended to recover. He did, however, explain the Company's rationale for increasing its customer charges "to collect a proportion of fixed non-gas costs through the fixed monthly Customer Charge."[21] By definition, fixed non-gas costs would include ESAC costs or any other costs that do not vary based on the amount of natural gas flowing through the Company's distribution system.[22] It appears from the record that the primary reason for the increase in the customer charge beyond the addition of just the SAVE Rider was to maintain the customer charge's percentage of fixed cost recovery. The Company's current $14.25 customer charge and $1.83 SAVE Rider recover approximately 52.7% of the Company's fixed costs through the customer charge. The proposed $18.00 customer charge would have recovered approximately 48.2% of the Company's fixed costs. Relying on its Minimum System Study, the Company has sought to gradually increase the percentage of fixed costs recovered through its customer charge.[23]

Considering the Commission's Remand Order, I find the following issues are presented in this case. First, what revenues/costs should be recovered in the Company's fixed monthly customer charge? Second, what percentage of SAVE or ESAC costs, if any, should be recovered in the Company's fixed monthly customer charge? Depending on whose position the Commission adopts in this case, the Company's or Consumer Counsel's, resolution of the first issue may by default resolve the second issue.

<u>*Code of Virginia*</u>

Section 56-604 F of the Code requires a gas distribution company that has a SAVE Rider to incorporate the rider into base rates and reset the rider to zero whenever it files a base rate case. Specifically, the statute provides:

> F. A natural gas utility that has implemented a SAVE Rider pursuant to this chapter shall file revised rate schedules to reset the SAVE Rider to zero, when new base rates and charges that incorporate eligible infrastructure replacement costs previously reflected in the currently effective SAVE Rider become effective for the natural gas utility, following a Commission order establishing customer rates in a rate case using

[19] Remand Order at 4.
[20] Ex. 10, at 20.
[21] *Id.* at 23.
[22] *See* Va. Code § 56-600.
[23] Ex. 33, at 4-8.

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the cost of service methodology set forth in § 56-235.2, or a performance-based regulation plan authorized by § 56-235.6.

In the absence of any limiting language in Subsection F of § 56-604 of the Code, I find that the Commission has the discretion to determine how the SAVE Rider should best be incorporated into the Company's base rates. The statute allows the SAVE Rider to be recovered 100% in customer charges, 100% in volumetric rates, or in any combination of the two.

The Company's Tariff

The term "customer charge" is not defined in the Company's tariff. The tariff states that: "[t]he minimum monthly charge will be the applicable Customer Charge."[24]

Customer Charges

In the absence of any definition of "customer charges" that would be controlling in this case, Staff witness Tufaro provided an excellent summary of customer charges and the threshold issue faced by the Commission in this case. Mr. Tufaro stated that:

> [t]he Staff has historically viewed customer costs as the operating and capital costs found to vary directly with the number of customers served rather than with the amount of utility service supplied. They include the expenses of meter reading, billing, collecting, and accounting, as well as those costs associated with the capital investment in metering equipment and in customers' service connections. Depending on the philosophy of the cost analyst, a portion of the costs associated with the distribution system may also be included as customer costs. However, the inclusion of such costs is controversial. The argument against the inclusion of these costs as customer costs is that mains are installed to deliver gas and, as such, their cost should be allocated based on throughput and demand and recovered through volumetric charges.[25]

Consumer Counsel's position is consistent with the Staff's historic view of customer charges in that Consumer Counsel believes no distribution main costs should be recovered in the customer charge. Consumer Counsel witness Watkins prepared his direct customer cost analysis by looking at costs that result from connecting a new customer to the Company's distribution system and maintaining that customer's account. Specifically, he looked at accounts under FERC's Uniform System of Accounts that directly related to supervision, meter reading, customer records and collections, and miscellaneous customer accounts expense. To the extent that SAVE or other ESAC costs were incurred replacing only service risers or meters, those costs were incorporated into Mr. Watkins' analysis. As shown in his Schedule GAW-2 (Revised),[26] Mr. Watkins' customer cost analysis resulted in the following indicated monthly customer charges: RS/RTS - $15.00; SGS1/SGTS1 - $14.38; SGS2/SGTS2 - $23.73; and SGS3/SGTS3 - $46.38. Mr. Watkins recommended the following customer charges: RS/RTS - $15.00; SGS1/SGTS1 - $25.00;

[24] *See*, Gas Tariff of Columbia Gas of Virginia, Inc. accepted for filing on January 18, 2011, at Original Sheet No. 103.
[25] Ex. 17, at 21.
[26] Ex. 35.

SGS2/SGTS2 - $25.00; and SGS3/SGTS3 - $40.00. For rate continuity purposes, Mr. Watkins recommended no change in the SGS1/SGTS1 class customer charge. He believes that reducing the customer charge while at the same time increasing the distribution charge is not the best regulatory practice. Additionally, his analysis indicates a higher customer charge for the SGS3/SGTS3 class. In the interest of gradualism, Mr. Watkins recommends a customer charge of $40.00, rather than the $46.38 indicated in his analysis.

The Company's approach to customer charges not only includes the costs incurred by the Company to connect a customer to its distribution system and bill the customer, but also includes a percentage of its non-gas fixed costs, which includes the customer-related portion of its distribution system. In its Minimum System Study, the Company determined that 52.61% of its distribution mains are customer-related and 47.39% are demand-related. The Company's uses the results of its Minimum System Study as a guide in setting its customer charges. The Company wants to gradually increase its customer charges to those indicated in the Minimum System Study to eliminate any intra-class subsidies. As shown in Revised Remand Schedule 2,[27] the Company's Minimum System Study indicated monthly customer-related costs are: RS/RTS - $23.14; SGS1/SGTS1 - $23.52; SGS2/SGTS2 - $43.10; SGS3/SGTS3 - $109.16; LGS1 - $788.78; TS1 - $288.41; and TS2 - $1,182.56.[28]

In this case, the Company proposed two customer charge options for the Commission's consideration. Option 1, which is the Company's recommended option, essentially maintains the status quo for its customers. Under Option 1, the Company's customers would continue paying the same total fixed monthly charges that they are paying today. The Company added the current SAVE Rider for each rate class to the existing monthly customer charge approved by the Commission to arrive at its recommended customer charge.[29] The Option 1 recommended customer charges are: RS/RTS - $16.08; SGS1/SGTS1 - $20.08; SGS2/SGTS2 - $30.47; SGS3/SGTS3 - $40.47; LGS1 - $697.49; LGS2 - $2,645.19; TS1 - $697.49; and TS2 - $2,646.19. In Option 2, which is the Company's alternative option, the Company added 52.61% of the current SAVE Rider to the existing monthly customer charge approved by the Commission to arrive at its alternative customer charge. The 52.61% of the SAVE Rider represents the customer-related portion of the Company's distribution system as determined in its Minimum System Study. The Option 2 alternative customer charges are: RS/RTS - $15.21; SGS1/SGTS1 - $18.88; SGS2/SGTS2 - $28.88; SGS3/SGTS3 - $30.47; LGS1 - $627.59; LGS2 - $2,322.84; TS1 - $627.59; and TS2 - $2,322.84.

The threshold question in this case is whether any portion of the costs related to the Company's distribution mains should be recovered in the customer charge. The short answer is no. I agree with Consumer Counsel that the Company's distribution system is required to deliver natural gas to its customers, and the cost of that distribution system should be recovered in the cost of the commodity sold. In other words, I find the cost of the Company's distribution system should

[27] Ex. 37.

[28] Currently, the Company has no LGS2 customers; therefore, no monthly customer charge was computed in the Minimum System Study.

[29] The Company's current SAVE Rider recovers the cost of replacing bare steel mains, cast iron mains, pre-1971 coated steel mains and services, certain first generation plastic pipe, isolated bare steel services, and certain risers that are prone to failure. *See Application of Columbia Gas of Virginia, Inc., For approval of a SAVE Plan and Rider as provided by Virginia Code § 56-604,* Case No. PUE-2011-00049, 2011 S.C.C. Ann. Rep. 501.

be recovered through its volumetric rates. This finding is consistent with the Commission's longstanding position regarding customer charges. It is a simple fact that not all residential customers are the same. Some may take gas service to operate a decorative fireplace, while others may use gas to heat their homes, hot water, swimming pools, and as a fuel for cooking. The Company's intra-class subsidy argument cuts both ways. When distribution system costs are included in the fixed customer charge, low usage customers subsidize high usage customers, and when the costs are included in volumetric rates, high usage customers subsidize low usage customers. There is, however, one common understanding among consumers – the more you buy, the more you pay. There is a reason the customer charge methodology of including only the cost of connecting the customer to the distribution system, administering the account, and billing the customer, while recovering all other costs in the volumetric rate, has withstood the test of time. Given the differences among customers of the same class, it is the fairest way for the Company to recover its costs. Everyone in the same class pays the same percentage of distribution system costs in each Mcf or Dth of gas that they purchase from the Company.

Accordingly, I find Consumer Counsel's recommended customer charges, which include only the costs to connect the customer to the Company's distribution system, administer the account, bill the customer, and SAVE- or ESAC-related service riser and meter replacement costs, are reasonable. Since the Company's Option 1 and Option 2 customer charges include SAVE-related distribution system costs, I find those charges are unreasonable. Consistent with the foregoing findings, I find SAVE and other ESAC distribution system-related costs should be recovered in the Company's volumetric rates. Taking into consideration VIGUA witness Collins' testimony, I find the LGS2 and TS2 customer charges of $2,700.00 are reasonable. Since no independent analysis of the LGS1 and TS1 customer charges has been performed, I find those charges should remain at the current $550.00 until such an analysis may be performed. The Company's Minimum System Study,[30] which includes the customer-related portion of distribution mains, indicates that the customer charge should be $788.78 for the LGS1 class, but only $288.41 for the TS1 class. Keeping the customer charges at $550.00 will ensure that customers in those classes will not be unduly harmed. The parties' and the Hearing Examiner's customer charge recommendations are summarized in Attachment 1 hereto.

Addendum and Modification of Stipulation and Proposed Recommendation

The stipulating parties filed an Addendum and Modification of Stipulation and Proposed Recommendation ("Addendum and Recommendation") in which they agreed that: (i) the language in Paragraph (2) of the Stipulation that rates would be developed as shown in Attachment 1 and the resulting bill impacts are shown in Attachment II shall be severed from the Stipulation; (ii) Attachments I and II shall be severed from the Stipulation; and (iii) all of the language in Paragraph (6) of the Stipulation shall be severed and superseded with the following language: "Rates established in this proceeding will be calculated using a revenue apportionment of the $25.2 million non-gas base revenue requirement increase, as specified in Exhibit A hereto, and the rates applicable to the LGS2/TS2 customer class will be designed in a manner that results in every billing block receiving the same percentage increase. The rates will reflect the segmentation of the SGS class into three separate classes."[31]

[30] Ex. 37, at Revised Remand Schedule 2.
[31] Ex. 32, at 1-2.

The stipulating parties further agreed that the Company will implement thermal (Dth) billing consistent with the methodology presented in Company witness Horner's testimony to be effective no later than July 1, 2016. This represents a change only in the effective date of thermal billing from January 1, 2016, to July 1, 2016.[32]

Finally, the stipulating parties agreed that all other provisions of the Stipulation shall remain in full force and effect.[33]

I find the parties' Addendum and Recommendation is reasonable and I recommend that it be adopted by the Commission. Further, I find the parties' recommendation to delay the implementation of thermal billing from January 1, 2016, to July 1, 2016, is reasonable and I recommend that it be adopted by the Commission.

FINDINGS AND RECOMMMENDATIONS

Considering the evidence received in this case and for the reasons set forth above, I find:

(1) Consumer Counsel's recommended customer charges, which include only the cost to connect the customer to the Company's distribution system, administer the account, bill the customer, and SAVE- or ESAC-related service riser and meter replacement costs, are reasonable;

(2) The Company's proposed Option 1 and Option 2 customer charges are unreasonable because SAVE-related distribution system costs are included in those charges;

(3) The Company's SAVE and ESAC distribution system-related costs should be recovered in its volumetric rate;

(4) The LGS2 and TS2 class customer charge of $2,700.00 is reasonable;

(5) The LGS1 and TS1 class customer charge should remain at $550.00 until such time as an analysis similar to the one performed by Consumer Counsel witness Watkins may be performed for those rate classes;

(6) The parties' Addendum and Recommendation is reasonable; and

(7) The parties' recommendation to delay the implementation of thermal billing from January 1, 2016, to July 1, 2016, is reasonable.

I therefore ***RECOMMEND*** the Commission enter an order that:

(1) ***ADOPTS*** the findings and recommendations contained in this Report;

(2) ***APPROVES*** the customer charges recommended in this Report;

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[32] *Id.* at 2.
[33] *Id.*

(3) ***ADOPTS*** the Addendum and Recommendation;

(4) ***APPROVES*** the change in the effective date of thermal billing from January 1, 2016, to July 1, 2016; and

(5) ***PASSES*** the papers herein to the file for ended causes.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5 VAC 5-20-120 C) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within **ten (10) calendar days** from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P.O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all counsel of record and any such party not represented by counsel.

Respectfully submitted,

Michael D. Thomas

Michael D. Thomas
Hearing Examiner

The Clerk of the Commission is requested to send a copy of this Report to all persons on the official Service List in this matter. The Service List is available from the Clerk of the State Corporation Commission, c/o Document Control Center, 1300 East Main Street, Tyler Building, Richmond, VA 23219.

ATTACHMENT 1

Application of
Columbia Gas of Virginia, Inc.
Case No. PUE-2014-00020

Customer Charge Comparison

Rate Class	CGV Current Customer Charges[1]	CGV Stipulated Customer Charges[2]	CGV Option 1 Recommended Customer Charges[3]	CGV Option 2 Alternative Customer Charges[4]	AG Recommended Customer Charges	Staff Recommended Customer Charges[5]	VIGUA Recommended Customer Charges	H.E. Recommended Customer Charges
RS/RTS	$14.25	$18.00	$16.08	$15.21	$15.00	$15.00-15.21		$15.00
SGS1/SGTS1	$25.00	$22.00	$20.08	$18.88	$25.00	$18.88		$25.00
SGS2/SGTS2	$25.00	$33.00	$30.47	$27.88	$25.00	$27.88		$25.00
SGS3/SGTS3	$25.00	$45.00	$40.47	$30.47	$40.00	$40.00		$40.00
LGS1	$550.00	$700.00	$697.49	$627.59		$627.59		$550.00
LGS2	$1,995.00	$2,700.00	$2,645.19	$2,322.84			$2,700.00	$2,700.00
TS1	$550.00	$700.00	$697.49	$627.59		$627.59		$550.00
TS2	$1,995.00	$2,700.00	$2645.19	$2,322.84			$2,700.00	$2,700.00

[1] The Company's current customer charges were approved by the Commission in Case No. PUE-2010-00017. The Company's SAVE costs were collected in a separate rider.

[2] In the Stipulation, the Company proposed to include 100% of its SAVE rider and modest increases in the customer charge to recover its fixed costs. For the RS/RTS rate class, the calculation was $14.25 + $1.83 = $16.08, with the difference to $18.00 recovering a proportion of other non-gas fixed costs. The Company's Minimum System Study indicated a minimum system cost-based customer charge for the RS/RTS class of $23.14.

[3] The Company's recommended customer charges generally include the Company's current customer charge plus 100% of the SAVE rider for that rate class. For the SGS2/SGTS2 rate class, the Company added the SAVE rider cost of $5.47 to the $25 current customer charge to produce a recommended customer charge of $30.47. For the SGS1/SGTS1 rate class, the Company added $4.00 to the $16.08 RS/RTS recommended customer charge to recognize that the SGS1/SGTS1 rate class has a higher cost of service than the residential rate class. For the SGS3/SGTS3 rate class, the Company added $10.00 to the $30.47 SGS2/SGTS2 recommended customer charge to recognize the higher cost of service for the SGS3/SGTS3 rate class.

[4] The Company's Alternative Customer Charges generally include the Company's current customer charge plus 52.61% of the SAVE rider for that rate class, with the same caveat for the SGS1/SGTS1 and SGS3/SGTS3 Rate Classes as in footnote 3. The 52.61% represents the customer component of mains calculated in the Company's Minimum System Study.

[5] The Staff's recommended customer charges generally follow the Company's Option 2 Alternative Customer Charges. Since the Commission expressed its concern about the SAVE rider being fully included in the fixed customer charge, Staff was unable to recommend that the Commission adopt the customer charges in Option 1. For the RS/RTS class, the Staff is comfortable with any customer charge in the indicated range.

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

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APPLICATION OF

COLUMBIA GAS OF VIRGINIA, INC.

CASE NO. PUE-2014-00020

For authority to increase rates and charges
and to revise the terms and conditions
applicable to gas service

FINAL ORDER

On April 30, 2014, Columbia Gas of Virginia, Inc. ("Columbia" or "Company"), filed with the State Corporation Commission ("Commission") an application pursuant to Chapter 10 of Title 56 (§ 56-232 *et seq.*) of the Code of Virginia ("Code") requesting authority to increase its rates and charges, effective for the first billing unit of October 2014, and to revise other terms and conditions applicable to its gas service ("Application"). In its Application, Columbia advises that the proposed rates and charges are designed to increase the Company's annual non-gas base revenues by approximately $31.8 million, which includes $6.9 million currently being collected by the Company outside of base rates in a surcharge pursuant to the Steps to Advance Virginia's Energy Plan (SAVE) Act, § 56-603 *et seq.* of the Code, in accordance with the Company's authorized plan ("SAVE Plan").[1] Columbia states that its requested increase in annual non-gas base revenues reflects (i) Columbia's costs and revenues for the test year ended December 31, 2013; (ii) the increase in the Company's rate base since its last base rate increase in 2011;[2] (iii) an updated capital structure and requested return on equity ("ROE") of 10.9%; and (iv) certain

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[1] Exhibit ("Ex.") 2 (Application) at 1; Ex. 3 (Levander Direct) at 4-5. The proposed rates represent an increase of $24.9 million per year over current revenues. *Id.* at 5.

[2] *See Application of Columbia Gas of Virginia, Inc., For authority to increase rates and charges and to revise the terms and conditions applicable to gas service*, Case No. PUE-2010-00017, 2010 S.C.C. Ann. Rept. 475, Final Order (Dec. 17, 2010).

rate year adjustments that are "reasonably predicted to occur" during the twelve months ending September 30, 2015, as permitted by § 56-235.2 of the Code.[3]

On May 28, 2014, the Commission issued an Order for Notice and Hearing ("Procedural Order") in which it, among other things, docketed the Application; scheduled a hearing on the Application; established a procedural schedule for parties to file testimony and exhibits; and appointed a hearing examiner ("Hearing Examiner") to conduct all further proceedings on behalf of the Commission.[4] In its Procedural Order, the Commission allowed the Company to implement its proposed rates and tariff modifications, other than the thermal-based billing proposal, on an interim basis, subject to refund with interest, for services rendered on and after September 29, 2014.

On December 10, 2014, the Company presented a Stipulation and Proposed Recommendation ("Stipulation"), which all participants signed except Stand Energy. The Stipulation resolved all of the outstanding issues in the case, as among the stipulating participants. Specifically, the Stipulation stated, in part: (i) the Company's earned return for the 2013 test period fell below the midpoint of the authorized ROE range of 9.6% to 10.6% established in Case No. PUE-2010-00017 and, therefore, there is no required accelerated recovery of any regulatory assets; (ii) the stipulating parties agreed to an increase in the Company's jurisdictional non-gas base revenue requirement of $25.2 million, with the resulting rates developed as shown on Attachment I of the Stipulation and the customer bill impact shown

[3] Ex. 2 (Application) at 4.

[4] The Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel"); County of Fairfax, Virginia ("Fairfax County"); Virginia Industrial Gas Users Association ("VIGUA"); Stand Energy Corporation ("Stand Energy"); and Chaparral (Virginia) Inc. ("Chaparral"), filed Notices of Participation. In accordance with the Commission's Procedural Order, VIGUA and Consumer Counsel filed testimony on October 14, 2014, and the Staff of the Commission ("Staff") filed testimony on November 5, 2014. The Company filed rebuttal testimony on November 19, 2014.

on Attachment II of the Stipulation; (iii) the Company agreed to adopt the capital structure and cost of debt in Staff witness Gleason's testimony, and the stipulating parties agreed to an authorized ROE range of 9.00% to 10.00%, with a ROE of 9.75% used to determine the revenue requirement in this case, and the midpoint of the ROE range to be used for earnings tests; and (iv) the Company would implement thermal (Dth) billing, to be effective no later than meter readings on and after January 1, 2016.[5] The parties also agreed to the treatment of eligible safety activity costs ("ESAC") deferred prior to the rate year beginning October 1, 2014.[6]

On January 13, 2015, the Hearing Examiner filed his Report, which recommended that the Commission adopt the Stipulation, approve the Company's Application as modified by the Stipulation, and direct the Company to make appropriate refunds.

On March 30, 2015, the Commission issued its Order Remanding for Further Action ("Remand Order"). The Remand Order found that the total revenue requirement and class allocation set forth in the Stipulation are supported by the evidence and are reasonable. The Commission further found, however, that the Stipulation's proposed rate design within each class is not reasonable, for the reasons that (i) the amount of revenue assigned to the fixed customer charges is unreasonably high, and (ii) it is unreasonable to assign such a large percentage of costs of the Company's distribution integrity management program and SAVE Plan to fixed charges, as set forth in the Stipulation. Accordingly, the Commission remanded the case to the Hearing Examiner to conduct further proceedings and issue a report with findings and recommendations on establishing a reasonable rate design for each customer class to recover the revenue requirement assigned to that class pursuant to the Stipulation.

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[5] Ex. 31 (Stipulation) at 1-3.

[6] *Id.* at 3-4.

On April 10, 2015, the Hearing Examiner issued a Ruling ("Ruling") scheduling an evidentiary hearing and establishing a procedural schedule for the filing of remand testimony. In accordance with the Hearing Examiner's Ruling, the Company filed remand direct testimony on April 24, 2015; VIGUA and Consumer Counsel filed remand testimony on May 8, 2015; and Staff filed remand testimony on May 15, 2015. The Company filed remand rebuttal testimony on May 22, 2015.

The remand hearing was convened as scheduled on June 3, 2015. Counsel for Columbia, VIGUA, Fairfax County, Consumer Counsel and Staff attended the remand hearing.[7] At the remand hearing, the parties presented an Addendum and Modification of Stipulation and Proposed Recommendation ("Addendum and Recommendation") severing the rate design issue from the remaining issues in the Stipulation (which the stipulating parties agreed would remain in full force and effect) and modifying the thermal billing implementation date to be no later than July 1, 2016.[8]

On June 30, 2015, the Report on Remand of Michael D. Thomas, Hearing Examiner ("Hearing Examiner's Report on Remand" or "Report on Remand") was filed. In his Report on Remand, the Hearing Examiner reviewed the rate design proposals set forth by the Company, VIGUA, Consumer Counsel and Staff, and made the following findings and recommendations:

> (1) Consumer Counsel's recommended customer charges, which include only the cost to connect the customer to the Company's distribution system, administer the account, bill the customer, and SAVE- or ESAC-related service riser and meter replacement costs, are reasonable;

[7] Chaparral did not attend the hearing and Stand Energy did not participate in the remand case.

[8] *See* Ex. 32 (Addendum and Recommendation).

(2) The Company's proposed Option 1 and Option 2 customer charges are unreasonable because SAVE-related distribution system costs are included in those charges;

(3) The Company's SAVE and ESAC distribution system-related costs should be recovered in its volumetric rate;

(4) The LGS2 and TS2 class customer charge of $2,700.00 is reasonable;

(5) The LGS1 and TS1 class customer charge should remain at $550.00 until such time as an analysis similar to the one performed by Consumer Counsel witness Watkins may be performed for those rate classes;

(6) The parties' Addendum and Recommendation is reasonable; and

(7) The parties' recommendation to delay the implementation of thermal billing from January 1, 2016, to July 1, 2016, is reasonable.[9]

Fairfax County, VIGUA, and Consumer Counsel timely filed comments supporting the findings and recommendations in the Hearing Examiner's Report on Remand.[10] On July 10, 2015, Columbia Gas filed comments ("Columbia Gas Comments") supporting adoption of the Hearing Examiner's recommended customer charges, the Hearing Examiner's finding that the Addendum and Recommendation is reasonable, and the Hearing Examiner's finding that the recommendation to delay the implementation of thermal billing to July 1, 2016, is reasonable. The Company does not, however, support the Hearing Examiner's recommendation to establish a "bright-line" rule for the types of costs that may or may not be recovered through the customer charge. The Company specifically opposes the Hearing Examiner's Finding (1), insofar as it

[9] The Hearing Examiner's recommended customer charges, along with the customer charges recommended by the Company, Staff and respondents, are summarized in Attachment 1 to the Hearing Examiner's Report on Remand.

[10] Fairfax County filed their comments on July 8, 2015, and VIGUA and Consumer Counsel filed their comments on July 10, 2015. Staff filed a letter on July 10, 2015, indicating that Staff would not be filing comments on the Hearing Examiner's Report on Remand.

limits the types of costs that may be included in the customer charge, and the Hearing Examiner's Findings (2) and (3).[11]

NOW THE COMMISSION, upon consideration of this matter, finds that the Stipulation (as modified by the Addendum and Recommendation) and Addendum and Recommendation are reasonable and should be adopted. We further find that the Hearing Examiner's recommended rate design for each customer class to recover the revenue requirement assigned to that class pursuant to the Stipulation is reasonable. Accordingly, we adopt the Hearing Examiner's findings in his Report on Remand with regard to the recommended rate design for each class, as well as the Hearing Examiner's Findings (6) and (7), above.

In so doing, however, we do not approve a bright-line rule of what costs may or may not be included in the fixed customer charge. Rather, the Commission's findings in the instant case are based on the specific facts as presented in this proceeding. As noted in the Company's comments, the Commission has historically exercised discretion in determining the appropriate level of customer charges based on the facts and circumstances of each case.[12] That is what we have done here and we need not adopt a bright-line rule governing what costs may or may not be included in a fixed customer charge.

Accordingly, IT IS ORDERED THAT:

(1) The findings and recommendations of the June 30, 2015 Hearing Examiner's Report on Remand are hereby adopted in part, consistent with our findings above.

(2) In accordance with the findings made herein, the Stipulation attached hereto as Attachment A is adopted, as modified by the Addendum and Recommendation, and the terms of

[11] Columbia Gas Comments at 12.

[12] *Id.* at 6-8.

the Stipulation not modified by the Addendum and Recommendation are incorporated herein. The Addendum and Recommendation attached hereto as Attachment B is adopted, and its terms are incorporated herein.

(3) The rates and charges approved herein are fixed and substituted for the rates and charges and terms and conditions that took effect on an interim basis on September 29, 2014. The Company shall forthwith file revised tariff sheets incorporating the findings herein on rates and charges and terms and conditions of service with the Clerk of the Commission and the Commission's Division of Energy Regulation in accordance with this Final Order. The Clerk of the Commission shall retain such filing for public inspection in person and on the Commission's website: http://www.scc.virginia.gov/case. Refunds of interim rates shall be made as required below.

(4) The Company shall recalculate, using the rates and charges approved herein, each bill it rendered that used, in whole or in part, the rates and charges that took effect on an interim basis and subject to refund on and after September 29, 2014, and, where application of the new rates results in a reduced bill, refund the difference with interest as set out below within ninety (90) days of the issuance of this Final Order.

(5) Interest upon the ordered refunds shall be computed from the date payments of monthly bills were due to the date each refund is made at the average prime rate for each calendar quarter, compounded quarterly. The average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin or in the Federal Reserve's Selected Interest Rates (Statistical Release H. 15) for the three (3) months of the preceding calendar quarter.

(6) The refunds ordered herein may be credited to the current customers' accounts. Refunds to former customers shall be made by check mailed to the last known address of such customers when the refund amount is $1 or more. The Company may offset the credit or refund to the extent of any undisputed outstanding balance for the current or former customer. No offset shall be permitted against any disputed portion of an outstanding balance. The Company may retain refunds to former customers when such refund is less than $1, however such refunds shall be promptly made upon request. All unclaimed refunds shall be subject to § 55-210.6:2 of the Code.

(7) Within sixty (60) days of completing the refunds ordered herein, the Company shall deliver to the Commission's Divisions of Energy Regulation and Utility Accounting and Finance a report showing that all refunds have been made pursuant to this Final Order and detailing the costs incurred in effecting such refunds and the accounts charged.

(8) The Company shall bear all costs incurred in effecting the refunds ordered herein.

(9) This matter is dismissed.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to all persons on the official Service List in this matter. The Service List is available from the Clerk of the State Corporation Commission, c/o Document Control Center, 1300 East Main Street, First Floor, Tyler Building, Richmond, Virginia 23219. A copy also shall be delivered to the Commission's Office of General Counsel and Divisions of Energy Regulation, Utility Accounting and Finance, and Utility and Railroad Safety.

ATTACHMENT A

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

APPLICATION OF)
)
COLUMBIA GAS OF VIRGINIA, INC.)
) CASE NO. PUE-2014-00020
For authority to increase rates and charges)
and to revise the terms and conditions)
applicable to gas service)

STIPULATION AND PROPOSED RECOMMENDATION

This Stipulation and Proposed Recommendation ("Stipulation") represents the agreement between Columbia Gas of Virginia, Inc. ("CGV" or the "Company"), the Staff of the State Corporation Commission ("Staff"), the Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel"), the Virginia Industrial Gas Users' Association ("VIGUA"), the Board of Supervisors of Fairfax County ("Fairfax"), and Chaparral (Virginia) Inc. (collectively, "the Stipulating Participants") resolving all issues raised by the Stipulating Participants relating to the Application filed by CGV on April 30, 2014 ("Application") for authority to increase rates and charges and to revise the terms and conditions applicable to gas service. The Stipulating Participants, by their undersigned counsel, recommend that this Stipulation be adopted and stipulate and agree as follows:

1. Earnings Test: The results of the 2013 Earnings Test analysis demonstrate that the Company's earned return for the 2013 test period fell below the midpoint of the authorized return on equity ("ROE") range of 9.6% - 10.6% established in Case No. PUE-2010-00017, and that the level of earnings during the 2013 test period does not result in the accelerated recovery of any regulatory assets.

2. Revenue Requirement: The increase in the Company's jurisdictional non-gas base revenue requirement will be $25.2 million. Resulting rates will be developed as shown on

Attachment I. An illustrative calculation of the impact on average monthly customer bills by rate class is shown on Attachment II, hereto.

3. Cost of Capital and Return on Equity: For purposes of settlement, the Company agrees to adopt the capital structure and debt costs as stated in the testimony of Staff Witness Gleason. The authorized ROE range for the Company will be 9.00% to 10.00%, and a ROE of 9.75% is reasonable for purposes of determining the revenue requirement in this proceeding. The Company's overall weighted average cost of capital is 7.35%, as set forth in Attachment III, hereto.

4. NCSC OPEB Transition and Metered Propane Service Conversion Costs: The Company agrees to forego regulatory asset treatment of the Metered Propane Service conversion costs and the NiSource Corporate Services Company ("NCSC") other post-retirement employee benefits ("OPEB") transition obligation which were presented in this proceeding. Metered propane conversion expenses incurred subsequent to the test year will be accrued against income in the period incurred.

5. Cost Amortization: The non-gas base revenue requirement increase specified in Paragraph (2) reflects the amortization of (i) environmental remediation costs over the remaining portion of the 10-year amortization period; (ii) strategic natural gas facilities costs under § 56-235.9 of the Code of Virginia ("Va. Code"), as of September 30, 2014, over a period of five years; and (iii) Natural Gas Energy Infrastructure for Economic Development costs in the manner recommended by Staff Witness McLeod.

6. Revenue Apportionment and Rate Design: Rates established in this proceeding will be calculated using a revenue apportionment of the $25.2 million non-gas base revenue requirement increase, as specified in Paragraph (2) above, in the manner presented in Company Witness Balmert's testimony and as agreed to by Staff Witness Tufaro. Staff Witness Tufaro's proposed rate design for the Residential, Small General Service ("SGS") and Large General Service customer classes will be implemented, except that (1) the respective customer charges

will be increased as specified in Company Witness Balmert's testimony, and (2) the rates applicable to the LGS2/TS2 customer class will be designed in a manner that results in every billing block receiving the same percentage increase. This rate design reflects the segmentation of the SGS class into three separate classes.

7. Tariff Modifications: The Company will implement thermal (Dth) billing consistent with the methodology presented in Company Witness Horner's testimony to be effective no later than meter readings on and after January 1, 2016. The Company agrees to provide a schedule of monthly BTU values from each of the five pipeline scheduling points for the preceding calendar year in its Annual Informational Filings ("AIFs") submitted to the Commission. The Company's additional proposed modifications to its tariff language and General Terms and Conditions will be adopted as reflected in the Company's Application, except that the Company will withdraw (i) the proposed tariff changes to *Section 5 – Force Majeure and Company Liability* and (ii) the proposed tariff changes to *Section 12.1 – Budget Payment Plan* for new customers.

8. Precedential Effect: The ROE of 9.75% used to establish rates in this proceeding will be used for purposes of calculating rates under the Company's Steps to Advance Virginia's Energy Plan and will be the Company's authorized ROE prior to any further change in ROE adopted by the Commission. It is further agreed that, until changed by the Commission, the midpoint of a ROE range of 9.0% - 10.0% will be used for earnings tests. Until the next rate proceeding, the Company will recognize the accounting treatment reflected in Paragraph (5) for earnings test purposes.

9. Eligible Safety Activity Costs:[1] The Stipulating Participants agree to the following concerning the treatment for eligible safety activity costs ("ESAC") deferred prior to the Rate Year, amortized over a five-year basis, and incurred during and after the Rate Year: (1) the

[1] In the testimony of Staff witness McLeod, ESAC was referred to as distribution integrity management plan operation and maintenance expenses, or DIMP O&M expenses.

revenue requirement included in Paragraph (2) includes $7.72 million of ESAC, as reflected on Line 23 in Attachment IV; (2) the Company will calculate and record the over/under collection of ESAC on its books by comparing (i) ESAC recoveries determined using an ESAC recovery factor of $2.54/bill as reflected on Line 30 in Attachment IV, to (ii) actual ESAC; (3) For purposes of calculating the ESAC deferral for periods preceding the Rate Year, CGV will calculate a baseline of ESAC using 2012 pipeline safety costs following the methodology used to develop the 2009 baseline study submitted in this proceeding, as revised by Staff witness McLeod. The results of the 2012 study will be filed for Commission review with the Company's next AIF, and the Commission approved 2012 baseline study will be used to adjust the calculation of pre-rate year ESAC deferrals; and (4) the ESAC deferral balance will be included as a component of rate base in future AIFs.

10. 7/12 Class Cost of Service Study: The Company will conduct a Class Cost of Service study based on the Customer/Demand methodology, adjusted to allocate seven-twelfths (7/12) of demand-related costs to interruptible customer classes. The Company will file the results of that study for informational purposes with the Company's next non-gas base rate case. However, the Company will not be obligated to utilize the results of the study.

Additional Provisions

11. The Company will refund, with interest and pursuant to such terms and conditions as specified by the Commission, the increased revenues collected under the interim rates implemented for service rendered on and after September 29, 2014.

12. The Stipulating Participants further stipulate as follows with respect to the evidentiary record:

a. CGV's Application and Attachments and the Pre-Filed Direct Testimony, Attachments and Exhibits of Company witnesses Carl W. Levander, Michael A. Huwar, Vincent V. Rea, S. Mark Katko, Chad E. Notestone, Brian E. Elliott, Chun-Yi Lai, Mark P. Balmert, Jeffrey C. Eing, Jennifer L. Sawyers, Patrick L.

Baryenbruch and Robert E. Horner, filed on April 30, 2014 and as corrected on October 21, 2014, shall be made part of the record without cross-examination.

b. The Pre-Filed Direct Testimony, Attachments and Exhibits of VIGUA Witness Brian C. Collins, filed on October 14, 2014, shall be made part of the record without cross-examination.

c. The Pre-Filed Direct Testimony, Attachments and Exhibits of Consumer Counsel Witness David C. Parcell, filed on October 14, 2014, shall be made part of the record without cross-examination.

d. The Pre-Filed Direct Testimony, Attachments and Exhibits of Staff Witnesses Paul M. McLeod, Marc A. Tufaro, Michael W. Gleason and James M. Hotinger, filed on November 5, 2014, shall be made part of the record without cross-examination.

e. The Pre-Filed Rebuttal Testimony, Attachments and Exhibits of Company Witnesses Carl W. Levander, Vincent V. Rea, S. Mark Katko, Chad E. Notestone, Panpilas Fischer, Brian E. Elliott, Chun-Yi Lai, Mark P. Balmert, Jennifer L. Sawyers, and Robert E. Horner, filed on November 19, 2014 and as corrected on November 20, 2014, shall be made part of the record without cross-examination.

13. The Stipulating Participants agree that this Stipulation represents a compromise for the purposes of settlement of this case. None of the signatories to this Stipulation necessarily agree with the treatment of any particular item, any procedure followed, or the resolution of any particular issue in agreeing to this Stipulation other than as specified herein, except that the Stipulating Participants agree that the resolution of the issues herein, taken as a whole, and the disposition of all other matters set forth in this Stipulation are in the public interest. This Stipulation is conditioned upon and subject to acceptance by the Commission and is non-severable and of no force or effect and may not be used for any other purpose unless accepted in its entirety by the Commission.

14. In the event that the Hearing Examiner does not accept the Stipulation in its entirety, including the issuance of a recommendation to approve the Stipulation, each of the signatories herein retains the right to withdraw support for the Stipulation. In the event of such action by the Hearing Examiner, any of the signatories to the Stipulation will be entitled to give notice exercising its right to withdraw support for the Stipulation; provided, however, that the signatories to the Stipulation may, by unanimous consent, elect to modify the Stipulation to address any modifications required, or issues raised, by the Hearing Examiner or the Commission. Should the Stipulation not be approved, it will be considered void and have no precedential effect, and the signatories to the Stipulation reserve their rights to participate in all relevant proceedings in the captioned case notwithstanding their agreement to the terms of the Stipulation. If the Hearing Examiner or the Commission chooses to reject the Stipulation, an *ore tenus* hearing shall be convened at which time testimony and evidence may be presented by the case participants and cross-examination may occur.

[SIGNATURE PAGE FOLLOWS]

Accepted and Agreed to this 10th day of December, 2014.

VIRGINIA INDUSTRIAL GAS USERS' ASSOCIATION

By: ______________________
Counsel

Michael J. Quinan, Esq.
James G. Ritter, Esq.
Christian & Barton, LLP
909 E. Main Street, Suite 1200
Richmond, Virginia 23219

CHAPARRAL (VIRGINIA) INC.

By: ______________________
Counsel

Robert F. Riley, Esq.
Williams Mullen
1666 K Street, NW
Suite 1200
Washington, DC 20006

R. Brian Ball, Esq.
Williams Mullen
200 S 10th St., Suite 1600
Richmond, Virginia 23219

BOARD OF SUPERVISORS OF FAIRFAX COUNTY

By: ______________________
Counsel

Susan E. Cooke, Esq.
Assistant County Attorney
Office of the Fairfax County Attorney
Suite 549
12000 Government Center Parkway
Fairfax, Virginia 22035-0064

OFFICE OF ATTORNEY GENERAL,
DIVISION OF CONSUMER COUNSEL

By: ______________________
Counsel

C. Meade Browder, Jr., Esq.
Kiva B. Pierce, Esq.
Office of the Attorney General
Division of Consumer Counsel
900 E. Main Street, 2nd Floor
Richmond, Virginia 23219

STAFF OF THE VIRGINIA STATE
CORPORATION COMMISSION

By: ______________________
Counsel

Andrea B. Macgill, Esq.
Garland S. Carr, Esq.
Mary B. Adams, Esq.
Office of General Counsel
State Corporation Commission
1300 E. Main Street, Tyler Bldg., 10th Fl.
Richmond, Virginia 23219

COLUMBIA GAS OF VIRGINIA, INC.

By: ______________________
Counsel

T. Borden Ellis, Senior Counsel
Columbia Gas of Virginia, Inc.
1809 Coyote Drive
Chester, Virginia 23836
Telephone: (804) 768-6475
tbellis@nisource.com

Vishwa B. Link
Joseph K. Reid, III
Elaine S. Ryan
McGuireWoods LLP
One James Center
901 East Cary Street
Richmond, Virginia 23219-4030
Telephone: (804) 775-4330 (VBL)
Telephone: (804) 775-1198 (JKR)
Telephone: (804) 775-1090 (ESR)
vlink@mcguirewoods.com
jreid@mcguirewoods.com
eryan@mcguirewoods.com

ATTACHMENT B

EX. 32

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

APPLICATION OF COLUMBIA GAS OF VIRGINIA, INC. For authority to increase rates and charges and to revise the terms and conditions applicable to gas service	)))))))	CASE NO. PUE-2014-00020

ADDENDUM AND MODIFICATION OF
STIPULATION AND PROPOSED RECOMMENDATION

NOW COME the undersigned parties to the December 10, 2014 Stipulation and Proposed Recommendation ("Stipulation") filed in Case No. PUE-2014-00020, Columbia Gas of Virginia, Inc. ("CGV" or the "Company"), the Staff of the State Corporation Commission ("Staff"), the Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel"), the Virginia Industrial Gas Users' Association ("VIGUA"), the Board of Supervisors of Fairfax County ("Fairfax"), and Chaparral (Virginia) Inc. (collectively, "the Stipulating Participants"), to agree and recommend to the Commission that it issue an order or orders in this matter approving the Stipulation, as supplemented, or modified as indicated, by the provisions set forth herein ("Addendum"):

15. Consistent with the Commission's Order Remanding for Further Action ("Remand Order") issued on March 30, 2015 in the captioned case, the Stipulating Participants agree that:

i. the language in Paragraph (2) of the Stipulation stating that:

> Resulting rates will be developed as shown on Attachment I. An illustrative calculation of the impact on average monthly customer bills by rate class is shown on Attachment II, hereto.

shall be severed from the Stipulation;

ii. Attachments I and II shall be severed from the Stipulation; and

iii. all of the language in Paragraph (6) of the Stipulation shall be severed and superseded with the following language:

Rates established in this proceeding will be calculated using a revenue apportionment of the $25.2 million non-gas base revenue requirement increase, as specified in Exhibit A hereto, and the rates applicable to the LGS2/TS2 customer class will be designed in a manner that results in every billing block receiving the same percentage increase. The rates will reflect the segmentation of the SGS class into three separate classes.

16. Each of the Stipulating Participants retains the right to fully participate in all relevant proceedings in the captioned case on the sole issue of "establishing a reasonable rate design for each customer class to recover the revenue requirement assigned to that class pursuant to the Stipulation" as directed on page 4 of the Commission's Remand Order and as directed by the Hearing Examiner's Ruling issued on April 10, 2015.

17. The Stipulating Participants further agree that the Company will implement thermal (Dth) billing consistent with the methodology presented in Company Witness Horner's testimony to be effective no later than July 1, 2016. This Paragraph modifies the provisions of Paragraph (7) of the Stipulation only to the extent that it modifies the thermal billing implementation date.

18. All other provisions of the Stipulation shall remain in full force and effect.

WHEREFORE, the undersigned parties agree that the Stipulation, as supplemented or modified by this Addendum, represents a compromise for the purposes of settlement of this case and balancing of many interests, and none of the signatories to this Stipulation and Addendum necessarily agrees with the treatment of any particular item, any procedure followed, or the resolution of any particular issue in agreeing to this Stipulation and Addendum other than as specified herein, except as required to implement provisions of this Stipulation and Addendum, and the parties agree that the resolution of the issues herein, taken as a whole, and the disposition of all other matters set forth in this Stipulation and Addendum, except as may be subject to further proceedings, are in the public interest.

15-03-0286

Accepted and Agreed to this 2nd day of June, 2015.

VIRGINIA INDUSTRIAL GAS USERS' ASSOCIATION

By: James G. Ritter
Counsel

Michael J. Quinan, Esq.
James G. Ritter, Esq.
Christian & Barton, LLP
909 E. Main Street, Suite 1200
Richmond, Virginia 23219

CHAPARRAL (VIRGINIA) INC.

By: ______________________
Counsel

Robert F. Riley, Esq.
Williams Mullen
1666 K Street, NW
Suite 1200
Washington, DC 20006

R. Brian Ball, Esq.
Williams Mullen
200 S 10th St., Suite 1600
Richmond, Virginia 23219

BOARD OF SUPERVISORS OF FAIRFAX COUNTY

By: ______________________
Counsel

Susan E. Cooke, Esq.
Assistant County Attorney
Office of the Fairfax County Attorney
Suite 549
12000 Government Center Parkway
Fairfax, Virginia 22035-0064

Accepted and Agreed to this 2nd day of June, 2015.

VIRGINIA INDUSTRIAL GAS USERS' ASSOCIATION

By: ______________________

Counsel

Michael J. Quinan, Esq.
James G. Ritter, Esq.
Christian & Barton, LLP
909 E. Main Street, Suite 1200
Richmond, Virginia 23219

CHAPARRAL (VIRGINIA) INC.

By: ______________________

Counsel

Robert F. Riley, Esq.
Williams Mullen
1666 K Street, NW
Suite 1200
Washington, DC 20006

R. Brian Ball, Esq.
Williams Mullen
200 S 10th St., Suite 1600
Richmond, Virginia 23219

BOARD OF SUPERVISORS OF FAIRFAX COUNTY

By: ______________________

Counsel

Susan E. Cooke, Esq.
Assistant County Attorney
Office of the Fairfax County Attorney
Suite 549
12000 Government Center Parkway
Fairfax, Virginia 22035-0064

Accepted and Agreed to this ____ day of ____, 2015.

VIRGINIA INDUSTRIAL GAS USERS' ASSOCIATION

By: ______________________
Counsel

Michael J. Quinan, Esq.
James G. Ritter, Esq.
Christian & Barton, LLP
909 E. Main Street, Suite 1200
Richmond, Virginia 23219

CHAPARRAL (VIRGINIA) INC.

By: ______________________
Counsel

Robert F. Riley, Esq.
Williams Mullen
1666 K Street, NW
Suite 1200
Washington, DC 20006

R. Brian Ball, Esq.
Williams Mullen
200 S 10th St., Suite 1600
Richmond, Virginia 23219

BOARD OF SUPERVISORS OF FAIRFAX COUNTY

By: ______________________
Counsel

Susan E. Cooke, Esq.
Assistant County Attorney
Office of the Fairfax County Attorney
Suite 549
12000 Government Center Parkway
Fairfax, Virginia 22035-0064

OFFICE OF ATTORNEY GENERAL,
DIVISION OF CONSUMER COUNSEL

By: ______________________
Counsel

C. Meade Browder, Jr., Esq.
Kiva B. Pierce, Esq.
Office of the Attorney General
Division of Consumer Counsel
900 E. Main Street, 2nd Floor
Richmond, Virginia 23219

STAFF OF THE VIRGINIA STATE
CORPORATION COMMISSION

By: ______________________
Counsel

Andrea B. Macgill, Esq.
Garland S. Carr, Esq.
Mary B. Adams, Esq.
Office of General Counsel
State Corporation Commission
1300 E. Main Street, Tyler Bldg., 10th Fl.
Richmond, Virginia 23219

COLUMBIA GAS OF VIRGINIA, INC.

By: ______________________
Counsel

T. Borden Ellis, Assistant General Counsel
Columbia Gas of Virginia, Inc.
1809 Coyote Drive
Chester, Virginia 23836
Telephone: (804) 768-6475
tbellis@nisource.com

Vishwa B. Link
Joseph K. Reid, III
Elaine S. Ryan

150840076

OFFICE OF ATTORNEY GENERAL,
DIVISION OF CONSUMER COUNSEL

By: ______________________
Counsel

C. Meade Browder, Jr., Esq.
Kiva B. Pierce, Esq.
Office of the Attorney General
Division of Consumer Counsel
900 E. Main Street, 2nd Floor
Richmond, Virginia 23219

STAFF OF THE VIRGINIA STATE
CORPORATION COMMISSION

By: ______________________
Counsel

Andrea B. Macgill, Esq.
Garland S. Carr, Esq.
Mary B. Adams, Esq.
Office of General Counsel
State Corporation Commission
1300 E. Main Street, Tyler Bldg., 10th Fl.
Richmond, Virginia 23219

COLUMBIA GAS OF VIRGINIA, INC.

By: ______________________
Counsel

T. Borden Ellis, Assistant General Counsel
Columbia Gas of Virginia, Inc.
1809 Coyote Drive
Chester, Virginia 23836
Telephone: (804) 768-6475
tbellis@nisource.com

Vishwa B. Link
Joseph K. Reid, III
Elaine S. Ryan

OFFICE OF ATTORNEY GENERAL,
DIVISION OF CONSUMER COUNSEL

By: ______________________
Counsel

C. Meade Browder, Jr., Esq.
Kiva B. Pierce, Esq.
Office of the Attorney General
Division of Consumer Counsel
900 E. Main Street, 2nd Floor
Richmond, Virginia 23219

STAFF OF THE VIRGINIA STATE
CORPORATION COMMISSION

By: ______________________
Counsel

Andrea B. Macgill, Esq.
Garland S. Carr, Esq.
Mary B. Adams, Esq.
Office of General Counsel
State Corporation Commission
1300 E. Main Street, Tyler Bldg., 10th Fl.
Richmond, Virginia 23219

COLUMBIA GAS OF VIRGINIA, INC.

By: T. Borden Ellis
Counsel

T. Borden Ellis, Assistant General Counsel
Columbia Gas of Virginia, Inc.
1809 Coyote Drive
Chester, Virginia 23836
Telephone: (804) 768-6475
tbellis@nisource.com

Vishwa B. Link
Joseph K. Reid, III
Elaine S. Ryan

150824069

Exhibit A

Columbia Gas of Virginia, Inc.
Revenue Apportionment of Non-Gas Base
Revenue Requirement Increase

	Revenue Increase
RS/RTS	$18,944,084
SGS1/SGTS1	807,717
SGS2/SGTS2	567,152
SGS3/SGTS3	1,670,698
LGS1/TS1	1,725,213
LGS2/TS2	1,291,847
Other Service Charge Revenue	193,289
	$25,200,000

151827276

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing was sent via first class mail and e-mail on this 17th day of August 2015, to the following:

Andrea B. Macgill, Esq.
Garland S. Carr, Esq.
Mary B. Adams, Esq.
Office of General Counsel
State Corporation Commission
1300 E. Main Street, Tyler Bldg., 10th Fl.
Richmond, Virginia 23219

C. Meade Browder, Jr., Esq.
Kiva B. Pierce, Esq.
Office of the Attorney General
Division of Consumer Counsel
900 E. Main Street, 2nd Floor
Richmond, Virginia 23219

Michael J. Quinan, Esq.
James G. Ritter, Esq.
Christian & Barton, LLP
909 E. Main Street, Suite 1200
Richmond, Virginia 23219

R. Brian Ball, Esq.
Williams Mullen
200 S 10th St., Suite 1600
Richmond, Virginia 23219

Susan E. Cooke, Esq.
Assistant County Attorney
Office of the Fairfax County Attorney
Suite 549
12000 Government Center Parkway
Fairfax, Virginia 22035-0064

Robert F. Riley, Esq.
Williams Mullen
1666 K Street, NW
Suite 1200
Washington, DC 20006

Brian R. Greene, Esq.
Eric J. Wallace, Esq.
GreeneHurlocker
1807 Libbie Avenue, Suite 102
Richmond, Virginia 23226

Joshua B. Lim

Exhibit A

Columbia Gas of Virginia, Inc.
Revenue Apportionment of Non-Gas Base
Revenue Requirement Increase

	Revenue Increase
RS/RTS	$18,944,084
SGS1/SGTS1	807,717
SGS2/SGTS2	567,152
SGS3/SGTS3	1,670,698
LGS1/TS1	1,725,213
LGS2/TS2	1,291,847
Other Service Charge Revenue	193,289
	$25,200,000

[Service Date March 25, 2015]

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PACIFIC POWER & LIGHT COMPANY, a Division of PacifiCorp, Respondent.	DOCKET UE-140762 *(Consolidated)* ORDER 08 FINAL ORDER REJECTING TARIFF SHEETS; RESOLVING CONTESTED ISSUES; AUTHORIZING AND REQUIRING COMPLIANCE FILINGS;
. . . .	
In the Matter of PACIFIC POWER & LIGHT COMPANY Petition for an Order Approving Deferral of the Washington-Allocated Revenue Requirement Associated with the Merwin Fish Collector.	DOCKET UE-140617 (*Consolidated*) GRANTING, IN PART, RECOVERY OF DEFERRED COSTS;
. . . .	
In the Matter of PACIFIC POWER & LIGHT COMPANY Petition for an Order Approving Deferral of Costs Related to Colstrip Outage.	DOCKET UE-131384 (*Consolidated*) DENYING PETITION FOR ACCOUNTING ORDER;
. . . .	
In the Matter of PACIFIC POWER & LIGHT COMPANY Petition for an Order Approving Deferral of Costs Related to Declining Hydro Generation.	DOCKET UE-140094 (*Consolidated*) DENYING PETITION FOR ACCOUNTING ORDER
. . . .	

changes in rate spread: fairness, perceptions of equity, economic conditions in the service territory, gradualism, and rate stability. Indeed, in Pacific Power's 2010 GRC the Commission found that increases of 114 percent of the average were too extreme.[295] The other parties' proposals effectively present a more measured move in the direction of greater parity, capping the disproportionate increases to residential and other customer classes at 112 percent of the average increase. On balance, while we appreciate Staff's efforts to move quickly toward greater parity, we believe the Company's proposal comports best with principles the Commission has enunciated in prior orders. We therefore accept the Company's proposal in this case.

3. Rate Design

a) Residential Rates

203 Pacific Power proposes to increase the residential basic charge for Schedule 16 customers from $7.75 per month to $14.00 per month, an 81 percent increase from the current level. The Company would make an exception for Schedule 17, which sets rates for qualifying customers under the Company's Low Income Bill Assistance (LIBA) Program, increasing the basic charge by one dollar to $8.75. Ms. Steward testifies that the Company's embedded cost of service results supports an even higher basic charge of $28.00 per month.[296] This figure includes distribution system fixed costs (line transformers, poles, and wires), now recovered in volumetric rates, as well as the traditional costs included in basic charges that vary based on the number of customers served (service drops, meters, meter reading, and billing).[297] Ms. Steward implies that all fixed costs are appropriate for inclusion in the basic charge, including transmission and generation, which would raise the charge even more, to $47.00 per month.[298]

204 Staff proposes increasing the basic charge to $13 to allow the company more stable revenues and in support of its proposal to add a third volumetric block to encourage conservation and distributed generation (DG).[299] Staff reaches its proposed $13 basic

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[295] *WUTC v. PacifiCorp,* Docket UE-100749, Order 06, ¶ 315 (March 25, 2011).

[296] Steward, Exh. No. JRS-1T at 19:1-18.

[297] *Id.* at 19:1-18.

[298] *Id.* at 19:7-9.

[299] Twitchell, Exh. No. JBT-1T at 4:10-19.

charge by including the cost of line transformers, a distribution system cost previously included in energy rates.[300]

205 Public Counsel, TASC, and the Energy Project all offer testimony that the basic charge should include only costs that vary based on the number of customers served.[301] Public Counsel and TASC argue, based on the traditional "direct customer cost" analysis and a Regulatory Assistance Project paper, that transformer costs vary based upon demand and should be included in energy rates.[302] Public Counsel and TASC also argue that the Company's increase in the basic charge violates the regulatory principle of gradualism and is contrary to conservation efforts.[303] Mr. Watkins, for Public Counsel calculates that using traditional "direct customer cost" analysis, the basic charge should be between $7.31-7.50.[304] Mr. Fulmer, for TASC, supports a basic charge of $9.00.[305] Mr. Eberdt testifies that the Energy Project opposes an increase to the basic charge for all customers.[306]

206 *Staff* supports its proposed increase in the basic charge by reasoning that "in the absence of a decoupling mechanism to reduce Pacific Power's risk of under-recovering fixed costs due to declining load, it is appropriate to shift the distribution of the Company's cost recovery toward fixed sources of recovery, such as the monthly basic charge."[307] Mr. Fulmer, for TASC, points out that increasing the basic charge would discourage distributed generation, and that decoupling, attrition adjustments, minimum bills and forward-looking test years are more appropriate ways to address utility revenue deficiency than higher fixed charges.[308] Staff agrees with

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[300] *Id.* at 26:21-27:7.

[301] Watkins, Exh. No. GAW-1T at 27:1-30:22; Fulmer, Exh. No. MEF-1T at 6:1-8:2; Eberdt, Exh. No. CME-13 at 10.

[302] Fulmer, Exh. No. MEF-1T at 9:17-21 (note 9) (*citing* Weston, Frederick, "Charging For Distribution Utility Services: Issues In Rate Design," the Regulatory Assistance Project. (December 2000)).

[303] Watkins, Exh. No. GAW-1T at 17:17-21; Fulmer Exh. No. MEF-1T at 10:3-12:16.

[304] Watkins, Exh. No. GAW-1T at 27:15-20.

[305] Fulmer, Exh. No. MEF-1T at 3:3-4.

[306] Eberdt, Exh. No. CME-1T at 21:17-22:16.

[307] Twitchell, Exh. No. JBT-1T at 26:15-18. Pacific Power provides a similar argument in support of revenue stability. *See* Steward Exh. No. JRS-1T at 19:19-21:17.

[308] Fulmer, Exh. No. MEF-1T at 12:20-28.

TASC on this point, stating in its Initial Brief that it is curious that Pacific Power did not request a decoupling mechanism in this case. Staff argues that "[t]he decoupling mechanisms recently approved by the Commission provide the affected utilities a guaranteed amount of revenue, regardless of actual retail sales."[309] In Staff's view, a decoupling mechanism would provide the Company more certainty of cost recovery than do other approaches.

207 Staff combines an increase in the basic charge with the addition of a third volumetric block to Pacific Power's residential rates in order to:

- Provide the Company more reliable recovery of fixed costs.
- Establish clear price signals for consumers that support energy efficiency and distributed generation.

208 *The* bases for Staff's three-block proposal are:

- Block 1 to correspond to inelastic use,
- Block 2 to reflect average use, and
- Block 3 to assign a greater share of the increase to high-use customers and not impose additional costs on average users.[310]

Staff proposes this new structure to send a price signal that encourages conservation among customers with discretionary, or elastic, electricity use. Staff attempts to set the first volumetric block to cover a typical customer's inelastic consumption, thereby placing discretionary use in the second and third volumetric blocks.[311]

209 Relying on a U.S. Dept. of Housing and Urban Development (HUD) guidebook, Staff believes that the first 800 kWh of residential usage is inelastic because it represents use for essential needs (e.g., cooking, domestic hot water, lighting, and home

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[309] Staff Initial Brief ¶ 117 (citing Twitchell, Exh. No. JBT-1T at 24:5-11; *see* Dockets UE-140188 and UG-140189, Order 05).

[310] Twitchell, Exh. No. JBT-1T, at 12:28-29.

[311] *Id.* at 28:1-13.

appliances).[312] Using data from its 2013 IRP the Company argues that the amount of electric energy use for the most common types of appliance and lighting load in a home is under 600 kWh per month.[313] This 600 kWh excludes electric heating, which is present in 56 percent of homes in the Company's service territory.[314]

210 Staff witness Mr. Twitchell estimates that the addition of the third block could result in as much as 7,660 MWh of savings annually, or 14 percent of the company's average annual conservation savings.[315] The Company claims that its rate design will result in 2 percent more conservation because a higher volumetric rate (from sales in the larger second block) would apply to more kWh sales.[316]

211 Under Staff's proposal, most customers with average use will see a bill decrease, while low use and high use customers will see a bill increase. The Company argues that lower bills for most customers mean that Staff's proposal does not encourage conservation.

212 The Company does not believe that Staff's rate design will improve its revenue stability because it will recover 22 percent of its revenue from the third block, in contrast to its own rate design, which will recover 18 percent of revenues from use over 1,700 kWh.[317] The Company argues that as a result of Staff's proposal, variances in weather will result in larger variances in revenues.[318]

213 Mr. Eberdt testifies that "the Energy Project opposes any increase to the monthly residential basic charge until such time as more thorough data is available and analyzed regarding the true number and nature of PacifiCorp's low income customers and their energy consumption."[319] Some low-income customers are relatively high

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[312] *Id.*

[313] Steward, Exh. No. JRS-13T at 44:15-20.

[314] *Id.* at 45 (Table 14).

[315] Twitchell, Exh. No. JBT-1T at 33:8-11. The estimate was developed using state-specific price elasticity data from a 2006 National Renewable Energy Lab study. *Id*.

[316] Steward, Exh. No. JRS-21; Steward Exh. No. JRS-13T at 39:9-12.

[317] Steward, Exh. No. JRS-13T at 39:23-40:2.

[318] *Id.* at 40:3-17.

[319] Eberdt, Exh. No. CME-1T at 24:2-5.

users in the winter months, not by choice, but because of poor housing stock and an inability to finance conservation measures such as insulation and more efficient heating. To these customers, an increased basic charge coupled with a third tier rate will mean increases in monthly bills to customers who can least afford it.[320] At the other end of the low-income spectrum, very low volume users will experience significantly higher bills and a disproportionate impact from an increased basic charge. Because of these impacts, the Energy Project supports raising the upper end of the first block from 600 to 800 kWh, but thinks the beginning of the third block should be higher than 1,700 kWh. Mr. Eberdt argues that many low-income customers would be subject to third block rates in the winter, "running the risk of greater shut-offs and less revenue recovery than expected."[321] Mr. Eberdt provides data that shows in two months, January and December 2013, average low-income use was about 2,200 kWh and would result in higher bills under Staff's proposal; in all other months average low-income use was in the range that will result in bill reductions.[322]

214 *The* Energy Project argues that the Company's proposal to increase the basic charge by only $1.00 for low income customers who receive benefits under either LIHEAP or LIBA does not recognize the scope of the problem increased basic charges pose for the low-income population.[323] The Energy Project points to Staff witness Mr. Kouchi's testimony that the LIHEAP/LIBA recipients to whom Schedule 17 applies constitute only 5.6 percent of the Company's residential population, yet the poverty levels in Pacific Power's Yakima and Walla Walla service areas might be as high as 23 percent to 38 percent respectively.[324] "Thus, limiting the basic charge increase to only those customers already receiving some form of assistance hardly scratches the

[320] Energy Project Initial Brief at 7.

[321] Eberdt, Exh. No. CME-8T at 3:14-17. This is because low-income households rely on electric resistance for space and hot water heating more than other customers. *Id*., 4:1-13.

[322] Eberdt, Exh. No. CME-13.

[323] *See* Eberdt, Exh. No. CME-1T at 22:4-13.

[324] Energy Project Initial Brief at 3; *See* Kouchi, Exh. No. RK-1T at 9:1-4. These figures refer only to customers who are at 150 percent or less of the federal poverty threshold, the qualifying criterion for the Company's low-income programs. The percentages of low-income customers at 200 percent of the federal poverty level, a threshold used by some utility companies, range even higher from 31 to 49 percent. *Id.* at 9:10-15.

surface of the true low income population, the majority of whom will bear the full brunt of a considerable basic charge increase."[325]

215 Mr. Eberdt also testifies that "we just don't have a good handle on the usage characteristics of PacifiCorp's low-income customers," due to conflicting usage data from the Company's proxy group (LIBA and LIHEAP participants) and the Company's residential use survey completed last year.[326] Accordingly, he recommends rejecting Staff's proposal and requiring the Company to conduct another study that better identifies low-income customers and their usage characteristics.[327] Mr. Eberdt acknowledges that this recommendation is the same as the outcome in the Company's previous general rate case, but argues that the usage study was not done well enough.

216 *Commission Determination:* We reject the Company's and Staff's proposals to increase significantly the basic charge to residential customers. The Commission is not prepared to move away from the long-accepted principle that basic charges should reflect only "direct customer costs" such as meter reading and billing. Including distribution costs in the basic charge and increasing it 81 percent, as the Company proposes in this case, does not promote, and may be antithetical to, the realization of conservation goals.

217 Staff's similar proposal to raise the basic charge significantly from the current level is tied to its other major rate design recommendation, which is to move Pacific Power's residential rates from a two-block to a three-block inverted rate structure. Such rate restructuring might promote conservation to a degree that offsets the incentive to use more electricity that may be caused by a high basic charge but we are not convinced on the record in this case that this is so. Mr. Twitchell, for Staff, performed some analysis of this question as reflected in his testimony in some detail.[328] He cautions, however, that his results "are only rough projections." He testifies that "there are a number of other factors that will affect the total reduction in electricity usage. Staff's

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[325] Energy Project Initial Brief at 3.

[326] Eberdt, Exh. No. CME-9T at 13:12-14:5.

[327] *Id.* at 14:7-15:3.

[328] Twitchell, Exh. No. JBT-1T at 30:12-33:11.

projection should be interpreted as an upper-bound estimate of the reduced usage that may occur."[329]

218 The Commission supports generally the concept of adding a third block to residential rates because it sends a price signal that promotes conservation and distributed generation. Yet we hesitate to implement a third block with a low basic charge in this case because, as Staff acknowledges, "Staff's core proposals (the increased basic charge and the third rate block) are mutually dependent."[330] No party provides analysis of the customer bill impact and company revenue impact of implementing a third block with a low basic charge. Without this analysis in the record, we are unwilling to implement a third block with a low basic charge in this case.

219 While we hope to see in the Company's next case a proposal from Pacific Power, Staff, or other parties for a third block rate that is not tied to a higher basic charge for residential customers,[331] we remain concerned about the impact of adding a third block on low-income customers. We acknowledge and commend the parties for presenting data and some analysis of the issue in the record of this case. However, the evidence does not dispel the concerns raised by the Energy Project that the rate design proposals by the Company and Staff will disproportionately impact the customers least able to afford high basic charges and high third-block usage rates. We expect the Company and others to continue developing data and undertaking analyses of low-income customer usage patterns in Pacific Power's service territory. These can inform thoughtful consideration in testimony in the Company's next general rate case concerning the price signals a third block rate design will likely have on such customers.

220 Several parties touch on decoupling, recognizing it as the Commission's preferred approach to address the various goals the Company and Staff residential rate design proposals are meant to address. The Commission's long history with decoupling dates back to 1991, when the Commission first approved decoupling for PSE's

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[329] *Id.* at 33:12-15.

[330] Staff Initial Brief ¶ 130.

[331] We note the Commission's approval of such a rate design for Avista and the Commission's recent approval of a settlement adding a third block to PSE's residential rates. *See WUTC v. Avista Corp.*, Docket UE-140188 and UG-140189, Order 05 (November 25, 2014); *WUTC v. Puget Sound Energy, Inc.*, Docket UE-141368, Order 03 (January 29, 2015).

predecessor electric company, Puget Sound Power & Light Company.[332] In 2005, the Commission conducted a rulemaking inquiry into the subject of decoupling. After taking stakeholder comments and conducting a workshop, the Commission determined that "the wide variety of alternative approaches to decoupling make it more efficient to address these issues in the context of specific utility proposals included in general rate case filings rather than through a generic rulemaking."[333]

221 Following this, the Commission considered several decoupling proposals, implementing some and rejecting others.[334] In its 2010 Decoupling Policy Statement, the Commission expressed support for full decoupling and provided utilities and other parties with guidance on the elements that a full decoupling proposal should include.[335] Essential to the policy was recognition that the mechanism should aid the company when revenue per customer decreases and aid the customer when revenue per customer increases. The Commission stated that it believed that "a properly constructed full decoupling mechanism that is intended, between general rate cases, to balance out both lost and found margin from any source can be a tool that benefits

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[332] *WUTC v. Puget Sound Power & Light Company*, Docket UE-901183-T and *In the Matter of the Petition of Puget Sound Power & Light Company for an Order Approving a Periodic Rate Adjustment Mechanism and Related Accounting,* Docket UE-901184-P, Third Supp. Order (April 1, 1991. This program was referred to as Periodic Rate Adjustment Mechanism or PRAM. The Commission monitored the program closely and, in 1993, determined it was achieving its primary goal of removing disincentives to the Company's acquisition of energy efficiency. *See Petition of Puget Sound Power & Light Company for an Order Regarding the Accounting Treatment of Residential Exchange Credits, Docket UE-920433, WUTC v. Puget Sound Power & Light Company,* Docket UE-920499 and *WUTC v. Puget Sound Power & Light Company*, Docket UE-921262 (consolidated), Eleventh Supp. Order at 10 (September 21, 1993). However, in 1995, at the Company's request, the Commission approved discontinuance of the PRAM. *See WUTC v. Puget Sound Power & Light Co., Third Supp. Order Approving Stipulations; Rejecting Tariff Filing; Authorizing Refiling,* Docket UE-950618, at 6 (Sept. 21, 1995).

[333] Rulemaking to Review Natural Gas Decoupling, Docket UG-050369, Notice of Withdrawal of Rulemaking (October 17, 2005).

[334] *See* W*UTC v. PacifiCorp,* Docket UE-050684, Order 04, ¶¶ 108-110 (April 17, 2006); *In re Petition of Avista Corp. for an Order Authorizing Implementation of a Natural Gas Decoupling Mechanism and to Record Accounting Entries Associated with the Mechanism,* Docket UG-060518, Order 04 (February 1, 2007); *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-060266 & UG-060267, Order 08, ¶¶ 53-69 (January 5, 2007); and W*UTC v. Cascade Natural Gas Corp.*, Docket UG-060256, Order 05, ¶¶ 67-85 (January 12, 2007).

[335] *See In re WUTC Investigation into Energy Conservation Incentives,* Docket U-100522, Report and Policy Statement on Regulatory Mechanisms, including Decoupling, To Encourage Utilities to Meet or Exceed Their Conservation Targets at (Nov. 4, 2010) (Decoupling Policy Statement).

both the company and its ratepayers."[336] By "decoupling" sales from revenues, a utility should no longer be encouraged to sell more energy, and conserve less, in order to earn more profit. Ending this so-called "throughput incentive" is the essence of a full decoupling mechanism.[337]

222 We approved full decoupling for PSE in 2013[338] and for Avista in 2014.[339] We invite such a proposal from Pacific Power and other parties in the Company's next general rate case. We encourage Pacific Power to engage in meaningful discussion with Staff, Public Counsel, and other interested stakeholders and to develop a proposal.

b) Non-Residential Rates

223 The Company proposes several non-controversial changes to its non-residential rate design. For Schedule 48T and 48-T Dedicated Facilities, the Company proposes larger increases to demand charges than other portions of rates.[340] Neither Boise White Paper nor Staff oppose the Company's proposal for these schedules. For general service, agricultural pumping, and street lighting schedules, the Company proposes allocating more of the increase to demand rates in order to move cost components closer to cost of service.

224 Walmart proposes a substantial increase to demand charges and a substantial decrease in energy charges for Large General Service Schedule 36. Walmart argues that "Pacific Power's current and proposed Schedule 36 charges are not reflective of the underlying cost of service and are disproportionately weighted towards collection of energy-related costs and, as a result, under collect demand-related costs."[341] In

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[336] Decoupling Policy Statement ¶ 27.

[337] *See* Regulatory Assistance Project, *Revenue Regulation and Decoupling: A Guide to Theory and Application.*

[338] *In the Matter of the Petition of Puget Sound Energy, Inc. and NW Energy Coalition For an Order Authorizing PSE to Implement Electric and Natural Gas Decoupling Mechanisms and to Record Accounting Entries Associated with the Mechanisms,* Dockets UE-121697 and UG-121705, Order 06 (June 25, 2013).

[339] WUTC v. Avista Corporation, Dockets UE-140188 and UG-140189, Order 05 (November 25, 2014).

[340] Steward, Exh. No. JRS-1T at 29.

[341] Walmart Initial Brief ¶ 11 (citing *See* Chriss, Exh. No. SWC-1T at 11:10-18).

Service Date: December 5, 2017

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, Respondent.	DOCKETS UE-170033 and UG-170034 *(consolidated)* ORDER 08 FINAL ORDER REJECTING TARIFF SHEETS; APPROVING AND ADOPTING SETTLEMENT STIPULATION; RESOLVING CONTESTED ISSUES; AND AUTHORIZING AND REQUIRING COMPLIANCE FILING

Synopsis*: The Commission approves and adopts a Settlement Stipulation that all parties to this proceeding except Public Counsel support as proposed resolutions of most of the many issues initially contested. The Settlement Stipulation would establish new revenue requirements, update PSE's cost of capital, address increased depreciation expense established in connection with shortened depreciation schedules for PSE's coal-fired production assets in Colstrip, Montana, accept numerous uncontested individual revenue requirement adjustments, and resolve several individual adjustments to which Public Counsel objects, including depreciation of natural gas capital investments, pension expense, non-Colstrip environmental remediation costs, storm damage expense, and the costs of assets held for future use. The Settling Parties agreed to, and the Commission approves in this Order, an overall electric revenue increase of $20 million (1.0 percent increase) and an overall natural gas revenue decrease of $35 million (3.9 percent decrease).*

The Settlement Stipulation also addresses several contested non-revenue issues, including guidelines for a possible expedited rate filing (ERF) to update PSE's rates within 12 months after the date of this order, plans to address the continuation of the Company's water heater program, and a changed metric for PSE's Service Quality Index. Finally, the Settlement Stipulation expressly recognizes as prudent eight projects, including capital projects improving or acquiring production, distribution, and storage assets, a power purchase agreement acquiring additional hydropower, new and renewed BPA transmission contracts, and deferred non-Colstrip depreciation expense.

issues not fully addressed in the Settlement Stipulation are uncontested and supported by the record, we find PSE's electric rate spread should be approved as described above.

b. Fully Contested Rate Design Issues: Residential Rates

i. Basic Charge, Minimum Bill, Seasonal Rates

344 PSE proposed to increase its basic charge for single-phase electric service to $9.00 per month. Mr. Piliaris testified that this reflects the current level of costs traditionally recovered through the Company's residential electric basic charges, including customer service, customer accounting, meter reading, billing, plus the costs of line transformers.[427] This would result in a $1.51 per month increase over current rates.

345 Mr. Piliaris stated that "the proposed increase is reasonable for several reasons"[428]:

- PSE currently is collecting $0.38 per month of that amount through Schedule 141 (Expedited Rate Filing), which will be zeroed out in prospective rates effective after this general rate case, leaving a net impact on customer bills of $1.13 per month.[429]
- PSE's current overall residential basic monthly charge of $7.87 is based on a test year ending June 2012 and costs have grown since then.
- PSE's electric cost of service study in this filing supports a basic charge over $2 per month higher than the $9.00 being proposed in this filing.
- Had the 3 percent annual increases allowed under the Rate Plan been applied to basic charges, where the underlying costs are usually recovered, instead of being recovered through volumetric rates under the Rate Plan (a compromise reached in support of decoupling approval) the basic charge in effect in 2017 would have been $9.12 per month.[430]

346 Mr. Piliaris also reviewed the basic charges of national and local investor-owned electric utilities, and government and customer-owned utilities in Washington state and determined a national average of $9.17 for basic charges. Based on this review, he

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[427] Piliaris, Exh. JAP-1T at 66:8-13.

[428] Piliaris, Exh. JAP-1T at 66:15.

[429] Piliaris, Exh. JAP-1T at 66:16-67:2.

[430] Piliaris, Exh. JAP-1T at 67:9-17.

determined that the average basic charge of the Washington utilities he surveyed is $17.76, "or almost double the basic charge being proposed by PSE in this filing."[431]

347 Staff proposed that the Commission establish a higher basic charge and a minimum bill with a seasonal rate two-block structure for both summer (April – September) and winter (October – March).[432] Mr. Ball testified that a minimum bill ensures that all customers contribute their full share of customer costs, while maintaining enough flexibility in energy rates to send appropriate economic signals in support of conservation.[433] Staff's identified customer cost of $10.88 includes line transformers, which Mr. Ball argues is appropriate given his analysis that establishes a strong correlation between customer count and transformer plant balances.[434]

348 Staff argues that seasonal rates are more appropriate than higher marginal rates because customers do not have enough information at a point in time to make informed decisions based on which price tier they are facing. Rather, Staff argues, customers respond to overall bills, and seasonal rates will send an intelligible price signal to customers that corresponds with the Company's higher power costs in the higher-demand winter months.[435] Mr. Ball provides detailed analysis in support of the seasonal rate calculation in Exh. JLB-4 and various analyses gaging the impact of seasonal rates on different customers.[436]

349 PSE argues that Commission Staff's proposal is too confusing and that the costs of implementing it outweigh the benefits. PSE estimates the additional $300,000 in revenue that is likely to result from the minimum bill, over and above what PSE would have recovered from the same customers without a minimum bill through volumetric rates, does not outweigh the confusion customers are likely to experience or the cost that PSE would incur in adding a minimum bill component into its residential rate structure.[437]

350 Mr. Watkins, testifying for Public Counsel, contends that three of Mr. Piliaris' four justifications for increasing the basic charge have little merit because they simply "relate to

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[431] Piliaris, Exh. JAP-1T at 68:1-12.

[432] Staff Initial Brief ¶ 32.

[433] Ball, Exh. JLB-1T at 37:8-43:11.

[434] Ball, Exh. JLB-1T at 26:1-28:10.

[435] Ball, Exh. JLB-1T at 33:1-34:3.

[436] Ball, Exh. JLB-1T at 37:8-43:11.

[437] *See* Piliaris, Exh. JAP-46CT at 42:1-44-7.

the time elapsed between the last rate case and the effects of various settlements," which are negotiated amounts that may, or may not, reflect the costs that should be included in the basic charge.[438] Mr. Watkins disputes Mr. Piliaris's cost justification, purportedly supporting a basic charge of $11.24 per month, because his "analysis inappropriately includes many costs that should not be deemed customer-related for purposes of evaluating the reasonableness of residential customer charges."[439]

351 Mr. Watkins identifies specific capital costs that Mr. Piliaris included in his customer cost analysis, including gross plant investments "in Meters ($88.5 million), Services ($175.6 million), Distribution Line Transformers ($333.2 million), and an allocated portion of General plant ($74.3 million)"[440] as being either otherwise accounted for in customer connection fees, contrary to accepted industry standards and practice, or overhead costs that should not be considered in a customer cost analysis.[441] Mr. Watkins also identifies operations and maintenance costs that he argues should not be included because they are "more appropriately considered demand-related (*e.g.*, transformer expenses) or are general overhead expenses required in order to sell electricity."[442] He acknowledged, however, that certain other Meter Reading and Customer Records & Collections expenses are properly included in Mr. Piliaris's customer cost analysis.

352 Mr. Watkins testifies that he conducted a "direct customer cost analysis," taking guidance from the Commission's treatment of this issue in Pacific Power's 2014-15 general rate case, calculating the direct residential customer cost with and without the inclusion of services cost, and under current and Company-proposed depreciation rates. He also used the Company's proposed cost of capital in this case (*i.e.*, 7.74 percent). Mr. Watkins's analysis produced a direct residential customer cost between $4.05 and $5.61 per month at the Company's requested rate of return. He proposed on this basis, and for policy reasons related to price signals and conservation, to essentially retain PSE's current $7.49 customer charge, suggesting that for purposes of "a more logical rate" the charge should be rounded up by one cent, to $7.50 per month.[443]

353 Mr. Shawn Collins testified for The Energy Project that PSE's proposal to raise the residential electric basic monthly charge to $9.00 makes an essential service "less

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[438] Watkins, Exh. GAW-1T at 42:12-43:2.

[439] Watkins, Exh. GAW-1T at 43:5-12.

[440] Watkins, Exh. GAW-1T at 43:15-17.

[441] Watkins, Exh. GAW-1T at 43:18-54-5.

[442] Watkins, Exh. GAW-1T at 46:4-9.

[443] Watkins, Exh. GAW-1T at 51:13-19.

affordable and penalizes low-volume users within the residential rate class, since a greater portion of the bill is fixed, relative to higher use customers." Mr. Collins also testifies that increased basis charges:

> [R]educe customers' ability to control their own household utility bills. For lower usage customers, a reduction in usage has a relatively smaller impact on the bill, since a larger percentage of the bill is unaffected by their behavior. As a result, customers have a diminished price incentive to reduce their usage, and therefore their utility bill, through conservation. Increases in basic charges, therefore, tend to run counter to state policies and utility programs that promote energy efficiency and encourage customers to weatherize homes, purchase energy efficient appliances and reduce usage in other ways.

354 NWEC/RNW/NRDC argued that PSE's and Staff's proposals to increase monthly charges for residential electric customers are based on an "unprecedented treatment of line transformer costs as customer-related costs."[444] NWEC/RNW/NRDC said that if transformer costs are not treated as customer-related costs, there is no basis for increasing the monthly basic charge or imposing a new minimum bill.[445] In addition, NWEC/RNW/NRDC argues the proposals to increase monthly charges are regressive rate designs that would hurt low-income customers and impose barriers to conserving energy.

355 NWEC/RNW/NRDC echoed The Energy Project's argument that increasing basic charges disproportionately impacts low-income customers.[446] NWEC/RNW/NRDC also argued that increasing basic monthly charges sends the wrong price signal to customers.[447] NWEC/RNW/NRDC related in this connection that the Commission rejected a proposal from PacifiCorp and Staff to increase the basic charge as a disincentive for customers to conserve energy. NWEC/RNW/NRDC quotes from the Commission's order, as follows:

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[444] NWEC/RNW/NRDC Initial Brief ¶ 20.

[445] NWEC/RNW/NRDC Initial Brief ¶ 23 (citing Levin, Exh. AML-13T at 2:18 to 3:3; Ball, Exh. JLB-1T at 31:23 to 32:2).

[446] NWEC/RNW/NRDC Initial Brief ¶ 32.

[447] NWEC/RNW/NRDC Initial Brief ¶ 33 (citing *See* Levin, Exh. AML-1T at 9:18 to 10:15; Watkins, Exh. GAW-1T at 49:13 to 52:2; Collins, Exh. SMC-3T at 6:6-7).

> We reject the Company's and Staff's proposals to increase significantly the basic charge to residential customers. The Commission is not prepared to move away from the long-accepted principle that basic charges should reflect only "direct customer costs" such as meter reading and billing. Including distribution costs in the basic charge and increasing it 81 percent, as the Company proposes in this case, does not promote, and may be antithetical to, the realization of conservation goals.[448]

356 In sum, NWEC/RNW/NRDC asks the Commission to reject PSE's and Staff's proposals to increase the basic charge and imposes a new minimum bill because these proposals would hurt low-income customers and frustrate efforts to conserve energy.

Commission Determination

357 We determine that neither PSE's proposal to increase basic charges for residential customers, nor Staff's recommendations to add a minimum bill to basic charges and establishing seasonal rates, should be adopted. We are not persuaded on the basis of the current record that transformer costs should be recovered in basic charges, or through a minimum bill. We have never approved such a proposal and continue to believe these costs are not customer-related costs as that term is generally understood. Transformer costs should be recovered as distribution charges subject to PSE's electric decoupling mechanism, which adequately protects the Company's recovery of its fixed costs.

ii. Miscellaneous Electric Rate Design Issues.

(a) Addition of a Third Block Rate

358 NWEC/RNW/NRDC recommends that the Commission convene another technical conference to address three-tier rate design. NWEC/RNW/NRDC points out that the Rate Design Settlement in Docket UE-141368 required PSE to propose an inverted three-tier rate structure in this docket, but it failed to do so.[449] According to NWEC/RNW/NRDC, "there are several ways in which PSE could calculate a three-tier rate structure that would promote energy conservation by making each successive block more expensive than the preceding block."[450] Considering that Staff proposed an alternative rate structure with

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[448] NEWC, Initial Brief ¶ 33 (quoting *WUTC v. Pacific Power*, Docket UE-140762, Order 08 ¶ 216 (Mar. 25, 2015).

[449] *See supra* ¶ 283.

[450] NWEC/RNW/NRDC Initial Brief ¶ 41.

COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
P.O. BOX 3265, HARRISBURG, PA 17105-3265

IN REPLY PLEASE REFER TO OUR FILE

February 8, 2007

R-00061398
R-00061398 C0001
R-00061398 C0002
R-00061398 C0003
R-00061398 C0004

PAUL E RUSSELL
ASSOCIATE GENERAL COUNSEL
PPL SERVICES CORPORATION
TWO NORTH NINTH STREET
ALLENTOWN PA 18106

DOCUMENT FOLDER

Pennsylvania Public Utility Commission
Office of Small Business Advocate and Office of Consumer Advocate
Mary Kay Gummo and Michael Blake
v.
PPL Gas Utilities Corporation

To Whom It May Concern:

This is to advise you that the Commission in Public Meeting on February 8, 2007 has adopted an Opinion and Order in the above entitled proceeding.

An Opinion and Order has been enclosed for your records.

Very truly yours,

James J. McNulty
Secretary

encls
cert. mail
MH

See attached list for additional parties of record.

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting held February 8, 2007

Commissioners Present:

Wendell F. Holland, Chairman
James H. Cawley, Vice Chairman, Concurring and Dissenting Statement attached
Kim Pizzingrilli
Terrance J. Fitzpatrick

Pennsylvania Public Utility Commission, Office of Small Business Advocate, Office of Consumer Advocate, Mary Kay Gummo, Michael Blake	R-00061398 R-00061398C0001 R-00061398C0002 R-00061398C0003
v.	R-00061398C0004
PPL Gas Utilities Corporation	

OPINION AND ORDER

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BY THE COMMISSION:

Before the Commission for consideration and disposition is the Recommended Decision of Administrative Law Judge (ALJ) Angela T. Jones issued on December 8, 2006, in the above captioned general rate increase proceeding involving the PPL Gas Utilities Corporation (PPL Gas or the Company). Also before the Commission are the Exceptions and Reply Exceptions filed thereto.

Exceptions to the Recommended Decision were filed on January 3, 2007, by the following Parties: PPL Gas, the Office of Consumer Advocate (OCA), the Office of Trial Staff (OTS) and the Commission on Economic Opportunity (CEO).

The following Parties filed Reply Exceptions on January 12, 2007: PPL Gas, the OCA, the OTS, the Office of Small Business Advocate (OSBA), CEO and the PPL Gas Large Users Group (PGLUG).

I. HISTORY OF THE PROCEEDING

On April 27, 2006, PPL Gas filed Supplement No. 11 to Tariff – Gas Pa. P.U.C. No. 3 (Supplement No. 11) with the Pennsylvania Public Utility Commission (Commission) to become effective July 1, 2006. Through Supplement No. 11, PPL Gas proposed increases in rates calculated to produce $12,813,000 (6.2%) in additional annual revenues. PPL Gas provided twelve volumes of supporting data including eight statements of witnesses' testimony to comply with the Commission's rate case filing requirements by natural gas public utility companies.

By Order entered June 22, 2006, the Commission instituted an investigation into the lawfulness, justness and reasonableness of the proposed rate increase. Pursuant to Section 1308(d) of the Public Utility Code (Code), 66 Pa. C.S. § 1308(d), Supplement

No. 11 was suspended by operation of law until February 1, 2007, unless otherwise permitted by Commission Order to become effective at an earlier date. In addition, the Commission ordered that the investigation include consideration of the lawfulness, justness and reasonableness of the Company's existing rates. The matter was assigned to the Office of Administrative Law Judge (OALJ) for hearings to culminate in the issuance of a Recommended Decision. In accordance with the Commission's Order, the matter was assigned to ALJ Angela T. Jones.

The following entities and individuals filed Formal Complaints: the OSBA, the OCA, Ms. Mary Kay Gummo,[1] and Mr. Michael Blake.[2] PPL Gas timely answered all Complaints.

The following entities filed Petitions to Intervene which were granted: the CEO, Transcontinental Gas Pipe Line (Transco), the Hess Corporation (Hess), and PGLUG. PPL Gas objected to the CEO's Petition to Intervene; however, the ALJ overruled the objection finding CEO's interest germane to the proceeding to further the public interest. On July 13, 2006, the OTS filed its Notice of Appearance.

A Notice dated June 29, 2006, scheduled an initial telephonic Prehearing Conference for July 18, 2006. By Order issued July 5, 2006, the ALJ set forth requirements for participating in the Prehearing Conference which, among other things, included submitting a prehearing memorandum proposing a procedural schedule. Prior to

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[1] Although Ms. Gummo filed a Formal Complaint, she did not participate in any stage of the proceeding.

[2] Mr. Blake complained that the rates charged by PPL Gas are higher than the current wholesale price of natural gas. On October 17, 2006, PPL Gas filed an Answer to the Complaint requesting that the Complaint be denied because the purchased gas costs are recovered pursuant to Section 1307(f) of the Code, 66 Pa. C.S. § 1307(f), in a separate proceeding.

convening the Prehearing Conference, prehearing memoranda were submitted by the Company, the OSBA, the OCA, Hess, Transco, the CEO, and PGLUG.

A telephonic Prehearing Conference was held as scheduled on July 18, 2006. The following entities participated: the Company, Hess, Transco, the OTS, the OCA, the OSBA, PGLUG, and the CEO. During the Prehearing Conference, the OCA's modifications to discovery rules were granted. The Parties agreed to one public input hearing and an evidentiary hearing schedule. All of the substantive actions and agreements at the Prehearing Conference were confirmed through the Procedural Scheduling Order issued on July 19, 2006. On July 21, 2006, the ALJ issued special instructions to the Parties regarding Briefs and Exceptions in major rate proceedings.

A public input hearing was held in the Potter County Courthouse in Coudersport, Pennsylvania on August 16, 2006. Approximately forty persons attended, and seven witnesses presented sworn testimony.

Evidentiary hearings were held in this matter in Harrisburg on September 25, and 29, 2006, with PPL Gas, the OTS, the OCA, the OSBA, PGLUG and Transco participating.[3] PPL Gas, the OTS, the OCA and the OSBA, presented witnesses and exhibits. On September 29, 2006, the evidentiary record to the proceeding was closed.

PPL Gas, the OCA, the OTS, the OSBA, PGLUG and Transco filed Main Briefs. Reply Briefs were filed by all of the aforementioned parties except Transco. Both Main and Reply Briefs were filed in accordance with the established schedule.

By Recommended Decision issued December 8, 2006, ALJ Jones rejected the Company's Supplement No. 11 finding it to be unjust and unreasonable and

3 Due to agreements between the Parties, the evidentiary hearing scheduled for September 28, 2006 was canceled.

recommended that PPL Gas file tariffs which produce a revenue increase not in excess of $7,678,000. The ALJ also dismissed the Complaints filed by Ms. Mary Kay Gummo and Mr. Michael Blake.

On December 13, 2006, PPL Gas filed Supplement No 18 to Tariff-Gas Pa. P.U.C. No. 3, to voluntarily postpone the effective date of Supplement No. 11 from February 1, 2007, until February 9, 2007.

Exceptions and Reply Exceptions were filed as noted above.

II. DISCUSSION

A. General Principles for a 1308 General Rate Increase

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 Co. v. Pa. PUC*, 341 A.2d 239 (Pa. Cmwlth. 1975). In determining a fair rate of return the Commission is guided by the criteria provided by the United States Supreme Court in the landmark cases of *Bluefield Water Works and Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). In *Bluefield*, the Court stated:

> 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.

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 filed 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, 66 Pa. C.S. § 315(a):

> **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.

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 Public Utility Code, 66 Pa. C.S. § 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.*

Lower Frederick Twp. Water Co. v. Pa. PUC, 48 Pa. Cmwlth. 222, 226-227, 409 A.2d 505, 507 (1980) (emphasis added). See also, *Brockway Glass Co. v. Pa. PUC*, 63 Pa. Cmwlth. 238, 437 A.2d 1067 (1981).

In general rate increase proceedings, it is well established that 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 Company's filing. The Pennsylvania Supreme Court has held:

> [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. Pa. PUC, 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. Pa. PUC, 570 A.2d 149, 153 (Pa. Cmwlth. 1990) (citation omitted). See also, *Pa. PUC v. Equitable Gas Co.*, 73 Pa. P.U.C. 310, 359 – 360 (1990).

Additionally, the provisions of 66 Pa. C.S. § 315(a) cannot reasonably be read to place the burden of proof on the utility with respect to an issue the utility did not include in its general rate case filing and which, frequently, the utility would oppose. Inasmuch as the Legislature is not presumed to intend an absurd result in interpretation of its enactments,[4] the burden of proof must be on a party to a general rate increase case who proposes a rate increase beyond that sought by the utility.

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. Pa. PUC*, 72 Pa. Cmwlth. 171, 456 A.2d 686 (1983).

In analyzing a proposed general rate increase, the Commission 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. The Commission determines a proper rate of return by calculating the utility's capital structure and the cost of the different types 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 Co. v. Pa. PUC*, 45 Pa. Cmwlth. 610, 405 A.2d 1055 (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).

Any issue or Exception that we do not specifically address has been duly considered and will be denied without further discussion. It is well settled that we are not required to consider, expressly or at length, each contention or argument raised by the Parties. *Consolidated Rail Corporation v. Pennsylvania Public Utility Commission*, 625 A.2d 741 (Pa. Cmwlth. 1993); *see also*, *University of Pennsylvania v. Pennsylvania Public Utility Commission*, 485 A.2d 1217 (Pa. Cmwlth. 1984). "A voluminous record does not create, by its bulk alone, a multitude of real issues demanding individual attention . . . ." *Application of Midwestern Fidelity Corp.*, 26 Pa. Cmwlth. 211, 230 fn.6, 363 A.2d 892, 902, n. 6 (1976). With the foregoing principles in mind, we turn to the rate issues before us.

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[4] 1 Pa. C.S. § 1922(1), *PA Financial Responsibility Assigned Claims Plan v. English*, 541 Pa. 424, 64 A.2d 84 (1995).

B. Rate Base

1. Fair Value

a. Positions of the Parties

PPL Gas' 2006 test year forecasted natural gas inventory claimed amount is $13,912,000 while PPL Gas forecasted natural gas inventory of $11,258,000. ($11,258,000 -13,912,000 = -$2,654,000). PPL Gas has accepted the OCA's valuation of the Company's natural gas inventory in storage of $11,194,000. The portion of the claim attributed to the Pennsylvania service territory of PPL Gas is 99.42% (-$2,654,000 x 0.9942 = -$2,638,607 or round to -$2,639,000), thereby reducing the Company's claim by $2,639,000. (Tr. 129-30; OCA St. 1S. Sch. B-1; R.D. at 8). PPL Gas agreed to this adjustment and it is incorporated in PPL Gas' calculation of rate base for future test year ending December 31, 2006. (R.D. at 8).

b. Disposition

There were no exceptions filed to the ALJ's recommendation in regard to this issue. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted. Accordingly, we agree with the OCA's position, and PPL Gas' concomitant reduction to rate base of $2,639,000.

2. Plant in Service

a. Positions of the Parties

PPL Gas inadvertently included in its original cost of plant in service $1,862,000 of assets used in non-regulated businesses. The OCA drew this to the attention of PPL Gas and PPL Gas agreed that this amount should be removed from rate base yielding a net reduction as of December 31, 2006 of $1,067,000. ($1,862,000 plant in service - $795,000 depreciation reserve). (PPL Sch. C-2 to Exhibit Future 1-Revised; R.D. at 8 - 9).

b. Disposition

There were no exceptions filed to the ALJ's recommendation in regard to this issue. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted. Accordingly, we agree with the OCA's position, and PPL Gas' concomitant reduction to rate base of $1,067,000.

3. Net Lag Days

a. Position of the Parties

The OTS updated the net lag days for both revenue and expenses from historic to future test year the result of which increased the net lag days from 8.6 days to 10.29 days resulting in an $832,000 increase in PPL Gas' cash working capital requirement for operation and maintenance expenses from $4,344,000 to $5,176,000. PPL Gas has incorporated this change in its cash working capital (CWC) requirement for operation and maintenance expenses to the future test year level. (PPL Gas Exhibit Future 1-Revised, Sch. C-5, p. 2; R.D. at 9).

b. Disposition

There were no exceptions filed to the ALJ's recommendation in regard to this issue. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted. Accordingly, we agree with the OTS's position, and PPL Gas' concomitant increase to CWC of $832,000.

4. Unamortized Balance of Environmental Clean Up

a. *Position of the Parties*

The OCA alleged that as of December 31, 2006, PPL Gas will have recovered from insurers and ratepayers $12.917 million more for environmental remediation than it will have spent for environmental remediation. Since the $12.917 million is an over-recovery of ratepayer funds, according to the OCA, it should be adjusted to net out the income taxes of $5.360 million, resulting in an adjustment of $7.558 ($12.917-$5.360 = $7.557) million to rate base.[5] (OCA St. 1, Sch. B-3; R.D. at 9).

PPL Gas opposed the adjustment alleging it is inappropriate because balances that are amortized for ratemaking purposes may not be included in rate base. When an expense is amortized in rates it is improper to reflect the unamortized balance of that expense in rate base. The rationale against including the unamortized expense within rate base is that a utility cannot earn a return on and also receive a return of an expense item. To do so would provide the utility with a double recovery of that expense. The distinguishing factor presented in this proceeding is that instead of unamortized expenses, unamortized revenues, or ratepayer funds collected but not yet spent, are at issue.

PPL Gas asserted that the Pennsylvania appellate courts have held that utilities may not include unamortized balances of expenses in rate base. Therefore, on the same basis, unamortized revenues should not be deducted from rate base. (PPL Gas MB at 11). Said differently, the distinction of expense versus revenue is of no consequence. (R.D. at 10).

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5 Actual figures rounded result in $7.558 million.

b. ALJ's Recommendation

The ALJ found that PPL Gas has shown that the adjustment recommended by the OCA regarding unamortized revenues is not warranted because revenue cannot be simultaneously capitalized in rate base and obtained from ratepayers. Consequently, the ALJ recommended that the OCA's adjustment regarding the unamortized balance (of ratepayer provided revenues not yet spent) for environmental clean up be rejected. (R.D. at 10).

c. Exceptions

In its Exceptions the OCA states that the ALJ erred in identifying the OCA proposed deduction to rate base as "unamortized revenues." (OCA Exc. at 3; R.D. at 9-10). For the following reasons, the OCA believes that the ALJ erred in accepting the Company's position.

When a utility incurs an expense and is permitted recovery through an amortization, customers are repaying the utility for an expense incurred in the past. The environmental remediation funds at issue here, however, are not repayment for a past expense. Rather, these represent a prepayment of expenses anticipated under the Consent Agreement. PPL Gas has collected $12.9 million from ratepayers, in addition to recoveries from insurers, in advance of Company expenditures to remediate contaminated sites. (OCA MB at 13-17; OCA RB at 5-6; see OCA St. 1 at 10-12). These ratepayer-supplied funds are being held by PPL Gas just like customer deposits or customer advances. Just as customer deposits or customer advances are deducted from rate base, so too must the pre-collected ratepayer provided environmental remediation expense be deducted from rate base. (OCA St. 1 at 11-12; OCA MB at 14-16); see *Pa. PUC v. West Penn Power Co.*, 53 Pa. PUC 410, 429 (1979)(Customer deposits); *Pa. PUC v. Philadelphia Suburban Water Co.*, 75 Pa. PUC 391, 402 (1991)(Unexpended customer advances treated as an offset to rate base); *Pa. PUC v. Pennsylvania-American Water Co.*, 71 Pa. PUC 210, 241-43 (1989)(Customer advances); see also *Pittsburgh v. Pa. Pub. Util. Comm'n*, 370 Pa. 305, 88 A.2d 59 (1952) (Pittsburgh) (Customer-supplied funds treated as an offset in cash working capital determination). (OCA Exc. at 4; OCA MB at 15-16).

The OCA states that its recommended adjustment is to prevent the Company from receiving a windfall from the use of customer-supplied funds. (OCA MB at 14-15). The OCA asserts that the ALJ's recommendation is contrary to the record evidence and sound ratemaking principles recognized by the courts and Commission. Accordingly, the OCA believes that the Company's rate base should be reduced by $7,558,000, as calculated at OCA Statement No. 1, Schedule B-3. (OCA Exc. at 4).

In reply PPL Gas states that the only difference between this case and those cited by the OCA in its Exceptions is that those prior cases involved expenses, and in this case, the issue relates to recoveries from ratepayers. PPL Gas believes that the Commission should apply the same ratemaking principle to pre-paid revenue supplied by ratepayers as it has applied to pre-paid expenses. (PPL Gas R.Exc. at 9).

d. Disposition

The distinguishing factor presented in this proceeding is that instead of unamortized expenses, unamortized revenues, or ratepayer funds, collected but not yet spent, are at issue. PPL Gas asserted that the Pennsylvania appellate courts have held that utilities may not include unamortized balances of expenses in rate base. Therefore, on the same basis, it argues that unamortized revenues should not be deducted from rate base. (PPL Gas MB at 11). Said differently, the distinction of expense versus revenue is of no consequence. (R.D. at 10). Based upon prior Commission decisions, the ALJ recommended rejection of the OCA's adjustment. We agree, finding the ALJ's recommendation to be reasonable, appropriate, and in accordance with the record evidence and prior Commission decisions. Our review of the record supports the finding of the ALJ. Accordingly, we shall adopt the ALJ's recommendation and reject the OCA's Exceptions.

In conjunction with our allowance of the Company's claim, we shall direct the Bureau of Audits to review the activity within this account during the Company's next Purchased Gas Cost Rate Audit. Specifically, we direct the Bureau of Audits to review the Company's accounting for the funds collected through rates and those recovered through insurance, that are to be used for environmental clean-up as well as all previous and planned expenditures associated with all projects included within this activity. The findings of the Bureau of Audits shall be included within the Company's next base rate case filing.

5. Adjustment to Depreciation Reserve for Account 330

a. Positions of the Parties

The OTS advocated that Account 330, Producing Gas Wells – Well Construction, should be reduced by $397,348 to $270,582 since the net salvage is not being depreciated. The OTS asserted that this adjustment is necessary because the account is fully accrued and there is no annual 2006 accrual. If the adjustment is not made, the OTS stated that the future accrual will be in rate base indefinitely with no offsetting annual accrual. (OTS MB at 12, 15).

PPL Gas contended that the OTS adjustment is not warranted because future amortization of negative net salvage will reduce future accruals to zero at the end of the five-year amortization period. PPL Gas stated further that the OTS' adjustment is inconsistent with the Uniform System of Accounts and Pennsylvania precedent regarding ratemaking treatment amortizing negative net salvage as established in *Penn Sheraton*

Hotel v. Pa. P.U.C., 198 Pa. Super. 618, 184 A.2d 324 (1962). (PPL Gas MB at 12). Lastly, PPL Gas asserted that the OTS proposed adjustment unduly harms the Company. (PPL Gas RB at 6-7; R.D. at 11).

The OTS believes that the Company failed to explain the applicability of *Penn Sheraton* for this account since there are no annual accruals associated with the account and thus, Account 330 is not a typical account being depreciated. Furthermore, according to the OTS, the Company's assertion that it has followed the Uniform System of Accounts and the requirements under *Penn Sheraton* since 1999, and this past treatment would somehow preclude the Commission from correcting improper treatment once detected is not valid. As OTS states, "all aspects of the Company's filing are subject to review by the parties and ultimately by the Commission in . . . any . . . rate case." (OTS RB at 8).

b. ALJ's Recommendation

The ALJ found that the record evidence demonstrated that Account 330 is unique in that it has no annual accruals to depreciate, it has fully accrued; that the Company has failed to substantiate its claim regarding Account 330 and the applicability of *Penn Sheraton* to an account that has fully accrued. However, according to the ALJ, the OTS has reasonably substantiated why an adjustment should be made to Account 330, and believes that the adjustment advocated by OTS to Account 330 reducing the future accrual claim is warranted and reasonable. (OTS St. 3 at 12, OTS St. 3-SR at 4-5, and OTS Exh. 3-SR, Sch. 1, line 12). The adjustment to Account 330 suggested by OTS was adopted by the ALJ. (R.D. at 10).

c. *Exceptions*

PPL Gas excepted to the ALJ's recommendation as being erroneous for two principal reasons. First, her concern that PPL Gas would be allowed to earn a return on a negative depreciation reserve of $397,348 in perpetuity is factually unfounded. Second, in any event, the recovery by PPL Gas of its capital investment in plant through depreciation accruals and amortizations of net salvage is under continual review by the Commission, and PPL Gas has done nothing improper to give rise to the substantial rate base disallowance. (PPL Exc. at 11 – 12).

PPL Gas states that it is undisputed that PPL Gas has followed the Uniform System of Accounts and the rules for recovery of net salvage established in *Penn Sheraton*. (Tr. 185; PPL Gas St. 7-R, at 1-3; PPL Exc. at 12). Contrary to the ALJ's concern, the amortization of net salvage will fully recover and, thereby, eliminate all actually incurred salvage costs over five-year periods following the year that each salvage cost is actually incurred. (PPL Exc. at 12).

The ALJ adopted the adjustment to rate base recommended by OTS based on her conclusion that, absent the adjustment, the negative reserve will exist in perpetuity. Such conclusion misunderstands the nature of the accounting of net salvage under *Penn Sheraton*. The ALJ states that the negative depreciation reserved for Account 330 will remain, because there are no future accruals to reduce it. (R.D. at 12; PPL Exc. at 15).

Although it is correct that, absent future investments in plant under Account 330, there are no future accruals (PPL Gas Exh. JJS-2, p. III-155), that does not mean that the negative reserve will remain indefinitely. Instead, under *Penn Sheraton*, net salvage is amortized (not accrued) over five years commencing with the year after the net salvage was incurred. The fact that no accruals remain does not mean that the balance of net salvage will not be eliminated over a five-year period. (PPL Exc. at 15).

PPL Gas has consistently distinguished between accruals and amortization. (*See, e.g.*, OTS Exh. 3, Sch. 4). PPL Gas has explained, as set forth above, that the net salvage balance will be eliminated through amortization, regardless of whether any future accruals remain. (PPL Exc. at 15).

PPL Gas, and its predecessor, North Penn Gas Company, have made Annual Depreciation Reports required by Chapter 73 of the Commission's regulations. Tr. 187-88. Account 330 has had a substantial negative reserve since at least 1999. Nevertheless, OTS has not challenged any of the entries to that account in any of the Annual Depreciation Reports. (Tr. at 188; PPL Exc. at 14).

The filing by PPL Gas and its predecessors of Annual Depreciation Reports has special significance under the Commission's regulations, which provide:

> "In subsequent ratemaking proceedings, the most recent annual depreciation report or service life study approved or deemed approved for accounting purposes only under this chapter, constitutes a rebuttable presumption as to the reasonableness of the accrued depreciation claimed for ratemaking purposes, and the burden of proving the unreasonableness of the accrued depreciation shall be on the challenging party."

52 Pa. Code § 73.9(c). For the reasons stated above, the adjustment to the depreciation reserve for Account 330 proposed in this proceeding is erroneous. (PPL Exc. at 14 – 15).

Alternatively, if the Commission seeks to make certain that the balance of negative net salvage will be eliminated over five years, as contemplated by the Superior Court in *Penn Sheraton*, the Commission could simply order PPL Gas to amortize all amounts in the depreciation reserve as of December 31, 2006, excluding the portion of the reserve equal to the original cost of plant in service, so that such amounts will be eliminated by the end of 2011. Such an order would not harm PPL Gas, because such amortization would occur in any event. The order, however, would provide assurance to the Commission, the ALJ and the OTS that the negative depreciation reserve, in fact, will be eliminated, as contemplated under *Penn Sheraton*, by the end of 2011. (PPL Exc. at 17).

In reply, the OTS first asserts that the Company missed the point of the adjustment and again failed to explain how the claimed $667,930 of Future Accruals for Account 330 will be reduced if there is no annual accrual associated with this account. (OTS R. Exc. at 7).

To defend the level of its original claim, the Company puts forth the argument in its Exception that it followed the "Uniform System of Account" and did "nothing wrong" regarding the account. The OTS believes that the Company failed to point to any provision in the Uniform System of Accounts that allows "Future Accruals" to exist in perpetuity and have no annual accrual. Such failure is due to the fact that no such provision exists. (OTS R.Exc. at 7 – 8).

d. Disposition

We find the Company's explanation of this issue to be persuasive. Accordingly, we shall grant PPL Gas' Exceptions and reverse the ALJ's recommendation, thereby adopting the Company's claim. As contemplated by the Superior Court in *Penn Sheraton*, we will order PPL Gas to amortize all amounts in the depreciation reserve as of December 31, 2006, excluding the portion of the reserve equal to the original cost of plant in service, so that such amounts will be eliminated by the end of 2011.

In conjunction with our allowance of the Company's claim, we shall direct the Bureau of Audits to review the activity within this account. This review shall be conducted during the Bureau's next Purchased Gas Cost Rate Audit. The findings of the Bureau of Audits shall be included within the Company's next base rate case filing.

6. Cash Working Capital Requirement Regarding Payments of Interest

a. Positions of the Parties

PPL Gas included within its calculation of cash working capital ("CWC") a claim regarding payments of interest. (PPL Gas Exh. Future 1, Sch. C-5 at 5; R.D. at 12). The Company claimed a net lag for interest payments of 7.5 days resulting in an adjustment of $114,000.[6] The OTS proposed disallowance of this portion of the Company's CWC claim stating that the payments of interest are "below the line" and are not to be considered when establishing rates. Additionally, the OTS stated, "the return dollars provided to utilities in rates compensates them for all debt and related costs [and] the Commission has never allowed a positive interest payment component to CWC." (OTS MB at 16). Subsequently, the OTS admitted that the Commission has reflected positive interest payments in CWC calculations. (PPL Gas MB at 17-18 citing, OTS St. 2-SR at 18-19 and PPL Gas RB 5).

PPL Gas stated "below the line" items are those revenues, expenses and investments that are not subject to Commission jurisdiction and consequently are excluded from consideration in establishing rates. (PPL Gas MB at 17 citing *Edison Electric Institute, Glossary of Electric Industry Terms*, at 12 (April 2005)). PPL Gas asserted that interest paid to finance rate base is subject to Commission regulation and is

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[6] The components of this adjustment are the measure of value at December 31, 2006; the Company's claimed debt ratio of 44.32% which is comprised of short-term and long-term debt; the Company's claimed embedded cost of debt of 6.35%. (PPL Exh. Future 1 Sch. B7, B8 and C5).

therefore considered in setting rates. PPL Gas stated that it produced an example through PPL Electric Utilities Corp where the CWC calculation for preferred stock produced a positive CWC balance and suggested that the interest payments were not incorrectly calculated or differentiated from the preferred stock. (R.D. at 13).

b. ALJ's Recommendation

The ALJ found that even if the PPL Electric Utilities Corp. CWC treatment for preferred stock produced a negative CWC balance, it is not logical to treat an item differently based on whether it is a negative or positive quantity. The rationale for the treatment of the item remains regardless of whether it is positive or negative. Accordingly, the ALJ rejected the OTS' adjustment. (R.D. at 13).

c. *Exceptions*

With respect, the OTS contends that the ALJ's decision is based on a misunderstanding of the history of this adjustment, a lack of understanding of the adjustment, a misinterpretation of the OTS testimony and a misplaced sense of fairness brought about by fundamental misrepresentations put forth by the Company. In fact, Commission acceptance of the ALJ's recommendation would improperly overturn thirty years of clear-cut precedent regarding this issue.

To understand the error in the ALJ's reasoning, it is important to reiterate why there is an interest "offset" to a cash working capital claim in the first place. As stated in OTS Direct Testimony, it is inappropriate to include such an interest payments claim as part of an allowable CWC because the return dollars provided to utilities in rates already compensate them for all debt and related costs. As such, any monies needed for interest payments would be subsumed in the return allowance and should not be part of a CWC allowance. (OTS St. 2, p. 37-; OTS MB at 16). Stated another way, the rates paid by customers already include a revenue allowance to service debt and preferred obligations. These rates are collected on a continuous basis throughout the year. Debt interest may be paid on a quarterly or semi-annual basis. If revenue collected from ratepayers, but not yet paid to bond holders and preferred stock holders, is not recognized as a source of working capital contributed by the rate payers and correspondingly offset against the CWC allowance, then PPL Gas' common equity holders will receive a return on capital not supplied by them and will thus receive an inappropriate supplemental return not authorized by any traditional ratemaking standard. The crux of this issue is that such an interest "offset" has no corresponding equitable "flip side" that requires any addition to the CWC calculation as argued by the Company. (OTS Exc. at 4 – 5).

Turning to the Company's claim, the OTS argues that since the interest payment lag is less than the CWC revenue lag, an additional component to the CWC calculation is thereby created that must be reflected in the calculation. This argument improperly seeks to make the inclusion of interest a necessary part of a lead/lag study when it constitutes nothing more than a potential offset to the results of a lead/lag study. (OTS Exc. at 6).

In response, the OTS asserts that it is well established in prior Commission and Commonwealth Court decisions that the timing and payment of interest may create an offset to the CWC claim, but is not part of the actual CWC calculation. (OTS Exc. at 6 – 7).

The OTS states that the timing of revenue receipts and interest payments has long been recognized as an appropriate "offset" to the CWC requirement. In fact, Webster's Dictionary defines offset as "to place over against something or to serve as a counterbalance for." The point being that interest has long been recognized as an offset and that an offset by definition works in the opposite direction of the claim. An offset by regulatory practice or by definition has not constituted, nor should it constitute, an increase or enhancement to the Company's claim. (OTS Exc. at 7).

However, at page 13 of the Recommended Decision, the ALJ states that:

> Even if the PPL Electric CWC treatment for preferred stock produces a negative CWC balance, it is not logical to treat an item differently based on whether it is a negative or positive quantity. The rationale for the treatment of the item remains regardless if it is positive or negative.

(R.D. at 13).

The Company's Main Brief at page 18 cites a Commonwealth Court decision for People's Natural Gas wherein People's challenged a \$550,000 offset reduction based on the fact that revenue lagged the actual payment of interest. The Court agreed and rejected the offset. *Peoples Natural Gas Co. v. Pennsylvania Public Utility Commission*, 52 Pa. Cmwlth. 201, 205-206, 415 A.2d 937, 939 (1980). However, the Company's Main Brief fails to point out that a full reading of the Court's opinion discloses that the offset was reduced to zero. The facts in that case are identical to the instant situation, yet the Court did not recognize or authorize a negative offset even though interest payments occurred prior to receipt of revenue. (OTS Exc. at 8).

Again at page 13 of the Recommended Decision, the ALJ states:

> Additionally, PPL Gas points to clarification made by OTS to admit that the Commission has reflected positive interest payments in CWC calculations. (PPL Gas MB at 17-18 citing, OTS St. 2-SR at 18-19 and PPL Gas RB at 5).

(R.D. at 13; OTS Exc. at 8).

Simply put, the ALJ has misinterpreted the OTS testimony. The OTS reference was to the fact that the Commission has always required an offset to the CWC and should not be construed to mean that the Commission recognized a negative offset. The Commission either reflected a positive offset or reflected zero, nothing else.

Also at page 13 of the Recommended Decision, the ALJ provides that:

> PPL Gas states that it produced for the record an example through PPL Electric Utilities where CWC calculation for preferred stock produced a positive CWC balance.

(R.D. at 13).

Here, the ALJ has relied upon an incorrect Company representation. The offset to CWC is for interest and preferred dividends. The net of the two is what is reflected as the offset. They do not stand alone. In the cited PPL Electric case, the interest offset was negative by an amount greater than the positive claim for preferred dividends. The net of the two was an offset reduction to CWC. The OTS asserts that the Company is simply incorrect when it claims the Commission has previously accepted positive balance for preferred dividends. (OTS Exc. at 9).

Finally, the fundamental point to consider is that CWC measures the amount of cash outlay that the Company must have available to cover expenses from the rendition of service to payment for these services. The expenses reflected in a lead/lag study are those above-the-line cost of service O&M expenses. As pointed out above, the Company already recovers its interest cost through the return component of rates. It is therefore no more appropriate to include interest in the CWC calculation than it is to reflect a return component in a CWC calculation. (OTS Exc. at 9).

For the foregoing reasons, the OTS believes that the Commission should reject the ALJ's recommendation and adopt the OTS-recommended reduction of $114,000 to the Company's CWC claim to properly exclude interest payments. (OTS Exc. at 10).

In reply the Company describes the OTS' proposal as a "one-way" calculation in that the OTS contends that interest payments cannot increase CWC 'because return dollars provided to utilities in rates already compensate them for all debt and related costs.' (PPL R. Exc. at 10). The Company also states that the OTS' reliance upon *Pa. PUC v. West Penn Power Co.*, 1981 WL 178838 and *Peoples Natural Gas Co., Pa. PUC*, 52 Pa. Cmwlth. 201, 415 A.2d. 937 (1980), is misplaced. PPL states that these cases do not address the issue of whether interest payments could increase the CWC requirement, because the issue was not presented. (PPL R.Exc. at 11).

d. Disposition

We agree with the ALJ, it is not logical to treat an item differently based on whether it is a negative or positive quantity. The rationale for the treatment of the item remains regardless of whether it is positive or negative. Accordingly, we shall adopt the Company's position on this issue and deny the Exceptions of the OTS. We do not find the OTS' reasoning to be persuasive.

7. Accumulated Deferred Income Taxes Related to Contributions in Aid of Construction

a. Positions of the Parties

The balance of accumulated deferred income taxes ("ADIT") consists of two components: 1) deferred taxes related to accelerated depreciation on plant in service; and 2) deferred taxes related to contributions in aid of construction ("CIAC"). The CIAC portion is a debit balance that reduces the balance of ADIT deducted from plant in service. (OCA M.B. at 10 – 11). More simply stated, plant in service is increased by number one above and reduced by number two, above. Thus, if the amount of ADIT on

CIAC, number 2 above, is reduced, the plant in service is lower and fewer return dollars are allowed.

PPL Gas recorded ADIT on CIAC in compliance with Commission procedures and the Tax Reform Act of 1986. Under that Act, CIAC are treated as taxable income. The Commission allows jurisdictional utilities to select a method for treatment of income taxes on those contributions. *See, Re Contribution in Aid of Construction and Customer Advances,* 70 Pa. PUC 44 (1989). PPL Gas opted to pay income taxes on CIAC which results in a reduction to deferred taxes. (PPL Gas MB at 20).

PPL Gas projected $5,909,000 of ADIT on CIAC for the future test year. (PPL Gas Exh. Future 1, Sch. C-1). The OCA stated that the Company's proposed future test year claim for ADIT on CIAC is a 31% increase from the historic test year level[7] and recommended that the future test year balance be reduced by $1,294,000[8] to a projected balance of $4,615,000. (OCA MB at 11). The OCA stated that while ADIT on CIAC for 2004 and 2005 was roughly the magnitude of that forecasted by the Company for 2006, the ADIT on CIAC averaged only $70,000 per year for 2001 through 2003. The OCA looked at the Company's actual experience for the five months of the future test year ending May 2006 and found that the CIAC growth rate was closer to that in the years 2001 – 2003. (OCA M.B. at 11). During this period the average monthly growth in CIAC was $9,000. This is the monthly, annual growth allowed by the OCA in its proposed future test year CIAC of $4,615,000. (OCA St. 1S, Schedule B-2).

[7] For the historic test year the calculated balance of ADIT ~~for~~ on CIAC was $4,507,000. (($5,909,000 - $4,507,000 = $1,402,000) / $4,507,000 = 31.1%) (PPL Gas Exh. Historic 1, Sch. C-6).

[8] PPL Gas has a portion of service territory in Maryland which is outside of the jurisdiction of the Commission. Acknowledging this portion outside of the jurisdiction of the Commission, the OCA reduces its adjustment to $1,286,000 in proportion to that portion of the Company's service territory that is within the Commonwealth of Pennsylvania.

According to the Company, the OCA's proposal does not consider that the increases in ADIT on CIAC do not occur uniformly throughout the year. For example, for the five-month period ending December 2005, the balance in accumulated deferred income taxes increased by over $1 million. (PPL M.B. at 21). The OCA admits that the magnitude of the 2004 and 2005 ADIT on CIAC is the approximately same of that being forecasted by the Company for 2006 confirming that the more recent level of CIAC is significantly higher than that acquired in 2001 through 2003. Further, according to PPL, the facts confirm that the actual ADIT for CIAC are not uniform per month through the year and thus, the level collected in the first five to seven months of 2006, cannot be concluded to be at the same level of CIAC as assumed for the latter portion of the year. (R.D. at 14 – 15).

b. ALJ's Recommendation

The ALJ found that evidence supports the projection of ADIT on CIAC proposed by PPL Gas. PPL Gas substantiated its proposal for ADIT on CIAC based on the facts presented and its $5,909,000 figure for ADIT on CIAC shall be implemented in full. The OCA's proposed reduction of $1,294,000 ($1,286,000 jurisdictional) to the future test year ADIT on CIAC figure is not supported by the facts on the record and thus, the ALJ deemed the OCA adjustment to be unwarranted. (R.D. at 15).

c. Exceptions

In its Exceptions, the OCA stated that the ALJ's recommendation is contrary to the record evidence in this proceeding. Also, the OCA contends that its recommended end of future test year ADIT on CIAC balance of $4,615,000 should be adopted. Additionally, in support of its adjustment, the OCA points out that the balance of ADIT on CIAC at August 2006 was $4,551,000 or $64,000 below the future test year claim. Accordingly, the OCA believes the Company's claim is overstated and speculative. (OCA Exc. at 5).

In reply, PPL Gas states that the actual balance at August 2006, is insignificant and that the allowance in this proceeding should be based upon the most recent experience from 2004 and 2005. (PPL R.Exc. at 12).

d. Disposition

Based upon our review of the record evidence, as well as the post record submissions of the Parties, we agree with the ALJ on this matter. We agree with PPL Gas in that the additions to CIAC do not occur ratably during the year and therefore, the OCA's use of a six-month average to represent an annual growth rate CIAC is unrealistic. Additionally, we find that the more recent years' experience to be germane to this account as being more reflective of current economic activity within the PPL Gas service territory. Accordingly, we shall adopt the recommendation of the ALJ and deny the Exceptions of the OCA in this matter.

C. Revenues

1. Off-System Sales

a. Positions of the Parties

PPL Gas proposed an adjustment removing $150,000 in net margins from off-system sales in the future test year revenues. This adjustment would have the effect of removing off-system sales revenues as an item in this base rate proceeding. PPL Gas explained that it retains a portion of the net revenues from off-system sales as an incentive to encourage the Company to obtain as much off-system sales as practical. The remaining portion of net revenues is then flowed through to ratepayers in annual Section

1307(f), 66 Pa. C.S. § 1307(f), proceedings. PPL Gas averred that because these revenues result from a sharing program implemented through annual Section 1307(f) proceedings, it would be inappropriate to reflect these revenues in this proceeding for determining rates as it would defeat the purpose of the sharing mechanism. (PPL Gas MB at 22, PPL Gas St. 4-R at 6-7, PPL Gas Exh. Future 1-Revised, Sch. D-2 Rev. 9-1-06).

This adjustment was unopposed by any of the Parties. (R.D. at 16).

b. ALJ's Recommendation

The ALJ recommended that the Company's adjustment removing $150,000 in net margins from off-system sales be approved. (R.D. at 16).

c. Disposition

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

2. Storage Service Contracts

a. Positions of the Parties

The OCA recommended using more updated information regarding the storage service contracts. Specifically, the OCA recommended that three cost of service allocators be modified to reflect increased contracted storage service capacity and storage service maximum daily demand. (OCA MB at 22-23; OCA St. 3 at 4).

PPL Gas agreed that more updated information for storage service contracts should be used and added that the revenue from storage customers should also reflect a change in volume. The end result was a proposed increase of $169,000 to the Company's initial claim for storage service revenue of $7,209,172. The Company acknowledged that this adjustment was appropriate. (PPL Gas St. 8-R at 6, PPL Gas MB at 22, Tr. 213-16).

b. ALJ's Recommendation

The ALJ recommended that the Company's adjustment, which increased the claim for storage service revenue to $7,378,172, be approved. (R.D. at 16; PPL Gas Exh. PRH-1R, Sch. A and A1).

c. Disposition

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

3. Weather Normalization Adjustment

a. Positions of the Parties

PPL Gas adjusted actual test year revenue levels to reflect "normal" weather conditions based upon degree day data obtained from the National Oceanic and Atmospheric Association. PPL Gas performed four calculations: (1) for residential customers in the southern region (old PFG); (2) for the residential customers in the northern region (old NPG); (3) for commercial customers in the northern region; and (4) for the commercial customers in the southern region. PPL Gas used calendar month degree days and revenue month revenues where the revenue months are based upon revenues billed on a billing cycle basis throughout a month. Revenues during a revenue month can be related to a customer usage during the prior calendar month. (PPL Gas MB at 23; R.D. at 17).

The OCA found anomalies based on the methods used by PPL Gas in making calculations. The OCA stated the primary factor for the anomalies is due to the Company's calculation on a month by month basis which caused an extra element of randomness to the calculation; that is, the billed sales for a month included bills sent out the prior calendar month while degree days were recorded on a calendar month. Furthermore, the OCA criticized the Company's methodology because there may be differences in the weather as a whole for the year that is not apparent when comparing weather on a month-to-month basis or *vice-versa*. (OCA MB at 19-20; R.D. at 17).

The OCA proposed an alternative method, using the heat-sensitive load per degree day for the entire year rather than for each individual month to mitigate the randomness and the effect of mismatch between calendar month and revenue month. The OCA further refined its alternative by weighting the sales adjustment on the distribution of sales in February 2005, the month of sales most heavily weighted toward the tail block evidencing high volume of usage. The result yields an adjustment increase of $401,245 to the Company's *pro forma* test year revenues under present rates. (OCA MB at 21-22, OCA Sch. C-1 Revised Appendix A; R.D. at 17).

b. ALJ's Recommendation

The ALJ stated that this adjustment is founded upon the use of different weather normalization methodology. She found it disconcerting that under PPL Gas' method of weather normalization, a colder than normal month in a warmer than normal year, would result in a reduction to *pro forma* sales. (OCA MB at 20). However, the

ALJ noted that the Company explained that this result happens in the non-heating months which do not substantially effect the weather normalization calculation. Furthermore, according to the ALJ, the OCA does not refute the Company's criticism that the OCA's methodology assumes usage per degree day is uniform throughout the year. The ALJ concluded that OCA Cross Exam. Exh. No. 8 shows that usage per degree day increases exponentially in proportion to colder weather. (R.D. at 18).

The ALJ concluded that the methodology employed by the Company, while not perfect, is substantiated by the record and is reasonable. She found the OCA alternative method to be flawed and not reasonable. The ALJ recommended that the adjustment proposed by the OCA for weather normalization should be rejected. (R.D. at 18).

c. Exceptions

In its Exceptions, the OCA states that the ALJ erred in adopting the weather normalization presented by the Company even though the calculation used a mismatch of billing revenue to monthly degree day data. The OCA also states that the Company's method did not produce reasonable, normalized results. (OCA Exc. at 8).

The Company supports the ALJ's recommendation adopting its weather normalization calculation. PPL Gas states that its methodology is superior to that of the OCA for two principal reasons. First, its method demonstrates that usage per degree day increases exponentially as heating degree days increase and second, that the OCA's conversion of usage to revenue, as originally proposed and as revised, is computed incorrectly. (PPL R.Exc. at 13).

d. **Disposition**

We agree with the ALJ's finding on this issue. While the Company's weather normalization computation is not perfect, it is supported by record evidence and is reasonable. The adjustment proposed by the OCA and its revised calculation, are not reasonable and are substantially flawed. Accordingly, we shall deny the Exceptions of the OCA and adopt the recommendation of the ALJ.

D. Expenses

1. Undisputed Expense Adjustments

PPL Gas' *pro forma* annual operations and maintenance (O&M) expense claim for the future test year ended December 31, 2006, is $186,926,000.[9] During the course of this proceeding, PPL Gas accepted, in whole or in part, certain adjustments proposed by other parties. These uncontested adjustments are described briefly in this section.

a. Company-use Gas

PPL Gas' O&M expense claim included $1,289,000 for the costs of gas used by the Company. The OTS originally proposed to eliminate the recovery of the costs of all company-use gas from base rates, based on its concern that PPL Gas was recovering these costs entirely through rates for recovery of purchased gas costs ("PGC") established under Section 1307(f) of the Pennsylvania Public Utility Code, 66 Pa. C.S. § 1307(f).

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[9] The Company's final claim of $186,926,000 reflects the three uncontested adjustments discussed in this section. The Company's revised claim on rebuttal of $186,952,000 did not include the $26,000 adjustment for lobbying expenses, *infra*. (PPL Gas. Exh. Future 1 – Revised, Sch. D-1).

Upon review, PPL Gas determined that, of the total amount of company-use gas of $1,289,000, it does recover $618,000 through PGC rates. The remaining $671,000 of gas is used to operate storage facilities. The cost of gas used to operate storage facilities traditionally has been recovered through base rates because PPL Gas has storage customers who do not pay PGC rates. PPL Gas reasoned that it is proper to recover the cost of gas used to operate storage facilities through base rates so that storage customers would pay their fair share of the costs. (PPL Gas MB at 27, PPL Gas St. 4-R at 1-3).

The OTS accepted the reduced adjustment in the amount of $618,000 for company-use gas. (OTS MB at 30-31; OTS St. 2-SR at 7-8), and the ALJ's Recommended Decision incorporated this adjustment. (R.D. at 18).[10] No Exceptions were filed to the ALJ's recommendation on this issue, which we will adopt.

b. Universal Services Hardship Company Matching Funds

PPL Gas' O&M expense claim included $50,000 for the Universal Services Hardship Fund (Fund). The OTS asserted that the claim should be denied because the Fund is financed by voluntary contributions from the Company's customers, whose contributions are matched by the Company's shareholders. The OTS contended that it would be inappropriate to recover the shareholders' matching funds from ratepayers, but agreed that the Company should be entitled to recover the portion of the expenses used to administer the Fund. (OTS St. 2 at 15-16).

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[10] PPL Gas St. 4-R at 2 indicates that $618,000 is reflected as a cost of purchased gas and recovered through the PGC filing. PPL Gas Exh. Future 1 - Revised at Sch. D-2, however, reflects a larger reduction of $854,000 in company-use gas, which in turn is reflected in the total O&M claim of $186,926,000. The discrepancy of $236,000 is not explained. Because all Parties and the ALJ accepted the Company's adjustment, we will assume that it is correct.

On rebuttal, PPL Gas stated that ten percent, or $5,000, of the Fund's expense was used for administration and accepted an adjustment of $45,000. (PPL Gas St. 1-R at 9). The OTS accepted the modified adjustment of $45,000. (OTS MB at 29-30; OTS St. 2-SR at 6-7).

The Company's revised O&M claim reflects the reduction of $45,000. (PPL Gas Exh. Future 1- Revised, Sch. D-2.) The ALJ's Recommended Decision incorporated this adjustment. (R.D. at 19). No Exceptions were filed to the ALJ's recommendation on this issue, which we will adopt.

c. Lobbying Expense

PPL Gas' O&M expense claim included $89,000 for "governmental relations and lobbying service and various Corporate Communications activities," which the OCA initially proposed to eliminate in its entirety. (OCA St. 1 at 26). PPL Gas acknowledged that $26,000 of the $89,000 expense claim related to lobbying activities. (PPL Gas St. 2R at 4-5). The OCA subsequently amended its adjustment to eliminate only the portion of the expense related to lobbying expenses. (OCA St. 1S at 4).

PPL Gas agreed to the $26,000 expense adjustment, which the ALJ's Recommended Decision incorporated. (PPL Gas MB at 28; PPL MB Table II, line 3; R.D. at 19-20, Table I). No Exceptions were filed to the ALJ's recommendation on this issue, which we will adopt.

2. Variable Pay Expense

a. Positions of the Parties

PPL Gas' O&M expense claim included a variable pay expense claim of $279,085 for the future test year. Both the OTS and the OCA advocated that a portion of the variable pay expense claim be disallowed. The OTS proposed to disallow fifty percent of the variable pay claim; the OCA proposed to disallow thirty percent of the claim.

PPL Gas' compensation package for all non-union employees includes a market-based salary with two components – base pay and variable pay. The base pay component compensates an employee for the accountabilities and competencies related to the position. The variable pay component compensates an employee for achievements related to various financial, operational and safety-related objectives. (PPL Gas MB at 28, PPL Gas St. 5-R at 5). Under this salary structure, ten percent of a non-union employee's compensation is placed at risk based on the achievements of the established objectives. (PPL Gas RB at 11).

The OTS argued that fifty percent of the variable pay expense, or $139,543, should be disallowed, based on the rationale that both shareholders and ratepayers benefit from the variable pay award program and should share the costs. (OTS St. 2 at 2, 21). The OTS argued that, through division earnings targets, the variable pay award emphasizes the financial performance of the Company. The OTS stated that shareholders benefit from the Company's improved financial performance through increased dividends and/or stock prices, and ratepayers may benefit from improved financial performance if rates are maintained at existing levels or future rate increase are minimized. (OTS St. 2 at 22). The OTS reasoned that, since both shareholders and ratepayers benefit from the variable pay program, both should share in the expense. (OTS MB at 32). In surrebuttal, the OTS raised an additional issue, arguing that to the extent that the goals are not achieved and employees do not receive variable compensation, ratepayers will be paying more than PPL Gas' actual expenses. (OTS St. 2-SR at 3).

The OCA contended that thirty percent of the variable pay program expense, or $83,000, should be disallowed as related to the achievement of the

Company's financial goals. Specifically, ten percent of the program expense is related to net income goals set by the Company, and twenty percent is related to the achievement of rate case goals. The OCA characterized the claim as requiring ratepayers to reward management for getting them to pay higher rates. (OCA St. 1 at 18-19). The OCA argued that ratepayers should not be required to pay for that portion of the incentive compensation related to the achievement of financial or profitability goals, citing *Pa. PUC v. Roaring Creek Water Co.*, 81 Pa. PUC 285, 299 (1994); *Pa. PUC v. UGI Utilities – Electric Div.*, 82 Pa. PUC 488, 508 (1994). (OCA St. 2 at 19; OCA MB at 26-27).

PPL Gas argued that the adjustment advocated by the OTS was contrary to the law; that the adjustment advocated by the OCA was contrary to the facts; and that both adjustments therefore should be rejected.

PPL Gas stated that the OTS adjustment was flawed because the concept of sharing expenses between ratepayers and shareholders on the theory that the expenses are incurred for the mutual benefit of both has been rejected by Pennsylvania's appellate courts. In *Butler Township Water Co. v. Pa. PUC*, 473 A.2d 219 (Pa. Cmwlth. 1984), the Commonwealth Court reversed the Commission's disallowance of one-half of a rate case expense claim based on the shared benefit theory. The Court held that a utility generally is entitled to recover expenses reasonably necessary to provide service, and that operating expenses include prudently incurred rate case expenses. The Court held that there must be evidence in the record that a rate case expense is unreasonable, imprudently incurred or excessive to support its disallowance. PPL Gas stated that the Court's rationale is equally applicable to variable pay expense, and that the OTS made no claim that the variable pay expense was unreasonable, imprudent or excessive. Further, the arbitrary disallowance proposed by the OTS would reduce incentives to achieve goals that are beneficial to ratepayers. (PPL Gas MB at 29-31).

With regard to the issue that the OTS raised on surrebuttal, PPL Gas stated that the OTS misunderstood the mechanics of the variable pay program; that when certain employees do not receive all of their variable pay, such funds are available to compensate other employees who receive more than 100 percent of their variable pay budget; and that in the last four years, variable pay expenses exceeded the variable pay budget in all but one year, and that shareholders bore such amounts in excess of budget. (PPL Gas MB at 32).

PPL Gas stated that the adjustment proposed by the OCA also was flawed, but for different reasons. PPL Gas acknowledged that a portion of variable pay is tied to financial goals, but argued that PPL Gas must operate its system efficiently to achieve these goals; that operational efficiency leads to lower rates; and that rewarding employees for efficient operation of the system therefore is beneficial to ratepayers. PPL Gas also acknowledged that twenty percent of the total variable pay expense, or $55,817, was related to this rate case, but argued that the rate case goals also were in the interest of ratepayers. The Company's rate case goals are to achieve a quality and user-friendly filing, and to restore the Company's financial health through the recovery of prudently incurred costs. PPL Gas asserted that achieving these goals will allow it to continue to provide safe, adequate, reasonable and reliable service to customers. (PPL Gas MB at 31).

The OTS argued in reply that the *Butler* case cited by the Company was limited to necessary expenses, such as rate case expense, but that its holding did not extend to the variable pay program expense. The OTS also disagreed with the Company's assertion that the OTS had not claimed that the expense was unreasonable, imprudent or excessive. The OTS argued that recovering the full amount of the claim from ratepayers would be unreasonable and excessive in this or any other case. The OTS also asserted that, since the record supports a conclusion that the program is not necessary to providing service, the entire program expense could be disallowed, rather than half of the expense proposed by the OTS as a compromise position.

The OCA argued in reply that rate case expense and incentive compensation are not analogous. According to the OCA, rate case expense is reasonably necessary to provide service and, therefore, recoverable from ratepayers, unlike incentive pay tied to net income and rate case goals. The OCA concluded that the holding of the Commonwealth Court in *Butler* does not apply.

PPL Gas argued in reply that its variable pay program is distinguishable from the programs at issue in *Roaring Creek* and *UGI*, *supra.*, cited by the OCA. In both of these cases, the programs focused on the utility's parent company. The Commission stated in *UGI* that, at a minimum, the utility must show that the program has a "direct bearing on cost reduction and rate control efforts." PPL Gas argued that its program is not based on holding company performance; that its program has balanced objectives that promote efficient operations; and that even its rate case objectives promote the interests of customers.

b. ALJ's Recommendation

The ALJ recommended that the OTS adjustment be adopted and that half of the variable pay expense claim, or $139,543, be disallowed. (R.D. at 22). The ALJ reasoned that the variable pay expense is not analogous to rate case expense as argued by PPL Gas, since rates and rate cases are necessary to provide service. Incentive pay to reward employees for meeting shareholders' net income goals and rate case goals are not reasonably necessary expenses related to service to customers.

The ALJ found that the Company's reliance on *Butler* was misplaced, and that the Commission has held that ratepayers have no duty to pay for incentive compensation related to achievement of financial or profitability goals, citing *Roaring Creek*. The ALJ found that "[b]ecause it is determined that the Company is incorrect on the applicable law, PPL Gas' rebuttal to the adjustment proposed by OTS must fail. PPL has not sustained its burden to show the full claimed variable pay expense of $279,085 is reasonable." (R.D. at 22). The ALJ concluded that the OTS adjustment appropriately models the shared benefit of the expense by ratepayers and shareholders.

c. Exceptions

PPL Gas excepts to the ALJ's recommendation. PPL Gas states that the sum of base pay and variable pay equals the market rate for each position; that its program is *not* a bonus program; and that the program permits employees to earn the market compensation rate for their position only if they achieve various objectives. PPL Gas states that the ALJ factually was mistaken that variable pay expenses are not necessary. "As explained previously, the sum of base pay and variable pay equals the market-based compensation rate for particular positions. It is necessary for PPL Gas to compensate employees at market rates." (PPL Gas Exc. at 20). PPL Gas distinguishes *Roaring Creek* as a case that addressed a bonus program tied to the financial goals of the corporate parent. PPL Gas reiterates that the goals of its program are balanced and unrelated to the financial performance of any corporate affiliate. PPL Gas also repeats its argument that the rate case goals in its program, achieving a quality filing and achieving the best possible outcome for the Company, are beneficial to ratepayers. PPL Gas states that it is in the best interests of ratepayers for there to be as few rate cases as practical, since rate cases are expensive and inefficient. "Achieving a good result in a rate case will permit PPL Gas to file fewer rate cases in the future, thereby, controlling rate case expense, which is properly borne by customers." (PPL Gas Exc. at 22-23).

PPL Gas also reiterates its position that the rationale for disallowing one-half of the variable pay expense is contrary to law. "Indeed, it cannot be the law that ratepayers and shareholders should share expenses that are for their mutual benefit, because the result could be a financial disaster for utilities." (PPL Gas Exc. at 18-19). PPL Gas points out that many expenses could be said to benefit both ratepayers and shareholders, such as purchasing gas supplies. PPL Gas, citing *Butler*, states that a public utility is entitled to recover fully its reasonable expenses incurred in providing service, and that there is no basis in the record for a finding that any portion of the variable pay expense is unreasonable, imprudent or excessive.

The OTS' Reply Exceptions state that the Company has not responded to the possibility that ratepayers could pay more than the Company's actual variable pay expenses if employees do not achieve program goals and receive payments. The OTS also argues that the Company's reliance on *Butler* as controlling precedent is misplaced, since unlike rate case expense, variable pay expense is discretionary. (OTS R.Exc. at 11-13).

The OCA's Reply Exceptions state that, while the OCA continues to support its recommendation for a disallowance of thirty percent based on the percentage of variable pay tied to the Company's net income and rate case goals, the fifty percent disallowance recommended by the ALJ is supported by the record and consistent with Commission precedent. (OCA R.Exc. at 11). The OCA responds to PPL Gas' argument that its variable pay program is not a bonus program as ignoring the fact that variable pay is "at risk" and is the very type of bonus or incentive program that was the subject of prior Commission disallowances. Second, the OCA responds to PPL Gas' argument concerning the 50/50 sharing reversed by the Commonwealth Court in *Butler* as involving rate case expense, which factually is distinguishable from the variable pay expense at issue here. As the ALJ explained, rate case expense is non-discretionary, whereas the Company has discretion when establishing goals for the variable pay component of employee compensation.

d. Disposition

On review, we will grant the Company's Exception. Although we do not agree with the Company that the adjustment urged by the OTS would be prohibited as a matter of law under *Butler*, we find that, under the facts of this case, the Company has demonstrated that its variable expense claim is reasonable and should be approved.

Several considerations lead us to this conclusion. First, the compensation program's variable component is tied to balanced operational and financial objectives. Only thirty percent of variable compensation is related to net income and rate case goals while fully seventy percent is related to operational and safety goals. Second, only ten percent of an employee's salary is categorized as variable, or at-risk. Base pay constitutes ninety percent of compensation. Third, the program extends to *all* non-union employees, as opposed to a bonus program that is limited to the very top echelon of management. Fourth, variable pay is unrelated to the performance of a PPL Gas holding company or affiliate. All of these factors support a determination that the Company's broad-based compensation program provides for market-based compensation rates for its non-union employees. Since we conclude that the Company's compensation program provides for market-based rates for its non-union employees, we conclude that both its fixed and variable components are reasonable and hence recoverable in rates.

The Company's variable pay component of its employee compensation program does not constitute a bonus program of the type disallowed in *Roaring Creek* and *UGI*. In *Roaring Creek*, we disallowed a claim for a bonus program that was limited to management employees, where fully one-third of the program expense was earmarked for one employee. In addition, the bonus program was tied largely to income and earnings targets for the parent company, which were unrelated to improvements in service to ratepayers. We disallowed the claim because the bonus program was not aimed at enhancing the productivity and efficiency of the utility. In *UGI*, we disallowed a claim for a bonus plan and a stock option plan where most of the eligible persons were holding company employees and the plans again were aimed at the parent company's financial performance. We stated that "[i]ncentive compensation plans are a good idea and they should be utilized to stimulate innovative operational improvements to create a better performing company. *In order to be passed on to ratepayers, however, there must be an* adequate factual basis for the Commission to conclude that the Company seeks to maximize more than just shareholder value. Even if no specific cost savings can be shown to result from the incentive compensation plan, at a minimum the plan must be shown to have a direct bearing on cost reduction and rate control efforts." 82 Pa. PUC at 508. In the instant case, PPL Gas has demonstrated that the variable pay component of its compensation program is related to the Company's operational performance and efficiency objectives.

We reject the argument of the OTS that its proposed disallowance is supported by the fact that there is a possibility that the Company's actual variable pay expense could be less than its ratemaking allowance if employees do not achieve program goals and receive all of their variable pay. The Company stated that, in three of the last four years, actual variable pay expense exceeded its variable pay budget, and that shareholders bore the amounts in excess of budget. In addition, a similar argument could be made concerning nearly all expense items. Expenses that are allowed for ratemaking purposes nearly always will be either greater or lesser than actual expenses incurred when the rates are in effect. Such is the inherent nature of budgets and projections used in establishing rates.

3. Affiliates Charges

a. Positions of the Parties

Within the PPL corporate system, certain services are provided to all members from a common pool of resources. When the user of services can be identified specifically, expenses are charged directly to that user. General administrative support costs are allocated among the member companies. In this case, PPL Gas claimed total charges of $9,453,000 from several affiliates for the future test year. Included in this amount was $8,705,000 in charges from PPL Services Corporation (PPL Services). (PPL St. 2-R at 3).

PPL Gas stated that indirect costs are allocated among the members of the PPL corporate system based on a three-factor formula that was recommended in a Commission-sponsored management audit. The three factors include a payroll factor, an investment factor, and an O&M expense factor.

The OTS proposed an adjustment to total direct and indirect charges based on a four-year (2003-2006) average of charges from affiliates. The OTS proposed an adjustment of $844,000. (OTS MB at 28-29; OTS St. 2; OTS Exh. 2, Sch. 6).

The OCA proposed an adjustment of $238,000, which would disallow the increase in indirect support expenses over the level of such expenses in 2005.[11] The OCA noted that PPL Gas had forecast an increase of approximately seven percent in its indirect support expense, from actual 2005 expense of $3,386,000, to projected 2006 expense of $3,624,000. The OCA argued that, when asked to explain this increase, PPL Gas cited two factors: (1) a "modest" increase in the percentage of total indirect support provided by PPL Services; and (2) a "minor" increase in the costs being allocated. (OCA MB at 37; OCA St. 1 at 27). The OCA submitted that this explanation does not demonstrate how these factors translate into an increase of seven percent. Because the

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[11] As noted, the OCA also proposed an adjustment to eliminate $26,000 in lobbying expenses, which PPL Gas accepted. *See* Section D(1)(c) of this Opinion and Order.

increase had not been adequately justified, the OCA recommended that the forecasted increase of $238,000 be disallowed. (OCA St. 1 at 28, Sch. C-2).

PPL Gas argued that the increases in costs from support groups within the PPL corporate system are reasonable. PPL Gas noted that its total support charges between 2003 and 2006 increased only five percent annually on average. Charges to PPL Gas for direct and indirect support services increased by $672,000 and $238,000, respectively, from 2005 to 2006. Over the four-year period, indirect support charges increased by approximately eight percent annually, while direct support charges increased by approximately 3.1 percent annually. PPL Gas argued that, through the first six months of 2006, PPL Gas was charged an annualized amount of $8,738,000 for direct and indirect costs, which was slightly more than its budget of $8,705,000, the basis for the claimed affiliate charge expense in this proceeding. The fact that PPL Gas actually is incurring the claimed level of expenses demonstrates the reasonableness of its claim. (PPL Gas MB at 35, PPL Gas St. 2-R at 3).

In reply, the OCA stated that the fact that the Company's claim for indirect service charges resulted from allocation factors recommended in a Commission management audit does not relieve the Company from its burden of proof. The OCA argued that its adjustment of $238,000 should be adopted because PPL Gas did not meet this burden of proof. (OCA RB at 17).

In reply, PPL Gas contended that both the OTS and the OCA seek to arbitrarily limit expenses to historic levels based only on their subjective feelings that the increases to the charges are too great. PPL Gas stated that neither party was clear on the basis for its proposed adjustment. Presumably the basis for the proposed adjustments was that PPL Gas' projections either were not accurate or were excessive. PPL Gas reiterated that its actual charges for the first six months of 2006 demonstrate that its projections are reasonably accurate and, indeed, slightly conservative. PPL Gas also reiterated that the increase in affiliate charges is justified by the increased level of services provided by affiliates, citing the cost to comply with increased regulatory requirements imposed following the collapse of Enron in 2001. Finally, PPL Gas stated that the OTS adjustment particularly is unreasonable because it would allow only an annual increase of 1.5 percent over the four-year period from 2003-2006. (PPL Gas RB at 12-14).

b. ALJ's Recommendation

The ALJ recommended that both the OTS and the OCA adjustments be rejected, and found that PPL Gas had substantiated its affiliated expense claim. The ALJ stated that "[t]he arguments relayed by OCA and OTS fail to show that the magnitude of the increase in the 2006 future year expense claim is unreasonable, inappropriate, inaccurate or unsupported. The claimed 2006 affiliated expense of PPL Gas at $8,705,000 in charges from PPL Services Corporation should be approved." (R.D. at 24).

c. Disposition

Neither the OTS nor the OCA excepted to the ALJ's recommendation on this issue. Based on our review of the record, we shall adopt the recommendation of the ALJ and allow the Company's claim for $9,453,000 in charges from several affiliates, including $8,705,000 in charges from PPL Services Corporation. The record demonstrates that, through the first six months of 2006, PPL Gas was charged an annualized amount greater than its budget, and that its budget was reasonably accurate. We also accept PPL Gas' contention that the increased regulatory requirements imposed on publicly-held companies following the collapse of Enron, including the Sarbanes-Oxley Act of 2002, reasonably explains and justifies the increased level of expense.

4. Environmental Remediation Expenses

a. Positions of the Parties

PPL Gas' claim for environmental remediation expense of $987,000 is based on the methodology previously accepted by the Commission through the approval of the settlement of PPL Gas' prior base rate case at Docket No. R-00005277. (PPL Gas Exh. Future 1 - Revised, Sch. D-2 at 1, PPL Gas MB at 36). The Company first forecast spending on environmental remediation projects in excess of insurance recoveries through the end of 2011. The Company then determined that this amount exceeds the environmental remediation expenses recovered in rates through December 31, 2006, by $4,935,000. The Company then normalized this difference over the five-year period 2007-2011, resulting in the *pro forma* annual expense claim of $987,000. (OCA MB at 38).

The OTS proposed two adjustments that together would reduce the Company's claim by $882,000 and provide an annual allowance of $105,000: (1) the elimination of the three percent (3.0 %) annual escalation used by the Company to project environmental remediation expenses after 2006; and (2) the elimination of remediation expenses at sites that the Company has not yet identified. The OTS then netted the total amount of expected costs through 2011 against the amount already recovered. (OTS St. 3 at 9-12; OTS MB at 24-27). First, the OTS argued that the three percent escalation factor is not supported historically. (OTS St. 2 at 11). Second, the OTS proposed to eliminate $510,299 in remediation expenses attributable to "Unknown Utility MGP [Manufactured Gas Plant] & Mercury Sites." (OTS St. 2 at 10; OTS Exh. 2, Sch. 4 at 2). The OTS opined that test year expenses claimed for ratemaking purposes must be known and measurable, and that remediation expenses for unknown sites were neither. The revenue impact of the two adjustments recommended by the OTS is a reduction of $882,000 to the annual environmental remediation expense claimed by the Company of $987,000. (OTS St. 2 at 11-12; OTS MB at 24-27).

PPL Gas argued that a modest allowance for inflation for the five year period ending December 31, 2011, would be appropriate. The remediation of MGP sites and mercury is labor-intensive, and costs are escalating as the price for labor, equipment rentals, fuel costs, disposal costs and property acquisitions continue to rise. The OTS adjustment to disallow inflation is contrary to the experience of PPL Gas and without foundation. (PPL Gas St. 3-R at 11; PPL Gas MB at 38-39).

PPL Gas also argued that it was appropriate to include remediation costs for unknown MGP and mercury sites, as the prospect of having to remediate presently unknown sites is a serious concern. PPL Gas currently is remediating and/or monitoring four previously unidentified MGP sites. PPL Gas stated that its inclusion of $3,061,794 for unknown sites through 2011 is reasonable, given the fact that the average cost of fully remediating an MGP site is about $2 million. (PPL Gas St. 3-R at 11; PPL Gas MB at 38).

The OTS replied that the Company's general arguments are not sufficient to deviate from the standard ratemaking requirement that expenses be known and measurable as a prerequisite to being recoverable. (OTS RB at 13).

The OCA proposed that the Company's expense claim be rejected in its entirety and set at zero until its next base rate case. The OCA objected to the Company's forecasting its expense level through 2011 on the basis of its estimate of remediation expenses of $2,879,000 in 2006. Through the first five months of 2006, the Company has spent only $329,000, an annualized expenditure of only $790,000. (OCA St. 1 at 23; OCA MB at 39). In the three-year period 2003 through 2005, the highest annual expenditure by the Company was only $1,507,000, not much more than half of the forecasted 2006 level of $2,879,000 used to determine the expense claim in this proceeding. The OCA stated that the Company already has recovered $12,621,000 more than its actual expenditures through the rate recovery mechanism approved by the Commission. If this over-recovered amount were used to fund expenditures between now and the end of 2011, the Company would have $2,524,000 available each year for environmental expenditures. Between 1989 and 2005, the Company never has reached a spending level of $2,524.000. (OCA St. 1 at 23-24; OCA MB at 39).

PPL Gas stated that the OCA's adjustment would decrease the Company's 2006 test year environmental remediation expense by $2,089,000, to $790,000, and require that all projected expenses be charged against amounts previously recovered from ratepayers and insurance companies. PPL Gas argued that the "OCA ignores the fact that environmental remediation expenses are expected to increase during the later years of the DEP [Department of Environmental Protection] Consent Order, when remediation expenditures typically reach their highest levels." (PPL Gas MB at 39). PPL Gas contended that it would be inappropriate to eliminate recovery of environmental remediation costs when they are expected to escalate. (PPL MB at 39, PPL Gas St. 3-R at 12).

The OCA replied that the Company had not rebutted the OCA's calculation of a future test year level of expense of only $790,000, or otherwise provided updated information to support the Company's 2006 expense claim of $2,879,000:

> Thus, Mr. Kleha's "first step" of calculating expenditures and recoveries through the end of the future test year, which PPL Gas relies upon in its Main Brief, is not supported by record evidence. Further, OCA witness Effron found the Company's forecast annual environmental remediation expenditures of $2,879,000 overstated, compared to the Company's future test year level of spending and historic levels. The Company's theory of a net deficiency at the end of 2011 of $4.935 million is based on supposition and assumptions which are without support in the record.

(OCA MB at 10 (citations omitted)). The OCA argued that the Company's theory that the OCA would not provide the Company with funds to pay for environmental remediation expenses was incorrect and ignored the OCA's testimony that the Company already has $12,621,000 on hand, the amount of the net over-recovery through the end of the historic test year. This amount is sufficient to provide an annual expenditure of $2,524,000 for 2007 through 2011, a level in excess of historic levels. (OCA RB at 10).

b. ALJ's Recommendation

The ALJ recommended that the OTS adjustment of $882,000 to the Company claim of $987,000 for annual environmental remediation expense be granted.[12] (R.D. at 28).

With respect to the $510,000 adjustment for unknown sites, the ALJ found that the Company had not refuted the OTS assertion that test year expenses should be known and measurable, and had affirmed that the MGP and mercury sites are unknown. (R.D. at 27).

With respect to the adjustment to eliminate the three percent escalation factor, the ALJ found that nothing in the record demonstrates that inflation will reach levels of three percent per year over the next five years, and that PPL Gas simply had not supported through record evidence an inflation factor of that magnitude. (R.D. at 28).

12 The text of the ALJ's Recommended Decision reversed the OTS recommended allowance of $105,000, and the OTS recommended downward adjustment of $882,000. (R.D. at 27). Table II to the Recommended Decision, however, correctly reflects a downward adjustment of $882,000.

The ALJ concluded that the OCA adjustment to disallow all projected environmental remediation expenses was over zealous, drastic and unreasonable, and should be rejected on that basis.

c. **Exceptions**

The Company's Exceptions to the ALJ's recommendation argue that the inclusion of projected expenses for unknown sites is appropriate, given that it currently is in the process of remediating four MGP sites that were unidentified when it entered into the Consent Order with DEP. The Company contends that it is reasonable to expect that additional sites will be identified during the remaining five years of the Consent Agreement and that its projected costs of approximately $3 million for these unknown sites is reasonable. With respect to the elimination of its 3.0 percent inflation factor, the Company concedes that it did not specifically introduce evidence of inflation for environmental remediation costs, but states that there is evidence in the record regarding prospective inflation. The Company refers to evidence introduced by the OTS that inflation for the period 2007 through 2011 is expected to range between 2.4 and 2.8 percent (OTS Exh. 1, Sch. 3), and states that its projection of 3.0 percent is consistent therewith, rounded to the nearest whole number. (PPL Gas Exc. at 23-26). PPL Gas concludes that it would be inappropriate for the Commission to reduce recovery of environmental remediation expenses at the time when they are expected to increase, and that the elimination of expenses for unknown sites would be inconsistent with the "matching" principles established in the settlement of PPL Gas' last base rate case.

The OTS' Reply Exceptions state that the Company simply had not met its burden of proving the legitimacy of its claim and that the ALJ properly applied the reasonable, known and measurable standard set forth at *Pa. PUC v. West Penn Power*, 73 Pa. PUC 454 (1990). (OTS R.Exc. at 14).

The OCA's Reply Exceptions state that, while it had recommended that the Company's entire expense claim be eliminated because the Company was not spending on a pace that would utilize the $12.6 million it previously collected by the end of 2011, the adjustments proposed by the OTS are well supported and necessary. The OCA states that, insofar as the Company's claim is related to unknown sites, it does not meet the requirement that expenses allowed in a rate case must be reasonable, known and measurable, citing *West Penn*. The OCA also states that the ALJ correctly found that the Company had not supported its three percent allowance for inflation to environmental remediation expenses. Contrary to the Company's argument that the ALJ's recommendation denies the Company any financial resources, the OCA submits that it simply provides for the recovery of a reasonable level of expenses from ratepayers based on the record in this case. (OCA R.Exc. at 12-14).

d. Disposition

We will adopt the recommendation of the ALJ regarding disallowance of the expenses associated with unknown sites, and will deny the Company's Exceptions on this point. We will, however, grant, in part, the Company's Exceptions regarding an inflation factor. However, rather than an inflation factor of 3.0 percent sought by the Company, we will utilize an inflation factor of 2.4 percent to calculate the Company's annual expense allowance.

The Company's claim for expenses associated with the remediation of unknown sites is speculative, and fails the basic ratemaking tenet that expenses must be known and measurable in order to be recoverable. PPL Gas' argument that expenses to remediate sites that it has not yet discovered should be recoverable from ratepayers is based solely on the fact that it discovered four sites since its consent order with DEP was signed. It essentially then extrapolates this information as proof that additional sites will be discovered in the future. Without additional support and explanation, the Company's claim for expenses to remediate undiscovered sites must be denied.

The Company's claim for a 3.0 percent inflation factor similarly is not supported on the record. The Company did not provide any evidentiary support for its claim that environmental remediation expenses will increase by 3.0 percent per year. In lieu of providing evidence of its own, the Company relied on evidence introduced by the OTS' witness on rate of return regarding forecasted changes to the general rate of inflation, specifically the Consumer Price Index (CPI). The OTS witness forecast increases to the CPI ranging from 2.4 percent to 2.8 percent for the years 2007 through 2011. (OTS St. 1 at 14; OTS Exh. 1, Sch. 3). As a matter of common sense, PPL Gas' argument that environmental expenses will be subject to inflation is convincing. PPL Gas argued that the remediation of MGP sites and mercury is labor-intensive, and costs are escalating as the price for labor, equipment rentals, fuel costs, disposal costs and property acquisitions continue to rise. However, because there is no evidence on the record to support the Company's claimed inflation rate of 3.0 percent, we will utilize an inflation rate of 2.4 percent, the low end of the range of forecasted increases to the CPI introduced into the record by the OTS.

The disallowance of the claimed expenses for unknown sites, and the inclusion of an inflation factor of 2.4 percent, results in an adjustment of $705,000 to the Company's claim, as opposed to the adjustment of $882,000 as recommended by the ALJ. *See* Table VII attached to this Opinion and Order.

5. Rate Case Expense

a. Positions of the Parties

PPL Gas proposed to normalize its rate case expense claim of $1,125,000 over two years, resulting in an annualized claim of $563,000. (PPL Gas Exh. Future 1, Sch. D-5). No Party disputed the total amount of the rate case expense, but both the OTS and the OCA recommended that, based on the past ten-year history of PPL Gas' base rate case filings, the expense should be normalized over five years. (OTS St. 2 at 2-6; OTS MB at 18-21; OCA St. 1 at 16-17; OCA MB at 25-26).

PPL Gas argued that both Parties failed to recognize that events that precluded more frequent filings in the past are not expected to recur in the future. These events include the acquisition of Penn Fuel Gas, Inc. (Penn Fuel) by the PPL corporate system in 1998, and the required applications of Penn Fuel's regulated subsidiaries for approval of their restructuring plans under the Natural Gas Choice and Competition Act, 66 Pa. C.S. §§ 2201 *et seq.* (Competition Act). PPL Gas averred that potential rate cases were disrupted by rate caps under the Competition Act, and that base rate increases generally were banned for eighteen months, from July 1, 1999, until January 1, 2001. Both Penn Fuel subsidiaries underwent a detailed review of their existing rates and a rate cap period during the last ten years, which is not consistent with future circumstances.

PPL Gas further argued that it is experiencing reductions in the average annual usage of natural gas by residential customers, which declined almost nine percent between 2000 and 2005. In addition, PPL Gas averred that there are increasingly stringent requirements for replacement of aging infrastructure and safety regulations, which will require an increased level of pipeline replacements and other maintenance, and that all of the related changes will increase expenses. (PPL MB at 40-42). PPL Gas implies that all of these pressures will lead to more frequent rate case filings in the future.

The OTS argued that the normalization period should be determined based on a utility's actual, historical rate filings, not upon the utility's intentions, citing *Popowsky v. Pa. PUC*, 674 A.2d 1149, 1154 (Pa. Cmwlth. 1996). The OTS recommended that the Company's rate case expense be normalized over five years, which would result in an annual allowance of $225,000 and a reduction in rate case expense of $338,000. The sixty-month normalization period recommended by the OTS is the average interval between the 1996 and 2000 filings, and the 2000 and 2006 filings. (OTS St. 2 at 2-6; OTS MB at 18-21). The OTS further argued that the Company's assertions of future events lacked documentation and specificity. (OTS RB at 11-12).

The OCA recommended the same normalization period of five years for the same reasons as the OTS. In addition, the OCA responded to the Company's argument concerning changed circumstances, and argued that requirements such as those cited by the Company have existed for many years. "These requirements have certainly existed at least since the time of the Company's last two rate cases, which were in 1996 and 2000." (OCA St. 1-S at 5; OCA MB at 25-26).

In reply, the Company argued that "if OTS and OCA were simply to acknowledge that the restructuring proceeding is the equivalent of a full investigation of rates and the fact that PPL Gas (and its predecessors) were barred from increasing rates for the eighteen-month rate cap period, their adjustments would be reduced substantially." (PPL Gas RB at 16). The Company argued that, by subtracting the eighteen-month rate cap period, and recognizing the restructuring proceeding as a rate case, the resulting interval was 34.7 months, less than three years, and far less than the five years proposed by the OTS and the OCA. PPL Gas then argued that its two-year normalization period should be adopted, but that in no event should the rate case normalization period exceed three years. (PPL Gas RB at 17).

b. ALJ's Recommendation

The ALJ recommended that rate case expense be normalized over a three-year period, based on the Company's argument in its Reply Brief that the restructuring period should be considered as the equivalent of a base rate case, and that the eighteen-month rate cap period should be subtracted from the calculation. Normalizing the rate expense claim of $1,125,000 over three years results in an annual rate case allowance of $375,000 ($1,125,000/3 = $375,000), thereby reducing PPL Gas' claim by $188,000. (R.D. at 29).

c. Exceptions

The OCA argues that the ALJ erred by adopting the alternative normalization period of three years that was proposed for the first time in the Company's Reply Brief. The OCA argues that no Company witness testified in support of a three-year normalization period or the specific calculation made by the Company in its Reply Brief. The OCA argues that deducting the eighteen-month rate cap period is without merit, noting that the Company was allowed to increase its base rates when the rate cap period expired on January 1, 2001, and filed a base rate case in June 2000 to accomplish this. The OCA states that the five-year normalization period is less than the 72-month interval between the June 2000 filing and the April 2006 filing in the present case. The OCA further argues that the inclusion of a "non-Section 1308(d) regulatory filing in the calculation of historic interval between base rate cases is unprecedented and unrelated to the normalization of base rate expense to be recovered in base rates." (OCA Exc. at 11).

The OTS did not file a specific Exception to the ALJ's recommendation on this issue. The OTS, however, reaffirms its support for all of the OTS recommendations in this proceeding, and requests that the Commission review and adopt each OTS recommendation rejected by the ALJ, whether or not OTS filed a specific Exception. The OTS cited rate case expense as an example of a recommendation that it is not withdrawing by virtue of not filing a specific Exception on the issue. (OTS Exc. at 2).

The Company's Reply Exceptions state that the OCA's criticism of its proposed compromise of a three-year normalization is unwarranted, and that looking at the average span between rate cases over the last ten years simplistically ignores many factors that influence past and future filings. Following a recital of several of these factors, the Company states that its proposal for a three-year amortization of rate case expense is reasonable. (PPL Gas R.Exc. at 14-16).

d. Disposition

We shall adopt the ALJ's recommendation on this issue and adopt a three-year normalization period, which reduces the Company's initial rate case expense claim by $188,000. (R.D. at 28-29, Table II). Although we agree with the OTS and the OCA that a normalization period for rate case expense should be based on a utility's actual, historic rate filings, the OTS and the OCA have taken an overly prescriptive view of the Company's filing history. The Company's calculation of an interval of 34.7 months between cases, after recognizing the restructuring proceedings of its subsidiaries as equivalent to rate cases and subtracting the eighteen-month rate cap period, is persuasive. Similar to base rate cases, the Company's restructuring proceedings entailed the equivalent of a full investigation of existing rates. It would be unrealistic to disregard these restructuring proceedings when determining a reasonable rate case normalization period simply because the cases were not filed under a particular section of the Public Utility Code. We also agree with the Company that subtracting the eighteen-month rate cap period is reasonable when assessing the frequency with which the Company likely will file base rate cases in the future.

We accordingly deny the Exception of the OCA on this issue. Although it is correct that the Company did not propose a three-year normalization period until the filing of its Reply Brief, its calculation of a 34.7 month interval was simply an arithmetic result based on evidence already in the record. The three-year normalization period was proposed by the Company as a compromise between its proposed two-year and the OTS/OCA proposed five-year normalization periods. Compromise proposals generally are welcome, and should be encouraged. We conclude that the three-year period is reasonable, and that it is supported by the Company's filing history, including its restructuring proceedings and rate cap periods.

6. Payroll Expense and Appropriate Budgeted Employee Complement

a. Positions of the Parties

PPL Gas' annual payroll expense claim of $12,633,000 is based on a complement of 321 employees. (PPL Gas Exh. Future 1, Sch. D-6). Both the OTS and the OCA proposed adjustments based on a lower complement of employees. The OTS recommended an adjustment of $274,176 based on seven unfilled positions as of August, 2006, and an employee complement of 314. (OTS St. 2 at 12; OTS errata sheet). The OCA proposed an adjustment of $316,000 based on an employee complement of 315. (OCA St. 1 at 17-18).

The Company argued that its detailed information comparing budgeted employee complement with the actual number of employees over a three-year period showed that its employee complement has been very close to its budgeted complement. The Company asserted that, on average, its employee complement was seven thirty-sixths (less than 1/5) of one position below budget over the three-year period. (PPL Gas MB at 43; PPL Gas RB at 17). The Company also asserted that it was in the process of hiring four new employees in September 2006 alone, and that only three additional employees would restore the employee complement to the full budget level. (PPL Gas RB at 17-18).

The OTS argued that the Company's claim was based on a complement of 321 employees at the end of 2006, but as of August, 2006, seven positions remained unfilled. The OTS noted that there were no guarantees that the positions ever would be filled, and recommended an adjustment of $274,176 based on the Company's average wages for seven positions. (OTS St. 2 at 12-13; OTS MB at 27-28).

The OCA argued that the last time that the Company had 321 employees was in March 2004; that the increase to 321 employees in July 2006 was due to the summer hiring of temporary employees; and that by August 2006 the number of employees had dropped again to 314. The OCA therefore recommended an adjustment of $316,000 based on a total complement of 315 permanent employees (314 permanent employees plus two temporary employees equivalent to one permanent employee). (OCA St. 1 at 17-18; OCA St. 1S at 3-4; OCA MB at 34-35).

b. ALJ's Recommendation

The ALJ recommended that the Company's claim of $12,633,000 in annual payroll expense based on a complement of 321 employees be approved, finding that it was reasonable and supported by record evidence. The ALJ found that over a three-year period, the average employee complement has been less than one-fifth of one position below the budgeted amount, and that at times the Company's complement of employees has been greater than budgeted. (R.D. at 30-31).

The ALJ found that the adjustments proposed by the OCA and the OTS were based on employee complement numbers that were not supported by historic data, and that it would be inappropriate and inaccurate to establish an employee complement based upon one month in time. (R.D. at 30).

c. Exceptions

The OCA's Exceptions contend that the ALJ erred when the record clearly demonstrates that the number of Company employees consistently ranged between 313 and 315. The OCA argues that the Company based its claim on the peak number of employees that was achieved in only two months, March 2004 and July 2006. The OCA notes that the July 2006 complement of 321 employees included six temporary employees.

The Company's Reply Exceptions state that its number of employees compared to budget varies over time, and that on average its actual employee complement is less than one-fifth of one position below budget. The Company argues that the OCA did not specifically address its contentions, and that the OCA focused on the employee complement from December 31, 2005 through August 2006, rather than considering the relationship of employee complement to budget over time. (PPL Gas R.Exc. at 16-17).

d. Disposition

We will adopt the ALJ's recommendation on this issue. We agree that the Company adequately demonstrated that its budgeted employee complement is reasonably accurate and supported by historic data. As demonstrated, its actual employee complement was less than one-fifth of one position below budget over a three-year period. Although in the one-month snapshot taken in August 2006 there were seven unfilled positions, over time the difference between employee complement and budget has been insignificant. The relative insignificance of the employee complement in one individual month is confirmed by the Company's averment that in the next month it was in the process of hiring four additional employees. The OCA's Exception on this issue is denied.

7. Amortization of Storage Field Gas Losses

a. Positions of the Parties

PPL Gas claimed $282,000 for gas losses from two storage fields, based on a total loss of 482,336 Dth valued at $2,820,000, from 2002 through 2005, and a proposal to amortize this amount over ten years. (PPL Gas St. 3-R at 19). The OCA proposed to eliminate the claim entirely on the basis that its approval would constitute retroactive ratemaking.

PPL Gas argued that the OCA's proposal should be rejected because its method of recovering storage field gas losses has been approved by the Commission in prior rate proceedings over the OCA's objections. PPL Gas averred that its long-standing practice has been to determine periodically the amount of lost gas during a prior period from the Meeker and Tioga storage fields, and then to amortize the losses for ratemaking purposes. *Pa. PUC v. North Penn Gas Co.*, 65 Pa. PUC 215 (1987). PPL Gas stated that the OCA ignored the ratemaking treatment history of this issue and that its proposal should be rejected on this basis. (PPL Gas MB at 43-45).

The OCA characterized the Company's claim as a request for the recovery of past losses in future rates, or retroactive ratemaking. (OCA St. 1 at 20, OCA MB at 28). The OCA disputed the ratemaking history relied upon by the Company, noting that the last base rate case was resolved through a settlement and cannot be relied upon as precedent. Additionally, in this case PPL Gas proposed a change in practice. To comply with new accounting practices under the Sarbanes-Oxley Act of 2002, the Company now is expensing the cost of gas lost from storage when it occurs. To match the timing of revenue and expense, the Company proposed an annual expense for future gas losses of $507,420, which the OCA has not opposed. The OCA is opposed, however, to the recovery of gas lost from storage from 2002 through 2005, and argued that prior expenses cannot be recovered unless the expense is unanticipated, extraordinary and non-recurring. *Philadelphia Electric v. Pa. PUC*, 502 A.2d 722, 728 (Pa. Cmwlth. 1985). According to the OCA, PPL Gas did not allege that the lost gas expense fits within these exceptions to the rule against retroactive ratemaking. The OCA pointed to a Commission decision that denied a claim for recovery of past sludge removal expense, but allowed the recovery on a going-forward basis. The Commission found that "[t]he existence of the unchallenged ongoing expense, however, is proof positive that the cost for removal of the sludge ... is not extraordinary, non-recurring expense which should be amortized in current rates." *Pa. PUC v. Mechanicsburg Water Co.*, 80 Pa. PUC 212, 232 (1993). The OCA concluded that its proposal to deny the claim for recovery of past storage losses was supported by the record and by the law.

PPL Gas replied that it properly referenced the inclusion of storage field gas losses in the settlement of its 2000 rate case, because the purpose of the reference was to establish the fact of an existing practice, as opposed to legal precedent. More importantly, the Commission approved the recovery of storage field gas losses in the Company's litigated proceeding in the 1987 *North Penn* case. PPL Gas argued that these two cases demonstrate that the Commission in the past allowed the Company to amortize past storage field gas losses, and that the OCA's proposal is inconsistent with prior Commission orders.

b. ALJ's Recommendation

The ALJ recommended that PPL Gas' annual expense claim of $282,000 for amortization of storage field gas losses be approved. The ALJ concluded that the OCA failed to show how the 1987 Commission decision in *North Penn* does not apply in this proceeding. (R.D. at 32).

c. Exceptions

The OCA's Exceptions argue that the ALJ's finding that it had not distinguished this case from the 1987 *North Penn* case is erroneous. The OCA states that the Company itself departed from past practice by claiming an expense for current storage field gas losses, which the OCA did not oppose. In the past, the Company deferred the recovery of losses, but the Company has since changed its accounting practices to comply with the Sarbanes-Oxley Act of 2002. Since the Company now expenses gas losses, the OCA argues that it no longer can defer such amounts for future recovery. The OCA argues that the Company no longer uses the accounting practices upon which the *North Penn* decision was based, and that the recovery of gas lost between 2002 and 2005 would be improperly retroactive where the Company also has proposed to recover lost gas expense on a normalized, recurring basis.

The Company's Reply Exceptions argue that the OCA proposes to depart from well-established practice and allow PPL Gas to recover losses only prospectively. The Company states that, while it is willing to recover losses on a current basis prospectively, as part of a transition to current recovery it is necessary to recover losses for the period 2002 through 2005. The Company distinguishes its claim from the disallowed sludge removal expenses at issue in *Mechanicsburg Water*. According to the Company, in *Mechanicsburg Water* there had been no prior approval of amortization of past expenses, and the Commission found that the expenses were routine, normal and ongoing and did not qualify for amortization. In contrast, in this case the Commission previously concluded that the Company's storage field losses qualify for amortization. Here, one last amortization is necessary to complete the transition from amortization of past expenses to current recovery of such expenses. (PPL Gas R.Exc. at 17-19).

d. Disposition

We shall adopt the ALJ's recommendation and deny the OCA's Exception on this issue. While it is true that the Company now is expensing its storage field gas losses on a current basis, it would be unfair to depart abruptly from past practice and prevent the Company from recovering the losses it incurred from 2002 through 2005. It is important to note that the gas losses from 2002 through 2005 will not be expensed on a going-forward basis, and that there is no double recovery issue, as the OCA's Exceptions seem to imply. We agree with the Company that one last amortization is necessary to complete the transition from amortization of past expenses to current recovery of expenses going forward.

8. Right-of-Way Maintenance Expense

a. Positions of the Parties

PPL Gas claimed an expense of $678,000 for its right-of-way (ROW) maintenance program. (PPL Exh. Future 1 – Revised, Sch. B-4 at 3). PPL Gas also provided testimony that its projected ROW maintenance expense for the 2006 future test year was $765,000. (PPL Gas St. 1-R at 10). PPL Gas and the OCA describe this issue in terms of a claimed expense of $765,000; the OTS and the ALJ describe the issue in terms of a claimed expense of $678,000. The discrepancy between the two amounts is not explained.

PPL Gas averred that the increase over prior years' expense results from changes in legal requirements. Specifically, the ROW maintenance program has expanded to accommodate testing under the Company's Integrity Management Plan, which is a result of the Company's response to federal regulations. The ROW maintenance program now must incorporate a wider clear path over and along the Company's pipelines, and an open tree canopy above the pipelines, to accommodate global positioning system (GPS) tools. PPL Gas further argued that it now expects that its actual expense in 2006 will be approximately $855,000, significantly more than its 2006 budget of $765,000. (Tr. at 121-23). PPL Gas argued that the Commission should encourage natural gas distribution companies to maintain their system in a safe and adequate manner, in compliance with all legal requirements.

The OTS argued that the Company's claim of $678,000 should be adjusted downward by $202,000 to $476,000, which is the Company's projected average expense level for the five-year period 2006 - 2010. (OTS St. 2 at 20; OTS Exh. 2, Sch. 12). [13]

The OCA argued that the Company's claim of $765,000 represents a significant increase to actual ROW expenditures in recent years, and should be adjusted downward by $440,000 to $325,000, the Company's actual expense in 2005. The OCA noted that, from 2001 through 2004, the annual ROW program costs never exceeded $284,000. (OCA MB at 30). The OCA also noted that the Company recorded $120,000 in payments for work performed in late 2005 as 2006 expenses. The OCA argued that, while some level of increased expense would be reasonable, the Company's claim was abnormally high and inconsistent with the Company's recent experience. The OCA stated that, given the Company's projected average expense of $476,000 for 2006 through 2010, even the Company does not consider its claim for $765,000 to be normal. In addition, the OCA argued that the Company's spending in 2006 was not on pace to support its claim, and that exclusive of the payment of $120,000 for work performed in 2005, the actual expenses during the first six months of 2006 were only $82,000.

Based on the Company's actual costs and its own projected level of on-going expense, the OCA recommended that the claim be adjusted downward by $440,000 to reflect an annual expense allowance of $325,000, equal to the Company's actual expenditure in 2005 of $205,000, adjusted upward for the $120,000 for work performed in 2005 but recorded in 2006. (OCA St. 1S, Sch. C-2 Revised; OCA MB, Table II). This would represent an increase of 75 percent over 2004 costs and 146 percent over 2003 costs.

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[13] To add further confusion, the Company stated that the OTS proposed an adjustment of $289,000 to the Company's ROW "program cost" of $765,000, and an allowance of $476,000. (PPL Gas MB at 45).

PPL Gas replied that the OCA's proposed adjustment should be rejected because it is based on 2005 expenditures and does not provide for any expense increase. PPL Gas averred that it provided unrebutted evidence that 2006 expenses will be $855,148, an amount that exceeds the budgeted expense. PPL Gas claimed that the OCA ignored its explanation of the increased work that was required to meet the requirements of federal regulations, and that even the OCA admitted that it was reasonable to expect some level of increased expense. PPL Gas' Reply Brief did not address the OTS' proposed adjustment.

The OTS replied that the Company's argument seems to be that expense levels from previous years should be ignored in favor of the disproportionately higher level of expense in 2006, the future test year. The OTS rejected the Company's argument that changes in legal requirements will cause expenses to increase as too vague, stating that the Company failed to quantify any such alleged increase or address such legal requirements with sufficient specificity to render the increase known and measurable for ratemaking purposes. The OTS also stated that the Company presented no evidence that its increased 2006 expenditures were not scheduled to coincide with the future test year and will be typical for the post-2006 years that these rates will be in effect. The OTS argued that the sharp escalation in the 2006 expense level justifies the reliance on the Company's own projection of an annual normalized expense level of $476,000 as a better representative of the normal level of expense. (OTS RB at 19-21).

The OCA replied that PPL Gas improperly mixed the question of how much the Company will spend in 2006 with the question of a reasonable, normal level of ROW expense for the purpose of establishing just and reasonable rates. The OCA stated that, even if the Company spends $765,000 in 2006, there is nothing in the record that supports this amount as a normal level of expense, noting that the average of the Company's own forecasted expense for the five years 2006 through 2011 was less than the Company's rate case claim. The OCA also noted that, as of the close of the record in September 2006, the Company incurred only $239,318 in ROW expense.

b. ALJ's Recommendation

The ALJ recommended that PPL Gas' claim be approved. The ALJ found that the Company's claim was supported by the record; that PPL Gas presented evidence that the actual cost of the ROW maintenance will exceed the amount budgeted for the 2006 test year; and that this supportive evidence was not refuted by either the OTS or the OCA. The ALJ concluded that the arguments presented by the OTS and the OCA and OTS were not persuasive. (R.D. at 32-34).

c. Exceptions

The OCA argues in its Exceptions that the ALJ erred in concluding that the record evidence supports the Company's budgeted claim for ROW clearing costs of $678,000.[14] The Company's actual expenditures for the first six months of 2006 were only $82,000; the actual expenditures at the end of August 2006 were only $119,000; and the record does not support a conclusion that the Company will spend the budgeted amount of $765,000, either in 2006 or in the future. "Based on the Company's actual expenditures and the Company's own expectations of a normal level of on-going ROW maintenance expense, the ALJ erred in accepting the Company's abnormally high ROW program expense claim in this case." (OCA Exc. at 16). The OCA submits that the Commission should adopt *either* the OCA's proposed allowance of $325,000 based on 2005 expenses, *or* the OTS proposed allowance of $476,000 based on the Company's forecasted expenses from 2006 through 2010.

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[14] The OCA also states that its adjustment is directed at the Company's "broader claim for ROW related expenses of $765,000." (OCA Exc. at 15).

The Company's Reply Exceptions state that, contrary to the OCA's argument that the Company did not prove its claimed level of expense in the future test year, the Company demonstrated that the increased level of expense results from changes in legal requirements, and that its actual costs for ROW maintenance will exceed its 2006 budget. (PPL Gas R.Exc. at 19-20).

d. Disposition

We will adopt the ALJ's recommendation on this issue. The Company has demonstrated that its ROW maintenance program is expanding significantly to accommodate GPS tools and testing required by the Company's Integrity Management Plan. Although the Company's claim is based on its 2006 budget of $765,000, it presented testimony that its actual expense in 2006 will be approximately $855,000. The OTS and the OCA adjustments both are based on the Company's past level of expenditures, and make no allowance for higher costs from the increased maintenance required to maintain a wider clear path and open tree canopy along the Company's pipeline ROWs. The OCA's Exception is denied.

9. Customer Records Expense

a. Positions of the Parties

PPL Gas claimed $2,284,000 in customer records expense for the future test year. The Company's expense in the historic test year was $1,774,000. (PPL Gas Exh. Historic 1, Sch. B-4 at 4; PPL Gas Exh. Future 1, Sch. B-4 at 4). The OCA proposed an adjustment of $100,000 based on the expenditure for a new telephone system, which the OCA maintained was a non-recurring expense.

The Company argued that, while viewed in isolation the installation of a new telephone system, appears to be a non-recurring charge, similar projects are done routinely every year. Similar projects in recent years included radio coverage studies and enhancements, electronic dispatching equipment set-up, consultant support for enhancements to software, and distribution system alarm programming. (PPL Gas MB at 47-48).

The OCA argued that the inclusion of the one-time cost of installing the new telephone system would mean that ratepayers would be charged for this cost every year. The OCA submitted that the Company did not meet its burden of proof that the customer records expense claim should include $100,000 for the new telephone system, noting that the Company's claim increased from $1,774,000 in the historic test year to $2,284,000 in the future test year. (OCA St. 1 at 29; OCA Sch. C-2 Revised; OCA MB at 35-36).

The OCA argued in reply that the Company attempted to shift the burden of proof and has asked the Commission to accept that the Company will spend $100,000 per year for different projects chargeable to different accounts. Such expenditures imply a deduction to customer records expense and a corresponding increase to some other account. However, the Company's claims in rebuttal can not substitute for the substantial evidence that is required to support its claim. (OCA RB at 18).

b. ALJ's Recommendation

The ALJ recommended that the OCA's proposed adjustment be adopted, finding that PPL Gas failed to meet is burden of proof on its inclusion of the expense for the new telephone system. "PPL Gas attacks the logic of the OCA's reasoning stating that the conclusion is flawed because the expenditure is viewed in isolation. However, PPL Gas does not present any credible rationale for why the expenses should be viewed as recurring annually and thus, justifiably applied to rates for recovery each year the rates are in effect." (R.D. at 34). The ALJ recommended that the jurisdictional expense of

$99,000 for the new telephone system should be rejected, and that the OCA's adjustment should be adopted.[15] (R.D. at 34-35).

c. Disposition

No party filed an Exception to the ALJ's recommendation on this issue. On review, we agree with the ALJ's reasoning and will adjust the Company's claim downward by $99,000 on a jurisdictional basis. The Company claimed that the expenditure for the new telephone system was representative of a recurring expense, but did not present adequate evidence to support its claim.

10. Uncollectible Accounts Expense

a. Positions of the Parties

PPL Gas claimed $2,916,000 in uncollectible accounts expense, which it calculated by multiplying a projected uncollectible accounts of 1.5 percent by the budgeted future test year revenues, then adding $200,000 for anticipated arrearage forgiveness under its Customer Assistance Program (CAP). The OTS and the OCA proposed adjustments of $179,621 and $343,000, respectively.

PPL Gas argued that its uncollectible accounts of 1.5 percent is based on judgment and historical experience. Excluding CAP arrearage forgiveness, over the last four years uncollectible accounts expense ranged from 1.07 percent in 200,5 to 1.41 percent in 2002.[16] PPL Gas submitted that the lower percentage in 2005 was due to unusual circumstances, including the publicity surrounding the implementation of Chapter 14, increased LIHEAP funding, the Governor's *Stay Warm Pennsylvania*

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[15] The OCA's proposed adjustment deducted $100,000 from O&M Expense before applying a jurisdictional allocation factor of 99.41 percent. (OCA St. 1, Sch. C-2).

[16] The actual percentages from 2002 through 2005 were 1.41, 1.32, 1.32, and 1.07 percent, respectively. (PPL Gas MB at 48).

initiative and the increase in the Company's CAP enrollment. More significantly, gas cost increases in the latter part of 2005 increased 2005 revenues significantly without affecting uncollectible accounts expense for that year. Uncollectible accounts expense related to the higher level of purchased gas costs will not materialize until several months after the service is provided. (PPL Gas St. 1-R at 5). PPL Gas submitted that the combination of suppressed uncollectible accounts expense and increased revenues in 2005 produced an extraordinarily low ratio of expense to revenue. PPL Gas selected 1.5 percent as the ratio for its filing because certain of the 2005 factors will have no effect in 2006, and others will have the opposite effect and increase uncollectible accounts expense. Most importantly, the continuation of high purchased gas costs will result in an increased number of customers being unable to pay their bills.

PPL Gas' inclusion of an additional $200,000 to reflect arrearage forgiveness under its CAP reflects the expansion of its CAP and the historically increasing trend of CAP arrearage forgiveness, which steadily has increased from $73,091 in 2002 to $164,463 in 2005. (PPL Gas St. 1 at 12). PPL Gas stated that it had completed the expansion of its CAP from 2,200 to 2,500 customers, and that no further increase in the CAP population is anticipated. (PPL Gas RB at 22). PPL Gas criticized the adjustments proposed by the OTS and the OCA, both of which were based on an average of multiple years' write-offs, as failing to recognize that changes have occurred and that historical experience is not a reliable indicator of uncollectible accounts expense in 2006 and beyond.

The OTS proposed an adjustment based on the write-off ratio over four years, which would lower the 1.5 percent ratio proposed by the Company to 1.27 percent. The OTS also opposed the inclusion of an additional $200,000 in CAP arrearage forgiveness in the calculation of the Company's claim. The OTS methodology excluded arrearage forgiveness write-offs from net write-offs in its calculation, and then added back the Company's projected CAP arrearage of $200,000 to the uncollectible allowance.

The calculation produced an OTS-recommended adjustment of $179,621. The OTS argued that the Company improperly included CAP arrearages in the development of its proposed write-off ratio because these amounts are fixed and do not vary with revenue. According to the OTS, the Company improperly included CAP arrearage amounts twice in its calculation – first as part of the calculation of the ratio, and second as an add-on to arrive at the Company's total claim. The OTS criticized the Company's methodology as "double dipping." (OTS MB at 21-24).

PPL Gas argued that the OTS failed to recognize that there is an annual thirty percent turnover among CAP customers, and that the CAP population is increasing, both of which will increase the level of CAP arrearage forgiveness. In reply, PPL Gas also contested the OTS' argument that PPL Gas included the CAP arrearage forgiveness amount twice in its calculation, and flatly asserted that arrearage forgiveness amounts were not included in the 1.5 percent ratio used to calculate uncollectible accounts expense. PPL Gas pointed out that the OTS witness on this issue made no such criticism of PPL Gas' calculation, and the OTS provided no record citation in support of its argument. PPL Gas reiterated that the only difference between its and the OTS' methodology was that the OTS used a write-off ratio of 1.27 percent based on an average of historical write-offs, while PPL Gas used a judgmental ratio of 1.5 percent.

The OCA recommended three adjustments to the Company's calculation: (1) a reduction in the write-off ratio from 1.5 percent to 1.33 percent based on the Company's actual experience from 2001 through 2005; (2) a weather normalization adjustment; and (3) an update to reflect the recent settlement of the Company's Section 1307(f) case under which the purchased gas cost rate is $12.4738 per Mcf. The OCA observed that its recommended write-off ratio of 1.33 percent, which was based on the five-year period 2001 through 2005, was not materially different than the 1.35 percent average for the three-year period 2002 through 2004. The total adjustment recommended by the OCA was $343,000. (OCA MB at 32-33).

PPL Gas criticized the OCA's use of a lower level of revenues to calculate the expense. PPL Gas states that changes in purchased gas cost rates that took effect on December 31, 2006, will not affect uncollectible account expense until late in 2007, and argues that the OCA should not be allowed to reach beyond the future test year to reduce uncollectible accounts expense. Further, PPL Gas argued that, because purchased gas cost rates are adjusted quarterly, there is no reason to believe that the rates established by the settlement of its Section 1307(f) proceeding will be maintained on an ongoing basis. Finally, PPL Gas averred that its uncollectible accounts expense clearly is on the rise, and that as of July 31, 2006, it had 410 more accounts shut off for nonpayment than at the same time in 2005, an increase of thirty-six percent, and that the amounts owed by customers terminated for nonpayment was ninety-five percent higher. (PPL Gas MB at 48-52).

In reply, the OCA argued that the Company's write-off ratio of 1.5 percent is in excess of any level experienced in the last five years, and that the Company's claim that 2005 was atypical was addressed by the OCA's use of a five-year average. Second, the OCA applied its recommended ratio of 1.33 percent to the Company's *pro forma* future test year revenues, updated to reflect known and measurable rates, while the Company did not offer a substitute or better rate. Third, the OCA stated that its recommended expense level included an allowance of $196,000 for CAP arrearage forgiveness. (OCA RB at 15-16).

b. ALJ's Recommendation

The ALJ recommended that the Company's uncollectible accounts expense claim be adjusted to reflect the OCA's recommended write-off percentage of 1.33 percent. The ALJ recommended, however, that the OCA's recommended adjustment to revenues be rejected. The ALJ recommended that the uncollectible accounts expense claim be adjusted to $2,861,609, a reduction of $54,391 to the Company's claim.[17] (R.D. at 36-37).

The ALJ found that a write-off ratio of 1.33 percent was supported by record evidence, and that the Company's argument that 2005 data should be disregarded as abnormal was unconvincing. The ALJ concluded that the use of an average ameliorates variations in the magnitudes of uncollectibles. "Simply put, PPL Gas' assertion that the historical experience cannot be relied upon to provide an accurate estimate of uncollectible accounts for the future is not persuasive since PPL Gas to some extent reflects historical experience in its presentation of the proposed claim." (R.D. at 36-37).

The ALJ rejected the OCA's recommended adjustment to revenues to reflect rates established by the settlement of the Company's Section 1307(f) proceeding because these rates are subject to quarterly adjustment and will not remain constant on a going forward basis. (R.D. at 37).

c. **Exceptions**

The OCA's Exceptions argue that, while the ALJ correctly adopted a write-off ratio of 1.33 percent, she applied the ratio to the wrong revenue amount when calculating uncollectible accounts expense. The OCA avers that the ALJ applied the write-off ratio to a revenue amount of $200,121,000, whereas the Company used $181,321,000 to calculate its uncollectible accounts expense. The OCA suggests that the ALJ erroneously used a revenue figure from OTS Exhibit No. 2, Schedule 2, which included transportation revenues that should not be included in the calculation of

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[17] $200,121,000 (future test year billed revenues) x 0.0133 = $2,661,609 + $200,000 (CAP arrearage forgiveness) = $2,861,609. $2,916,000 (PPL Gas expense claim) - $2,861,609 = $54,391.

uncollectible accounts expense. The OCA submits that the ALJ's recommendation should be corrected to reflect a *pro forma* uncollectible accounts expense of $2,612,000.[18] (OCA Exc. at 16-17).

The Company's Reply Exceptions state that the OCA's criticism of the ALJ's calculation is erroneous because the ALJ's use of future test year billed revenues, as proposed by the OTS, was not criticized in the record, is supported by substantial evidence in the testimony of the OTS, and is consistent with past Commission practice. The Company cites *Pa. PUC v. National Fuel Gas Distribution Corp.*, Docket No. R-901670, p. 5 (December 24, 1990) and *Pa. PUC v. National Fuel Gas Distribution Corp.*, Docket No. R-891218 (December 29, 1989). As to the OCA's contention that the ALJ did not intend to use the level of revenues proposed by the OTS, the Company states that there is no such indication in the Recommended Decision. Finally, the Company disputes the OCA's contention that it is improper to include transportation revenues in the calculation because a portion of transportation revenues become uncollectible. (PPL Gas R.Exc. at 20-21).

The Company did not except to the ALJ's determination that a write-off ratio of 1.33 percent as proposed by the OCA is appropriate.

d. Disposition

No party excepted to the ALJ's recommendation to adopt the OCA's proposed write-off ratio of 1.33 percent, which we shall adopt. This ratio comports with the Company's actual experience for the five-year period from 2001 through 2005. It also is not materially different than the Company's 1.35 percent average for the three-

[18] ($181,321,000 x 1.33 percent) + $200,000 = $2,611,569, rounded up to $2,612,000. (OCA St. 1, Sch. C-2.2).

year period 2002 through 2004, which excludes the year 2005 that the Company claims was abnormal.

With regard to the level of revenues against which the write-off ratio will be applied to determine the Company's uncollectible accounts expense, we agree with the OCA's argument that the most recent purchased gas cost rate should be used to calculate the Company's revenues. Although, as the Company points out, the rate is subject to quarterly adjustment going forward, the more recent rate is a more reliable indicator of the Company's future revenues than is a rate that already has been rescinded. The Company's argument against using the more recent rate because it may change really is an argument against using any rate at all. We know for a fact that the rate preferred by the Company is no longer operative; we can only assume that the current rate will not be in effect for the duration of the base rates established in this proceeding. Such is the nature of the rate setting process. In order to calculate a revenue amount against which the write-off ratio will be applied, we must select a rate certain, knowing in advance that the rate is subject to change. We believe that the more recent rate is a better predictor of future revenue than is a past rate no longer in effect. Accordingly, we adopt the OCA's revised adjustment in this regard. After multiplying the adjusted present rate revenue by the write-off ratio of 1.33 percent, we will add $200,000 for CAP arrearage forgiveness to determine the total uncollectible accounts expense allowance. This results in an uncollectible accounts expense of $2,695,615, and a downward adjustment of $220,385 to the Company's claim.[19]

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[19] $187,672,000 (Rate Revenue) + $12,449,000 (Transportation Revenue) - $13,070,750 (GCR Reduction) = $187,050,250 x 1.33% = $2,495,615 + $200,000 = $2,965,615 - $2,916,000 (Company Claim) = ($220,385).

11. LIURP Initiative

a. Positions of the Parties

The issue in this proceeding is whether or not the Company should be required to implement a low income usage reduction program (LIURP). The settlement of the Company's restructuring proceeding in 2000 at Docket No. R-00994788 provided that the Company would not be required to implement a LIURP through the end of its four-year ramp up of its CAP. After this four-year period, any party was free to recommend that a LIURP be implemented. In this proceeding, the Commission on Economic Opportunity (CEO) has advocated that the Company be required to implement a LIURP. The CEO is a non-profit corporation whose clients are the low-income population in Luzerne County. (CEO MB at 1).

The CEO averred that it has a particular expertise in weatherization programs, having weatherized more than 25,000 homes under the U.S. Department of Energy Weatherization Assistance Program. The CEO serves as a subcontractor for the LIURPs operated by PPL Electric, UGI Gas, and PG Energy. The CEO argued that PPL Gas should be required to establish a LIURP because the Commission found that LIURPs have been one of the most successful programs for assisting low-income customers. The CEO also argued that PPL Gas is required by law to implement a LIURP with minimum annual funding equal to 0.2 percent of jurisdictional revenues, citing 52 Pa. Code § 58.4. The CEO argued that, while 52 Pa. Code § 58.18 authorizes exemptions from the requirement for special circumstances, a covered utility is required to petition the Commission for an exemption. PPL Gas did not file such a petition; rather, it simply has operated without a LIURP. Finally, the CEO argued that the Competition Act requires that the Commission ensure that universal service programs are available and appropriately funded; that universal service programs include LIURPs; and, therefore, that the Act mandates that PPL Gas have a LIURP. (CEO MB at 3).

The CEO proposed that PPL Gas be directed to establish a LIURP at the regulatory minimum level of 0.2 percent of jurisdictional revenues, or $300,000. The CEO averred that this funding level would provide services to 107 customers per year, out of the total 66,000 plus residential customers served by PPL Gas. (CEO MB at 4-5).

PPL Gas argued that there are valid reasons why it is inappropriate for PPL Gas to implement a LIURP. First, PPL Gas argued that a LIURP would not be practical because it is a small gas distribution company with a service territory geographically disbursed throughout the Commonwealth. As of December 31, 2005, PPL Gas served 66,537 residential customers in thirty-four different counties. PPL Gas' service territory extends from the New York state line to northern Maryland, and from the Delaware River to forty-five miles from the Ohio state line. (PPL RB at 23). To implement a LIURP to serve thirty-four counties, PPL Gas would be required to use services from eighteen different community-based organizations (CBOs).

PPL Gas argued that the fifteen percent regulatory cap on administrative costs at 52 Pa. Code § 58.5 would not be feasible, given the large number of CBOs with which it would be required to work. All of the reporting and monetary requirements would be the same as those for large utilities, and PPL Gas would be required to obtain and consolidate required information from each of the eighteen CBOs that would be involved. The fifteen percent cap on administrative costs would equate to $45,000, which would not be sufficient to pay the wages and benefits of even one full-time employee, or the other requisite costs such as travel, office space and computer systems. (PPL MB at 53). PPL Gas argued that, if it were required to implement a LIURP, it would need relief from the cap on administrative expenses. (PPL Gas RB at 24).

PPL Gas further argued that, even assuming none of the LIURP costs of $300,000 were used for administration, only 107 residences could be weatherized per year, on average only three customers per county. Each CBO would be able to weatherize only six residences per year. A CBO could not be expected to maintain a program under which only one residence could be weatherized every two months. PPL Gas noted that these already low numbers would be reduced to even lower levels to accommodate administrative costs. PPL Gas argued that the CEO simply ignores the practical difficulties in implementing a LIURP in PPL Gas' service territory, and that it would not be in the best interests of customers to implement such an inefficient program.

PPL Gas also contested the CEO's interpretation of the Commission's regulatory requirements. The Commission's LIURP regulations took effect on January 16, 1993, and therefore were in effect in 2000 when PPL Gas specifically was exempted from the requirement to implement a LIURP. (PPL Gas MB at 54).

Although PPL Gas argued that it would not be appropriate for the Commission to require it to implement a LIURP, it stated that is willing to develop a program tailored to its specific circumstances, which would provide less aggressive usage reduction measures to more customers. Such an alternative program would have significantly reduced analysis and reporting requirements so that the administrative costs would not be disproportionate to the program's costs. PPL Gas stated that it would be willing to work with the CEO and other CBOs to develop such a program, and noted that the program's size would be commensurate with the revenue allowance, if any, approved by the Commission. (PPL Gas MB 52-55).

In reply, the CEO argued that, although PPL Gas should be compelled to implement a LIURP, at a minimum it should be directed to implement its alternative proposal. The CEO argued that, regardless of whether a traditional LIURP or an alternative program is established, the funding level should be $300,000 annually.

b. ALJ's Recommendation

The ALJ concluded that PPL Gas should not be required to implement a traditional LIURP, and that the Commission had provided a specific exemption from the regulatory LIURP requirement to PPL Gas. The ALJ concluded that the fact that the Commission provided this exemption after Chapter 58 of the Commission regulations became effective in January 1993 was compelling. (R.D. at 39).

The ALJ determined that an alternative program as suggested by PPL Gas would satisfy 66 Pa. C.S. § 2203(8), and recommended that: (1) PPL Gas be required to file a program proposal within a time certain; (2) PPL Gas be directed to work with the CEO in implementing its program; (3) PPL Gas and the CEO be required to propose analysis and reporting requirements to the Commission's Bureau of Consumer Services at least three months prior to implementation of the program similar to the provision in the settlement at Docket No. R-00991488; and (4) PPL Gas should not commence the program without Commission approval. (R.D. at 39).

c. Exceptions

PPL Gas' Exceptions object to the ALJ's failure to include any rate recovery provision for the costs of an alternative program. Although PPL Gas does not object to undertaking a design of a scaled-back usage reduction program, it strongly objects to any requirement to implement such a program without a cost recovery provision. In order to address this problem, PPL Gas states that it is willing to submit to the Commission a program that would address funding in addition to program design. In the alternative, PPL is willing to propose a program in conjunction with its next base rate case, when funding could be addressed. (PPL Exc. at 26-27).

The CEO's Exceptions object to the ALJ's failure to require that the funding for the Company's program be established at $300,000 annually. Although the CEO does not object to the type of program recommended by the ALJ, it objects to the lack of a required funding level of $300,000 for the program.

PPL Gas' Reply Exceptions do not respond to the CEO's Exceptions on a specific funding level. The CEO's Reply Exceptions, however, object to the alternative proposed by the Company of waiting until its next base rate case to address the design and funding of a program. The CEO submits that, because the Company's low income residential customers have been without a LIURP for years, funding should be established as part of the current rate case. The CEO points out that the Company did not argue that program funding should be scaled back, but rather that the usage reduction measures provided to customers be less than those in a traditional LIURP so that more customers could be reached in the Company's dispersed service territory. Although the CEO has no objection to scaled-back program measures and reporting requirements if it means more customers would be served, the CEO does object to funding at less than $300,000 annually. The CEO requests that funding be established at $300,000 and that this amount be recoverable through rates.

The OCA's Reply Exceptions state that funding should be addressed in conjunction with a filing by the Company on program design. The OCA refers to the Commission's recent Order regarding CAPs where the Commission expressed its intent to more closely link the review of CAP program design and funding. *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms*, Docket No. M-00051923 (December 18, 2006). The OCA states that the same approach for a scaled-back low income weatherization program is appropriate.

d. Disposition

We agree with and will adopt the ALJ's recommendation that the Company be required to implement an alternative to a traditional LIURP program. The ALJ recommended that the Company be required to file a proposed program with the Commission for approval within a date certain. We shall require that the Company file a program proposal within six months of the date of this Order, or with the filing of its next base rate proceeding, whichever comes first.

With regard to the Exceptions filed by the Company and by the CEO, we believe that the Company should propose a funding level and a funding mechanism at the time that it files its program proposal. Establishing a funding level in advance for a program that has not been proposed or approved seems to us to be ill advised. Waiting to establish a funding level will enable the Company to tailor its requested funding level to the program that it develops and proposes. If the proposed program measures are revised in the forthcoming Commission proceeding, the funding level can be adjusted accordingly. If, however, we were to establish a fixed and immutable funding level in a vacuum, the Company would have to design its program to fit the funding, rather than the other way around.

We also do not believe that the funding level for the Company's program is or should be dictated by our regulation at 52 Pa. Code § 58.4. First, the funding level of 0.2 percent of jurisdictional revenues is described as a general guideline subject to revision when the Commission reviews the need for program services and addresses the recovery of program costs in utility rates. Program services and program costs will be reviewed in the Company's filing that we are requiring in this Order. Second, the Commission previously has exempted the Company from the requirement that it establish a low income usage reduction program. Today we are requiring that the Company begin the process of establishing such a program and file a proposal within six months. We will establish the appropriate funding level in that proceeding. Until that time, the Company's current exemption shall continue in effect.

E. Taxes

1. Federal Income Tax & Consolidated Tax Savings

a. Positions of the Parties

PPL Gas originally filed a calculated federal income tax liability on a stand-alone, separate company basis although the Company filed with the Internal Revenue Service as part of a consolidated group under parent corporation PPL Corporation. (PPL Gas Exh. 1-A at 66). Although PPL Gas asserted that it is inappropriate to adjust the federal income tax expense to reflect its participation as a member of the PPL Corporate System in a consolidated tax return, the Company acknowledged that the Commission makes adjustments in rate cases where a utility participates in a consolidated federal income tax return and unregulated affiliates experience losses for the purposes of calculating federal income taxes. Consequently, PPL Gas concurred with the methodology regarding federal income tax advocated by the OTS in using three years of data for computing an adjustment reflecting consolidated savings. (PPL Gas MB at 56-57). In addition, PPL Gas also suggested removal of certain non-recurring items: non-recurring bonus tax depreciation which expired at the end of 2004; one-time losses associated with sale of specific assets or business units; losses from discontinued operations and now divested assets; and losses from Synfuel operations as the operations are being shut-down and thus will not recur. (PPL Gas MB at 57, PPL St. 3-R at 15-16). The result of these adjustments yields a reduction to income tax expense of $59,715. (See PPL Exh. JMK-2 Sch. 2, PPL Gas Exh. Future-1 Revised Sch. D-12). The OTS accepted this adjustment. (OTS MB at 40).

The OCA recommended a reduction of $411,000 (on a jurisdictional basis) to the federal income tax expense claim. (OCA MB at 42, Appendix A Sch. C-4 and

C-4.1 corrected 9/22/06). The difference between the Company's claim and the position of the OCA hinges upon the use or disregard of a three-year average of taxable income for PPL Gas. The OCA did not use a three-year average of PPL Gas' taxable income but used the *pro forma* federal taxable income under present rates. (See PPL Gas Exh. Future-1 Revised Sch. D-12). The OCA essentially contended that, because of the quantities of the historic three years, two years with zero amounts and one with a positive amount, it is unsound to base consolidated tax savings on these data. The OCA chose instead to base its recommendation on the best available record data, the Company's normalized three-year average of affiliates' tax losses. (OCA RB at 20).

PPL Gas refuted the OCA's assertion that using the three-year average of taxable income for PPL Gas is unsound. According to PPL Gas, the OCA's calculations contain several inconsistencies because of mismatched data. PPL Gas noted that the OCA mismatched data from different time periods, 2003 – 2005 for affiliates, and 2006 for PPL Gas, and mismatched per books federal taxable income for the affiliates with normalized future test year federal taxable income, as adjusted for ratemaking purposes, for PPL Gas. PPL Gas asserted that this mismatching is inconsistent and inappropriate. Additionally, PPL Gas asserted that the OCA's method is inconsistent with Commission practice of using the Modified Effective Tax Rate method. PPL Gas cited *Pa. PUC v. Pa. American Water Co.*, 2002 Pa. PUC LEXIS 1, 93 for the contention that the Commission's practice is to use multiple year averages to smooth out year-to-year fluctuations in taxable income. (PPL Gas RB at 24-27).

b. ALJ's Recommendation

The ALJ concluded that the adjustment presented by the OCA was unreasonable and not objective and should be rejected. Conversely, the ALJ recommended that the adjustment as presented by PPL Gas in its Main Brief, yielding a

$59,175 reduction in its income tax expense claim consistent with PPL Gas Future-1 Revised Sch. D-12, was reasonable and should be accepted. (R.D. at 41).

c. **Exceptions**

In its Exceptions, the OCA submits that the ALJ erred in accepting the Company's adjustment rather than its recommended adjustment for consolidated tax savings. The OCA avers that the Company's adjustment understates the consolidated tax savings due to its selective "normalization" adjustments and should not be used in this proceeding. The OCA notes that the ALJ appeared to suggest that the OCA disregarded unfavorable data in its calculations but opines that the Company's method does exactly what the ALJ finds to be unreasonable. The OCA avers that the Company does not take the data as it exists but makes numerous "normalization" adjustments to the taxable income of the tax loss affiliates, but makes no such normalization adjustment to the taxable income of PPL Gas. According to the OCA, the Company's selective adjustments to the data had the effect of reducing the magnitude of the consolidated tax savings adjustment. (OCA Exc. at 17-18).

In reply, PPL Gas reiterates its position that the OCA's calculation is replete with inconsistencies, and is contrary to the Commission's Modified Effective Tax Rate method. PPL Gas rejoins that its consolidated federal income tax savings calculation is consistent with the calculation presented by the OTS, which was based on three years of data, from 2003 to 2005, for the PPL Corporate System. PPL Gas avers that the only difference between the OTS calculation and its calculation is that PPL Gas made certain adjustments to remove the effects of non-recurring items from the calculation. PPL Gas cites to *Pa. PUC v. Pennsylvania Water Co. – Sayre Division*, Docket No. R-00891473, at 6-8, 70-71 (Aug. 31, 1990) and to *Pa. PUC v. Philadelphia Suburban Water Co.*, 75 Pa. PUC 391, 420 – 424 (Oct. 18, 1991) as support for its position that the elimination of non-recurring items has been consistently approved by the

Commission. PPL Gas also notes that the OTS did not object to its consolidated tax calculations. (PPL Gas R.Exc. at 21-22).

d. Disposition

The OTS has employed the Modified Effective Tax Rate method utilizing a three-year average of the most recent available tax years to compute its consolidated tax adjustment. Upon review of the OTS calculation, PPL Gas concurred with this methodology, but recalculated the proposed consolidated income tax savings by excluding certain non-recurring items. Both the OTS and the ALJ accepted the PPL Gas recommended $59,715 amount as the appropriate adjustment to the Company's federal income tax liability in this proceeding. Based on the evidence of record, we are in agreement with the ALJ and find the OCA's arguments against the removal of non-recurring items to be unreasonable and inconsistent with Commission precedent.

Accordingly, we deny the Exceptions of the OCA and shall adopt the recommendation of the ALJ.

2. Payroll Taxes

a. Positions of the Parties

The OCA advocated that the payroll tax should be adjusted commensurate with the appropriate complement of employees on payroll. (OCA MB at 40).

b. ALJ's Recommendation

The ALJ did not recommend adjusting the Company's claim for payroll expense and complement of employees. (R.D. at 30-31). Consequently, the ALJ did not recommend adjusting payroll taxes corresponding to the payroll expense position of the OCA. (R.D. at 41).

c. **Disposition**

In its Exceptions filed in regard to PPL Gas' annual payroll expense, the OCA noted that a corresponding adjustment to payroll taxes also should be adopted. (OCA Exc. at 13). Consistent with our discussion on the Company's payroll expense claim, we shall deny the OCA's Exception.

3. **Capital Stock Taxes ("CST")**

a. **Positions of the Parties**

PPL Gas calculated a CST of $382,000. (PPL Gas Exh. Future 1 Sch. D-11 at 2). PPL Gas used a 4.99 mills tax rate because it was currently in effect. The OTS opposed the use of the 4.99 mills and advocated use of 3.99 mills which becomes effective January 1, 2007, and will be in effect on the proposed effective date of the rate change from this proceeding, February 1, 2007.[20] The change in the tax rate advocated by the OTS yields a reduction in the capital stock tax claim of $76,000. The OTS also recommended disallowance of the Company's attempt to iterate the CST under proposed rates as inappropriate and unnecessary. (OTS MB at 35).

b. **ALJ's Recommendation**

The ALJ concluded that PPL Gas' use of the 4.99 mills tax rate instead of the 3.99 mills tax rate that will be in effect when this rate change takes place was not reasonable. The ALJ found that the adjustment to the capital stock tax of $76,000

[20] Note that the effective date was voluntarily extended by the Company until February 9, 2007.

reflecting the appropriate tax rate in 2007 is appropriate and supported by record evidence. The ALJ recommended the adjustment of $76,000 to the capital stock tax be approved as recommended by the OTS. Furthermore, the ALJ recommended that PPL Gas be required to make a second STAS filing on February 1, 2007, that will increase the Company's STAS charge because the CST rate will have decreased from that effective January 1, 2007. (R.D. at 42).

The ALJ also noted that the Commission rejected the CST iteration claimed by PPL Electric Utilities Corporation in *Pa. PUC v. PPL Electric Utilities Corporation*, Docket No. R-00049255 (December 22, 2004). The ALJ concluded that PPL Gas did not provide any persuasive record evidence to distinguish this case from Commission precedent. Therefore, in addition to the OTS adjustment of $76,000 to reduce the Company's claim for Capital Stock Tax, the ALJ recommended that the Company's claim for an additional $37,000 in CST based on PPL Gas' requested increase should be rejected. (R.D. at 42).

c. Exceptions

In its Exceptions, PPL Gas first notes that it is not excepting to the ALJ's first recommendation concerning capital stock tax, which adopted the OTS position to use a tax rate of 3.99 mills. PPL Gas avers that the difference between the tax rate effective in 2006 and the rate effective in 2007 can be addressed through proper use of the State Tax Adjustment Surcharge.

However, PPL Gas does except to the ALJ's recommendation that the value of the capital stock of PPL Gas be based upon historical data instead of net income calculated on a *pro forma* basis, at rates established by the Commission in this proceeding. PPL Gas opines that the OTS' characterization of the valuation of PPL Gas for tax purposes is correct, but it is not appropriate for ratemaking purposes. PPL Gas notes that the OTS valuation assumes that the capital stock tax for ratemaking purposes will be an exact repetition of historical net income for the five-year period from 2002 through 2006, during which time the rates of PPL Gas were deficient. PPL Gas avers that instead, capital stock tax, like all other taxes for ratemaking purposes, should be calculated based upon the level of net income allowed by the Commission in the Final Order. PPL Gas acknowledges that the Commission, in *PPL Electric,* accepted the approach of the OTS, but requests the Commission reconsider that conclusion and reject the OTS' proposed adjustment. (PPL Gas Exc. at 27-28).

In reply, the OTS reiterates its position that capital stock tax should be excluded from the iteration process because it does not increase in direct proportion with an increase in revenues as does gross receipts tax and federal and state income taxes. The OTS responds that the Company is correct that the Commission has rejected the same CST iteration claimed By PPL Electric Utilities Corporation in *PPL Electric* and claims there is nothing in the instant record to successfully distinguish this present claim from the Commission's determination there. The OTS requests that the Commission follow its own precedent and disallow the iteration of the claim and adopt the additional $37,000 recommended reduction to PPL Gas' CST claim. (OTS R.Exc. at 15-16).

d. Disposition

We are in agreement with the OTS that PPL Gas has failed to distinguish its CST claim in this proceeding from our determination in *PPL Electric.* Consistent with this precedent, we adopt the OTS recommendation to disallow the iteration claimed by the Company because capital stock tax does not increase in direct proportion with an increase in revenues.

Accordingly, we shall adopt the recommendation of the ALJ and deny PPL Gas' Exception concerning this matter.

F. *Rate of Return*

The following table summarizes the Company's position as to its required fair rate of return in this proceeding. The capital structure ratios and cost of long-term debt are the estimated levels at December 31, 2006, the end of the future test year in this case. PPL Gas' claimed cost of common equity is 11.75 percent.

Rate of Return[21]

Capital	**Capital Structure Ratio**	**Cost Rate**	**Weighted Cost**
Long-Term Debt	26.90%	6.30%	1.69%
Short-Term Debt	17.42%	6.44%	1.12%
Common Equity	55.68%	11.75%	6.54%
Overall Rate	100%		9.35%

Both the OCA and the OTS challenged the capital structure proposed by the Company. The capital structures proposed by the OCA and the OTS are hypothetical capital structures. The capital structures and cost rates proposed by the OCA and the OTS are shown in the table below:

	OCA[22]			**OTS**[23]		
Capital	Capital Ratio	Cost Rate	Weighted Cost	Capital Ratio	Cost Rate	Weighted Cost
Long-Term Debt	55%	6.35%	3.49%	37.16%	6.30%	2.34%
Short-Term Debt				17.42%	6.44%	1.12%
Common Equity	45%	9.625%	4.33%	45.42%	9.00%	4.09%
Total	100%		7.82%	100%		7.55%

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21 PPL Gas Exh. PRM-1 Schs. 1, 5 and 6.

22 OCA St. 2 at 3, Exh. DCP-1 Sch. 11.

23 OTS St. 1 at 9, Exh. 1 Sch. 1.

1. Capital Structure (Actual vs. Hypothetical)

a. Positions of the Parties

PPL Gas proposed an actual capital structure of 55.68 percent common equity and 44.32 percent debt. This capital structure proposed by PPL Gas was based upon the actual capital to be employed at December 31, 2006, with a 13-month average of short-term debt to reflect the variations in the amount of stored gas to be financed during different months of the year. (PPL Gas St. 6 at 17-20). PPL Gas asserted that it has no plans to issue additional debt or equity in 2006. (PPL Gas MB at 68, note 8 citing PPL Gas St. 6 at 17).

PPL Gas stated that in reviewing the barometer gas group common equity ratios based upon permanent capital for 2004, the average was 53.2 percent with that average reduced to 47.2 percent if short-term debt is included. PPL Gas averred that it is only about 1/10th the size of the average barometer group company and investors view small size as creating greater risk for the investor. PPL Gas reasoned that, because of its smaller size, investors would expect to be compensated for greater risk with a higher equity ratio. Furthermore, PPL Gas cited Commission decisions where common equity ratios greater than 55 percent were adopted. *Pa. PUC v. Peoples Natural Gas Co.*, 63 Pa. PUC 6, 28-31 (1986) (61.2%); *Pa. PUC v. Peoples Natural Gas Co.*, 69 Pa. PUC 138, 164 (1989) (59.5%). (PPL Gas MB at 68).

The OTS rejected the Company's capital structure and instead recommended a hypothetical capital structure of 37.16 percent long-term debt, 17.42 percent short-term debt, and 45.42 percent common equity. The OTS posited that the Company's proposed permanent capital structure, that does not include short-term debt, is not representative of the industry norm. The OTS asserted that the projected actual equity ratio for PPL Gas is 67.43 percent compared to the nine gas distribution companies making up the gas barometer group's average equity ratio of 54.47 percent.[24] Based on these industry averages, the OTS proposed a hypothetical capital structure based upon permanent capital of fifty-five percent (55%) equity and forty-five percent (45%) long-term debt. (OTS MB at 43-44).

The OTS then made a further adjustment to its recommended capital structure due to the inclusion of PPL Gas' gas storage in its rate base. The OTS opined that since gas storage is included in rate base and is financed by short-term debt, it is appropriate to include short-term debt in the company's capital structure for ratemaking purposes. The OTS calculated the short-term debt using PPL Gas' thirteen month average for the future test year of $38,819,000 as appropriate, and arrived at the same figure advocated by PPL Gas at 17.42 percent for short-term debt. Using this short-term debt quantity, the OTS hypothetical capital structure was recalculated to 37.16 percent long-term debt, 17.42 percent short-term debt and 45.42 percent equity. (OTS MB at 44).

The OCA also opposed the Company's proposed capital structure and recommended a hypothetical capital structure of 55 percent debt and 45 percent equity. The OCA found PPL Gas' proposed capital structure problematic because the amount of equity is excessive and inappropriate for ratemaking and inconsistent with the common equity ratios of other gas distribution companies and PPL Gas' sister company, PPL Electric, and its parent PPL Corporation. (OCA MB at 49, OCA St. 2 at 3). The OCA found PPL Gas' level of short-term debt "unusually high" compared with the capital structure of PPL Corporation. The OCA found that PPL Corporation maintained more consistent and lower common equity ratios of 43.3 percent, including short-term debt, and 44.1 percent, excluding short-term debt, in the parent capital structure. (OCA MB at 47-49).

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[24] The OTS accepted PPL Gas' barometer group of nine gas distribution companies.

PPL Gas criticized the capital structure presented by the OTS as flawed because it calculated short-term debt by including $25.8 million which financed non-storage gas. Therefore, according to PPL Gas, the short-term debt was overstated by the OTS and should be reduced to $13 million.[25] PPL Gas averred that the correction to the calculations presented by the OTS using the $13 million for short-term debt yields a common equity ratio of 51.79 percent and total debt of 48.21 percent. (PPL Gas RB at 29-30, PPL Gas MB at 69, PPL Gas St. 6R at 9). The OTS did not dispute the rationale for executing this correction to its calculation of common equity. (OTS RB at 28).

b. ALJ's Recommendation

The ALJ concluded that the OTS presentation, with the Company's correction to short-term debt, was supported by the record evidence. Therefore, the ALJ recommended that a common equity ratio of 51.79 percent and a total debt ratio of 48.21 percent be used to adjust PPL Gas' capital structure. According to the ALJ, both the OTS and the OCA, by implication, found the actual capital structure unreasonable. The ALJ concluded that the record evidence supported the conclusion that the actual capital structure proposed by PPL Gas was unreasonable. (R.D. at 50).

c. Exceptions

In its Exceptions, PPL Gas opines that its higher equity ratio is reasonable given that PPL Gas is much smaller than the average barometer group company and, therefore, faces greater risk, but does not except to the ALJ's capital structure recommendation. However, PPL Gas noted that it does except to the ALJ's failure to reflect its greater risk in the determination of the cost of equity. (PPL Gas Exc. at 4).

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[25] $38.8 million (short-term debt) - $25.8 million = $13 million.

The OCA states in its Exceptions that the ALJ erred in rejecting the OCA recommended hypothetical capital structure of 55 percent debt and 45 percent equity. The OCA avers that, while the ALJ correctly recognized that the Company's actual capital structure was unreasonable, the capital structure recommended by the ALJ of 48.21 percent debt and 51.79 percent equity should not be adopted for determining a fair rate of return in this proceeding. The OCA opines that this capital structure is still out of line with the industry average, whether compared to the 47.2 percent common equity ratio for PPL Gas' proxy group in 2004 or the 45 percent common equity ratio supported by capital structures of the Value Line companies examined by the OCA. The OCA maintains that adoption of the ALJ recommended capital structure will impose unfair costs on ratepayers through use of an atypical capital structure. The OCA requests that the Commission adopt a capital structure comprised of 55 percent debt and 45 percent equity. (OCA Exc. at 19-20).

In reply, PPL Gas explains that the capital structure recommended by the ALJ aligns the hypothetical long-term debt and common equity used on average by the much larger barometer group with the short-term debt used to finance stored gas employed by the Company. PPL Gas avers that the OCA's calculations do not properly reflect PPL Gas' short-term debt. PPL Gas maintains that the ALJ properly adopted the hypothetical capital structure ratios developed by the OTS after consideration of all of the evidence. (PPL Gas R.Exc. at 1-2).

d. Disposition

Our review of the record evidence leads us to adopt the hypothetical capital structure recommended by the OTS, as adjusted by PPL Gas to correct the short-term debt amount. We do not find the arguments of the OCA convincing or persuasive, and agree with PPL Gas that this calculation aligns the hypothetical long-term debt and common equity used on average by the larger barometer group with the short-term debt used to finance stored gas employed by PPL Gas. The OCA's calculations do not properly reflect this short-term debt. Therefore, we shall adopt the recommendation of the ALJ that a common equity ratio of 51.79 percent and a total debt ratio of 48.21 percent are reasonable and should reflect the capital structure of PPL Gas in this proceeding.

Accordingly, the Exceptions of the OCA are denied.

2. Cost of Debt

a. Positions of the Parties

Both the OCA and the OTS accepted PPL Gas' cost of debt in determining a reasonable rate of return. (OCA St. 2 at 14; OTS St. 1 at 9). PPL Gas proposed a 6.35 percent overall embedded cost of debt for rate of return purposes. The Company's 6.35 percent future test year cost of debt was based on the Company's long-term debt (6.30 percent) and its short-term debt (6.44 percent) cost rates. (PPL Gas Exh. PRM-1 Sch. 1 and Sch. 6 at 2). However, PPL Gas stated that the cost of debt should be adjusted if either the proposals of the OTS or the OCA for capital structure were adopted. (PPL Gas St. 6R at 6). PPL Gas asserted that the ratio of debt and the cost of debt would be mismatched if this adjustment were not made. (PPL Gas St. 6R at 1). Additionally, PPL Gas argued that an adjustment should be made because the Company's capital structure was actual and the OCA's and the OTS' capital structures were hypothetical. Consequently, according to the Company, the actual cost of debt would be mismatched with a hypothetical capital structure. (R.D. at 50).

The OCA disagreed that PPL Gas' adjustment was necessary because it concluded that the cost of debt was supported by the record and is reasonable. According to the OCA, the Company valued the short-term debt based on three months of actual interest rates and nine months of projected London Interbank Offered Rates (LIBOR) interest, adjusted to reflect PPL Gas' short-term borrowing rate. (PPL Gas St. 6 at 21). The OCA cited precedent where a hypothetical capital structure has been used by the Commission. (*Pa. PUC v. Citizens Utilities Water Co. of Pa.*, 86 Pa. PUC 51 (1996) (where the Commission approved a hypothetical capital structure but found it inappropriate to adjust the cost of debt absent strong, specific evidence to do so). The OCA averred that PPL Gas failed to distinguish this proceeding from *Citizens*. (OCA MB at 53-55).

b. ALJ's Recommendation

The ALJ concluded that the record lacked strong, specific evidence to adjust the cost of debt. The ALJ stated that Commission precedent requires strong, specific evidence to make such an adjustment and found that the Company's request to adjust the cost of debt if a hypothetical capital structure is adopted was without merit. The ALJ recommended that the Commission use 6.35 percent as the overall cost of debt as proposed by PPL Gas and as agreed to by the OTS and the OCA. (R.D. at 51).

c. Disposition

No Party filed Exceptions 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.

3. Cost of Equity

Although there are various models used to estimate the cost of equity, the Commission favors the Discounted Cash Flow (DCF) Model. The DCF analysis theory is based upon finding the present value of an expected future stream of net cash flows during the investment holding period discounted at the cost of capital or capitalization rate. The capitalization rate is the total return rate anticipated and commonly is expressed in terms of the sum of a representative dividend yield plus a growth rate to capture investors' expectations of future increases in cash dividends.

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

Methodology	PPL Gas (1) (%)	OCA (2) (%)	OTS (3) (%)
DCF	10.4 (4)	9.0-9.5	9.0
CAPM	12.49	10.25	n/a
CE	14.45	10.00	n/a
RP	11.5	n/a	n/a
Range Recommendation	11.25 to 11.75	9.0 to 10.25	8.75 to 9.25
Point Recommendation	11.75	9.625	9.0

(1) PPL Gas St. 6 at 1,5.

(2) OCA St. 2 at 4.

(3) OTS St. 1 at 21.

(4) This includes a 0.70% leverage adjustment and a 0.31% size adjustment.

a. Positions of the Parties

PPL Gas employed four separate methodologies to determine the range of the cost of equity: DCF, Risk Premium (RP), Capital Asset Pricing Model (CAPM) and Comparable Earnings (CE). PPL Gas averred that it is appropriate to use multiple methods because investors use multiple methods and because each method has deficiencies. (PPL Gas MB at 71). The Company stated that its adjusted DCF cost of equity result was 10.4 percent. The remaining methods used by PPL Gas resulted in costs of equity of 11.5 percent for RP, 11.54 percent for CAPM and 14.45 percent for CE. From these results, PPL Gas selected a cost rate range of 11.25 percent to 11.75 percent. PPL Gas requested that the Commission select the high end of the range, or

11.75 percent, based upon the Company's exemplary management performance.[26] (PPL Gas MB at 82).

PPL Gas relied on analysts' projections of growth rates in the DCF analysis because analysts consider all historical and projected information, and analyst projections affect the price used in the dividend yield component in the DCF analysis. PPL Gas used a DCF growth rate of 5.0 percent, although its updated growth rates supported a growth rate of 4.9 percent. (PPL Gas St. 6R at 22) (PPL Gas MB at 73).

Within PPL Gas' DCF analysis, the Company included a 70 basis point leverage adjustment designed to reflect the fact that the DCF cost of equity reflects the investor expected return on market price. PPL Gas claimed that because the DCF cost rate reflects the percentage of debt based on capital structure including equity at market prices, the cost rate understates the cost of equity based upon capital structure calculated with book value. PPL Gas averred that the Commission repeatedly has approved and accepted this financial risk adjustment, citing *Pa. PUC v. Aqua Pennsylvania, Inc.*, 99 Pa. PUC 204, 234 (2004) and *Pa. PUC v. PPL Electric Utilities Corp.*, 99 Pa. PUC 389, 426 (2004). (PPL Gas MB at 74).

PPL Gas also made an adjustment of 31 basis points to its DCF analysis to reflect the greater risk it faces, relative to the barometer group, because it is a much smaller company. PPL Gas stated that a smaller company faces greater risk and that the size adjustment is calculated based upon the difference in bond yields between A-rated and Baa-rated debt to estimate the increased risk to the investor in equity due to increased risk. According to the Company, the barometer group cost rate does not account for risk associated with a smaller company. (PPL Gas MB at 76).

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[26] PPL Gas used the midpoint of the range, or 11.50%, plus 25 basis points for management performance to equal 11.75%. (PPL Gas St. 6 at 2).

The following table summarizes PPL Gas' DCF results.

Dividend Yield	Growth Rate	Leverage Adjustment	Size Adjustment	DCF Cost Rate
4.39	5.00	.70	.31	10.4

In addition to the DCF analysis, PPL Gas performed a CAPM analysis. According to PPL Gas, the CAPM identifies a risk free rate and an equity premium in excess of the risk free rate that is proportional to the systematic risk of a stock or portfolio of stocks. PPL Gas stated that the risk premium of the market is adjusted by the "beta" of the barometer group to reflect differences in risk. (PPL Gas MB at 78).

PPL Gas used a risk free rate of 5.5 percent, based upon the prospective yield on U.S. Treasury Bonds. (PPL Gas St. 6 at 47). The Company determined the market premium by averaging the historic market performance of Treasury Bonds (6.5 percent) and the projected market performance of Treasury Bonds (5.95 percent) which resulted in a premium of 6.23 percent. PPL Gas used adjusted betas to reflect the leverage adjustment. The Company's CAPM analysis produced a CAPM result of 11.54 percent. PPL Gas noted that financial literature also supports an additional adjustment for the size of the average gas group relative to the average size of the companies in the general market. The size adjustment would require an additional 0.95 percent. With the size adjustment, the final result of PPL Gas' CAPM analysis is 12.49 percent. (PPL Gas MB at 78-79).

PPL Gas also performed a CE analysis. According to PPL Gas, the CE method reviews the earnings of non-regulated, similar risk entities to determine cost of capital. Critical to the CE analysis is the choice of those entities identified with similar risk. PPL Gas selected companies from the Value Line Index to reflect the overall investment risk of the gas group. PPL Gas asserted that non-regulated companies generally have higher business risk but generally have less debt, thereby producing similar total investment risk. PPL Gas determined the cost of equity of 14.45 percent based upon an average of the historical returns in equity of comparable group (14.40 percent) and the projected return (14.50 percent) on book equity. (PPL Gas MB at 80-81).

Additionally, PPL Gas performed a RP analysis. According to the Company, the RP analysis is based upon the conclusion that equity investors require a premium over the expected cost of debt to provide equity capital because investors do not receive any return until debt holders receive their full return. PPL Gas explained that RP is the sum of a prospective bond yield and the premium of the bond yield expected by investors. PPL Gas concluded that the RP cost rate was the sum of 6.50 percent (expected yield) plus 5.00 percent (premium yield) or 11.50 percent. PPL Gas contended this result is likely understated because PPL Gas would not have an A bond rating (the 6.50 percent is based on A-rate utility bonds), and thus that percentage would be higher reflecting the lower bond rating and higher risk of PPL Gas. (PPL Gas MB at 77-78).

The OCA utilized the DCF, CAPM and CE methods. The OCA submitted that the Company's request for an 11.75 percent cost of equity is excessive, unjust and unreasonable. The OCA position is that, due to low capital costs, stable economic factors and the Company's lower risk profile, a cost of common equity of 9.625 percent is just and reasonable. The OCA developed this market-based cost of common equity recommendation using the DCF model, claiming that this is the method relied upon by the Commission. (OCA MB at 55-56).

The OCA applied the DCF methodology to two proxy groups of natural gas utilities: (1) a group of fifteen gas distribution companies followed by Value Line, excluding those that did not pay cash dividends; and (2) a group of nine distribution utilities used by PPL Gas in its analysis. (OCA St. 2 at 15, Exh. DCP-1 Sch. 5). This DCF analysis of the two proxy groups showed a DCF indicated range of 9.0 percent to

9.5 percent. The OCA also conducted a cost of equity analysis using the CAPM, which found a cost of equity of 10.25 percent, and using a CE approach, resulting in a cost of equity of 10.0 percent. As a result, the OCA recommended a range of 9.0 percent to 10.25 percent for cost of equity and selected the midpoint, 9.625 percent, as the cost of equity for PPL Gas, giving more weight to results of the DCF method and recognition of the slightly higher cost of equity indicated by the other two methodologies. (OCA MB at 58, 61).

In its CAPM analysis, the OCA stated that U.S. Treasury securities customarily are used to represent a risk-free investment rate as they are guaranteed by the government and are default free. The OCA used the three month average yield (April – June 2006) for 20 year U.S. Treasury bonds, with an average yield of 5.29%. In calculating the measure of risk or beta, Mr. Parcell used the Value Line betas for each company in his Value Line Group and the Company's Group. Based on these inputs, the OCA concluded that the CAPM cost of equity for the proxy groups was 10.25 percent. (OCA MB at 66).

The OCA stated that the CE analysis is viewed more or less as a reasonableness check on the result of the DCF analysis citing, *Aqua Pennsylvania*. The OCA claimed that it examined realized equity returns and evaluated investors' acceptance of those returns for several groups of companies and used market data as part of its CE analysis. The OCA used equity returns of several groups of companies covering the period of 1992 through 2005 and a risk comparison of utilities versus unregulated entities. The OCA used its Value Line Gas group, PPL Gas' nine company barometer group and the S&P 500 Composite group for the level of return to be expected and realized in the regulated and competitive sectors of the economy. (OCA St. 2 at 25). The OCA concluded, after comparing risk levels, that the S&P 500 group is more risky than the Value Line proxy group and PPL Gas' nine company barometer group. The

OCA concluded that the CE method of the two groups yielded a result of no more than 10 percent for the cost of equity. (OCA MB at 67-68).

The OCA opposed the Company's 70 basis point leverage adjustment, the Company's 31 basis point adjustment for size and the Company's request for a higher cost of equity in recognition of management performance. (OCA MB at 74, 77-79).

The OTS employed a DCF analysis to determine its recommended cost of equity for PPL Gas. The OTS submitted that the 11.75 percent return on common equity recommended by PPL Gas is excessive. The OTS used the DCF method applied to the Company's barometer group of nine gas companies to determine its recommended 9.00 percent cost rate of common equity. Based on the DCF results for the nine company barometer group, the OTS concluded that the appropriate cost rate of common equity for the LDC industry on average is in the range of 8.75 percent to 9.25 percent. The OTS recommended 9.00 percent as the common equity rate for PPL Gas, finding that this figure is supported by its analysis. Additionally, the OTS pointed out that, since the hypothetical capital structure for ratemaking purposes was based on the barometer group average, a financial risk adjustment is not necessary and that the selection of a cost rate of common equity at the midpoint of its range is appropriate. (OTS MB at 45-52).

b. ALJ's Recommendation

Based on her review, evaluation and analysis of the evidentiary record, the ALJ recommended adoption of a cost of equity rate of 10.26 percent as reasonable and adequately supported. The ALJ noted that in this proceeding she considered the DCF analysis and considered the analysis and critiques of the other methods for checking the reasonableness of the results of the DCF analysis. The ALJ based her recommendation on the DCF analysis of PPL Gas including the 31 basis point size adjustment, but only a 56 basis point leverage adjustment. The ALJ found the 70 basis point leverage adjustment proposed by the Company to be excessive and concluded that 56 basis points equated to a more reasonable adjustment. The ALJ concluded that the analysis of the record supports a DCF cost of equity of 10.26 percent (4.39 percent + 5.00 percent + 0.56 percent = 9.95 percent + 0.31 percent (size adjustment) = 10.26 percent). (R.D. at 61-65).

The ALJ stated that the OTS and the OCA are correct that the Commission favors the DCF method to determine the cost of equity. However, the ALJ concluded, based on recent precedent, that the Commission consistently has adopted a leverage adjustment to compensate for the difference between market prices and book value (used in ratemaking). (See, *Aqua Pennsylvania*, 204, 234 (2004); *Pa. PUC v. PPL Electric Utilities Corp.*, Docket No. R-00049255, at 70-71 (2004); *Pa. PUC v. Pennsylvania American Water Co.*, 2002 Pa. PUC LEXIS 1; *Pa. PUC v. Phila. Suburban Water Co.*, 219 PUR 4th 272 (2002); *Pa. PUC v. Pennsylvania American Water Co.*, 231 PUR 4th 277 (2004)). According to the ALJ, these cases are persuasive that a leverage adjustment should be employed with the DCF analysis. (R.D. at 62-63).

Additionally, the ALJ concluded that the argument to increase the equity return in recognition of management performance as presented by PPL Gas is without merit. The ALJ noted that noticeably absent in PPL Gas' presentation is any precedent for this adjustment. The ALJ recommended that the adjustment advocated by PPL Gas to recognize its management performance should be rejected. (R.D. at 65).

Based upon the testimony and evidence of record, the ALJ recommended the following overall rate of return for PPL Gas based upon her conclusions regarding the capital structure ratio and the cost rate for the debt and common equity capital:

Capital	Capital Structure Ratio	Cost Rate	Weighted Cost
Debt	48.21%	6.35%	3.06%
Common Equity	51.79%	10.26%	5.31%
Overall Rate	100%		8.37%

(R.D. at 65-66).

c. Exceptions

PPL Gas excepts to the ALJ's recommendation because she: (1) improperly adjusted the DCF analysis by reducing PPL Gas' leverage adjustment from 70 to 56 basis points; (2) did not give any weight to the other equity cost rate methods; and (3) incorrectly rejected consideration of management performance. First, PPL Gas notes that the ALJ accepted PPL Gas' DCF analysis, except that she reduced its leverage adjustment from 0.70 percent to 0.56 percent. PPL Gas maintains that this is incorrect because the ALJ calculated the adjustment based on PPL Gas' actual debt ratio instead of the hypothetical ratio she recommended. The Company maintains that, if the leverage adjustment is to be modified, it should be synchronized with the hypothetical capital structure and would result in a 0.80 percent leverage adjustment. According to PPL Gas, this would result in a DCF cost rate of 10.5 percent. (PPL Gas Exc. at 4-7).

Next, PPL Gas contends that the ALJ erred in not giving any weight to other equity cost rate models. PPL Gas noted that in reviewing the other methods, the ALJ criticized the CAPM analysis performed by the Company for its use of adjusted betas and for employing an adjustment for PPL Gas' size relative to the barometer group. The Company notes that the ALJ arrived at a CAPM result of 10.61 percent using unadjusted beta and no size adjustment, yet she gives absolutely no weight to this revised CAPM by simply adopting her DCF result of 10.26 percent. PPL Gas then points out that the ALJ rejected its RP and CE analysis because they are market-based and yield results that are questionable due to more risk being included than what exists in regulated industry. PPL Gas avers that the reasons offered by the ALJ provide no basis for rejection of the Company's RP analysis because it was based on public utility bond yields and returns. (PPL Gas Exc. at 8-10).

Finally, PPL Gas complains that the ALJ incorrectly rejected consideration of management performance because it did not cite authority for this adjustment. The Company states that it cited *Pa. PUC v. West Penn Power Co.*, 83 Pa. PUC 628, 675 (1994) and *Pa. PUC v. Aqua Pennsylvania Inc.*, 263 PUR 4th 218, 247 (2004), both of which affirmed the authority and policy of the Commission to exercise its discretion in selecting a cost of equity within the range of reasonableness to reward or penalize a company based on the quality of its service. PPL Gas requests the Commission to consider management performance and adopt an equity cost rate at the high end of the equity cost rate range. (PPL Gas Exc. at 10-11).

In its Exceptions, the OCA avers that the ALJ erred in recommending adjustments for leverage and size to the DCF-based cost of equity. The OCA notes that if these adjustments are eliminated, the ALJ's DCF analysis results in a 9.39 percent cost of equity which is within the range the OCA recommended as appropriate. The OCA notes that, while it recognizes that the Commission has made leverage adjustments in other cases, it is within the Commission's discretion whether to make such an adjustment or not. The OCA opines that use of the higher end of the DCF-only results would adequately account for the effect of current financial conditions on the DCF calculation. Additionally, the OCA submits that the 31 basis point adjustment for size is unwarranted as PPL Gas' source of capital comes from PPL Corporation and affiliates, not from the much smaller gas subsidiary. The OCA reiterates its position that a cost of common equity for PPL Gas of no more than 9.625 percent should be adopted by the Commission. (OCA Exc. at 20-24).

The OTS also excepted to the ALJ's recommended adoption of a 10.26 percent return on equity for several reasons. First, the OTS states that the ALJ mistakenly rejected the OTS' dividend yield of 4.26 percent in favor of the Company's 4.39 percent dividend yield. The OTS opines that the Company's claim contains a 13 basis point adjustment for an ex-dividend adjustment to dividend yields that should not be adopted by the Commission. Next, the OTS states that the ALJ erroneously used PPL Gas' 5.0 percent growth rate and provided no rationale for disregarding the OTS recommended growth rate of 4.65 percent. Additionally, the OTS excepts to any leverage adjustment. The OTS opines that the leverage adjustment is unsupported and inconsistent with the proper determination of an appropriate rate of return for PPL Gas or any other public utility. (OTS Exc. at 12-16).

In reply, PPL Gas avers that the Exceptions of the OCA and the OTS do not comport with prior Commission decisions or investor expectations. PPL Gas states that the OCA and the OTS arguments against the leverage adjustment specifically were rejected in *PPL Electric* and both argue incorrectly that the leverage adjustment maintains a certain market price to book value ratio. PPL Gas notes, as the Commission has recognized, that the leverage adjustment reflects the greater risk caused by the greater level of debt as a percentage of total capital with equity and debt at book value when compared to the percentage of debt of total capital with equity at market prices. Because the DCF estimates the investor-required return at market prices, an adjustment is necessary to determine the investor-required return on equity at book value, according to PPL Gas. (PPL Gas R. Exc. at 4-5).

Concerning the OCA's Exception on the size adjustment, PPL Gas notes that the OCA did not dispute that size affects risk, but contends size should not be considered here because PPL Gas is a subsidiary of the much larger PPL Corporation. PPL Gas rejoins that the Commission is determining the cost of equity for PPL Gas, not PPL Corporation. PPL Gas maintains that the Commission has concluded that cost of equity is to be determined based upon the risks of the operating utility. *Pa. PUC v. West Penn Power Co.*, 1993 LEXIS 62, 172-173 (1993). The Company requests that the Commission reaffirm that the cost of equity is to be determined for the utility, particularly in the post-restructuring environment. (PPL Gas R.Exc. at 5-7).

Concerning the OTS' Exceptions regarding the dividend yield, PPL Gas avers its adjustment is appropriate because the stock prices change on the ex-dividend dates and that such data are widely reported and understood by investors. In regard to the OTS exception on PPL Gas' growth rate, the Company notes that several analysts' growth rates reported by the OTS resulted from a double count of the same analyst's estimate. PPL Gas avers that the ALJ properly rejected the OTS' dividend yield and growth rate. (PPL Gas R.Exc. at 7).

In its reply to PPL Gas' Exceptions, the OCA rejoins that the Company's position that an 80 basis point adjustment is appropriate to "synchronize" the equity return in its leverage adjustment calculation with the capital structure equity ratio recommended by the ALJ is flawed and without support. The OCA points out that no Company witness testified in support of an 80 basis point adjustment and did not propose a leverage adjustment based upon the Company's actual, less leveraged, capital structure. The OCA opines that under the Company's scenario the savings to customers that would result from adoption of a hypothetical capital structure with less equity should be offset by an increase to the common equity cost for increased financial risk. The OCA maintains that the ALJ correctly rejected the Company's proposal to increase the cost of debt for ratemaking if a hypothetical capital structure were adopted. The OCA reiterates its position that no leverage adjustment should be adopted in this case. (OCA R.Exc. at 2-4).

Next, the OCA rejoins that the ALJ did not err in rejecting the Company's 11.75 percent cost of equity claim, which was based heavily on the results of the

Company's non-DCF costing methods. The OCA opines that the ALJ properly rejected PPL Gas' RP analysis and CE analysis as conceptually flawed and not persuasive, and properly relied on the DCF methodology and informed judgment, as supported by Commission precedent. (OCA R.Exc. at 6-8).

Concerning PPL Gas' Exception regarding a cost of equity adjustment for management performance, the OCA submits that the ALJ correctly determined that the Company's request unreasonably would require ratepayers to pay twice, once through operating and maintenance expense and again through rate of return. The OCA avers that management performance adjustments requested by the utilities in *PPL Electric* and *Pa. PUC v. Pennsylvania-American Water Co.*, 99 Pa. PUC 4, 40, 43 (2004) were not granted. (OCA R.Exc. at 8).

In its reply to PPL Gas' Exceptions, the OTS contends that the issue of the proper calculation of any leverage adjustment is immaterial because, in its opinion, no such adjustment should be applied in the first place. The OTS next avers that the credibility of the CAPM model is questionable, while the CE and RP methods should not be given equal weight with the DCF method. None of these methods should be considered by the Commission for ratemaking purposes, in the opinion of the OTS. Concerning the size adjustment, the OTS points out that the Company failed to note any prior ruling by this Commission where a specific adjustment to the allowed rate of return was made due to the size of the utility. In regard to the management performance adjustment, the OTS maintains that the Company did not provide any conclusive evidence to support its position that PPL Gas is more efficiently and economically operated in comparison to the companies in PPL Gas' barometer group and, absent such evidence, any claimed adjustment must be rejected. (OTS R. Exc. at 3-7).

d. Disposition

As noted previously, we have relied primarily upon the DCF methodology in arriving at our determination of the proper cost of common equity. However, we agree with the ALJ's statement that other methodologies can be used as a check on the reasonableness of the results of the DCF method, tempered by informed judgment. We note that both PPL Gas and the OCA have done so in the instant proceeding. We also will use the results of the CAPM, CE and RP methodologies as a check of the reasonableness of our DCF-derived equity return calculation.

Based upon our analysis and review of the record evidence, the Recommended Decision and the Exceptions and Replies thereto, we reject the ALJ's recommendation to adopt 10.26 percent as the appropriate cost of equity in this proceeding. We note that the ALJ recommended the adoption of PPL Gas' DCF calculations, except for the reflection of a lower leverage adjustment, 56 basis points in lieu of 70 basis points. We agree with the ALJ that PPL Gas' unadjusted DCF proposal of 9.39 percent is reasonable in comparison to the results of the OCA (range of 9.0 to 9.5 percent) and the OTS (9.0 percent). We further agree with the ALJ that the 11.75 percent request of PPL Gas is excessive and unreasonable.

We note that the Company has proposed the addition of three separate adjustments in determining the allowable return on equity in this proceeding. PPL Gas has requested the adoption of a 70 basis point leverage adjustment, a 31 basis point size adjustment and a 25 basis point management performance adjustment. We are in agreement with the ALJ that the size adjustment is appropriate and that the additional adjustment for management performance is unsupported and should be denied. In regard to the ALJ's recommended reduction of the leverage adjustment, we find that the Company's original requested 70 basis point adjustment is reasonable and should be adopted. We are persuaded by the Company's argument that the ALJ was incorrect because she calculated the adjustment based on PPL Gas' actual debt ratio instead of the hypothetical ratio she recommended and we have accepted. Therefore, the ALJ's recommended reduction to the leverage adjustment requested by PPL Gas is rejected.

Based upon these findings, we are of the opinion that an equity return of 10.4 percent is reasonable and will be adopted. This amount is comprised of the PPL Gas DCF result of 9.39 percent, a 0.70 percent adjustment for leverage and a 0.31 percent size adjustment. Accordingly, the Exceptions of PPL Gas are granted in part and denied in part to the extent consistent with the foregoing discussion. The Exceptions of the OCA and the OTS are denied.

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

Capital Structure	**Ratio (%)**	**Cost Rate (%)**	**Weighted Cost (%)**
Debt	48.21	6.35	3.06
Common Equity	51.79	10.40	5.39
Overall Rate	100.00		8.45

G. Rate Structure and Rate Design

1. Cost of Service

PPL Gas submitted a fully allocated cost of service study (COSS) to determine the cost of providing gas service to each rate class based on the future test year ending December 31, 2006. (PPL Gas Exh. PRH-1 at I-2). The study also determined the customer cost per month by service allocation. (PPL Gas Exh. PRH-1R, Sch. J). PPL Gas used the Average and Extra Demand Method for allocating costs to each class. (PPL Gas MB at 84). The three basic cost responsibility categories in the allocation study are:

(1) commodity; (2) capacity; and, (3) customer. (Id.). In the Average and Extra Demand Method of allocation, capacity costs are allocated among service classes based on average use and use above average at periods of peak demand. (PPL Gas Exh. PRH-1 at I-2 to I-3). PPL Gas accepted some of the modifications proposed by opposing Parties and submitted Exh. PRH-1R as its revised COSS. (PPL Gas MB at 85).

a. Modifications to COSS Accepted by PPL Gas

The OSBA proposed that uncollectible accounts expense and forfeited discounts be allocated based upon the actual experience of PPL Gas for each rate class. (OSBA St. 1 at 21-23). The OCA also proposed that the uncollectible accounts expense be based upon actual experienced write-offs over the last two years. (OCA St. 3 at 8). PPL Gas accepted this modification and incorporated it in its revised allocation. (PPL Gas MB at 86, 88; PPL Gas Exh. PRH-1R).

The OCA proposed an adjustment to update certain allocation factors to reflect more recent information concerning storage service. (OCA St. 3 at 4). PPL Gas accepted this adjustment and reflected the update corresponding to storage service in its revised allocation. (PPL Gas MB at 87, PPL Gas Exh. PRH-1R). The OCA further proposed amending the allocation of taxable income to reflect additional deductions from income. (OCA St. 3 at 4). Noting the small effect upon the returns of each class, PPL Gas agreed to change the allocation as suggested by the OCA. (PPL Gas MB at 87, PPL Gas St. 8-R at 6).

b. Modification to Allocation of Cash Working Capital

1. Positions of Parties

The OSBA advocated allocating 100% of the Company's cash working capital requirement to the residential class. According to the OSBA, working capital costs are incurred because PPL Gas must pay its bills before its supplier bills before it gets paid by its ratepayers. (OSBA MB at 10). However, the OSBA opined that business customers do not contribute to the need for working cash because the revenue lag for all business customers is less than the cost payment lag. (*Id.*). In contrast, the OSBA stated that residential customers' revenue lag is greater than the cost payment lag; resulting in the Company's working cash cost. (OSBA St. 1 at 22, Tr. at 254-55).

PPL Gas stated that cash working capital requirement is determined on a total company basis rather than by rate class. (PPL Gas MB at 86, PPL Gas St. 8R at 5). PPL Gas opined that an allocation exclusively to the residential class would be inappropriate. (R.D. at 68).

2. ALJ's Recommendation

The ALJ recommended that the OSBA's modification to the cash working capital allocation should be rejected as unreasonable and inappropriate. (R.D. at 68). The ALJ found that the OSBA did not demonstrate that business customer revenues for gas services routinely come to the Company before the Company's payments to suppliers are due. The ALJ found PPL Gas' statement that cash working capital is determined on a total company basis, implying that all customers contribute to the Company's need for cash working capital, to be reasonable. As such, the ALJ recommended that PPL Gas' allocation for cash working capital should be accepted. (*Id.*).

3. Disposition

No exceptions have been filed to this determination. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

c. Modification to Allocation of Distribution Mains Costs on Minimum or Zero-Intercept System

1. Positions of Parties

The OSBA's witness, Mr. Knecht, recommended that the distribution mains be classified on a minimum or zero-intercept system as 28% customer-related and 72% demand-related since the mains are built to connect customers and sized to meet peak demands. (OSBA MB at 7-8, OSBA St. 1 at 13-17). The OSBA posited that it is more costly to construct gas distribution networks to serve many smaller customers than to install capacity for a few larger customers. The OSBA stated that because PPL Gas' COSS fails to reflect this fact, it, "over-assigns mains costs to business customers and under-assigns mains costs to residential customers." (OSBA MB at 8, OSBA St. 1 at 4).

PPL Gas classified the distribution mains cost as 100% demand costs based on growth in demand. (R.D. at 69). PPL Gas argued that the OSBA proposal to modify the allocation based on 28% customer-related and 72% demand-related be rejected. According to PPL Gas, quantifying the cost of the minimum or zero-intercept system is extremely difficult and imprecise. (PPL Gas M.B. at 85; PPL Gas St. 8-R at 2-3).

The OCA argued that the Commission has in the past rejected the zero-intercept and minimum system methods as inconsistent with cost causation. (OCA MB at 105, OCA St. 3R at 4). According to OCA witness, Mr. Watkins, the OSBA's method of determining the demand/customer related allocation ignores the fact that while peak demands are a major design consideration for main extension or construction, the fact remains that mains are joint costs serving many groups of customers throughout the year. (OCA M.B. at 104; OCA St. 3R at 2). Mr. Watkins also found that the OSBA's zero-intercept analysis violates statistical foundations and principles which render the linear regression analysis, the technique used in the zero-intercept method, an invalid model and its results illogical. (OCA MB at 105, OCA St. 3R at 5).

2. ALJ's Recommendation

The ALJ recommended that the modification to allocate the mains distribution costs on a 28% customer-related and 72% demand-related basis should be rejected and that the allocation based on 100% demand should be approved. (R.D. at 71). ALJ Jones noted that the Commission has rejected minimum and zero-intercept system methods as inconsistent with causation. (*Id.*). The ALJ noted that while the concept of main costs derived from both distance and capacity factors is persuasive, the model and calculations provided present misgivings to implement the concept as proposed. (*Id.*). As such, the ALJ rejected the OSBA's alternative allocation.

3. Disposition

No exceptions have been filed to this determination. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

d. Modification to Allocation of Demand Costs

1. Positions of the Parties

PPL Gas used and average and excess (A&E) method to allocate demand costs. The Company allocated 40% of demand costs based upon commodity usage and 60% based on excess demand (demand in excess of average demand). (PPL Gas MB at 85). PPL Gas stated that the 40% for commodity was based upon system average load factors for 2004 and 2005 of 39.1% and 39.8% respectively. (PPL Gas St. 8-R at 4). The excess demand was allocated using non-coincidental peak factors for each classification. (PPL Gas MB at 86). The factors were based upon the experienced class factors over the last three years. (*Id.*).

The OSBA argued that the demand related costs should be allocated in proportion to each class' share of peak demand rather than the A&E allocator used by PPL Gas. (OSBA MB at 8-9). According to the OSBA, while the A&E allocator would produce the same results as a peak demand allocator, the Company's COSS incorrectly calculates the A&E allocator, and, therefore, incorrectly assigns more costs to higher load customers and less to lower load customers. (OSBA MB at 8). The OSBA opined that because peak day demands for PPL Gas' smaller customers are not directly metered, the Company had to estimate when developing the demand allocators. (OSBA MB at 9, OSBA St. 1 at 17-20).

The OCA identified three areas of concern with regard to the OSBA's demand allocator: (1) The OSBA's method has a timing mismatch in that it considers each class' total monthly booked consumption with calendar monthly heating degree days as a means of measuring weather sensitivity. Meanwhile, the Company has twenty different billing cycles and consumption measured over the course of the cycle often includes usage registered in two different calendar months. (OCA St. 3R at 7); (2) the OSBA's monthly analysis was done on a total class basis rather than a per customer basis and failed to consider either customer growth/attrition or declining usage per customer over a six-year period in which gas prices increased dramatically. (OCA St. 3R at 8); and, (3) the OSBA's method for estimating class peak demands did not employ any statistical analyses to estimate or test the reasonableness of results. (*Id.*).

2. ALJ's Recommendation

The ALJ found that the OSBA never corrected or provided guidance as to what corrections need to be made to the A&E allocator. (R.D. at 72; OSBA RB at 7). The ALJ determined that the record does not demonstrate that the A&E allocator as calculated by PPL Gas is incorrect and that the OSBA failed to support its conclusion by explaining or demonstrating how the definition of the A&E methodology used by the Company is wrong. Finding that the A&E allocator is supported by the evidence, and that the OSBA modification to replace the A&E allocator with a peak demand allocator is not supported by the evidence, the ALJ recommended approval of the Company's A&E allocator. (R.D. at 72).

3. Disposition

No exceptions have been filed to this determination. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

e. Modification to Allocate CAP Costs Among All Rate Classes

The OCA proposed allocating CAP costs among all non-storage customer classes instead of assigning 100% of the CAP costs to the residential customer class. (OCA St. 3 at 5). The OCA excluded the storage class because that class' service is not natural gas delivery service. (OCA MB at 89, n. 16). The OCA argued that CAP is a social program that benefits all ratepayers in that "low income [CAP customers] have virtually zero propensity to save. Therefore, the additional income available to CAP participants [as a result of lower natural gas bills] is spent in the local economy and benefits local businesses." (R.D. at 73; OCA MB at 90; OCA St. 3 at 5-6).

The OSBA, PPL Gas, and PGLUG opposed the OCA's proposed amendment to allocate CAP costs to all customer classes. (OSBA MB at 11-12; PPL Gas MB at 87; PGLUG MB at 8-10).

1. ALJ's Recommendation

The ALJ noted that CAPs are narrowly tailored to the residential class and determined that overwhelming Commission precedent supported 100% allocation of CAP costs to the residential customer class. (R.D. at 74-75). Finding that the OCA presented no persuasive argument to change this Commission policy, the ALJ recommended that the OCA's proposed modification to allocate CAP costs to all non-storage customers be denied. (*Id.*).

2. Exceptions

The OCA submits that the Commission's policy of allocating CAP costs only to residential customers does not properly reflect the recent decision in *Lloyd v. Pa.* PUC, 904 A.2d 1010 (Pa. Cmwlth. Ct. 2006) which found that Section 2804(9) of the Code regarding certain conservation programs – according to the OCA, a parallel provision to Section 2203(6) at issue here – did not require that a customer class receive a direct benefit as a condition of accepting cost responsibility for the program. (OCA Exc. at 31). OCA witness Watkins opined that CAP programs do provide benefits to all customer classes, both as social benefits accruing to society as a whole, and as direct benefit to PPL Gas' local economy. (OCA Exc. at 32; OCA St. 3 at 5-6).

PPL Gas rejoins that even if *Lloyd* were interpreted to permit the PUC to allocate CAP costs to all rate classes, it does not mandate that result. (PPL Gas R. Exc. at 23). PPL Gas continues that the Commission was well aware of *Lloyd* when it entered its Order in *Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms*, Docket No. M-00051932 (December 18, 2006), where it rejected the OCA's contention again. (Id.).

The OSBA replied that the ALJ was correct when she concluded that the overwhelming Commission precedent, which requires 100% allocation of CAP costs to the residential class, is consistent with sound regulatory practice and that the OCA's proposed modification should be rejected. (OSBA R. Exc. at 7).

3. Disposition

The ALJ properly denied the OCA's proposal to amend the Company's COSS to allocate CAP costs to all customer classes with the exception of the storage class. Contrary to the OCA's reading, the Commonwealth Court in *Lloyd* did not address how universal service costs were to be allocated, it simply rejected PPLICA's argument that conservation program funding should come (if at all) through generation rates and not through distribution rates. Therefore, *Lloyd* is not precedent for the OCA's argument that universal service costs are to be allocated to all customer classes. We concur with the ALJ who correctly limited recovery of the CAP costs to residential customers. This recommendation is consistent with cost causation and the Commission's Order on Customer Assistance Programs: Funding Levels and Cost Recovery Mechanisms, Docket No. M-00051923 (December 18, 2006). As such, the OCA's Exception on this issue is denied.

f. Modification to Allocation of Off System Sales

1. Positions of the Parties

PPL Gas explained that Off Systems Sales were reflected in the COSS as the result of an oversight. (PPL RB at 43). PPL stated that these sales are a "below the line" revenue stream because they are the subject of a sharing mechanism established in the Company's annual Section 1307(f) proceedings. (*Id.*). To include these proceeds in base rates would flow the revenues through to customers disregarding PPL Gas' sharing mechanism where parties agreed PPL Gas is entitled to some proceeds as an incentives to obtain sales. (PPL Gas RB at 43; PPL Gas St. 4R at 6-7).

The OCA proposed assigning Off System Sales margin revenue on retail sales volumes. The OCA opined that Off System Sales margins "represent opportunity sales of gas obtained and reserved for PPL [Gas'] retail gas sales customers. As such, it is inappropriate to provide Off System Sales credit to transportation and storage classes." (R.D. at 75; OCA St. 3 at 7).

2. ALJ's Recommendation

The ALJ determined that the record evidence does not support the OCA's proposal. The ALJ stated that the OCA ignored the nuance of the sharing mechanism developed in the Company's Section 1307(f) proceedings which established the sharing mechanism to provide the Company an incentive to achieve large volumes in these sales. (R.D. at 75-76). As such, the ALJ recommended denial of the OCA's modification on Off Systems Sales. (R.D. at 76).

3. Exceptions

The OCA excepts to the ALJ's determination arguing that the sharing mechanism addresses only the amount of off-system sales revenue that is flowed back to customers and has no impact on how the revenues are derived or how the revenues are reflected in rates. (OCA Exc. at 26). The OCA argues that the fact that the revenues are used to reduce the total cost of service does not reflect the reason that the off-system revenue exists. (OCA Exc. at 26-27). According to the OCA, its allocation properly matches these revenues to the class of customers providing the benefit, the NGDC sales customers, for cost of service purposes. (OCA Exc. at 27; OCA St. 3S at 3).

PPL Gas rejoins that the OCA is erroneous in its claim that the sharing mechanism addresses only the amount of off-system sales to be flowed back to customers and that the mechanism has no impact on how revenues are derived or how revenues are reflected in rates. (PPL Gas R. Exc. at 23). The Company states that the sharing mechanism specifically contains a formula for determining the amount of revenues from off-system sales to be flowed back to customers, and the mechanism requires that such revenues be reflected as a reduction to purchased gas costs. (*Id.*; PPL Gas Exh. CPW-1 at 8.1).

4. Disposition

Based on our review of the record evidence, we will deny the OCA's Exception on this issue. The sharing mechanism has no impact on distribution rates and as such, should not be reflected in a distribution rate COSS.

g. Modification to Allocation of Timber Sales Based on Land and Land Rights

1. Positions of the Parties

PPL Gas provided that Timber Sales offset the need to recover revenues from all rate classes. As such, PPL Gas stated that it is appropriate to allocate Timber Sales among the rate classes proportionately based on the total cost of service allocated to each rate class. (PPL Gas MB at 87-88, PPL Gas St. 8R at 7).

The OCA opined that since Timber Sales are a function of PPL Gas' land, the sales should be allocated based on Land and Land Rights. (OCA MB at 94, OCA St. 3 at 7).

2. ALJ's Recommendation

The ALJ found that the rationale offered to support the OCA's modification for allocation of Timber Sales was not persuasive and the method of allocation for Timber Sales provided by PPL Gas was reasonable and supported by the evidence. (R.D. at 75).

3. Exceptions

The OCA submits that as with off-system sales revenue, the allocation should reflect the reasons for the sales, in this instance the land and land rights of PPL Gas. (PPL Exc. at 27). The OCA argues that the ALJ erred in rejecting the OCA's modification to allocate these revenues on the same basis as Land and Land Rights are allocated in the COSS. (*Id.*).

4. Disposition

Based on our review of the record evidence, we will deny the OCA's Exception on this issue. The OCA has not persuaded us that its modification is in the public interest. Furthermore, the OCA failed to rebut the Company's evidence that timber sales offset the need to recover revenues from all rate classes. As such, we agree with the Company that it is appropriate to allocate timber sales among the rate classes proportionately based upon the total cost of service allocated to each rate class.

h. Modification to Allocation of Outside Service Based on Rate Base

1. Positions of Parties

PPL Gas would allocate Outside Service Expenses (Account 923) based upon rate base. (PPL Gas MB at 88). PPL Gas claimed that the expenses for this account represent administrative and general functions not performed by PPL Gas employees. The Company stated that because these expenses are typical administrative and general expenses they should be allocated using the factor for allocating other administrative and general costs. (PPL Gas MB at 88, PPL Gas St. 8R at 7).

The OCA opined that because over 90% of the outside services costs are from affiliates to provide a wide range of service to support PPL Gas operations, it is more appropriate to allocate this account in rate base. (OCA St. 3S at 2).

2. ALJ's Recommendation

ALJ Jones determined that the OCA's proposal was not supported by the record evidence and recommended denial of the OCA's modification to allocate the Outside Service Expenses based on rate base. (R.D. at 77).

3. Exceptions

The OCA argues that since 90% of these expenses are attributable to affiliate transactions to provide a wide range of services to support all of PPL Gas operations, OCA witness Watkins proposed to allocate this account based on the Company's investment in rate base was more reasonable. (OCA Exc. at 28; OCA St. 3 at 7-8; OCA St. 3S at 2). The OCA contends that given the wide range of services included in the expenses recorded in Account 923, its proposed allocation more properly reflects cost causation. (OCA Exc. at 28).

OSBA witness Knecht rejoined that absent a detailed study of the individual components of outside services costs, "it is not unreasonable to assume that these services are related to either overall O&M costs or to PPL's direct labor-related costs. As the labor allocator is much more similar to PPL's proposed O&M allocator than to Mr. Watkins' rate base allocator, I see no reason to change PPL's proposed approach." (OSBA St. 2 at 13; OSBA R.Exc. at 10).

4. Disposition

The OCA failed to prove that Account 923 Outside Service Expenses are any different from the general administrative functions. As such, we will deny the OCA's Exception on this issue.

i. Modification to Allocation of General Plant

1. Positions of Parties

The Company proposed allocating General Plant based on O&M expense (excluding administrative and general expense, credit for gas used for other utility operations, storage gas losses, and compressor station fuel expense). PPL Gas stated that general plant includes office buildings, office furniture, office equipment, *etc.*, all of which are used to provide administrative and general services. (PPL Gas MB at 88). According to PPL Gas witness, Mr. Herbert, "the general plant and the associated maintenance and depreciation [accounts], support the employees who work primarily in the administrative, customer accounting and distribution functions." (OCA MB at 96 quoting PPL St. 8R at 7-8).

The OCA proposed allocating General Plant based production, transmission and distribution plant in service and claimed that this allocation is the preferred industry method. (OCA St. 3S at 2).

The OSBA opined that there is no reason to change the Company's approach without a thorough study of cost causation factors. (OSBA St. 2 at 14).

2. ALJ's Recommendation

The ALJ was not persuaded by the OCA's argument to modify the allocation of general plant and recommended denial of the modification. The ALJ noted that the OCA did not claim that the Company's position was either incorrect or unreasonable, only that it was not the typical method used in the industry. (R.D. at 78).

3. Exceptions

The OCA argues that while not totally unreasonable, PPL's method still does not accurately reflect cost causation, as generally accepted in the industry. (OCA Exc. at 28; OCA St. 3S at 5). The OCA contends that it is important that the most accurate allocation be used for cost of service study purposes, particularly as the ALJ recommends an allocation of the revenue requirement in this case based largely on the results of the cost of service study. (OCA Exc. at 28).

OSBA witness Knecht testified that General Plant rate base is comprised primarily of buildings, garages, shops, and tools, and that such facilities are more related to providing support for both the O&M and A&G activities of the Company than they are to distribution rate base. (OSBA R.Exc. at 8-9). The OSBA cautioned against rejecting the Company's judgment and substituting some other arbitrary allocation method for General Plant. (OSBA R.Exc. at 9).

4. Disposition

We note that the OCA conceded that PPL's methodology is not unreasonable. Moreover, the OCA has not presented evidence to demonstrate that its methodology is more consistent with cost causation. The allocation of general plant based on administrative and general expenses as presented by PPL Gas is supported by the evidence. As such, the OCA's Exception on this issue is denied.

j. Modification to Allocation of Costs Record in Account 903, Customer Records & Collections

1. Positions of Parties

OCA proposed allocation of the Customer Records & Collections based on a 50/50 split between throughput and the quantity of customers. (OCA M.B. at 99; OCA St. 3 at 9). OCA's Mr. Watkins explained that small volume customers require no contracts and are billed monthly based on a single meter read. In contrast, storage and transportation customers require written contracts, daily usage metering, balancing and more complex billing information. (*Id.*). The OCA posited that because large customers impose higher record and collection cost, customer size should be considered in the allocation. (OCA MB at 99).

The result of the allocation proposed by OCA yields 35 percent of the costs to 1½ percent of the customers and 65 percent of the costs to 99.45 percent of the customers. (PPL Gas MB at 88-89). Both the OSBA and PPL Gas disagreed with the OCA's proposed 50/50 split based allocation because the result of the allocation is not supported by the record evidence as reasonable or appropriate or sound. (PPL Gas MB at 89). PPL Gas stated that in recognition of the cost differential between the small and large customers, it used a factor number 10 to allocate expenses in Account 903. (PPL Gas MB at 89; PPL Gas Exh. PRH-1R). The Company explained that this factor is based on the "number [of] meters measuring and regulation equipment for each rate class weighted by equivalent factors and therefore it recognizes a higher weighting for larger customers." (PPL Gas MB at 89; PPL Gas St. 8-R at 8-9). The Company stated that the OCA's argument is flawed in that the employees that carry out daily nominations, usage metering, daily balancing, etc., for large customers are the same ones that provide balancing for the entire system. (PPL Gas RB at 44). PPL Gas claimed that such expenses are charged to Account 851, not to account 903. (PPL Gas RB at 44-45).

2. ALJ's Recommendation

The ALJ found that the record does not support the OCA's allocation for the Customer Records and Collections expenses and recommended that the Commission reject the modification. The ALJ further found PPL Gas' proposal to be reasonable noting that it incorporates the contrasts in customer size that the OCA emphasized. (R.D. at 80).

3. Exceptions

The OCA submits that its allocation is far more reasonable that the Company's allocation on the basis of the number of customers which significantly understates the cost responsibility of the large volume users. (OCA Exc. at 29). According to the OCA, this account includes significant expense associated with services provided to large volume users, including the costs of customer applications, contracts and credit investigations. (OCA Exc. at 29-30). The OCA opines posits that since the costs are incurred in support of services provided to a particular class, the cost of service study should reflect this fact. (OCA Exc. at 30).

The OSBA rejoins that the OCA did not offer any explanation or basis for why the allocation factor should be based 50 percent on throughput. (OSBA R.Exc. at 9). The OSBA argues that the OCA methodology erroneously implies that records and collections costs are 58 percent higher per GS-Small customer than per Residential customer. (*Id.*). The OSBA counters that both of those classes include only sales customers for whom PPL faces the same billing arrangements and the collections costs for GS-Small customers are likely to be lower than those for residential customers. (*Id.*; OSBA St. No. 2 at 14).

4. Disposition

We agree with the ALJ's determination that the OCA did not prove that its modification to the allocation of Customer Records and Collections expenses is reasonable or in the public interest. As noted by the ALJ, PPL Gas' proposal is reasonable and took into consideration the contrasts in customer size that the OCA emphasized. We will, therefore, deny the OCA's Exception.

k. Modification to LVS Class' Rate Discountts

1. Positions of the Parties

PPL Gas offers a discounted rate to some LVS (large volume service) customers as a result of negotiated contracts between the Company and the customer. The contracts have at least one of the following characteristics: (1) high energy consumption with alternate fuels as a threat; (2) usage levels such that bypassing the local distribution company is advantageous; (3) significant impact on the local economy; and (4) multiple locations to vie competitive service providers. (R.D. at 80; PPL St. 5R at 3). These factors and the potential loss of any one customer leaving large fixed costs to be distributed to the remaining customer base results in PPL Gas offering discount rates for the customer's remaining with PPL Gas. (R.D. at 80). PPL Gas reflected the difference between the actual revenues from Rate L (rate for LVS customers) and the revenue required to produce the system average rate of return. The purpose is to allocate among the other rate classes the discounted revenue received by the Company that is less than the system average rate of return. (PPL Gas RB at 45). The Company, the OSBA, and the OCA agree that under-recovery of costs that results from the rate discounts provided to Rate LVS customers should be shared among the customer classes. However, the OCA disagrees with PPL and the OSBA on the amount to be re-allocated to the classes other than LVS.

For COSS purposes, OCA witness Watkins proposed that the cost of the rate discounts provided to Rate LVS customers should be shared equitably among the customer classes since all ratepayers are better off with some revenue contribution to fixed costs by these customers. (OCA St. 3 at 10). This amount is proposed to be allocated across all customer classes, except storage, on the basis of class throughput. The OCA proposed to quantify rate discounts allocated among the rate classes based upon the difference between the discounted rates and the revenue produced from full tariff rates for the large volume class. Mr. Watkins determined that the cost of the Rate L discount is $5.6 million. (OCA St. 3S at 5).

PGLUG interpreted the OCA's proposal as effectively abolishing the negotiated contracts between the Rate L customers and the Company and requiring those customers to pay full tariff rates. (PGLUG RB at 2, PGLUG MB at 2-5). PGLUG opined that the result would be to nullify the benefits of keeping these targeted characteristic Rate L customers in that remaining customers will be saddled with a greater share of fixed cost when the customer ceases to be a PPL Gas customer. (PGLUG RB at 2).

2. ALJ's Recommendation

The ALJ determined that to propose allocation based on a rate that is beyond what the utility is entitled would necessarily overstate the cost of retaining these identified customers. (R.D. at 81). The OCA's proposal would unnecessarily overstate the cost of retaining the discount Rate L customers and should be rejected. (R.D. at 81).

3. Exceptions

The OCA argues that while the Company may only be entitled to rates to produce the system average rate of return on an overall basis, the rate of return by class will vary. (OCA Exc. at 30). At full tariff rates, the Rate LVS class produces a greater than system average rate of return, but without a discount, it is the full tariff rate that would be paid, not a lower rate based on the system average rate of return. As such, the OCA opines that the amount of Rate LVS discount allocated to other customer classes should be the $5.6 million. (OCA Exc. at 31).

PPLUG responds that the OCA's approach would overstate the cost of retaining the discounted Rate L customers because the full tariff rate is significantly above the system average rate of return. (PPLUG R.Exc. at 3). According to PPLUG, acceptance of the OCA's proposal would improperly base the calculation on a rate in excess of what the utility is permitted to recover and must be rejected. (*Id.*).

The OSBA rejoins that since the LVS class is over-recovering its costs at present rates, the cost of the discounts to be re-allocated to the other classes are significantly less than the $5.6 million recommended by the OCA. (OSBA R.Exc at 8).

4. Disposition

PPL Gas' allocation reasonably and appropriately calculates the difference between the system average rate and the amount of discounted revenues. ALJ Jones correctly concluded that, "[t]o propose allocation based on a rate that is beyond what the utility is entitled to would necessarily overstate the cost of retaining these identified customers. The OCA's proposal would thus, unnecessarily overstate the cost of retaining the discount Rate L customers which is not appropriate." (R.D. at 81-82). The OCA's Exception on this issue is denied.

I. Modification to Reflect Uncollectible Accounts Expense as a Volumetric Cost Instead of a Customer Cost

1. Positions of the Parties

PPL Gas allocated 100 percent of the uncollectible accounts expense claim to the customer cost function stating that the expense is more closely related to the number of customers rather than the volume of sales. (See PPL Gas Exh. PRH-1 Sch. E at II-8).

The OTS proposed that the uncollectible accounts expense be allocated as a commodity cost based on the volume of sales rather than a customer cost. (OTS St. 3 at 2-6; OTS MB at 55-59; OTS RB at 40-42). The OTS posited that because the Company receives over 91 percent of its revenue from volumetric sales, it is appropriate to allocate over 91 percent of the uncollectible accounts expense to the volumetric cost function. (*Id.*).

2. ALJ's Recommendation

The ALJ found PPL Gas' argument supporting the allocation of 100 percent of the uncollectible accounts expense claim to the customer cost function to be reasonable. (R.D. at 82-83). The ALJ determined that the OTS' modification to amend the uncollectible accounts expense to a volumetric cost to be unreasonable and recommended that it be denied.

3. Exceptions

The OTS excepts to the ALJ's recommendation and argues that its proposal addresses the proper allocation of the expense within a class rather than between transportation and usage customers. (OTS Exc. at 11). According to the OTS, the ALJ erroneously accepted the Company's mischaracterization of the issue as a comparison of received revenues between transportation and sales customers. (*Id.*). The OTS states that the adjustment is not dependent upon whether the customer is a sales or transportation customer, it simply allocates uncollectible expense to the function or "cause" of the uncollectible expense. (*Id.*).

PPL Gas rejoins that there is no direct relationship between volumes and uncollectible accounts. (PPL Gas R.Exc. at 24). The Company argues that a volumetric allocation ignores the fact that there are different levels of revenues for different classes of service. For example, revenues from a sales customer for 100 Dth of natural gas are much greater than revenues from a transportation customer for 100 Dth of gas, because a transportation customer is not paying for the cost of gas purchased by PPL Gas to meet its customers' requirements. (PPL R.Exc. at 24; OSBA St. 1 at 21). The Company acknowledges that uncollectible accounts, clearly, are affected by customer failures to pay their bills and notes that it modified its COSS in a manner that treats a portion of the expense as volumetric in nature. (PPL Gas R.Exc. at 24; PPL Gas St. 8-R at 5).

4. Disposition

We are persuaded by the Company's argument that there is not a direct relationship between sales volumes and uncollectible accounts being cognizant of the different revenue levels earned from different customer classes. The OTS, in arriving at its proposal that uncollectible accounts expense should be allocated to the volumetric cost function failed to provide evidence of record showing that it considered and applied factors such as differing class revenue levels to arrive at its 91 percent figure. We will, therefore, deny the OTS' Exception on this issue.

2. Allocation of Revenue Requirement

The tables presented below summarize PPL Gas' present and proposed rates. (PPL Gas Exh. PRH-1R Schs. B (present rates) & C (proposed rates)).[27]

Present Rates

Rate	System	Res.	GS-S	GS-L	LVS	Storage
Actual	5.63%	4.03%	8.09%	5.85%	6.23%	6.57%
Relative	100%	72%	144%	104%	111%	117%

[27] Under PPL Gas' proposed rates allocation the only class that has not moved closer to the system average is LVS because that class is subject to competitive restraints. (PPL Gas MB at 91).

Proposed Rates

Rate	System	Res.	GS-S	GS-L	LVS	Storage
Actual	9.35%	9.33%	11.85%	8.47%	7.76%	9.06%
Relative	100%	99%	125%	90%	82%	96%

As discussed in our COSS discussion above, the OCA and the OSBA each proffered their own COSS alternatives and allocation modifications which we have denied as being unreasonable and not in the public interest. The revenue requirement allocations presented by PPL Gas are based upon its COSS which we shall approve as being reasonable and appropriate. The relative return for the proposed rates comports with the Commission's policy of gradualism and provides the magnitude of change in the correct direction for the appropriate rate classes. (R.D. at 85). The margins between the proposed rate of return for each rate class relative to the system average proposed by PPL Gas are getting smaller; thus showing that all rate classes are approaching the system average rate of return. (*Id.*).

The discussion below considers the proposals by the OSBA and the OTS if the Company's COSS is recommended. These proposals are based on the potential of rejecting the full increase proposed by PPL Gas in additional annual revenues.[28]

a. OSBA's Proposed First Dollar Relief for Small Business Customers

[28] The proposed revenue allocations of the OCA and of the OSBA are rejected because they are based on the modifications to the Company's COSS advocated by these Parties which we have denied. The alternative revenue requirement allocation proposed by the OTS providing the first $882,415 be used to reduce usage rates for the GS-S customer class, where that class includes Resale customers is contingent upon a grant of the full rate increase requested and, therefore, is rejected.

1. Positions of the Parties

Premised upon the approval of PPL Gas' COSS, the OSBA proposed that a first-dollar relief (FDR) approach be used to reduce the subsidy provided by the GS-S class. OSBA explained how it formulated its FDR proposal:

> Mr. Knecht calculated the first dollar relief for the GSSmall class so that the subsidy provided by that class is reduced and the class is on a par with the other classes. Specifically, Mr. Knecht reduced the subsidy from the GS-Small class to the level of the subsidy provided to the class with the second highest revenue cost ratio under PPL proposed rates. In this case, that class is the residential class. To bring the GS-Small class in line with the residential class requires assigning the first $1.49 million which the Commission trims from PPL's proposed rate increase as an offset to PPL's proposed increase to the GS-Small class.

(OSBA MB at 23; Exh. RDK-R1; OSBA St. 2 at 4; Exh. RDK-R1).

The OTS also proposed using the FDR method for allocating revenue. The OTS recommended that the first $882,415 of any Commission decrease from the full requested amount be used to reduce the three Small Service – General Service, and Resale class usage rates and that any further required scale back be in proportion to the ratios in the Company's filing. (OTS RB at 36; OTS MB at 54; OTS St. 3 at 12-13). OTS opined that its recommendation is a more balanced approach to moving the rate of return for the GS class closer, but not immediately, to the system average rate of return under PPL Gas' COSS. (OTS RB at 38-39).

2. ALJ's Recommendation

The ALJ determined that PPL Gas' revenue requirement allocation is unreasonable because it results in discriminatory rates. The ALJ rejected the Company's argument that the allocation was justified by the principle of gradualism. (R.D. at 88). The ALJ further determined that neither the OTS' proposed allocation for revenue requirement if the revenue increase is less than $11.9 million, nor PPL Gas' allocation of revenue requirement comply with the mandates directed by the Commonwealth Court in *Lloyd*. The ALJ found that the sole proposed revenue requirement allocation supported by the record and conforming to the applicable case law is the FDR of $1.49 million proposed by the OSBA. (*Id.*).

3. Exceptions

The OCA submits that the ALJ erred in concluding that *Lloyd* dictates that gradualism cannot be considered in establishing rates. (OCA Exc. at 34). The OCA argues the Commonwealth Court decision in *Lloyd* does not require that rates be set precisely so that all customer classes provide the system average rate of return as shown by one cost of service study. (*Id.*). The OCA further argues that a proportional scale back is a more reasonable method to reflect any reduction in the claimed revenue requirement and it ensures that all customer classes are provided some relief from the Company's full request if the Commission determines that less than the full request should be awarded. (OCA Exc. at 35).[29]

PPLUG approves of the ALJ's adoption of the Company's COSS but argues that Commission precedent supports the proportional scale back methodology proposed by the OCA. (PPLUG R.Exc. at 6).

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[29] The OCA states that the ALJ appears to have adopted the Company's allocation at the full rate increase amount since it forms the basis of the OSBA FDR proposal. (OCA Exc. at 36). The ALJ clearly states that it does not adopt the full increase as proposed by PPL Gas. (R.D. at 85).

The OSBA replies that the OCA fails to recognize that, at present rates, the GS-Small class exhibits the highest rate of return of any rate class, meaning that the GS-Small class is subsidizing the other rate classes. (OSBA R.Exc. at 13). The OSBA posits that, here, as in *Lloyd*, it is wrong to assert that assigning an above average increase to a rate class that is already a net provider of a subsidy will achieve cost-based rates. *(Id.)*.

PPL Gas submits that by adopting the OSBA's proposal for the First Dollar Relief method of allocating PPL Gas' overall revenue requirement, the ALJ moved all rate classes, particularly the General Service – Small class, toward their cost of service provided. (PPL Gas R.Exc at 25). The Company opines that the ALJ properly recognized the cost of providing service, in a manner consistent with *Lloyd*. (*Id.*; OSBA Exh. RDK-R1; OSBA St. 2 at 2-8).

4. Disposition

With regard to the OCA's claim that the ALJ concluded that *Lloyd* dictates that gradualism cannot be considered in establishing rates, we must clarify that the ALJ did not make this statement. The ALJ stated that, "[t]he contentions presented by OSBA to reject the Company's rationale of gradualism as progress toward the cost of service relative to the GS-S class are inconsistent with the holding in *Lloyd,* violates the Commission statute in discriminatory rates because the Company gives no other justification for the difference in rates." (R.D. at 88). This statement is in accord with the Commonwealth Court's holding that the cost of providing service is the polestar of ratemaking which trumps other concerns such as gradualism or rate shock. *Lloyd v. Pa. PUC*, 904 A.2d 1010, 1020.

We disagree with the OCA's argument that there is no sound basis to deviate from a proportional scale back if the rate increase is less than the Company has requested. GS-Small is the only class with a rate of return above the system average at both present and proposed rates. A straight scale back, as proposed by the OCA, would perpetuate the problem of over-recovery from GS-Small customers and would actually move the GS-Small class farther away from its cost of service, since that was the result of PPL's original proposal. It is important to note that application of the FDR does not mean that GS-Small will avoid a rate increase entirely. GS-Small will still experience an increase; however, it will concurrently move closer to its cost of service. It is also important to note that the FDR method cannot cause rates for any customer class to be higher than those proposed by the utility. (R.D. at 86-87; OSBA St. 2 at 3). We find that the FDR proposed by the OSBA is supported by the record evidence and is a reasonable method of progressing toward cost-based rates. Accordingly, the OCA's Exception on this issue is denied.

3. Residential Customer Charge

a. Positions of the Parties

PPL Gas proposed a 23.8% increase in its residential customer charge from the current $10.50 per month to $13.00 per month. (PPL Gas Exh. CPW-4 at 3). The Company provides a calculation demonstrating the residential customer costs to provide service is $19.73 per month, more than the $13.00 requested. (PPL Gas Exh. PRH-1R, Sch. J).

The OCA argued that the Commission precedent has stated that the residential customer charge is to be limited to those costs which directly relate to the meter and service drop and customer service expenses associated with meter reading and billing. (OCA MB at 120). The OCA argued for a customer charge of $12.00, based on the customer cost analysis performed by its witness Mr. Watkins, which was based on direct customer costs, i.e., those that vary directly with customer connections. (OCA MB at 121-122; OCA RB at 48). The OCA stated that if the Company receives a revenue increase less than its full claim, the customer charge increase should be scaled back proportionately. (OCA RB at 50).

b. ALJ's Recommendation

The ALJ determined that the evidence presented by the OCA was persuasive and recommended approval of the OCA's modification to implement a residential customer charge of $12.00. (R.D. at 91).

c. Exceptions

PPL Gas states that its proposal is based upon an analysis of customer cost which is consistent with recent prior orders of the Commission and that residential customer costs per month are $19.73. (PPL Gas Exc. at 30). The Company argues that its proposal that the residential customer charge be increased to $13.00 per month encompasses the principle of gradualism, while also recognizing the cost of service. (*Id.*). PPL Gas claims that the OCA attempted to justify its residential customer cost analysis based upon Commission precedent that is outdated. (PPL Gas Exc. at 29).

The OCA submits that the $12.00 customer charge it has proposed serves the interests of both energy conservation and gradualism, as well as being cost based. (OCA R.Exc. at 15-19). The OCA opined that that a smaller increase in the current customer charge is appropriate because high fixed monthly charges such as the Customer Charge are inconsistent with the Commission's general goal of fostering energy conservation in that the more money collected in high fixed charges, the lower the volumetric (per ccf or mcf) charge, thus affecting the conservation decision. (OCA R.Exc. at 19).

PPL Gas rejoins that the OCA is erroneous in its claim that the sharing mechanism addresses only the amount of off-system sales to be flowed back to customers and that the mechanism has no impact on how revenues are derived or how revenues are reflected in rates. (PPL Gas R. Exc. at 23). The Company states that the sharing mechanism *specifically contains a formula for determining the amount of revenues from* off-system sales to be flowed back to customers, and the mechanism requires that such revenues be reflected as a reduction to purchased gas costs. (*Id.*; PPL Gas Exh. CPW-1 at 8.1).

d. Disposition

OCA witness, Mr. Watkins, performed a residential customer cost analysis based only on direct customer costs (those costs that vary directly with customer connections). Based on his analysis, Mr. Watkins determined that the direct customer cost revenue requirement is $12.12 per month. (OCA MB at 121; OCA St. 3 at 21; Sch. GAW-7). After conducting his analysis, Mr. Watkins recommended a customer charge increase from $10.50 to $12.00. (OCA St. 3 at 22). We find that the OCA's proposal is supported by record evidence, supports the public policy of gradualism, and is less likely to erode conservation by customers. As such, we will deny PPL Gas' Exception on this issue.

4. Declining Rate Blocks for Residential Service

a. Positions of the Parties

The structure of the distribution charge for Residential customers of PPL Gas is a declining rate block structure (the first block applying to the first 5 Dth of gas use and the second block applying to greater than 5 Dth of gas use). (R.D. at 91; PPL Gas Exh. CPW-2 at 17). PPL Gas proposed increasing the commodity charges in each block by 25.2%. (PPL Gas Exh. CPW-4 at 3).

The OCA proposed narrowing the differential in this declining block structure over time contending: "(1) the rate structure shifts an appropriate level of risk to ratepayers and away from shareholders, as the majority of residential revenue is collected in the customer charges and [the] first usage block; (2) the rate structure promotes additional consumption of gas and is at odds with conservation efforts; and (3) PPL [Gas'] declining block distribution usage charge is at odds with cost causation and sends a price signal to consumers to use more gas at all times, including peak periods." (R.D. at 91; OCA MB at 122 citing OCA St. 3 at 22-23).

The OCA recommended starting a transition to gradually reduce the differential in the declining block beginning with this proceeding. (R.D. at 91). The OCA specifically recommended that the difference between the first and second usage rate blocks should be reduced from 40 percent to 25 percent with further reductions made in PPL Gas' next base rate case. (OCA MB at 122; OCA St. 3 at 24). Stated differently, the first 5 Dth usage rate would be increased to just 10.8 percent while the usage rate for greater than 5 Dth (the second usage rate block) would be increased to 38.8 percent. (OCA RB at 50-51). The non-uniformity in the rate increases proposed by the OCA reduces the difference in the usage rates of the two rate blocks from 40 percent to 25 percent. This alters the Company's proposal which was to increase both blocks uniformly by 25.2 percent. (R.D. at 92).

b. ALJ's Recommendation

The ALJ recommended that OCA's rate design regarding the declining rate blocks for customer usage of gas should be rejected as unreasonable. ALJ Jones stated that the reasons provided by the OCA for changing PPL Gas' proposed 25.2 percent increase for each rate block were based in conservation. (R.D. at 92). The ALJ accepted PPL Gas' argument that costs are to be the basis of rate design not conservation. (*Id.*).

The ALJ determined that PPL Gas' suggestion that conservation of the gas commodity procedures can be evaluated at a 66 Pa. C.S. § 1307(f) proceeding was reasonable. As such, the ALJ found that PPL Gas' proposal of a 25.5 percent increase uniformly to both rate blocks for customer usage is supported by the evidence and reasonable. (R.D. at 93).

c. Disposition

No exceptions have been filed to this determination. Finding the ALJ's recommendation to be reasonable, appropriate and in accordance with the record evidence, it is adopted.

H. Miscellaneous

1. PPL Gas Changes to Tariff

a. Positions of the Parties

PPL Gas proposed several changes to the rules and regulations sections of its tariff, and their witness, Mr. Charles P. Weekes, summarized these changes as follows:

> The proposed changes [to the Description of the Company's Territory] were made to correct spelling mistakes and to remove "Unincorporated Communities" that are not defined political boundaries. Townships and Boroughs were not changed and those designations fully define the Company's territory. These changes in the Description of Territory did not affect, in any way, the territory actually served by the Company.
>
> Rule 2.6 was changed to include Rate Schedules CAP 1 and CAP 2.
>
> Rule 2.9 was changed to include Rate Schedules CAP 1 and CAP 2.

Rule 3.8 was changed to remove the paragraph that defines how deposit interest is calculated for residential customers. Chapter 14 of the Public Utility Code now mandates the method of calculating deposit interest for residential customers. In addition, deposits by non-residential customers was changed from "customers" to "accounts" because a single customer may have multiple accounts that could have different refund dates established for a refund of their deposit and deposit interest.

Rule 4.2 was changed to clarify the wording of the Rule. Specifically, the word "put in" was replaced with "installed" regarding the reference to installation of meter connections.

Rule 4.3 was changed to clarify that a customer may not install barriers that inhibit access to Company equipment.

Rule 9.1 was changed to state that billing will begin once the meter is set.

Rule 9.3 was changed to differentiate the calculation for a single residential construction from the calculation for a residential development. Also, a change was made in the calculation of the Company's funding for new facilities in residential developments and for non-residential customers.

Rule 9.6 was changed to clarify when a customer may receive a refund for all or a portion of an advance for construction. Also, the refund period was changed from 5 years to 3 years.

Rule 11.1 was changed to include the use of procedures set forth in Chapter 14 of the Public Utility Code when pursuing collections of outstanding residential delinquent accounts.

Rule 15.1 was changed to add "Chapter 14" to the list of Common Natural Gas Competition Terms.

(Citing PPL Gas St. 4 at 10-13; PPL Gas Exhs. CPW-1 and CPW-2).

No Party opposed or disputed these tariff changes as unreasonable or inappropriate. (R.D. at 93).

b. ALJ's Recommendation

The ALJ recommended that the Commission approve the proposed changes to the PPL Gas tariff rules and regulations section as they were uncontested by any of the Parties in this proceeding. (R.D. at 93).

c. Disposition

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

2. OCA Proposed Maintenance of Records for Discounted Rates

a. Positions of the Parties

PPL Gas provides discounted rates to LVS customers based on the customer's (1) potential to bypass; (2) threat of switching to an alternative supplier; (3) significance to the local economy; and (4) multiple sites to vie for competitive suppliers. (PPL Gas St. 5R at 3). During this proceeding, it was revealed that the Company could not provide documentation to support the discounted rates it had awarded. The OCA's witness, Mr. Watkins, contended that without supportive documentation for the discounts it is impossible to analyze and evaluate whether the discounts are appropriate and effective at the levels awarded to retain customer or whether the levels can be adjusted. (OCA St. 3 at 14-15). As such, the OCA submitted that the following recommendation by Mr. Watkins be adopted:

> PPL [Gas] should be required to maintain current records supporting any discounted rate. Moreover, these records should include a detailed analysis of not only alternative burner tip fuel prices but any storage capacity, or emissions

> constraints imposed on the customer. For those customers that claim to have the ability to bypass the PPL [Gas] system a cost analysis supporting this claim should be required. Finally, PPL [Gas] should be required to update these studies and records at least annually.

(OCA MB at 124 *citing* OCA St. 3 at 17).

The OCA reasoned that the recommendation provides the Company and the Commission with the appropriate documentation to affirm and ensure the rates and discounts for LVS customers are reasonable. (OCA MB at 124).

No Party opposed or disputed the OCA recommendation regarding documenting LVS customer discounts. (R.D. at 94).

b. ALJ's Recommendation

The ALJ found the OCA's recommendation regarding maintenance of records documenting support for LVS customer discounts to be reasonable. Noting that it was uncontested by any Party, the ALJ recommended that the Commission direct PPL Gas to keep and maintain records supporting the discounts to LVS customers, consistent with the OCA's recommendation, and that the records associated with the documentation be updated on an annual basis. (R.D. at 94).

c. Disposition

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

III. CONCLUSION

For the reasons discussed above, we will adopt the Recommended Decision of Administrative Law Judge Angela T. Jones as modified by, and consistent with the foregoing Opinion and Order; **THEREFORE,**

IT IS ORDERED:

1. That the Exceptions of the Parties are granted or denied, consistent with this Opinion and Order.

2. That PPL Gas Utilities Corporation shall not place into effect the rates contained in Supplement No. 11 to Tariff – Gas Pa. P.U.C. No. 3, which have been found to be unjust and unreasonable and therefore, unlawful.

3. That PPL Gas Utilities Corporation is hereby authorized to file tariffs, tariff supplements, or tariff revisions containing proposed rates, rules and regulations, consistent with the findings herein, to produce a revenue increase not in excess of $8,142,000.

4. That PPL Gas Utilities Corporation's tariffs, tariff supplements, or tariff revisions described in Ordering Paragraph No. 3 may be filed upon less than statutory notice, pursuant to the provisions of 52 Pa. Code §§ 53.31 and 53.101, and may be filed to be effective for service rendered on and after the date of entry of this Opinion and Order.

5. That PPL Gas Utilities Corporation shall file detailed calculations with its compliance filings, which shall demonstrate to this Commission's satisfaction that the filed tariffs and adjustments comply with the provisions of this Opinion and Order. The filing shall include a redlined version of the tariff indicating where changes have been made.

6. That PPL Gas Utilities Corporation shall allocate the authorized increase in operating revenues to each customer class and rate schedule within each class pursuant to and in the manner set forth in this Opinion and Order.

7. That the Commission's Bureau of Audits is directed to review, in conjunction with PPL Gas' next Purchased Gas Cost Rate audit, PPL Gas' accounting for the funds collected through rates and those recovered through insurance, that are to be used for environmental clean-up as well as all previous and planned expenditures associated with all projects included within this activity. The findings of the Bureau of Audits shall be included within PPL Gas' next base rate case filing.

8. That the Commission's Bureau of Audits is directed to review, in conjunction with PPL Gas' next Purchased Gas Cost Rate audit, the activity within Account 330, Producing Gas Wells – Well Construction. The findings of the Bureau of Audits shall be included within PPL Gas' next base rate case filing.

9. That within 6 months from the entry date of this Opinion and Order, or with the filing of its next base rate proceeding, whichever occurs first, PPL Gas Utilities Corporation shall file a proposed low income usage reduction program, including a mechanism for funding, with the Commission for review and approval, and shall serve a copy of the filing upon the Parties to this proceeding.

10. That upon entry of this Opinion and Order, PPL Gas Utilities Corporation is directed to keep and maintain records supporting the discounted rates to Rate LVS customers consistent with the recommendation of the Office of Consumer Advocate and to update any studies and records associated with this documentation on an annual basis.

11. That PPL Gas Utilities Corporation shall comply with all directives, conclusions and recommendations contained in the body of this Opinion and Order, which are not the subject of any individual directive in these ordering paragraphs, as fully as if they were the subject of a specific ordering paragraph.

12. That the formal Complaints filed by Ms. Mary Gummo at Docket No. R-00061398C0003 and Mr. Michael Blake at Docket No. R-00061398C0004 are dismissed consistent with this Opinion and Order.

13. That the Complaints filed by the Office of Small Business Advocate at Docket No. R-00061398C0001 and the Office of Consumer Advocate at Docket No. R-00061398C0002 are sustained in part and dismissed in part, consistent with this Opinion and Order.

14. That after acceptance and approval by the Commission of the tariff revisions filed by PPL Gas Utilities Corporation, the investigation at Docket No. R-00061398 shall be terminated and the record shall be marked closed.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: February 8, 2007

ORDER ENTERED:

FEB 08 2007

TABLES

TABLE I
PPL Gas Utilities Corporation
INCOME SUMMARY
R-00061398
(000)

	Pro Forma Present Rates (1)	Company Adjustments (1)	Pro Forma Present Rates (Revised) (1)	**Commission** Adjustments	Pro Forma Present Rates	Revenue Increase	Total Allowable Revenues
	$	$	$	$	$	$	$
Operating Revenue	207,866	169	208,035	0	208,035	8,142	216,177
Expenses:							
O & M Expense	186,952	(26)	186,926	(1,212)	185,714	0	185,714
Depreciation	6,876		6,876	0	6,876	0	6,876
Taxes, Other	1,592		1,592	(76)	1,516	0	1,516
Income Taxes:							
State	307	20	327	88	415	813	1,228
Federal	1,608	61	1,669	276	1,945	2,565	4,510
Deferred	(57)		(57)		(57)	0	(57)
ITC	(64)		(64)		(64)	0	(64)
Total Expenses	197,214	55	197,269	(924)	196,345	3,378	199,723
Inc. Available for Return	10,652	114	10,766	924	11,690	4,764	16,454
Rate Base	194,566	0	194,566	151	194,717		194,717
Rate of Return	5.47%		5.53%		6.00%		8.45%

(1) Company Main Brief

TABLE I(A)
PPL Gas Utilities Corporation
RATE OF RETURN
R-00061398

	Structure	Cost	After-Tax Weighted Cost	Effective Tax Rate Complement	Pre-Tax Weighted Cost Rate
Total Cost of Debt			3.06%		
Long-term Debt	48.21%	6.35%	3.06%		3.06%
Short-term Debt	0.00%	0.00%	0.00%		
Preferred Stock	0.00%	0.00%	0.00%	0.585065	0.00%
Common Equity	51.79%	**10.40%**	5.39%	0.585065	9.21%
	100.00%		8.45%		12.27%
Pre-Tax Interest Coverage	4.01				
After-Tax Interest Coverage	2.76				

TABLE I(B)
PPL Gas Utilities Corporation
REVENUE FACTOR
R-00061398

100%	1.00000000
Less:	
Uncollectible Accounts Factor	0.00000000
PUC, OCA, OSBA Assessment Factors	0.00000000
Gross Receipts Tax	0.00000000
Other Tax Factors	0.00000000
	1.00000000
State Income Tax Rate	0.09990000
Effective State Income Tax Rate	0.09990000
Factor After Local and State Taxes	0.90010000
Federal Income Tax Rate	0.35000000
Effective Federal Income Tax Rate	0.31503500
Revenue Factor (100% - Effective Tax Rates)	0.58506500

TABLE II
PPL Gas Utilities Corporation
SUMMARY OF COMMISSION ADJUSTMENTS
R-00061398
(000)

Adjustments	Rate Base	Revenues	Expenses	Depreciation	Taxes-Other	State Income Tax	Federal Income Tax
	$	$	$	$	$	$	$
RATE BASE:							
CWC:							
Int. & Div. (Table IV)	6						
Taxes (Table V)	166						
O & M (Table VI)	(21)						
Dep. Reserve/Acct. 330	0						
EXPENSES:							
Variable Pay			0			0	0
Environmental Remediation			(705)			70	222
Rate Case			(188)			19	59
Customer Records			(99)			10	31
Uncollectible Accounts			(220)			22	69
TAXES:							
Capital Stock					(76)	8	24
Interest Synchronization (Table III)						(41)	(129)
TOTALS	151	0	(1,212)	0	(76)	88	276

TABLE III
PPL Gas Utilities Corporation
INTEREST SYNCHRONIZATION
R-00061398
(000)

	Amount $
Company Rate Base Claim	194,566
Commission Rate Base Adjustments	151
Commission Rate Base	194,717
Weighted Cost of Debt	3.06%
Commission Interest Expense	5,958
Company Claim (1)	5,550
Total Commission Adjustment	(408)
Company Adjustment	0
Net Commission Interest Adjustment	(408)
State Income Tax Rate	9.99%
State Income Tax Adjustment	(41)
Net Commission Interest Adjustment	(408)
State Income Tax Adjustment	(41)
Net Commission Adjustment for F.I.T.	(367)
Federal Income Tax Rate	35.00%
Federal Income Tax Adjustment	(129)

(1) Company Exhibit Future I, Revised

TABLE IV
PPL Gas Utilities Corporation
CASH WORKING CAPITAL - Interest and Dividends
R-00061398
(000)

Accrued Interest	Long-Term Debt	Short-Term Debt	Preferred Stock Dividends	
Company Rate Base Claim	$194,566	$194,566	Company Rate Base Claim	$194,566
Commission Rate Base Adjs.	$151	$151	Commission Rate Base Adjs.	$151
Commission Rate Base	$194,717	$194,717	Commission Rate Base	$194,717
Weighted Cost of Debt	3.06%	0.00%	Weighted Cost Pref. Stock	0.00%
Comm. Annual Interest Exp.	$5,958	$0	Comm. Preferred Dividends	$0
Average Revenue Lag Days	45.3 (1)	0.0	Average Revenue Lag Days	0.0
Average Expense Lag Days	37.8 (1)	0.0	Average Expense Lag Days	0.0
Net Lag Days	7.5	0.0	Net Lag Days	0.0
Working Capital Adjustment				
Comm. Daily Interest Exp.	$16	$0	Comm. Daily Dividends	$0
Net Lag Days	7.5	0.0	Net Lag Days	0.0
Commission Working Capital	$120	$0		$0
Company Claim (1)	$114	$0	Company Claim (1)	$0
Commission Adjustment	$6	$0		$0
Total Interest & Dividend Adj.	$6			

(1) Company Exhibit Future 1, Revised, C-5, p. 4-5

TABLE V
PPL Gas Utilities Corporation
CASH WORKING CAPITAL -TAXES
R-00061398
(000)

Description	Company Proforma Tax Expense Present Rates	Commission Adjustments	Commission Pro forma Tax Expense Present Rates	Commission Allowance	Acommission Adjusted Taxes at Present Rates	12-Month Accrued Factor (1)	Accrued Tax Adjustment
Prepayments							$106
Public Utility Realty	$129	$0	$129		$129	17.29%	$22
Capital Stock Tax	$382	($76)	$306		$306	-7.71%	($24)
State Income Tax	$327	$88	$415	$813	$1,228	-7.71%	($95)
Federal Income Tax	$1,669	$276	$1,945	$2,565	$4,510	-9.80%	($442)
	$2,507	$288	$2,795	$3,378	$6,173		($433)

Commission Allowance	(433)
Company Claim (1)	(599)
Comm. Adjustment	166

(1) Company Exhibit Future I, Revised, C-5, p. 4

TABLE VI
PPL Gas Utilities Corporation
CASH WORKING CAPITAL -- O & M EXPENSE
R-00061398
($000)

Description	Company Pro forma F.T.Y. Expense	Commission	Commission Pro forma Expenses
Net Operation and Maintenance	$183,700 (2)	($992)	$182,708

Comm. Average Revenue Lag	47.84 (1)	
Less: Comm. Avg. Expense Lag	37.55 (1)	
Net Difference	10.29	Days
Commission Pro forma O & M Expense per Day	$501	
Comm. CWC for O & M	$5,155	
Less: Company Claim (1)	$5,176	
Commission Adjustment	($21)	

(1) Company Exhibit Future 1, Revised, C-5, p. 2
(2) $186,926 less non cash items, Co. Future 1 Revised, C-5, p. 2

TABLE VII
PPL Gas Utilities Corporation
Projected Environmental Remediation Expenses 2007-2011
Future Test Year December 31, 2006
($000)

	Company Claim (a)	Commission Adjustment (b)
Projected Environmental Remediation Expenses		
2007	2,965	2,426
2008	3,054	2,484
2009	3,146	2,544
2010	3,240	2,605
2011	3,338	2,667
	-----------	----------
Total	15,743	12,726
Excess Expenses	1,466	956
	-----------	-----------
Total	17,209	13,682
Amount recovered through rates	12,274	12,274
	-----------	-----------
Total	4,935	1,408
Normalized Amount	987	282
Commission Adjustment		**(705)**

(a) Based on 2006 claim of $2,879 escalated 3% annually.
(b) Based on 2006 claim of $2,369 per OTS escalated 2.4% annually.

1994 Pa. PUC LEXIS 120

Pennsylvania Public Utility Commission

July 26, 1994

R-00932670; R-00932670C0001; R-00932670C0002; R-00932670C0003; R-00932670C0004; R-00932670C0005; R-00932670C0006; R-00932670C0007; R-00932670C0008; G-00940374

Reporter
1994 Pa. PUC LEXIS 120 *

Pennsylvania Public Utility Commission; Office of Consumer Advocate; Louise Bernick; Armco Advanced Materials Company; Office of Small Business Advocate; Terry Beane; Pennsylvania-American Water Large User Group; Ronald A. Codding; Mark E. Bartas v. Pennsylvania-American Water Company Affiliated Interest Agreement between Pennsylvania American Water Company and American Water Works Service Company, Inc.

Core Terms

recommend, customer, lag, depreciate, lease, calculate, growth rate, rate base, dividend, water company, reply, service company, public utilities commission, plant, original cost, retirement, salvage, barometer, revise, software, stock, accrued, ratemaking, estimate, meter, pension, capital cost, annual, ratio, amortize

Panel: Commissioners Present: David W. Rolka, Chairman, Concurring & Dissenting in part; Joseph Rhodes, Jr., Vice-Chairman; John M. Quain, Concurring & Dissenting in part; Lisa Crutchfield, Concurring & Dissenting in part; John Hanger

Opinion

OPINION AND ORDER

I. HISTORY OF THE PROCEEDINGS

On October 28, 1993, Pennsylvania-American Water Company ("PAWC" or "Company" hereafter) filed with the Commission its Tariff Water - Pa. P.U.C. No. 2 (Tariff No. 2) to be effective December 27, 1993. Tariff No. 2 provided for additional annual revenues of $ 11,063,361 over existing rates, or approximately a 6.65% increase over existing rates, [1] based on the level of operations for a future test year ending June 30, 1994. Tariff No. 2 was suspended by operation of law by order of this Commission entered on December 6, 1993, until July 27, 1994. The matter was, thereupon, assigned to the Office of Administrative Law Judge, per Ky Van Nguyen, for hearings and the issuance of a Recommended Decision.

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[1] The Company's original proposed increase was $ 11,363,030, or 6.84% (PAWC Ex. 3-A, p. 1). During the rebuttal phase of the case, the utility made various revisions to its rate base, revenues, expenses and taxes that reduced its proposed increase to $ 11,236,514 or 7.76% (PAWC Ex. 3-A Revised, p. 1; PAWC Ex. 3-B). Appendix B to Pennsylvania American Water Company's Initial Brief incorporates additional revisions, as summarized on Table II of the Appendix, which finally reduce its proposed increase to $ 11,063,361.

[*2]

Eight formal complaints were filed against the proposed increase. Customers who primarily complained about the rate structure and cost of service are Armco Advanced Materials Company (R-00932670C0003) and the Pennsylvania-American Large Water Users Group (R-00932670C0006) (American Home Foods, Hershey Foods Corporation and the USX Corporation - U.S. Steel Group). Active participants included the Commission's Office of Trial Staff ("OTS"), the Office of Consumer Advocate ("OCA") (R-00932670C0001), and the Office of Small Business Advocate ("OSBA") (R-00932670C0004).

A prehearing conference was held in Harrisburg on December 21, 1993. A prehearing order was issued to establish a schedule for the investigation and the conduct of discovery and briefing. Nine days of technical evidentiary hearings were held in Harrisburg and Philadelphia. Six public input hearings were held in Uniontown, Liberty Borough, Clarks Summit, Norristown, Lemoyne, and Norristown. The public input hearing in Pittsburgh, scheduled for March 9, 1994, was cancelled due to inclement weather.

The record adduced over nine-hundred (900) pages of transcribed notes of testimony and numerous exhibits. PAWC presented **[*3]** 14 witnesses who submitted 22 written statements and 43 exhibits.

Further, the parties explored the possibility of settlement, consistent with *52 Pa. Code §§ 5.231*; 5.232. The parties managed to achieve a stipulation with respect to most issues concerning the appropriate rate structure for PAWC, the lone exception being the question of an increase in customer charges for 5/8" and 3/4" meters. Also, a stipulation was reached with regard to the treatment of Post Retirement Benefits Other Than Pensions ("OPEBs").

On June 7, 1994, presiding Administrative Law Judge ("ALJ") Ky Van Nguyen issued the Recommended Decision ("R.D.") in this matter. The presiding ALJ, after the close of the record and consideration of the briefs and reply briefs of the parties, concluded that PAWC had demonstrated the need for $ 170,881,599 for its total annual operating revenues, or an increase of $ 4,585,433 (41.4% of the originally requested increase). See R.D., p. 109.

Exceptions and Replies were filed by the Company, the OCA, and the OTS.

On review of the R.D., the Exceptions and Replies to Exceptions, we conclude that the record herein demonstrates that PAWC has shown a need for an increase **[*4]** over existing rates of $ 6.981 million.

II. THE COMPANY

Pennsylvania-American Water Company (as noted, PAWC or the Company) is a regulated Pennsylvania public utility. The Company renders water service to about 375,000 customers in a service territory covering more than 200 communities across the Commonwealth with a combined population of over 1,000,000. (PAWC Exh. 3-A Revised, p. 20; PAWC St. 1) PAWC was formed, with the approval of the Pennsylvania Public Utility Commission, by the merger of the former Pennsylvania-American Water Company with Western Pennsylvania Water Company (WPW) on January 31, 1989. (PAWC Exh. 1-A, p. 65). The former Western Pennsylvania Water Company was originally established in 1972 when 16 separate water companies in Western Pennsylvania were merged. The former Pennsylvania-American Water Company (PAWC) was initially formed in 1987, when Riverton Consolidated Water Company (Riverton) merged with Keystone Water Company (Keystone). Keystone itself was established in 1973 when 14 separate companies located in Eastern and Central Pennsylvania were merged. Similarly, Riverton was the combined derivative of many small independent water companies, all **[*5]** serving the area in the Harrisburg vicinity known as "The West Shore." Exhibit 3-C of the Company's filing contains a detailed corporate history, outlining all of the mergers, acquisitions and consolidations which have created PAWC as it is today.

PAWC utilizes various sources of water supply to meet its customers' requirements. In addition, the Company owns and operates water treatment facilities, distribution storage facilities, booster pumping stations, and transmission and distribution mains for furnishing water service to customers. Detailed descriptions of PAWC's scope of operations and of the facilities which it employs to provide water service are set forth in PAWC Statement 1 and PAWC Exhibit 1-A.

PAWC is a subsidiary of American Water Works Company, Inc. ("American"). Another subsidiary of American, the American Water Works Service Company, Inc. ("Service Company"), provides technical and administrative services to American's water utility subsidiaries. The Service Company provides various "in-house" technical and administrative services to PAWC at cost, such as engineering, water quality and risk management. (PAWC St. 4, pp. 33-36)

III. RATE BASE

The Company's **[*6]** filing is based on a future test year ending June 30, 1994. (PAWC Exh. 3-A Revised) PAWC's final rate base claim is for a depreciated original cost rate base of $ 523,967,525 for utility plant in service at June 30, 1994. (PAWC Main Brief, Appendix B) The Office of Trial Staff and the Office of Consumer Advocate proposed several adjustments which are discussed in the following sections.

A. Plant in Service Additions

To develop the future test year level of plant in service, the original cost of plant to be constructed or acquired during the twelve months ending June 30, 1994 was added to the original cost of plant recorded on the Company's books at June 30, 1993, and the original cost of plant to be retired during the twelve months ending June 30, 1994 was subtracted. (PAWC St. 3, pp. 5-7) The Company's final claim for the original cost of projected future test year plant additions and retirements, as set forth in PAWC Exhibit No. 1-C Revised, is as follows:

Additions	$ 59,866.600
Retirements	2,625,101
Net Increase in	
Plant In Service	[2] $ 57,241,499

[*7]

The OTS originally recommended adjustments to PAWC's future test year plant additions claim for projects which were either postponed ($ 393,000) or not started by October 31, 1993 ($ 5,957,066). (OTS St. 3, p. 14) However, from information provided by PAWC in the rebuttal stage, the OTS withdrew these adjustments to PAWC's claimed future test year plant additions. R.D., p. 4 citing OTS Main Brief.

Three issues originally contested by the OCA regarding the Company's future test year end measure of value claim were resolved through the course of discovery and litigation. First, PAWC adopted the OCA's adjustment which reduced PAWC's claimed value for Granular Activated Carbon (GAC) by $ 170,570 and decreased the Company's revenue requirement by $ 21,679. Second, the OCA proposed a disallowance of the $ 1.6 million future test year additions to an interconnection between the Hershey Treatment Plant and the recently acquired former Skyline Water Company, because the proposed addition would not be in service until months after the end of the future test year. Later, PAWC asserted that the interconnection would be in service by the end of the future test year and the OCA, therefore, **[*8]** withdrew its proposed adjustment. Third, the OCA and the Company agreed to a $ 434,336 reduction to PAWC's measure of value claim to reflect the removal of contractor retention balances from amounts on which an Allowance for Funds Used During Construction (AFUDC) was calculated. The reduction decreased PAWC's annual depreciation expense by $ 10,945. (OCA Main Brief, pp. 12-14)

The OCA also proposed two adjustments to the Hershey Data Center Management Information System furniture, equipment and software which would reduce the Company's rate base by $ 498,337. Of the $ 498,337 proposed adjustment, $ 238,849 is a portion of the original cost of a software license already recovered by Occoquan Land Corporation through capital lease payments, and $ 259,488 relates to the purchase of alleged, non used and

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[2] This figure includes customer advances for construction of $ 5,686,725 and contributions-in-aid-of-construction of $ 1.2 million. See PAWC Initial Brief, p. 7, n. 4.

useful assets. R.D., p. 5-6; OCA Main Brief, pp. 151-161. The two adjustments proposed to PAWC's rate base claim are discussed, below.

1. MIS Property

PAWC's claim for future-test-year plant additions included the depreciated original cost of $ 1,646,848 for the MIS property it acquired from Occoquan Land Corporation ("Occoquan"). Occoquan is a wholly-owned subsidiary of American **[*9]** engaged in the business of leasing property and equipment to the subsidiaries of American. PAWC's acquisition of the MIS property is subject to the Commission's approval under Section 2102(b) of the Public Utility Code, 66 Pa.C.S. § 2102(b). Consequently, on February 8, 1994, the Company filed a Request For Approval under 66 Pa.C.S. § 2102(b) ("Request For Approval") for the acquisition of the MIS property as well as the acquisition of the Hershey Office Building and associated building improvements and personal property. PAWC's Request For Approval was docketed by the Commission at No. G-00940374.

On February 22, 1994, the OCA filed a Notice of Intervention at Docket No. G-00940374. The OCA noted that it was intervening primarily to monitor the proceeding and that it intended to review the affiliated transactions and, in particular, their ratemaking implications in the context of the instant base rate proceeding.

On March 10, 1994, we entered an Order at Docket No. G-00940374 extending the time for consideration of the Company's Request For Approval and consolidating the request with the instant rate proceeding.

As noted, above, PAWC's claim for future test year plant additions **[*10]** included the depreciated original cost of $ 1,646,848 for Management Information System furniture, equipment and software (the "MIS Property"). That proposed price reflects the original cost of the assets, less accumulated depreciation through December 31, 1993, plus sales tax. <u>See</u> R.D., p. 7.

The OCA proposed two adjustments for ratemaking purposes to the Company's MIS property claim. First, the OCA proposed to reduce the Company's claim for the depreciated original cost of the MIS property by $ 238,849 based on the calculation of a hypothetical level of accrued depreciation. The OCA provided a detailed schedule by which it illustrated the amount recovered by Occoquan through the capital leasing arrangement, paid as part of bills rendered by Service Company. The payment of the capital lease was, argued by the OCA, achieved by way of ratepayer supplied funds. In deriving this schedule, the OCA sought to reduce the cost of MIS property reflected in rates, by an amount which the leasing arrangement exceeded the proposed purchased price. <u>See</u> OCA St. 2-R; OCA Exh. 2-R (RCS-3), Sch. 231 (Rev.).

Second, the OCA argued that the Company's rate base claim should be reduced **[*11]** further by $ 259,488 which, it asserted, related to the purchase of non used and useful assets of the remaining MIS property.

With regard to the first adjustment, namely the rejection of PAWC's depreciated original cost for the MIS property, the OCA argued that under normal circumstances, use of depreciated original cost as a measure of value is appropriate. However, under circumstances in which the utility is purchasing from an affiliate, it is important for the Commission to consider as well the value of the past stream of ratepayer-supplied funds which flowed to the seller, Occoquan. This occurred because all payments under the Occoquan MIS property leases were a part of the Service Company charges to the utilities, all the lease payments being the cost of service in the past.

As such, argued the OCA, if a purchase price is set in accord with the Service Company's per books depreciated cost, Occoquan will have recovered a portion of the original cost first through the lease payments and again through the proposed acquisition price. Ignoring the prior lease payments to Occoquan would create a windfall for the affiliate and an unfair burden on the ratepayers. In order to avoid **[*12]** this, the Commission should reduce the Company's future-test-year rate base claim of these assets by $ 238,849. The leases are structured so that Occoquan recovers the cost of the purchased assets over sixty months. Any additional assets purchased during a particular month are added to the list of leased assets, commencing the first day of the following month. A "lease rate" is calculated for each asset, based on the sixty-month recovery period and the prime rate, plus two hundred basis points (2%), at the time of the purchase of the assets.

For example, the amount of $ 352,000 for General Ledger Software was added to the MIS lease on January 1, 1989. Utilizing the sixty-month recovery period and an interest rate of 12.5%, the OCA arrived at the lease rate for the item at $ 22.49 per $ 1,000 of original cost, per month. For this particular item, the resulting increase in the monthly lease charges to the Service Company by Occoquan was $ 7,916.48 per month. R.D., p. 8.

The OCA calculated the total of all the lease payments on the Hershey Data Center furniture, equipment and software to be $ 2,257,176, from the commencement of the lease through December 31, 1993. In addition, **[*13]** the OCA calculated the portion of the amounts collected by Occoquan through the lease payments which reflect recovery by Occoquan of the original cost of the assets, which totalled $ 1,713,733, as of December 31, 1993. The remainder, which is the portion of the original cost unrecovered by Occoquan as of December 31, 1993, was therefore $ 1,083,502.

Since January 1, 1989, Occoquan has been recovering over sixty-month periods, its original cost of the assets, in the form of monthly payments under the lease with the Service Company. As such, the proposed purchase price of these assets at the Service Company's depreciated cost, to the extent in excess of the original cost already recovered by Occoquan through the lease payments, would generate a windfall to Occoquan, the nonregulated affiliate, and thus to the parent company, at an unreasonable expense to ratepayers. See R.D., p. 9.

In addition, the OCA challenged the Company's inclusion of an additional $ 259,488 cost for software, reflecting a purchase date of December 31, 1993. Through discovery, the OCA requested invoices for the December 31, 1993 purchase. In response, the Company provided a software license fee agreement **[*14]** between Occoquan and McCormack & Dodge (the software provider) on November 30, 1987. The amount contested by the OCA was a portion of the initial license fee of $ 825,000.

From the date of purchase to December 31, 1993, the software challenged by the OCA had not been used either by Occoquan or the Service Company, and was not depreciated by Occoquan. Further, the OCA argued that PAWC's witness was casual in his reference to mid-1994 as the target date for the implementation of this project. (OCA Main Brief, pp. 151-158)

PAWC responded to the two proposed adjustments of the OCA. Initially, PAWC replied that the proposed adjustment to reduce the Company's claim for the depreciated original cost of the balance of the MIS property by $ 238,848 was wrong for a variety of reasons.

PAWC noted that the MIS property was purchased new by Occoquan and leased to the Service Company under a "capital lease. " PAWC explained that under a capital lease, the renter assumes the risks and benefits of ownership of the leased property and, therefore, is treated as the owner under generally accepted accounting principles and for income tax purposes. As a consequence, the MIS property was recorded **[*15]** as an asset on the books of the Service Company. Occoquan, on the other hand, carried the lease itself as an asset on its books, but not the MIS property. Stated another way, under generally accepted accounting principles, the capital lease was properly characterized as a financing vehicle. That is, Occoquan was treated as having supplied the purchase-money financing for the Service Company to acquire the MIS property.

The capital lease between Occoquan and the Service Company had a 60-month (5-year) term and provided that the amounts "loaned" to the Service Company to acquire the MIS property would be repaid in 60 months with interest at the prime rate plus 200 basis points. The Service Company, however, did not charge the entire capital lease rental costs to PAWC. Rather, it used different recovery periods to calculate its charges to the Company for the MIS property. Specifically, the Service Company used a 10-year depreciable life for furniture and equipment, other than personal computers and software, for which a 5-year depreciable life was employed. The Service Company's charges to PAWC were based on those longer depreciable lives, not the cost-recovery period implicit **[*16]** in its lease payments to Occoquan.

Therefore, the Company argued that the amount included in its rate base in this case for the MIS property should reflect the depreciated original cost of those assets as recorded on the Service Company's books. The Service Company is the entity that properly carried the MIS property as an asset and was the beneficial owner for accounting, financial reporting and income tax purposes. Moreover, as previously explained, PAWC's asserted that its customers have never borne any costs reflecting Occoquan's implicit "cost recovery." Rather, they paid only the lesser depreciation amounts included in the Service Company's charges to PAWC. As much as the Service Company incurred rental costs under its "capital lease" that exceeded what it charged to PAWC, it had an uncompensated financing cost. (PAWC Main Brief, pp. 12-14).

PAWC emphasized that the OCA's proposal represented a radical departure form the concept of original cost ratemaking and, therefore, should be rejected. Also, with respect to the alleged "used and useful" question, PAWC stressed the practical necessity of having to phase-in the computerized financial management system as the reason **[*17]** that the inventory control and human resource management packages were not acquired by the Company until December 1993. [3]

2. ALJ Recommendation Re: MIS Property

The ALJ, at pages 12-14 of the R.D., concluded that the rate base claim for the Company should be reduced by $ 259,488 based on the removal of the inventory control software that would not be in operation by June 1994. He rejected the OCA's adjustment to reduce the claim for inclusion of the MIS Property by an amount representing a hypothetical depreciation adjustment of $ 238,838. The pertinent portion of his discussion is reprinted, below:

The MIS property was purchased new by Occoquan and leased to the Service Company under a capital lease. This capital lease was used as a financing vehicle for the Service Company to acquire the MIS property. The Service Company leases the MIS property back to PAWC at a charge based on longer depreciable lives, not on the cost-recovery period implicit in its lease payments with Occoquan. Through December **[*18]** 31, 1993, neither the Service Company nor PAWC paid anything, by way of lease expenses or otherwise, for the human resource management that went on line in March 1994 or the inventory control software that will be in operation by June 1994. OCA recommended that only the portion of the original cost uncovered by Occoquan as of December 31, 1993, rather than the Service Company's claim [sic] depreciated original cost, be charged to ratepayers in order to avoid a windfall to the unregulated for-profit affiliate (Occoquan). OCA did not dispute that the charge based on longer depreciable lives was unreasonable and improper, and that the charge so paid was in excess of the reasonable cost of furnishing such property. Transactions between affiliated companies are not in and of themselves unreasonable and improper. They are only when the Commission lacks data and information from which the reasonableness and propriety of the services rendered and the reasonable cost of rendering such services by the servicing companies can be ascertained. See *Solar Electric Co. v. Pennsylvania Public Utility Commission, 137 Pa. Superior Ct. 325, 9 A.2d 447 (1939).* Throughout the proceedings, PAWC **[*19]** was cooperative and provided any data or information requested by the parties. From this record, I conclude that PAWC and its customers realized cost savings by avoiding the carrying costs on the software for the six-year period from 1987 to 1994 and obtaining the 1994 version of the software at 1987 prices. (PAWC Main Brief, p. 11) Therefore, PAWC's future test year claim for $ 238,839 for the human resource management software that went on line in March 1994 should be allowed. However, for the inventory control software that will be in operation by June 1994, the end of the future test year, because this software is not used and useful in the future test year, PAWC's rate base should be reduced by $ 259,488.

R.D., pp. 12-13.

3. Exceptions

PAWC excepted to the ALJ's recommendation that the rate base claim for an inventory control software package be denied on the basis of the non used and useful nature of the package. [4]

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[3] Also, at various times, PAWC defended the necessity of the inventory control software as being consistent with the recommendations of a recently concluded management audit.

[4] At page 22, note 7, PAWC points out that the asset at issue here, although referred to as "software" , is in actuality a license to use proprietary computer programs developed for specialized business applications. The license was acquired by Occoquan in

[*20]

PAWC's Exception concerning this issue also clarifies what the Company points out as error in the amount of the adjustment recommended by the ALJ. PAWC states that the amount of the adjustment is erroneous because it included the original costs of a human resource management software package that went on line in March 1994. The ALJ found this software package to be properly included in rate base in this proceeding. PAWC theorizes that the ALJ was under the mistaken impression that the original costs of the inventory control and human resource management software were $ 259,488 and $ 238,838, respectively. PAWC Exc., p. 21, referencing R.D., p. 13. In reality, argues PAWC, the figure of $ 259,488 included both software packages while the figure of $ 238,838 related to an entirely different adjustment proposed by the OCA for other MIS property. PAWC Exc., pp. 20-21.

The OCA, on the other hand, excepted to the ALJ's rejection of its hypothetical depreciation adjustment for the MIS Property. See OCA Exc., pp. 1-5.

Both the Company and the OCA are in agreement that the two proposed adjustments, i.e. the $ 259,488 related to the inventory control software based on the **[*21]** "used and useful" nature of the property, and the $ 238,838 based on the capital recovery prior to the Occoquan acquisition, are separate and distinct.

On review of the record, this Commission agrees that there was some degree of confusion on the part of the ALJ with respect to the two proposed adjustments.

On consideration of the Exceptions and Replies, we shall, as explained below, reverse the ALJ concerning his rejection of the hypothetical depreciation adjustment, and adopt that reduction to the Company's claim consistent with the OCA's position. This would reduce PAWC's claimed rate base by $ 238,838.

However, we shall reverse the ALJ concerning his determination that the remaining MIS property is neither used nor useful. Based on the record herein, we conclude that the software's on-line date falls squarely within the test year, [5] and will produce tangible benefits to the operations of PAWC and, consequently, its ratepayers.

In its Replies to Exceptions, the Company defends the claimed original cost, less depreciation, of the MIS property. **[*22]** PAWC emphasizes the nature of the capital lease between Occoquan and the Service Company. PAWC repeats the major benefit of a capital lease, i.e. the renter assumes the risks and benefits of ownership of the leased property. Therefore, the renter is treated as the owner under generally accepted accounting principles for income tax purposes. PAWC R.E., p. 9. Consequently, the MIS property was recorded as an asset on the books of the Service Company and Occoquan was treated as having loaned the Service Company the money to acquire that property.

In summary, PAWC's argument against the OCA proposal can be summarized as follows: (1) the nature of the capital lease here involved was such that the Service Company did not charge the full capital lease rental costs to the Company. The MIS property was carried as an asset on the Service Company's books of account and its charges included (a) interest expense, and (b) the amounts it recorded as depreciation expense, which amounts were based on depreciable lives substantially longer than 60 months for most of the MIS property. Therefore, the purchase price to PAWC was the depreciated original cost recorded on the books of the Service **[*23]** Company which is also the amount its has claimed in rate base; (2) the OCA's approach is akin to using as a utility's rate base, the unpaid balance of the debt issued to finance its plant in service, instead of the original cost less accrued depreciation recorded on its books for that property. This is a radical and unlawful departure from the concept of original cost ratemaking; (3) the allegation that the PAWC and its customers bore the full amount of the Occoquan lease payments is contradicted in the record; (4) the analogy set forth by the OCA in its Exceptions, differs in material respects from the capital leasing transaction involved here. See PAWC R.E., pp. 8-11.

1987 and the software itself, when installed, was the latest version developed by Dunn & Bradstreet Systems. (Tr. 861, 863-864).

[5] At R.D., p. 13, the ALJ notes that the software at issue here will be in operation by June, 1994. See OCA Exc., p. 2, n. 1.

We view the essential question here as one pertaining to a transaction between affiliated interests. Notwithstanding that we do not endorse the OCA's analogy set forth at pages 3-4 of its Exceptions as elucidating the issue, we agree with the major portion of the reasoning therein.

The OCA schedule illustrated the amount recovered by Occoquan through the capital leasing arrangement was $ 1,713,733 as of December 31, 1993. We find persuasive, the schedule showing that the original cost already recovered by **[*24]** Occoquan through the capital leasing arrangements exceed the proposed purchased price. Consequently, we shall not be bound by the original cost of the asset as stated on the books of Service Company.

We note that the Pennsylvania Supreme Court, in interpreting the predecessor statute of Section 2102(c) of the Public Utility Code, 66 Pa. C.S. § 2102(c), in *Berner v. Pennsylvania Public Utility Commission, 382 Pa. 622, 116 A.2d 738 (1955),* clearly articulated the utility's responsibilities concerning affiliated interest transactions in the following statements:

It is abundantly clear, therefore, that when, as here, a utility includes in its rate base an ascribed value of inter-affiliate transactions, whether as an item of fixed capital or of operating expense, section 701(c) [Section 701(c) of the Public Utility Law of May 28, 1937, P.L. 1053] imposes on the utility a two-fold burden: first, to show that the inter-affiliate transaction was reasonably necessary, and second, to demonstrate that the amounts paid or payable therefor "are not in excess of the reasonable costs of furnishing such services." The wisdom of imposing such an obligation on the utility is pointed out in **[*25]** *Solar Electric Co. v. Pennsylvania Public Utility Commission, 137 Pa. Superior Ct. 325, 374, 9 A.2d 447, 473,* where it was said: "The desire of public utility management, evidenced by various methods, to secure the highest possible return to the ultimate owners is incompatible with the semi-public nature of the utility business, which the management directs. It therefore follows that the commission should scrutinize carefully charges by affiliates, as inflated charges to the operating company may be a means to improperly increase the allowable revenue and raise the costs to consumers of the utility service as well as an unwarranted source of profit to the ultimate holding company.

382 Pa. at 626-627.

Further, we have, consistently disallowed inter-company contract payments pursuant to our jurisdiction over affiliated interest transactions pursuant to our authority over affiliated transactions. See *The Bell Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission, 83 Pa. Commonwealth Ct. 331, 478 A.2d 821 (1983).*

Unless that part of the OCA adjustment which recognizes the previously leased property is recognized, the Company's ratepayers will overpay **[*26]** for these assets. This overpayment would result if ratepayers pay for both the lease payments, plus the remaining non-depreciated [6] value of the assets. Therefore, we shall adopt the OCA adjustment which results in a reduction to the rate base claim of the Company in the amount of $ 238,848. The Exceptions of PAWC are, hereby, denied.

Pertaining to the two software packages, we shall adopt the position of the Company and permit its claim for $ 259,488. This represents the original costs of both the human resource management and inventory control software packages. We concur with the Company that the ALJ determination that the software was not "used and useful" during the test year is not supported by the record evidence. The Company has already begun using some of the software as of March 1994 and testified that the remainder of **[*27]** the software would be operational by the end of the future test year. Further, the Company's automation efforts are consistent with findings reached in the most recent management audit of PAWC.

4. Purchase of Hershey Building

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[6] Also, in *Bell v. Pennsylvania Public Utility Commission, supra,* the Commonwealth Court, in a context not directly related to affiliated interest dealings, affirmed our discretion to not be bound by any particular method of estimating accrued depreciation for assets included in the rate base of a utility. *83 Pa. Commonwealth Ct. at 341.*

The ALJ's discussion of PAWC's purchase of the Hershey Building begins at page 13 of the R.D. There, based on the fact that the record was scheduled to close within 14 days of the notification of our concerns with regard to the acquisition, the ALJ denied rate base recognition of said costs in their entirety. ALJ Nguyen determined that there was not sufficient time to present evidence in response to the concerns identified in the March 10, 1994 consolidation order. As the ALJ observed:

On March 10, 1994, the Commission issued an Order consolidating this rate proceeding with the Company's Request for approval of the proposed acquisition agreements of the Hershey land and office building, in addition to the MIS property. In that Order, the Commission stated its concerns as follows:

1. Have the lease and rental expenses incurred over the past 14 years and, subsequently passed along to ratepayers been less than or equal to the costs of original ownership **[*28]** by Pennsylvania American Water Company?

2. Are the terms and conditions of the proposed transactions fair and equitable for the ratepayers of Pennsylvania-American Water Company?

Order of March 10, 1994 at 1.

As the consolidation order was issued only fifteen days before the close of the record, it was not possible to evaluate costs and expenses over a fourteen year period. The acquisition of the MIS property would pose no problems for the Commission's approval because the evaluation of the costs and expenses over the 14-year period could easily be ascertained. The MIS property was bought new and, from the date of its purchase, it was not leased to any individuals or entities before PAWC's proposed acquisition. Here, no such simple rental history can be found. And although no parties contested the approval, the purchase of the building by PAWC must be disapproved because nothing in the record would address the Commission's concerns.

R.D., pp. 13-14.

5. Exceptions

Both the OCA and the Company excepted to the ALJ's disapproval of the costs pertaining to the purchase of the Hershey Building. The Company notes that no party opposed the Company's acquisition, and neither **[*29]** did any party propose an adjustment with respect to that property. PAWC Exc., p. 25.

The OCA, in its Exceptions, notes that it did not propose an adjustment to the Hershey Building acquisition as it determined that a benefit, in the form of an overall reduction in revenue requirement, albeit small, would inure to the ratepayers. OCA Exc., p. 10.

Additionally, both the OCA and the Company observe that to the extent this Commission would require answers to the questions outlined in our March 10, 1994 Order, concerning the acquisition, it should not deprive ratepayers of the benefits of the revenue requirement reduction during such time as it would take to answer said questions. Importantly, PAWC notes the following: (1) the acquisition of the Hershey Building for the purchase price specified in the Agreement of Sale would be between &70,000 and $ 720,000 less than the fair market value of the acquired assets; (2) as a result of the acquisition, PAWC's revenue requirement would be $ 161,669 lower, as compared to the Company's continued lease of office space; (3) the acquisition would facilitate the Company's internalization functions; and (4) the Commission's first concern with **[*30]** regard to the lease and rental expenses incurred over the past 14 years can be allayed without the need for an extensive and detailed analysis envisioned by the ALJ. See PAWC Exc., pp. 27-31.

On consideration of the Exceptions and Replies, we shall reverse the ALJ, and permit PAWC to include the Hershey Building acquisition in its rate base. We determine that the record evidence could not be comprehensively developed in the time available. Nonetheless, we acknowledge that the parties presented sufficient information in their pleadings to respond to this Commission's concerns.

B. Accrued Depreciation

PAWC's accrued depreciation is its book reserve, as established by Commission Orders entered January 24, 1985 at 59 Pa. PUC 178 (WPW), March 29, 1985 at Docket No. R-842755 (Keystone), and March 21, 1985 at 59 Pa. PUC 286 (Riverton). PAWC Main Brief, p. 19.

PAWC's witness, Mr. Mark Schubert, computed accrued depreciation related to PAWC's plant in service as of June 30, 1994 by reflecting all appropriate entries required to establish what the Company's book reserve would be at that time. (PAWC St. 9, pp. 10-11)

The only challenge to the Company's accrued depreciation was **[*31]** made by Michael J. Gruber, the OTS' depreciation witness. OTS witness Gruber proposed adjustments related to so-called "extraordinary" retirements and negative net salvage. Mr. Gruber's proposed adjustments to the Company's accrued depreciation and annual depreciation expense for Account 324.10 (5/8" Mechanical Meters) were adopted by the Company and presented in its final claim.

1. Extraordinary Retirements

Mr. Gruber proposed changing the Company's book reserve for Account 312.11 (Collecting and Impounding Reservoirs) from a debit balance of $ 1,577,631 to a credit balance of $ 1,925,040, or an increase of $ 3,502,671. In support of this adjustment, Mr. Gruber contended that the debit balance in the book reserve for Account 312.11 resulted from "extraordinary" retirements and that the unrecovered investment related to such retirements should be amortized as an extraordinary property loss. R.D., pp. 16-17.

Additionally, the OTS urged that PAWC's negative $ 1,577,631 claim should not be included in the Book Reserve. The effect of these retirements being on PAWC's book reserve is that PAWC earns a return on an extraordinary event and the ratepayers are forced to provide the **[*32]** company with a return on plant not used and useful in the public service. If the amount is amortized as an extraordinary property loss, then the company will receive a return of its investment. According to the OTS position, ratepayers should not have to provide a return on an investment which is not used and useful in the public service. Amortization of extraordinary property losses has been recognized by this Commission as proper. Id.

Mr. Gruber removed the negative $ 1,577,631, and determined that a proper level of accrued depreciation for Account 312.11 is $ 1,925,040. This number was developed from data provided by the company in PAWC Exhibit 9-A, pp. 23, 24. PAWC Exhibit 9-A shows an original cost of $ 5,064,144, an Accrued Depreciation of $ 1,926,574, and a net plant ratio of .6196 as of January 1, 1995 for the plant to be depreciated under the Broad Group procedure. To arrive at a depreciated original cost, Mr. Gruber multiplied the original cost by the net plant ratio of .6196. Applying this ratio to the Broad Group account balance at June 30, 1994 of $ 5,060,570 results in depreciated Original Cost of $ 3,135,529 and an accrued depreciation of $ 1,925,040 on **[*33]** June 30, 1994. This is shown as the estimated Book Reserve for Account 312.11 under the column labeled "1994 OTS Book Reserve" Broad Group Category for June 30, 1994, in OTS Exhibit 3, Schedule 2.

The OTS recommended that PAWC be directed in this proceeding to file with the Commission for permission to amortize the unrecovered portion of the retirement as an extraordinary property loss rather than treating it as a normal retirement, and that the Commission establish a book accrued for this account at $ 1,925,040 as of June 30, 1994. If the Commission does not order PAWC to petition for permission to amortize the unrecovered portion of the retirement as an extraordinary property loss, then OTS advocated that the Commission should direct PAWC to use $ 1,925,040 to determine the book accrued for account 312.11 in all future rate cases.

PAWC responded to the OTS proposed adjustment by noting that this recommendation was in direct conflict with the principles of the remaining life method of depreciation that this Commission approved for ratemaking purposes for the Company. PAWC Main Brief, p. 18; PAWC St. 10-R, pp. 9-10. PAWC argued that this Commission has twice rejected the same **[*34]** treatment of "extraordinary" retirements that the OTS advocated in this case in *Pennsylvania Public Utility Commission v. Keystone Water Company, 61 Pa. P.U.C. 763, 771-772 (1986)* and

Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company, 61 Pa. P.U.C. 328, 339-340 (1986). Id.

In 1985, the Commission entered rate orders for each of PAWC's corporate predecessors directing them to adopt the book reserve and the remaining life method of depreciation for ratemaking purposes. Under this method, the retirement of a unit of property is recorded by deducting its original cost from both the applicable plant account and the book reserve. Through the normal operation of the remaining life method of depreciation, any unrecovered investment in the retired property is recovered over the remaining life of the utility's plant in service. The method provides for a precise and automatic "true-up" of original cost and accrued depreciation, which the Commission has long regarded as one of the principal advantages of this depreciation method.

Retirements that are classified as "extraordinary" would be treated as an exception to the normal operation of the Commission-approved **[*35]** remaining life method. For such "extraordinary" retirements, the amount deducted from the book reserve would not be the original cost of the retired property -- an amount readily determinable from plant records -- but an estimate of the amount of depreciation accrued on the unit of property up to its retirement date. The difference between the estimated accrued depreciation and the original cost of the retired property is treated as a "deferral" and amortized to expense over a reasonable period -- usually five to ten years.

The amount of $ 1,588,342 that does relate to retirements is clearly not "extraordinary" for PAWC, a company with a rate base in excess of $ 500 million.

Among the properties Mr. Gruber identified as "extraordinary" retirements was the Glen Brook Reservoir, which had been owned by Keystone, PAWC's corporate successor. In a 1986 Keystone rate case, the Trial Staff proposed the same "extraordinary" treatment for the Glen Brook Reservoir retirement. The Commission rejected the "extraordinary" retirement approach and held that the normal operation of the book reserve and the remaining life method of depreciation properly accounted for the retirement of collecting **[*36]** and impounding reservoirs. (PAWC Main Brief, pp. 16, 18, 19, 21, 22)

a. ALJ Recommendation

After consideration of the position of the OTS, the ALJ reasoned that it is established that when a utility retires and removes a property without replacing it or replaces it after removal and incurs actual negative salvage, the expenditure should be capitalized and amortized by some reasonable method and for and over a reasonable length of time. See R.D., pp. 18-19, citing *T. W. Phillips Gas v. Pennsylvania Public Utility Commission, 81 Pa. Commonwealth Ct. 205, 474 A.2d 355 (1984).* Therefore, he rejected the OTS recommendation that PAWC be directed to file for permission to amortize the unrecovered portion of the retirement as an extraordinary loss.

However, ALJ Nguyen did recommend that PAWC be directed to use $ 1,925,040 to determine the book accrued for account 312.11 in all future rate cases. R.D., p. 19.

2. Exceptions

The Company excepted to that portion of the ALJ recommendation directing it to use $ 1,925,040 to determine the book accrued for account 312.11 in all future rate cases. PAWC argues that the recommendation is inconsistent with the ALJ's resolution of **[*37]** the issue presented in this case, is in conflict with the principles of the remaining life method of depreciation, and is contrary to prior Commission determinations. PAWC Exc., p. 17.

Our consideration of the matter leads us to agree with the Company. We have consistently declined to acknowledge extraordinary retirement since the adoption of the remaining life method of depreciation for ratemaking purposes. We conclude that the accrued depreciation for Account 312.11 was determined by the normal operation of remaining life depreciation principles. The derivation of the $ 1,925,040 to determine the book accrued for Account 312.11 was a product of the "extraordinary" retirement theory of the OTS and for reasons similar to the ALJ rejection of the other extraordinary retirement adjustments, should also have been rejected. Therefore, we shall grant the Exception of the Company as to this issue.

3. Net Salvage

The OTS proposed a $ 1,207,590 downward adjustment to the Company's accrued depreciation to reflect the removal of salvage. This adjustment reduced annual depreciation expense by $ 21,660.

In the view of Trial Staff, the Company inappropriately included salvage in its **[*38]** accrued depreciation, as reflected in PAWC estimated book reserve as of June 30, 1994. This inclusion, says OTS, inflates PAWC's rate base because it reflects (negative) net salvage, which reduces book reserve. (OTS Main Brief, p. 20). The OTS cited *Penn Sheraton Hotel v. Pennsylvania Public Utility Commission, 198 Pa. Superior Ct. 618,* A.2d 324 (1962), for its definition of negative net salvage: the loss realized by a utility upon the retirement of property resulting from the necessity of expending funds in excess of the salvage value of the property in order to remove it. The OTS contended that the expenditure should be treated as an expense rather than as a capital cost. Id., p. 18.

In support of its proposed exclusion of salvage, whether negative or positive, from rate base, the OTS relied upon *Pennsylvania Public Utility Commission v. Duquesne Light Company, 48 Pa. PUC 14 (1974)* and *Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company, 48 Pa. PUC 358 (1974).* Because net salvage is an operating expense, the OTS argued that inclusion of the unamortized balance of the expense in rate base by reflecting net salvage in the book reserve **[*39]** improperly results in a return being earned on the unamortized balance. Id., pp. 21, 22.

The OTS argues that PAWC's treatment of net salvage as a capital cost is in violation of the Public Utility Code and court decisions which hold that only property which is "used and useful" should be included in rate base. Furthermore, Section 102 of the Public Utility Code, 66 Pa.C.S. § 102, defines rate base as the "value of the whole or any part of a public utility which is used and useful in the public service." Thus, by including the unamortized balance of net negative salvage in rate base, PAWC is improperly including balances associated with retired property, which, by definition, is not used and useful. Id.

The Company, in contrast, argued that inclusion of negative net salvage in rate base as a capital cost is consistent with Commission plant accounting rules, accepted ratemaking principles and applicable judicial precedent. PAWC Initial Brief, p. 24.

PAWC stated that under the Commission's Uniform System of Accounts, both the cost of removal and salvage value occasioned by the retirement of property are recorded in Account 250, Reserve for Depreciation of Utility Plant. **[*40]** Account 250 is a balance sheet account, not an operating expense account. Thus, under Commission-mandated accounting principles, net salvage is a capital cost. Id., p. 25.

PAWC further attempted to distinguish *Penn Sheraton Hotel v. Pennsylvania Public Utility Commission, supra.* In that case, argues PAWC, our Superior Court, after holding that the cost of removal of retired property should not be reflected in rates until it is actually expended, went on to state that such expenditure "should be capitalized and amortized." *198 Pa. Superior Ct. at 628, 184 A.2d at 319.* A utility's investment is included in rate base and it is entitled to recover the cost through depreciation and earn a return on the undepreciated balance. Id. at 17.

PAWC notes that the cases cited by OTS rely on principles of "fair value" rate base and "calculated" accrued depreciation that the Commission abandoned in the early- to mid-1980's when it adopted original cost as the measure of value and cost recovery as the proper basis for depreciation. Significantly, says the Company, the Trial Staff has given no weight to rate orders and Commission practice subsequent to the Commission's policy shift **[*41]** to the book reserve and the cost recovery concept of depreciation, cases which uniformly reject the treatment of net salvage advocated by its witness. (PAWC Reply Brief, pp. 19-22)

With respect to the statute-based argument of OTS concerning used and useful property, PAWC counters that Section 1311 of the Public Utility Code, 66 Pa.C.S. § 1311, was amended so as to vest in the Commission's sound discretion the matter of depreciation methods and procedures. Whether net salvage is to be reflected in the book reserve obviously involves depreciation procedure. Thus, the Commission has properly determined that net salvage is a plant cost and should be recorded in the book reserve. Id., pp. 22, 23.

a. ALJ Recommendation

The ALJ concluded that the OTS argument in the case at bar was inconsistent with the OTS position taken in 1993 in *Pennsylvania Public Utility Commission v. Metropolitan-Edison Company, 141 PUR 4th 336 (1993)* (Met-Ed hereafter). In Met-Ed, the utility sought to treat net negative salvage as an expense, projecting a test year level and applying the same inflation factor used for other expense items. There, OTS contended that the utility:

. . . failed **[*42]** to recognize that net salvage is the result of netting the salvage value recovered from a plant asset that has been retired to the cost of removing the plant and is not an O&M expense.

141 PUR 4th at 344. The presiding ALJ in the Met-Ed proceeding agreed with the Trial Staff's view and the Commission adopted his recommendation, reducing the net salvage claim. Id.

Concerning the cases cited by the OTS on brief in support of its approach to net salvage, the ALJ noted that those cases were decided during an earlier period when the Commission utilized an entirely different methodology for ascertaining depreciation and rate base. Thus, such cases did not provide support for the adjustment proffered by the OTS. *Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company, 67 Pa. PUC 752, 764, 765 (1988).* With regard to the "used and useful" argument presented by Trial Staff, ALJ Nguyen found it flawed because that test applies just to the property valuation element of the rate base equation and not to the proper computation of depreciation. R.D., p. 23.

On the basis of the foregoing, the ALJ recommended the rejection of the OTS proposal and approval **[*43]** of the Company's claim for net negative salvage.

3. Exceptions

The OTS presented vigorous objection to the ALJ recommendation. The OTS emphasizes that the inclusion of net negative salvage in rate base gives the utility a return on and return of its costs since PAWC has included net salvage as a five-year historical average expense claim and as part of its accrued depreciation. The OTS cites *UGI Corporation v. Pennsylvania Public Utility Commission, 49 Pa. Commonwealth Ct. 69, 410 A. 2d 923 (1980)* for the well-settled proposition that a utility cannot capitalize an item in its rate base and, at the same time, recover the item as an expense from ratepayers. OTS Exc., p. 3-4.

The OTS also argues that the Commission has refused to allow utilities to earn returns on the unamortized balance of an expense, as it is alleged would occur here. OTS Exc., p. 4 citing *Pennsylvania Public Utility Commission v. Dauphin Consolidated Water Supply Company, 55 Pa. P.U.C. 44, 47 (1991); Pennsylvania Public Utility Commission v. National Fuel Gas Distribution Corporation, 72 Pa. P.U.C. 1, 27 (1989).* On the basis of the foregoing, the OTS requests that the balance of net salvage be **[*44]** excluded from PAWC's book reserve. Id.

The OTS further argues that the ALJ committed error in failing to realize that the Company was making both an expense and a capital cost claim for net negative salvage. Error is also alleged in that the ALJ inappropriately ruled that *Penn Sheraton Hotel, supra,* supported capitalization of net negative salvage, and in failed to recognize its used an useful argument concerning net negative salvage.

Additionally, the OTS embellishes its used and useful argument by stating the following:

The ALJ erroneously ruled that OTS' "used and useful" argument is inapplicable to net salvage because the salvage issue herein pertains to the property computation of depreciation rather than property valuation. The ALJ apparently failed to recognize that the effect of inclusion of net negative salvage in accrued depreciation is to increase rate base. This is because the inclusion of net negative salvage results in a reduced accrued depreciation which, when subtracted from plant in service, yield the net rate base upon which a return is allowed to be earned. Thus, PAWC would, in effect, be allowed to earn a return on "non-used and useful" plant **[*45]** if the ALJ's recommendation is adopted. The ALJ's recommendation should, therefore, be rejected. (Emphasis original).

OCA Exc., p. 6.

Finally, the OTS explains what appeared to the ALJ to be an inconsistent position taken in the Met-Ed proceeding. It notes that the position it took with respect to net negative salvage related to the use of an inflation factor for net negative salvage. The excerpt from the Met-Ed proceeding should, according to the OTS, be interpreted to mean that it the OTS' view that net salvage is not an O&M expense subject to inflation. OTS Exc., p. 7.

On consideration of the position of the OTS, and the R.D., we shall deny its Exceptions and adopt the ALJ recommendation. The OTS adjustment is contrary to Commission-prescribed plant accounting rules under which we have, consistently, treated net salvage as a capital cost. See Pennsylvania Public Utility Commission v. Bloomsburg Water Company, 74 Pa. P.U.C. 244 (1990). [7]

We do **[*46]** 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. [8] 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 ongoing nature of plant additions and plant retirement. On the basis of the foregoing, we shall deny the OTS Exception on this issue.

C. Additions to Rate Base [9]

In addition to the depreciated original cost of net utility plant in service, the Company included in its rate base claim, its investment in materials and supplies, **[*47]** cash working capital and accrued and prepaid taxes.

1. Materials and Supplies

The Company's rate base claim included an amount of $ 736,838, representing its investment in materials and supplies. That amount consists of: (1) the average monthly balances of the Company's materials and supplies accounts for the 13 months ending with the historic test year; less (2) the portion of materials and supplies supported by accounts payable. (PAWC St. 3, pp. 7, 8) No party disagreed with the Company's materials and supplies claim. Consequently, the ALJ recommendation concerning same is adopted.

2. Cash Working Capital -- Expenses

PAWC calculated its cash working capital requirement using the Commission-approved lead-lag method. Lead-lag studies were performed which showed the following lags in the receipt of revenues and payment of expenses:

Revenue lag	49.8 days
Expense lag	13.1 days
Net lag	36.7 days

Based on the experienced net lag of 36.7 days, PAWC calculated its gross cash working capital requirement for the future test year level of operation.

a. Revenue Lag

The Company's initially claimed revenue lag consisted of three components: (1) service period lag (15.2 **[*48]** days); (2) billing lag (5.0 days); and (3) collection lag (27.4 days).

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[7] To the extent the position of the OTS in Met-Ed is argued to be inconsistent, we would generally agree that in the Met-Ed proceeding, the OTS implicitly conceded negative salvage to be a capital cost.

[8] Section 1315, although addressing used and useful concepts, is directed toward electric utilities and generating units. In Barasch v. Pennsylvania Public Utility Commission, infra, the Court observed, in the context of responding to an equal protection challenge, that the concept applies to all utility types. See *516 Pa. at 169, 532 A.2d at 338.*

[9] Adapted from the R.D., pp. 24-47.

The Company's calculation of the billing lag includes the date a customer's bill is mailed.

The Company calculated collection lag by dividing the average daily accounts receivable balance by the average daily billed revenue. This method computes the average period that a water bill is outstanding before payment, i.e., collection lag.

Finally, the Company's initial five-day billing lag calculation counted working days only. Weekends and holidays were excluded. In response to Mr. Smith's proposed one-day adjustment, Mr. Diskin analyzed approximately 1,500 monthly billing routes in the last quarter of 1993, which showed an average billing lag of 7.2 calendar days. The Company has used the 7.2 calendar-day billing lag, or a total revenue lag of 49.8 days, to calculate its final claim in this case. It would not oppose the adoption of its original 5-day billing lag, or a total revenue lag of 47.6 days, if the OCA's proposed one-day adjustment is rejected.

b. Expense Lag

The Company opposed increasing the Company's expense lag to 17.8 days to reflect the later of expense invoice due dates or the "check clearing **[*49]** lag. " The check clearing lag, which incorporates "disbursement float" in the cash working capital calculation, has been rejected by the Commission in prior rate orders for other utilities and is based on the unacceptable -- and impractical -- assumption that the Company should write checks for amounts that exceed its checking account balance.

(1) Check Clearing Lag

The check clearing date for each invoice is determined by adding 5 days to the actual payment date as an estimate of the average time required for each check to clear PAWC's bank. The 5-day estimated check clearing lag is derived from the dollar-weighted average of the "clearing" times for a sample of 100 checks written by PAWC in the first quarter of 1993. The methodology appears to suggest that the Company could write checks for a cumulative amount that exceeds the balance in its checking account.

Even if a company were disposed to write checks that exceed its account balance, it would face the practical problem of predicting how long it will take for each check to clear, in order to avoid overdrafts and the attendant costs and potential legal ramifications.

Therefore, the Company must dedicate funds to its working **[*50]** accounts that are sufficient to pay all checks on the earliest date that any check could be presented. (PAWC St. 3-R)

(2) Specific Expense Lags -- The OCA's Fall-Back Position

The Company also opposed increasing the Company's expense lag to 15.3 days based on a traditional analysis of service periods and payment dates. The computations reflected the later of the due date or the actual payment date and are based on seriously flawed assumptions about the ability of a company as large as PAWC -- which issues over 42,000 checks a year -- to perfectly "time" its disbursements without missing due dates, incurring late charges or damaging its credit standing. Moreover, the method is internally inconsistent -- if "due dates" are the proper benchmark for calculating expense lags, then "due dates" should have been used uniformly in computing expense lags.

PAWC did not dispute that it, like virtually all major utilities, pays some expense vouchers in advance of their due dates. When 42,000 checks must be issued each year, that outcome is probable, particularly if the Company is to avoid missing due dates and, thereby, incurring late charges and running the risk of adverse effects on its **[*51]** creditworthiness. Thus, the fact that a sample analysis shows some invoices paid before their due date is clearly not a "sign of poor cash management."

Working capital for a regulated utility has been generally defined as the average amount of capital provided by investors in the company, over and above the investments in plant and other specifically identified rate base items, to bridge the gap between the time that expenditures are required to provide service and the time collections are received for that service. *Pennsylvania Public Utility Commission v. Pennsylvania-American Water Company, 68 Pa. PUC 343, 356 (1988),* citing, *City of Pittsburgh v. Pa. P.U.C., 171 Pa. Superior Ct. 187, 90 A.2d 607 (1952).*

Cash working capital allowances are discretionary and may not be needed at all:

If the financial situation of an operating company shows that sufficient funds are readily available to bridge the gap between rendition of and payment for services, no cash working capital is required and none should be allowed by the Commission.

City of Pittsburgh v. Pennsylvania Public Utility Commission, 370 Pa. 305, 309-310, 88 A.2d 59, 62 (1952).

In this PAWC rate case, the **[*52]** OCA evaluated each of the components of the Company's lead lag study to ascertain how and to what extent the Company's working capital claim has been overstated.

Company witness Diskin calculated cash working capital requirements by multiplying the net lag days (revenue lag days less expense lag days) by the operating expenses per day (operating expenses divided by 365 days). At close of record, PAWC's future test year cash working capital claim for O&M and taxes consisted of $ 8,301,467.

OCA witness Smith's recommendations to the Company's cash working capital requirement would reduce PAWC's working capital allowance by $ 2,693,844.

The issues concerning PAWC's cash working capital allowance which remained outstanding for disposition by the ALJ were: (1) calculation of PAWC's revenue lag, specifically the billing lag portion of the revenue lag; (2) inclusion of an appropriate check clearing lag for specific expenses; and (3) specific adjustments to several PAWC proposed expense lags. R.D., p. 29.

c. SFAS 106 Trust Fund Payments

The ALJ's discussion of this issue is very succinct. We reprint the pertinent portion of the discussion below:

In the Company's prior base rate case, **[*53]** the Commission authorized the recovery of post-employment benefits other than pensions (principally retiree health insurance costs) in accord with Statement of Financial Accounting Standards No. 106 ("SFAS 106"). It has strictly adhered to the quarterly payment pattern mandated by the Commission. Each payment is made at the approximate mid-point of the service period to which it relates and, as a consequence, there is a relatively small expense lag of approximately one day.

OTS's witness, Mr. Smith, proposes that the Company should withhold payment to the trust until the end of the applicable quarterly service period and, during that interval, use the funding payments to meet its own cash needs. If the Company were to do so, the expense lag would be 44.8 days.

Mr. Smith's proposal is in direct conflict with the spirit, if not the letter, of the Commission's final Order in the Company's last case. As evidenced by the external funding requirement, the Commission perceives SFAS 106 cost recovery in a special light. Largely for that reason, it took extraordinary steps to ensure that those funds would be placed outside the Company's control as soon as practicable. In short, the **[*54]** Commission does not want funds, which are dedicated to paying retiree health benefits, being treated as just another source of cash for unrestricted Company use, as Mr. Smith seemingly is recommending.

The Company's payment pattern responds to the Commission's concerns by ensuring that there is virtually no "lag" between the time SFAS 106 expenses are incurred and when they are funded by payments to the trust. Accordingly, Mr. Smith's recommendation that the Company employ an end-of-quarter payment pattern should be rejected.

R.D., pp. 29-30.

(1) OCA Exceptions

The OCA filed Exceptions to the ALJ recommendation. [10] The OCA argues that the language in the 1992 proceeding involving this issue did not mandate or require payment on any particular day within a quarter, but was permissive. Also, it notes that the matter is a cash working capital issue, and not an issue relating to a dollar for dollar recovery.

Finally, the OCA argues that a lag of 44.8 days for SFAS 106 trust **[*55]** fund expense is consistent with PAWC's payment pattern for pension expense, also paid on a quarterly basis. OCA Exc., p. 6. On this basis, the OCA requests adoption of its recommendation and the reduction of PAWC's cash working capital claim by $ 376,640. The computation is set forth at Appendix A-1, p. 1 to its Exceptions.

On consideration of this issue, we shall not disturb the ALJ recommendation. We duly note that the issue is one not pertaining to a dollar for dollar recovery. However, we conclude that the payment pattern employed by the Company is consistent with our intent that funds dedicated to the payment of retiree healthcare costs not be used as an additional and unrestricted source of working capital.

d. Revenue Lag

The revenue lag dollars represent the amount investors must finance to cover the payment lag from the rendition of service to the date the cash is collected from customers for that service. A utility's revenue lag is typically composed of a service period lag, a billing lag and a collection lag.

PAWC originally proposed a revenue lag of 47.6 days consisting of the following components: (1) a service period lag of 15.2 days; (2) a billing lag of 5.0 **[*56]** days; and (3) a collection lag of 27.4 days. In Rebuttal Testimony, Company witness Diskin revised and increased the billing lag component of the revenue lag by 2.2 days, to a new lag of 7.2 days. Accordingly, the Company's final revenue lag, as revised, is 49.8 days.

OCA witness Smith proposed a total revenue lag of 46.6 days, constituting a decrease of one (1) day to the Company's originally claimed revenue lag of 47.6 days. The proposal is based upon record evidence that the Company included one mailing day in both the billing lag and the collection lag as used in the Company's lead-lag study.

The ALJ, therefore, found the Company's revised revenue lag of 49.8 days to be improper as it significantly overstated the Company's revenue lag for determination of PAWC's cash working allowance. R.D., p. 31.

The ALJ observed that PAWC overstated the revenue lag by one day. The overstatement occurred because the Company for computation of its billing lag in this case calculated the billing lag as beginning on the same day that the meter is read. But, the service period ends when the meter is read. When PAWC collects revenue from customers, it has use of those funds on the same **[*57]** day customer collections are received through a "lock box" mechanism. However, PAWC counted the meter read date in both the meter-reading-to-billing lag and the collection lag. Therefore, PAWC improperly included an extra day in its revenue lag computation because the meter read date was included in both the billing lag and the collection lag.

During the rebuttal stage, PAWC increased the billing lag portion of its revenue lag by two days, to a new lag of 7.2 days. The Company's revised claim was based on its analysis of data for the fourth quarter of 1993. This revision again, overstated the Company's revenue lag, and accordingly, overstated the Company's cash working capital allowance. First, the Company's new billing lag includes data from the fourth quarter of 1993, thereby includes a concentration of holidays that may not be representative of a typical calendar year lag.

Second, a review of PAWC's own billing data and history, as provided to support its filing, indicates that PAWC can process a bill in less three days -- not 7.2 days as PAWC now asserts.

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[10] The OCA notes, and we so agree, that the statement that PAWC revised its lag days expense to .8 days in accordance with OCA witness Smith's recommendation is not accurate. OCA Exc., p. 5, n. 7.

Third, OCA witness Smith compared PAWC's proposed meter-read-to-billing lag with the same lags recently proposed by **[*58]** seven other Pennsylvania utility companies. The average billing lag utilized by this group is 1.9 days.

The OCA witness Smith, consequently, recommended a maximum 4-day billing lag for ratemaking purposes for PAWC.

The ALJ recommended adoption of the OCA proposal. We find no Exceptions taken to the R.D. concerning the above recommendations. Finding said recommendations supported by the record, we so adopt them.

e. Check Clearing Lag

OCA witness Smith proposed an average check clearing time of 7 days. Use of the dollar-weighing approach reduces the lag to 5.2 days. OCA witness Smith utilized a 5-day lag time by calculating the average check clearing time from a random sample of a 100 checks provided to the OCA by the Company.

Because expense lag dollars represent non-investor supplied funds which are provided and because the utility can remit payment for expenses beyond the date that service is provided, OCA witness Smith recommended that PAWC should retain use of funds until the check is cashed.

ALJ Nguyen, on consideration of the OCA position, rejected the OCA proposed recognition of a check clearing lag. At page 46 of the R.D., the ALJ rejected the use of the check clearing **[*59]** lag calculation, to which the OCA filed Exception. See R.D., p. 46.

In its Exception, the OCA properly notes that a utility's cash working capital allowance is a hypothetical amount used for ratemaking purposes and does not represent actual amount subject to overdraft. See OCA Exc., p. 7, n. 9. Notwithstanding the accuracy of that observation, we conclude that the Company's calculation pertaining to check clearing lag is reasonable. Therefore, we adopt the ALJ recommendation concerning the check clearing lag calculation and deny the OCA's Exceptions.

f. Specific Expense Lags

The R.D.'s discussion of specific expense lag calculations extends from page 33 to 46 of the R.D. The ALJ's conclusions regarding the use of competing computations was as follows:

I recommend that PAWC's expense lag calculations for power, water, telephone and waste disposal, and OCA's expense lag calculation for pension be adopted. I believe that expense lags should be calculated to reflect the use of the due dates, the service period mid-points and the actual number of days in a service period. For this reason, for the balance of the expense lags, I recommend approval of OCA's calculations **[*60]** but not including the 5 day check clearing lag.

R.D., p. 47.

On consideration of the R.D., we shall adopt the ALJ recommendations concerning the expense lag calculations, with the exception noted above, of SFAS 106 costs. We duly note that the OCA, at pages 8 through 9 of its Exceptions, brings our attention to miscellaneous discrepancies in the R.D. with regard to the appropriate tables to be used in the determination of cash working capital allowances. We shall grant the OCA's Exception only to the extent that we have taken into consideration the clarifications so outlined.

IV. REVENUES

The Company presented its calculation of revenues under present rates in accord with the Commission practice of eliminating non-recurring items and annualizing known or anticipated changes. (PAWC Exhibit 3-A Revised) Following further revisions, the Company's claim for test year revenues under current rates is $ 177,359,477. (PAWC Main Brief, App. B)

The Company removed from pro forma future test year revenues two sale for resale customers -- North Penn Water Authority and North Wales Water Authority (North Penn and North Wales, respectively). PAWC anticipated revenue losses of $ 1,014,706 **[*61]** attributable to North Penn and $ 255,000 attributable to North Wales. These changes in revenues were projected to occur post-test year ending June 30, 1994. (OCA Main Brief, p. 54)

According to Company witness Modeer on rebuttal, North Penn and North Wales, which will be leaving the PAWC system due to the construction of a new water treatment facility, will be operational by future test year end, June 30, 1994. (PAWC Exh. 1-G; PAWC Exh. 1-H) When the new water treatment facility becomes operational, North Penn and North Wales will significantly curtail purchases from PAWC. (PAWC St. 1-R, pp. 23-26; PAWC St. 4-R, p. 7)

OCA made no objections to the Company's claim for test year revenues under current rates. OTS made no comments on the claim.

1. ALJ Recommendation

With PAWC's adjustments to pro forma revenues for revenue decreases attributable to North Penn and North Wales sales for resale, the ALJ recommended that the Company's claim for test year revenues be adopted.

On consideration of the ALJ recommendation, we find no controversy here. We shall adopt his recommendation concerning the appropriate level of revenues.

V. OPERATING AND MAINTENANCE EXPENSES

In developing **[*62]** its future test year claims, the Company adjusted the expenses recorded on its books of account for the twelve months ended June 30, 1993 to annualize the impact of known changes and to reflect the effect of changes that were reasonably anticipated to occur. In addition, as actual data became available during the course of this proceeding, PAWC revised the original claimed amounts of several expenses. These revisions are reflected in the Company's final income statement, which is attached to the Company's Main Brief as Appendix B. Appendix B indicates that PAWC's final claim for alleged operating and maintenance expenses is $ 83,556,683. We address the major components seriatim.

A. Salaries and Wages

The Company's claim for salaries and wages is $ 31,664,541. (PAWC Exh. 3-A Revised, p. 38R). This claim represents expenses related to the projected level of employees and annual group insurance costs and payroll taxes. (PAWC Exh. 3-A, pp. 40R, 64R; PAWC St. 8, pp. 6-7). The claim further reflects a projected total of 867 full-time employees, incorporates a $ 320,854 reduction to adjust for computational errors, and includes withdrawal of proposed adjustments reflecting non-union **[*63]** wage and salary increases tentatively effective on July 1, 1994 (N.T. 175, PAWC St. 6-R, pp. 2-4; PAWC Exh. 3-B; OCA St. 2-R, p. 41).

The R.D. outlined the two contested issue raised in connection with PAWC's Salaries and Wages expense claim as: (1) future union wage increases; and (2) the employee adjustment or vacancy rate. Also discussed in this section was the capitalization ratio.

The R.D. noted that the vacancy rate adjustment is based on a comparison of the Company's budgeted and actual level of employees, by month, for the period between January 1989 and November 1993 (R.D. at 54). The R.D. recommends adoption of OTS' calculation for the average annual salary for all full time employees with the capitalization rate being changed from 11.61% to 12.45% on the belief that the calculation was comprehensive and likely to reflect the total costs incurred. R.D. at 55. Notwithstanding the Company's claim that the vacancy rate of 1.177% provides an accurate depiction of the current and future vacancy levels given the major restructuring and reorganization of January 1993, the R.D. dismissed the Company's conclusion that their vacancy rate was reasonable. R.D. at 50-52, 55. **[*64]** The R.D. reasoned that for a company the size of PAWC, a vacancy rate of 1.177% or the equivalent of 10 employees is reasonable. Id.

These factors translated into a recommended expense reduction of $ 441,842 based on PAWC's calculation of a six employee vacancy, as presented in PAWC St. No. 6R, at p. 5, consisting of $ 210,153 (wages), $ 17,420 (payroll taxes), $ 37,532 (group insurance) and $ 176,377 for an additional four vacancies (R.D. at 55). The recalculation necessitated by adoption of OTS' reduction to reflect a 12.45% capitalization ratio results in a recommended expense reduction of $ 437,641 consisting of $ 346,925 (wage), $ 28,757 (taxes) and $ 61,959 (group insurance) (R.D. at 55).

The Company excepted to that recommendation by claiming that the recommendation is based in substantial part on data that pre-dates the January 1993 restructuring, whereas the Company claims that the budget-to-actual calculation should employ data <u>only</u> for periods subsequent to that date (Company Exceptions at 33). The Company claims that the resulting vacancy rate of .6886% or the equivalent of six employee positions, or a total adjustment of $ 265,105, provides a more accurate **[*65]** description of the likely vacancy rate (Company Exceptions at 33). The Company further responds to OCA's position on wage rate increases by noting that OCA is the only party making these allegations, that the Commission has always shown greater flexibility in applying the test year to union wage increase, that OCA reads the alleged "six-month" limit precedent too narrowly, that the recently completed contract negotiations with the Norristown District employees is an excellent benchmark for what will occur in the other districts, and that the Commission has approved such contract increases in prior cases (PAWC Reply Exceptions at 18-20).

The OCA excepted to the future wage increase and vacancy adjustment rate recommendations (OCA Exceptions at 17-21; OCA Reply Exceptions at 13-16). The OCA claims the recommendation is invalid because the increase in post-test year wage expense is not supported by known and measurable union contract increases given the speculative nature of contracts still subject to negotiation. Also, the OCA argued that the proposed increases were 12 months beyond the test year in violation of Commission precedent which limits such increases to six months beyond **[*66]** the test year. Additionally, the proposed increases will distort the test year expenses, and because the Commission does adjust both projected wage rate increases and vacancy rates whereas the R.D. mistakenly assumes that the Commission may do either one but not both (OCA Exceptions at 17-21). The OCA further responded to PAWC's exceptions by alleging that the Company's view is wholly without merit, analysis of the 1989-1993 employee levels incorporate the affect of PAWC's restructuring, there is no record evidence that transfer of employees from the service company to the water company impacts the vacancy levels, that the recommendation is consistent with Commission precedent in <u>PAWC 1992,</u> and that the retirement of an additional 13 employees by January 30, 1994 suggests that the restructuring has not affected the vacancy rate (OTS Exceptions at 14-15).

The OTS responded to PAWC's Exception to the vacancy rate adjustment (OTS Reply Exceptions at 9-10). The OTS claims the Exception should be rejected because the record evidence reasonably establishes that such a vacancy rate adjustment is not unusual for a company of PAWC's size given PAWC's historic pattern of budgeting for **[*67]** more employees that it actually employees. OTS Reply Exc., at pp. 9-10.

We recognize that three related issues are comprised within this salaries and wage increase claim. These concern the future union wage increase, the employee adjustment and the capitalization ratio. We agree with the OCA that union wage increases should be disallowed to the extent they are not expected to occur until twelve months <u>after</u> the end of the future test year. Furthermore, the OCA correctly notes that these contract are not yet finalized and are still subject to negotiation. However, a vacancy rate adjustment of 1.177%, or ten employees, was also recommended by the ALJ, the OTS and the OCA in light of the fact that the adjustment included corporate restructuring, PAWC's practice of budgeting more employees than are actually employed, and the projected retirements. The Company claims this adjustment is overstated and that, if one must be used, a vacancy rate of 0.6886%, or six employees, is more appropriately included in light of the corporate restructuring.

We support the Company's corporate restructuring and believe this Commission should enable PAWC to carry out their hiring plans as they **[*68]** see fit. Consequently, we do not endorse the use of a vacancy rate adjustment for PAWC because of our conclusion that use of a vacancy rate adjustment for PAWC here is the equivalent of micromanagement of the Company. Consequently, we also disagree with the ALJ's recommended capitalization ratio of 12.45%. We believe a more appropriate capitalization ratio should be 11.91% based on the most current data submitted by the Company.

B. Pension Expense

The Company's pension expense of $ 1,998,194 reflects a final figure that moved from an original claim of $ 1,856,117 and was increased to $ 2,524,034 before settling on this amount (R.D. at 56, 59). This final expense claim is based on the projected future test year operating expenses reflecting the additional costs incurred in making pension plan contributions during the period that the rates established in this proceeding are in effect (R.D. at 56).

The Company claims the expense is warranted, despite an overfunding in the 1990-1993 period that did not require or even permit contributions, because a current projected underfunding of pensions requires a $ 9.5 million contribution for the pension year beginning July 1, 1994 and **[*69]** that denial would adversely impact PAWC's somewhat weak "A-" bond rating (R.D. at 56-58). Both OTS and OCA challenged this expense on the grounds that the expense was not known and measurable and because the actual contributions will not commence until after the end of the future test year (R.D. at 56).

Both OTS and OCA propose that the Company's entire claim be disallowed in its entirety on the grounds that (1) the estimated contribution level is not known and measurable and (2) the actual contribution payments will not commence until after the end of the future test year (R.D. at 56). OTS and OCA collectively claim that PAWC seeks an entire year's contribution in this case although contributions are made quarterly, the expense is only an estimate for a pension year that begins after the test year in question, and that such immediate and premature recognition in rates of estimated and uncertain expenses should be disallowed. R.D. at 58-61.

The R.D. disallows the expense because OCA and OTS' positions are well taken. The ALJ determined that pension expenses should be treated on a "cash only" basis for ratemaking purposes. The fact that PAWC might book pension expenses during **[*70]** the test for financial or accounting purposes is deemed irrelevant to determining whether the expense should be included for ratemaking. *Pennsylvania Public Utility Commission v. West Penn Power Company, 119 PUR 4th 110 (1990).* The R.D. recommends disallowance of PAWC's claim. R.D. at 61-62.

The Company excepts to disallowance of this hotly contested expense for several reasons (PAWC Exceptions at 9-17). The Company claims this is an expense that will be incurred during the first year rates are in effect, that PAWC never suggested book entry or accounting value treatment of the expense, that attacks on the Company's documentation because of their "interim" nature and the fact they were not required in the 1990-1993 period could be attributed to earlier pension overfunding and that PAWC will incur a $ 2.0 million pro rata expense as part of the American System obligation of $ 9.5 million (PAWC Exceptions at 12). PAWC further excepts to the prior Commission precedent cited to sustain the R.D. on the grounds that the Commission precedent does not reject an expense as speculative merely because it is estimated, that Commission precedent is to accept estimates rather than **[*71]** pretend an expense does not exist, and that on the West Penn precedent case is misplaced because PAWC does not intent to propose book treatment nor does PAWC have an overfunding situation (PAWC Exceptions at 12-14). PAWC also excepts on the grounds that delayed contributions would only increase the expense later, that delay would result in the loss of tax deduction treatment, and that the normalization approach strongly suggested by opponents' approach should be rejected (PAWC Exceptions at 12-15). Finally, PAWC contends the earlier practice of collecting for pension expense even after contributions had ceased is no that unique or unusual, that such practice is not basis for disallowance, and that the Commission's rejection the argument that FAS 106 expense should be rejected as speculative is appropriate here. PAWC Exc. at 16-17.

In their Reply Exceptions, both OCA and OTS support disallowance (OCA Reply Exceptions at 6-11; OTS Reply Exceptions at 3-6). The OCA supports disallowance on the grounds that Commission precedent has consistently permitted recovery only of actual pension expenses incurred during a test year, that recovery is not based on pension expenses incurred **[*72]** during the first year rates are in effect, that PAWC's reliance on precedent before West Penn is misplaced, that PAWC's recognized practice of filing annual rate cases warrants close scrutiny of actual pension expenses paid during a test year, that neither PAWC nor their plan sponsor are legally required to make any contributions during the test year, that delayed payment will not result in a loss or write-down, and that PAWC could have avoided the entire dispute by simply filing with a test year that included actual, as opposed to projected, pension expenses (Reply Exceptions at 6-10). OTS supports disallowance because PAWC will not make a cash contribution during the test year and that the Commission should dismiss PAWC's attempt to get the Commission to depart from their practice of limiting pension expense to actual cash contributions and replacing it with estimates for that expense -- especially given that PAWC intends to file another case two months after these rates go in effect (OTS Reply Exceptions at 3-6).

We conclude that the pension expense is appropriately included as an expense during the test period. We do so in light of the fact that this case is not like the **[*73]** situation in West Penn. PAWC is not seeking to recover for a pension expense that need not be made because of overfunding nor does PAWC intend to give this expense book or accounting treatment. Consequently, we are persuaded that the testimony of Mr. Marks, demonstrates that the American System pension plan will experience a minimum contribution for ERISA standards of approximately $ 9.5 million, of which approximately $ 2.0 million would be PAWC's liability. Therefore, we conclude that this claim should be allowed.

C. SFAS 106

As part of its requested rate increase, the Company included claims for (a) the cost of providing post-retirement benefits (OPEBs) other than pensions to its employees and (b) PAWC's proportionate share of the costs of providing OPEBs to employees of the Service Company, each computed in accord with the provisions of Statement of Financial Accounting Standards No. 106. The Company's adjusted OPEB claims equal $ 3,124,396 for PAWC employees and $ 183,746 for Service Company employees. These figures reflect the capitalization rates actually experienced by the Company during the twelve months ended February 28, 1994 (capitalization rates of 11.91% for **[*74]** PAWC and 21.81% for Service Company) (R.D. at 62).

On April 28, 1994, the parties submitted a stipulation on this expense which does not change the amounts claimed by the Company although they could not agree on a capitalization rate (R.D. at 62 citing The Parties' Stipulation at p. 3). We conclude that endorsement of this stipulation, premised on inclusion of the 11.91% capitalization rate we decide below, is appropriate and in the public interest.

D. Capitalization Rate

In January, 1993, the Company instituted a new capitalization policy to calculate the portion of applicable cost categories that are capitalized (R.D. at 63). Under the new approach, a portion of salaried employees' pay is capitalized even if that employee is not working directly on construction projects (R.D. at 64). The relevant data, annualized to reflect a full year's experience, were revised during the proceeding and resulted in PAWC's claimed capitalization rate of 11.61% (R.D. at 63).

The R.D. recommended a capitalization rate of 12.45% as more reflective of PAWC's actual experiences during the first fiscal year and the calendar year in which the new capitalization policy was in effect (R.D. at 64). **[*75]** The R.D. apparently endorsed the OCA's calculations given that the only difference between the Company's calculation and OCA witness Smith's calculation is that PAWC used the first six months of data when the new capitalization policy was implemented, whereas OCA witness Smith used data from the first six months and the full year of 1993, the first full fiscal year in which PAWC's new policy was in effect (R.D. at 64).

The Company excepts to use of a 12.45% capitalization rate, as well as the resulting $ 425,793 expense reduction entailed with that rate, on the grounds that the 12.45% rate is too high, inconsistent with the Commission preference for updated data, and insupportable in light of the ration adjustments that occurred during the case (PAWC Exceptions at 31-32). OCA's Reply to PAWC's Exception contends that the issue turns on the appropriate time period, given that no party disputes the Company's new capitalization period, and that a ratio based on actual experience during the first fiscal year and calendar year is more reliable than one that relies on only six months of actual data (OCA Reply Exceptions at 12).

We conclude that an 11.91% capitalization rate is appropriate **[*76]** because it represents a middle ground between PAWC's figure based on six months actual data and OCA's figure based on the first fiscal year and calendar year. Furthermore, the 11.91% rate does not exceed the figure indicated by the most current data available at the close of the record (PAWC Exceptions at 31-32).

E. 401(k) Plan

As of August 1, 1993, the Company established a 401(k) plan for all of its employees. Under the terms of the plan, an employee may contribute up to 2% of his or her salary and the Company will make a matching contribution of 30 cents for each employee-contributed dollar. The Company claimed a future test year expense of $ 165,000 for its 30 cents "matching" contribution, which it projected by analyzing actual data for August 1993 (R.D. at 66).

OCA witness Smith's final recommendation was to reduce the Company's 401(k) expense claim by $ 45,197, to a recommended allowance of $ 120,315. OCA witness Smith's adjustment is based on three factors: (1) reflection of the effects of OCA recommended payroll expense; (2) capitalization of a portion of this employee benefit; and (3) reflection of updated and annualized actual employee contributions.

The R.D. recommended **[*77]** adoption of the OCA's disallowance of $ 45,197 to the expense (R.D. at 67). No party has excepted to this adjustment. However, we conclude the adjustment should reflect the payroll expense approved above, a capitalization rate of 11.91% for the relevant portion of this expense, and an adjustment to reflect updated and annualized actual employee contributions.

F. Vehicle Expense

PAWC claimed expense is $ 1,661,627 for 416 vehicles (R.D. at 68). OCA witness Smith recommended two adjustments totalling $ 72,758 (R.D. at 68). The proposed adjustments pertain to a disallowance of only that portion of PAWC's future test year leased vehicle expense claim that represents the costs for employee personal use of Company vehicles and application of a capitalization rate of 12.45%.

The R.D. recommended a $ 72,758 adjustment in the claimed expense in light of the fact that other regulated utilities have adopted similar cost-cutting measures and practices to alleviate burdens on their ratepayers and to encourage PAWC to consider whether its current policy, as opposed to reimbursement for mileage, is not imposing greater burdens on its ratepayers (R.D. at 68-69).

The Company excepts to the **[*78]** disallowance on the grounds that the vehicles in question are largely of a utility type that have special equipment needed to provide significant after-hours service which would be delayed in their absence or that the vehicles are needed by corporate persons who spend a large amount of their time on the road and that use of the proposed mileage reimbursement option would increase expenses (PAWC Exceptions at 34-36). OCA's Reply Exceptions challenge the Company's claims by noting that 48 automobiles (not utility vehicles) are provided to employees and that PAWC fails to address the primary issue of enhanced cost-cutting measures which will not burden ratepayers (OCA Reply Exceptions at 16-18).

We conclude that the record evidence sustains PAWC's policy. Most of the vehicles are devoted to service delivery and contain specialized equipment that would not normally be contained in personal automobiles. However, we do note that the capitalization expense associated with this expense shall be adjusted to reflect the 11.91% figure we adopted above.

G. Rate Case Expense Normalization

OCA witness Smith proposed an adjustment to reduce the Company's claim for rate case expense by $ 85,568 **[*79]** to reflect normalization over 14 months instead of 12 months (R.D. at 70). Mr. Smith's recommended normalization period is the historical average of the intervals between filing dates for the Company's last five rate cases, including the current case (R.D. at 70).

The R.D. adopted PAWC rate case expense of $ 599,000 by recommending rejection of the OCA's proposed adjustment of $ 85,568 (R.D. at 70-71; OCA Reply Exceptions at 21, 23). The recommendation was based on Commission precedent which defines the reamortization period as the time period between the end of this rate case and the filing of the next. (R.D. at 71 citing Pennsylvania Public Utility Commission v. Western Pennsylvania Water Co., Docket No. R-870825 (Pa. PUC July 1, 1988).

In their Exceptions, both OCA and OTS dispute the recommendation (OCA Exceptions at 21-24; OTS Exceptions at 7-8). OTS urges the Commission to reject the recommendation even though OTS did not actively litigate the issue (OTS Exceptions at 7-8). OCA alleges that its 14-month normalization period represented the average time between actual filings over the last five years is more appropriate because use of a 12-month period allows PAWC **[*80]** to collect from ratepayers a cost which has ceased to be recorded on the books, that use of the 12-month period in PAWC 1992 generated a $ 150,000 benefit to shareholders at ratepayers expense, that the 14-month average overlooks Commission precedent which considers a company's actual base rate filing practice, and that the current practice unjustifiably rewards shareholders by permitting earlier-than-actual recovery of normalized amounts (OCA Exceptions at 22-23).

Conversely, PAWC's Exceptions support the recommendation (OTS Reply Exceptions at 20-21). PAWC alleges that the recommendation accords with precedent in PAWC's last rate case and with the Commission's historic practice of adopting a 12-month normalization period for PAWC based on a reasonable projection of the interval between its current and next rate filings (PAWC Reply Exceptions at 20). Furthermore, PAWC alleges that OCA's position on this issue contradicts their earlier claim, that the next filing will be exactly 12-months after the filing of this case, and that the allegation of shareholder benefit is absurd (PAWC Reply Exceptions at 21).

We agree with the ALJ's recommendation on this issue. We do so in light **[*81]** of our historic practice, earlier precedent, and PAWC's actual filing history. Consequently, we reject the arguments that this normalization approach somehow benefits shareholders and that the R.D. ignored prior precedent.

H. Inflation Adjustment

The Company applied an inflation factor to operating and maintenance expenses booked during the historical test year for which specific future test year adjustments were not made (R.D. at 70). The inflation factor of 2.54% used by the Company was based on the average change from June 1992 to June 1993 in the principal inflation indices: the Consumer Price Index, the Producer Price Index and the Gross National Product Deflator (R.D. at 70).

The OCA alleges that the Company did not update the inflation of 2.54% for more current data. OCA's witness expects inflation to fluctuate between 2.8% and 3.0% in 1994 (OCA St. 1, pp. 10-11).

The R.D. recommended that the Company's estimated inflation rate of 2.54% be accepted as reasonable given the evidence (R.D. at 70). The net result is a $ 389,413 adjustment, adjusted downward from $ 394,673 to reflect the removal of rental expense, to PAWC's claimed O&M expense levels (OCA Exceptions a 24, **[*82]** n. 18).

The OCA excepts to the recommendation on the grounds that the recommendation erroneously compares PAWC's composite index with OCA's Consumer Price Index, misapplies record evidence and fails to consider Commission precedent requiring the use of updated information, and that PAWC never provided updated information on the issue throughout the proceeding (OCA Exceptions at 24-25).

PAWC's Reply Exceptions support the recommendation. PAWC claims that the adjustment is very conservative in light of OCA's own witness' statements concerning inflation and that OCA's insistence on current updated information for inflation purposes contradicts their unwillingness to include updated information through February 1994 on the capitalization issue (PAWC Reply Exceptions at 21-22).

We agree with the R.D. concerning this issue. We do so in light of the fact that the conservative estimate is lower than that even proposed by OCA's witness, the OCA's position on updated information is correct even if it contradicts OCA's position on the capitalization issue, and because the adjustment allows PAWC to account for price increases.

I. ALCOSAN Legal Fees

During the historical test year, the **[*83]** Company incurred legal expenses of $ 14,589 to defend an action brought by the Allegheny County Sanitary Authority (ALCOSAN). The Company provides meter reading data to ALCOSAN for use in calculating its sewer bills for common customers. ALCOSAN sought a substantial reduction of the rate charged by PAWC for that service and, after negotiations reached an apparent impasse, exercised its statutory right to have the Commission arbitrate the dispute. The matter was assigned to an Administrative Law Judge, but a settlement was ultimately reached and approved by the Commission (R.D. at 70-71).

OCA witness Smith has proposed eliminating ALCOSAN legal fees from the Company's expense claim because they represent a "nonrecurring cost." No further litigation expense related to it is expected. The recurring nature of expenses, the Company argues, should not be assessed on an item-by-item basis, as Mr. Smith has done. Rather, recurrence must be analyzed by looking at rationally-defined categories of costs. The Company litigates a variety of cases each year and it is simply wrong to select one case and exclude test year expenses associated with it because it has been concluded (R.D. at 70-71). **[*84]**

The R.D. noted that not all legal fees are recoverable. R.D. at 71. Legal fees incurred during the test year from litigation against a contractor who damaged a company's distribution system (Pennsylvania Public Utility Commission v. Riverton Consolidated Water Co., 38 Pa. PUC 525 (1961)) or in defending a service complaint where a company was found to be at fault (Township of Spring v. Citizens Utilities Water Co. of Pennsylvania, 42 Pa. PUC 761 (1966)) were disallowed as an operating expense. R.D. at 71.

We agree with the R.D. that the expense incurred by the Company as a result of negotiations with ALCOSAN does not represent an ongoing cost that the Company will continue to incur after June 30, 1994. Therefore, this nonrecurring expense of $ 14,589 should be disallowed. R.D. at 70 citing *Garber v. Philadelphia Suburban Water Co., 45 Pa. PUC 118 (1971).*

J. Other Expense Adjustments

OCA witness Smith proposed three additional reductions to other PAWC expense claims, which the Company does not contest, and a fourth reduction was agreed to as part of the resolution of a discovery matter (R.D. at 72-73). These consist of the following:

[*] Miscellaneous Expenses **[*85]** ($ 8,469): To eliminate the Company's costs to sponsor an annual Air Force Band concert ($ 6,369) and contributions to an Employee Association ($ 2,100) (OCA St. 2, p. 79);

[*] Service Company Relocation Expense ($ 13,000): To normalize Service Company employee relocation expense based on a six-year average (OCA St. 2-S, p. 12);

[*] Service Company Lease Expense ($ 43,348): To correct mathematical errors in the computation of the rent charged by Occoquan to the Service Company under leases of furniture and equipment for the Voorhees Office of the Service Company and the Belleville Laboratory (OCA St. 2-S, p. 25);

[*] Main Extension Complaint Costs ($ 4,779): To eliminate costs incurred during the historic test year to defend main extension complaint cases. (This adjustment is made pursuant to agreement of counsel to resolve a disputed discovery matter.)

(R.D. at 72)

Given that all of these adjustments have been included in the Company's final accounting scheduling (R.D. at 72 citing PAWC Main Brief at p. 84), we conclude that these adjustments to PAWC's claimed expenses are appropriate.

K. Leases Between Occoquan and the Service Company

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[*] PAWC Main Brief page 97.

Occoquan is a subsidiary of American **[*86]** that is engaged in the business of leasing property and equipment to other American subsidiaries, including the Service Company. The Service Company acquires office space, office furnishings and equipment by leasing them from Occoquan. The property leased from Occoquan is used by the Service Company in providing services to the operating water companies of the American system. Rental costs paid by the Service Company to Occoquan are included in the total costs of operation of the Service Company, which charges the operating companies an amount sufficient to recover its costs under the terms of the uniform contracts between the Service Company and each of the operating companies, including PAWC. R.D. at 73.

Although no issue was raised concerning the reasonableness of the Occoquan lease expense, the OCA raised the question whether the Occoquan-Service Company leases are within the scope of Section 2102 of the Public Utility Code (66 Pa.C.S. § 2102) (R.D. at 73-74). The R.D. recommended that Section 2102(a) was inapplicable because neither Occoquan nor American were public utilities within the ambit of Section 2102(a) and that, even if they were so deemed, the Commission's prior **[*87]** approval of the Service Contract between PAWC and the Service Company and the Commission's prior allowance of all Service Company charges in the last rate case were tantamount to approval under Section 2102(a) (R.D. at 74-75).

The OCA excepts to that determination on several grounds (OCA Exceptions at 25-28). Although the OCA concedes that PAWC's contracts with corporate entities which are not public utilities do not generally come within the Commission's jurisdiction, the OCA argues for the nonapplicability of that general rule because of the close managerial relationship between the entities (OCA Exceptions at 26). The OCA further alleges that the objective of the Service Company to provide services at cost is fundamentally in conflict with the objective of Occoquan Land to maximize profit such that a careful scrutiny of those relationship is necessary under Pennsylvania precedent (OCA Exceptions at 26 citing *Solar Electric Co. v. Pa.P.U.C., 137 Pa. Superior Ct. 325, 374, 9 A.2d 473 (1939).* The OCA also excepts to the ALJ's blithe dismissal of that precedent, notes that these leases have been hidden from view until this proceeding, and concludes that not reviewing these **[*88]** leases would enable a public utility to easily evade the review required by Chapter 21 (OCA Exceptions at 26-27).

In its Replies, PAWC disagrees with the OCA's characterization and position (PAWC Reply Exceptions at 22-23). The Company urges the Commission to adopt the ALJ's well-reasoned recommendation regarding the inapplicability of Section 2102 to Service Company provision of property and equipment to PAWC through Occoquan based, in part, on the OCA's mischaracterization of these leases as previously hidden when, in fact, they had been closely scrutinized in PAWC 1992 and in an earlier Commission-sponsored Management Audit.

On consideration of the issue, we agree with the ALJ's conclusion that review of the particular contractual relationships encompassed in this proceeding do not need further review under Section 2102(a). We conclude that any necessary review of these contractual arrangements have clearly been satisfied by our prior approval of the Service Contract between the Service Company and PAWC, our close scrutiny and determination in the PAWC 1992 proceeding that these contractual arrangements were reasonable, and our prior review in the earlier Management **[*89]** Audit. Consequently, we see no need to conduct the additional review of these particular contractual arrangements advocated by the OCA in this proceeding.

L. Hershey Treatment Plant "Early Window" Costs

On August 14, 1992, the Company filed a Petition for Declaratory Order requesting that the Commission approve certain accounting procedures in order to permit the synchronization of the commercial operation and rate recognition of its new Hershey Treatment Plant, which was placed in service on November 1, 1992. The Petition sought permission to defer the capital costs (i.e., carrying charges and depreciation) associated with the Hershey Treatment Plant from the date of commercial operation to the date the plant would be reflected in rates. The Petition also sought approval of a ten-year amortization period for these interim expenses so that they would commence with the rates established at the conclusion of its prior rate case, which was then pending as PAWC 1992.

On October 22, 1992, the Commission entered an Order at Docket No. P-00920603 which authorized, and in fact required, PAWC to utilize deferred accounting for the interim expenses that would be incurred during the **[*90]** period from the date of commercial operation to the date the plant would be reflected in rates. However, the Commission did not approve PAWC's recovery of the deferred costs but instead concluded that rate recovery of these such would be addressed in a future rate proceeding following PAWC 1992. The Company now seeks to recover $ 92,461 consisting of a portion of the 10-year amortization of the deferred costs that were deferred by the October 1992 order. R.D. at 75-76.

The R.D. recommended allowance of that expense even though the normal recovery of these deferred expenses would be prohibited as retroactive ratemaking. R.D. at 76-77. The R.D. did so based on the conclusion that these deferred expenses were excepted from the general ban because they were nonrecurring and extraordinary expenses. R.D. at 76-77.

The OCA and OTS filed Exceptions to this recommendation (OCA Exceptions at 10-17; OTS Exceptions at 8-10; OTS Reply Exceptions at 12). The OCA excepted on the grounds that their recovery contravenes the ban on retroactive ratemaking, that the Company has failed to establish the expense as an exception to the ban, and that the Company has failed to establish either **[*91]** the rate recovery treatment or reasonableness of the claimed expense (OCA Exceptions at 11-12, 13-16, 13). OTS excepts on the grounds that the ALJ wrongfully permitted recovery of the post-in-service AFUDC expense represented by the deferred expenses, PAWC should bear the impact of the fact that these AFUDC expenses fell outside the applicable test years given their annual rate case filings, and that Commission practice and recent Commonwealth Court precedent prohibit recovery (OTS Exceptions at 8-10).

The Company challenges the OCA and OTS position in several respects (PAWC Reply Exceptions at 12-18). The Company claims that the current consideration of rate treatment for this expense based on the Commission prior approval of deferred treatment does not constitute retroactive ratemaking (PAWC Reply Exceptions at 15). The Company further claims that the earlier denial of amortized recovery was without prejudice to a substantive determination on the merits in the later proceeding (PAWC Reply Exceptions at 15). The Company also claims that prior Commission precedent permits amortization of such early window costs given the practical inability to precisely time the placement of plant **[*92]** in service with rate case filings and that inclusion of such expenses would not constitute retroactive ratemaking (PAWC Reply Exceptions at 14-16). In addition, the Company claims that the OCA's reliance on the May 1994 PP&L decision of the Commonwealth Court is misplaced because that decision is not the final word on the matter, may be subject to Supreme Court appeal, and is distinguishable from this case on the facts (PAWC Reply Exceptions at 17-18). Finally, the Company claims that the recovery period for such unusual capital expenses occurring outside the test year is a determination within the Commission's expertise and that denial of the expenses subject to the October 1992 order will adversely impact the Company's financial condition given the $ 20 million dollar nature of the expense in question. PAWC R.E. at 17-18.

We reject the OCA and OTS claim that rate recovery of the "early window" deferred accounting costs would constitute impermissible retroactive ratemaking. However, the Company's claim must fail given their failure to provide sufficient evidence to meet the threshold showing of adverse financial impact.

The OCA cites the recent Commonwealth Court decision **[*93]** of May 1994 involving PP&L's recovery of FAS 106 costs. Popowsky v. Pa.P.U.C., No. 1315 *C.D. 1993* (May 26, 1994) (hereinafter "PP&L"). The OCA cites PP&L for the proposition that rate recovery of the early window Hershey Plan costs constitutes retroactive ratemaking. We obviously disagree with the Court's decision, in part, because the effect of that decision would be to overturn our prior approval for deferred accounting and deferred ratemaking treatment of the FAS 106 expense at issue in that case. In this case, our earlier decision limited our approval of the Hershey Plant costs for accounting purposes only. Even more to the point, the Commonwealth Court's approval of the base rate recognition of PAWC's FAS 106 costs is more squarely on point. In that decision, the Commonwealth Court ruled:

Furthermore, in both Pike and Philadelphia Electric "[a]n exception to this rule in the case of retroactive recovery of unanticipated expenses has been recognized where the expenses are extraordinary and nonrecurring." [citations omitted]. In Pike, this Court rejected the company's argument that the Commission could not order the company to account for loss carryovers **[*94]** occurring in the past, available as deductions for federal income tax purposes, since they were extraordinary losses to be amortized over a period of years.

In Philadelphia Electric, this Court declined to permit the utility to recover part of the cost of deferred pollution control facilities' expense amortized over a three year period, because they were past expenses that could have been anticipated and requested in a prior rate case proceeding and they were neither extraordinary nor non-recurring.

In this case also, PAWC had no opportunity to seek recovery of its OPEBs until the issuance and acceptance of SFAS 106 and the Commission approval of accrued accounting treatment of such obligations. We, therefore, hold that PAWC's application is timely; that the transitional obligation arises from an extraordinary and non-recurring one-time event -- the change from cash to accrual accounting -- and the allowance of the recovery of that obligation amortized over a period of twenty years is not retroactive ratemaking.

PP&L, Slip Op. at 6-8. With regard to the Hershey Plant costs, there is no question that the Company's ratemaking claim is timely given that the claim was initially **[*95]** made in its prior base rate case which was the first case following the PUC's approval of deferred accounting for these costs. The Commission deferred the claim to a subsequent proceeding. The present case is the next base rate case following the Commission's deferral of the ratemaking treatment of these costs. There is also no question that these cost are non-recurring in the sense that the costs relate to a one-time event of this large project being operational. Nonetheless, it is appropriate to evaluate these costs according to the rules governing amortizations of extraordinary and non-recurring costs because the Company's claim represents a request for recovery of costs in addition to an ongoing level of rate recovery associated with the operation of the Hershey Plant.

As to whether these costs are extraordinary, we are guided by the appellate precedents as well as prior Commission precedent addressing ratemaking claims for deferral costs pursuant to window petitions. The PUC decision in the 1990 PECO base rate case required the utility to show that window costs are both extraordinary and non-recurring, and that the denial of recovery would have a substantial negative financial **[*96]** impact on the utility. We view the first evidentiary prong as requiring a qualitative demonstration and the second prong as requiring a quantitative demonstration that the costs are extraordinary. The concurring opinion in the 1990 PECO case clearly advised that this evaluation must proceed on a case by case basis, looking at the financial impact of the utility during the period that the costs were experienced.

PAWC has satisfied the qualitative evidentiary showing that the Hershey Plant costs were extraordinary, relying on the 1992 PG&W case. With regard to the quantitative evaluation, however, PAWC's evidence is insufficient. As OCA pointed out in Exceptions, there was no comparison of the potential effect on PAWC's earnings with and without rate recovery of these window costs. Simply because the Company may not have earned its authorized rate of return during the period in question that the costs were experienced does not meet its burden of showing substantial negative financial impact. For these reasons, we reject PAWC's ratemaking claim for the Hershey window costs.

M. Purchased Power

OTS's witness Mr. Laudenslager recommended a disallowance of $ 94,863 of PAWC's originally **[*97]** claimed increase in purchased power (electricity) costs. This amount represents a portion of the estimated increase in charges for electrical service attributed to a rate increase anticipated by West Penn Power (R.D. at 77)

PAWC witness Balmer indicated in her rebuttal testimony that the Company adopted this proposed adjustment and eliminated the estimated West Penn Power increase from its claim for purchased power expense. No parties contested this issue. (OTS's Main Brief, p. 34 and OCA's Main Brief, p. 56) (R.D. at 77-78).

The R.D. recommend that the disallowance be adopted. Given the absence of objections to this disallowance, we affirm the R.D.'s recommendation.

N. Purchased Water

The Company proposed a future test year adjustment to purchased water costs for three items: (1) a projected 15% rate increase from North Fayette Municipal Authority during the first quarter of 1994; (2) the inclusion of expenses for water purchased from the North Wales Municipal Authority, which began in April 1993; and (3) a projected 9% rate increase from the Pittsburgh Water and Sewer Authority which PAWC anticipated would occur January 1, 1994. OCA witness Smith recommended adjustments **[*98]** to each of PAWC's pro forma purchased water adjustments (R.D. at 78).

In rebuttal testimony, the Company revised its purchased water claim to reflect two adjustments recommended by OCA witness Smith. The third recommendation, an adjustment for an anticipated rate increase from the North Fayette Municipal Authority, was subsequently revised by PAWC and, the revised known increase of 9.8% as approved by the North Fayette Board was then adopted by OCA witness Smith (R.D. at 78).

Accordingly, the OCA and PAWC agree that the Company's revised purchased water expense claim must be decreased by $ 52,702 from the Company's original claim, thus reflecting OCA witness Smith's recommendations and the known increase of 9.8% rate increase approved by the North Fayette Board (R.D. at 78-79 citing OCA's Main Brief at 57).

The R.D. recommended that the Company's original purchased water expense claims be decreased by $ 52,702. Since this adjustment is already reflected in the Company's claim (PAWC Exh. 3A, p. 45R), the R.D. concluded that no additional adjustment was necessary (R.D. at 79). Based on the absence of significant objection to this recommendation, we affirm the ALJ's recommendation. **[*99]**

O. Change in Consumption

PAWC future test year claim reflected a decrease in consumption. PAWC proposed an adjustment to reduce the future test year consumption expense consisting of power and chemical costs. PAWC's claimed a total decreased change in consumption of $ 127,576, based upon 378,307,769 gallons less a decrease of 4,883,640 gallons projected at the future-test-year end. Given that the parties make no objection to the change in consumption, we affirm the R.D.'s recommendation on this point.

P. Fines

During the historic test year, the Company incurred two fines, each amounting to $ 1,000, for a total cost of approximately $ 2,000, which PAWC claimed in this case. Company witness Balmer in Rebuttal Testimony adopted OCA witness Smith's adjustment (PAWC St. 6-R at 9), which reduces expense by $ 2,039. (OCA's Main Brief, p. 59). This adjustment has already been reflected in PAWC's revised claim (PAWC St. No. 6-R, p. 9). See R.D. at 79. We affirm the R.D.'s recommendation given the absence of significant objection to the recommendation.

Q. Previously Allowed Amortizations

PAWC proposed an adjustment to continue with amortizations which were previously allowed **[*100]** by the Commission for ratemaking purposes. PAWC's calculations derived a pro forma adjustment of $ 178,020. R.D. at 80.

OCA witness Smith discovered errors in the Company's calculations which were corrected by the Company and adopted in Rebuttal Testimony submitted by Company witness Balmer. The OCA adopts the Company's per book offset of $ 20,119 for proper calculation of previously allowed amortizations. (OCA's Main Brief, p. 59). This adjustment also has been reflected in PAWC's revised claim (R.D. at 80 citing PAWC St. No. 6-R, p. 9). We affirm the ALJ's recommendation on this point given the absence of significant objection.

R. Chemical Expense

When PAWC filed its request for a rate increase, the Company had not selected winning bids for 1994 chemical purchases and PAWC based its future test year chemical expense on 1993 unit prices and adjusted for inflation and usage per chemical. OCA witness Smith obtained actual and known vendor prices and adjusted PAWC's pro forma chemical expense to reflect actual 1994 chemical unit prices. See R.D. at 80.

PAWC revised its chemical expense claim. The OCA accepts the Company's revised claim, resulting in a $ 58,434 increase **[*101]** in chemical expenses (R.D. at 80 citing OCA's Main Brief at 55-56).

The R.D. recommended that the Company's revised claim be accepted. Given the absence of significant objection to this recommendation, we hereby affirm the ALJ's recommendation.

VI. TAXES

As in its last case, PAWC included in its initial filing a "consolidated tax savings" adjustment. The adjustment was developed in a manner identical to that employed by the OTS's expert witness and adopted by the Commission in the Company's rate proceeding at Docket No. R-911909, when this issue was last contested. No parties contested tax issues in this case and we shall use the tax calculation as set forth in the R.D.

VII. RATE OF RETURN

The calculation of the appropriate rate of return is a major issue in this proceeding and is the subject of various methodologies and interpretations of financial data. Rate of Return has been defined by Garfield and Lovejoy in their Public Utility Economics at 116 (1964):

The 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, **[*102]** the rate base. Included in the "return" are 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.

(emphasis in original)

A public utility, whose facilities and assets have been dedicated to public service, is entitled to an opportunity to earn a fair rate of return on its investment. The standards used by the Commission in determining what is a fair rate of return are well-established, having been set forth more than six decades ago by the United States Supreme Court in *Bluefield Waterworks and Imp. Co. v. P.S.C. of West Virginia, 262 U.S. 679 (1923):*

Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and **[*103]** their enforcement deprives the public utility of its property in violation of the Fourteenth Amendment. *(262 U.S. at 690)*

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. *(262 U.S. at 693)*

These principles have been adopted and applied by the Appellate Courts of Pennsylvania in numerous circumstances. See, e.g., *Riverton Consolidated Water Co. v. Pennsylvania Public Utility Commission, 186 Pa. Superior Ct. 1, 140 A.2d 114 (1958), Pittsburgh v. Pennsylvania Public Utility Commission, 182 Pa. Superior Ct. 376 126 A.2d 777 (1956); Lower Paxton Twp. v. Pennsylvania Public Utility Commission, 13 Pa. Commonwealth Ct. 135, 317 A.2d 917 (1974).*

The return allowed to investors must be commensurate with the risk assumed, as the Supreme Court has stated in three landmark opinions. *Bluefield, supra,* requires that the rate of return reflect:

[A] return on the value of the [utility's] property which it employs for the convenience **[*104]** of the public equal to that generally being made at the same time on investments in other business undertakings which are attended by corresponding risk and uncertainties. *(262 U.S. at 692)*

Twenty-one years later, the Supreme Court reiterated that standard in *Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944),* as follows:

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. *(320 U.S. at 603)*

More recently, in reaffirming the Hope decision, the Supreme Court, in *Duquesne Light Co. v. Barasch, 488 U.S. 299, 109 S.Ct. 609, 619, 102 L.Ed. 2d 646, 661 (1989),* observed that "[o]ne of the elements always relevant to setting the rate under Hope is the return investors **[*105]** expect given the risk of the enterprise."

The determination of a fair rate of return thus requires the review of many factors, including: (1) the earnings which are necessary to assure confidence in the financial integrity of the company and to maintain its credit standing; (2) the need to pay dividends and interest; and (3) the amount of the investment, the size and nature of the utility, its business and financial risks, and the circumstances attending its origin, development and operation. Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Co. - *Water Division, 19 Pa. Commonwealth Ct. 214, 233, 341 A.2d 239 (1975); Lower Paxton Twp., supra.* Moreover, the Commission's findings must be based upon substantial and competent evidence on the record before it, not upon speculation or hypotheses. *Ohio Bell Telephone Co. v. Pub. Utility Comm. of Ohio, 301 U.S. 292 (1937); United States Steel Corp. v. Pennsylvania Public Utility Commission, 37 Pa. Commonwealth Ct. 195, 390 A.2d 849 (1978); Octoraro Water Co. v. Pennsylvania Public Utility Commission, 38 Pa. Commonwealth Ct. 83, 391 A.2d 1129 (1978).*

Three parties, PAWC, OCA and OTS, actively contested **[*106]** of return question.

Capital Structure

The following table summarizes the capital structure proposal of PAWC:

Capital Structure	**PAWC** *
Long-Term Debt	58.6
Preferred Stock	3.7
Common Equity	37.7
	100.0

PAWC's pro forma capital structure as of June 30, 1994 proposal, according to the Company, reflects the ratios PAWC will experience during the period the rates will be in effect. (PAWC St. 11, pp. 29-30) Since, the OCA and OTS both accepted PAWC's capital structure claim in this proceeding, the ALJ recommended that PAWC's proposal be approved. Accordingly, we will adopt the ALJ recommendation regarding PAWC's capital structure.

Long-Term Debt and Preferred Stock Cost

PAWC's pro forma June 30, 1994 Long-Term Debt cost rate claim is 8.79 percent and Preferred Stock claim is 7.62 percent. (PAWC Exh. 11, Sch. 17) The PAWC cost rate claims are based on its anticipated costs. Neither the OCA or the OTS oppose PAWC's Long-Term Debt and Preferred Stock cost rate claims. (OCA St. 1, p. 12; OCA Main Brief, p. 176 and OTS Main Brief, p. 35). Accordingly, the ALJ recommended accepting PAWC's cost rate claim. As in the issue of capital **[*107]** structure, we will adopt the ALJ's recommendation regarding the cost rate of long-term debt and preferred stock.

Common Equity Cost

The following table summarizes the common equity methodologies and claims of the parties:

Methodology	PAWC [1]	OCA [2]	OTS [3]
	%	%	%
Discounted Cash			
Flow (DCF)	11.0	9.9-10.4	9.09-10.12
Risk Premium (RP)	12.25		
Capital Asset Pricing			
Model	10.5-10.63		
Comparable Earnings			
	13.5		
Claim	11.75	10.4	9.84

The ALJ observed that PAWC is a subsidiary of American Water Works Company, Inc. (AWWC) and as such does not have publicly traded common stock. The ALJ continued that the cost of common equity for AWWC is a poor proxy for PAWC, and he recognized the need for similar risk barometer groups upon which to base **[*108]** a market related cost rate for PAWC. The ALJ repeated the finding that appears in numerous Commission decisions that no barometer groups are ever universally comparable to the subject utility. The ALJ found that each sponsoring party argues that its barometer group consists of water utilities are as similar in terms of risks to PAWC as it is possible to be. ALJ Nguyen further found that PAWC and the barometer group companies face the same business risks that are reflected in the market price of their stocks. ALJ Nguyen conceded the inevitability of the existence of risk rate imperfections between a specific utility and a barometer group.

Since PAWC, the OCA and the OTS have submitted DCF calculations, we shall begin our review of the cost of equity recommendations with a brief description of the DCF method, followed by a discussion of each party's DCF recommendation. Immediately following our discussion of the DCF calculations, we will consider PAWC's CAPM and RP, and Comparable Earnings Method recommendations.

The DCF method uses the following formula, k = (D/P) + g, where "k" is the cost of equity, "D" is the dividend, "P" is the price of the stock, and "g" is the growth **[*109]** factor. The D/P calculation is used to compute the dividend yield. Therefore, as stated supra, the DCF equity cost is usually expressed as the dividend yield, adjusted for future period growth, plus the growth factor. The DCF analysis technique is based upon finding the present value of an expected future stream of net cash flow and capital gains, during the investment holding period, discounted at the cost of capital or capitalization rate. The capitalization rate is the total anticipated return rate and is usually expressed as the sum of a representative dividend yield plus a growth rate necessary to meet investors' expectations of future increases in cash dividends.

The following table summarizes the dividend yield and growth rate recommendations of the parties:

DCF	PAWC [1]	OCA [2]	OTS [3]
	%	%	%
Dividend Yield	5.58-6.00	5.77	6.00
Growth Rate	4.75-5.00	4-4.5	3-4

[*110]

PAWC utilized data from two separate water-specific barometer groups consisting of (1) a barometer group of fourteen water companies deemed representative of the entire investor-owned water utility industry, [1]1 and (2) a smaller group of six water companies that operate in the Northeastern United States consisting of: Aquarion Water Company, Connecticut Water Service, Inc., E-Town Corporation, Middlesex Water Company, Philadelphia Suburban Corporation, United Water Resources. Additionally, PAWC reviewed and considered comparable information for the Standard and & Poor's ("S&P") group of twenty-four public utilities (PAWC M.B. at 104-105), for use in its analysis to support a recommendation based upon the Comparable Earnings Method.

PAWC developed the dividend **[*111]** yield component by calculating average dividend yields for the twelve months ended February 1994 using ex-dividend adjusted price levels. [1]2 PAWC argues that the use of the ex-dividend price is necessary to reflect true yields on the underlying stocks and has been accepted by the New York Public Service Commission for several years. (PAWC M.B. at 106).

In computing the growth rate component, PAWC reviewed historical dividend and earnings performance, published growth rate forecasts and indicated growth rate patterns. Based upon its analysis, PAWC found a growth rate of 5.0% for the fourteen-company barometer group, and a growth rate of 4.75% for the six-company barometer group.

Thus, concluded PAWC, the combination of growth rates **[*112]** and dividend yields, resulted in a recommended range for the DCF method of 10.72% to 10.89%. PAWC argued, however, that the DCF results clearly understate its actual cost of equity for two reasons. First, PAWC points out that the companies in its barometer groups have, on average, significantly higher equity ratios than PAWC. Specifically PAWC contends that the average equity ratio of the barometer group companies is 44%, compared to 38% for PAWC. Secondly, PAWC argued that the use of twelve month average data served to mask the substantial increase in yields since the fall of 1993, when, according to PAWC, the yields "bottomed out." Therefore, PAWC argued that these two factors support a common equity return well in excess of 11.0% (PAWC M.B. at 107-108).

The OCA used the same barometer group, of six Northeastern water companies, as was used by PAWC. The OCA computed the dividend yield by averaging the high and low stock prices to compute the average stock price for a six-month period ended December, 1993. The OCA used S&P's Stock Guide as a reference to obtain the stock prices for the period. Also using the S&P Stock Guide for a reference, the OCA obtained the dividends **[*113]** for the same six-month period in order to compute the dividend yield. The OCA then updated its data for the purpose of filing surrebuttal testimony, by using a six-month period ended February 28, 1994. OCA argues that the dividend yields for the updated period were virtually identical to those in the first six-month period, which was 5.77% (OCA M.B. at 190).

After obtaining the average dividend yield for the barometer group, of 5.77%, the OCA adjusted its yield from 5.77% to 5.90%. The adjustment was intended to reflect two calendar quarters' growth in dividends so that the computed yield would represent the dividend that the investor would expect to receive during the first year after the purchase of the stock. (OCA M.B. pp. 190-191).

In determining its growth rate component, the OCA used three methods: 1) earnings retention, 2) historical growth rates and 3) published analysts' forecasts. The OCA determined that the earnings retention growth rate was 1.2%; a figure that its witness considers, "quite low and clearly understates the long-term future growth in dividends expected by investors. " (OCA M.B. at 191).

The OCA opined that a more realistic assessment of earnings retention **[*114]** growth could be obtained by referencing the Value Line Investment Survey ("Value Line"). The OCA continued that three of the six companies in its barometer group are followed by Value Line, including American Water Works Corporation, parent corporation of PAWC. The OCA continued that adding .5% to the Value Line projected "internal" earnings to account for possible growth established by a new stock issuance, the projections for near term dividend growth averages

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[1] PAWC's common equity cost rates are found at PAWC Main Brief pages 97, 108-111. PAWC's DCF common equity includes a financial risk adjustment. (PAWC Main Brief, p. 108)

3.4%, and long-term growth averages 3.0%. The OCA concluded that the weighted average or composite growth rate is 3.1%. (OCA M.B. 191-192).

The OCA's analysis of historical growth rates concluded that dividend growth has averaged 2.0% to 2.5% for the barometer group over the period 1988-1992. The OCA opined that the figures were generally weak due to the general market conditions over the past few years.

The OCA examined projected earnings growth projections prepared by Value Line, Institutional Brokers Estimate System, ("IBES") and S&P. The results of the OCA's analysis was an average growth rate of 6.0% to 6.5% for the six company barometer group. The OCA continued that the 6 to 6.5% average is **[*115]** inflated due to an 11% growth rate projected for one of the companies in the barometer group. The OCA's analysis results in the conclusion that a growth rate of 4 to 4.5% is "plausible albeit optimistic." (OCA M.B. at 192).

The OCA concluded that adding the growth rate of 4.0% to 4.5% to the dividend yield of 5.9%, a reasonable return on equity would be anywhere between 9.9% to 10.4%. The OCA takes into account PAWC's higher level of financial risk due to its smaller equity ratio compared to the barometer group, and accordingly, recommends an equity return for PAWC of 10.4%. Finally, the OCA asserted that the recommended figure of 10.4% is the upper most figure in its return on equity range.

The OTS used two barometer groups for its DCF analysis. The primary group consisted of: Connecticut Water Service, E-Town Corporation, IWC Resources Co., Middlesex Water Co. and United Water Resources. A second barometer group consisted of the water companies followed by Value Line: American Water Works Corporation, Aquarian Company, Consumers Water, Philadelphia Suburban Corporation and United Water Resources. (OTS M.B. at 37-38).

The OTS computed its dividend yield in a manner similar **[*116]** to OCA, by using the S&P Stock Guide, for dividends and stock prices over a 12-month period ended December 31, 1993. The stock prices used in the OTS analysis was an average of high and low stock prices during the period. The average dividend yield for the primary comparison group for the 12-month period ended December 31, 1993, was 6.00%. The OTS then adjusted the 6.0% dividend yield by 1/2 of the next period growth rate to reflect the growth in the next quarterly dividend.

In computing its growth rate component, the OTS used computed dividend and earnings growth rates for 5 and 10 year time frames using a point-to-point growth formula. The OTS also used log- linear regression to determine growth rates for 5, 10, 15 and 17-year time frames for a period from 1976 to 1993. The OTS recommended a growth rate of from 3% to 4%, based upon the observation of its witness that recent growth rates appear to be depressed in relation to those expressed over the long-term. The OTS recommendation based upon the estimated dividend yield and growth rate components is a range from 9.09% to 10.12%.

PAWC considers OTS' common equity cost rate to be inadequate for four reasons. First, PAWC **[*117]** is critical of OTS's exclusive reliance on the DCF method. PAWC argued specifically that no single methodology is sufficiently reliable to establish the cost of equity without further verification. PAWC further criticizes the exclusive use of the DCF method because its stock is not publicly traded, and consequently, does not provide direct evidence as to the cost of capital.

Second, PAWC claimed that OTS' selection of barometer group companies that may not be comparable to PAWC. PAWC contends that in selecting its barometer group, the OTS did not recognize and account for significant risk differences between the barometer group and PAWC. PAWC contends that the failure of the OTS to account for these risk factors seriously understate its estimate of the cost of equity capital.

Third, PAWC contends that the OTS adopted unrealistically low growth rates in its DCF calculations. PAWC attributes the low growth rates to the inclusion of IWC Resources ("IWC") in the OTS barometer group, since IWC went five years without raising its dividend.

Finally, PAWC argued that the OTS's witness misinterpreted published capital cost data in his calculation of the recommended DCF-based returns. **[*118]** PAWC claimed that the OTS purported to compare capital cost levels at December 1993 with anticipated conditions for the first quarter of 1995. Consequently, PAWC concluded that based the assumption that the data from the two time periods were comparable, OTS concluded that analysts were projecting a decline in public utility bonds over the forecast period, and therefore water utility dividend yields and equity cost rates could be expected to fall. However, PAWC asserted that the sources were used by the OTS witness were incompatible. (PAWC M.B. at 118-124)

PAWC considers OCA's common equity cost rate to be inadequate for five reasons. First, PAWC argued that OCA misinterpreted recent upward movement in capital costs as only a short term phenomenon. PAWC argues further that although the OCA witness acknowledged that bond and dividend yield and interest rates had increased since PAWC filed the instant rate case. PAWC contends that the OCA erroneously concluded that such increases could be discounted because offsetting declines had been experienced in the past. PAWC commented that, "under this approach, capital costs could be rising dramatically or falling like a stone and yet, **[*119]** provided that the average over the relevant period was the same in each instance, the proposed equity allowance would be identical." (Emphasis supplied by PAWC).

Second, PAWC argued that OCA's growth rate of 4.25% understates current investor expectations. PAWC contends that the growth rate recommendation of OCA, understates current expectations by 50-75 basis points. PAWC argued that the companies of its barometer group, which was also used by the OCA, experienced average earnings of 10.6% in 1993. PAWC adds that investors would expect a performance similar to that in 1993 in formulating their return requirements (PAWC M.B. at 125-126).

Third, PAWC argued that the OCA attempted to support its 10.4% recommendation on the grounds that it was very close to the 10.6% equity return projected by PAWC for financial planning purposes. However, PAWC claimed that the 10.5% represented an achieved return, while the 10.4% recommended by the OCA is an opportunity rate, which PAWC contended will never be achieved due to attrition and regulatory lag. (PAWC M.B. at 125-126).

Fourth, PAWC warns that a 10.4% equity allowance may result in a downgrading of PAWC's securities. The result **[*120]** of a downgrade, argued PAWC, would be to make it more difficult and expensive for PAWC to raise needed capital.

Finally, PAWC argued that the OCA took the position that a 3.2% premium over the cost of "A" rated bonds would be in line with the actions taken by other public utility commissions. PAWC pointed out that at the close of the record the yields on "A" rated bonds had climbed to 7.8% which it concluded would counsel for an equity return of no less than 11.0%

The OCA claims that PAWC's DCF calculation is inflated because of inflated dividend yields. Specifically, the OCA claims that PAWC's witness applied the DCF model in a manner that provides sightly inflated results. The OCA continues that the use of the ex-dividend price and the quarterly compounding adjustment are not generally acceptable, and result in slightly inflated dividend results.

The OTS also criticized PAWC's DCF calculation on three specific points. First, the OTS contended PAWC's barometer company groups were not representative of PAWC. Specifically, the OTS argued that PAWC's barometer groups include data for water companies located across the United States. Second, the OTS argued that PAWC's growth **[*121]** rate estimates in its DCF calculation overstate growth rates. The OTS claimed that PAWC's use of IBES earnings overstated the growth rate estimate because the estimates were based upon historical earnings per share. Further, the OTS noted that PAWC's witness stated that negative growth rates do not represent investor's future expectations, and therefore, PAWC eliminated negative values from its computation. This calculation, according to OTS, skewed the results of PAWC's analysis upward, thus the result is not reflective of true growth expectation. Third, the OTS argued that the inclusion of water companies in the state of California in one of the PAWC barometer groups led to an overstated dividend yield of 6.21%. The OTS argued further that water companies in the state of California are different from water companies operating in the Eastern United States in terms of weather, watershed management, and regulation. The OTS adds that California water companies on average have higher equity ratios than those companies in the Eastern U.S. The OTS concluded that California-based water companies are not risk-comparable to PAWC. (OTS M.B. at 52-56).

The ALJ reached the following **[*122]** result concerning a DCF-based rate of return:

It is obvious that no cost of common equity is without flaws. The DCF method generally accepted by this Commission is not perfect and is, in fact, flawed. Nevertheless, of all the methods available to determine the cost of common equity, it may be the most accepted. The assumptions of a predictive model do not have to be perfect as long as the model predicts the future in a reasonable and accepted manner. An example of this are the assumptions of a perfect economic market place model, which is unrealistic in the real world, but is still predictive of the real market activity. Therefore, I will employ the DCF method analysis in this recommendation with full knowledge of its various flaws but adjusted to mitigate the effects of those flaws.

This recommendation finds an unadjusted dividend yield of 6.00 percent. The 6.00 percent unadjusted dividend yield is premised upon OTS's proposal. OTS based its proposal upon the twelve month average for OTS barometer group of five companies. The range of 5.58-6.00 of dividend yield proposals is relatively small with the OCA's proposal approximately the midpoint of the range. This is not unusual **[*123]** because of the small group of investor water companies available from which to choose. I find the reasonableness of OTS dividend yield to be supported by PAWC and OCA dividend yield proposals. The 6.00 percent unadjusted dividend yield adjusted for next period growth is 6.14 percent (unadjusted dividend yield of 6.00 percent times the growth adjustment of 1.0225).

This recommendation finds a growth rate of 4.5 percent. I do not find the growth rate evidence of any party to be persuasive. The evidence indicates that the growth rate is between 4 and 5 percent. I have chosen the midpoint of that range or 4.5 percent. The use of the midpoint range should mitigate the market aberrations and the bias of the witnesses.

Therefore, this recommendation finds a DCF common equity cost rate based upon the previous discussion to be 10.64 percent (adjusted dividend yield of 6.14 percent plus growth rate of 4.5 percent equals a DCF cost rate of 10.64 percent).

R.D., p. 92.

In addition to the 10.64% derived from the application of the DCF-based method, each party sponsored an adjustment based upon the higher risk of PAWC compared to those companies in the particular barometer groups. **[*124]** The specific adjustments are as follows:

	PAWC [1]	**OCA** [2]	**OTS** [3]
	%	%	%
Adjustment	.11-.28	.20	.24

The ALJ's resolution of the risk issue is as follows:

The existence of differences between PAWC and the barometer groups based upon financial risk indicators such as capital structure ratios indicate that a risk differential exists. The exact measurement of that risk is not possible based upon the record. Therefore, this recommended decision will adjust its DCF find by 20 basis points to reflect financial risk and any possibility that the DCF method may understate the cost of common equity.

This recommendation finds a cost of common equity of 10.84 percent (DCF recommendation of 10.64 percent plus a risk adjustment of .20 percent or 10.84 percent).

(R.D. at 94)

The ALJ proffered the following summary of his recommendations:

Summary of Recommendation

Capital Structure	Ratio	Cost Rate	Weighted Cost
	%	%	%
Long-Term Stock	58.6	8.79	5.15
Preferred Stock	3.7	7.62	.28
Common Equity	37.7	10.84	4.09
Total	100.0		9.52

[*125]

(Ibid).

In its Exceptions, PAWC argues that a substantially higher rated of return is warranted than that recommended by the ALJ. PAWC finds no justification in lowering PAWC's currently authorized equity allowance of 11.0%, granted in our Opinion and Order entered April 21, 1993. PAWC strongly contends that capital costs have risen dramatically, since the last rate order was issued, and also since the close of the record. For example, PAWC cited increases in the following financial instruments since the close of the record in March 1994, as follows:

	Close of Record	Current [1]3
Federal Funds Rate	3.5%	4.25%
Prime Rate	6.25%	7.25%
30-Year Treasury Bonds	6.85%	7.30%
"A" Rated Utility Bonds	7.8%	8.20%

(PAWC Exceptions at 6)

PAWC argued that the ALJ's recommendation cannot be reconciled with the Commission's 10.48% equity cost rate finding in Pa. P.U.C. v. Roaring Creek Water Company, docketed at No. R-00932665 (Order entered February 3, 1994) ("Roaring Creek"). PAWC continues that, putting aside the 20 basis point adjustment, the implication of the ALJ's recommendation **[*126]** is that equity costs have increased by only 16 basis points since the close of the record in Roaring Creek. (Ibid).

PAWC then argues that sudden fluctuations in either direction in capital costs can be effectively masked if there is exclusive reliance on the DCF method, and more specifically, on historic dividend yield data that may be stale by the time the new rates go into effect. PAWC continues that the deficiency is evident in this case wherein the ALJ adopted the OTS's unadjusted dividend yield of 6.0%, which was based entirely upon calendar year 1993. PAWC submits that, "for several months", the OTS's barometer group has been yielding in the 6.5% to 6.7% range. (PAWC Exceptions at 7).

Additionally, PAWC submits that more current data suggests that the ALJ's recommended 4.5% growth rate may also be too low. PAWC repeats its argument that the primary barometer group employed by PAWC and the OCA, experienced an annual growth rate of 10.6% in 1993. Although PAWC concedes that it would be inappropriate to put undue weight on the results of any one year, PAWC suggests that the 1993 performance is certainly something that investors would take into account in formulating **[*127]** their return requirements.

PAWC concludes that the Commission has a long-standing preference for the DCF method. However, PAWC cites Pa. P.U.C. v. Philadelphia Suburban Water Company, docketed at No. R-870840 (Order entered June 26, 1988), and Application of Lake Latonka and Western Utilities, Inc., docketed at No. A-210017 (Order Entered April 11, 1991), for the proposition that the Commission has made upward adjustments to DCF based findings where necessary to reflect investors' actual return expectations. (PAWC Exceptions at 8).

In its Reply Exceptions, the OCA renews its objection to PAWC's presentation of the data regarding rising capital costs which appears previously herein. The OCA continues that although the record in this proceeding closed on March 25, 1994, PAWC cites data of June 17, 1994. The OCA asserts that PAWC does not disclose the movement in company stock prices or dividend yields since the close of the record. The OCA insists that these factors, as well, have an impact on the DCF cost of capital. The OCA maintains that to imply that movement in market interest rates alone is sufficient to require a revised DCF result is misleading. According to **[*128]** the OCA, the evidence presented by PAWC regarding interest rate movement, is not evidence of record, has not been cross-examined and is insufficient data to support revision to the DCF recommendation. (OCA Reply Exceptions at 18).

The OCA continues that the DCF recommendations of the parties, in the matter before us, is not based upon a dividend yield for a single month, but on an average yield over a six to twelve month period. Any proper comparison, insists OCA, must be based upon averages of a period six to twelve months prior to the date of comparison. The OCA noted that PAWC compares the market interest rates in effect at the time of the close of the record Roaring Creek with the interest rates in effect on June 17, 1994, when the Exceptions were filed. The OCA maintains that the return recommendation in Roaring Creek was based on an average of data, not on a spot rate. (OCA Reply Exceptions at 19).

The OCA submits that PAWC, in referring to economic data beyond the close of the record, is urging the Commission to apply a different standard than was used in its most recent previous rate case. According to the OCA, the record in the previous PAWC case closed in **[*129]** late 1992, and through the time when the Commission issued its final Order, the trend in capital costs was declining. However, adds the OCA, no extra or post record evidence was considered in the that particular case. (Ibid).

In response to PAWC's assertion that the DCF method "lags" behind movements in the market, the OCA argues that it is indisputable that capital costs continue to fluctuate. The OCA continues that such fluctuations make it impossible to determine a cost of capital that will be reflective of the most recent market rates up until the next rate case is filed and litigated. OCA adds that the foregoing is true regardless of the method of determining the cost of capital. The OCA concludes that the only way capture upward and downward movements in capital costs, would be to index returns to certain market factors. The OCA continues that such an "index" would be wholly inappropriate for ratemaking purposes. (OCA Reply Exceptions at 20-21).

The OCA addresses PAWC's contention that the DCF method "masks" the trend in capital costs. The OCA argued that the DCF method, based upon market data averaged over time, rather than a spot price which levelizes movements **[*130]** in rates. Further, the OCA adds that although PAWC used several different methods to make its equity cost recommendations, it did not advocate the use of a spot price in determining the cost of capital. (OCA Reply Exceptions at 21).

In its Reply Exceptions, the OTS makes the same objection, as the OCA, to the financial data presented by PAWC regarding the increase in capital costs. The OTS, as did the OCA, regards the data as extra-record and thus cannot be considered. Moreover, the OTS contends that reference to the extra record data invites the Commission to make rate of return decisions based upon spot data. The OTS adds that the Commission has refused to make rate of return decisions based upon spot data. (OTS Reply Exceptions at 1).

The OTS asserts that similar data has been considered by its witness in making his recommendation. Further, the OTS contends that consideration of what it considers extra-record, spot data ignores reputable analysts forecasts. Moreover, adds the OTS, its testimony showed that Long term, Intermediate and Short term government bonds at December 1993, had not risen to the cost rate that they were in January 1993. (OTS Reply Exceptions at 2). **[*131]**

In its Exceptions, the OCA argues that the ALJ's recommended cost of equity is not based upon substantial and competent record evidence. Specifically, the OCA excepts to the ALJ's recommendations concerning the growth component, and an additional 20 point basis adjustment to compensate for risk and the use of the DCF method. (OCA Exceptions at 28).

First, the OCA excepts to the 20 basis point risk adjustment. The OCA argues that the ALJ erred in his conclusion, which appears supra in tabular presentation, that the parties, PAWC, OCA and OTS, had added 11-28, 20, and 24 basis points, respectively, for a risk premium adjustment. The OCA continues that there is no record support for such a conclusion. Moreover, the OCA submits that the ALJ conceded that the exact measurement of such risk is not possible based upon the record. [14] (OCA Exceptions at 29).

The OCA continues that DCF recommendations similarly take into account risk factors, such as low equity ratios, through recommendations made at the high end of the range. The OCA notes that the recommendations of the OCA and OTS were made at the high end of the range to adjust **[*132]** for the capital structure of PAWC.

The OCA also excepts to the ALJ's use of a midrange of the parties' recommendations on the growth rate component. Specifically, OCA cited *Pa. P.U.C. v. West Penn Power Co., 73 Pa. P.U.C. 454 (1990),* and Pa. P.U.C. v. Pennsylvania American Water Co., docketed at No. R-901652 (Order entered December 14, 1990), for the proposition that a "mechanical" averaging of the parties' positions on rate of return is inappropriate to reach a cost of common equity. The OCA continued that in the case before us, each of the parties offered considerable evidence as to how their respective growth rate determinations were calculated. The OCA concluded that except for PAWC's updated growth rate, the evidence was both substantial and competent, and that the ALJ erred in concluding that none of the growth rate evidence was persuasive. (OCA Exceptions at 29-31).

The OCA argues further that the ALJ erred in concluding that the appropriate growth rate range was from 4% to 5%, and that the ALJ erred in concluding that 5% was the top end of the range supported by evidence. The OCA points out that although PAWC's witness testified to a 5% growth rate, the witness **[*133]** offered no support for the conclusion. [15] OCA characterizes PAWC's growth rate adjustment as a device to compensate for a decreasing twelve month average dividend yield, despite climbing interest rates in the months which this case was litigated. (OCA Exceptions at 31)

The OCA concludes therefore, that the midpoint of the growth rate range substantiated by evidence (4.0% to 4.75%) would be 4.38%, and not 4.5%. (OCA Exceptions at 32).

In its Reply Exceptions, PAWC repeats its argument that the recommendation of the ALJ, and the other parties to the matter, continue to ignore the dramatic rise in capital costs that have occurred over the past six months. PAWC labels as incongruous the OCA's opposition to the risk adjustment, since the OCA's witness moved his recommendation to the mid-point of the equity range, because of PAWC's weaker financial profile. (PAWC Reply Exceptions at 3-4).

PAWC continues that the OCA's exception to the ALJ's growth rate is difficult to fathom. PAWC attacks the OCA assertion that its witness' growth rate recommendation was unsubstantiated. PAWC contends that the OCA had ample **[*134]** opportunity to probe the basis for the increase in the growth rate proposals through cross-examination, but declined to do so. PAWC adds that the OCA requests that the Commission approve the 4.5% growth factor. PAWC summarizes that the OCA exception appears to be to the method used by the ALJ and not the result. (PAWC Reply Exceptions at 4-5).

In its Exceptions the OTS, argued that the ALJ's recommended equity return of 10.84% is excessive and should be rejected in favor of a return on common equity that does not exceed 10.12%. The OTS argues that it did not recommend a common equity return of 9.84% as indicated in the R.D. The OTS maintained that it recommended a range of between 9.09% and 10.12%, and he recommended that PAWC be permitted to earn a return at the upper end of the range. OTS adds that 9.85% is the mid-point for the upper half of the range. (OTS Exceptions at 10).

The OTS continues that the ALJ's recommended return is based upon an inflated growth rate and an upward adjustment for risk. OTS criticizes the rationale of the ALJ that the evidence indicates that the growth rate is between 4 and 5 percent, in making his growth rate recommendation of 4.5%. The **[*135]** OTS repeats that its witness' recommended range is 3 to 4 percent. (OTS Exceptions at 11). On pages 12 through 14 of its Reply Exceptions, the OTS reviews the method used by its witness in determining its growth rate recommendation.

With regard to the risk adjustment, the OTS states that the adjustment is unwarranted and unsupported by credible evidence. and should be rejected. The OTS continues that there is no support in the OTS's case for a 24 basis point adjustment. The OTS repeats that its witness' recommendation accounted for financial risk by recommending an equity return in the top half of his range. (OTS Exceptions at 14-15).

In its Reply Exceptions, PAWC argues that there are significant differences in the barometer groups used by PAWC and the OTS in terms of risk. Specifically, PAWC argued that its analysis showed that PAWC had a lower bond rating, lower pre-tax interest coverage and a substantially higher debt ratio than the barometer group as a whole. PAWC added that there is no merit in the OTS' argument that risk differences were reflected in its recommendation. PAWC repeats that the OTS historic growth averages were skewed downward by the fact that one of **[*136]** his barometer group companies, IWC resources went five years without increasing its dividend. PAWC contends that the OTS growth rate recommendations are out of line with recent findings for water utilities. See Roaring Creek supra, and Pa. P.U.C. v. Mechanicsburg Water Co., docketed at No. R-00922502 Order Entered July 22, 1993. PAWC contends that the differences in ranges result only from the range in the OTS's growth rate analysis. (PAWC Reply Exceptions at 3).

Initially, we agree with the position taken by the OCA and OTS that the data concerning interest rates and bond yields as of June 17, 1994, submitted by PAWC in its Exceptions filed on that date is extra-record, and will not be considered. However, we can and will take notice of rising interest rates and higher bond yields in our consideration of the proper cost of equity capital.

We observe that the points of contention in this issue are the growth rate recommendation, and the risk adjustment. We note that there is no controversy regarding the ALJ's adoption of the OTS recommendation of the dividend yield of 6.14%.

We found two of PAWC's arguments in support of the ALJ-recommended growth rate of 4.5% to be **[*137]** convincing. First, PAWC argued that the OTS growth rate range of 3-4 percent is skewed downward due to the inclusion of IWC Resources, a company that had not increased its dividend in five years. Second, PAWC argued that its witness had sponsored an increase in his original growth rate adjustment, and was available for cross-examination however the OCA chose not to do so. Therefore, we find reasonable, the ALJ-recommended growth rate of 4.5%. Thus, we find reasonable the ALJ-recommended DCF-based rate of return of 10.64%, before any risk adjustment.

Regarding the risk adjustment, our review of the parties' positions leads us to conclude an adjustment is appropriate. Our finding is supported by the financial risk resulting from PAWC's low equity ratio and lower bond rating relative to the barometer group companies used in the OTS analysis, in addition to our own recognition of the risk which results from rising interest rates. Although we agree with the ALJ that this risk is nearly impossible to quantify, we will use our discretion to make upward adjustments to DCF-based findings where necessary to reflect investors' actual return expectations. Accordingly, we will adopt the **[*138]** ALJ's 20 basis point adjustment for risk. Thus, we adopt the ALJ's recommendation for a risk-adjusted DCF-based equity return of 10.84%.

Alternate Methods

PAWC, in addition to its DCF calculation, submitted equity returns based upon the Risk Premium ("RP") and Capital Asset Pricing Model ("CAPM"), and the Comparable Earnings Method. The ALJ observed that this Commission has in numerous recent decisions determined the cost of common equity primarily upon the DCF method and informed judgment. See *Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Co., 71 Pa. PUC 593, 623-632 (1989); Pa. Public Utility Commission v. Western Pennsylvania Water Co., 67 Pa. PUC 529 559-570 (1988).*

The ALJ continued that the RP and the Capital Asset Pricing Model ("CAPM") methodologies have been criticized by the Commission in recent years. The ALJ added that in *Pennsylvania Public Utility Commission v. Pennsylvania American Water Co., 68 Pa. PUC 343, 377-378 (1988),* the Commission did not give any weight to the RP analysis. See also *Pennsylvania Public Utility Commission v. Peoples Natural Gas Co., 69 Pa. PUC 138, 165-168 (1989);*

Pennsylvania Public Utility Commission v. National Fuel Gas Distribution Corp., 67 Pa. PUC 264, 331-332 (1988); Pennsylvania Public Utility Commission v. York Water Co., 62 Pa. PUC 459, 79 PUR 4th 332 (1986). The ALJ cited the Commission order in *Pennsylvania Public Utility Commission v. Duquesne Light Company, 66 Pa. PUC 518, 696, 91 PUR 4th 546 (1988),* as follows:

We continue to believe that the economic environment over lengthy time frames is not representative of current economic conditions and therefore does not produce realistic risk premium results.

The ALJ further noted that in *Pennsylvania Public Utility Commission v. Pennsylvania Power Company, 67 Pa. PUC 91, 164 (1988),* the Commission ruled as follows:

[F]irst, we cannot accept that historic experienced earnings reflect the cost of capital. We know of no reputable analyst who would seriously argue that experienced earnings represent the cost of capital, except by pure happenstance. But, such is the inherent assumption of each methodology [Risk Premium and CAPM]. Second, we cannot accept, even assuming that historic experience earnings represented the cost of capital that the average premium of an equity investment over a fixed income **[*140]** investment over a period as long as 50 years, represents the investor required premium in today's and tomorrow's market. Accordingly, we conclude that we can place little credence in the results of these methodologies.

(R.D. 87-88).

Accordingly, the ALJ did not consider equity rate recommendations using any other method except DCF.

In its Exceptions, PAWC argues that the DCF method usually understates costs particularly when its results are applied to an original cost rate base. In support of its position PAWC cites a decision of the Indiana Utility Regulatory Commission ("IRUC"), which PAWC contends stands for the proposition the DCF method has a tendency to understate the cost of common equity. Specifically, IRUC found that if the traditional DCF model is strictly applied to an original cost rate base, the investor could earn the cost of capital only if the investor paid no more than book value for the stock. (PAWC Exceptions at 7-8).

In its Reply Exceptions, the OCA supports the ALJ's exclusive use of the DCF method in determining the cost of equity capital. The OCA points out that, as the ALJ stated in his R.D., the Commission has in numerous recent decision determined **[*141]** the cost of equity by the use of the DCF method, and informed judgement. See *Pa. P.U.C. v. Philadelphia Suburban Water Co., 71 Pa. P.U.C. 593, 623-632 (1989); Pa. v. Western Pennsylvania Water Co., 67 Pa. P.U.C. 529-570 (1988).* (OCA Reply Exceptions at 19).

The OCA argues that PAWC is incorrect in its reliance on the IRUC case to refute this Commission's exclusive reliance on the DCF method. The OCA repeats that there are ample cases in Pennsylvania which discuss the merits of the various methods utilized for determining the cost of capital. (OCA Reply Exceptions at 20).

Upon consideration of the parties' positions, we agree with the ALJ that there is nothing on the record in this proceeding which would cause us to find that the use of any of the three alternative methods to be appropriate. Accordingly, we will adopt the cost of capital recommendations of the ALJ. PAWC's Exception on this issue is denied.

VIII. RATE STRUCTURE

A. The Joint Stipulation

The rate structure area was contested by the opposing parties and a number of proposals dealing with the allocation of the cost of service and the distribution of the allowed increase among customer classes were **[*142]** considered. During the proceeding the parties held various discussions and attempted to narrow the issues and to develop a rate structure and rate design finding to which all could agree. An agreement was finally achieved. That agreement is embodied in a "Stipulation Concerning Rate Structure And Rate Design."

The stipulation contemplates that Rate Zone C (the former California service area) will be merged into the predominant Rate Zone 1. A new Rate Zone S will be established for purposes of serving the former Skyline Water Company customers. This rate zone will have the same customer charge as that of Rate Zone 1, however, the consumption charge remains the same as it was under Skyline. The parties further agreed that the rates for Public and Private Fire will be as proposed by the Company in the filing. Lastly, the parties agreed that any reduction to the Company's requested increase will be allocated by proportionately reducing the Company proposed increase for each of the classes after Public and Private Fire Protection are held at requested levels. The parties have agreed that the resulting increases will be applied to both the customer charges and the consumption charges **[*143]** as set forth in the stipulation except where the 5/8" and 3/4" meters are concerned.

The stipulation reserves for litigation the issue of whether and to what extent the customer charge should be increased for residential customers having 5/8 - inch and 3/4 - inch meters.

B. Customer Charges

Under PAWC's Rate Zone 1 proposal, customer charges for all classes of customers and all meter sizes were increased by an amount approximately equal, on a percentage basis to the proposed system average increase. (PAWC Ex. 10 - A. Sch. F) Thus, a residential or commercial customer with a standard 5/8 - inch meter would experience a monthly increase from $ 8.40 to $ 9.00 or 60 cents. If the Commission grants less than PAWC's total requested increase the proposed customer charge would be scaled-back uniformly.

The OTS contends that total customer charge revenues exceed the cost allocated to the customer functions. (OTS St. 5, p. 5) The OCA contends that customer charge revenues exceed customer costs even for the residential class. (OCA St. 4, p. 14 and Sch. TSC - 3) [1]6

[*144]

PAWC witness Stout explained:

Although the revenues under proposed rates from customer charges exceed the allocated customer costs; this is only true with respect to the commercial, industrial public and other water utilities classes. The proposed customer charge revenue for residential customers is less than the customer costs that I have allocated to the class. Thus, for over 90 percent of the Company's customers, the unproposed customer charges are less than the allocated customer costs. [1]7

(PAWC St. 10-R, p. 24)

PAWC argues that OTS witness Rodrock has accepted that customer charges should be designed to recover customer costs and has accepted its witness' allocation of costs to the customer function. Therefore, OTS position that customer charges not be increased is not applicable to the residential class. (PAWC Main Brief, p. 131)

The OCA did its own computation of customer costs which shows that customer charge revenues exceed customer costs even for the residential **[*145]** class. (OCA St. 4, p. 14 and Sch. TSC-3) The OCA calculation excluded all so-called "indirect" costs, because the OCA determined that the Commission "in various rate proceedings has found that customer service charges need only be high enough to recover direct customer costs." (OCA St. 4, p. 14)

PAWC witness states that the costs labelled "indirect" by the OCA are, in fact, cost that should be properly allocated to the customer function. Witness Stout explained:

Mr. Catlin has excluded an allocation portion of administrative and general expenses, as well as the depreciation expense and rate base for an allocable portion of general plant. The administrative and general costs and the related plant are required to support all functions of the Company including the customer accounting and collecting function. Such costs should be prorated to all cost functions including the customer cost function. It is inappropriate to exclude such indirect costs from any function whether it be the provision of treatment, transmission, distribution or customer services.

(PAWC St. 10-A, pp. 25-26)

On cross-examination OCA witness Catlin, according to PAWC, admit that "indirect" costs should **[*146]** be allocated to the customer function as done by PAWC witness Stout:

Q. Just to summarize and, for purposes of clarity, then, under the application of the base extra capacity method, some portion of administrative and general costs would be allocated to the customer cost function. Is that correct?

A. [Mr. Catlin] Yes. Some costs are allocated to the customer function because they are allocated there in proportion to other directly assignable costs. (Tr. 756)

PAWC contends that there is no Commission policy precluding the recovery of "indirect" costs in the customer cost. In Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company, Docket No. R-911892 (October 18, 1991), pp. 130, 136, the PAWC states that the Commission rejected an OCA argument that ". . . indirect costs . . . should not be used in the calculation of customer costs."

The OCA argues that the utility can recover only basic customer costs" in customer charges. *Pennsylvania Public Utility Commission v. Metropolitan Edison, 60 Pa. PUC 349 (1985).* In *Pennsylvania Public Utility Commission v. West Penn Power Company, 59 Pa. PUC 552, 612, 69 PUR 4th 470, 521 (1985),* the Commission **[*147]** defined the "basic customer cost" method for developing customer charges. The Commission stated:

He [OTS witness Strausbaugh] defined "basic customer cost" as those expenses for items the Company must have in place each month for each customer. This includes the costs for the meter and service drop, meter reading and billings. It excludes consideration of asserted "customer-related" costs of transformation and distribution plant.

* * *

We have adopted the "basic customer cost" method for several major Pennsylvania electric utilities (cite omitted), and we now conclude that it is likewise appropriate for WPP.

This analysis of customer costs has also been adopted by the Commission for water utilities. See, Pennsylvania Public Utility Commission v. Mechanicsburg Water Co., Docket No. R-00922502, Order entered July 22, 1993; see also, Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Company, Docket No. R-00922482, Order entered June 23, 1993 (PG&W). In PG&W, the Commission adopted ALJ Solomon's recommendation regarding the appropriate costs to be included in a customer charge:

. . . a true customer charge should only include costs that are directly **[*148]** related to metering, billing, meters, and services . . .

Id. at 119-120.

The OCA contends that the residential customer charges are adequate to recover allowable basic customer costs. (OCA St. 4 at 14) OCA witness Catlin included only the basic customer costs in his calculation of the customer charge as allowed by the Commission. Id. Witness Catlin identified the items as follows:

The direct costs to be included in a customer service charge include: the depreciation, return and income taxes associated with meter and services investment; the O&M costs for meters and services; and the expenses associated with meter reading and billing. The revenues from the existing Zone 1 service charges are more than sufficient to recover these direct customer costs. Therefore, I am recommending that the existing service charges applicable to customers in Zone 1 not be increased.

(OCA St. 4 at 14)

From PAWC figures, the residential class should recover $ 20,601,354 for the customer charge. (OCA St. 4, Sch. TSC-3) PAWC actually receives revenues, with its existing residential customer charges of $ 34,895,978. Id. This calculation is consistent with Commission precedent. **[*149]** (OCA St. 4A at 5)

About PAWC's "additional costs", witness Catlin said:

The measurement of direct customer costs which I utilized is consistent with the definition of direct customer costs which the Commission has found to be appropriate in various rate proceedings of Pennsylvania utilities. Moreover, as shown on Schedule TSC-4, customer charge revenues still far exceed direct customer costs, even if all of the additional direct costs which Mr. Stout has identified on 25 of PAWC Statement 100-R (sic) are included. Therefore, no increase in the current Zone 1 customer charge is necessary or appropriate.

(OCA St. 4A at 5)

With the "additional direct" costs included, the customer costs would total $ 28,676,820; four million dollars less than the Company currently recovers through its customer charge. (OCA St. 4A, Sch. TSC-4)

The OCA submits that if the residential class recover the basic customer costs for that class, whether the "additional direct" costs claimed by the Company are included or not, there should be no increase in the residential customer charges in this case.

The OCA argues that only those costs which this Commission has found acceptable to include in the customer **[*150]** charge should be recovered through the customer charge. Therefore, any uniform increase not tied directly to an increase in direct customer charge-related expenses is inappropriate.

The ALJ recognized that PAWC's position, simply stated, is that because its overall costs have increased, the customer charge should be increased proportionately. This Commission has consistently rejected such proposed increase in the absence of evidentiary support.

In Pennsylvania Public Utility Commission v. West Penn Power, Docket No. R-00922378, Order entered May 14, 1993, this Commission was faced with a similar argument. In that case, the ALJ rejected a proposed 20% increase in the customer charge. A lesser increase, which would have served the principles of gradualism, was also rejected because it was not based upon any increase in basic customer costs. In regard to the full increase requested by the Company the ALJ reasoned:

I am inclined to agree with OCA on this issue. I believe the evidence shows that WPP's proposed residential customer charge includes costs that go beyond the definition of true customer costs as set forth by the Commission in West Penn 1985. There is no doubt **[*151]** that WPP included costs in its analysis that are not properly considered to be customer costs. Furthermore, I agree with OTS that the proposed 20% increase in the residential customer charge violates the principle of gradualism.

WPP, supra, at 217 (emphasis added).

Regarding the lesser proposed increase the ALJ stated:

the proposed charge is not based upon any analysis of WPP's customer costs and thus, should not be accepted. Therefore, I recommended that WPP's residential customer charge remain at its current level . . .

Id. at 217 (emphasis added).

The OCA opposed the Company's inclusion of these "additional direct" and "indirect" costs in the customer charge. These indirect costs are not basic customer costs as the Commission defines those costs in previous cases. The expense amount attributed to each of these accounts does not increase or decrease with the addition or loss of each residential customer. For these reasons, the Commission should reject PAWC's attempt to include these additional costs in the customer charge and only allow recovery of appropriate amounts in the volumetric charge.

Not only does the company include improper costs in its customer **[*152]** charge expense calculation, but it erroneously concludes that even with those costs included, the proposed increase in the customer charge under-recovers the customer charge expense for the residential class.

The Company is currently over collecting customer charge revenues from the residential class. (OCA St. 4A at 5) If the Company is permitted to implement its customer charge allocation, this over-collection will be exacerbated. OCA submits, therefore, that the customer charge for the 5/8" and 3/4" meter should remain at their present levels.

OTS witness Mr. Rodrock recommended that customer charges remain at present rates. OTS argues that all metered customers are subject to a monthly customer charge, based on the meter size serving the customers. Customer charges should recover customer costs which are incurred regardless of consumption. In response to an interrogatory of the OTS, OTS-RS-3, PAWC indicated that annualized customer charge revenues are $ 44,131,000 under present rates. PAWC indicated that customer charge revenues will be $ 47,283,000 (OTS-RS-1). Thus, after PAWC's rate increase proposal, customer charge revenues would be $ 3,960,000 higher than related **[*153]** customer costs. (OTS St. 5, pp. 5, 6)

The purpose of a customer charge is to recover costs up front each month before a customer is charged for consumption. Customer charges do not recover demand costs.

Customer charges appropriately recover billing and collection costs, meter reading costs and costs of meters and services. Because PAWC's current customer charge revenues recover more than related customer costs, the Commission should reject PAWC's proposed increase to customer charges for 5/8" and 3/4" service to residential and commercial customers.

Therefore, for the current customer charge for 5/8" and 3/4" meters, the ALJ accepted the OCA and OTS positions that since customer costs are more than covered by the current customer charge, no additional amount should be added to the current customer charge.

1. PAWC Exceptions

PAWC filed Exceptions to the above recommendation. On consideration of the R.D., and the Exceptions, we find that PAWC has raised no issues overlooked in the R.D. We are, therefore, in agreement with the reasoning and conclusion therein. We find the stipulation as to Rate Structure to be in the public interest. Consequently, PAWC's Exceptions are denied. **[*154]**

IX. MAIN EXTENSION TARIFF RULES

Background

PAWC's Tariff Rule No. 23 provides that the Company will extend a main 35 feet to serve a bona fide applicant for service at no cost to the applicant. The Rule further provides that an applicant must advance the cost for extensions in excess of 35 feet. A portion of the advance equal to the cost of installing 35 feet of main is refunded to the applicant for each bona fide customer that takes service from the main extension within 15 years. Tariff Rule No. 23 has been reviewed and approved by the Commission.

On August 20, 1992, at L-900053, the Commission issued a Policy Statement on facility extension tariff provisions. One year later, on September 2, 1993, at P-930717, PAWC filed a Petition for declaratory order essentially offering to file tariff revisions to extend mains to any bona fide customer without requiring any contributions in aid of construction (CIAC) or Advance if the Commission would agree to allow deferred accounting and AFUDC until the extensions are recognized in rates. OCA and OTS both filed Answers in opposition to PAWC's Petition at P-930717, and, as of the filing of this rate case, the Commission has not **[*155]** entered an order on the Petition. This rate proceeding was filed on October 28, 1993.

On November 10, 1993, the Commission instituted a rulemaking proceeding to consider the promulgation of regulations regarding utility line extensions.

The Company's Position

The Commission's Policy Statement articulated broad, common law principles that the Commission believes should be applied in determining when a utility may require an applicant for service to advance the cost of a line extension:

Only if a given extension of service would materially handicap the utility in securing a fair return on its investment or would place an undue burden on utility customers as a result of rate increases is the utility permitted to require a contribution-in-aid-of-construction from the service applicant.

After the Policy Statement was issued, a number of complaints were filed with the Commission by applicants for new service who alleged that utilities had improperly demanded advances or contributions for line extensions. In the process of reviewing Recommended Decisions in several of those cases, the Commission recognized that the general principles articulated in the Policy Statement could not **[*156]** be directly applied to specific extension requests without further interpretation and rational guidelines.

The Proposed Rulemaking is the proper forum for deciding the issues raised by Ms. Kraus, OCA's Senior Regulatory Analyst. These issues are not ripe for decision in this case. The Company moves to strike Ms. Kraus' testimony. (PAWC Main Brief, pp. 134, 135, 138)

OTS's Position

OTS's position is similar to that of the Company's. It further asserts that Ms. Kraus' testimony is outside the scope of this rate proceeding.

OCA's Position

OCA witness Kraus reviewed certain cases pending before the Commission in which prospective customers are challenging the Company's application of its tariff to require contributions in advance of construction. (OCA St. 3, pp. 3-4) As an example, Ms. Kraus noted that in the case of Adrian McConnell v. Pennsylvania-American Water Company, Docket No. C-00923948, the Company indicated that the additional revenue requirement (return, depreciation and taxes) associated with a $ 13,000 main extension to that Complainant would be $ 1,250. Her review of the data available in pending cases indicated that the revenue impact of the Company's **[*157]** investment in a main extension of this magnitude would be slightly less than one-thousandth of one percent.

The Company has suggested that the cumulative or aggregate financial impact, rather than the impact of individual projects, is what should decide whether requests for customer contributions are lawful or not. However, the aggregate data presented by the Company varies from proceeding to proceeding and depends on the witness. Ms. Kraus used the "worst case scenario" and concluded,

. . . [I]n one of the cases currently pending before the Commission, PAWC presented an estimate that the cost of all potential main extensions, if constructed at the utility's expense in the next year, would be $ 12.9 million. . . . Using this estimate and the Company's total present revenues in the current case of approximately $ 166 million, the revenue increase resulting from the investment in main extensions would be only 0.72% [seventy-two one hundredths of one percent], even assuming no additional revenues resulted from the main extensions.

OCA St. 3 at 6 (citation omitted).

The revenue requirement impact of 0.72%, according to OCA, is an extremely conservative one.

The OCA submits, **[*158]** therefore, that the Commission should reject Tariff Water -- PA PUC No. 2, Original Pages 50 through 52, and should require the Company to submit a revised tariff consistent with current law and with the OCA's recommendations.

ALJ Recommendation

The ALJ concluded as follows:

I agree with OTS that the issues raised by OCA are outside the scope of this investigation. The investigation is designed to establish, if any, new rates, and not to revise the rates that are already in place. None of the issues contained in the Order entered December 6, 1993 that authorizes the investigation of this rate proceeding requires a revision of the current rates. Therefore, OTS's and PAWC's motion to strike Ms. Kraus' testimony must be granted.

R.D., p. 109.

We conclude that the ALJ properly found the matters raised by the OCA to be better placed in the pending rulemaking proceeding. This is not to say that ultimately, such main extension matters will not be prosecuted during the course of a base rate proceeding.

X. CONCLUSION

From the review and discussion above, we conclude that PAWC has demonstrated that $ 173,277,634 is a reasonable level for its total annual operating revenues. **[*159]** This amount translates into an increase of $ 6,981,468.

XI. ORDER

THEREFORE, IT IS ORDERED:

1. That the Application of the Pennsylvania American Company at Docket No. R-00932670 for a general rate increase and the request for approval of the Affiliated Interest Agreement between the Pennsylvania American Water Company and the American Water Works Service Company, Inc. at Docket No. G-00940374, be consolidated.

2. That the Affiliated Interest Agreement be approved so much that it relates to the acquisition of the Harrisburg Data Center Management Information furniture, equipment, and software.

3. That the Pennsylvania American Water Company shall not place into effect the rates contained in Tariff Water - Pa. P.U.C. No. 2, the same having been found to be unjust, unreasonable, and therefore, unlawful.

4. That the Stipulation Concerning Rate Structure and Rate Design entered in this record is approved as being in the public interest and is adopted.

5. That the Stipulation Concerning Post Retirement Benefits Other Than Pensions entered in this record is approved as being in the interest of the public and is adopted.

6. That the Pennsylvania American Water Company shall **[*160]** file, effective for service rendered on or after the date of entry of this Opinion and Order, or within thirty (30) days thereafter, as it may elect, a tariff or tariff supplements prepared in accord with this Opinion and Order, containing rates designed in accordance with the decisions herein regarding rate structure to provide annual water operating revenues of $ 173,277,634, exclusive of state tax adjustment surcharge revenues.

7. That the tariff(s) or tariff supplement(s) shall be filed on less than statutory notice.

8. That the tax surcharge shall be computed in accord with the State Tax Adjustment Surcharge Order of March 10, 1970, as revised.

9. That the Pennsylvania American Water Company shall file detailed calculations with the tariff which shall demonstrate to this Commission's satisfaction that the filed rates comply with this Commission's Order.

10. That the Pennsylvania American Water Company shall comply with all directives, conclusions and recommendations contained in the body of this Opinion and Order which are not the subject of an individual directive in these Ordering Paragraphs as fully as if they were the subject of specific ordering paragraphs.

11. **[*161]** That the proposal of Pennsylvania American Water Company for its compliance with SFAS 106 is approved conditioned upon its compliance with the following conditions:

A. The capitalization rate is 11.91%.

B. The Company must agree to make cash deposits to an irrevocable trust fund, no less frequently than quarterly, in amounts that are proportional and, on an annual basis equal, to the annual test period allowance for other post-employment benefits. The trust must provide that any disbursements made from the trust are limited to payments for the benefit of employees pursuant to the Company's post-retirement plans, payments for expenses of the trust, and refunds to customers pursuant to a Commission approved refund plan in the event the funds are not to be paid to employees. The trustee must be independent of the Company and authorized to make only those investments which are consistent with sound investment policies for funds of this nature.

C. The Company must agree, when it is consistent with good business practices to do so, to maximize the use of income tax deductions for contributions to funds of this nature. If tax deductions are not available for some portion of currently **[*162]** funded amounts, deferred income tax accounting must be followed for the tax effects of such transactions.

12. That the Complaints filed by the various parties are sustained or dismissed as is consistent with this Opinion and Order.

13. That the request for approval of the Affiliated Interest Agreement between the Pennsylvania-American Water Company and the American Water Works Service Company, Inc. at Docket No. G-00940374 shall be terminated and the record marked closed.

14. That upon the filing of tariff revisions acceptable to this Commission as being in compliance with this Commission's Order, and upon Commission approval of the tariff provisions, the investigation at R-00932670 and R-00932670C0001-C0008 shall be terminated and the record marked closed.

15. That the June 7, 1994 Recommended Decision of Administrative Law Judge Ky Van Nguyen be, and is, hereby, adopted, to the extent consistent with this Opinion and Order.

16. That the Exceptions are granted and denied consistent with this Opinion and Order.

TABLE I

PENNSYLVANIA-AMERICAN WATER COMPANY

INCOME SUMMARY

	Pro-Forma Present Rates (1) $	**Company Adjustments (1) $**	**Pro Forma Present Rates (Revised) $**
Operating Revenue	166,296,166	0	166,296,166
Expenses:			
O & M Expense	83,580,309	(92,246)	83,488,063
Depreciation	17,021,400	(10,945)	17,010,455
Taxes, Other	10,265,257	0	10,265,257

	Pro-Forma Present Rates (1) $	Company Adjustments (1) $	Pro Forma Present Rates (Revised) $
Income Taxes:			
State	1,954,933	14,099	1,969,032
Federal	8,077,682	35,349	8,113,031
Total Expenses	120,899,581	(53,743)	120,845,838
Net Inc. Available for Return	45,396,585	53,743	45,450,328
Rate Base	524,142,658	0	524,142,658
Rate of Return	8.66%		8.67%

[*163]

	Commission Adjustments $	Commission Pro Forma Present Rates $	Commission Revenue Increase $
Operating Revenue	0	166,296,166	6,981,468
Expenses:			
O & M Expense	(582,631)	82,905,432	43,484
Depreciation	(51,881)	16,958,574	0
Taxes, Other	0	10,265,257	61,816
Income Taxes:			
State	92,685	2,061,717	842,331
Federal	232,375	8,345,406	2,111,843
Total Expenses	(309,452)	120,536,386	3,059,474
Net Inc. Available for Return	309,452	45,759,780	3,921,994
Rate Base	(2,275,289)	521,867,369	

	Commission Adjustments $	Commission Pro Forma Present Rates $	Commission Revenue Increase $
Rate of Return			0

	Total Allowable Revenues $
Operating Revenue	173,277,634
Expenses:	
O & M Expense	82,948,916
Depreciation	16,958,574
Taxes, Other	10,327,073
Income Taxes:	
State	2,904,048
Federal	10,457,249
Total Expenses	123,595,860
Net Inc. Available for Return	49,681,774
Rate Base	521,867,369
Rate of Return	9.52%

TABLE II

PENNSYLVANIA-AMERICAN WATER COMPANY

SUMMARY OF ADJUSTMENTS

Adjustments	Rate Base $	Revenues $	Expenses $
RATE BASE:			
CWC:			
Int. & Div. (Table IV)	(234,726)		
Taxes (Table V)	(314,973)		

Adjustments	Rate Base	Revenues	Expenses
	$	$	$
O & M (Table VI)	(1,486,741)		
Previously Leased MIS Property	(238,849)		
REVENUES:			
		0	0
		0	0
EXPENSES:			
Payroll			
Wages			(278,181)
401(k) Plan			(43,580)
Legal Fees			(14,589)
Capitalization Ratio			(153,820)
Early Window Costs			(92,461)
TAXES:			
Interest Synchronization (Table III)			
	(2,275,289)	0	(582,631)

[*164]

Adjustments	Depreciation	Taxes-Other	State Income Tax
	$	$	$
RATE BASE:			
CWC:			
Int. & Div. (Table IV)			
Taxes (Table V)			
O & M (Table VI)			
Previously Leased MIS Property	(51,881)		6,355
REVENUES:			
		0	0
		0	0

Adjustments	Depreciation	Taxes-Other	State Income Tax
	$	$	$
EXPENSES:			
Payroll			
Wages			34,077
401(k) Plan			5,339
Legal Fees			1,787
Capitalization Ratio			18,843
Early Window Costs			11,326
TAXES:			
Interest Synchronization (Table III)			14,958
	(51,881)	0	92,685

Adjustments	Federal Income Tax
	$
RATE BASE:	
CWC:	
Int. & Div. (Table IV)	
Taxes (Table V)	
O & M (Table VI)	
Previously Leased MIS Property	15,934
REVENUES:	
	0
	0
EXPENSES:	
Payroll	
Wages	85,436
401(k) Plan	13,384

Adjustments	Federal Income Tax
	$
Legal Fees	4,481
Capitalization Ratio	47,242
Early Window Costs	28,397
TAXES:	
Interest Synchronization (Table III)	37,501
	232,375

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1994 Pa. PUC LEXIS 134; 83 Pa. PUC 262

Pennsylvania Public Utility Commission

December 06, 1994

Docket Nos. R-00942991; R-00942991C0001; R-00942991C0002; R-00942991C0003; R-00942991C0004; R-00942991C0005; R-00942991C0006; R-00942991C0007; R-00942991C0008; R-00942991C0009; R-00942991C0010; R-00942991C0011; R-00942991C0012; R-00942991C0013; R-00942991C0014; R-00942991C0015; R-00942991C0016; R-00942991C0017; R-00942991C0018; R-00942991C0019; R-00942991C0020

Reporter
1994 Pa. PUC LEXIS 134 *; 83 Pa. PUC 262

Pennsylvania Public Utility Commission, Kenneth C. Springirth, Earl and Alice Carothers, Anthony Goedecker, John Scurry, Pstachu S. Kohut, Viva H. Watson, Robert L. Gaddess, Richard R. Reed, John L. and N. Jean Conlon, Gerald E. Doutt, Eunice M. Porsch, Edna K. Torres, Office of Consumer Advocate, Office of Small Business Advocate, Marcella V. Janick, et al., Walter C. Edwards, Mark Summers, IOGA Customer Group, Hospital Council of Western Pennsylvania, George Touris v. National Fuel Gas Distribution Corporation

Core Terms

customer, recommend, ratemaking, ratepayer, arrearage, calculate, capital structure, rate base, advertize, reply, weather, plant, refund, ratio, storing, top, uncollectible, payroll, rate of return, amortize, annual, residential, retirement, fuel, retroactive, write-offs, residential customer, degree-day, inflate, methodology

Panel: Commissioners Present: David W. Rolka, Chairman; Joseph Rhodes, Jr., Vice-Chairman; John M. Quain; Lisa Crutchfield; John Hanger

Opinion

OPINION AND ORDER

BY THE COMMISSION:

I. INTRODUCTION

A. History of the Proceeding

On March 8, 1994, National Fuel Gas Distribution Corporation ("NFGD" or "the Company") filed Supplement No. 39 to Tariff Gas-Pa. P.U.C. No. 8 to become effective May 7, 1994. This filing contained proposed changes in rates, rules and regulations calculated to produce $ 15,960,000 [1] in additional annual revenues, based upon the projected level of operations for the twelve months ended November 30, 1994. Pursuant to Section § 1308(d) of the Public Utility Code ("Code"), 66 Pa. C.S. § 1308(d), the filing was suspended by operation of law until December 7, 1994, unless permitted by Commission Order to become effective at an earlier date.

[*2]

By Order adopted April 7, 1994, and entered April 8, 1994, we instituted an investigation into the lawfulness, justness and reasonableness of the proposed increase, as well as the Company's existing rates. Formal Complaints against the proposed increase were filed by the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), the Hospital Council of Western Pennsylvania ("Hospital Council"), and Kenneth C. Springirth and several other NFGD customers. The IOGA [2] Customer Group ("IOGA") sought and received permission to intervene in this proceeding, but did not actively participate. The Commission's Office of Trial Staff ("OTS") was directed to participate and filed a Notice of appearance.

The matter was assigned to Administrative Law Judge ("ALJ") George M. Kashi on April 15, 1994 and a prehearing conference was scheduled for and held before ALJ Kashi in Harrisburg on April 27, 1994. Technical evidentiary hearings were held in Harrisburg on June 13, 14, and 15, July 7, 8, and 15, and July 26, 27, and 28, 1994. Additionally, two public input hearings were held; one in Sharon, PA on the afternoon **[*3]** of June 16, 1994 and one in Erie, PA on the evening of June 16, 1994. The record consists of 1266 pages of technical evidentiary transcript, 128 pages of public input testimony in Sharon, PA, 114 pages of public input testimony in Erie, PA, numerous statements of prepared testimony and numerous exhibits. The record closed on July 28, 1994. Main Briefs in excess of 600 pages were filed by the participants on August 16, 1994, with Reply Briefs, exceeding 300 pages, filed on August 25, 1994. Both NFGD and the OTS petitioned to reopen the record at the time briefs were filed to include in the record certain updated material which had been previously agreed to by the parties. Reopening was granted by ALJ Kashi. Additionally on September 1, 1994 the OTS filed a Motion to Strike Portions of the Reply Brief of NFGD ("Motion"). NFGD filed a Response to the Motion on September 2, 1994 and OCA filed a letter in support of the Motion on September 7, 1994. Upon consideration of the Motion and the response, and for the reasons advanced in the Motion, the ALJ granted the Motion of OTS. Consequently, the last sentence of page 33 and page 37, line 12 to and including page 40, line 2, of NFGD's Reply **[*4]** Brief was stricken.

On October 12, 1994, the Recommended Decision of ALJ Kashi was issued ("R.D."). ALJ Kashi recommended that NFGD be granted an operating revenue increase not to exceed $ 2,261,000, to become effective for service rendered on, and after December 7, 1994 (R.D. at 270). [3] Exceptions were filed by NFGD, the OCA, the OTS, the OSBA, IOGA, and the Hospital Association of Western Pennsylvania. Reply Exceptions were filed by NFGD, the OCA and the OTS.

B. <u>The Company</u>

In his Recommended Decision, ALJ Kashi provided the following information regarding the Company:

National Fuel Gas Distribution Corporation ("Distribution") is a corporation organized and existing under the laws of the State of New York. Distribution is a wholly-owned subsidiary of National Fuel Gas Company ("National"), a public utility holding company duly registered with the Securities and Exchange Commission under the Public Utility

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[1] Supplement No. 39 to Tariff Gas Pa. P.U.C. No. 8, based upon a future test year ending November 30, 1994, would have increased bills to customers, on average, by approximately 6.77 percent. <u>See</u> R.D., pp. 3-4. During the course of the proceeding, as a result of certain corrections, updates and acceptance of certain recommendations of other parties, NFGD's proposed increase in annual operating revenues was reduced to $ 15,401,000, an approximate 6.58 percent average increase in bills to customers. <u>Id.</u>

[2] The Independent Oil and Gas Association of Pennsylvania.

[3] Substantial portions of ALJ Kashi's Recommended Decision are reproduced without specific attribution.

Holding Company Act of 1935. National also owns all issued and outstanding shares of common capital stock of its other subsidiaries (Ex. No. 25).

Distribution **[*5]** furnishes gas sales and transportation service to the public in northwestern Pennsylvania and western New York. Within Pennsylvania, Distribution provides gas service in the counties of Armstrong, Butler, Cameron, Clarion, Clearfield, Crawford, Elk, Erie, Forest, Jefferson, McKean, Mercer, Venango and Warren (Ex. No. 25, p. 3).

II. EVIDENTIARY ISSUES

At pages 4-5 of the R.D., ALJ Kashi discusses the applicable legal standards pertaining to the burden of proof in this proceeding. This matter is a general rate increase pursuant to Section 1308(d) of the Public Utility Code, and we, therefore, agree with the citations of ALJ Kashi and his discussion which placed the burden of establishing the justness and reasonableness of all components of the requested rate increase on the Company. See Section 315(a) of the Public Utility Code, 66 Pa. C.S. § 315(a).

III. RATE BASE

A. Plant in Service

Distribution's claimed plant in service, as adjusted for ratemaking purposes, net of customer advances for construction, is $ 298,870,000. This was the final plant in service amount, reflecting all updates and corrections. The claimed plant in service amount reflects the level of plant **[*6]** as shown on Exhibit 108-A, p. 1, adjusted, and to reflect the capitalization of certain software, as proposed by OCA. These adjustments remove from rate base $ 307,000 of post future test year revenue producing plant additions and add $ 399,000 of software.

The major controversy related to Distribution's rate base claim was (1) the inclusion of projected non-revenue producing plant additions through May 31, 1995, the midpoint of the year when rates established in this proceeding will be in effect; and (2) a claim for Construction Work In Progress ("CWIP") of $ 1,654. [4] We address each issue in the order above stated.

1. Plant Not in Service at End of Future Test Year

NFGD's reasons for including plant additions through May 31, 1995 are explained at pages 16-17 of Statement No. 101.

The OCA and OTS objected to the inclusion of post future test year non-revenue producing plant additions in rate base (OCA St. 3, pp. 15-16; OTS St. No. 3, pp. 6-11). The ALJ noted that the principal objections of the OCA and the OTS to including post future test **[*7]** year non-revenue producing plant additions in rate base are that the amounts are estimated, not actual, and that such projected plant additions are not matched to revenues and expenses.

The OTS submits that the Company's claim for projected post-test year plant additions of $ 3,973,000 (net of retirements) and associated depreciation expense of $ 215,014 should be rejected. The OTS asserts that since the claim is based purely on mathematical calculations rather than scrutiny of identifiable construction projects, there is no way that the Company can meet its burden of proof. OTS M.B. at 13. Also, argues OTS, the inclusion of post-future test year plant in rate base would improperly allow the Company a return of and a return on plant which is not used and useful in the public service at the end of the test year, and would violate the ratemaking principle of matching revenues, expenses, and rate base to a test year. OTS M.B. at 17. This, concludes OTS, should not be permitted.

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[4] The calculation of the post future test year non-revenue producing plant additions is explained at pages 17-18 of Statement No. 101.

The OTS, through its witness, witness Michael Gruber, proposed the total disallowance of these purported post-test year plant additions. OTS Stmt. 3, pp. 7-8. The ALJ found that Mr. Gruber's adjustment results **[*8]** in a net reduction to the Company's claim for Net Plant in Service at November 30, 1994, of $ 3,972,485 ($ 4,849,792 in post-test year plant additions - $ 877,307 in projected retirements = $ 3,972,485). OTS Exhibit 3A, Schedule 1, column B, line 1. See also, OTS Ex. 3A, Sched. 5, p. 3. The ALJ observed that the corresponding depreciation expense reduction is $ 215,014. Id. at 18. The ALJ noted that since the retirements that are to take place during December 1, 1994 - May 31, 1995 represent assets that are fully depreciated, NFGD also subtracted $ 877,307 from the accrued depreciation at November 30, 1994. The OTS pointed out that if the post-test year additions and retirements are disallowed, the $ 877,307 of accrued depreciation on these retirements should then be added back to the accrued depreciation, as described in Mr. Gruber's testimony. OTS Stmt. 3, p. 10.

According to the OCA, the Company has included in its rate base claim plant that it has estimated will not be in service within the future test year but will be in service within six months of the future test year. The OCA continued that this claim is further broken down into plant which constitutes Construction **[*9]** Work in Progress (CWIP) at the end of the future test year, and plant for which no expenditures have been made at the end of the future test year but which is anticipated to be in service within 6 months of the end of the future test year. The OCA has presented evidence to support each of the two categories described immediately above.

1. Non-Revenue Producing Plant That Will Not Be In Service And For Which No Expenditures Will Have Been Incurred By Future Test Year End.

The OCA observes that the Company has estimated that, within 6 months of the end of the future test year in this proceeding, it will have non-revenue producing plant-in-service in the amount of $ 3.521 million, and it has claimed this amount as an addition to rate base in this proceeding. NFGD Exh. 108-A, p. 1. The OCA continued that NFGD, through the testimony of its witness, Rosetta Brocato, indicated that this amount is estimated based upon certain mathematical calculations. N.T. at 152; NFGD Exh. 108-A-7, p. 2 of 3. The ALJ noted that those mathematical calculations are set forth in NFGD Exh. 108-A-5 and reflect a ratio of actual additions and retirements for fiscal years 1992 and 1993. NFGD Exh. 108-A-5. **[*10]** However, the OCA submits that Ms. Brocato testified that these estimated additions and retirements do not reflect specific projects but are solely based upon mathematical calculations (N.T. at 155). OCA M.B. at 28.

The OCA's witness, James D. Cotton, recommended a disallowance of the projected additions and retirements for the period from December, 1994 through May, 1995. Mr. Cotton proffered the following explanation of the basis for his position:

It should not be allowed in rate base. Not only does the $ 3.5 million not represent used and useful plant-in-service within the future test year, it does not even represent CWIP at test year end, November 30, 1994. No expenditures related to this addition to plant-in-service will have been spent as of the future test year end.

In addition to being speculative, this claim essentially extends the future test year out to May 1995, but in an inequitable manner, since no other ratemaking elements are extended that far out. Thus, rate base, revenues, and expenses, the major components that make up rates, are mis-matched in time.

OCA St. 3 at 16.

Additionally, it is the position of the OCA that while the Company clearly identified these **[*11]** additions as non-revenue producing, no effort was made by the Company to determine whether any of the additions would be expense-reducing. The OCA continued that the only testimony regarding whether these additions were expense reducing was provided by Ms. Brocato in her Rebuttal Testimony and that testimony proved unreliable, as brought out on cross-examination. NFGD St. 201 at 2-3; N.T. at 991-95. In particular, the OCA contends that Ms. Brocato could not testify to the circumstances under which mains are typically replaced (N.T. at 991). OCA M.B. at 29. Further argues the OCA, her claims regarding the non-expense reducing characteristic of the plant was apparently based upon the statements of fellow employees, who were not provided for cross-examination (N.T. at 994). Moreover asserts the OCA, Ms. Brocato herself has no experience with the engineering side of NFGD's business

(N.T. at 995). OCA M.B. at 29 & 30. Thus, argues the OCA, the Company failed to produce any reliable evidence that plant-in-service added during the period December 1994 through May 1994 is not expense-reducing. Consequently, the Company's position should be rejected.

The OCA argues that the law is clear that **[*12]** only plant which is used and useful in service to ratepayers is appropriately included in rate base in the establishment of rates. See, e.g., *Barasch v. Pennsylvania Pub. Util. Comm'n, 516 Pa. 142, 532 A.2d 325 (1987),* aff'd *Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989).* OCA M.B. at 30. However, OCA does concede that the Commission has discretion in applying the "used and useful" standard to include in rate base a utility's investment in plant that will not be placed in service until some time after the end of the test year. See, e.g. Pennsylvania Pub. Util. Comm'n v. Pennsylvania-American Water Co., R-00922428, slip op. at 8 (April 21, 1993) ["PAWC 1993"].

However, the ALJ observed that in this case, OCA submits that there is no sound rationale for inclusion of speculative post-future test year plant additions based simply upon a mathematical estimate in future test year rate base. R.D. at 10.

On consideration of the positions of the parties, the ALJ recommended the disallowance of the claim. The ALJ cited the testimony of Mr. Gruber, that the Company has selected November 30, 1994 as the end of its future test year, and that it is at this point that revenues and **[*13]** expenses are annualized and plant in service and rate of return is calculated to determine a representative level of income required by the Company to operate. OTS Stmt. No. 3, p. 8. The ALJ found that if post-test year additions are allowed, the balance established by the test year is lost and the matching principle is violated (matching of expenses, revenue, and rate base to the same time period). The ALJ continued that the OTS noted that the Company had included no post-future test year revenues in this proceeding, which would offset the inclusion of additional post-test year claims. N.T. 206-207.

The ALJ further cited Mr. Gruber's testimony in support of his finding that the inclusion of post-future test year plant in rate base would allow the Company a return of and a return on plant not used and useful in the public service at the end of the test year is improper. (R.D. at 11). Further, the ALJ cited *Barasch v. Pa. P.U.C., 516 Pa. 142, 162, 532 A.2d 325, 334 (1987),* aff'd, *488 U.S. 299, 109 S. Ct 609 (1989)* as follows:

one of the cardinal principles of this state's public utility law is that, in the setting of rates for services to the public, a utility company is **[*14]** entitled to a return only on such of its property as is "used and useful" in the public service.

(R.D. at 11). See also, *Pennsylvania Electric Co. v. Pa. P.U.C., 509 Pa. 324, 502 A.2d 130 (1985).*

The ALJ continued that Section 102 of the Code, 66 Pa. C.S. § 102, defines rate base as the "value of the whole or any part of a public utility which is used and useful in the public service." Thus, the ALJ concluded that by including admittedly non-used and useful property in rate base, which is derived solely from mathematical calculations rather than scrutiny of individual projects and which is merely calculated to be the value of additional plant in service between December 1, 1994 and May 31, 1995, the Company is clearly violating the "used and useful" principle (R.D. at 11-12).

Additionally, the ALJ relied upon Section 1315 of the Code, 66 Pa. § 1315 which states in pertinent part as follows:

[E]xcept for such nonrevenue producing, non-expense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, **[*15]** the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

(R.D. at 12).

The ALJ noted that the Pennsylvania Supreme Court, in *Barasch, supra, 532 A.2d at 338 (1987),* ruled that Section 1315 of the Code codifies pre-existing principles of law, which are applicable to all utilities. See also, *Pa. P.U.C. v. UGI Corp., 58 Pa. P.U.C. 155 (1984).*

The ALJ observed that according to NFGD, its projected post-test year plant addition claim consists entirely of non-expense reducing, non-revenue producing plant, which will be in service within six months after the end of the test year. [5] However, the ALJ found that as stated previously, NFGD's claim is based solely on mathematical calculations rather than an examination of individual **[*16]** projects to ascertain whether a project will actually produce revenues or reduce expenses or whether a projected in-service date is realistic. Furthermore, the ALJ opined that other parties' analysts are also precluded from scrutinizing these purported projects to test the reasonableness of the Company's assertions because there is no listing of projects (R.D. at 13). The ALJ found that without an examination of individual projects, it is not possible for NFGD to meet its burden of proof on its post-test year plant additions claim pursuant to Section 315(a) of the Code, 66 Pa. C.S. § 315(a) (Id).

The ALJ noted that NFGD witness Ms. Brocato contended that the Company's post-test year additions claim was developed by projecting construction expenditures using methods previously accepted by the Commission. NFGD Stmt. 101, p. 16. The ALJ found that while **[*17]** the Commission may have accepted historical ratios to develop test year expenses, he was unaware of any Commission Order which has explicitly accepted NFGD's methodology for projecting post-future test year plant additions (i.e. plant that it is purported to be completed and serving customers from November 30, 1994 to and including May 31, 1995).

The ALJ additionally cited *Pa. P.U.C. v. Pennsylvania-American Water Company, 68 Pa. P.U.C. 343, 352, 97 PUR 4th 469 (1988),* for the proposition that the cases in which the Commission allowed post-future test year additions have related to the inclusion of specific projects which are to be completed within a short time after the end of the test year. The ALJ continued that, while NFGD has not claimed its $ 3,973,000 post-test year additions as CWIP, the Commission is currently considering a proposed policy statement concerning ratemaking treatment of CWIP. See, Docket No. M-930497; 24 Pa. Bulletin 882-884 (February 12, 1994). The ALJ noted that in this proposed policy statement, the Commission states that in determining whether to include post-test year CWIP in rate base, the Commission will consider, inter alia, whether the CWIP **[*18]** project is reasonably identifiable as nonrevenue producing and nonexpense reducing and whether the project is reasonably certain to be completed within the first six months that new base rates will be in effect. The ALJ found that since NFGD has not identified any specific projects in its post-test year claim, and has relied on mathematical calculations, it is not possible for NFGD to satisfy this criteria, even if its claim was for CWIP. (R.D. at 13-14).

The ALJ found that while the Company clearly identified these additions as non-revenue producing, no effort was made by the Company to determine whether any of the additions would be expense-reducing. The only testimony regarding whether these additions were expense reducing was provided by Ms. Brocato in her Rebuttal Testimony. The ALJ opined that this testimony proved unreliable, as brought out on cross-examination (R.D. at 16).

The ALJ determined that the law is clear that only plant which is used and useful in service to ratepayers is appropriately included in rate base in the establishment of rates. See, e.g., *Barasch v. Pennsylvania Pub. Util. Comm'n, 516 Pa. 142, 532 A.2d 325 (1987),* aff'd *Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989).* Based on this principle, continued that ALJ, the Commission has found that plant that is not providing service to customers should not be utilized in setting rates. However, ALJ Kashi noted that the Commission has discretion in applying the "used and useful" standard to include in rate base a utility's investment in plant that will not be placed in service until some time after the end of the test year. See, e.g. Pennsylvania Pub. Util. Comm'n v. Pennsylvania-American Water Co., R-00922428, slip op. at 8 (April 21, 1993) ("PAWC 1993"). The ALJ continued that in Pennsylvania-American Water Company's last rate case, the Commission rejected a claim for a project that was not expected to

[5] In rebuttal, NFGD agreed that $ 307,000 in CWIP should be removed from the Company's $ 3,973,000 post-test year plant additions claim. NFGD Stmt. No. 201, p. 4. However, the OTS tables must reflect the full $ 3,973,000 adjustment to remove all the originally claimed post-test year plant additions as filed by the Company.

be completed until three months after the end of the test year. PAWC 1993, slip op. at 6-9. The ALJ cited PAWC 1993 as follows:

The Respondent complains that the disallowance of its claim will penalize the Company. However, the ALJ determined, and we agree, that in view of the Company's nearly annual rate filings, to allow plant in rate base that is not "used and useful" would not be fair to the Company's customers.

The Respondent may be correct in its assertion **[*20]** that we have never adopted or approved the rate case frequency distinction proposed by the ALJ. This does not mean, however, that such a distinction may never be made, and in this proceeding we find that the frequency of the Company's rate filings is a significant consideration in assessing the impact of its CWIP claim on the customers.

(R.D. at 17).

The ALJ found that similar to PAWC, NFGD has been filing rate cases on an almost annual basis. Thus, the ALJ found that the lag between the time plant is placed in service and the time it is recognized in rates is relatively small. The ALJ found specifically that, especially in such circumstances, there is no justification for including in rates amounts related to plant which does not yet provide service to customers.

The ALJ's disposition of the issue appears below:

For all the above reasons, NFGD's speculative, unsupported post-future test year claim for purported plant additions of $ 3,521,000, retirements of $ 877,000, and associated depreciation expense of $ 215,000, should be denied. Consequently, we will recommend that the Commission should exercise its discretion to deny the Company's claim. Tables appended to this Recommended **[*21]** Decision will include the adjustment proposed by the OCA because it does not duplicate the $ 307,000 adjustment accepted by the company in its final claim.

(R.D. at 17-18).

2. Exceptions

In its Exceptions, NFGD argued that the ALJ's reasoning that inclusion of these additions in rate base would violate the matching principle disregards several Commission decisions. See *Green v. Pa. P.U.C., 81 Pa. Commonwealth Ct. 55, 473 A.2d 209, 214 (1984),* aff'd, *Barasch v. Pa. P.U.C., 507 Pa. 430, 490 A.2d 806 (1985); Pa. P.U.C. v. NFGDC, 67 Pa. P.U.C. 264, 271-274 (1988);* Pa. P.U.C. v. Peoples Natural Gas Co., Docket No. R-832315, p. 16 (January 13, 1984); *Pa. P.U.C. v. Philadelphia Suburban Water Co., 55 Pa. P.U.C. 407 (1976); Pa. P.U.C. v. Philadelphia Electric Co.-Gas Division, 54 Pa. P.U.C. 1 (1980).* (NFGD Exceptions at 3-4). Specifically, NFGD argues that the matching principle is not violated if, as here, the plant additions do not increase or decrease. NFGD concludes that neither the ALJ nor the OCA provided any basis for reversing the above cited precedents. NFGD repeats that it is within the Commission's discretion to include, in rate base, amounts spent **[*22]** on plant that will be in service within six months after the future test year. (NFGD Exceptions at 4).

In its Reply Exceptions, the OCA contends that NFGD has misconstrued its position on this issue. The OCA states that precedent does support leaving to the Commission's discretion the allowance for non-revenue producing CWIP. The OCA insists, however, that precedent does not mandate that every claim for CWIP be allowed. The OCA continues that the Commission clearly has the discretion to allow or deny such CWIP claims.

Upon consideration of the Exceptions and Reply Exceptions, we agree with the ALJ's resolution of this issue. We agree with the OCA that we have the discretion to allow or deny the CWIP claim before us. Our careful consideration of the issue before us leads us to the conclusion that the Company's argument does not rise to the level that would counsel in favor of adoption of its CWIP claim. Accordingly, we deny NFGD's Exception and adopt the reasoning and recommendation of the ALJ.

B. Construction Work In Progress

Regarding the issue of Construction Work In Progress ("CWIP"), ALJ Kashi made the following disposition:

The OCA has proposed the elimination of NFGD's **[*23]** final claim for Construction Work in Progress ("CWIP") of $ 1,654,000, representing actual or projected construction expenditures through the end of the future test year, which will not be in service as of that date. The basis of the OCA's adjustment is that this CWIP is not "used and useful" and its inclusion in rate base creates intergenerational inequity. OCA M.B., pp 32-33.

Distribution did not respond to this proposal in either its main or reply briefs; therefore, the adjustment will be accepted in this Recommended Decision.

(I.D. at 18)

In its Exceptions, NFGD argues that the ALJ, in adopting the OCA position that such CWIP is not used and useful and further, creates an integenerational inequity, incorrectly stated that the Company did not respond to these arguments. Specifically, the Company disputes the OCA argument that an intergenerational inequity exists because for a brief time after the rates become effective, ratepayers would pay for CWIP that is not yet in service.

NFGD continues that the Commission and the appellate courts have determined that the Commission has the discretion to include in base rates, plant that will be completed within nine months of the future **[*24]** test year. NFGD submits that the cases cited in its Exceptions relating to non-revenue producing plant not in service within six months of the end of the test year, discussed previously, support that proposition.

NFGD submits that the ALJ also disregarded the fact that there is no need to recognize throughput or revenue decreases after the future test year because there is no basis for concluding that any such increases will occur. The Company continues that residential and commercial usage continues to decline as a result of customer conservation. Similarly, according to NFGD, there is no reason to believe that reductions in expenses will occur while rates in this proceeding are in effect. Furthermore, NFGD avers that its expenses have increased steadily from year-to-year, and that there will be no increases in revenues or decreases in expenses to offset the revenue requirement associated with plant additions. (NFGD Exceptions at 4-5).

NFGD criticizes the ALJ's reasoning that the Company's claim for projected post test year additions were based upon mathematical extrapolations which use historical construction rates and construction budgets, rather than identifying specific projects. **[*25]** Adoption of the ALJ's objection, argues NFGD, would result in the virtual preclusion of gas distribution companies from meeting the burden of justifying inclusion of post future test year projects in rate base. NFGD contends that its construction program involves numerous small projects completed over a relatively short period of time. NFGD characterizes the requirement to track such projects as unrealistic. Further, NFGD asserts that such a requirement is particularly unrealistic when compared to prolonged, substantial individual projects such as water treatment plants and electric generating stations.

NFGD argues that the ALJ's reliance on Section 1315 of the Code, is erroneous. The Company argues that this particular section of the Code applies only to electric utilities because it contains an exception for non-revenue producing and non-expense reducing investments which improve safety. The Company contends that its construction program consists primarily of pipe replacement, which is conducted based upon leak surveys. NFGD contends that pipes which leak are safety hazards due to the risk of explosions. Therefore, concludes NFGD, even if Section 1315 of the Code can be construed **[*26]** to apply to gas companies, it would present no bar to inclusion of the claim in rate base of the Company's post future test year plant additions.

In its Exceptions, the OTS requests a correction to the depreciation expense adjustment shown as $ 215,000 in Table II of the R.D. The OTS submits that the number should be reduced to $ 197,098. The OTS points out that the $ 215,000 depreciation expense adjustment is based upon a recommended disallowance of the Company's originally filed $ 3,972,485, net post test year plant addition claim. The OTS continues that the Company conceded $ 307,000 of the $ 3,972,485 as being revenue-producing. Further, the OTS points out that the tables attached to the R.D. (Specifically, Table II) are based upon the Company's revised rate base claim rather than the original claim. Therefore, the OTS submits that the proper depreciation expense disallowance is $ 17,056 less than that calculated in the R.D., or $ 197,098, because the $ 17,056 is the depreciation expense associated with the Company's conceded $ 307,000 post-test year plant reduction (OTS Ex. p. 3).

Since Table II of the R.D. reflects a post-future test year plant in service adjustment of $ 3,521,000, **[*27]** the OTS states that rather than the $ 3,972,485 as recommended by Mr. Gruber, further explanation is required. According to the OTS, the difference between the Company's original post-future test year plant in service claim of $ 3,972,485 and the Company's $ 307,000 rebuttal adjustment, is $ 3,665,485. However, $ 145,000 of the $ 3,665,485 is estimated non-revenue producing unidentified CWIP purported by the Company to be completed by May 31, 1995. The OTS states that since this $ 145,000 is included in the $ 1,654,000 CWIP adjustment discussed previously and included in Table II, this $ 145,000 must be netted out of the post-future test year plant addition adjustment to avoid double-counting. Thus, concludes the OTS, the test year plant adjustment is shown as $ 3,521,000. (OTS Exceptions at 4-5).

In its Reply Exceptions, the OCA counters the argument of NFGD regarding specific identification of projects. The OCA states that the Company failed to present any evidence on these points, and its Exception is not based upon evidence of record. Specifically, the OCA asserts that no Company witness contended that it was unrealistic to specify the projects included in its post-test year **[*28]** claim. (OCA Exceptions at 3).

The OCA addresses NFGD's criticism of the ALJ recommendation concerning Section 1315 and the Commission's decision in PAWC.

With respect to the Company's dispute of the ALJ's reliance upon Section 1315 of the Code, and the Commission's decision in PAWC, supra the OCA states that NFGD attempts to distinguish PAWC from this case on the basis that the PAWC claim dealt with a single plant addition which was delayed beyond the future test year, creating uncertainty regarding the in service date. According to the OCA, the PAWC addition was relatively more certain than the NFGD additions which have not even been identified. (OCA Exceptions at 4).

Upon our consideration of the issue before us, we shall adopt the recommendation of ALJ Kashi. We agree with the ALJ's reasoning. However, we adopt the ALJ's recommendation as modified by the OTS Exceptions. As in the previous issue, we are of the opinion that the Company did not meet its burden of proof regarding this issue, specifically in its failure to identify the specific projects. We find the argument contained in the Company's Exceptions to be unconvincing. Accordingly, we will grant the **[*29]** OTS Exception and deny the NFGD Exception.

C. Working Capital

1. Materials and Supplies

NFGD's balance of materials and supplies is set forth in Exhibit No. 108-C, in the amount of $ 1,858,000. The ALJ noted that no party has raised any issue with regard to materials and supplies, and the amount of $ 1,858,000 is reflected on page 7 of the tables appended to its Main Brief. The ALJ recommended that this amount should be accepted and included in rate base. No party has excepted to the ALJ's recommendation, therefore we will adopt the ALJ's recommendation as our disposition of the issue.

2. Prepayments

NFGD's average prepayment balance is provided on Exhibit No. 108-C, p. 1. The balance is $ 428,000. Prepayment balances include the Commission's assessment, unamortized insurance premiums and American Gas Association dues. Of the total amount of $ 428,000, $ 170,000 is for the Commission's assessment, $ 244,000 is for unamortized insurance premiums, and $ 14,000 is for American Gas Association dues. Kenneth C. Springirth was the only Complainant who raised issues with regard to the foregoing prepayments. Mr. Springirth criticizes NFGD's payment of AGA dues (KCS Statement **[*30]** No.1.). The ALJ rejected Mr. Springirth's criticisms, reasoning that the AGA activities benefit Distributions ratepayers. See, NFGD M.B. at 199. The ALJ recommended that the average balance of $ 428,000 should be included in rate base. No exceptions were filed to the ALJ's findings and recommendation on this issue. Accordingly, we shall adopt ALJ Kashi's recommendation as our own action.

3. Gas Storage Inventory

Distribution's working capital requirement claim for gas in storage was updated in rebuttal testimony, and the final amount is $ 4,014,485. NFGD Stmt. 215, p.2; NFGD EX. 215-A; NFGD M.B. at 15. The Company argues that this working capital requirement is appropriate and should be adopted.

The Company initially proposed to include in rate base $ 4,183,378 for working capital related to underground gas in storage. NFGD St. 15 at 3; NFGD Exh. 108-C-3. Company witness Smycznyski testified that this amount was computed based on an estimated average inventory cost of $ .8052 per Mcf at September 30, 1994. (Id at 4). He testified that this reflects the average inventory rate at September 30, 1993, which reflects the purchase of gas in place from Supply effective August **[*31]** 1, 1993, at Supply's cost of its top gas in storage (Id). September 30 was used because it reflects the end of Distribution's fiscal year. Mr. Smyczynski then computed an average volumetric quantity of storage gas for a thirteen month period to calculate the working capital amount of storage gas of $ 4,183,878. (Id). While the OTS accepts the company's working capital claim for gas in storage, OCA strongly disagrees with Mr. Smyczynski's position.

The OCA has two disagreements with the NFGD proposal. First, Mr. Cotton, in challenging the initial claim, updated the inventory price and amounts in inventory and these adjustments are reflected on Mr. Cotton's Schedule 5. OCA St. 3 at 22 & Sch. 5. He utilized the actual average price of gas in inventory for the 13-month period shown on NFGD Exhibit, 108, page 2, of $ 0.7839/Mcf. (Id.) This resulted in an indicated storage gas in inventory of $ 3,413,582, resulting in an adjustment of $ 770,418. (R.D. at 20).

Next, the OCA argues that this Commission has consistently held that a 13-month average balance of working capital for gas in inventory is appropriate in establishing rates. See, e.g., *Pennsylvania Pub. Util. Comm'n v. Philadelphia Elec. Co., 66 Pa. PUC 60, 66-69, 93 PUR 4th 12 (1988)* ["PECO"]. In the PECO case, asserts the OCA, the Commission specifically rejected the Company's proposal to utilize a 12-month average based on an estimated cost of gas. In support of its position NFGD proffers the following cite from PECO:

We concur with the recommendation of the ALJ that we adhere to the use of the thirteen month average balances based upon actual volumes and actual price for the future test year for determining the appropriate gas storage inventory claim. PECO has utilized a future test year in this proceeding, and we find it inappropriate to further adjust the thirteen month balances to reflect estimates of volumetric and cost changes for gas storage inventories.

R.D. at 21-22

Moreover, argues the OCA, Company witness Smyczynski has failed to demonstrate that utilizing a 13-month average does not eliminate the seasonality associated with storage balances. The OCA submits that is the whole purpose of utilizing a 13-month average. OCA M.B. 35. In revised Schedule 5, Mr. Cotton reflects the 13-month average through May, 1994, which reflects a final claim of $ 3,596,283, and an **[*33]** adjustment to rate base of $ 587,717. It concludes that its position on this matter should be adopted as consistent with Commission practice.

The Company argues that OCA submitted no testimony or exhibits in response to Distribution's final claim for gas in storage. The ALJ observed that the OTS concurs with the NFGD working capital claim for gas in storage. (R.D. at 22; Footnote 3).

The ALJ observed further that in its brief, OCA submitted a new calculation of its adjustment to gas in storage. In performing its calculation, OCA maintains that a thirteen month average is to be used, and that the monthly storage balances are to be calculated at an inventory rate of $ .7839/Mcf. OCA contends that its calculation was undertaken in accordance with the Commission's PECO decision. OCA proposes a gas in storage working capital amount of $ 3,596,283. (Id).

The ALJ found that the primary difference between NFGD and OCA concerns the use of a 12-month versus a 13-month average for computing the average storage balance. In PECO, supra, the utility claimed a gas storage inventory balance based upon a normalized level of monthly inventory balances. The ALJ continued that in PECO, **[*34]** the Commission rejected the approach and adopted OTS' calculation of a 13-month average using actual storage volumes available for the future test year and estimated storage balances through the end of the future test year.

The ALJ concluded that although the record contains the data necessary to compute a 13-month gas storage inventory balance for Distribution for the 13 months ended November, 1994, in accordance with PECO (actual data from November, 1993 through June, 1994 and projected data from July through November, 1994), the OCA disregarded this data. Instead, found the ALJ, the OCA, in its brief, calculated a 13-month average ended May, 1994 [6] using actual data from September, 1993 through May, 1994, and hypothetical data for May, 1993 through August, 1993. [7] By using non-current data in its calculation, and ending its 13-month calculation in a low storage balance month, the OCA achieved an artificially low gas inventory balance. (R.D. at 23-24).

[*35]

The ALJ continued that if, as OCA suggests, a 13-month balance is to be used, per the PECO decision, the gas storage inventory to be included in rate base, calculated at a $ .8052/Mcf average inventory rate, would be $ 4,210,312, as shown below:

DATE	**STORAGE BALANCE AMOUNT**
	$
November, 1993	6,810,344
December, 1993	4,564,847
January, 1994	2,398,462
February, 1994	914,672
March, 1994	519,216
April, 1994	1,034,000
May, 1994	2,279,418
June, 1994	3,995,876
July, 1994	5,348,370
August, 1994	6,450,132
September, 1994	6,834,146
October, 1994	6,844,968
November, 1994	6,739,605
13 Month Average	4,210,312

(I.D. at 24; Footnotes Omitted.)

The ALJ noted that NFGD points out that this rate base amount, $ 4,210,312, based upon a 13-month average ended November, 1994, is virtually identical to the balance that would result using a 13-month average ended September, 1994, of $ 4,231,382. The ALJ noted that NFGD presented the calculation of a 13-month average ended September in rebuttal because it included all available actual monthly storage balances (September 1993-June 1994) and updated projections for the remaining months (July 1994-September 1994). According to **[*36]** ALJ Kashi, this calculation, using the greatest amount of actual data, confirms the accuracy of the 13-month average ended November 1994. Therefore, the ALJ concluded that if the Commission were to decide that a thirteen-month average should be used, the correct gas in storage inventory should be $ 4,210,312.

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[6] The ALJ found that as it did in direct testimony (OCA St. 3, Sch. 5; Tr. 597-98), OCA continued to disregard record evidence of more recent actual data. According to the ALJ, in the case of the calculation presented in its brief, OCA truncated its calculation as of May, 1994, even though actual data through June, 1994 was available.

[7] The ALJ found that it is to be emphasized that Distribution had no storage prior to August, 1993 (St. No. 15, p. 3); therefore any data used by OCA for that period is hypothetical, based upon Distribution's original filing. Distribution has provided updated, actual data for May and June, 1994 and updated projected data for July through September, 1994 in Exhibit No. 215-A.

The ALJ found the OCA position on this issue unconvincing. While the OCA disputed NFGD's use of an average inventory cost of $ .8052/Mcf, it did not specify its reason for objecting to this cost. The ALJ found that NFGD's calculations are based upon the average storage inventory cost to be effective October 1, 1994, two months prior to the end of the future test year. The ALJ noted that NFGD calculated that average cost based upon the actual average cost of $ .7839/Mcf for 8,357,430 Mcf in storage at September 30, 1994, plus the additional actual purchase of 130,171 Mcf in October, 1994 at a cost of $ 2.171/Mcf (Ex. No. 215-A, p.2). Therefore, ALJ Kashi determined that it would be erroneous to contend that the average cost of $ .8052/Mcf is not a future test year cost. Consequently, objections to the use of the average inventory cost of $ .8052/Mcf were rejected. [8] The ALJ **[*37]** concluded that this cost is a readily determinable amount. The ALJ pointed out that as shown on Exhibit No. 215-A, p. 2, NFGD purchased 8,357,430 Mcf of gas in place at an average inventory cost of $ .7839/Mcf (St. No. 15, p. 4). In addition, NFGD purchased 130,171 Mcf for storage injection in October, 1993 at an average inventory cost of $ 2.171/Mcf. These purchases, when averaged, produce an average inventory cost of $ .8052/Mcf (Ex. No. 215-A, p. 2). This rate was then used by Distribution to value the monthly balances of gas in storage. (R.D. at 25-26).

ALJ Kashi viewed gas in storage as a recent working capital requirement for NFGD, arising as a result of the transfer of the gas storage function from NFG Supply ("NFGS") to NFGD. This is as a result of the restructuring of pipeline services under FERC Order No. 636 (St. No. 15, pp. 3-4). The ALJ found that NFGD's final working capital claim for gas in storage reflects **[*38]** actual volumes of gas in storage for the ten months ended June 30, 1994 and two months of projected volumes of gas in storage. [9]

The ALJ continued that NFGD's final working capital calculation for gas in storage is based upon average volumes for a twelve-month period, rather than the thirteen-month period traditionally used for other inventory working capital claims. [10] The ALJ noted that as NFGD's witness, Mr. Smyczynski, explained, gas storage balances are strongly affected by the seasons of the year (St. No. 215, p. 2). Thus the ALJ found that the gas storage balance as of the end of September (near the end of the storage injection period) will be substantially greater than the gas storage balance as of the end of March (near the end of the storage withdrawal period). As a result, found the ALJ, a thirteen month average ended September would produce a substantially different result than a thirteen month average ended in March, **[*39]** even if storage injection and withdrawal patterns were precisely the same on a monthly basis throughout the year. Thus, the ALJ concluded that a twelve-month average gas in storage balance be used. [11]

Accordingly, ALJ Kashi recommended adoption of the recalculation of the company's claim as presented by NFGD witness James Smyczynski, using 10 months actual data through June 1994 and two months projected data (July-August), for a twelve month average claim of $ 4,014,485, **[*40]** as included in NFGD's final claim. (R.D. at 26-27).

Exceptions

In its Exceptions, the OCA cites *Pa. P.U.C. v. Philadelphia Electric Company, 66 Pa. PUC 60, 66-69, 93 PUR 4th 12 (1988),* ("PECO 1988") for the proposition that a 13-month average balance of working capital for gas in inventory is appropriate in establishing rates. The OCA continues that in PECO 1988, the Commission specifically

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[8] The ALJ noted that according to NFGD, a 13-month average for gas in storage based upon the 13 months ended November, 1994, valued at a cost of $ .7839/Mcf would be $ 4,098,936 ($ 4,210,312 / .8052 X .7839), or approximately $ 85,000 more than NFGD's final claim.

[9] Because NFGD was not fully engaged in storage activities until September, 1993, it is necessary to provide a partial projection of storage volumes in order to present an average level of storage activities for a full year (St. No. 215, pp. 2-3).

[10] Although Distribution supports the use of a twelve-month average, Distribution also has presented the results of a 13-month average on its Exhibit No. 215-A, in the event the Commission were to conclude that a 13-month average is to be used. The cash working capital allowance for gas in storage in the event a 13-month average were used would be $ 4,231,382.

[11] OCA originally proposed an adjustment to gas in storage based upon a thirteen-month average ended March 31, 1994. OCA's witness conceded that the calculation should reflect all current data (N.T. 598). OCA presented no testimony in response to Distribution's final claim that was based upon a twelve-month average and that incorporated more current data.

rejected PECO's proposal to utilize a 12-month average based on an estimated cost of gas. The OCA proffers the following cite from PECO 1988:

We concur with the recommendation of the ALJ that we adhere to the use of the thirteen month average balances based upon actual volumes and actual price for future test year for determining the appropriate gas storage inventory claim. PECO has utilized a future test year in this proceeding, and we find it inappropriate to further adjust the thirteen month balances to reflect estimates of volumetric and cost changes for gas storage inventories. (Emphasis in original).

(OCA Exceptions at 5).

The OCA argues that, contrary to the ALJ's assertions, its adjustment is very clearly intended to adhere to the Commission's PECO 1988 **[*41]** decision wherein the use of 13-month actual volumes and actual prices was required in establishing the level of storage working capital for the future test year. (Id.)

The OCA excepts to what it views as the ALJ's apparent acceptance of the Company's claim that it was not engaged in storage activities until September 1993, and thus its storage activities would be understated if data prior to that date were utilized. According to the OCA, these arguments were not presented until the Company's Main Brief. Furthermore, the OCA claims that it had not had a previous opportunity to respond to those arguments. (OCA Exceptions at 5-6).

The OCA concedes that NFGD's storage activity was somewhat lower prior to September 1993 than in subsequent periods. However, the OCA argues that this is not a sufficient reason to change the accepted practice of using 13-month averages. It is the opinion of the OCA that fluctuations in price and inventory balance can normally be expected from year-to-year, but that does not justify changing a methodology which is designed to even out those swings. The OCA strongly disagrees with the Company's argument that the seasonality of storage gas balances justifies **[*42]** its approach over OCA's proposal. The OCA continues that a 13-month average is designed to balance out seasonal fluctuations and should be utilized precisely to deal with this concern. (OCA Exceptions at 6).

Finally, the OCA points out that the ALJ noted that its schedules reflect data only through May 1994, and no data for June 1994, that was available at the close of the record. The OCA concludes that it does not object to updating the data through June, 1994. The OCA urges that its adjustment, which is based upon the actual 13-month averages of storage gas balances and prices be adopted. (Id.).

In its Reply Exceptions NFGD argues that if PECO 1988, which was relied upon by the OCA, were strictly applied an average balance greater than that presented by NFGD would be required in rate base. NFGD continued that in PECO 1988, the Commission applied a 13-month average of storage balances at the end of the future test year. NFGD calculated that if one used the PECO 1988 formula, then the average gas inventory would be $ 4,210,312, instead of $ 4,014,485, as claimed by NFGD. (NFGD Reply Ex. at 1-2).

NFGD notes that the difference between the amount computed under **[*43]** PECO 1988 and the figure proposed by the OCA results from what the Company views as a distortion caused by the choices of the initial, and therefore, ending months for the 13-month averages. According to NFGD, a starting date for a 13-month calculation, beginning in February or March, will always produce a much lower average than the 13-month average beginning in October or November due to the storage injection/withdrawal cycle. NFGD offers as an example, a 13-month average beginning in March double counts a monthly balance of approximately $ 500,000, in the Spring when storage is depleted as a result of Winter use. In contrast, NFGD submits that a 13-month average beginning in November, when storage is full in preparation for the winter, a monthly balance of nearly $ 6.8 million is double counted. Thus, concludes the Company the choice of a starting month can produce a swing of nearly $ 500,000. (NFGD Reply Ex. at 2).

Based upon the foregoing discussion NFGD repeats that it has presented its gas in storage inventory based on a 12-month average to avoid issues on the choice of a future test year that can arise where a 13-month average is used for gas inventory. NFGD urges that **[*44]** the Commission adopt its proposal which was adopted by the ALJ. (Id.).

Upon our careful consideration of the Exceptions and Reply Exceptions, we agree with the ALJ's decision to adopt the NFGD analysis and base its working capital allowance of 10 months of actual data and two months of projected data. We find that the OCA's Exceptions do not give us sufficient basis for overturning the ALJ's recommendation on this issue. Accordingly, we will adopt the recommendation of the ALJ, and deny the OCA's Exception.

4. Cash Working Capital

No party raised any cash working capital issue. The amount of $ 14,754,000 was reflected in NFGD's rate base, subject to adjustments based upon changes in levels of expenses by this Commission. R.D., p. 29.

5. IRS Audit Assessment

The Internal Revenue Service ("IRS") has notified NFGD of tax deficiencies with regard to tax years 1977-1986. A portion of such tax deficiency relates to IRS' conclusion that amounts received by NFGD during this period from customers for installation of service lines constituted taxable income to NFGD.

The ALJ points out that prior to the adoption of the Tax Reform Act of 1986, NFGD and other utilities considered **[*45]** amounts received from customers for construction of utility facilities to be contributions in aid of construction that were exempt from taxation under *Section 118 of the Internal Revenue Code*. The ALJ continued that as part of the Tax Reform Act of 1986 ("TRA-86"), the Internal Revenue Code was amended to provide that such payments by customers to construct facilities were taxable to the utility. Pursuant to TRA-86, property financed with the payment became part of the depreciable assets for tax purposes thereby increasing tax deductions over the tax life of the property (St. No. 16, p. 9).

At the request of OTS, the Commission initiated an investigation at I-880083 to determine the appropriate ratemaking treatment of such increased taxes. By Order adopted May 11, 1989, at I-880083, the Commission determined that gas and electric utilities should include in rate base the tax that is paid by the utility as a result of receipt of the contribution. As the tax depreciation on plant constructed with a contribution is received, the rate base reduction is removed (Order of May 11, 1989, at I-880083, pp. 3 and 24).

The IRS tax assessment makes contributions received from customers for service **[*46]** lines during tax years 1977 to 1986 taxable income. Consistent with the Commission's determination at I-880083, NFGD has included in rate base in this proceeding the portion of taxes on such service line contributions that will not have been recouped through increased tax depreciation by the end of the future test period in this proceeding.

OCA contends that this rate base adjustment is somehow retroactive ratemaking. The ALJ included the following colloquy from the record which occurred when the OCA's witness was asked to explain this theory:

Q. How does retroactive ratemaking preclude the remaining balance of that tax from being included in the rate base in this proceeding?

A. Well, I think what you're trying to do is to change the rate base in this proceeding to reflect the fact that the treatment of contributions changed in the past.

Q. But the point is that IRS will have said that is a taxable event, and that tax will remain paid by the company and unrecouped by the company through depreciation, will it not?

A. Yes, I agree with that.

Q. Is recovering a return on that on a prospective basis, in your opinion, retroactive ratemaking?

A. Well, I think when you say on a prospective **[*47]** basis, it's because there was a prior change.

Q. It's a prior change that affects rates from now forward. Is that retroactive ratemaking in your mind?

A. If it's due to the IRS audit changes, yes. If it's not due to the IRS audit changes, no. Maybe that answers your question.

(R.D. at 32-33)

The ALJ was of the opinion that such explanation provided no rational basis for denying this rate base adjustment. The ALJ found that the IRS has determined that service line contributions were taxable, and that at the end of the future test year, $ 204,000 of taxes associated with such service line contributions will remain unrecovered through increased depreciation. The ALJ concluded that inclusion of such amount in rate base for determining rates on a prospective basis until such time as such tax is recovered through tax depreciation is prospective ratemaking and is consistent with the Commission's treatment of taxes on contributions subsequent to TRA-86. The ALJ commented that the OCA's contentions are without support and should be rejected. (R.D. at 33).

In its Exceptions, the OCA disagrees with the ALJ's conclusion that the Company's claim does not constitute retroactive ratemaking, **[*48]** and instead is prospective ratemaking and is consistent with the Commission's treatment of taxes on contributions subsequent to TRA-86. The OCA continued that since these taxes relate to contributions made during the period 1977-1986, it raises the question of how inclusion of these taxes in rate base would not constitute retroactive ratemaking. The OCA contends that in essence, NFGD is requesting and the ALJ has agreed to make a line-by-line examination of prior tax expense with respect to one item which is in clear violation of precedent prohibiting such retroactive ratemaking. See *Cheltenham & Abington Sewerage Co. v. Pennsylvania Public Utility Commission, 344 Pa. 366, 25 A.2d 334 (1942),* ("Cheltenham"); *Barasch v. Pennsylvania Public Utility Commission, 507 Pa. 496, 491 A.2d 94 (1985),* ("Barasch"). (OCA Exceptions at 7-8).

The OCA continues that in Barasch the Pennsylvania Supreme Court stated that "current ratepayers should shoulder only actual expenses of providing current utility service." *Barasch at 507 Pa. 517, 491 A.2d at 104.* Thus, it is the position of the OCA that NFGD's proposed inclusion of $ 204,000 in taxes related to the period 1977-1986 does **[*49]** not constitute a current expense necessary to provide current service. (OCA Exceptions at 8).

The OCA continues that this claim does not involve a change in tax law. According to the OCA, the deficiencies caused by the IRS audit adjustment for which NFGD requests recovery, were not incurred due to an unusual and nonrecurring occurrence. The OCA asserts that NFGD wants rate recovery for this deficiency to reward it for past aggressive tax positions that ultimately resulted in a penalty. (Id.)

The OCA cites the testimony of OTS witness Mr. Maher that because ratemaking calculations are hypothetical, based upon pro forma revenues and expenses normalized to a future test year level, the actual taxes allowed may be substantially different than the actual taxes due on a return. The OCA contends that here, NFGD seeks to retroactively fix a deficiency that occurred in a prior period due to its past tax practices through current recovery. It is the position of the OCA that this is improper and should be permitted. (OCA Exceptions at 8-9).

Finally, the OCA points out that the Company has appealed the IRS audit decision. Thus, points out the OCA, the extent of the Company's tax liability **[*50]** to the IRS is now not known and measurable. Therefore, the OCA suggests that in the alternative, the claim should not be recovered at this time since it is speculative. (OCA Exceptions at 9).

In its Reply Exceptions, NFGD notes that its appeal to the IRS is expected to be resolved by the years' end. NFGD continues that it is highly unlikely that the Revenue Agent's Report would be reversed. (NFGD Reply Exceptions at 4).

Upon consideration of the issue, we will not adopt the ALJ's recommendation which would allow the Company to recover the portion of taxes on such service line contributions that will not have been recouped through increased tax depreciation by the end of the future test period in this proceeding. As noted previously, the Company has appealed the IRS ruling, and therefore the results of the ruling are not final, so therefore the request to recover the associated expenses remain speculative.

We support the Company's position on appeal and fully expect that NFGD will prevail on the merits of the claim. We hasten to add that our disallowance of the claim is without prejudice to future recovery of the expense in the unlikely event that the Company's appeal is unsuccessful. **[*51]** Based upon the foregoing discussion, the OCA's Exception is granted to the extent consistent with this Opinion and Order.

6. Customer Deposits

NFGD reduced its rate base to reflect customer deposits. NFGD M.B. Tables p. 7. The amount of the reduction was $ 555,000. See R.D., p. 34. No party raised an issue with respect to this reduction and we shall adopt the ALJ recommendation concerning same.

REVENUES

Weather Normalization-Degree Days

In this proceeding, NFGD states its opposition to its usual practice of using a 30-year average of historical annual degree-days to normalize the effects of temperature variation on throughput and revenues for ratemaking purposes. NFGD contends that the use of 30 years of data produces poor forecasts and results in the overstating of throughput and revenues. NFGD M.B., pp. 23-25. Citing various articles taken from meteorological journals, NFGD argues that there is no real scientific basis for the use of 30 years of data to establish climatic normals. NFGD argues that this standard was the result of a compromise among options which was reached at the 1933 convention of the International Meteorological Organization in Warsaw. According **[*52]** to NFGD, such normals are expressions of climatic conditions within the 30-year period, and cannot be used to predict conditions beyond that period. Id., pp. 42-44.

NFGD also contends that periods other than 30 years have been used in the past for weather normalization purposes in Pennsylvania and elsewhere. NFGD claims that in recent years there has been increased use of periods significantly shorter than 30 years in numerous jurisdictions. Id., pp. 49-50. The Company asserts that in its most recent base rate case, weather normalization was based on the average of the 30-year and the 10-year normals. Id., p. 50.

Based on an article with regard to climatic conditions in the state of Illinois which concluded that 5- and 10-year normals have better predictive value than 30-year normals, NFGD performed its own statistical study of historical temperature data for the Erie, Pennsylvania Weather Service Office. From this study, NFGD concluded that the use of a 10-year period is more appropriate than a 30-year period for the determination of degree-day values for weather normalization purposes. Id., pp. 44-46. Thus, in this proceeding, NFGD has utilized the 10-year period **[*53]** from 1984 through 1993 to establish its figure for the normal number of annual degree-days, which it has determined to be 5,955. It is this number which NFG used to develop its forecasted sales volumes for the future test year. NFG St. No. 14, pp. 17-18.

The OTS opposes NFGD's use of the 10-year average instead of a 30-year average, arguing that the goal is not to predict weather but to derive a normal level of degree-days. OTS M.B., p. 23. The OTS contends that NFGD's use of only 10 years of data is not consistent with the National Oceanic and Atmospheric Administration's (NOAA) definition of "normal" as the arithmetic mean of a climatological element computed over a long time period. Id., pp. 23-24. The OTS further contends that "the Commission has historically used thirty years of data for revenue normalization purposes and has used thirty years of data for NFGD in all fully litigated cases, as indicated in interrogatory response OCA-8-9 (included as Appendix A to OCA Statement 3)." OTS R.B., p. 12.

With respect to the Company's reference to the use of a period other that 30 years for weather normalization in its most recent rate case, the OTS notes that the prior case was **[*54]** resolved through stipulation and not litigated. Id. In this regard, the OTS objects to the Company's reference to this case, as set forth in the following:

OTS strenuously objects to NFGD's misuse of the settlement process in this manner. Parties will definitely be reluctant to settle cases and issues in the future, in contravention of Commission policy to encourage settlements, if utilities continue to use settlements against parties in future litigation of issues. See 52 Pa. Code §§ 5.231 and 5.224(f); 52 Pa. Code §§ 69.391-69.395.

Furthermore, the Stipulation concerning degree days which was entered into in the Company's last base rate case, specifically provides that the stipulation is made without any admission against, or prejudice to, any position which any party to the Stipulation may adopt during litigation of this proceeding following a disapproval by the Commission of this Stipulation and in any proceeding initiated after the Commissions's final order in this proceeding. Emphasis supplied.

See, Stipulation Concerning Degree Days To Be Used In Weather Normalization Of Sales Volumes And Revenues For Ratemaking Purposes, Docket No. R-00932548; approved by **[*55]** the Commission by Order entered December 1, 1992. The instant base rate proceeding was obviously instituted subsequent to the Commission's final Order in the last base rate case. NFGD should not be permitted to "prejudice" other parties' positions in this proceeding by referring to this prior degree day stipulation.

Id., pp. 12-13.

In place of the Company's 5,955 number, the OTS developed a figure of 6,193 as the appropriate number of annual degree-days to use for weather normalization, based on the most recent 30-year period of December 1, 1964 through November 30, 1993. The resulting revenue adjustment to reflect the difference between actual and normalized sales is $ 1,142,696 for residential revenues, and $ 111,986 for commercial revenues. Id., p. 24. The OTS asserts that its adjustment "is reasonable and should be adopted for the following reasons: (1) it is consistent with the NOAA definition of 'normal' in that it uses heating degree-day data over a thirty-year period, (2) it encompasses a length of time which is sufficient to smooth out short term aberrations of data, (3) it is based upon published and readily available source material and (4) a presentation of **[*56]** data based upon a period of time less than three decades is merely an 'average' and not a 'normal'." Id., p. 25.

The OCA is also opposed to NFGD's use of the 10-year average of degree-day data for weather normalization. Like the OTS, the OCA argues that the purpose of determining normal weather is not to predict the weather, but to determine what is normal or typical weather from year to year in the area in question. The ALJ found that it is the OCA's position that the 30-year average of data is the only common standard used for this purpose in utility regulation. OCA M.B., p. 37. The OCA contends that while one of the articles cited by NFGD concludes that 30 years of data is not optimum for predicting weather over the next few years, it is equivocal as to the preferable period to use in determining a normal. OCA R.B., pp. 15-17. The OCA contends that the articles cited by NFGD actually support the argument that a 30-year normal represents typical weather experience. OCA M.B., pp. 38-39.

With regard to the article concerning the analysis of Illinois data on which NFGD based its own study, the OCA asserts that the Company's reliance on this article is misplaced. The OCA argues **[*57]** that the credentials of the article's authors are unknown, and that the authors were not available for cross examination in this proceeding. OCA R.B., p. 13. The OCA further argues that NFGD's study was not as rigorous or otherwise comparable to the study detailed by the article. Id., pp. 13-15.

Finally, with respect to NFGD's reference to past rate cases, the OCA, like the OTS, objects to the Company's inclusion of settlements among these cases. In this regard, the OCA argues as follows:

Those settlements clearly specified that the treatment of weather normalization of revenues in those cases was not to be construed to represent approval of any party's position on any issue. Nor was the methodology by which the degree days utilized in NFGD's last proceeding specified therein, but was the subject of confidential settlement discussions that were not memorialized in the settlement document, and should therefore have remained confidential. Pennsylvania Pub. Util. Comm'n v. National Fuel Gas Dist. Corp., R-932548, Stipulation Concerning Degree Days To Be Used In Weather Normalization Of Sales Volumes and Revenues For Ratemaking Purposes (May 26, 1993) ["Degree day Stipulation"]. **[*58]** Only the degree day number of 6,202 was shown in that settlement document, not the method used to reach it. That stipulation stated:

It is expressly understood by the Parties that their joining in this Stipulation does not involve any agreement, either in this proceeding or in future proceedings, concerning the propriety of any specific methodolgy (sic) for determining a normal level of annual heating degree days. Therefore, Parties joining in this Stipulation will be permitted, despite this Stipulation, to advocate in future proceedings the use of any number of years of data to normalize volumes and revenues, and Distribution may in future proceedings proposed a weather normalization clause.

Degree Day Stipulation, P11.

Id., pp. 17-18.

For these reasons, the OCA advocates the continued use of the 30-year average of data for weather normalization. Based on this position, OCA utilized the NOAA 30-year normal degree-day figure of 6,279. OCA M.B., p. 36. The resulting revenue adjustment is an increase to present revenues of $ 2.199 million. Id., p. 41.

The OSBA also objects to NFGD's use of 10 years of data to develop its degree-day figure. Like the OTS and the OCA, **[*59]** the OSBA criticizes the Company's reliance on the various climatological articles it cited. The OSBA asserts that none of these articles offers a definitive statement as to the appropriate climatic average to use, and none supports use of a 10-year average. The OSBA M.B., pp. 7-10. With respect to the article on which NFGD based its specific climatological study, OSBA states the following:

While the authors found ten year normals to have a "high probability" of being the best predictors as suggested by the Company, the ten year period was not endorsed as providing the most frequent closest estimate of the next year's summer and winter mean temperature and precipitation. Yet, the authors acknowledged that "[t]hirty year normals tend to be the best predictors when the temperature departures are of intermediate size." The Illinois Situation, p. 1387. Once again, there was no definitive endorsement of a ten year period.

Id., p. 10.

Moreover, the OSBA questions the applicability of the results of the Illinois study to NFGD's service area in northwestern Pennsylvania. Id., pp. 10-11.

With respect to NFGD's reference to its previous base rate case, the OSBA, like the OTS **[*60]** and the OCA, sharply objects to such a reference because the case involved a stipulated degree-day number. The OSBA argues that "NFGD's discussion and apparent reliance on the alleged methodology used in reaching the stipulated degree-day value in the Company's prior rate proceeding is in direct contravention to the express language, understanding and agreement of the parties, including NFGD, to that stipulated settlement." OSBA R.B., pp. 5-6. Furthermore, the OSBA asserts that the parties to the stipulation agreed only on a degree-day number, not a specific methodology for determining it. Id., p. 6.

Thus, with regard to the proper time period to consider in developing a degree-day forecast, the OSBA concludes as follows:

The Company's determination that a ten year normal should replace the well-established 30-year NOAA normal is inconclusive at best. Certainly, the Company has failed to present sufficient evidence in this case to support a change to a ten year period as opposed to any other time period, particularly the 30-year period used in prior litigated cases. As OSBA witness Edwards illustrated in his thorough testimony on the subject, there is evidence which is just **[*61]** as strong, if not stronger, to support the position that a period greater than 30-years should be used to develop a normal degree-day value.

OSBA M.B., p. 11.

In addition to its belief that NFGD used an improper time period, the OSBA also contends that the Company used incorrect data in developing its degree-day forecast. The OSBA argues that the Company incorrectly used a computational procedure which was developed by NOAA to estimate normal degree-days when a complete history is not available. However, the OSBA asserts, a complete history is available in this case. Id., p. 13. The OSBA also contends that NFGD improperly used data that had been adjusted by NOAA for reasons that were not entirely clear, but apparently had to do with allowing for comparisons of data across different weather stations. According to the OSBA, the purpose for these adjustments is not applicable in this case where the task is to determine the appropriate numbers to use for Erie International Airport for purposes of setting utility rates for NFGD. OSBA M.B., pp. 13-16; R.B, pp. 13, 26. Furthermore, the OSBA asserts that while NFGD witness Mark D. Pijacki used the adjusted data to determine **[*62]** a normal degree-day value, NFGD witness Joanne E. Zablonski used unadjusted data to perform sales and revenue forecasts. OSBA M.B., p. 15. Thus, the OSBA concludes that the Company's revenue projections are internally inconsistent. Id., pp. 15-16.

In place of the Company's degree-day number of 5,955, the OSBA recommends a figure of 6,414. This figure was developed by OSBA witness Herbert J. Edwards through the use of statistical techniques known as Box-Jenkins analysis and Fourier regression. OSBA M.B., pp. 17-19; R.B., pp. 23-24. Mr. Edwards' analyses resulted in twelve different forecasts based on twelve different combinations of methodology and time frame. OSBA M.B., p. 19. Of these twelve forecasts, Mr. Edwards chose 6,414 degree-days as the most appropriate number to use in this case. The OSBA describes this choice as follows:

As Chart 11 of OSBA Stmt. No. 1, p. 41 indicates, the consensus of the data indicates a value generally at or about the 6,400 level, not the 5,900 suggested by the Company. The most straightforward approach - the use of a straight average - also suggested a number in the 6,400 range: specifically 6,414. Further, the average of the NOAA 30-year normal **[*63]** of 6,279 and the NOAA 30-year average actual of 6,513 also falls within the 6,400 range: specifically 6,396 degree-days. Since the straight 46 year average was consistent with his other forecasts and given that this source also permits the identification of monthly values (See, OSBA Ex. No. 1, Sch. 1, p. 2) which are also needed to support studies like forecasting analyses and weather-normalization of actual histories, 6,414 was adopted as Mr. Edwards' specific degree-day recommendation for this case. OSBA Stmt. No. 1, p. 43.

Id., p. 20.

The 46-year history used by OSBA witness Edwards represents the period from January 1948 to December 1993. OSBA R.B., p. 25. With regard to its analysis using 46 years of data, and the resulting degree-day number, the OSBA concludes as follows:

In this case, the available and reliable information spans a 46-year history. Last year, the number would have been 45 years, which was the period used in a 1983 Pennsylvania rate case involving Equitable Gas Company at Docket No. R-822123. When all is said and done, this time frame has at least one unquestionable advantage over the Company's preferred ten year history: It contains more than four **[*64]** times as many observations, which correspondingly reduce the potential for misleading results. The OSBA further believes that there is no magic involved in the selection of a particular time period. To the contrary, the OSBA believes that, once the decision is made to seek some alternative to the time-honored use of the NOAA normal, the selection of an appropriate time period should be based on sound analysis and good sense. Only the OSBA has met this standard.

The OSBA's studies have produced a number of results based upon different combinations of time frame and technique. The results, not surprisingly, have covered a range of values which, as noted elsewhere, tend to fall both above and below 6,400. The ALJ and the Commission can take reassurance from such results, because they indicate that the use of the 46-year average of 6,414 reflects exactly the appropriate regulatory standard: Striking a reasonable balance between the interests of ratepayers and those of NFGD's investors.

Id., pp. 27-28.

The OSBA contends that because of NFGD's use of an improper degree-day figure, the Company has overstated its increase request in this proceeding by $ 2.4 million. OSBA M.B., **[*65]** p. 5. Therefore, the OSBA asserts that the Company's total requested increase in this case should be $ 13.5 million and not $ 15.9 million. OSBA St. No. 1, p. 52. The OSBA submits that should the Commission choose not to depart from the NOAA standard, then the NOAA 30-year normal of 6,279 would be the appropriate degree-day number to use for weather normalization. OSBA M.B., p. 21. This is the number advocated by the OCA.

In response, the Company criticizes the OSBA's analysis, arguing that its use of a 46-year history and unadjusted data does not take into account the inhomogeneity of such data due to changes in instrumentation over the years. NFG M.B., pp. 52-55. NFGD also criticizes the OSBA's use of the Fourier regression analysis. NFGD contends that use of this technique on raw data is not supported by meteorological or climatological literature, and produces impractical results. Id., pp. 55-56. With respect to the difference between the types of data used by NFGD witnesses Mr. Pijacki and Ms. Zablonski, NFG argues as follows:

In summary, Distribution uses the annual NOAA-adjusted degree days where annual data are sufficient for its purposes. For actual revenue calculations, **[*66]** however, the adjusted data are not sufficient because they are computed only for calendar months. These data cannot be used for revenue calculations because they do not provide daily values. To make monthly consumption analyses, daily data are necessary so that temperature data can be matched to billing cycle data so that the temperature data are for the same period as consumption data.

Id., p. 56.

In general, with regard to the OSBA's position, NFGD concludes as follows:

Despite the sheer size and number of statistical exercises contained in OSBA's presentation, . . . it is seriously flawed. If OSBA's approach had been used in the last ten years, it would have overstated actual degree days in nine of the last ten years. There would have been a cumulative total overstatement of degree days of 4,106 offset by a single occurrence in which annual degree days exceeded its recommended normal by only 89 degree days.

Statistical analyses can be useful tools in analyzing data. They cannot be used, however, without an occasional reality check. OSBA's recommendation fails this check and should be rejected.

Id., p. 58.

With regard to this issue, ALJ Kashi concluded as follows: **[*67]**

After a careful evaluation of the positions of the parties as presented above, we must conclude that the Company's use of a degree-day figure based on a 10-year average of data is not appropriate. Support for the Company's study is weak with regard to methodology and data, based as it is upon a single article which does not relate to NFG's service territory, and which does not appear to have wide support or use for ratemaking within the utility industry. Also, as OSBA argues, the use of only 10 years of data as opposed to a larger sample is questionable, and likely to produce inaccurate results with regard to normal weather. Nor is the Company's proposal supported by the other articles cited in this case, whose conclusions appear to be ambiguous with regard to the proper number of years to use in determining a normal number of degree-days for ratemaking purposes. For these reasons we are reluctant to depart from the use of the 30-year standard as advocated by OTS and OCA.

With regard to OSBA's proposal, although it is based on a larger sample of data and an apparently more sophisticated statistical analysis, we find no compelling reason to favor it over the more well-established **[*68]** use of a 30-year normal. Therefore, we recommend that the NOAA 30-year normal degree-day number of 6,279 be used for weather normalization in this proceeding. This is the figure proposed by OCA, and supported by OSBA as an alternative to its primary position. According to OCA, use of 6,279 degree-days will result in an adjustment of $ 2,199,032 to NFG's present revenues. OCA St. No. 3, p. 23.

(R.D. at 46-47).

The ALJ also proffered the following remarks prior to concluding his discussion of the issue:

Before leaving this issue, we will address the matter of NFG's reference to its most recent base rate case at Docket No. R-932548 in support of its position in this case. As the other parties in this case have pointed out, the issue of degree-days for weather normalization was resolved in a stipulation in that proceeding. The stipulation specified a degree-day number, but did not specify a methodology to use in its development. Thus, as OTS, OCA, and OSBA argue, it is not appropriate for NFG to assert that its proposed methodology in this case was adopted in the prior rate case. Such an assertion violates the language and spirit of the stipulation. As the other parties argue, this **[*69]** use of the stipulation does damage to the settlement process because it tends to create an atmosphere of distrust and a reluctance among parties to enter into settlements in future proceedings. This is contrary to the Commission's policy of encouraging settlements of rate proceedings whenever possible. Therefore, we recommend that NFG be directed to refrain from making any future references to settlement agreements that involve inaccurate claims or reveal information that was meant to remain confidential, or is otherwise irrelevant to the proceeding in question.

(R.D. at 47-48).

In its Exceptions NFGD proffers a schedule which, in its view illustrates, that the use of 30 years of data has failed to produce realistic or fair results for more than a decade. (NFGD Exceptions at 8). NFGD continues that the ALJ's recommendation, if applied to the period set forth in the said schedule, would produce an annual average overstatement of revenues actually recovered of approximately $ 1.8 million. Thus, argues NFGD, it is clearly shown that recurring annual accuracies of this magnitude cause a significant underrecovery of the cost of providing service to heat-sensitive customers. The use **[*70]** of 10 years of data to normalize revenues according to NFGD is more responsive to recent and current weather conditions. (NFGD Exceptions at 8-9).

NFGD repeats that it conducted a study of scientific literature which it claims supports its position that the use of 30 years of data produces poor forecasts. NFGD continues that 30 year periods are only intended to define normal, only with other 30-year periods. (NFGD Exceptions at 9).

NFGD also repeated the results of the temperatures as reported by the Erie Weather Service Office. According to NFGD, the results of that study demonstrated that a 10-year period is the best prediction of future degree day values in its service territory. NFGD proffered the testimony of the OTS witness in which, in the Company's view, the witness agrees that a 10-year period appears to be a better predictor of degree day tendencies. Additionally, NFGD submits that the OCA witness agreed with that view. (NFGD Exceptions at 9-10).

The Company concluded that contrary to the ALJ's interpretation, of the scientific material, the said material uniformly condemns the use of 30 years of data to establish normal temperatures. The Company repeats that its own **[*71]** statistical studies of degree days at the Erie Weather Service Office demonstrated that the use of 10 years of data was optimal. (NFGS Exceptions at 10).

In its Reply Exceptions, the OCA referenced arguments advanced in its Main and Reply Briefs, that the Illinois study, relied upon by the Company, did not attempt to address the applicability of 30-year normals in other jurisdictions. The OCA continued that the 30 year model proffered by NFGD in its Exceptions is limited to a single period, and is not as comprehensive as the study sponsored by the OCA. (OCA Exceptions at 5-6).

The OCA acknowledges a wide range of opinions regarding the appropriate base for normalizing revenues in a rate proceeding. The OCA continues that the company's approach has as its objective the prediction of weather during the period that the rates will be in effect. However, the OCA maintains that the objective of weather normalization for ratemaking purposes is to determine what is typically experienced in the area where service is provided from year to year. In this regard, continues the OCA, the impact of weather on revenues is little different from other factors weighing on other revenue and expense items. **[*72]** For such items, says the OCA, while it may be possible to predict the expenditure or revenue change, the preference in setting rates is to utilize the normal, or typical level, absent a known and measurable change in the data. For that purpose, the OCA submits that the 30-year NOAA study serves well and the ALJ's recommendation for its continued use should be followed. (OCA Reply Exceptions at 6-7).

The OTS in its Reply Exceptions, re-emphasizes that while NFGD alleges that according to the statistical analysis the ten year average is a more accurate predictor of future weather, the goal of revenue normalization is to predict a normal level of degree days. The OTS reiterated that the 30-year NOAA study has been historically relied upon for weather normalization purposes. The OTS concludes that the 10-year normalization period proposed by NFGD is inconsistent with the NOAA definition of normal which requires computations over a long time period. (OTS Reply Exceptions at 7).

Upon our consideration of the positions of the parties, we reject the proposal of NFGD to adopt a 10-year period of degree day data for revenue weather normalization. We agree with the OCA and the OTS that the **[*73]** Company has not provided sufficient support for its proposal for us to abandon the recognized standard of 30 years of data.

Insofar as a numerical adjustment, we find most reasonable, the proposal of the OTS, discussed, supra, herein, and at pages 36-38 of the Recommended Decision. The specific adjustment proposed by the OTS utilizes 30 years of data for degree day computation, and arrives at an average degree day total of 6,193 as opposed to the average of 5,955 for the Company and 6,279 for the OCA. Thus the total OTS adjustment between actual and normalized sales is $ 1,142,696, for residential revenues, and $ 111,986 for commercial revenues, or $ 1,254,682. Our adoption of the OTS adjustment in lieu of the ALJ's adjustment of $ 2,199,032, will result in a reduction to the expense adjustment of $ 944,350. Accordingly, the allowable revenues will increase by the same amount. Based upon the foregoing, the ALJ's recommendation is adopted insofar as it rejects the proposal to establish a 10-year period of data collection and study for weather revenue normalization and rejected regarding the adoption of the OCA calculation of the dollar value of the adjustment.

Weather Normalization **[*74]** Clause

In this proceeding, NFGD is proposing to establish a Weather Normalization Clause ("WNC") which would be applicable to the rates of all weather sensitive customers, and would essentially eliminate the effect of temperature fluctuations on the Company's ability to recover non-gas cost revenues. As NFGD explains, the Company recovers the majority of its non-gas costs through commodity rates applied to the volume of gas sold and transported. For heat sensitive customers (mainly residential, commercial and public authority classes), these rates are based on pro forma sales and revenues which, in turn, are based on the determination of a "normal" number of degree-days. NFG M.B., pp. 26-28. According to the Company, if the actual experienced number of degree-days differs from the determined normal, experienced sales will vary from the pro forma amount. The Company argues that its recovery of fixed costs (the majority of non-gas costs) will be affected by any fluctuations from the normal number of degree days since these costs do not vary with usage. Id., pp. 28-29. As NFGD explains:

If weather is warmer than "normal," recovery of such fixed costs is less than actual fixed **[*75]** costs and a portion of amounts intended as an allowance for return on investment must be used to pay these fixed expense. If weather is colder than "normal," more than fixed expenses are recovered and return is enhanced. The result is that Distribution either overearns or underearns its allowed return, due to a factor, weather, which is outside Distribution's control.

Id., p. 29.

NFGD claims that it has experienced substantial average annual margin revenue shortfalls during the period between 1983 and 1993 due to this weather factor. Id. NFGD argues that the weather normalization process as it now stands only addresses one-half of the problem of the effects of weather on revenue recovery. That is, weather normalization attempts to remove temperature as a distorting influence on the level of revenues to be allowed in the ratemaking process, but does not remove it as a distorting influence on the level of revenues actually recovered. Thus, NFGD proposes to establish the WNC as "the next logical and reasonable step to correct the continued failure of the weather normalization process to adjust for temperature variations." Id., p. 34.

NFGD describes the operation of the **[*76]** WNC as follows:

The WNC adjusts the rate per Mcf based upon the difference between actual heating load and weather-normalized heating load, calculated in accordance with the procedure used to derive normalized load for ratemaking purposes (St. No. 14, pp. 25-27). The WNC would be applied during all billing cycles, except the June, July, August and September billing cycles, when there is virtually no heating load. The WNC computes the amount of the adjustment by setting forth the applicable monthly degree day factors for residential and for commercial/public authority customers and by identifying, separately, average non-heating or "base" loads for the residential and for the commercial/public authority rate classes.

Id., p. 30, footnote omitted.

According to NFGD, the formula used to derive the monthly weather adjustment that would be applied to each residential, commercial and public authority customer's monthly bill during the 8 months of the year when there is a significant heating load, is as follows:

WA = (R X DDF (NDD-ADD)) / (BL + (DDF X ADD))

where R is the tailblock non-gas cost margin for the customer's rate class, BL is the average non-heating or "base-load" **[*77]** for the customer class, DDF is the degree day factor, stated as Mcf used per degree day, NDD is normal degree days for the billing period and ADD is actual degree days for the billing period. The R, BL, DDF and NDD components are all established as part of the ratemaking process. The ADD component will be provided by the National Oceanic and Atmospheric Administration.

Id., p. 31, footnote 21.

NFGD asserts that the WNC will stabilize revenue recovery and customer bills, but will not increase or enhance its revenues for recovery of non-gas costs above the level allowed by the Commission. Id., p. 31. NFGD further asserts that the WNC will not adjust bills to account for load lost due to non-temperature factors such as customer conservation, loss of customers, or changes in expense levels. Id., p. 32.

NFGD notes that WNCs have already been established by utility companies in other jurisdictions, including NFG in New York. Id., p. 35. NFGD witness Mark D. Pijacki provided an extensive list of such companies in his direct testimony. NFGD St. No. 14, pp. 31-32.

In conclusion, NFGD presents the following argument:

Although the WNC does not provide a complete solution **[*78]** to the problems of determining "normal" temperatures for a future period when rates will be in effect, it does reduce significantly the importance of degree day controversies. As explained by Mr. Pijacki:

Another significant benefit of the WNC is that it should reduce controversy in future base rate cases concerning the method and data chosen for weather normalization. The WNC will adjust achieved margin revenues toward the normalized level per account as used in the base rate case to forecast sales and revenues.

St. No. 14, p. 23. NFG M.B., p. 42.

The OTS objected to NFGD's proposed WNC. Initially, the OTS notes that the Commission rejected the WNC when the Company first proposed it in its base rate case at Docket No. R-911912. The OTS further notes that NFGD proposed the WNC again in its base rate case at Docket No. R-00932548, but withdrew the proposal as part of a stipulation. OTS M.B., p. 111. The OTS is now opposed to NFGD's third attempt to establish a WNC for a variety of reasons.

First, the OTS contends that the WNC is designed to effect a reconciliation of margin revenues, which is contrary to Pennsylvania ratemaking practice. The OTS argues that reconciliations are **[*79]** only allowable in Section 1307(f) and 1307(a) filings. Id., pp. 114-115. Citing the Commission's Final Statement of Policy Regarding Recovery of Take-or-Pay Expenses set forth at Docket No. L-880043, the OTS asserts that approval of the WNC would violate the "standard ratemaking principle that all costs allowed in base rate proceedings be recovered on the basis of the utility's ability to project, not sufficiently guarantee, its sales and throughput." Id., p. 115. Moreover, the OTS argues that the proposed WNC seeks to guarantee a certain level of revenue and therefore profit, thus violating the traditional regulatory principle that a utility be allowed an opportunity, not a guarantee, to earn a fair rate of return. Id., pp. 115-117.

The OTS also contends that the WNC would reduce NFG's incentive to control costs. The OTS asserts that the recovery of a substantial portion of NFGD's total costs relating to the residential and commercial/public authority classes is already largely guaranteed through the 1307(f) reconciliation of gas costs and through customer charges. The OTS argues that the WNC would largely guarantee the recovery of the remaining margin revenue for these **[*80]** respective classes, thus eliminating any incentive for the Company to control margin costs. The OTS asserts that this is contrary to the public interest. Id., pp. 117-118.

Another reason for the OTS' opposition to the WNC is its contention that it will not allow customers to realize the gas bill savings they would otherwise experience through conservation measures in a colder than normal winter. The OTS asserts that this would penalize conservation efforts, in contravention of statutory and Commission intent to encourage such efforts. Id., pp. 118-119.

Finally, the OTS contends that the WNC would complicate billing, and is not acceptable to NFGD's customers. In this regard the OTS notes that each of the seven customers who testified at the public input hearing were opposed to the WNC. Id., pp. 119-120. The OTS argues that under the WNC, customer bills would send inappropriate and confusing messages since bills will be higher than expected when the weather is warmer, and lower than expected when the weather is colder. OTS R.B., p. 47.

Should the WNC be approved in this proceeding, the OTS submits that NFGD's rate of return on common equity should be reduced to recognize **[*81]** the lower risk the Company would face with regard to the volatility of its earnings as a result of the WNC. Specifically, the OTS recommends a reduction of 25 basis points, which, the OTS contends, is identical to the 25 basis points downward adjustment to the cost of equity proposed by NFG's New York Division when it first proposed a WNC in New York. OTS M.B., pp. 120-121.

The OCA also objects to NFGD's proposed WNC for reasons similar to those of the OTS. Like the OTS, the OCA notes that the Commission rejected the WNC in NFG's 1991 rate case. OCA M.B., pp. 218-219. The OCA argues that the WNC is inconsistent with sound principles of utility ratemaking because it protects the Company from the risk of weather variations, and removes the incentive for the Company to manage its operations as efficiently as possible. Id., pp. 220-221. The OCA also provides arguments similar to those of the OTS with regard to customer confusion, the hindering of conservation efforts, and the violation of the regulatory principle that utilities be allowed an opportunity, not a guarantee, to recover a certain level of revenue and profit. Id., pp. 222-226. In addition, the OCA makes the following **[*82]** argument concerning the proposed WNC:

[W]ith annual changes to the clause outside of the context of a base rate proceeding, there would necessarily be changes to the utility's rates without consideration of the level of utility earnings. Thus, NFGD would be permitted to recover a certain fixed level of margin revenues without having to prove before this Commission that it is unable to earn a fair return at the time the weather is other than normal -- even if its cost of capital may have decreased, its operating expenses may have decreased, or its operating revenues may have exceeded its own projections. Indeed, it is for this reason that a Weather Normalization Clause is wholly unlike a purchased gas cost mechanism or other sliding scale of rates designed to recover a particular expense, since in those instances the utility is required to show in a later proceeding that the costs it seeks to recover are actual, prudently incurred and subject to reconciliation.

Id., p. 223, citations omitted.

In response to the positions of the OTS and the OCA with regard to conservation incentives, the Company contends that there is no merit to these arguments. NFGD argues as follows:

The **[*83]** operation of the WNC is indisputable. Customers who undertake conservation efforts would achieve the same level of savings with a WNC that they would have achieved under normal weather conditions without a WNC. That it, margin revenues savings would not be affected by weather conditions. The portion of the bill that is for recovery of purchased gas costs is not adjusted by the WNC, and therefore, with regard to revenues of recovery of purchased gas costs, the customer who conserves would save exactly the same amount regardless of the WNC.

NFG M.B., p. 39.

With regard to the charge that the WNC would reduce NFG's incentive to control costs, the Company contends that such incentives would exist regardless of whether or not the WNC is approved. NFG argues that this is so because a utility is allowed to retain savings from any efficiencies achieved in its operations. Id., p. 40. Moreover, NFGD contends that without a WNC, abnormal weather can mask quality of management. In this regard, NFGD makes the following argument:

For example, during periods of colder-than-normal temperatures, an inefficient utility can achieve its allowed rate of return. Similarly, during periods of warmer-than-normal **[*84]** weather, even an extremely efficient utility will not be able to achieve its allowed rate of return. With a WNC, however, where the effects of abnormal temperatures are removed, an efficient utility may have an opportunity to achieve consistently its allowed rate of return despite abnormal weather conditions, and an inefficient utility will have virtually no possibility of achieving its allowed rate of return. The WNC, by removing the effects of abnormal weather, allows quality of management to show. Results of operations will be based upon performance -- not uncontrollable temperature variation. A WNC will increase management accountability.

NFG R.B., p. 32.

Finally, NFGD contends that there is no merit to the argument that the WNC has or will result in significant customer opposition. NFGD asserts that only a small percentage of the customers at the public input hearing spoke against the WNC. NFG M.B., p. 40. NFGD further argues that WNCs have been approved in 15 other states, and that there was no evidence provided in this case of customer opposition or commission withdrawal of the WNC in any of these states. Id., p. 41. NFGD asserts that it will provide a pamphlet to its **[*85]** customers to explain the WNC. Id., pp. 41-42.

The ALJ made the following disposition of this issue:

The WNC, despite the objections, has a certain appeal to it. In making the company less risky the equity return could be adjusted downward which could be beneficial to ratepayers. However, in following Commission precedent we feel compelled to reject the WNC as did the Commission when the company first proposed it in its rate case at Docket No. R-911912.

(R.D. at 56-57).

In its Exceptions, NFGD notes that for the second time, an ALJ has ruled on its proposed WNC. And for the second time, notes the Company, the presiding ALJ spoke favorably of the WNC, but recommended its rejection for other reasons. The Company points out that in a previous rate proceeding involving NFGD, Docket No. R-911912, another ALJ found that the WNC had conceptual merit but recommended rejection due to anticipated customer reaction. NFGD continues that in the instant matter, ALJ Kashi recommended its rejection based upon the Commission's prior decision.

It is also argued that customer reaction provides no basis for rejecting the WNC at this time. According to NFGD, WNC's are becoming increasingly common. **[*86]** NFGD continues that there has been no movement to repeal any of the numerous WNCs nor has any party produced any Commission order or literature from any other jurisdiction indicating any material adverse reaction by customers to a WNC. NFGD adds that a WNC has effective in its New York division since November, 1988. The Company points out that during the severe 1993-94 winter, its New York customer's received substantial savings in the non-gas cost portion of bills. NFGD adds that during the past winter of 1993-94, its New York customers filed no complaints and made no inquiries concerning the WNC and the Company received inquiries concerning only seven of the approximately 4.1 million bills rendered over the previous winter. (NFGD Exceptions at 12).

The Company submits that the WNC has several substantial benefits. The Company contends that under the present system, during colder-than-normal temperatures, an inefficient management can achieve its allowed rate of return despite its inefficiencies. Conversely says NFGD, during warmer-than-normal temperatures, even an efficient utility cannot achieve its allowed rate of return while maintaining service. The WNC, asserts the Company, **[*87]** removes the effect of abnormal temperatures. The Company continues that an efficient utility with a WNC has a reasonable opportunity to achieve its allowed rate of return even in warm weather because it is not penalized for factors outside its control. However, conversely, an inefficient utility will not achieve its allowed rate of return in unusually warm weather even with a WNC. Thus, concludes NFGD, the quality of management can show by removing the effects of abnormal weather. (NFGD Exceptions at 12-13).

The Company submits that another advantage of the WNC is that it will make rates more affordable during cold periods. NFGD continues that some of the discontent at the public input hearings was due to high bills caused by the unusually severe 1993-94 winter. NFGD claims that if the WNC had been in effect during the past severe winter, bills to customers would have been reduced by approximately $ 3,965,000. The Company continues that the WNC would reduce the non-gas portion of bills when bills are highest because of higher use, and would increase bills when they are lowest due to reduced use. This, opines NFGD, would be a good and equal bargain for ratepayers. (NFGD Exceptions **[*88]** at 13).

The Company continues that the ALJ correctly found that the other parties criticisms of the WNC are baseless. NFGD asserts that the WNC does not provide for reconciliation, thus there is no adjustment for lost load, lost customers or increased expenses. Moreover, adds the Company, a WNC will not defeat incentives for management efficiency, since utilities are entitled to retain savings from increased efficiencies between rate cases with or without a WNC. Finally, NFGD adds that a WNC would not defeat incentives for customer conservation, since most of a heat-sensitive customer's bill is the cost of gas, which will remain unchanged by the WNC. (NFGD Exceptions at 13-14).

In its Exceptions, the OTS agrees with the ALJ's recommendation that the WNC be rejected, but excepts to the ALJ's recitation of only one reason why the WNC should be rejected. Specifically, the OTS states that the reason offered by the ALJ is that the Commission had previously rejected the WNC. The OTS expressed concern that the recommendation in the matter before us is unsupported by specific findings of fact about the WNC based upon the record in this proceeding. In the OTS' view, the lack of specific **[*89]** record here, would make the ALJ's recommendation insufficient to withstand appellate review. The OTS notes that NFGD appealed the previous rejection of the WNC to Commonwealth Court (OTS Exceptions at 4).

At a minimum, urges the OTS, findings of fact should have been should have been made to show that the current WNC proposal is substantially similar, in effect, to the WNC proposal which was previously rejected by the Commission, and that the reasons for the prior Commission rejection are equally applicable to the instant proposal. (OTS Exceptions at 4-5).

The OTS continues that the ALJ's decision adequately summarizes the various positions of the parties concerning the WNC, but then fails to specifically resolve the conflicting evidence which was presented. The OTS cites *W.J. Dillner Transfer Company v. U.S., 277 F. Supp. 420, 426 (1967),* for the proposition that the appraisal of conflicting testimony or other evidence, judging the credibility of witnesses and the evidence adduced, and a determination of the weight of evidence, is the exclusive function of administrative agencies, not appellate courts. Similarly, the OTS contends, that the Pennsylvania Commonwealth Court has **[*90]** stated that it is the province of the fact-finder, rather than the Commonwealth Court, to judge the weight and credibility of evidence in administrative matters. See *Feldbauer v. Commonwealth, Department of Public Welfare, 83 Pa. Commonwealth Court 379, 480 A.2d 1253 (1984).* The OTS adds that *Burlington Truck Lines, Inc. v. U.S., 371 U.S. 156, 168, 83 S. Ct. 239, 245-246, 9 L.Ed.2d 207 (1962),* stands for the proposition that an agency must make findings that support its decision, and must articulate a satisfactory explanation for its actions, including a rational connection between the facts found and the choice that is made (OTS Exceptions at 5).

According to the OTS, the evidence overwhelmingly supports rejection of the WNC, for the same reasons that a similar WNC was rejected in 1991, and for additional reasons which the Commission did not appear to address in its prior rejection. The OTS urges the Commission to specifically make the following findings of fact and to conclude based upon the following findings, which the OTS adds parenthetically, are not inconsistent with its findings regarding NFGD's 1991 proposal, the WNC should be rejected with prejudice. (Emphasis **[*91]** supplied by OTS). (OTS Exceptions at 6).

The OTS proposed finding of fact No. 1 follows:

1. The WNC would, at a minimum, reconcile margin recovery to normal weather and seeks to guarantee a certain level of return, which is contra to Pennsylvania ratemaking practice. (Emphasis in Original).

The OTS submits that NFGD's proposed WNC, similar to that proposed in 1991, is designed to stabilize recovery of non-gas costs of service or margin to the extent that such revenues fluctuate due to variations between "normal" and "actual" temperatures. It is the view of the OTS that the removal of this risk of recovery due to weather unpredictability seeks to guarantee a certain level of revenue, rather than to allow the utility the opportunity to earn its authorized rate of return. The OTS states that this is because weather unpredictability is a substantial element in the variability of NFGD's margin revenues, and rate of return dollars are recovered in those revenues. The OTS continued that the Commission previously rejected the WNC in 1991 due in part to its impermissible guarantee of a level of return. The OTS urges the Commission to reject the WNC request, here, for the same reason. **[*92]** (OTS Exceptions at 6-7).

The OTS continues that due to WNC adjustments for recovery of non-gas costs of service, there is essentially a reconciliation of these margin revenues to the level allowed by the Commission in the Company's most recent base rate proceeding. At a minimum, says OTS, there is a reconciliation of the margin revenues associated with the differential between and actual and normal weather. The OTS submits that this reconciliation of base rate expenses is inconsistent with Pennsylvania ratemaking practice, and should be rejected. Thus, the OTS argues that a WNC should be rejected because, inter alia, it would impermissibly reconcile rate base expenses and guarantee a certain level of return which is contra to Pennsylvania ratemaking practice.

Proposed Finding of Fact No. 2 follows:

The WNC will reduce efficiency incentives.

The OTS notes that at pages 52-53 of the R.D., ALJ Kashi has summarized the reasons why NFGD's proposed WNC would clearly reduce incentive to control non-gas costs through efficiency. The OTS adds parenthetically that the ALJ did not make a specific finding to that effect. The OTS indicates that about 78% of the total revenues for the residential **[*93]** class and 77% of the total revenues for the small commercial/public authority ("C/PA") are largely guaranteed to be recovered by NFGD through the purchased gas cost reconciliation and customer charges. The OTS continues that another 1.0% and .9% of total revenues for the residential and CP/A classes respectively is related to take-or-pay recovery. The balance of the revenues, which is about 21% and 22.1% for the residential and C/PA classes respectively, is sought by NFGD to be adjusted for weather variability by the WNC. (OTS Exceptions at 8).

The OTS continues that while the company has the ability to control costs that are recovered through margin revenue, there is simply no incentive to control those costs with a WNC in effect. The OTS concludes that there is no incentive because the WNC would largely guarantee recovery of margin revenue. The OTS asserts that it is not in the public interest to discourage utility cost control and for this additional reason OTS urges denial of the proposed WNC. (Id.).

Proposed Finding of Fact No. 3:

Energy conservation may be compromised

The OTS notes that every witness in this proceeding, including NFGD witness, Mr. Pijacki, agreed that **[*94]** NFGD customers who weatherized their homes and/or purchased energy efficient appliances after last winter's cold weather will not realize the gas bill savings that they would have otherwise have realized, in a colder than normal winter, if a WNC is approved in this case. This according to the OTS, would penalize conservation efforts in contravention of statutory and Commission intent to encourage conservation efforts. (OTS Exceptions at 9).

Proposed Finding of Fact No. 4 follows:

The WNC complicates billing and is not acceptable to NFGD's customers as indicated by the public input testimony.

The OTS argues that the public input testimony of record indicates that the WNC is not acceptable to NFGD's customers as indicated in the record of public input sessions in Sharon and Erie. (OTS Exceptions at 9-10).

The Company responds to the OTS Exceptions by stating that contentions that the WNC would guarantee a certain level of return and reconcile base-rate expenses are erroneous. NFGD continues that the OTS witness agreed that there is no adjustment for lost customers; and there is no adjustment for changes in expense. Also, NFGD points out that there is no "E" factor reconciliation. **[*95]** (NFG Reply Exceptions at 5).

The Company disputes the OTS argument that the WNC would reduce incentives for efficiency. NFGD argues that the Company is at risk to control expenses between rate cases, and that the WNC does not change that. It is the view of NFGD that such risk gives the Company an incentive to control expenses for its own benefit between rate cases, and for customers benefit after rate cases. <u>(Id.)</u>

The Company addresses the OTS contention that customers will not realize the gas bill savings they otherwise would have realized in a colder-than-normal winter if a WNC is approved. NFGD counters that the WNC adjusts only the margin portion of the bill to a customer toward the level that would have been billed under "normal" temperatures. NFGD continues that during colder-than-normal periods, a WNC will produce savings that are greater than they would have been without a WNC. NFGD submits that a customer will pay reduced gas costs because of conservation and, because of the WNC, reduced margin. Conversely, during warmer-than-normal periods, the margin portion of the bill to a customer is increased slightly to the level that would be billed if temperatures were normal. **[*96]** Also, NFGD insists that customers will still receive gas cost savings from conservation. (NFG Reply Exceptions at 5-6).

Finally, the Company addresses the OTS contention that customer dissatisfaction is a reason to disallow the WNC. According to the Company, the OTS ignores the favorable experiences of many gas companies in many jurisdictions. (NFGD Reply Exceptions at 6)

In its Reply Exceptions, the OCA submits that the Company's position in support of the WNC is without merit. Specifically, the OCA does not disagree that customer bills would be more affordable with a WNC during colder-than-normal temperatures. However, the OCA notes that the same bills are less affordable during warmer-than-normal periods. Thus, the OCA concludes that the claimed benefit is not without a cost. (OCA Reply Exceptions at 7).

The OCA continues that the Company's witness admitted that a WNC rewards every utility regardless of the efficiency of their operations. Moreover, the OCA repeats that, contrary to the company's position, by reducing the risk of a non-recovery of a portion of the Company's non-gas cost margin, the WNC would reduce the incentive to control expenses and keep rates as low as possible. **[*97]** Additionally says the OCA, through the reconciliation mechanism for purchased gas costs and the Customer charge, the Company is already able to collect a very large portion of its costs through fixed charges. The OCA states that a WNC would remove a significant amount of the weather-related risk. (OCA Reply Exceptions at 7-8).

In its Reply Exceptions, the OTS attacks the Company's assertion that the WNC is a "good and equal bargain for rate-payers." The OTS objects to the supporting reasoning advanced by NFGD that the bargain results from the reduction of the non-gas portion of the bills when they are highest due to high consumption and lowest due to low consumption. It is the position of the OTS that this reasoning sends absolutely the wrong conservation signals to ratepayers, in contravention of statutory and Commission intent to encourage conservation efforts. The OTS repeats the argument made in its Exceptions that a WNC would penalize customers who made conservation investments after last winter's severe weather because those customers will not realize the gas bill savings that they would have otherwise realized if the winter of 1994-95 is colder-than-normal. The OTS concludes **[*98]** that inverted conservation messages and conservation penalties are not a "good deal" for ratepayers. Thus, the OTS urges that the Commission reject the WNC with prejudice.

Upon our careful consideration of the positions advanced by the parties herein, we will adopt the position advanced by the OTS in its Reply Exceptions. We agree with the OTS that approval of the WNC would send the wrong message to ratepayers regarding conservation, and would ultimately discourage customer conservation. Based upon the foregoing discussion we reject, with prejudice, NFGD's proposal to establish a WNC.

Accordingly, we will adopt the recommendation of the ALJ to reject the WNC, but not his supporting reasoning. The Exceptions of the OTS, to the extent consistent with the preceding discussion, and denied in all other respects. The Exceptions of NFGD are denied in their entirety.

LIRA REVENUES

The OTS, through its witness Thomas Maher, argues that NFGD has understated present residential rate revenue because the Company's calculations were based upon 1,000 LIRA customers instead of the actual number of customers currently served under that tariff. See, NFGD Ex. 103-A-1, p. 1; OTS Stmt. **[*99]** No. 2, pp. 42-43. NFGD witness Ring stated that as of June 15, 1994, there were only 771 customers being served under the LIRA rate. N.T. 457. NFGD provided no further updates to the number of LIRA customers subsequent to June 15, 1994.

Under the LIRA rate, customers pay a reduced residential customer charge of $ 5.21/month rather than the $ 11.68/month customer charge currently paid by other residential customers. In addition, LIRA customers pay only the 1307(f) rate for all gas sales (i.e. $ 4.2769/Mcf rather than the $ 5.9575/Mcf rate for the first block and the $ 5.6417/Mcf rate for the tailblock paid by other residential customers) . N.T. 770. This produces a billing deficiency, on an annual basis, of $ 440 per LIRA customer. The calculation is shown on OTS Exhibit 2A, Schedule 6.

According to the OTS, since only 771 customers rather than 1,000 are on the LIRA rate, an additional 229 customers, over and above what NFGD has reflected in this case, are non-LIRA residential customers and will pay $ 440 more per year in their rates. This, asserts the OTS, results in additional residential revenue of $ 100,760 ($ 440 X 229 = $ 100,760).

The ALJ noted that at the time of preparation **[*100]** of Mr. Maher's testimony, the Company had a tariff provision (Supplement No. 39, page no. 31A, twelfth revised) which prohibited the addition of customers into the LIRA pilot program after the initial selection of 1,000 LIRA participants. OTS Stmt. No. 2, p. 43. The ALJ continued that while NFGD indicated during the hearings that it had filed a tariff supplement to delete this provision from its tariff, Mr. Maher testified that his LIRA revenue adjustment remained valid because it is doubtful the Company could enroll an additional 229 customers before the end of the future test year. N.T. 760-61, 795. (R.D. at 58).

The ALJ reached the following conclusion regarding this issue:

NFGD presented no rebuttal to this adjustment. The adjustment is reasonable as it properly reflects residential revenue at the appropriate tariff rate. Accordingly, it should be adopted. OTS has reflected this revenue adjustment of $ 101,000 in its Appendix, Table II, p.1.

(Id.)

In its Exceptions, the Company repeats that the OTS adjustment, which was adopted by the ALJ, was based upon the actual LIRA customers as of June 15, 1994. NFGD points out that it has amended its tariff to permit additional **[*101]** enrollment of additional customers into the LIRA program. The Company opines that the Commission should courage it to enroll additional customers into the LIRA program, and reflect 1,000 LIRA customers in rates. (NFGD Exceptions at 14).

In its Reply Exceptions, the OTS characterizes the NFGD Exception as being without merit and urges its rejection.

Upon review of the issue, we found persuasive the position of NFGD that the Commission should encourage the Company to enroll additional customers in the LIRA program. We note further that we have encouraged, through our Policy Statement at 52 Pennsylvania Code, Chapter 69, Section 261, *52 Pa. Code, § 69.261*, CAP programs such as NFG's LIRA program. Accordingly, we will grant the Company's Exception and not adopt the recommendation of the ALJ on this issue.

Industrial Revenues

The ALJ made the following Comments regarding this issue:

NFGD has removed or reduced volumes and associated revenue from the test year level for three LIS customers. OTS Stmt. No. 206, pp. 3-5. These customers are Franklin Steel (now projected to consume 0 Mcf due to business closure), Cytemp Specialty Steel (now projected to consume only 30,000 Mcf/year **[*102]** for plant protection) and PPG Industries (now projected to consume 0 Mcf due to bypass). Id. at pp. 3-5; NFGD Stmt. No. 12, p. 7.

While OTS witness Maher had originally disputed the certainty of these revenue losses, Mr. Maher accepted these adjustments in his surrebuttal testimony. N.T. 1256-57. As indicated in the summary schedules circulated by NFGD on August 8, 1994, and as included in the OTS Petition to Reopen, the net revenue effect of these lost volumes is $ 379,805 at present rates ($ 411,000 at tariffed rates minus $ 31,000 in purchased gas cost savings). The $ 379,805 revenue reduction amount has been reflected in the OTS Appendix tables.

(R.D. at 58-59).

Since no party opposes the ALJ's treatment of this issue, we will adopt his action, as our own.

EXPENSES

1. Payroll

The ALJ introduces the discussion on payroll adjustments as follows:

Both OTS and OCA have proposed substantial adjustments to Distribution's payroll for the future test year ending November 30, 1994. Both OTS and OCA make adjustments using a lower number of employees than Distribution and both OTS and OCA would eliminate all post future test year wage and salary increases (See OTS St. **[*103]** No. 2, pp. 27-39 and OCA St. No. 3, pp. 39-45). OTS M.B. at pp. 71 - 83, OCA M.B. at pp. 55 - 76. In addition, OTS has proposed adjustments to expense levels for summer, part-time, temporary, other and overtime payroll. The Company, quite naturally, argues that all of these proposed adjustments are inappropriate, at least in substantial part, and should be rejected. NFGD M.B. pp.64-76.

(R.D. at 59).

1(a). Number of Employees; Employee Complement

NFGD originally filed its labor expense claim in this proceeding on the basis of a 520 employee complement. NFGD Stmt. No. 205, p. 10. This 520 level reflects the number of NFGD employees as of January 15, 1994. NFGD Stmt. No. 5, p. 5. However, by March 15, 1994, NFGD had 496 employees due to retirements. NFGD Stmt. No. 205, p. 10. While NFGD revised its originally projected employee complement down to 508 for the test year, the employee count remained at 496 as of the close of the record on July 28, 1994. NFGD Stmt. No. 205, p. 11; N.T. 1219. NFGD M. B. pp. 64 & 65.

Both OTS witness Maher and OCA witness Cotton recommended that a 496 employee complement level be used for determining labor and benefits expense. NFGD Stmt. No. 205, **[*104]** p. 10. This is the actual number of employees which existed at the close of the record, and therefore, argue both the OTS and the OCA, reflects the most recent level of employees which is known with certainty. OTS M.B. at 72, OCA M.B. at pp. 57-60.

According to the OTS, While NFGD witness Higley indicated that the Company intends to replace 12 of the retirees (for a total of 508), this expressed intent of the Company is pure speculation. NFGD Stmt. No. 205, pp. 10-11. OTS M.B. at 72. Additionally, argue the OTS and the OCA, while Mr. Higley implied that a 496 level may not be sufficient to maintain adequate service, NFGD's Assistant Treasurer Mr. Wright testified that NFGD's service had absolutely not been inadequate or marginal since the employee level dropped to 496. NFGD Stmt. No. 205, p. 12; N.T. 1044.

Clearly, it is argued that the 496 level should be used for ratemaking purposes, rather than NFGD's speculative 508 employee complement level.

The OCA argued that as a result of the effects of the two special retirement programs, Distribution's employee complement dropped to 496. This employee complement is substantially lower than at any previous time in recent history. The average **[*105]** annual number of employees for 12-month periods ending November 30 is provided in summary form at page 11 of Statement No. 205 as follows:

Year	**Number of Employees**
1989	536
1990	538
1991	537
1992	535
1993	520

Monthly details of the employee complement are provided in response to Interrogatory OCA-1-51 (OCA St. No. 3, Appendix A). (R.D. at 61).

The OTS and the OCA argue that their adjustments are based upon the most recent employee complement level available at the close of the evidentiary record, and although such statements are factually correct (N.T.219), such contentions, argue NFGD, would produce a result grossly unfair to the Company. NFGD argues that the 496 figure fails to take into consideration the "domino" effect or the "rebound" effect. NFGD M.B. at pp. 66-67.

Mr. Higley explained that there are legitimate reasons for utilizing a higher than actual number of employees in calculating the Company's future test year payroll expense. He first testified that the positions of the 12 normal retirees were included in his future test year payroll calculation because these retirements were more like early retirements than "normal trends." NFGD Stmt. 205 at 13. **[*106]** He explained that, of the 12 to be replaced, five are for Union Local 22 meter readers for which there are open requisitions that are outstanding and the other seven are for management replacements that are subject to the "domino" effect. Id. at 11. According to Mr. Higley, the "domino" effect occurs when there are promotions to both replace retirees' positions and to fill vacancies caused by the promotions to replace retirees' positions. See NFGD M.B. at 66. Hence, the Company's position is that the "domino" effect will, in part, cause the need for full replacement of the 12 normal retirees. For this reason, Mr. Higley anticipates a total level of 508 employees. NFGD St. 205 at 11.

Mr. Higley also described another phenomenon called the "rebound" effect which occurs when employee levels that have dropped suddenly as a result of early retirement increase to a new "stabilized" level. NFGD St. 205 at 12-13. For this reason, according to Mr. Higley, the Company could easily anticipate a level of 511 employees instead of the 508 level it intends to maintain. Id.

The OCA and the OTS oppose both the initially proposed 520 and the revised 508 employee complements used to calculate **[*107]** the Company's payroll expense as unsubstantiated. First, the Company has not shown that a higher employee level than currently in place is needed to provide safe and adequate natural gas service. Secondly, the Company has not substantiated its claim that a "rebound" effect will occur in the future test year to boost current employee levels to the "anticipated" 511 or 508 employees. On the contrary, within the future test year, the Company has shown a significant decrease in employee levels from January, 1994 through July, 1994. Rather than evidencing a "rebound" effect, NFGD Exh. 205-B, Schedule 2 actually shows a steady overall decrease in employee levels from September, 1989 to March, 1994. Based on this historical trend, there is no evidence that the "rebound" effect would occur within the future test year. Additionally, the Company does not dispute that its permanent employee levels have been historically declining.

OCA witness Cotton identified two factors that demonstrate NFGD's declining permanent employee levels: (1) reductions in permanent staff coupled with increases in non-permanent sources of labor and (2) voluntary early retirement programs. OCA St. 3 at 39-40. As data **[*108]** provided by Company witness Higley reveals, the Company's permanent payroll has decreased over the most recent five years, from a high employee complement in 1990 of 538 to a low of 496 in 1994. NFGD St. 205 at 11. Simultaneously, the OCA submits that NFGD's claims for temporary part-time, summer and "other" payroll costs reflect substantial increases in each category over the past years. See OTS Cross Exam. Exh. 15. Similarly, the Company's history of overtime costs reveals a steady and substantial increase in overtime expense over the past five years. Id.

The ALJ proffered the following summary of these points including the most recent actual data on the permanent employee level and non-permanent labor expenses at page 64 of the R.D. as follows:

Year	Permanent Employees	Part-Time Temporary	Summer	Other	Overtime
1994	496	$ 142,754	$ 153,965	$ 54,983	$ 821,762
1993	520	143,433	146,456	63,231	718,938
1992	535	99,267	117,875	35,018	610,147
1991	537	95,573	133,080	27,752	434,671
1990	538	93,734	184,423	33,551	611,929
1989	536	111,628	155,723	50,396	553,494

OTS Cross Exam. Exh. 15; NFGD St. 205 at 11, 15.

The ALJ found **[*109]** that the data in the above diagram demonstrates that a comparison of the most recent data provided by NFGD for years 1992 and 1993, reveals that part-time temporary employee costs have increased by 44%; summer employee costs by 24%; "other" employee costs by 81%; and overtime costs by 18%.

The ALJ continued that this data reveals that, while there has been a steady decrease in the level of permanent employees, NFGD has been increasing its non-permanent employee levels. The ALJ noted that NFGD witness Wright testified that the Company has been reducing its employee count in Pennsylvania since 1981 as a cost-cutting measure. NFGD St. 219 at 6. The ALJ noted further that Mr. Wright testified that at September 30, 1981, Distribution-Pennsylvania employed 604 employees as opposed to the currently revised 508 employees reflected for the period ending November 30, 1994. Id. Moreover, that ALJ cited Mr. Wright's statements that, "While other Northeast utilities have been touting recently announced employee reduction plans, Distribution has been trimming its workforce for many years"; and that NFGD "has increased its use of part-time and contract labor to mitigate the requirement for **[*110]** full-time employees." R.D. at 65. The ALJ concluded that clearly, by admission, NFGD shows a history of reducing permanent staff levels. The ALJ adds that recent cost control measures have included increasing non-permanent labor to reduce the requirement for full-time employees. Moreover, the ALJ asserted that, "NFGD has not come forward with any compelling evidence that would justify the use of a higher than actual employee level for future test year payroll projections." (Id.)

The ALJ commented that, contrary to NFGD's assertions, the recommendation of OTS and OCA does not ignore historical experience. In fact, he continued that using an employee level of 496 is actually consistent with NFGD's history of decreasing employee levels. The ALJ cited the testimony of NFGD witness Wright, that the Company has been deliberately trimming its work force "for many years" in order to cut costs. In fact, continued the ALJ, Mr. Wright testified that in 1981, NFGD's employee level was at 604 and in 1990, the Company employed 538 people as compared to the current level of 496. At the same time, found the ALJ, NFGD has been drastically increasing its non-permanent employee levels over the past **[*111]** years and incorporates a further increase in non-permanent labor in this case. The ALJ opined that while it is true that NFGD has never operated at a level as low as 496 employees, actual historical data shows a consistent downward trend in permanent employee levels which, according to Mr. Wright, is a deliberate attempt on the part of Distribution to cut costs. Thus, concluded the ALJ, limiting the NFGD permanent workforce to a level of 496 employees would not be "grossly unfair" or "unreasonable." The ALJ also points out that, Company witness Wright testified that NFGD has continued to provide safe and adequate service at an employee level of 496. (R.D. at 66).

ALJ Kashi continued that the recommended adjustment does not ignore the Company's history of early retirements and the "rebound" effect. The ALJ found that ultimate effects of early retirements and the "rebound" are subsumed in the 496 employee level. The ALJ further found that the Company has not shown that the "rebound" effect will occur in the future test year to boost current employee levels to the anticipated 508 or 520 levels. The ALJ that there is no evidence that the "rebound" effect would not be offset by the trend **[*112]** of decreasing permanent employee levels and increasing non-permanent employee levels. Accordingly, the ALJ recommended the use of an employee complement of 496. (Id.)

The ALJ provided the following summary of the recommended adjustments to wages and related benefits:

Wages and Related Benefits

	Wages, Benefits and Taxes from OTS Main Brief, Table II, p. 2.
Temporary, Summer, Other & Overtime	
Wages	$ 101,866
Wage Increase	3,853
Wage Increase	39,907
Supervisory Wages	570,145
Clerical Wages	246,229
Local 2279	383,089
Locals 22 and 23	350,228
Wages from NFG Supply	124,322
Wages from NFGD - NY Division	39,159
Total Adjustment per OTS	$ 1,858,798
Less NFGD Adjustments (NFGD Ex. 205-B, Schedule 7, p. 2)	
Wages	(334,000)
Benefits	(79,000)
Payroll Taxes	(28,000)
Revised Adjustment	$ 1,417,798

(R.D. at 67).

We will discuss, in detail, the individual components of the employee complement reduction, as each relates to the ALJ's recommended reduction in the complement of employees from 508 to 496. We will defer discussion on the component of each adjustment which refers to post-test year pay increases until the **[*113]** section of our payroll discussion where the Company's specific claim is addressed.

1(b). Supervisory Payroll

OTS witness Maher developed his supervisory payroll adjustment using the March 1994 level of 102 instead of the Company's 109 employee level for this pay group (which accounts for 7 of the 24 employees who have retired since January). OTS Stmt. No. 2, pp. 32-33. The OTS has addressed why the post-retirement level of 496 employees should be used for ratemaking purposes and this is consistent with the use of 102 employees for developing supervisory payroll.

Mr. Maher also recommended that the Company's projected 4.8% pay increase for this group, which is claimed to be effective 1-1-95, be denied for ratemaking purposes. See, NFGD Ex. 104-A-1, p. 2. The OTS contends that Company has included eleven months of this projected post-test year wage increase in its future test year claim, so that the 4.8% increase is reflected up to 11/30/95 (i.e. a full year beyond the end of the future test year). NFGD Stmt. No. 205, p. 19. The OTS contends that there was no similar inclusion, by the Company, of revenues projected to be received from ratepayers beyond the end of the future **[*114]** test year. N.T. 206. Thus according to the OTS, the matching principle, previously discussed, is being violated.

In addition, Mr. Maher testified that the 1/1/95 4.8% increase is a projected post-test year increase which is not subject to a contract. N.T. 335. The OTS maintains that this Commission has previously rejected post-test year wage adjustments, such as this adjustment, which are not supported by a contract. See e.g., Pa. P.U.C. v. Columbia Gas of PA, supra (1984).

The ALJ made the following disposition of this issue:

For all the above reasons, we recommend that Mr. Maher's supervisory payroll adjustment be adopted. Mr. Maher revised this adjustment during surrebuttal to reflect a 32.2% [12] benefits loading factor for the seven supervisory employees who retired, instead of the 49.3% factor previously used for the computation. This was done to recognize the 17.1% portion which relates to OPEBs expense, because this expense does not necessarily decline when an employee retires. NFGD Stmt. No. 205, p. 18; OTS Ex. No. 2A, Sched. 12, p. 6. Mr. Maher's revised supervisory payroll adjustment (O&M expense portion), as calculated on OTS Exhibit No. 2A, Schedule No. 12, p. 3 **[*115]** (revised) is $ 570,145. This reflects an expense allocation percentage of 72.08%, as shown on OTS Cross Examination Exhibit 16 for O&M expenses.

(R.D. at 71).

1(c). Clerical Payroll

OTS witness Maher developed his clerical payroll adjustment using the March 1994 clerical employee number of 100, rather than the 105 level used by the Company to develop its claim. OTS Stmt. No. 2, pp. 34-35. This accounts for an additional five employees of the 24 which have retired since January, and is consistent with the use of a 496 employee complement level previously discussed.

Mr. Maher also recommended that the Company's projected 3.8% pay increase for this group, which is claimed to be effective 1-1-95, be denied for ratemaking purposes. See, NFGD Ex. 104-A-1, p. 2. The OTS repeated that the Company has again included eleven months of this projected post-test year increase in its future test year claim, so that the 3.8% increase is reflected up to 11/30/95 (a full year beyond the end of the **[*116]** future test year). NFGD Stmt. No. 205, p. 19. Again, the OTS asserts that there was no inclusion of revenues projected to be received beyond the end of the future test year, and therefore, the matching principle is again being violated. N.T. 206.

In addition, the OTS repeats that the 3.8% projected post-test year increase is not subject to a contract. N.T. 335-36. For the reasons previously stated, the OTS urges that this proposed increase should not be reflected in rates at this time.

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[12] The ALJ noted that the 8.4% payroll tax factor, which was a separate adjustment to the miscellaneous pay groups, is included in the 32.2%. See, OTS Ex. No. 2A, Sched. 12, p. 6.

Mr. Maher's revised clerical payroll adjustment (72.08% O&M portion), which reflects the 32.2% benefits loading factor previously discussed, is $ 246,229. The rate base portion (27.92%) is $ 95,376. The ALJ noted that the calculation which supports this adjustment was entered into evidence as OTS Exhibit No. 2A, Sched. No. 12, page 3 (revised). The ALJ recommended that the adjustment be adopted. (R.D. at 74).

1(d). Bargaining Group Payroll

(Local 2279 And Locals 22 and 23)

OTS witness Maher developed his bargaining group payroll adjustments using the March 1994 level of 158 for Local 2279, rather than the 164 used by the Company to develop its future test year claim. OTS Stmt. No. 2, pp. **[*117]** 36-37. Similarly, Mr. Maher used 136 employees in Locals 22 and 23, instead of the 142 level used by the Company. Id. at 37. This accounts for the remaining 12 employees who have retired since January, and is consistent with the use of a 496 employee complement (which was the employee level as of the close of this record).

Mr. Maher also recommended that the projected 2.69% (annualized percentage) increase ($ 170,348) to Local 2279, to be effective 4/13/95, be rejected for ratemaking purposes at this time because it goes far beyond the future test year (increased wages are reflected up to 11/30/95). Id. at 37; NFGD Stmt. No. 205, p. 19; NFGD Ex. 104-A-1, p. 2. Also, these projected expenses do not match the revenue projection time frame (projected revenues are cut off as of 11/30/94). OTS Stmt. No. 2, p. 36.

Similarly, Mr. Maher recommended that the projected 2.53% (annualized percentage) increase ($ 137,650) to Locals 22 and 23, to be effective 5/1/95, be rejected for ratemaking purposes at this time, for the same reasons the projected post-test year increase to Local 2279 should be rejected.

The ALJ found that Mr. Maher's bargaining unit adjustments are reasonable and **[*118]** properly reflect the matching of revenues and expenses, to the test year level. These adjustments, which have been revised in surrebuttal to reflect the 32.2% benefits loading factor previously discussed, are $ 383,089 (72.08% O&M expense portion) for Local 2279 and $ 350,228 (72.08% O&M portion) for Locals 22 and 23. The ALJ noted that the calculation which supports these adjustments was entered into evidence as OTS Exhibit No. 2A, Schedule No. 12, page 4 (revised). Further, the ALJ noted that the OTS has reflected these adjustments in its Appendix tables.

In its Exceptions, NFGD notes that it has reduced its Pennsylvania complement to reduce costs. NFGD continues that as of September 30, 1981, it had 604 Pennsylvania employees. At December 31, 1992, the permanent employee complement in Pennsylvania had been reduced to 535, which the Company computes to be a reduction of 11% in approximately 11 years. During 1993, continues NFGD, there was a further reduction in its Pennsylvania employee complement to 520 employees, a one-year reduction of nearly 3%. The Company notes that the 520 employee complement level was contained in its initial filing. (NFGD Exceptions at 14).

NFGD continues **[*119]** that during early 1994, it implemented an early retirement program and a special "90-plus" retirement plan. As a result of these two programs, NFGD states that during the first half of 1994, the employee complement was reduced by 24 retirements, to the level of 496 employees. This notes the Company, which was the level considered representative by the ALJ, for the time that the rates made in this proceeding will be in effect. (NFGD Exceptions at 14-15).

NFGD contends that in reaching this conclusion, the ALJ ignored its evidence concerning a "rebound" effect. The Company continues that when an early retirement program is implemented, the number of employees who will use the program is unknown. According to NFGD, retirement programs will rarely produce the optimal employee complement. The Company continues that in earlier programs, there was a rebound effect because employee levels were reduced below optimal levels. On average, avers the Company, 54% of the employees that retired during programs in 1985 and 1987, were replaced following such programs. The Company explained that it expected that the same effect would occur with the 1994 program. NFGD concludes that based upon the prior **[*120]** experience, it expects 12 of the 24 retirees will be replaced to bring the complement back to 508. (NFGD Exceptions at 15).

NFGD continues that there is a second effect which must be considered with regard to retirement programs which the Company refers to as the domino effect. According to NFGD, when supervisory retirements occur, such positions are filled predominately from within the Company. Therefore, according to the Company there must be a further selection of an individual to replace the promoted employee and so on, until an entry level position becomes vacant. NFGD contends that the process is time consuming, and avers that the domino effect prevented the Company from hiring new employees to replace retiring supervisory employees prior to the close of the record. NFGD submits that there are seven such supervisory replacements in the process of undergoing the domino effect. The remaining five employees, according to NFGD, are for union meter readers, for which there were open employment requisitions at the end of the evidentiary record. (Id.)

The Company adds that it NFGD's 1988 rate case, the Commission recognized the domino and rebound effects related to early retirements **[*121]** and approved its projected complement under very similar circumstances. The Company concludes that it would be unreasonable to impute a precipitous drop in the employee complement from 535 as of January 1, 1993, to 496 in May 1994, a reduction of 7.39% in less than 18 months. (NFGD Exceptions at 16).

The OCA in its Reply Exceptions, counters the Company's argument that it has ignored the rebound and domino effects. The OCA notes that the ALJ at page 66 of the R.D. states that the OCA and OTS recommendations did not ignore the said effects, but that the Company failed to show that the rebound effect would occur in the future test year to the anticipated 508 or 520 employee level. The OCA also argued that in the Company's 1988 rate case, the Commission did not recognize the domino effect. (OCA Reply Exception at 10).

In its Reply Exceptions, the OTS asserts that the Company had not come forward with any compelling evidence that would justify the use of a higher than actual employee level for future test year projections. The OTS insists that the expressed intent of the Company to replace 12 of its retirees (for a total of 508) is speculative and without record support. (OTS Reply **[*122]** Exceptions at 9-10).

Like the OCA, the OTS disputes the Company's assertion that the Commission had considered the rebound and domino effects in NFGD's 1988 rate case. The OTS submits that the case before us, is distinguished from the prior cases in that the Company was much more active in recruiting and hiring replacements, and actually had replaced 20 of 30 retirees by the close of the record in that proceeding. Here, claims the OTS, not one replacement has been hired for the 24 total retirees in the seven-month span between the time that the retirements commenced, January 1, 1994, and the close of the record. (OTS Reply Exceptions at 10).

Upon review of the issue, we find credible the Company's Testimony and Exception that it was actively seeking, and in fact, had requisitions in order to hire 5 employees in local 22 to replace those who had retired under the early retirement program. Therefore, we will allow an complement of 501 customers, as opposed to the 496 recommended by the ALJ.

The computation of the OTS's adjustment to eliminate 6 positions, with a total dollar value of $ 350,228, in bargaining unit 22 consisted of the elimination of the pay and benefits of the six positions **[*123]** ($ 212,578) and the elimination of a pay increase effective May 1, 1995 ($ 137,650). Since we will allow payroll expense for 5 of the six employee positions, the payroll and benefit adjustment is reduced to $ 26,016. In the next section of this Opinion and Order will address the issue of post-test year pay increases.

2. Post Test Year Payroll Increase

As discussed previously in our disposition of the employee Complement issue, NFGD proposed to include in pro forma payroll expense a 3.8% payroll increase to become effective January 1, 1995, and another pay increase for Locals 22 and 23 to become effective May 1, 1995. The OTS opposed inclusion of this claim in expenses for the following reasons discussed previously herein: 1) the increase is not supported by a union contract; 2) the Commission has previously rejected similar claimed increases not supported by the contract; and 3) the increase was projected for eleven months beyond the end of the future test year, with no similar reflection of revenues, thus violating the matching principle. As discussed previously, the ALJ adopted the OTS's proposed adjustment on this issue.

In its Exceptions, NFGD argues that the ALJ recommended **[*124]** reversal of an uninterrupted decade of Commission policy with regard to post future test year wage and salary increases but rejecting all such increases proposed in this proceeding. NFGD cites its 1990 rate case, Pa. P.U.C. v. Pennsylvania-American Water Company, docketed at No. R-932670 (Order entered July 26, 1994), and Pa. P.U.C. v. UGI, docketed at No. R-932862 (Order entered July 27, 1994), for the proposition that the Commission has been willing to reach out somewhat beyond a future test year for reasonably known and certain salary increases that will become effective shortly after new rates become effective. (NFGD Exceptions at 17-18).

The Company continues that the ALJ's statement that the wage increase will become effective a full year beyond the end of the test year is erroneous. NFGD maintains that the pay increase in question will become effective January 1, 1995, not November 30, 1995. (NFGD Exceptions at 18).

The Company concludes that a utility will have no reasonable opportunity to earn a fair return if wage and salary increases in the year following the rate increases are not reflected in the rate allowance. The Company urges the Commission not to reverse **[*125]** what NFGD considers to be past precedents on this issue. (NFGD Exceptions at 19).

In its Reply Exceptions, the OTS counters that it has previously distinguished the Pennsylvania-American, and UGI decisions in its Reply Brief. The OTS continues that while the Commission has allowed post-test year contractual increases, NFGD in this case, has included the dollar effect of all increases, contractual and non-contractual, up through November 30, 1995. Additionally, the OTS notes that NFGD has projected that it will file another base rate increase in early 1995. The OTS anticipates that the test year in that case will likely be from December 1, 1994, through November 30, 1995. Therefore, asserts the OTS, there is no reason why the Company cannot wait until that time to file its 1995 base rate claims for labor expense, and thereby comply with the matching principle. (OTS Reply Exceptions at 12).

In its Reply Exceptions the OCA argues that most of the wage increases claimed by the company are non-contractual and speculative estimates of wage increases. The OCA maintains that the Company has not provide the type of proof required by the Commission to support its proposal for supervisory **[*126]** salary increases. (OCA Reply Exceptions at 10-11).

The OCA notes that in NFGD's 1990 rate increase and in UGI, the Commission emphasized the Company's commitment to the increases based upon communication to the affected employees. Here, the OCA submits that in the absence of such a commitment the Company's claim should be disallowed. (OCA Reply Exceptions at 11-12).

Upon consideration of the position of the parties, we agree with the ALJ's recommendation that the claims post-test year payroll increases be denied. First, we agree with the OTS and the OCA that the increases are speculative and not supported by contract. Moreover, we adopt the OTS argument that since NFGD projects the filing of a rate case in early 1995, and such a projection is consistent with the Company's recent filing history, it will have the opportunity to reflect in rates the full impact of any 1995 wage increase which will have an effect upon the profitability of the utility. Accordingly, we will adopt the reasoning and recommendation of the ALJ on this issue. We will deny the Company's Exception.

3. Temporary, Part-Time; Summer; Other And Overtime Payroll.

NFGD based its temporary, part-time; summer; **[*127]** other; and overtime labor claim on the actual levels for the historic test year ended November 30, 1993. OTS Stmt. No. 2, p. 28. However, as indicated in OTS Cross Examination Exhibit No. 15, the historic test year amount for each of these four pay groups is the highest of each of the past three years. In fact, the historic test year level is the highest for all pay groups, with the exception of the summer pay group, since 1989. Id. at 28.

Accordingly, OTS witness Maher proposed adjustments to the projected labor claim for these four pay groups (also referred to as Miscellaneous pay groups), based on a three year average of actual labor expenses for the twelve months ended November 1991, 1992 and 1993. Id. at 29. Mr. Maher's original adjustments, based on the three year average, are shown on page 29 of OTS Statement No. 2. However, during rebuttal, NFGD witness Higley contended that Mr. Maher should have computed his average based on the payroll level at January 1, 1994. Mr. Higley prepared a schedule (NFGD Ex. No. 205-B, revised 7/25/94) to show this revised calculation. Mr. Maher accepted this adjustment to his computation, and has recomputed his adjustment, using the revised **[*128]** averages from Mr. Higley's exhibits.

The ALJ proffered the following schedule which shows the computation of the OTS adjustment (before O&M allocation), using the averages from revised NFGD Exhibit No. 205-B:

		Actual HTY	**Average**	**OTS**
		Company	**OTS**	**Adjustment**
A)	Temporary Part Time	$ 143,433	$ 121,465	$ 21,968
B)	Summer	$ 146,456	$ 143,306	$ 3,150
C)	Other	$ 63,231	$ 42,000	$ 21,231
D)	Overtime	$ 718,938	$ 632,800	$ 86,138
		$ 1,072,058	$ 939,571	
OTS Adjustment (Before O&M allocation)				($ 132,487)

(R.D. at 69).

Also the ALJ pointed out that, with the exception of the "other" pay group, NFGD has increased the historic test year actual expense by 4.10% and 3.8% to reflect wage increases effective 1-1-94 and proposed to be effective 1-1-95, respectively. NFGD Ex. No. 104-A-1, p. 2. Mr. Maher opposed recognition of the proposed 3.8% increase at this time for ratemaking purposes.

Mr. Maher, argued that the 3.8% increase is not supported by a union contract (N.T. 335-36) and absent a contract, NFGD has no legal obligation to increase the salary level to these wage groups. OTS Stmt. No. 2, p. 29. The OTS argues that the Commission **[*129]** has previously rejected projected post-test year wage increases, such as these, which are not required by contract. See, *Pa. P.U.C. v. Columbia Gas of PA, 58 Pa. P.U.C. 555, 583, 62 PUR 4th 1755 (1984); Pa. P.U.C. v. Duquesne Light Co., 54 Pa. P.U.C. 695, 43 PUR 4th 27 (1981).* It is the position of OTS these expenses lack the degree of certainty necessary for proper ratemaking.

The OTS continued that NFGD has reflected eleven months of this increase in its filing, i.e., from January 1, 1995 to November 30, 1995. This, the OTS asserts, is a full year beyond the future test year. The OTS asserts further that revenues have not similarly been reflected (N.T. 206) and therefore, the matching principle is violated. OTS Stmt. No. 2, pp. 29-30.

The denial of the 3.8% post-test year increase results in a downward adjustment to NFGD's labor claim of $ 39,907, as computed on OTS Exhibit No. 2A, Schedule 7. In addition, the recommended reduction of $ 132,487 to the historic test year salary levels reduces the 4.1% increase, effective 1-1-94, by $ 5,432 ($ 132,487 X .041 = $ 5,432). (R.D. at 70).

To be consistent with the use of a three year average of historical payroll expense for **[*130]** the four pay groups, Mr. Maher used a three year average of the expensed percentage of labor for these same years. The data to compute this average was admitted into the record as OTS Cross Examination Exhibit No. 16. Mr. Maher's average expense percentage, as calculated in OTS Statement No. 2, p. 31, is 70.93%. This percentage was used in the OTS Appendix tables to allocate these miscellaneous pay group adjustments between expense and capital, and results in a $ 126,132 expense disallowance for these payroll groups, computed as follows:

$ 132,487 + $ 5,432 + $ 39,907 = $ 177,826

$ 177,826 X .7093 = $ 126,132

In addition, there is an associated payroll tax disallowance of $ 14,937, of which $ 10,595 is the expense portion ($ 14,937 X .7093). The $ 14,937 payroll tax disallowance is computed using the 8.4% payroll tax factor supplied by the Company. See, OTS Ex. No. 2A, Sched. 12, p. 6 ($ 177,826 X .084 = $ 14,937).

The ALJ noted that Mr. Maher did not propose a benefits adjustment for these four pay groups because benefits are generally not applicable to these categories of pay. OTS Stmt. No. 2, p. 31. The ALJ found the adjustments proposed by the OTS reasonable, consistent **[*131]** with proper ratemaking and recommended their adoption. The ALJ noted further that the OTS has reflected these adjustments in its Appendix tables. (R.D. at 71).

In its Exceptions, the Company argued that the ALJ erred in adopting the OTS adjustment because in the Company's view it is improper to use a three-year average level of temporary payroll when the permanent employee count has declined and temporary payroll has increased. NFGD continues that the three-year average used by the OTS extends back to 1991 when the Company's permanent employee count was 537. NFGD also discussed the declining number of employees during the said three-year period. NFGD adds, by way of a footnote, that if the recommended complement level of 496 were adopted, consistency would require a temporary payroll expense $ 100,000 in excess of the amount that the Company claimed in its filing. Also, the Company claims to have demonstrated that it actual expenses for temporary labor exceeded its claim by $ 100,000. The Company, however, submits that it did not update its claim, because it proposed an employee complement higher than 496 employees. (NFGD Exceptions at 16-17).

In its Reply Exceptions, the OTS contends **[*132]** that the Company's argument that the temporary payroll be increased by $ 100,000 if the complement level is set at 496 employees should be disregarded. The OTS asserts that it is too late in the procedure for a party to be filing "rebuttal" expense claims. (OTS Reply Exceptions at 11).

We agree with a portion of the ALJ's recommended resolution of the temporary employee issue. First, the component of the claim which results from the projection of post-test year expense claim of $ 39,907 shall be disallowed consistent with our previous detailed discussion of this issue. Further, we agree with the OTS that the Company's claim for an additional $ 100,000 in expense for temporary employees is inappropriate at this point in the proceeding. Moreover, our decision to allow a payroll complement of 501 employees renders the argument moot. However, we find the Company's argument that since the complement of permanent employees has decreased dramatically in recent years, e shall grant the Company's Exceptions and allow the adjustment with the exception of the post-test year pay increase.

4. Wages from NFG Supply and NFGD (NY Division).

The Company is including within its labor expense **[*133]** claim, the labor expense charged to NFGD from NFG Supply (an affiliate) from the New York Division of NFGD. See, NFGD Ex. 104-A-1, pp. 3-4. This labor expense claim includes the annualized effect of a projected 3.8% wage increase, claimed to be effective in February 1995, for the NY Division employees, in the amount of $ 90,812. Also included is the annualized effect of a projected 3.8% increase, claimed to be effective April 1995, for the NFG Supply employees, in the amount of $ 28,604. NFGD Ex. 104-A-1, pp. 3, 4, column 9.

Mr. Maher has proposed that both of these projected post-test year increases be rejected. The proposed increase to the NY Division employees is not supported by a contract and the effect of both increases is reflected in this proceeding from the proposed effective date of the wage increase, until 11/30/95 (a full year beyond the end of the future test year). This, according to the OTS, creates a mismatch of revenue and expenses and should be disallowed. Mr. Maher's adjustment, which is $ 163,480 (labor expense plus benefits), is calculated on page 39 of OTS Statement No. 2. The ALJ recommended that the adjustment be adopted. (R.D. at 76). Based upon our previous **[*134]** discussion, we will adopt the reasoning and recommendation of the ALJ.

5. Capitalized Labor

OTS witness Maher proposed rate base adjustments to remove the capitalized labor portion of the labor and benefits adjustments previously discussed. The capitalized portion of the temporary, part time; summer; other; and overtime pay group is 29.07% (100% - 70.93% three year average expense allocation = 29.07%), while the capitalized portion of the remaining NFGD - PA pay groups is 27.92% (100% - 72.08% O&M expense allocation = 27.92%). OTS Stmt. No. 2, pp. 47-48. This adjustment, according to the OTS, is necessary to fully remove the rate effect of NFGD's inclusion of 24 employees which do not exist.

NFGD has objected to the adjustment, contending that this adjustment would somehow adversely affect its construction program. NFGD Stmt. No. 205, p. 25. The ALJ opined that this argument makes no sense. The ALJ noted that NFGD witness Higley, acknowledged that the reason for Mr. Maher's rate base adjustment is to remove labor which NFGD has capitalized, for employees which, in OTS' view, the Company no longer has. N.T. 1233-34. The ALJ found previously that NFGD has apparently functioned **[*135]** well since March 1994 with 496 employees, and he found no evidence that customer service has been compromised. N.T. 1044. The ALJ concluded that NFGD's objections should be disregarded and OTS' rate base adjustments should be adopted. (R.D. at 77).

The ALJ points out that rate base adjustment for salaries totals $ 656,305, as calculated using the salary adjustments in OTS Exhibit No. 2A, Sched. No. 12. The associated depreciation expense adjustment, at 3.1% of $ 656,305, is $ 20,345, and the corresponding accrued depreciation adjustment is 1/2 of the depreciation expense adjustment, or $ 10,173 (Id.).

In its Exceptions, NFGD characterizes the adjustment as a "follow-up" to the employee complement levels adjustment. However, the Company proffers another reason for reversing the ALJ's decision to adopt the adjustment.

The Company argued that the ALJ erred in his determination that the payroll adjustment would affect NFGD's construction program. The Company argued that its construction program is not driven by the number of employees, but is driven by the need to undertake construction to maintain safe and adequate facilities. Therefore, concludes the Company, if the employee **[*136]** complement is reduced to the point that it would affect the construction program, outside contractors would be substituted for employees to ascertain that the construction work is done in a timely manner consistent with engineering principles and standards. Thus, the Company states that the level of construction activity is unrelated to the level of employee complement. (NFGD Exceptions at 19-20).

In its Reply Exceptions, the OTS responds to the Company's argument regarding the use of outside contractors by stating that NFGD did not present proof of any outside expenditure. (OTS Reply Exceptions at 12-13).

The OCA replied that it would be improper to include capitalized labor in rate base for non-existing employees (OCA Reply Exceptions at 12).

Based upon our earlier discussion, we will adopt, in principle the recommendation of the ALJ insofar as he accepted the percentage of capitalization. We reject as unsupported, the argument of NFGD regarding the use of outside contractors. We will modify the OTS adjustment which was accepted by the ALJ only to reflect our change of the payroll complement from 496 to 501. Adjustment for this change amount in the reduction of the adjustment **[*137]** to rate base of $ 52,088, amounting to a total rate base adjustment of $ 604,217. Additionally, the associated depreciation expense, and accrued depreciation expense adjustments decrease to $ 18,733 and $ 9,367 respectively, based upon the calculations which appear at page 77 of the Recommended Decision, and supra, herein.

6. Inflation adjustment

Both the OTS and the OCA recommend the disallowance of the Company's inflation expense which is a separate adjustment of 2.58% to seventeen cost elements that are not otherwise adjusted. OCA M.B. at 117-123, OTS M.B. at 91-96. Both parties oppose this inflation adjustment because it is used in place of any actual anticipated and measurable price changes and would serve to institutionalize inflation. OCA M.B. at 118.

In its Main Brief, the Company contends that the OCA and the OTS oppose its inflation adjustment in its entirety "despite the fact that inflation adjustments in rates cases are so routine it is difficult to find a rate case in which any party proposed total disallowance of inflation adjustments." NFGD M.B. at 76-77.

The ALJ commented that the fact that a particular adjustment is "routine" is not a compelling reason **[*138]** to allow an unsubstantiated claim. The ALJ cited Lower Frederick Twp. Water Co. v. Pennsylvania Pub. Util. Comm'n, 48 Pa.Cmwlth. Ct. 222, *409 A.2d 505 (1980)* for the proposition that it is the Company's burden to prove each element of its rate request with convincing and substantial evidence. The ALJ continued that the Company's desire to continue a "routine" practice was best exemplified by the testimony of NFGD witness Higley who stated that the inflation factor was applied because it was "easier" than doing a detailed analysis of the cost elements. N.T. 355. Both the OTS and the OCA submit that this lack of analysis and substantiation of a claim cannot be accepted. OCA M.B. at 119, OTS M.B. at 92.

The OCA discusses at length the inherent flaws of a blanket inflation adjustment. OCA M.B. at 121-122. The OCA argues that an inflation adjustment has no regard for actual experience and violates the future test year concept of creating "typical" expenses. OCA M.B. at 121. The Commission has specifically held that inflation adjustments do not create known and measurable changes because not all expenses are affected by inflation and those that are affected by inflation experience inflation **[*139]** differently. The OCA cited *Pennsylvania Pub. Util. Comm'n v. Pennsylvania American Water Company, 71 Pa. PUC 210, 269 (1989),* for the proposition that costs do not move in a synchronized manner and therefore inflation factors would serve to overstate or understate actual price escalation that will be experienced.

The OCA continued that the data provided by NFGD on the trends in price variations for the seventeen items adjusted for inflation demonstrated the inaccuracy of the inflation adjustment. A tracking of all of the cost elements over the past several years reveals that changes in individual expenses do not approach a pattern and do not justify a blanket adjustment. OCA M.B. at 122. The OCA claims that Company attempted to show there is an average increase in actual expense levels over a four year period for all of the cost elements. Id. However, the OCA argues that the average of all items presented by the Company hides the dynamic nature of price and activity changes. Specifically, the OCA contends that on an item-by-item basis, there are both increases and decreases in cost levels over time. OCA M.B. at 121-122, OTS M.B. at 91.

Further, the OCA argues that the Company's **[*140]** inflation adjustment ignores that other cost elements, such as equipment rentals, may be governed by long term contracts. OCA M.B. at 122. The OCA pointed out that the Company witness sponsoring this adjustment could give no specific details about contracts that govern equipment rentals. Id. Again, it is the opinion of the OCA and the OTS that the Company believes that it is "easier" to just apply a blanket inflation factor instead of determining a reasonable level of expense for each cost element.

The ALJ proffered the following resolution of this issue:

The Company's 2.58% adjustment to the seventeen cost elements should be rejected as unreasonable and unsubstantiated. The resultant OCA adjustment is $ 442,000. OCA M.B. at 123; OCA St. 3 at 70-72, Sch. 11. This OTS adjustment is reflected as a $ 430,000 expense disallowance because it has previously disallowed the $ 12,000 rate case expense inflation adjustment in its rate case expense proposal. OTS M.B. at 92; OTS St. 2 at 42. We recommend the adoption of the OCA's adjustment of $ 442,000.

(R.D. at 80).

In its Exceptions, NFGD argues that each category of expense to which the inflation adjustment is applied actually increased **[*141]** during the during the 5-year period ended November 30, 1993 and that such expenses increased overall at a rate that exceeded the inflation rate. Therefore, concludes NFGD its inflation adjustment is conservative. (NFGD Exceptions at 20).

The Company addresses the criticism of the ALJ and the OCA that NFGD failed to prove that each cost component subjected to the inflation adjustment marched in perfect lock step with inflation. The Company continued that such a requirement is not realistic, and certainly not been met in any of the many cases in which the Commission has approved inflation adjustments in recent years. (Id.)

Finally, the Company criticizes the ALJ's reliance on *Pa. P.U.C. v. Pennsylvania-American Water Company, 71 Pa. P.U.C. 210, 267-69 (1989).* According to NFGD, in that case, the Commission did not reject an inflation adjustment, but rejected the utility's proposal to apply 18 months of inflation to historic test year levels to adjust expenses to the level at the end of the future test year. The Commission instead permitted a 12-month adjustment, exactly as NFGD has proposed in this proceeding. (NFGD Exceptions at 21).

In its Reply Exceptions, the OTS reiterates **[*142]** that the Company failed to meet its burden of proof on this adjustment due to the arbitrary nature of the Company's adjustment. specifically, according to the OTS, NFGD arbitrarily adjusted 17 O&M expense items without making any effort to determine whether or not the expenses were inflation sensitive. (OTS Reply Exceptions at 13).

The OCA in its Reply Exceptions, asserts that it had never argued, nor did the ALJ require that every cost item be in perfect lock step with inflation. The OCA argued that the adjustment is unsupported, and that the fact that inflation adjustments have become almost "routine" is not a compelling reason to allow an unsubstantiated claim for inflation. (OCA Reply Exceptions at 13).

Based upon our consideration of the positions of the parties, we do not find that the arguments contained in the Company's Exception rise to a level that would cause us to reverse the ALJ's resolution of this issue. We agree that the Company's adjustment is unsubstantiated. Based upon the foregoing discussion, we will deny the Company's Exception regarding this issue.

8. Advertising

The ALJ began his discussion of this issue by noting that under Section 1316(a) of the Code, **[*143]** 66 Pa. C.S. § 1316(a), advertising expenses are recoverable if they meet at least one 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 as preferable to other methods 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 production of community service or economic development.

(R.D. at 80-81)

At pages 47-53 of OCA Statement No. 3, the OCA proposes to disallow a substantial portion of Distribution's advertising expense. In making this proposed adjustment, the OCA would eliminate, for ratemaking purposes, advertising which it considers to be competitive in nature.

The Company argues that its advertising programs have not changed substantially over the years and therefore, since neither the OTS or **[*144]** the OCA have challenged the advertising in three of the last four litigated rate cases, we may look to those for instruction. NFGD M.B. at 81.

In the earliest of the three recent cases in which the Commission addressed advertising issues, *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 62 Pa. P.U.C. 407, 421-22 (1986),* the Commission considered conservation advertising emphasizing high efficiency gas appliances. The Company argues that the Commission found specifically that advertising efficient gas appliances meets criteria three and four by promoting wise use of domestic natural gas and provides important information concerning means of reducing usage or bills. NFGD continued that the Commission also noted that the cost of the advertising program amounted to only a small amount per customer per year so that only a small amount of conservation resulting from the advertising would justify the advertising expense. The Company proffers the following cite from the aforementioned case:

We find that the evidentiary nexus between the conservation appliance commercials and sufficient customer benefit is strong enough to justify the relatively modest expense involved.

Pa. P.U.C. v. National Fuel Gas Distribution Corp., 62 Pa. P.U.C., supra, at 422.

NFGD discussed the next Commission proceeding wherein its advertising program was considered, *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 67 Pa. P.U.C. 264, 307-09 (1988).* NFGD cited that particular Opinion and Order as follows:

Distribution's efficient appliance advertising promotes prudent use of natural gas supplies and provides customers with information about ways to reduce gas usage. In addition, to the extent that such advertising reduces conversion by customers to appliances and equipment that use other forms of energy, such as electricity or oil, such advertising helps to preserve Distribution's sales volumes with consequent benefits to customers because of loss of revenues and load would mean that higher fixed costs would have to be borne by Distribution's remaining customers.

In conclusion, we find that the Company's claim for advertising appliances does provide a direct benefit to ratepayers since such advertising, in addition to encouraging energy conservation, aids the Company in maintaining or improving load.

Pa. P.U.C. v. National Fuel Gas Distribution Corp., 67 Pa. P.U.C., supra, at 308-09.

The Company continues that issues concerning advertising were raised again in *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 73 Pa. P.U.C. 552, 582-583 (1990).* There, OTS had objected to an increase in Distribution's annual level of advertising expense. The Company cited the Opinion and Order at page 582, as follows:

We are not persuaded by the OTS' argument that the ALJ was incorrect in finding Distribution's projected expense for conservation advertising to be reasonable. Energy conservation on the part of all customers should be encouraged, and getting the message to them through advertising certainly helps in achieving that goal. In the context of this proceeding, the Company's conservation advertising claim is cost effective and of a direct benefit to ratepayers, as noted by the ALJ. We adopt the ALJ's recommendation and the OTS' Exception is denied.

However, the OCA submits that the case cited in its Main Brief involving Equitable Gas Company provides the Commission's most instructive and pertinent insight on the treatment of promotional activities in rates. See *Pennsylvania Pub. Util. Comm'n v. Equitable Gas Company, 73 Pa. PUC 301 (1990);* **[*147]** OCA M.B. at 84; 86-89 ("Equitable"). The OCA submits that specifically, the Commission determined in that 1990 case, that Equitable's cooperative advertising and promotional allowances (which are the same types of promotional activities engaged in by NFGD) did not meet any of the requirements of Section 1316 of the Code. *Id., 73 Pa. PUC at 320.* The OCA continues that the Commission emphasized that these types of activities do not benefit residential customers in particular. Id. Specifically, the OCA proffers the following cite from Equitable in support of its contention that the Commission concluded that cooperative advertising and promotional allowances benefit the developers, builders and realtors and not the ultimate customer:

Therefore, it is apparent that the gas company with which a developer or builder engages in cooperative advertising is likely to be the gas company to which the home buyer will be connected for the duration of his or her ownership. The builder or developer may not choose a gas company on the basis of rates or service to the homeowner, the ultimate customer, but may choose a gas company on the basis of the size of the promotional allowance **[*148]** or advertising allowance offered. Thus, the cooperative advertising benefits the developer, the realtor, or builder, but not necessarily the ultimate ratepayers.

Id. (emphasis added).

The ALJ stated that the Commission in Equitable held that cooperative advertising and promotional allowances are particularly detrimental to residential customers who are captive customers. The cited Equitable as follows:

To the extent that Equitable provides promotional allowances to developers or realtors, or shares advertising costs with developers or realtors, those parties may or may not pass on the amounts obtained from Equitable to their customers in the form of reduced housing costs. . . . We hasten to point out that residential ratepayers are basically captive ratepayers. While large industrial and commercial customers have some ability to switch LDCs . . ., and while some residential ratepayers have the ability to switch LDCs . . ., most residential ratepayers when connected to a gas line do not have a sufficiently large load to attract the interest of a competitive gas company.

Id., 73 Pa. PUC at 319 (emphasis added).

The ALJ continued that the Commission in **[*149]** Equitable was not convinced that competition justified these kinds of promotional activities. Again, said the ALJ, the Commission stressed that cooperative advertising and promotional allowances were "absolutely indefensible when used to attract or retain residential ratepayers who . . . are largely captive ratepayers. " *Id., 73 Pa. PUC at 327.* The ALJ then cited Equitable as follows:

While Equitable regards Duquesne Light and fuel oil companies as being its competitors . . ., the bulk of Equitable's competition is with other LDCs. . . . While it is true that by adding additional customers, Equitable, and its ratepayers, benefit by having a larger customer base over which to distribute fixed costs, that benefit simply comes at the expense of the other LDCs in the western Pennsylvania area and their ratepayers. . . . The ALJ observed that this kind of "competition" merely serves to "rob Peter to pay Paul.". . . . Furthermore, to the extent that Equitable expects to recover the cost of these promotional allowances from its ratepayers (as do all the other LDCs), these payments simply serve to raise the cost of service to all of the Western Pennsylvania ratepayers. **[*150]**

Id. (emphasis added).

The OCA commented that what is particularly egregious about NFGD's promotional activities is the fact that the Company does not, in fact, face real competition for most of its load. The OCA observed that NFGD has admitted that it holds the vast majority of the energy market in its service territory and that electric competition is de minimis. OCA M.B. at 81-82.

The OCA argues that the Company cites at length past cases wherein the Commission has permitted NFGD to recover the costs of "conservation advertising. " See NFGD 1986, supra; NFGD 1988, supra; NFGD 1990, supra. The OCA counters that, while it is true that the Commission permitted the recovery of conservation advertising expense, it did not have to address the Company's contention that its frequent rate case filings are due, in part, to the effects of these very "conservation" programs. OCA R.B. at 40. It is ironic, according to the OCA, that while NFGD witness Sprague represents these promotional activities as programs that encourage the efficient use of natural gas that will directly benefit Distribution's customers, Company witness Wright complained that these programs cause a decrease in **[*151]** sales load and is one factor that leads to NFGD's frequent rate increase requests. NFGD St. 219 at 4. The OCA argues that if NFGD's promotional programs do, in fact, promote conservation and if NFGD's witnesses are to be believed, customers ultimately have to pay higher rates to make up for the decreased sales load caused by energy efficiency. The ALJ presents a cite from Mr. Wright's testimony as follows:

Q. Now is it your testimony then that the result of encouraging gas efficiency would be another factor that necessitates frequent rate filings or higher rates to customers?

A. It would be my testimony that whenever somebody replaces an old appliance with a new appliance, all things being equal, the new appliance is more efficient, causing the customer to use less gas, causing sales to decline when one would compare them to prior usage.

Q. And as a result, the fixed costs that Distribution needs to recover from those customers must be spread over a lower volume, correct?

A. The denominator would definitely be lower.

R.D. at 86-87.

The OCA continued that Mr. Wright also agreed that the cost of providing such programs is another factor that would add to increased costs for **[*152]** which NFGD would file for rate relief. The OCA submits that he further agreed that these programs to promote efficient use of gas could be one of the reasons NFGD has to raise its rates since it must spread its fixed costs across a smaller customer base. N.T. 1031. Specifically, Mr. Wright explained as follows:

Q. Now, in addition to the fact that these programs cause decreased gas usage, which means recovering less money because of lower volumes consumed by customers, there's a cost incurred by the company, isn't that true, Mr. Wright, to provide these programs?

A. That's true.

Q. And that would probably be another factor contributing to the need for higher rates due to higher costs incurred by Distribution?

A. That's true.

Q. Now, using that analysis, if NFG were permitted to recover those costs in rates, of providing these programs, and if, in fact, customer consumed less gas because they were using energy more efficiently, customers might still pay higher rates to pay for higher costs, that you say NFG is incurring, spread across fewer billing units?

A. That might be the case.

N.T. 1031-1032.

The OCA submits that certainly, it would be difficult to justify allowing the **[*153]** recovery of so-called energy efficiency programs that NFGD essentially promises will result in higher rates to its customers. Additionally, in light of the public input testimony regarding the impact of increased gas rates upon customers, this expense is simply not warranted.

Furthermore, the OCA points out that the Commission has had recent occasion to address the cooperative advertising program of another utility. Pennsylvania Pub. Util. Comm'n v. UGI Utilities, Inc., R-00932862, slip op. (July 25, 1994) ("UGI 1994"). In the UGI 1994 case says the OCA, the Commission disallowed the costs associated with the Company's cooperative advertising program because it could glean no direct benefit to UGI's ratepayers. Id., slip op. at 74. The OCA continued that the Commission concluded that the benefit runs to the contractors and the utility's shareholders, and not the ratepayers. Id. OCA. R.B. at 42.

The ALJ made the following disposition of the advertising expense issue:

While NFGD argues that OCA's reliance on UGI 1994 is misplaced, we believe that the underlying rationale is indicative of the Commissions concerns to move away from advertising which does not **[*154]** benefit the ratepayer directly.

The OCA submits and we agree that NFGD's claim for promotional activities cannot be justified under Section 1316 of the Public Utility Code or by Commission precedent. Therefore, NFGD's $ 549,314 claim should be disallowed.

(R.D. at 88).

In its Exceptions, the Company argues that the ALJ erred in recommending rejection of its claim for advertising expenses despite the fact that the Commission had determined in three previous decisions wherein this expense claim was challenged that NFGD's advertising conformed to the standards articulated in Section 1316(a) of the Code. On page 22 of its Exceptions NFG proffers a cite from each of the three proceedings wherein its claim for operating was adopted. The Company repeated that in previous proceedings, the advertising programs were similar to that proposed in the instant matter.

The Company criticizes the ALJ's reliance on *Pa. P.U.C. v. Equitable Gas Co., 73 Pa. P.U.C. 301 (1990).* The Company argues that Equitable is inapposite because it predated the Commission's most recently expressed approval of the Company's advertising program by one month. The Company argued that the distinctions between **[*155]** its program and that of Equitable in that NFGD'S competitors in the residential market include electricity, oil and propane, while Equitable's main source of competition was other gas companies. NFGD continues that it can show that a public benefit to its advertising because the cost of water and space heating from gas is less than the cost of same by electricity, oil or propane. According to NFGD, equitable was unable to show a public benefit of its advertising because its rates for gas service were higher than the rates of the other gas companies. Thus, NFGD avers that Equitable, through its advertising, was encouraging people to pay more, not less, for the same service. (NFGD Exceptions at 23).

Another distinction between the instant proceeding and Equitable, continues NFGD is that Equitable's advertising program was not entered into evidence in that proceeding. NFGD argues that here, it produced its entire advertising program. NFGD adds that there was no criticism of any advertisement as being improper under the statutory standards. Instead, claims the Company, the advertisements are dismissed as being competitive or cooperative. The Company submits that a review of its advertising **[*156]** program would reveal that the portion thereof at issue clearly explains the advantages of natural gas as opposed to other energy, or identifies particularly efficient gas appliances. (NFGD Exceptions at 24).

The Company excepts to the ALJ's statement wherein he criticized its advertising program as being unnecessary because NFGD has been successful in retaining most of its load. The Company asserts that such criticism misses the point that NFGD faces competition in the residential market. NFGD continues that each year thousands of gas appliances are replaced, and that each replacement is a decision by a customer. Thus, the Company argues that when these decisions are made, the customer should have available information concerning the benefits of natural gas. NFGD contends that its message is fair and accurate because natural gas is economically advantageous to customers. Further, NFGD asserts that it is not in the customers' interest to continually hear advertisements for other forms of energy, while the company stands mute. NFGD concludes that its competitors pay more for advertising than does the Company. (NFGD Exceptions at 24).

The Company counters the ALJ's conclusion that **[*157]** NFGD's advertising promoting conservation may result in a rate case. The Company characterizes such criticism as misdirected. NFGD maintains that although conservation may contribute to a base rate proceeding, conservation will not, of itself, cause customers to pay more. The Company asserts that the result of conservation is that base rates must be increased to produce the same level of recovery of fixed costs prior to conservation efforts. therefore, NFGD claims that higher base rates may be needed to produce the same level of dollars, not additional dollars. The Company concludes by stating that base rate increases can be offset by savings in purchase gas resulting from reductions in usage. Thus, in this matter, says NFGD, conservation could result in lower total bills to customers. (NFGD Exceptions at 25).

The Company criticizes the ALJ's reliance on Pa. P.U.C. v. UGI, docketed at No. R-932862 (Order entered July 25, 1994). According to the Company the ALJ's reliance on UGI is misplaced because UGI's advertising, which was rejected by the Commission, was "patently a promotional effort intended to enhance housing contractors' sales [of homes]" UGI at 73. The Company **[*158]** concludes that its cooperative advertising places information where the selections among gas, electric or oil equipment and between higher and lower efficiency appliances are made (NFGD Exceptions at 25-26).

In its Reply Exceptions, the OCA pointed out that expense disallowances of $ 549,314 in advertising expenses associated with 5 specific programs were disallowed. The OCA continued that these specific programs were targeted at appliance dealers, heating and plumbing contractors, and building architects/engineers. Moreover, the OCA assets that it identified $ 19,600 in cash payments to commercial and industrial customers in direct violation of the Commission's regulations at 52 Pennsylvania Code, Chapter 57 Section 61, *52 Pa Code, § 57.61*. The OCA continues that Equitable and UGI stand for the proposition that the Commission is moving away from advertising that does not directly benefit the ratepayer. Moreover, the OCA asserts that the Commission has indicated its concern that advertising not be utilized for the purpose of competing for new or existing load. (OCA Reply Exceptions at 15).

The OCA argues that there is very little to distinguish it claim from Equitable's. **[*159]** Further, says OCA, in comparison to Equitable, NFGD has relatively little competition for load. Further, argues the OCA, NFGD has a 93.7% of the residential market for space heating in its service territory and 96% of the commercial market. Thus, OCA insists that the Company is the dominant supplier of space and water heating in its service territory. The OCA concludes that NFGD's advertising does not provide a direct benefit to ratepayers pursuant to Section 1316 of the Code. (OCA Reply Exceptions at 16).

The OTS, in its Reply Exceptions, stated that in the event that the Commission grants any part of the Company's claim for advertising expense, it should, at a minimum, disallow the portion of the advertising expense, in the amount of $ 40,791, identified by Mr. Maher as the Competitive Response Program. (OTS Exceptions at 14).

After our careful consideration of the positions of the parties, we will adopt the reasoning and recommendation of the ALJ on this issue. We found the Company's argument that its advertisement regarding the efficiency of natural gas vis-a-vis other energy sources is beneficial to the ratepayer, to be unconvincing. We found, in fact, that the Company's advertising **[*160]** is in essence targeted to seek and retain load. We find that the advertising program of NFGD does not meet the statutory requirements of Section 1316(a) of the Code. Based upon the foregoing discussion we will deny the Company's Exception.

9. Uncollectible accounts expense

9(a). Recovery Of Pre-Program LIRA

NFGD witness Thomas Ring developed the Company's revised uncollectible accounts expense claim of $ 3,323,514 [13] (exclusive of the Sharon Steel and Franklin Steel amortizations) using a ratio of historic (July 1991 to June 1994) net write-offs (write-offs less recoveries) to revenues. The net write-offs are comprised of final bills which are twelve months old. NFGD Stmt. No. 207, p. 3; NFGD Ex. No. 104-A-2, p. 1 (update as of July 19, 1994). NFGD explained that the ratio of historic net write-offs to revenues is then applied to projected future test year revenues to calculate the uncollectible accounts expense for ratemaking purposes. NFGD Stmt. No. 207, p. 3.

The ALJ observed that for the first time in developing **[*161]** its uncollectible accounts expense claim, NFGD has included $ 534,434 in Low Income Residential Assistance (LIRA) [14] pre-program arrearages in historic net write-offs (for May 1993 - June 1994). OTS Stmt. No. 2, pp. 2-3; OTS Ex. No. 2A, Sched. 1 (revised); N.T. 794. See late-filed exhibit OTS Ex. No. 2A, Sched. 1 (revised) for updated NFGD uncollectible accounts expense claim.

OTS witness Mr. Maher proposed an adjustment to NFGD's uncollectible accounts expense claim to remove the LIRA pre-program arrearage write-offs from the calculation. OTS Stmt. No. 2, pp. 2-3. The position of the OTS is

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[13] The ALJ pointed out that NFGD's original uncollectible accounts expense claim was $ 3,811,120 (exclusive of amortizations). NFGD Ex. 104-A-2, p. 2.

[14] The LIRA program, which is NFGD's pilot CAP program, provides a discounted residential rate to its participants. This discounted rate is subsidized by non-LIRA residential ratepayers. See, Pa. P.U.C. v. NFGD, R-911912, Order entered July 30, 1992, pp. 12-27. Under the LIRA program, a participant's pre-program arrearages are "forgiven" (i.e. wiped off the customer's account) after the customer pays the first three LIRA bills. NFGD Ex. 207-A, p. 7. These "forgiven" arrearages are now sought to be recovered from other residential ratepayers.

that inclusion of these "forgiven" arrearages **[*162]** in uncollectible accounts expense to be recovered from other ratepayers is not appropriate. OTS M.B. at 30. The OTS submits that while NFGD contends that the arrearage forgiveness aspect of its LIRA program was approved by the Commission as a part of the Company's CAP program, the Company has provided no evidence of Commission authorization to collect these forgiven arrearages from other ratepayers. NFGD Stmt. 207, pp. 2-3; N.T. 968. OTS M.B. at 30.

The OTS cites Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc., R-901873, Order entered October 31, 1991, ("Columbia 1990"), for the proposition that the Commission has previously denied recovery of forgiven CAP arrearages to utilities because to allow recovery would constitute retroactive ratemaking. The OTS' rationale for eliminating the arrearages forgiven under the LIRA program is provided at page 3 of OTS Statement No. 2 as follows:

1) [T]hey represent arrearage forgiveness, which has previously been rejected by the Commission as retroactive ratemaking, at Pa. P.U.C. v. PECO, Docket No. R-891364 and Pa. P.U.C. v. Columbia Gas, Docket No. R-891468; 2) any benefit of lower uncollectible accounts expense due to the **[*163]** LIRA program is defeated by increasing the net write-offs with pre-program arrearages.

NFGD's witness Mr. Ring noted that the Commission decision in Pa. P.U.C. v. Columbia Gas of Pennsylvania, R-891468, Order entered September 20, 1990, ("Columbia 1989") was reversed by the *Commonwealth Court at 613 A.2d 74 (1992),* and this reversal was affirmed by the *Pennsylvania Supreme Court at 636 A.2d 627 (1994).* NFG continued that in *Columbia Gas of Pennsylvania, Inc. v. Pa. P.U.C., 149 Pa. Commonwealth Ct. 247, 613 A.2d 74 (1992),* aff'd, *Pa. , 636 A.2d 627 (1994),* ("Columbia 1992"), Columbia Gas challenged, among other things, the Commission's disallowance of recovery of uncollectible arrearages that had arisen under a Commission-mandated program for assisting payment-trouble customers. The Commonwealth Court's discussion of the issue is provided at *Columbia Gas, 149 Pa. Commonwealth Ct. 247, 613 A.2d at 79-80:*

The only issue, therefore, is whether allowing the full claim now violates the principle of retroactive ratemaking. In our view, several factors distinguish this situation from that discussed above relating to the untimely claim for the York plant investigation **[*164]** expenses. Columbia emphasizes that it adopted and actively pursued the use of the budget plus program only pursuant to the direction of the Commission, and that the program disputed the workings of the normal termination and bad debt recovery procedures that were in place before.

The Commission did not order Columbia to incur a direct expense, for example, by ordering necessary repairs. Rather, the Commission ordered Columbia to adopt billing and termination procedures that ultimately created increasingly large arrearages and at the same time prevent Columbia from terminating service and writing them off as uncollectible. At the time of the two intervening rate cases, Columbia had no reason to seek to recover as uncollectible the arrearages claimed here, because it was complying with the PUC's direction to maintain them as accounts receivable. It was not until 1989, when the auditors informed Columbia that some of the accounts were not properly designated as receivable, that Columbia's duty was triggered to seek to terminate service and write off the accounts or to seek an assured method of payment. The money Columbia seeks to recover now as an expense definitely became owing in **[*165]** the past; however, under the peculiar circumstances of this case, the present rate proceeding is the first time that Columbia had an opportunity or a reason to seek recovery of that money in rates. We reverse the Commission's denial of recovery of the full $ 4.5 million.

NFGD asserts that the Commonwealth Court's order was affirmed, per curiam, on appeal to the Pennsylvania Supreme Court. *Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc., Pa. , 636 A.2d 627 (1994).*

NFGD contends that the OTS' contentions concerning arrearages forgiven under the LIRA program are without merit. In the evidence according to the Company, the OTS relied upon Columbia 1989 to contend that pre-program arrearages forgiven under the LIRA program should be excluded from the calculation of uncollectible accounts expense because including them would constitute impermissible retroactive ratemaking. As the Company explained at pages 89-92 of its Brief, the Commission order upon which the OTS relied was reversed by the Pennsylvania appellate courts. *Columbia Gas of Pennsylvania, Inc. v. Pa. P.U.C., 159 Pa. Commonwealth Ct. 247, 613 A.2d 74 (1992),* aff'd, *Pa. , 636 A.2d 627 (1994).* The **[*166]** OTS, argues NFGD, was alerted to the reversals through cross examination when its witness testified that he did not know the disposition, on appeal, of the case which he cited (N.T. 709-710). NFGD submits that apparently alerted by the cross examination, the OTS determined that the case on which it relied had been reversed. Consequently, argues NFGD, the OTS, in its Brief, now attempts to distinguish Columbia 1990, on which its witness relied, as dealing with budget plus arrearages. NFGD R.B. at 34. NFGD posits that now, instead, the OTS relies upon Columbia 1990. The OTS contends that there the Commission was dealing with a customer assistance or CAP program, and that the Commission determined that recognition of write-offs of pre-program arrearages in computing uncollectible accounts also would be impermissible retroactive ratemaking. The OTS also indicates that there is no appellate order in this case because the appeal was settled. NFGD R.B. at 35.

NFGD maintains that the OTS' latter contention concerning the disposition of the Columbia Gas appeal from the Commission Order at Docket No. R-901873 is incomplete and misleading. The Company continues that in an Order entered **[*167]** on February 18, 1994, the Commission approved a settlement, over the objections of the OTS. As part of the settlement, says the Company, the case was remanded to the Commission, where OTS reactivated its participation and opposition to recovery of pre-CAP program arrearages. The OTS objected to the reflection of any pre-program arrearages in the computation of uncollectible accounts expense for ratemaking purposes as retroactive ratemaking. NFGD proffered the following cite which shows the Commission's dispositions of the OTS' objections:

The pre-program arrearages that have been the subject of Columbia's appeals at Nos. 2547 *C.D. 1991 and 1660 C.D. 1992* are analogous to the pre-program arrearages dealt with in the 1993 Met-Ed decision and, while the rate recovery mechanism set forth in the proposed settlement (amortization over a period of 18 months) is not identical to that specified in Met-Ed (portion of uncollectible expense), for the limited purpose of this settlement agreement and in recognition of the risk of further litigation before the Commonwealth Court, we will accept the parties' proposal.

Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc., Docket Nos. R-901873 **[*168]** and R-891468, pp. 8-9 (February 18, 1994). NFGD R.B. at 35.

The ALJ pointed out that the Met-Ed case referenced in the quote is Pa. P.U.C. v. Metropolitan Edison Co., Docket No. R-922314 (January 21, 1993). There, says the ALJ, the Commission approved Met-Ed's proposed ratemaking treatment of write-offs of pre-CAP program arrearages, which proposal was to treat them as any other write off. This procedure, opined the ALJ, is exactly what Distribution had proposed in this proceeding. There is no special or unique treatment of pre-programs amounts forgiven under the LIRA program. Such amounts have been written off and are being recognized in the calculation of uncollectible accounts expense in the normal and ordinary course using procedures adopted by the Commission in previous cases. (R.D. at 103-104).

Similarly, the ALJ found that the OTS' citation, at page 33 of its Brief of the Commission's Order in Petition of the Pennsylvania Electric Co. Requesting Approval of a Pilot Customer Assistance Program and Related Ratemaking, Docket No. P-930718 (February 23, 1994), is inapposite. The ALJ continued that, Penelec had proposed to defer recovery of pre-program arrearages until **[*169]** its next rate case, which was not scheduled for any specific date. Additionally, the ALJ pointed out that Penelec was seeking preservation of the uncollectible accounts associated with a CAP program until its next rate case, which might be years in the future. NFGD R.B. at 36. Thus, said the ALJ, Penelec was suggesting some extraordinary special treatment of amounts written off in conjunction with a CAP program, contrary to the Commission's order in Met-Ed and contrary to the settlement it approved in Columbia Gas. Therefore, the ALJ found that there is no inconsistency between: (1) Distribution's proposed recovery of arrearages forgiven under the LIRA program through the normal write-off procedure and normal calculation of uncollectible accounts expense and (2) the Commission's rejection of Penelec's request for an extraordinary and indefinite deferral of such amount so that it could claim recovery at some unspecified time in the future. (R.D. at 105).

The ALJ recommended rejection of OTS' proposed adjustment here for the same reasons set forth in Columbia 1989. The ALJ noted that in Statement No. 207, pp. 2-7, NFGD explained the circumstances of its forgiven arrearages **[*170]** that are indistinguishable from those in the Columbia order of Commonwealth Court. The ALJ noted that the Company's LIRA program was implemented pursuant to the Commission's directives which culminated in the "Policy Statement on Customer Assistant Programs," Docket No. M-00920345. The Policy Statement encouraged expanded use of customer assistance programs, or CAPs, and provided guidelines for utilities implementing CAPs. The guidelines specifically state, at *52 Pa. Code § 69.265(f)(9)* that:

arrearage forgiveness should occur over a two or three year period contingent upon receipt of regular monthly payments by the CAP participant.

(R.D. at 106).

The ALJ continued that NFGD's specific LIRA program was implemented under the provisions of *52 Pa. Code § 69.267*, related to alternative program designs. NFGD M.B. at 93. The ALJ noted that NFGD's LIRA program was approved by the Commission initially in a base-rate case at Docket No. R-911912 (Order adopted December 19, 1991, and entered July 30, 1992). Thereafter, according to the ALJ, the Company resubmitted its plan to the Commission's Bureau of Consumer Services ("BCS") pursuant to the Policy Statement. The ALJ noted that on **[*171]** April 15, 1993, the Commission reviewed and reapproved the LIRA program with implementation of certain BCS recommendations. (R.D. at 105-106) The ALJ noted that the BCS report is provided as Exhibit No. 206-A. Mr. Ring, at page 3 of Statement No. 207 testified as follows:

we do not believe the Commission would approve an arrearage forgiveness program element in any 'CAP' or 'LIRA' program without realizing that approval is simultaneously implied for revenues to recover these expenses.

The Company cites Pa. P.U.C. v. National Fuel Gas Distribution Corp., 79 Pa. P.U.C. 552, 574-75 (1990); and *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 72 Pa. P.U.C. 1, 35 (1989),* in support of its position that OTS' proposed elimination from the calculation of uncollectible accounts expense of the LIRA write-offs is inappropriate. NFGD continued that recovery in the normal course for write-offs under the arrearage forgiveness provisions of the LIRA program is appropriate because these amounts were destined to be written off, irrespective of the LIRA program. NFGD M.B. at 94. Inevitably, according to the Company, these amounts would have been written off in the normal course of collection **[*172]** procedures (St. No. 207, pp. 4-5). But for the intervention of the Commission-mandated LIRA program, the Company concluded, there would have been no contention that the write-offs in question should be excluded from the calculation of uncollectible accounts under principles of retroactive ratemaking or for any other reason. NFGD M.B. at 94.

According to NFGD, it is to be noted also that OTS cannot contend that the write-offs under the arrearage forgiveness provisions of the LIRA program should have been claimed in a prior proceeding. NFGD argues that in a stipulation that was approved by the Commission in Pa. P.U.C. v. National Fuel Gas Distribution Corp., Docket No. R-932548, the specific procedures and methods for including LIRA arrearages in the write-off ratio used to calculate uncollectible accounts expense were expressly prescribed. Thus continues the Company, it was agreed that NFGD's claim for recovery of write-offs under the arrearage forgiveness provisions of the LIRA program would commence in this proceeding and not in the prior proceeding. The Company asserts that the OTS did reserve the right to contest the inclusion of the LIRA write-offs in the write-off ratio **[*173]** in this and future proceedings but not the right to contend that NFGD's claim should have been made in a prior proceeding. [15]

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[15] The language in the Stipulation is reproduced in ordering paragraph no. 14, page 29 of the order entered on December 1, 1993 as follows:

The allowance for uncollectible accounts expense in this proceeding is $ 3,501,922, exclusive of amortization of the $ 370,920 bad debt of Sharon Steel Corporation, which shall be amortized for ratemaking purposes over three years, commencing with the first day of the first full calendar month in which rates established in this proceeding are effective, for an additional annual expense allowance of $ 123,640. The amount of $ 3,501,922 includes no amount for write-offs related to pre-program arrearages of LIRA participants. Distribution may claim the ratemaking effect of such pre-program arrearages in future cases. Distribution shall make this claim in its next base-rate proceeding by calculating uncollectible accounts expense using the ratio of net write-offs to revenues from the most recent thirty-six month period for which data are reasonably available prior to the close of the record and to include write-offs of LIRA arrearages in such write-off ratio one year after the customer is enrolled

[*174]

The OTS' other contention, that recognition of write-offs of pre-program arrearages would offset lower uncollectible accounts expense under the LIRA program, is meaningless argues the Company. According to NFGD, the fact is that the pre-program arrearages would have been written off and recognized as uncollectible accounts irrespective of the LIRA program. The Company asserts that it would be improper for us to create a false appearance of "savings" by disallowing recovery of legitimate expenses. Indeed, says, NFGD, the "logic" of OTS' position would apply equally to LIRA and CAP program administrative costs, but such administrative costs are nevertheless recoverable because they are proper expenses for ratemaking purposes, as are the uncollectible accounts expense related to the pre-program arrearages. NFGD M.B. at 95 & 96.

The ALJ proffered the following explanation by Mr. Ring, that forgiveness of pre-program arrearages is a critical element for the potential success of the LIRA program:

It is important to note also that one of the underlying premises of the LIRA program is that customers may be willing to pay more in the future then they have in the past if their cost of gas **[*175]** service were more handleable. A critical element of attempting to encourage customers to pay more was to free them from the hopeless burden of accumulated arrearages. If the accumulated arrearages continued to hang over these peoples' heads, the could not be encouraged to pay more because they have no prospect of ever paying off the arrearages. Therefore, arrearage forgiveness was a critical element in the concept of the LIRA program. Arrearage forgiveness will not defeat possible savings under the LIRA program; it is critical for such savings to occur.

(NFGD ST. 207 at 8) (R.D. at 109)

For this reason the ALJ also rejected the OTS' proposal to delete from NFGD's tariff language providing that forgiven arrearages will be charged to uncollectible accounts expense. (Id.)

In its Exceptions the OTS argues that the effect of the ALJ recommendation is to allow NFGD to recover, through, the subterfuge of inclusion within historic net write-offs, the forgiven pre-program arrearages of current LIRA customers. The OTS continues that the recovery of these forgiven arrearages was expressly forbidden by the Commission as retroactive ratemaking in *Columbia, supra.* The OTS further contends **[*176]** that recovery of these pre-program arrearages constitutes impermissible retroactive ratemaking was recently reaffirmed by the Commission, in Petition of the Pennsylvania Electric Company Requesting Approval of a Pilot Customer Assistance Program and Related Ratemaking, Docket No. P-00930718, Order entered February 23, 1994 ("Penelec"). The OTS urges that the Commission rule that recovery of these forgiven preprogram arrearages constitute retroactive ratemaking, and is therefore forbidden. The OTS continues that this principle should be consistently applied, regardless of whether recovery forgiven arrearages is claimed as part of a CAP expense as in Penelec, or whether it is claimed as part of historic net write-offs in an uncollectible accounts expense calculation, as in the instant case (OTS Exceptions at 11).

The OTS submits that the ALJ apparently accepted the Company's argument that in Met-Ed the Commission previously approved the same ratemaking treatment for pre-program arrearages which is being proposed in the instant case by NFGD (i.e. recovery through uncollectible accounts expense). The OTS charges that the company failed to mention that in Met-Ed the **[*177]** Commission explicitly declined to rule on whether it would actually permit recovery of pre-program arrearages from other ratepayers. Thus, according to the OTS, Met-Ed cannot be considered precedent for allowance of recovery of pre-program arrearages from other ratepayers through uncollectible accounts expense calculation. (OTS Exceptions at 12).

The OTS criticizes the ALJ's reliance on the Commonwealth Court's reversal of Columbia. The OTS states that in Columbia the Commission had ruled that Columbia Gas could not recover past arrearages incurred under a non-CAP, Budget Plus program due to the principle of retroactive ratemaking. The Commonwealth Court reversed the Commission on this issue. The OTS asserts that Columbia is not controlling here and does not require the

in the program. OTS and OSBA may contest any inclusion of LIRA write-offs in the write-off ratio in future proceedings. OSBA and OTS may challenge the legality of LIRA rates prospectively in future proceedings.

Commission to allow recovery of the forgiven pre-program arrearages sought herein. The OTS continues that the forgiven arrearages sought to be recovered herein were incurred by certain NFGD ratepayers prior to their enrollment in the LIRA program. Under the LIRA program, a participant's bills are "forgiven" after the customer pays the first three LIRA bills. According to the OTS, forgiven arrearages **[*178]** are not the same as the Budget Plus arrearages because the Budget Plus arrearages continued to be owed by the customer who incurred them. Forgiven arrearages, however, are no longer a debt of the customer because the debt is expunged from the customer's account. Thus, argues the OTS, the case before us is readily distinushable from Columbia. (OTS Exceptions at 13).

Additionally, the OTS argues that the ALJ's reliance on the settlement of an appeal of a later Columbia case is misplaced. the OTS argues that the approval of a settlement does not constitute a decision by the Commission on the merits of an issue. The OTS continues that while the ALJ's decision seems to characterize the settlement as being somehow a litigated proceeding because the OTS reactivated its participation when the action was remanded to the Commission. However, the OTS maintains that the proceeding was settled. The OTS points out that it filed objections on the settlement on the grounds that it provided for recovery of preprogram arrearages, but there were no hearings on these objections. Thus, concludes the OTS, the Commission approval of that settlement should not be considered of precedential value here. **[*179]** (OTS Exceptions at 13-14).

The OTS argues that the ALJ erroneously dismissed it reliance on Penelec, supra. The OTS claims that, contrary to the ALJ's assertions, there is no indication in Penelec, that the Commission denied Penelec's requested recovery of pre-program arrearages, because the request was made for a deferral. Instead, says the OTS, the Commission approved Penelec's requested deferred accounting for other CAP costs. The OTS continues that the preprogram arrearages, however, were specifically singled out by the Commission for non-recovery. In support of that assertion, the OTS proffers the following cite from Penelec:

. . . [C]onsistent with the Commission precedent set forth in *Columbia CAP, supra,* we will deny Penelec's request to include pre-program arrearages as a CAP expense. Pre-program arrearages are no current costs but are the result of pre-pilot collection programs, attributable to a prior period. Recognition of these pre-program arrearages as CAP expenses would allow for recovery of such amounts from non-CAP customers and would constitute impermissible retroactive ratemaking.

(OTS Exceptions at 15).

The OTS notes that it is the opinion **[*180]** of the ALJ that recovery of pre-program arrearages through the normal course for write-offs, as sought herein is appropriate because the amounts were destined to be written off irrespective of the LIRA program. The OTS submits that the Company is not seeking what the OTS considers normal uncollectible accounts treatment which means writing off of final bills which are twelve months old. The OTS maintains that the pre-program arrearages are not final bills and are greater than twelve months old. Further, says the OTS, these arrearages would not be recovered in the normal course because the customer is still receiving service. (Id.)

In its Reply Exceptions, the Company argues that the OTS shows a bias against its LIRA program by its description of NFGD's methodology of including forgive pre-program arrearages in write-offs as a "subterfuge." NFGD argues that the methodology it followed was prescribed in a stipulation in its prior rate case ("NFGD 1993"). Further, the Company argues that it has followed the procedures outlined in several cases discussed previously herein. (NFGD Reply Exceptions at 6-7).

The Company counters the argument of the OTS that the case before us is **[*181]** distinguishable from the Columbia regarding the Budget Plus arrearages. NFGD charges that the OTS has identified a factual distinction to which no significance can be presented in the context of issues. NFGD continues that if anything, the fact that a forgiven arrearage is no longer a debt of the customer means that the amount can be identified as uncollectible with certainty and can be written off at a specific time. Also, the Company counters the OTS argument regarding the precedential value of the Columbia settlement by stating that any assertion of the OTS that its arguments were not given full and fair consideration were unfounded. (NFGD Reply Exceptions at 7-8).

Regarding the OTS discussion of the Commission Order in Penelec, the Company states that if the OTS interpretation of Penelec were correct, the Commission made a reversal in Met-Ed, and in the Columbia remand. The Company continued that the relief sought in the aforecited cases is different than that sought by NFGD here. (NFGD Reply Exceptions at 9).

The Company counters the two arguments offered by the OTS; 1) the arrearages are greater than a year old; and 2) they would not be recovered in the normal **[*182]** course.

First, the Company states that the inclusion of the LIRA arrearages are presented in exactly the same way as routine writ-offs. The LIRA arrearages are written off after the customer is enrolled in the program for one year. NFGD continues that the one-year delay in recognition of the forgiven arrearages makes the timing of their inclusion in the write-off ratio identical to normal write-offs of bills of customer who terminate service.

Next the Company characterizes as "demonstrably wrong", the OTS contention that the LIRA arrearages would not be recovered in the normal course because the customer is still receiving service. The Company argues that the arrearages forgiven under the LIRA program would have become write-offs in the normal course of collection procedures even if the LIRA program had never been initiated, because the customers considered for the LIRA program demonstrated a negative income on the analysis of their ability to pay, had an excessive account balance, and customers who had their service terminated at some point during the preceding twelve months. (NFGD Reply Exceptions at 9-10).

In our view, this expense item involves neither retroactive ratemaking **[*183]** nor double counting of a single expense. The Company determined its uncollectible accounts expense for the ratemaking period by determining the historic level of write-offs as a percentage of revenues during the prior three-year period and applying that percentage to the anticipated revenues during the test year. We find this to be a common ratemaking methodology. The uncollectible expense related to LIRA first arose in 1993-1994. The Company is not again seeking to collect that expense now. The Company is using the LIRA write-offs as part of the measure of historic write-offs, in fact, experienced. Since LIRA is a continuing program, we find that it is consistent to anticipate test year write-offs which include the LIRA expense. We further find that the Company is not requesting current ratemaking treatment for a deferred expense from a prior period.

The LIRA program, which we approved, attempts to more accurately reflect the limited value of low income arrearages by granting earned forgiveness, while maximizing current payments to prevent future arrearages in order to better limit or reduce the Company's uncollectible expense. We share view of the ALJ that, in the Columbia Gas **[*184]** case, *613 A.2d 74 (Commonwealth Court 1992),* aff'd *636 A.2d 627 (1994),* the Commonwealth Court required ratemaking recognition forgiveness on acting accounts, thus reversing the Commission. Based upon the foregoing discussion we will adopt the recommendation of the ALJ. Accordingly, the OTS Exception is denied.

9 (b) Franklin Steel Arrearage

In supplemental direct testimony, NFGD witness Ring proposed a three-year expense amortization ($ 73,598/year) for a purported uncollectible accounts expense of $ 220,795 related to arrearages of Franklin Steel. NFGD Stmt. No. 107-A. This $ 73,598 annual expense for three years would be in addition to the Company's claimed uncollectible accounts expense of $ 3,323,514 (exclusive of the Sharon Steel amortization) and the $ 123,640 expense attributable to the Sharon Steel amortization. [16] NFGD Ex. 104-A-2 (update as of July 19, 1994).

OTS witness Mr. **[*185]** Maher presented testimony in opposition to allowance of the Franklin Steel amortization at this time. OTS Stmt. No. 2, pp. 3-5. Originally, Mr. Maher believed that Franklin Steel might remain a customer of NFGD and that the account might not be judgement proof. However, the ALJ noted that given Mr. Ring's rebuttal

[16] OTS does not dispute NFGD's claim of $ 123,640 for the Sharon Steel amortization because this was agreed to in a prior stipulation at R-00932548. OTS' uncollectible accounts expense adjustment, as reflected in its Appendix tables, reflects the Sharon Steel amortization allowance.

testimony concerning this account, it appears unlikely that Franklin Steel will again be a customer of NFGD. NFGD Stmt. No. 207, pp. 9-12. Also, the ALJ noted that while it is possible that NFGD may recover on the Franklin Steel debt, that possibility likewise seems remote. However, Mr. Maher also recommended denial of current recovery of the Franklin Steel arrearages due to a timing factor. OTS Stmt. No. 2, p. 5.

According to NFGD, the two Franklin Steel accounts were "finalized", due to shut-offs, in April 1994. NFGD Stmt. 106-A, p. 3; N.T. 972. As testified to by Mr. Ring, NFGD normally makes uncollectible account write-offs after a final bill is 12 months old. NFGD Stmt. No. 207, p. 13. Therefore, NFGD points out, the Franklin Steel arrearage would not normally appear in the net write-off column, as shown on NFGD Exhibit 104-A-2 (updated), for purposes of calculating **[*186]** NFGD's uncollectible accounts expense for ratemaking purposes, until April 1995. N.T. 972-973. NFGD argues that this contention by OTS is based upon a misunderstanding of uncollectible accounts expense and the manner in which it is calculated for ratemaking purposes. The ALJ agreed with NFGD's argument. The ALJ continued that the OTS confuses the write-off with the expense (See, e.g. N.T. 716-19). The ALJ adopted the Company's argument that although it routinely waits one year to write off an uncollectible account, the write-off is different from the expense for ratemaking purposes, and there is no reason to delay recognition of the expense for ratemaking purposes. (R.D. at 111).

As explained by Mr. Ring, the accrual per books equals the expense for ratemaking purposes. Both are calculated in the same manner. A ratio of historical net write-offs to historical revenues is applied to pro forma revenues, in order to calculate a level of expense that is representative of current operations. An exception to the general procedure for calculating uncollectible accounts expense for ratemaking purposes and the accrual per books is applied to large industrial customers. The Company argued **[*187]** that it has not attempted to establish "normal" levels of uncollectible accounts for large industrial customers for ratemaking purposes. Instead, such large uncollectible accounts are amortized over a period of time short enough not to unduly delay recovery but long enough to avoid unreasonable distortion of uncollectible accounts expense (St. No. 207, pp. 13-14). It is the Company's position that because the uncollectible accounts expense in ratemaking is intended to be representative of current levels of expense, there is no reason to delay recognition of large uncollectible accounts for ratemaking (See, e.g., St. No. 107, p. 1 and St. No. 107-A, p. 1; N.T. 966-67).

The ALJ concluded that NFGD's request for a three-year amortization of the Franklin Steel arrearages should be granted at this time (R.D. at 112). No party filed exceptions to the ALJ's resolution of this issue. Therefore, we will adopt the ALJ's recommended resolution of this issue as our own action.

10. Disallowance Of Deferred Post-Retirement Benefits Costs.

NFGD has claimed $ 4.38 million in costs associated with post-retirement benefits other than pensions ("PBOPs" or "OPEBs") computed based upon Financial **[*188]** Accounting Standard No. 106 ("SFAS 106") issued by the Financial Accounting Standards Board ("FASB"). These costs include health care and life insurance benefits for the Company's retirees. The OCA has submitted testimony in this case, as it has in the past, that ratemaking allowances for OPEBs should reflect the Company's actual cash expense to provide such benefits, or the pay-as-you-go level of the Company's obligation, and not the SFAS 106 level of expense. OCA St. 3 at 27-33. The pay-as-you-go amount in this case is $ 867,012. OCA St. 3 at 28.

Despite the OCA's position that OPEBs should be included in rates at the pay-as-you-go level, the OCA recognizes that the Commission has determined in other cases to allow the SFAS 106 level of expense and has issued a Policy Statement indicating its intent to allow rate recovery based upon SFAS 106. The Commission's determination in that respect is currently on appeal in connection with the Commission's decision in the matter of Pennsylvania Public Utility Commission v. Pennsylvania American Water Company, R-922428, slip op. (April 21, 1993). [17] Consequently, the OCA has not made a specific adjustment to disallow the entire difference **[*189]**

[17] The ALJ pointed out that on June 7, 1994, Commonwealth Court affirmed the Commission's decision to allow recovery of the SFAS 106 level of expense. Popowsky v. Pennsylvania Pub. Util. Comm'n, 1188 *C.D. 1993,* slip op. (June 7, 1994). ALJ Kashi

between the pay-as-you-go amount and the SFAS 106 amount. Instead, noted the ALJ, OCA witness Mr. Cotton has made two recommendations. OCA St. 3 at 31-33. First, Mr. Cotton has recommended that the SFAS 106 amounts be allowed in rates subject to refund for the difference between the SFAS 106 and pay-as-you-go amount. He explained as follows:

Assuming the Company funds its OPEB liability and the Commission were to grant such rate recovery, and if as a result of a final resolution of these other pending cases (including further review by the Supreme Court of Pennsylvania), it is finally determined that the Commission erred as a matter of law or exceeded its discretion in allowing recovery of OPEB costs calculated in accordance with FAS 106 and if amounts recovered by other utilities in such cases are required to be returned to customers or credited to customers through use of the amounts to fund future OPEB expense, the Company should be obligated to return to customers amounts consistent with that final resolution.

[*190]

OCA St. 3 at 31-32.

Second, based upon advice of counsel, Mr. Cotton recommended that $ 91,438 in FAS 106 costs accrued from October 1993, when the Company adopted SFAS 106, to December 1993, the date new rates went into effect should be disallowed in accordance with the Commonwealth Court's decision in Popowsky v. Pennsylvania Public Utility Commission, 1315 *C.D. 1994,* slip op. (May 26, 1994) ["PP&L Case"]. [18] In that case, argues the OCA, Commonwealth Court held that the Commission could not pre-approve expense amounts for allowance in a future rate case. According to the OCA, the Company's inclusion of $ 91,438 related to the period prior to the Commission's approval of its SFAS 106 claim would constitute such improper pre-approved ratemaking and should be disallowed.

The OCA asserts that continued rate recovery, and trust deposits, for the remaining years of the five year recovery period for these OPEB costs is prohibited by the Commonwealth **[*191]** Court's decision in PP&L. NFGD argues that PP&L is readily distinguishable from the situation involving the Company. NFGD M.B. 101 - 102. NFGD continued that PP&L concerned Pennsylvania Power and Light Company's filing of a Petition for Declaratory Order with the Commission, seeking authority to record, as a regulatory asset, incremental OPEB costs incurred beginning January 1, 1993. According to NFGD, the Commission granted PP&L's request, and assured PP&L that all amounts recorded as a regulatory asset would be recoverable in PP&L's next rate case. NFGD argued further that PP&L indicated that its objective was to not file a rate case until the 1994-1995 time frame. *(642 A.2d at 650 n.5).* Thus, NFGD concluded that PP&L immediately began to deposit the amounts deferred as a regulatory asset into trusts. On review, said the OCA, the Commonwealth Court reversed the Commission's guarantee of future rate recovery of the deferred costs.

NFGD argues that the OCA's reliance on the PP&L case is misplaced. NFGD sees as critical to the Court's determination in the PP&L case the fact that PP&L sought to defer rate recovery of OPEB costs instead of immediately filing for **[*192]** rate relief. NFGD proffers the following cite:

PP&L could have recovered those costs had it filed a rate case rather than a request for declaratory order.

PP&L, supra, 642 A.2d at 652.

NFGD argues that the Court's conclusion that PP&L could have recovered its costs if it had filed for rate relief immediately confirms the propriety of Distribution's recovery of the costs challenged by the OCA. In Rebuttal Testimony, Company witness Smyczynski argued that the OCA's proposed adjustment should be rejected because

also pointed out that on July 7, 1994, the Office of Consumer Advocate filed a Petition for Allowance of Appeal with the Supreme Court of Pennsylvania at 309 Allocatur Docket 1994.

[18] The ALJ noted that Petitions for Allowance of Appeal to the Supreme Court of Pennsylvania were filed in that case by the Public Utility Commission and Pennsylvania Power and Light Company at No. 0294 M.D. Allocatur Docket 1994.

the Company's claim is distinguishable from that made in the PP&L case. NFGD St. 215 at 4. Specifically, he contends that NFGD made its claim for rate recovery as soon as possible after the FASB's Emerging Issues Task Force (EITF) indicated its Consensus Opinion identifying the requirements for accounting for OPEB costs by rate-regulated enterprises. Id. In particular, the EITF issued its opinion in January, 1993 and NFGD filed a rate case in March, 1993 with a future test year end of December 1993.

Despite Mr. Smyczynski's arguments, the facts are clear that NFGD deferred for later recovery amounts recorded on its books between October and December, 1993. These **[*193]** were not amounts that were extraordinary in nature or fit into an exception to the prohibition against retroactive ratemaking and they should, therefore, be denied.

Mr. Smyczynski also argues that cash payments into the trusts were not made in October and November, 1993, even if these amounts were recorded on the Company's books. NFGD St. 215 at 5. the OCA submits that, with accrual accounting, it is wholly irrelevant when the amounts were paid into the trusts. These amounts were recorded on the Company's books as incurred during October and November and it would be retroactive ratemaking to provide for their recovery after those dates.

Finally, Mr. Smyczynski argues that the capitalized portion of these costs are recovered over the life of the property constructed and therefore should not be disallowed. Id. With respect to this argument, the OCA submits that simply because a cost was capitalized does not make it a current cost. Only the amount that has not been depreciated represents a current cost of service and should be allowed. The Company, according to the OCA, has failed to demonstrate what portion of the capitalized OPEB costs that were deferred represent current costs. **[*194]** Consequently, the OCA urges that Mr. Smyczynski's argument be rejected.

The ALJ made the following disposition of the issue:

The OCA submits, and we agree, that the Commission should determine, as recommended by the OCA witness Cotton, that NFGD's entire claim for FAS 106 expense is subject to refund as the result of pending appeals. Further, the Commission should specifically disallow $ 91,438, which represents deferred FAS 106 costs. OCA St. 3, Sch. 10 (Revised). Of this amount, $ 65,909 represents amounts expensed and $ 18,178 represents amounts allocated to rate base.

(R.D. at 117).

In its Exceptions, the Company argues that the ALJ recommends disallowance of the second year of a five-year amortization of initial OPEB costs previously approved by the Commission. NFGD continues that the ALJ incorrectly concluded that continued recovery constitutes retroactive ratemaking, when he cited *Popowsky v. Pa. P.U.C., Pa. Commonwealth Ct. 642 A.2d 648 (1994).* The Company concluded that the ALJ's recommendation is premised upon the incorrect assumption that NFGD is amortizing past costs. According to NFGD, the amortization of these costs was begun at the conclusion of Distribution's **[*195]** 1993 rate case, which was based upon a future test year ended December 31, 1993. The OPEB costs, says the Company, were accrued in the months of October and November 1993, which the Company asserts were within the future test year in that proceeding. Thus, the Company concludes that under such circumstances, the ALJ incorrectly recommended disallowance of these costs by asserting that the costs were past costs, which should have been claimed previously. Additionally, the Company claims that in Pa-American a virtually identical five-year amortization of future test year OPEB costs was approved by the Commission, and the Commission's decision on the issue was affirmed by the Commonwealth Court. NFGD urges similar treatment here. (NFGD Exceptions at 26-27).

The Company concludes by urging the rejection of the ALJ's recommendation of an ongoing refund obligation with respect to pending court challenges to the Commission's approval of trust accounting for OPEB's. It is the view of NFGD that the OPEB mechanism established in NFGD's 1993 rate proceeding sets forth a complete mechanism for treatment of OPEB costs in the unlikely event that the Commission's decisions are reversed. (NFGD **[*196]** Exceptions at 27).

In its Reply Exceptions, the OCA repeats that the Commission should not allow the Company to continue to recover through an amortized expense, a portion of OPEB costs which it incurred between the date of adoption of SFAS 106 in October 1993 and the date of implementation of rates stated in accordance with SFAS 106. The OCA continues that the Commonwealth Courts decision cited by the OCA prohibits rate recognition of deferred ratemaking claims, absent a showing that they meet the other criteria for recognition of retroactive claims. The OCA states that the ALJ noted that the facts were clear that the amounts were recorded for later recovery, and were not extraordinary in nature and did not fit into an exception to the prohibition against retroactive ratemaking and should be denied. (OCA Exceptions at 16-17).

Upon consideration of the positions of the parties, we are constrained to reject the reasoning and recommendation of the ALJ and, consequently, grant the Exceptions of the Company. We agree with NFGD that the amortization for which it now seeks recovery was approved in its previous rate case and for that reason meets the criteria required for recognition. **[*197]** Accordingly, the Company's Exception is granting, and the instant claim is not barred by *Popowsky v. Pa. PUC, supra.*

11. Research, Demonstration and Development Expense

NFGD has included a claim of $ 241,000 for Research, Demonstration and Development ("RD&D") costs in its projected future test year. According to NFGD witness Sprague, NFGD's RD&D programs have as their principal goal "to attempt to make certain that customers' investments in gas-consuming appliances and equipment will be beneficial and that their expectations will be at least met, if not exceeded." NFGD St. 212 at 7. Mr. Sprague described the primary purpose of its RD&D program as follows:

The primary purpose of Distribution's RD&D program is the identification, development and demonstration of new products, processes and devices which will utilize natural gas in an efficient manner and provide service to the customer at the least overall cost.

Id. at 8

OCA witness Cotton recommends that the Company's pro forma test year research and development expense claim be reduced by approximately 33%, or by $ 83,860, to reflect the historical trend of actual to budgeted research and development expenses. OCA **[*198]** St. 3 at 79, Sch. 26. The ALJ noted that Schedule 26 was updated to an adjustment of $ 79,530 to reflect NFGD's final claim. The proffered the following schedule to summarize the history of budgeted to actual expenditures for RD&D:

Year	**Budget**	**Actual**	**Percentage**
1989	$ 218,125	$ 193,871	89%
1990	$ 366,505	$ 199,495	54%
1991	$ 382,971	$ 140,979	37%
1992	$ 298,489	$ 286,958	96%
1993	$ 285,131	$ 223,399	78%
	$ 1,551,221	$ 1,044,702	67%

OCA St. 3 at 78; OTS-RE-55.

In NFG 1990, according to the OCA, the Commission had occasion to address a similar claim for Research, Development and Demonstration expenses. NFG 1990 at 587-588. As in this case, the OCA recommended an adjustment of this expense because recent spending history demonstrated that NFGD had not ever approached spending 50% of its budget. Id. at 588. The OCA proffered the following cite from NFG 1990 to assert that Commission noted, in that proceeding, that R&D expense is difficult to accurately predict:

The difficulty in accurately projecting RD&D expense is attributable to several root causes: namely, the nature of RD&D itself, variations in the level of expense due to the type **[*199]** of product being developed, and lack of sole control over co-operator projects.

Id. at 587.

Here, Company witness Sprague testified about the difficulty of predicting actual RD&D costs. Mr. Sprague testified as follows:

In the past, at times, budget exceeded actual costs principally because 1) certain projects took longer to materialize than expected, such as the development of the Globoid Compressor, and 2) certain projects, like the Phase IV Linde Absorption Project, were canceled. Recognizing that predicting a time schedule for technology advancement is difficult, we stopped trying to base our budget on predictions of future projects.

NFGD St. 212 at 6.

NFGD's response to the unpredictability of actual RD&D costs was to simply use last year's actual experience, adjusted for inflation. Id. at 6-7. In NFGD 1990, according to the OCA, the Commission adopted the ALJ's recommendation to disallow 36% of the Company's claim:

The ALJ has concluded, from the evidence presented, that Distribution's current budgeted RD&D expense is overstated. He observes that, historically, Distribution has not been able to achieve even 50 percent accuracy in its projections.

Id. **[*200]**

In this case asserts the OCA, NFGD has, again, overstated its RD&D expense. Even utilizing the actual past year's RD&D expense does not take into consideration the significantly lower percentage of historic actual to budgeted RD&D expenses. Clearly, argues the OCA, it's adjustment more accurately reflects the RD&D future test year expense.

Alternatively, Mr. Cotton recommends a total disallowance of these costs since there is a question "as to why ratepayers should be required to fund Research and Development." Id. The OCA submits that the Company has not shown that ratepayers will benefit from these projects. Mr. Cotton testified as follows that these costs cannot be justified for ratemaking purposes:

The expenditures are providing no current benefits to ratepayers and, as far as we know, ratepayers are receiving no substantial royalties or other payments as a result of research and development costs charged through rates.

Id. at 79.

NFGD contends that the OCA's alternative proposal for the RD&D program, to "throw the whole thing out," is based upon its misperception that the RD&D program may not benefit ratepayers. NFGD responded to this contention at pages 7-16 of **[*201]** Statement No. 212. There, NFGD explained in greater detail the nature of and reasons for its RD&D program:

Distribution's RD&D program concentrates its efforts on the final development state of new products and appliances. In this stage, a specific design is chosen and subjected to extensive field testing in an operating environment. Emphasis is placed on reduction of production costs, the reliability and efficiency of performance in real world conditions. The goal of this stage of development is a pre-production prototype -- a thoroughly engineered model with costs and performance that are known under laboratory conditions, built by a production organization.

St. No. 212, p. 8.

Distribution then provided examples of current RD&D projects for the residential, commercial, industrial and company operation components of its RD&D program. For each example, specific benefits to customers or to company operations, which will benefit customers, are provided (St. No. 212, pp. 8-16).

In rebuttal testimony, Mr. Sprague provided general descriptions of the types of RD&D projects sponsored by NFGD and examples of a few actual projects. NFGD St. 212 at 12-16. For example, the Wave Air Heat **[*202]** Pump project is a residential RD&D project that provides financial assistance to Wave Air Corporation to develop a solid absorption gas fired heat pump. NFGD St. 212 at 12. Mr. Sprague testified that Distribution does not reserve a royalty on these RD&D projects and, hence, there is no return on the Company's investment. N.T. 1106. Mr. Sprague stated that the Company has no intention of selling any of the products for which they provide funding. N.T. 1107. Distribution explained also that the real purpose of its RD&D program is to produce information for customers' benefit:

Tests which demonstrate that a technology or an item of equipment will not produce savings for customers are just as important as tests that produce positive results. Negative results indicate either that projects should be dropped or further design work is necessary. Testing produces useful information and such information benefits customers because either new products will be proven to be worthwhile and customers will have the benefit of them or products will be proven to be ineffective and customers will not waste money investing in them.

St. No. 212, page 16. The ALJ proffered the following resolution of **[*203]** this issue:

OCA's proposed adjustments to Distribution's RD&D expense are valid but the entire budget should not be rejected. The Company's future test year claim for Research, Demonstration and Development costs of $ 241,000 should not be accepted. We adopt and recommend the OCA's adjustment of $ 83,860.

(R.D. at 121-122).

The Company, in its Exceptions, criticizes the ALJ's recommendation as contravening prior Commission precedent and being duplicative of adjustments that the Company made in this case in compliance with the precedent. Specifically, the Company argues that in NFGD 1990, the Commission considered its progress for budgeting RD&D based upon projections of progress on individual projects. The Company continued that the Commission concluded that the then-existing procedure was flawed and tended to overstate actual R&DD expenditures. In NFGD 1990, says the Company, the Commission adopted the OCA proposal that the RD&D be established for ratemaking purposes based upon the historic test year plus inflation. (NFGD Exceptions at 32).

NFGD continues that in preparing its budget which is the basis of its claim in this proceeding, the Company adopted precisely the **[*204]** OCA-proposed and Commission-approved procedure of using historical test year actual RD&D plus inflation. This change, says NFGD, in budgeting procedure resulted in a claim of $ 244,000, or nearly a 22% reduction in its RD&D budgeted expense as compared to the average expense for the last five years. The Company concluded that the ALJ recommends an additional 33% reduction to NFGD's claim because past budgets overstated actual costs and ignored the change in budgeting process that was previously supported by the OCA and the Commission. (NFGD Exceptions at 32-33).

In its Reply Exceptions, the OCA states that despite the Company's argument that the OCA's methodology is different from that presented in NFGD 1990, when it adjusted is R&DD Expense, the data shows that the Company's budgeted amount continues to be overstated. The OCA adds that its adjustment is the result of additional data obtained in the interim. This, the OCA contends, suggests that the ALJ's finding should be adopted. (OCA Reply Exceptions at 20-21).

Upon our consideration of the positions of the parties, we find the Company's Exceptions to be unconvincing, with regard refuting the finding of the ALJ that the Company's **[*205]** budgeted estimates of RD&D expense is overstated. Accordingly, we deny the company's Exception and adopt the reasoning and recommendation of the ALJ.

12. Take-Or-Pay

The ALJ observed that there are two issues regarding the Company's recovery of take-or-pay costs. First, there is the question whether Distribution should include in its TOP calculation a refund based on Supply's compliance filing with FERC at Docket No. RP91-47-000. Second, the Company seeks to retain interest on take-or-pay refunds from CNG Transmission Corporation and Columbia Gas Transmission Corporation in the amounts of $ 313,351 and $ 263,522 respectively. The ALJ found that the more important of the issues is NFGD's proposal to retain refund interest and he considered it first.

NFGD is proposing to retain the interest paid by the pipelines on pipeline take-or-pay (TOP) refunds rather than flowing that interest back to its ratepayers. NFGD Stmt. No. 101, p. 7. The TOP refund interest which the Company is intending to retain in this proceeding consists of $ 313,351 in interest associated with a CNG refund and $ 263,522 in interest associated with a Columbia refund. OTS Ex. No. 2A, Sched. 11, p. 1. In addition, **[*206]** NFGD has agreed to flowback to ratepayers over two years, the principal amount of the Columbia refund (i.e. $ 673,845), which was received after the filing of this base rate case. N.T. 126. This refund must be reflected in this proceeding, regardless of the disposition of TOP interest, to offset claimed TOP expenses. OTS Stmt. No. 2, pp. 23-24.

OTS witness Maher and OCA witness Cotton presented testimony in opposition to NFGD's proposal to retain the interest on TOP refunds. OTS Stmt. No. 2, pp. 21-24; OCA Stmt. 3, pp. 3438. As stated by Mr. Maher, NFGD should only be permitted to retain pipeline refund interest, based upon the percentage of TOP costs the Company originally agreed to absorb (i.e. 0%). See, *52 Pa. Code § 69.181(i)*; OTS Stmt. No. 2, p. 23. The ALJ stated that some background information would be helpful to an understanding of this issue.

On July 21, 1988, the Commission issued for comment a Proposed Statement of Policy Regarding Recovery of Take-or-Pay Expenses by Pennsylvania local distribution companies (LDCs) at Docket No. L-880043. Comments were filed by various parties and on August 5, 1989, the Commission published its Final Statement of Policy Regarding **[*207]** Recovery of Take-or-Pay Expenses, which is now codified at *52 Pa. Code § 69.181*. See, Final Statement of Policy Regarding Recovery of Take-or-Pay Expenses, Docket No. L-880043, Order entered June 30, 1989. (R.D. at 123).

The ALJ continued that under the Final Policy Statement, LDCs were provided two options with respect to recovery of TOP costs. The first option was that if an LDC elected to absorb what the Commission considered to be a reasonable portion of TOP costs, then the non-absorbed costs would be recoverable through a Section 1307(a), 66 Pa. C.S. § 1307(a), proceeding with full reconciliation of the non-absorbed costs to recoveries. The second option was that if the Company did not elect to absorb a reasonable portion of its TOP costs, then recovery should be sought through a standard Section 1308(b) or (d) proceeding. Under the second option, recovery would be allowed on a total throughput basis rather than as a reconcilable surcharge as under Section 1307(a). (R.D. at 123-124).

The ALJ noted that NFGD elected not to absorb any portion of its TOP costs and therefore sought recovery in a 1308(d) proceeding at Docket No. R-891218. In that proceeding, continued that ALJ, **[*208]** NFGD filed for recovery of $ 35,846,333 in TOP costs plus $ 5.2 million in interest to purportedly compensate NFGD for the time value of money cost between the payment of TOP billings by NFGD and the recovery of these payments from ratepayers, through the entire amortization period. See, *Pa. P.U.C. v. NFGD, 72 Pa. P.U.C. 1, 22-28 (1989).* (R.D. at 124).

The ALJ noted that the Commission allowed NFGD the opportunity to recover 100% of its billed TOP costs as an amortized expense over (initially) five years. [19] The ALJ noted further however, NFGD's claim for interest during the amortization period was specifically rejected by the Commission. The Commission, according to the ALJ, determined that, in accordance with the Commonwealth Court decision in Butler Township, supra, it would be inappropriate to allow carrying charges on the unamortized balance of an amortized expense. In accord, *Pa. P.U.C. v. Peoples Natural Gas Company, 71 Pa. P.U.C. 135 (1989).* (R.D. at 124-125).

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[19] The ALJ noted that the amortization period was extended in NFGD's last base rate case at R-00932548 to December 31, 1996.

The ALJ noted that the Commission did allow NFGD to collect $ 232,131 **[*209]** in interest for the period of October 21, 1988 through November 3, 1989 only (which was prior to the start of the TOP amortization). See, *52 Pa. Code § 69.181(n)*. The purpose of this interest allowance, according to the ALJ, was to compensate the LDC for the period of time during which the Commission was deliberating on its Final Statement of Policy. See, *72 Pa. P.U.C. 1, 27 (1990).* (R.D. at 125).

The ALJ opined that in the instant proceeding, NFGD is, in effect, again requesting that it be permitted to charge interest to ratepayers during the TOP amortization period. The Company has characterized its proposal to retain refund interest as being based upon its contention that it has borne the time value of money cost which was intended to be compensated by the TOP refund interest paid by the pipelines. This time value of money cost, in the Company's view, is the result of the lag between the payment by NFGD of the TOP billings and the recovery of this payment from ratepayers. N.T. 1011. By retaining this interest, the Company is compensating itself, in contravention of the express decision of the Commission at R-891218, that there would be no interest compensation for the lag **[*210]** between payments and recoveries during the amortization period.

The OTS/OCA position is that the Company's proposal is also not in accord with the Commonwealth Court holding in Butler Township, supra, because it provides for the payment of interest on the unamortized balance of an expense.

Also, the OTS and OCA note that NFGD does not link a particular ratepayer payment to a particular TOP bill, so it is possible that ratepayers have already paid NFGD for the CNG and Columbia TOP billings which are the subject of the refunds and interest in this proceeding. N.T. 1006. The OTS and the OCA point out that Ms. Brocato admitted that ratepayers should share in the interest if they have paid the principal. N.T. 1021-1023. Furthermore, Mr. Cotton testified that NFGD has not considered whether its customers have incurred their own carrying charges for the lag between the payment of a TOP charge to the LDC and the receipt of a refund of that amount in their bill, due to, e.g., a later determination by FERC that the TOP billing by the pipeline to the LDC was excessive. N.T. 1239-40. Mr. Cotton added that Customers should be compensated for this and thus, should receive a refund of the **[*211]** interest.

Finally, the ALJ pointed out that Mr. Maher noted that at least one other LDC (i.e. Peoples) has attempted to retain TOP refund interest from its ratepayers. OTS Stmt. No. 2, p. 22. Mr. Maher testified further that the Secretarial Letter, at Docket No. M-00930492, the Commission initially denied Peoples' proposal to retain all the interest and instead, permitted Peoples to retain 10%, consistent with the percentage of TOP costs which Peoples had initially elected to absorb under the Commission's TOP recovery options. Id. at 22; OTS Ex. No. 2A, Sched. 8. NFGD added that Peoples filed a Complaint against this ruling at Docket No. C-00945601, and evidentiary hearings were held. NFGD Stmt. No. 201, pp. 9-10.

The OTS continued that on July 25, 1994, ALJ Gesoff issued a Recommended Decision on, inter alia, the Peoples' Complaint at Docket No. C-00945601. ALJ Gesoff agreed with the OTS position and ruled that Peoples should be required to flowback 90% of the TOP refund interest to ratepayers, consistent with that utility's original absorption of 10% of its TOP liability. SeeRecommended Decision of ALJ Gesoff in Pa. P.U.C. v. The Peoples Natural Gas Company, R-00943028 **[*212]** et seq., R-00945601, issued July 25, 1994, pp. 147-150. [20]

The OTS noted that NFGD elected to absorb 0% of its TOP costs and instead, sought full recovery of those costs through a base rate filing. OTS M.B. at 63. The OTS continued that the *Commission's Final Statement of Policy Regarding Recovery of Take-or-Pay Expenses, supra,* now codified at *52 Pa. Code § 69.181*, states (at § 69.181(i)) that, in the case of an accepted offer by a utility to absorb a reasonable portion of TOP costs, if TOP refunds are approved by FERC after TOP recovery from ratepayers has begun, the recovery surcharge will be recomputed to reflect the refunds based on the percentage that the costs have been allocated between the company and its customers. The OTS argued that Commission's Secretarial Letter, referenced above, cited § 69.181(i) in allowing Peoples to retain 10% of the TOP refund interest since that Company had initially absorbed 10% of its TOP costs.

[20] By Opinion and Order entered September 30, 1994, Peoples' Complaint at C-00945601 was dismissed.

The OTS noted that ALJ Gesoff also cited § 69.181(i)) in his Recommended Decision, as providing for the retention by Peoples of only 10% of **[*213]** TOP pipeline refunds. [21] In the instant case, argued the OTS AND OCA, NFGD should receive 0% of the interest and 100% should be flowed back to ratepayers, because NFGD elected, in 1989, to absorb 0% of its TOP costs. The ALJ concluded as follows:

For all the above reasons, Mr. Maher's adjustment to NFGD's TOP claim is proper and in accord with Commission policy and case law. Accordingly, we recommend that it be adopted. The adjustment, which would be reflected over the two years remaining in NFGD's TOP amortization, is a reduction of $ 625,359 (inclusive of the Columbia refund of principal), as reflected in the OTS tables.

(R.D. at 128).

In its Exceptions, NFGD points out that the ALJ's recommended adjustment consists of a two-year amortization of $ 673,845 in principal refunded by Columbia Transmission and $ 576,873 in interest by upstream pipelines. According to the Company, the $ 673,845 amortization of the TOP refund from Columbia Transmission is incorrect because NFGD's final claim in this proceeding already incorporates this refund. Thus, NFGD assets the ALJ's adjustment must be reduced by $ 336,923 to correct this double counting. (NFGD Exceptions at **[*214]** 27-28).

The Company continues that the ALJ's recommendation for it to flow back interest payments from pipeline suppliers should also be reversed. The Company argues that the ALJ erred in relying on Section 69.181(a) of the Commission's TOP Policy Statement, *52 Pa. Code § 69.181(a)*. NFGD repeats that this section relates only to a 1307(a) recovery mechanism, wherein a utility has agreed to absorb a percentage of TOP costs in exchange for a fully reconcilable surcharge mechanism. NFGD states that its recovery of TOP costs is pursuant to Section 1308(d) of the Code, because it did not agree to any percentage absorption of interest, and the Commission must consider the actual facts and circumstances involving its TOP recovery. (NFGD Exceptions at 28).

The Company excepts to the ALJ's conclusion that the ratepayers have incurred carrying charges for TOP costs and must be compensated by passing back pipeline interest payments. The Company continues that the ALJ relies on a statement of an NFGD witness that ratepayers should share in interest if they have paid TOP principal. According to NFGD, however, review of its witness' testimony and exhibits clearly demonstrates that the interest **[*215]** at issue in this proceeding should not be refunded precisely because ratepayers have not paid the TOP principal that is being refunded. Additionally, the Company asserts that no party challenged by way of testimony or alternative calculations that the supplier refunds have been used to reduce, but not eliminate, the unrecovered balance of TOP costs, remaining to be paid by NFGD's other customers. (NFGD Reply Exceptions at 28-29).

NFGD continues that its situation is clearly distinguishable from that in Peoples, supra, wherein it refunded the pipeline supplier refunds to its ratepayers as a result of prior overcollections of TOP costs. In contrast with Peoples, NFGD insists that the interest it received related to pipeline refunds which clearly involved NFGD's funds, not ratepayers' funds. Thus, reasons the company, it is entitled to retain all interest. NFGD concludes that the ALJ's contention that it is seeking to charge interest to ratepayers is also incorrect. NFGD says it is seeking only to retain interest payments that are for compensation for the use of shareholders' funds. Finally, NFGD asserts that retaining interest refunds from pipelines as compensation for a cost **[*216]** incurred by the Company that were never paid by ratepayers is not equivalent to charging costs to such ratepayers. (NFGD Exceptions at 29).

In its Reply Exceptions, the OCA counters NFGD's argument that the ALJ's interpretation of Section 1307(a) of the Code is incorrect. The OCA states that the Policy Statement at *52 Pa. Code, § 69.181* is very clear in limiting base rate recovery to an amortization with no provision for true-up and requiring considerations of refunds in "a future rate proceeding." The OCA adds that it is also very clear that interest is limited to the time period from October 21,

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[21] Id.

1988 through November 3, 1989, regardless of the forum in which the costs were sought to be recovered. (OCA Reply Exceptions at 18).

The OCA countered the Company's allegation that the ratepayers have not incurred carrying charges associated with the time lag between the time that they made payment of top costs to NFG and the time that they received refunds is also in error. The OCA continues that the Company's argument is based upon the improper assumption that take-or-pay costs were covered by shareholder, not ratepayer funds, and therefore, ratepayers could not have incurred carrying **[*217]** costs. The OCA continues that given the Company's election to recover those costs through a base rate proceeding, rate payers must be deemed to have paid the full amount of take-or-pay costs for purposes of returning the refund. (Id.).

In its Reply Exceptions, the OTS agrees with the Company regarding the $ 673,845 in principal refunded by Columbia Transmission that the amount has already been reflected in NFGD's final claim. However, the OTS asserts that NFGD has refused to flow back to ratepayers the $ 576,873 in interest paid by Columbia and Consolidated Natural Gas on certain TOP refunds. The OTS continues that NFGD proposes to retain all future TOP refund interest as well. The OTS opined that the ALJ correctly ruled in accordance with prior decisions in policy that NFGD must flow back 100% of the interest to the rate payers. (OTS Reply Exceptions at 15-16).

The OTS countered the Company's attempt to distinguish this proceeding from the Peoples proceeding cited supra. The OTS noted that in Peoples the utility was ordered to flow back 90% of TOP refund interest to ratepayers, consistent with Peoples initial absorption of 10% of its TOP costs. The OTS continues **[*218]** that while NFGD claims that Peoples refunded the interest to ratepayers because of prior overcollections of TOP costs from ratepayers, the Commission Order directing that these refunds be made did not decide the refund issue on this basis. Instead, says the OTS, the Commission ruled that *52 Pa. Code § 69.181(i)* provide for an equitable sharing of refund interest based upon the percentage that the utility had originally elected to absorb, in that particular case, 90%. Thus, the argument of the OTS is that Peoples should control in the case before us. Thus, urges the OTS, NFGD should be directed to refund all interest to ratepayers, since NFGD did not agree to absorb any of its take or pay costs. (OTS Reply Exceptions at 17).

Upon our careful consideration of the positions of the parties, we find the interpretation of the OTS of the TOP policy statement correct regarding the amount of interest that should be flowed to ratepayers. We agree that Peoples is controlling herein. Therefore, we conclude that NFGD must refund all of the refund interest to its ratepayers, as the refund interest should be refunded in the same proportion as TOP costs are absorbed as the 90%/10% as in **[*219]** Peoples. Further, we agree with the following comment by the OTS in its Reply Exceptions:

". . . NFGD contends that *52 Pa. Code § 69.181(i)* of the Commission's TOP policy statement does not apply to NFGD because that section only applies to utilities (such as Peoples) which have agreed to absorb a reasonable percentage of TOP costs. NFGD's argument is nonsensical. Obviously, the Commission wanted to encourage utilities to absorb some TOP costs and therefore provided an equitable sharing of refunds (and interest) for those utilities which had absorbed some TOP costs. It would be incongruous for the Commission to reward non-absorbing utilities, such as Peoples, supra, to flow back 90% of TOP refund interest to ratepayers (consistent with Peoples' initial absorption of 10% of its TOP costs). (Emphasis in original).

(OTS Reply Exceptions at 17).

Finally, we note, as did the OTS that a double counting of the TOP refund from Columbia Transmission exists in the computation of the ALJ's computation. Therefore we will correct the error by reducing the ALJ's adjustment by $ 336,923 in the manner suggested by the Company at page 28 of its Exceptions. Accordingly, we will **[*220]** grant the Exceptions of the Company to the extent of correcting the double counting, and deny the Exception in all other respects. The recommendation and reasoning of the ALJ is adopted to the extent consistent with the foregoing discussion.

13. Corporate Charges

NFGD provides gas service to the public in northwestern Pennsylvania and in western New York (NFGD Ex. No. 26). Because its service territory is divided by a state line, and portions of its service territory are subject to regulation in different states, NFGD is divided into a Pennsylvania Division and a New York Division.

NFGD testified that in order to operate efficiently and avoid wasteful duplication of function, certain functions are handled for both the New York Division and the Pennsylvania Division by a single group of people (St. No. 205, p. 33). The Company noted that, these common groups are located in the largest city in its service territory, which is Buffalo, New York. Because these common groups provide services to both the Pennsylvania and New York divisions, NFGD submits, it is only fair and proper that the expenses of these groups are shared by both divisions. NFGD M.B. at 129. The Company reasons **[*221]** that because the groups are situated in Buffalo, New York, the New York Division charges the Pennsylvania Division a share of the common service. NFGD M.B. at 129.

The OCA has challenged certain of these intra-corporate charges as being unjustified "affiliate" charges. OCA St. No. 3, pp. 54-57, OCA M.B. at 94-106.

The OCA argues that the Pennsylvania Division of NFGD claims "affiliate" charges, including corporate charges from the New York Division, in the amount of approximately $ 2.85 million for the historic test year ending November 30, 1993. NFGD Exh. 4-F, pps. 15-16. Of the total affiliate charge of $ 2.85 million, $ 652,362 are direct charges for Administrative and General ("A&G") services from NFGD's affiliates. OCA St. 3, OCA M.B. at 94. These direct charges include the costs associated with approximately 17 departments of the New York Division such as Government Affairs, Public Affairs and Public Relations, and Market Research, called "common departments." OCA Cross Exam. Exh. 4. The charges associated with these departments are allocated based upon a predetermined allocation factor. Id. It is these A&G services from the New York Division that OCA challenges. OCA M.B. **[*222]** at 96.

The OCA argues that to support its claim for corporate charges and to be consistent with the legal requirements for proof of such costs, that Distribution must provide answers to the following queries:

(1) is the service needed to provide safe and adequate utility service, (2) is the service being provided at a cost no greater than it could be obtained from a third party, and (3) is the service needed for this entity's service territory.

OCA St. 3 at 56.

OCA argues that Section 2102 of the Public Utility Code, which governs affiliated interest contracts, requires that the utility show (1) that the affiliate charges are not in excess of the reasonable price for furnishing such services and (2) that such amounts are reasonably necessary and proper. The burden to prove these points is upon the utility. OCA concludes that NFGD did not carry its burden of proof on this claim, and proffered the following testimony of Mr. Cotton in support of that conclusion:

The information received so far has been sketchy at best. There have not been any substantive descriptions of the functions provided for Pennsylvania Division in the filing; for example, the latest information describes **[*223]** activities at corporate headquarters in New York in cryptic ways. . . . In addition, at the time of cross-examination, the Company's witness in this area was not intimately familiar with the activities and functions for which Pennsylvania is being charged. . . . We do not believe it is good regulation to accept less support for divisional charges from New York Division than for expenses claimed by a utility over which it has total control.

OCA St. 3 at 55-56 (Emphasis added).

The ALJ noted that OCA witness Cotton recommended a disallowance of $ 213,382, which is the sum of the corporate charges for the four departments identified in his testimony, because NFGD has failed to provide detailed information on these functions and has failed to adequately support the need for these services. OCA St. 3 at 54-57.

The OCA submits that mere general descriptions do not approach the Company's burden of proof for this claim under Section 2102. Section 2102, argues OCA, places the burden of proof for these kinds of transaction upon the utility to show that affiliate charges are reasonably necessary and proper and not excessive.

The OCA then cites a number of cases for the proposition **[*224]** that inter-company charges must be scrutinized with care under Section 2102 of the Public Utility Code. *Johnsonburg v. Public Utility Commission, 98 Pa. Super. 284, 291 (1929); Chambersburg Gas Co. v. Public Service Commission, 116 Pa. Super. 196, 226, 176 A. 794 (1935).* Further, the OCA set forth the well-recognized principle that the public utility seeking the rate increase must prove that the expenses paid to the affiliate were for services which were reasonable and proper, and that such amounts paid were not in excess of the reasonable cost to the affiliate of furnishing the services. *Solar Electric Co. v. Pa. P.U.C., 137 Pa. Super. 325, 373-374, 9 A.2d 447, 472-473* (1939) OCA M.B. at 98. See also, *Berner v. Pa. P.U.C., 177 Pa. Super 19 (1954),* rev'd and remanded, *382 Pa. 622, 116 A.2d 738 (1955).* In that case, the Court held that, under the standard expressed by *Solar Electric, supra,* the evidence presented by the utility concerning the charges related to inter-affiliate services, rental charges and purchases did not support the findings of the Commission and it thus remanded the case. *Id. 382 Pa. at 634, 116 A.2d at 745.* OCA M.B. at 99.

The OCA then **[*225]** goes on to cite the Pennsylvania Commonwealth Court where it has upheld Commission orders disallowing expenses related to affiliated charges where there was inadequate support as to the reasonableness of the claims and the need for the services related thereto. *Butler Twp. Water Co. v. Pa. P.U.C., 81 Pa. Commonwealth Ct. 40, 49, 473 A.2d 219, 224 (1984).* The OCA concludes that NFGD's claim in this regard should be rejected.

In response to the OCA's stated concerns about the government affairs, public affairs, market research and public relations departments, Distribution provided in rebuttal, at pages 35-36 of Statement No. 205, the following explanation of the functions of each department:

Government Affairs - This department works with appropriate governmental entities and various departments within the Company to represent the interests of National Fuel and its customers. In both Albany and Harrisburg, the Government Affairs Representatives present themselves as a conduit of information between the government and the Company, and keep abreast of events and issues occurring within the capitals and interact and keep others in the Company informed.

The Government Affairs **[*226]** Department does participate in some activities better labelled as lobbying. Any expenses in this regard are charged below-the-line to Account 426.4 and are not included in the $ 64,224 expense amount claimed by the Company.

Market Research - has the following functions: First, to provide an Audit Function which insures an unbiased, balanced and quantifiable assessment of National Fuel's sales/marketing performance by collecting market share/penetration/saturation data, etc. Second, to conduct Market Analysis of National Fuel's business markets to identify areas of risk and opportunity and develop strategies to retain/increase sales and market share by conducting market segmentation, base market surveys, target market surveys, etc. Third, to collect and maintain Market Intelligence required to support the sales/marketing programs of National Fuel as well as internal market research projects by collecting market demographic/market growth/customer attitude and opinion data, etc. and integrating this data into a comprehensive Customer Database. Fourth, to provide Research Support services to all departments within National Fuel on an as-needed basis by providing Sales/Marketing Plan **[*227]** Program support, Advertising Research, statistical analysis, etc.

Public Affairs and Public Relations - Both of these departments now fall under Corporate Communications. The Public Affairs Department includes such items as the salary and business expenses of the Corporate Communications Department head as well as other miscellaneous administrative expenses of the department. Public Relations includes labor charges for media relations, advertising (including advertisement of notices required by the Commission), community relations and employee communication personnel; the cost of employee communication; and expenses associated with media relations such as press releases.

NFGD argues that the services provided by these departments help Distribution to provide efficient and safe gas service and these services are useful for the Pennsylvania Division. NFGD M.B. at 131. NFGD's witness also explained that these services are being provided at a cost no greater than they could be obtained from third parties (St. No. 205, p. 37).

NFGD argues that the OCA's contentions are in error because of their misplaced reliance on Section 2102 of the Code, 66 Pa. C.S. § 2102. NFGD R.B. at 62. **[*228]** NFGD correctly submits that the OCA devotes substantial discussion to Section 2102 of the Code related to affiliated interests and to appellate court and Commission cases dealing with affiliated interests. The Company argues that in making these contentions, the OCA ignores the facts that:

(1) The charges from the New York Division of Distribution to the Pennsylvania Division of Distribution are not affiliated interest charges because they are intra-, and not inter-, corporate charges; and

(2) that there are sound reasons for treating intra-corporate charges differently from inter-corporate charges.

Clearly, argues NFGD, the two divisions of Distribution are not affiliated interests, as that term is defined in Section 2102 of the Code, because they are divisions of the same corporation, not separate corporate entities. NFGD insists that this distinction is not a mere technicality. According to NFGD, it goes to the very essence of the reason that affiliated interests charges are held to strict scrutiny. The Company argues that as explained, inter alia, at Exhibit No. 25, page 2, NFGD engages exclusively in the gas distribution business in Pennsylvania and in New York. NFGD adds that **[*229]** all of its activities are subject to rate regulation by either the New York Public Service Commission or this Commission.

The Company argues that charges from the New York Division to the Pennsylvania Division and vice versa affect the level of costs reflected in rates but provide no opportunity for profits since charges to one division will be recognized as savings in the ratemaking process to the other division. OCA's witness agreed that there is no element of return in the intra-corporate charges within the National Fuel system (N.T. 661). Therefore, argues NFGD, the intra-corporate charges cannot provide an opportunity for an "unwarranted source of profit". Solar Electric, 137 Pa Superior Court, supra, at 374, 9 A.2d at 473. NFGD R.B. at 63.

The Company continues that, having applied an incorrect legal standard to NFGD's intra-corporate charges, the OCA continues to seek to have them disallowed by mischaracterizing them. NFGD M.B. at 63. Contrary to the OCA's contentions at pages 101-06, the Company argues that it has provided substantial explanation of the activities of the departments which the OCA has questioned and the benefits of those departments.

The ALJ reached **[*230]** the following conclusions concerning this claim:

We believe that OCA seeks to apply the wrong standard when it uses Section 2102. Clearly, the two divisions are not affiliates. We are not looking at inter-company transactions but intra-company and the distinction carries a difference. However, we are not persuaded that Distribution has demonstrated that services provided are necessary for the provision of natural gas service or provide a direct ratepayer benefit. see, *Pa. PUC v. Equitable Gas Company, 73 Pa. PUC 301 (1990).*

(R.D. at 152-153).

In support of his conclusion, ALJ Kashi cited the testimony of OCA witness Cotton as follows:

"We do not believe it is good regulation to accept less support for divisional charges from New York Division than for expenses claimed by a utility over which it has total control." (Emphasis added).

(R.D. at 153)

The ALJ observed that Mr. Higley testified that the activities provided by the Market Research Department are "simply to analyze the type of market that we have." N.T. 1221. Mr. Higley agreed that part of the function of this

Department is to develop strategies to find new customers or retain current customers. Id. Mr. **[*231]** Higley testified that the Market Research Department also provides market studies and analysis that helped the Company to "know" what type of customer it serves and to better understand the type of customers it serves. N.T. 1222. Mr. Higley testified as follows:

Q. For what other purpose other than to find new customers or retain current customers could those analyses show --

A. Beyond that is to know what type of customer that we do have and to better understand the type of customers we have.

Q. To retain them?

A. Well, to retain them, but also just to know -- to better serve them, we have to know what type of customers we do have out there. And the type of customer base does change from time to time.

Q. And the better you serve them, the more likely they'd like to continue service with you?

A. That would be correct.

N.T. 1221-1222.

In fact, found the ALJ, the Market Research Department of the New York Division provides services that aid the Pennsylvania Division in meeting competition in its service territory. Id. The ALJ found further that NFGD has not shown how these types of services function to improve the Company's load factor, thereby allowing the Company to **[*232]** recover fixed costs over a greater number of sales units. (R.D. at 154).

The ALJ observed that the Commission has held in *Equitable, supra,* that a utility should not receive ratemaking treatment of its promotional activities simply to "stave off or beat its competitors for competitive load." *Equitable, 73 Pa. PUC at 328.* The ALJ continued that in response to Equitable's contention that these promotional or market-related activities conferred a ratepayer benefit, the Commission also held that competition among LDCs is of no benefit to residential customers. *Id., 73 Pa. PUC at 320.* The ALJ opined that although this case involved Equitable's claims for advertising and competitive allowances, the rationale is applicable here where NFGD claims costs associated with marketing services that have the same aim as other competitive activities previously addressed by the Commission. Accordingly, ALJ Kashi recommended disallowance of that portion of the claim as well. (R.D. at 154).

The ALJ observed that Mr. Higley described the Public Affairs and Public Relations Department of the New York Division. He indicated that the charges from this Department:

[I]ncludes labor charges for **[*233]** media relations, advertising (including advertisement of notices required by the Commission), community relations and employee communication personnel; the cost of employee communication; and expenses associated with media relations such as press releases.

NFGD St. 205 at 36.

The ALJ noted that during cross examination, Mr. Higley stated that this Department "provides shareholder information that comes from annual reports and other reports that already exist." N.T. 1223. The ALJ noted further that Mr. Higley also testified that this Department also sends out press releases that discuss the activities of employees and their families in the community. Id. Clearly, NFGD argued that at least a portion of the charges for this Department relates to shareholder services and general management expenses that are not appropriately allocated to NFGD-Pennsylvania.

The ALJ found that here NFGD has not provided detailed information on this department or the charge and has not shown how the various media and shareholder services benefit ratepayers. The charges for these services are not therefore properly allocable to NFGD's ratepayers. (R.D. at 155) See Roaring Creek Water Co., supra; **[*234]** PAWC 1990, supra; Mechanicsburg Water, supra; and Pa. PUC v. Citizens Utilities Home Water Company, Docket No. R-922209, slip op. (January 21, 1993). See also, *Pa. PUC v. Metropolitan-Edison Electric Company, 60 Pa. PUC 349 (1985)* ("Met-Ed"). In the Met-Ed case, the Company claimed expenses for media communication costs that involved lobbying for legislative or political action. *Id., 60 Pa. PUC at 382.* The ALJ continued that the Commission denied the Company's claim because there was no evidence showing specific customer benefits. *Id., 60 Pa. PUC at 383.*

The ALJ noted that as to the Governmental Affairs Department, Mr. Higley explained that this Department serves as a "conduit of information between the government and the Company." NFGD St. 205 at 35. The ALJ noted that Mr. Higley testified as follows:

The Government Affairs Department does participate in some activities better labelled as lobbying. Any expenses in this regard are charged below-the-line to Account 426.4 and are not included in the $ 64,224 expense amount claimed by the Company.

Id.

The ALJ found that during cross examination, Mr. Higley testified that there is not a stringent line **[*235]** drawn between lobbying and non-lobbying activities, but those determinations are made by the individuals engaged in these activities:

Q. What about discussions with legislators? Would that depend on the nature of the discussion or --

A. Yes. If it was to try to influence opinion, that would be lobbying and would be charged to 426.4. But if it was to get better information on a bill or something that the company would be interested in, that wouldn't be considered lobbying.

Q. And who makes the determination how to draw that line between lobbying and non-lobbying activities?

A. The individuals themselves as they're doing the activities.

N.T. 1225.

The ALJ continued that the Commission has disallowed costs associated with lobbying for ratemaking purposes. See Met Ed, supra. The ALJ also noted that, in Met Ed, the Commission disallowed this type of expense when considering it in the context of affiliates. The ALJ found no reason to arrive at a different result in the instant matter. In Met Ed, the Commission could find no ratepayer benefit from such services. Here, the Government Affairs Department serves as a "conduit" between government and the Company. Yet, according **[*236]** to the ALJ, NFGD has failed to prove that the services provided by this Department are for other than lobbying efforts. The ALJ noted that Mr. Higley testified that the distinction between lobbying and non-lobbying activities is done on an individual basis. Thus, found ALJ Kashi, NFGD has failed to justify the recovery of this element of its corporate charge expense.

The ALJ concluded as follows:

The OCA submits, and we agree, that NFGD did not prove that the services provided by New York Division's Government Affairs, Marketing and Public Affairs and Public Relations Departments confer any benefit to ratepayers or are necessary for the provision of natural gas service. For these reasons, we recommend that NFGD's claim for corporate charge expense be rejected. We recommend that the OCA's adjustment of $ 213,382 be accepted.

(R.D. at 157).

The Company in its Exceptions disagrees with the ALJ's recommendation to disallow the expense of the Market Research Department because he considered it to be competitive. The Company argues that, in fact, the Market

Research Department provides support for the company's market research programs. Further, according to the Company the Market **[*237]** Research Department evaluates market penetration and seeks to identify market opportunities and assists in devising strategies relative to market share. (NFGD Exceptions at 30).

The Company also addresses the ALJ's disallowance of the Public Affairs and Public Relations Departments, for the reason that the there appeared to be no benefit to ratepayers from these departments. The Company contends that there can be no controversy that those departments benefit ratepayers since they deal with the public, the community, and the media. The Company continues that these are functions which all corporations must undertake as a part of normal corporate affairs. The Company says that this is illustrated by the fact that the Commission maintains offices for press relations and community relations which are funded by ratepayers through assessments on utilities. (NFGD Exceptions at 30-31).

Similarly the Company urges that the expenses of its Government Affairs Department be approved. The Company continues that the Commission has recognized that such activities, carried on by this department, conducted by utilities are proper and necessary for utilities. The Company noted that the OCA raised **[*238]** for the first time in its Main Brief an issue concerning tracking of the portion of the Government Affairs Department that is identified for lobbying. NFGD states that it does maintain records of lobbying activities, and the expenses thereto have been removed from the cost of service for ratemaking purposes, including payroll. The Company continued that the OCA has suggested that there is something improper or suspect about the use of timesheets to identify the portion of the Government Affairs Department payroll attributable to lobbying. According to the Company, individual timesheets form the basis of most intracompany charges, to which the OCA has raised no objection. The Company concludes that there is nothing improper regarding its differentiation between lobbying and non-lobbying efforts. (NFGD Exceptions at 31-32).

In its Reply Exceptions, the OCA states that the Company's arguments regarding benefits to ratepayers are clearly without merit. The OCA argues that the market research is clearly done to aid the Company in addressing competition and should be disallowed for the same reason that promotional advertising are inappropriate. The OCA continues that the Public Affairs **[*239]** and Public Relations Departments provide shareholders with information and also discusses the activities of employees and families in their communities. The OCA submits that while public relations which are directed to the benefit of ratepayers may confer some benefit, the Company has failed to show how the various media and shareholder services benefit ratepayers. The OCA concludes that the Company's argument that non-lobbying Government Affairs activities are of benefit to ratepayers is without support. (OCA Reply Exceptions at 19-20).

Upon consideration of the positions of the parties, we find that NFGD failed to demonstrate how the activities of the departments described previously provide any direct benefits to ratepayers. Accordingly, we will adopt the reasoning and recommendation of the ALJ. We will deny the Exception of NFGD.

OTHER EXPENSES

We note that the ALJ's R.D. contained the discussion and resolution of several expense items which appear at pages 89 through 98, page 128 through page 141; and page 157 through 164. We shall incorporate those specific pages of ALJ Kashi's R.D. by reference. None of the parties to the proceeding excepted to the ALJ's reasoning or **[*240]** recommendations concerning those particular issues. Accordingly, we will adopt the ALJ's resolutions as our own action herein.

VI. TAXES

A. Consolidated Tax Savings Adjustment

NFGD has included in its tax claim an adjustment of $ 41,192 to reflect the benefits of joining with non-regulated affiliates in filing a consolidated federal income tax return. Exhibit 107-H-1. This adjustment is based on losses experienced by non-regulated companies for the three years ended September 30, 1991, 1992 and 1993. The current tax rate of 35% was applied to each tax loss to obtain the tax reductive effect of the losses, and the resulting tax saving was then allocated among all subsidiaries having positive taxable income in each year. NFGD M.B., pp. 135-136.

NFGD's share of the tax savings was determined by calculating its taxable income as a percentage of total positive taxable income. There is no dispute concerning NFGD's calculation up to this point. Finally, the tax savings allocated to NFGD was allocated between its New York and Pennsylvania divisions based upon the Pennsylvania Division's taxable income as a percentage of NFGD's total taxable income. Id.

The OCA proposes a Pennsylvania **[*241]** Division consolidated tax savings adjustment of $ 196,230, or $ 155,038 more than the Company's claim. OCA witness Cotton testified that he views the consolidated tax savings as a negative expense allocation. Therefore, he allocated the tax savings to the Pennsylvania Division based on the 27.02% allocation factor used to charge common expenses between the New York and Pennsylvania divisions (OCA Statement 3, p. 73). OCA M.B., p. 138, Appendix, Schedule 27.

NFGD argues that the OCA's allocation factor should be rejected for two reasons. First, it is contrary to the procedure used by the Commission in the Company's prior case. NFGD Exhibit 216, Schedule 1, page 1 shows that the adjustment in the proceeding at Docket R-901670 was allocated between the New York and Pennsylvania divisions in the same manner as it is proposed to be allocated by NFGD in this proceeding. NFGD M.B., pp. 136-137.

NFGD's second argument is that the OCA's proposal is contrary to the concept of actual taxes paid. NFGD witness Wagner explained that a utility can be construed to benefit from tax losses of affiliates only to the extent that it has taxable income. For this reason, the concept of actual taxes paid, **[*242]** on which the consolidated income tax adjustment is based, compels allocation of losses in proportion to actual taxable income. NFGD M.B., pp. 140-141.

While recognizing that taxable income has been utilized in the past to allocate taxable losses between NFGD's New York and Pennsylvania divisions, the OCA argues that this methodology does not provide for consistency, nor does it necessarily produce an accurate estimate of the percentage of taxable income that should be imposed. The OCA contends that the question is not whether its methodology reflects actual taxes paid, but whether it is appropriate in allocating taxable income. OCA R.B., pp. 67-68.

NFGD argues that, book/tax timing differences, relied upon by the OCA to support its recommended allocation factor, are precisely the reason that taxable income must be used consistently as the allocation factor. Timing differences such as over/under recoveries of gas costs normally are reversed in one year; therefore, consistent use of taxable income as the allocation factor makes such differences irrelevant. NFGD R.B., pp. 68-69.

The ALJ found NFGD's arguments to be persuasive. He found it reasonable to consistently allocate tax savings **[*243]** on the same basis as tax expense (i.e., the relative taxable incomes of the two divisions) since it is the presence of that taxable income which allows the consolidated tax group to benefit from losses of non-regulated affiliates. The ALJ found further that it is quite probable that a general expense allocation factor is based on considerations not directly related to taxes.

No party filed Exceptions to the ALJ's recommendation on this issue. We will therefore adopt the ALJ's action as our own.

B. IRS Tax Audit

The second tax issue in this proceeding is the result of Internal Revenue Service (IRS) audits of the consolidated federal income tax returns of National Fuel Gas Company (NFGC) and its subsidiaries for the years 1977 to 1982 and 1983 to 1986. According to the Company the IRS concluded in its May 4, 1993 Revenue Agent's Report that NFGD should have: 1) calculated its bad debts expense using a five year average (Black Motor Method) instead of the reserve method; and 2) included in taxable income amounts received from customers to pay the cost of installation of service lines (NFGD Statement 16, pp. 7-9). NFGD M.B., p. 141.

NFGD witness Wagner testified that NFGD used **[*244]** the reserve method to compute bad debts expense for financial accounting and income tax purposes. Under this method, NFGD recorded an annual accrual for bad debts expense which represented the portion of current billing which, in the future, would be written off as uncollectible. (The reserve method was also used for ratemaking purposes but was based on expected write-offs for the future test year, with ratepayers having been given tax benefits equal to such expected write-offs.) Poor economic conditions in NFGD's service territory lead to escalating bad debts expense, which Mr. Wagner testified would not have been reflected by the Black Motor approach. NFGD Statement 16, pp. 7-8.

Regarding the IRS decision to treat as taxable income amounts received by the Company to cover the cost of installing connections from the Company's mains to customers' premises, Mr. Wagner testified:

The Company treated the amounts as nontaxable contributions-in-aid-of-construction under *Internal Revenue Code Section 118*. Under the proposed IRS approach, Distribution would recognize taxable income in an amount equal to the amount received from customers each year during the audit period. Such amounts **[*245]** received would be capitalized for tax purposes and depreciated over the appropriate tax lives of the assets. Thus, the taxes resulting from including these amounts in taxable income would, over time, be recovered through the tax effects of depreciation deductions.

* * *

If the amounts in question had been included in taxable income for tax purposes as proposed by the IRS, a deferred tax debit (i.e., a rate base addition) would have been necessary to properly account for the prepaid tax remitted to the IRS. By treating these receipts as nontaxable contributions-in-aid-of-construction, Distribution did not establish such a deferred tax debit since the treatment of this item for ratemaking and tax purposes was the same. The absence of a deferred tax debit resulted in a lower rate base and this, in turn, resulted in lower rates for customers.

<u>Id.,</u> pp. 9-10.

Mr. Wagner further testified that the Company's claim is "not an attempt to adjust inaccuracies in prior rate allowances but rather a request for a prospective allowance for recovery of a current assessment by the IRS resulting from a change in tax policy. To the extent that the Company's tax filing positions benefited ratepayers **[*246]** in the past, subsequent interest assessments resulting from IRS challenges should be recoverable from ratepayers as a matter of equity." NFGD Statement No. 216, p. 6. The Company continued that OCA witness Cotton confirmed that prior to the Tax Reform Act of 1986 it was not unreasonable for the Company to have taken the position that contributions by customers were not subject to income tax (N.T. 588). NFGD M.B., p. 143.

NFGD claims that it is not requesting recovery of the tax payment deficiencies found in the IRS audits because both issues involve timing differences. The audits required payment of additional taxes for the audit years but created tax deductions for the Company in subsequent years. Actual payment of the estimated audit deficiencies and related interest expense was made in 1987 to limit the further accrual of interest by the IRS. This was done even though NFGD disputed the audit findings because its cost of borrowing was less than the rate at which IRS was assessing interest. NFGD Statement 16, pp. 10-11.

What NFGD is seeking to recover is an estimated $ 1,200,000 of related interest expense and $ 130,000 in state income taxes, amortized over three years for an annual **[*247]** expense of $ 443,000. The Company is also requesting a $ 204,000 rate base addition to reflect the remaining deferred tax consequences of the contributions to service lines issue. (Since the audit adjustment relating to bad debts expense has fully reversed during the years between the audit period and the present, no rate base adjustment is necessary regarding that issue (NFGD Statement No. 16, p. 11).) NFGD M.B., p. 144; NFGD Exhibit 104-A-14.

NFGD first requested recovery of this claim in its last base-rate proceeding at Docket No. R-932548 because that was the first proceeding following the issuance of the Revenue Agent's Report which quantified the IRS assessment. As a part of a stipulation in settlement of the case, NFGD agreed to postpone resolution of this issue because it was in the process of appealing the Revenue Agent's Report. It has again requested recovery because the appeal process is progressing. Mr. Wagner testified that the Company met with an IRS Appeals Officer on July 26, 1994. Based on that meeting, he testified that it is unlikely that IRS will make any meaningful concessions to its original assessments and that it is his opinion that the matter will be resolved **[*248]** by the end of 1994 (N.T. 1191-1192). NFGD M.B., p. 145.

The OCA opposes both the Company's interest expense and rate base claim while the OTS recommends disallowance of only the interest expense portion. Both parties contend that the Company's claim is contrary to the prohibition against retroactive ratemaking and speculative as to the amount of interest due to the IRS.

OTS witness Maher testified that the adjustment is comprised totally of estimated figures (NFGD Exhibit No. 104-A-14). Mr. Maher further testified that "[i]n a rate proceeding, the tax calculation is a 'hypothetical calculation' based on pro forma revenues and expenses normalized to a future test year. As a result, the actual tax expense allowed may be substantially different than the actual taxes due on the tax return." OTS St. No. 2, pp. 15-16.

OCA witness Cotton testified that the Company wants rate recovery of this claim to reward it for past aggressive tax positions that ultimately resulted in a penalty. Base rates are not based on a true-up methodology as is suggested by the Company's request; therefore, it would be inappropriate for the Commission to make a prospective rate order to effectively correct or **[*249]** increase past rates. OCA Statement 3, p. 67.

NFGD responds that its claim is not speculative. The mere use of estimates, the Company claims, does not make its claim speculative. NFGD argues that many future test year costs are estimates; the question is whether the estimate is reasonable. NFGD claims that neither OTS nor OCA has provided any substantive criticism of the estimate or provided any basis to conclude that IRS will abandon its position. If the assessed costs are reduced by an IRS Appeals Officer, NFGD has stated that it will adjust the proposed amortization in a future base-rate proceeding. Should an over recovery of interest occur, the Company will reconcile such over recovery in a future case by offsetting such amount against recovery of other expenses (NFGD Statement No. 216, p. 5). NFGD R.B., p. 73.

NFGD further contends that this claim is not barred by the rule against retroactive ratemaking. While recognizing the general rule of law that ratemaking is prospective, NFGD has cited several cases in support of exceptions to this general rule. See Philadelphia Electric Co. v. Pa. P.U.C., 93 Commonwealth Ct. 410, *502 A.2d 722, 727-728 (1985);* Columbia Gas of Pennsylvania, **[*250]** *Inc. v. Pa. P.U.C., 149 Pa. Commonwealth Ct. 247, 613 A.2d 74 (1992),* aff'd, *Pa. , 636 A.2d 627 (1994).* Id., p. 146.

The Company asserts that its claim for recovery of costs associated with tax assessments fits within established exceptions. See e.g., *Pike County Light and Power Co. v. Pa. P.U.C., 87 Pa. Commonwealth Ct. 451, 487 A.2d 118 (1985),* where the Court held that the Commission "may take into account extraordinary losses or gains occurring in the past by amortizing them over a period of years." *487 A.2d at 121,* citing *Pa. P.U.C. v. West Penn Power Co., 54 Pa. P.U.C. 602 (1981).* Id.

NFGD has also cited numerous cases in which the Commission required utilities to pass through to ratepayers tax refunds for prior years. See e.g., *Pa. P.U.C. v. West Penn Power Co., 52 Pa. P.U.C. 143 (1978); Pa. P.U.C. v. Pennsylvania Gas and Water Co., 54 Pa. P.U.C. 602 (1981); Pa. P.U.C. v. Philadelphia Electric Co. (Gas Division), 48 Pa. P.U.C. 183 (1976);* and *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 54 Pa. P.U.C. 401 (1980).* Id., p. 147.

According to NFGD, while addressing the issue of the flow through of tax refunds and deficiencies **[*251]** in its 1978 West Penn decision, the Commission stated: [22]

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[22] Although the Commission in West Penn (1978) noted the responsibility of a utility to aggressively pursue tax deductions, it declined to order flow through of either tax deficiencies or refunds in that instance, stating:

Since the tax refunds and tax deficiencies here practically balance each other out and the difference is negligible, neither should be considered at this time.

It is the responsibility of a utility to be aggressive in claiming all income tax deductions in order to keep its taxes low. Here the Company did this but its claims were rejected.

52 Pa. P.U.C. at 158.

The Company claims that in the 1981 West Penn decision, again citing diligent attempts to secure maximum deductions, the Commission also allowed recovery of certain tax deficiencies (54 Pa. P.U.C. at 633). Id., p. 147.

The Company cited Pa. P.U.C. v. Pennsylvania Gas and Water Co., 55 Pa. P.U.C. 339 (1981), wherein PG&W did not pay or accrue local property taxes which it believed were excessive. After PG&W negotiated a reduced tax bill, the Commission allowed **[*252]** recovery of these property taxes over nine years. See also Philadelphia Electric Co., 46 Pa. P.U.C. at 797; Philadelphia Electric Co., 48 Pa. P.U.C., supra, at 204-05, and National Fuel Gas Distribution Corp., 54 Pa. P.U.C., supra, at 419, in which the Commission ordered amortization of certain tax refunds received. Id. at 148.

NFGD contends that the two instances where the Commission did not flow through refunds or tax deficiencies to ratepayers are distinguishable from its situation. In Pa. P.U.C. v. Pennsylvania Power Co., 55 Pa. P.U.C. 552 (1982), the Commission's decision not to order flow through of a refund to customers was based on the fact that the refund resulted from operating losses which were borne solely by shareholders. Additionally, the Commission stated that its decision in Penn Power was limited solely to the facts of that case (55 Pa. P.U.C. at 578). Id. at 149.

In Pa. P.U.C. v. Philadelphia Electric Co., 56 Pa. P.U.C. 191 (1982), the Commission denied PECO's proposal to flow through tax deficiencies finding that this case was the converse of the situation in Penn Power. NFGD contends that reliance on Penn Power was misplaced **[*253]** in Philadelphia Electric. The tax deficiencies in Philadelphia Electric resulted from a retroactive change in tax law, [23] not from circumstances attributable to the shareholders. Id. at 149-150.

It is the OTS' contention that, should an IRS Appeals Officer rule in NFGD's favor, the payment made by NFGD will be refunded with interest. Therefore, the claim is not known with certainty, as is required for rate recognition. If the issue is decided against NFGD, the interest expense and state tax expense still should not be recovered from ratepayers. OTS takes the position that ratemaking is prospective, as recently reiterated by the Commonwealth Court in Popowsky v. Pa. P.U.C., Pa. Commonwealth Ct. , 642 A.2d 648 (1994).

The OTS disagrees with the Company's position that the interest expense and related state income tax expense, resulting from changes in tax policy, qualify as an unanticipated and extraordinary exception to the rule against retroactive ratemaking. In Popowsky, the Court held:

Although the rule against retroactive ratemaking applies to the recovery of costs relating **[*254]** to prior periods, PP&L argues that these costs would be allowed under the exception to the rule for extraordinary expenses. We have held that the PUC may, in a rate case, take into account extraordinary losses or gains occurring in the past, usually by amortizing for the loss of items that are part of the rate base. . . . Although our cases have not clearly defined the extraordinary exception by example, we know a weather-related expense caused by what is commonly referred to as an "act of God" is considered extraordinary. . . .

Extraordinary expenses are often described as unanticipated and non-recurring. We believe that any unanticipated, non-recurring, substantial expense to the rate base that would be normalized out if occurring in a test year is "extraordinary." Extraordinary cannot mean merely unanticipated, because then every unexpected occurrence or failure to predict an item would be recoverable and the exception would overwhelm the rule, making test years meaningless. To be extraordinary, it must also be a substantial, one-time expense or a substantial item that will not

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West Penn Power, 52 Pa. P.U.C., supra, at 158.

[23] The Economic Recovery Tax Act of 1981 repealed the ADR Repair Allowance.

appear as a continuing expense and could otherwise never be recovered in rates because, like the weather-related **[*255]** expenses, it would be normalized out of the test year as abnormal.

Popowsky, Pa. Commonwealth Ct. , 642 A.2d 648 at 652 (citations omitted).

The OTS submits that NFGD cannot now require the Commission to compensate it prospectively for purported deficiencies in rates previously found to have been just and reasonable. At page 98 of its Main Brief, OTS provided the following quotation from the Public Utility Code:

Section 316 of the Public Utility Code, 66 Pa. C.S. § 316, provides that:

Whenever the commission shall make any rule, regulation, finding, determination or order, the same shall be prima facie evidence of the facts found and shall remain conclusive upon all parties affected thereby, unless set aside, annulled or modified on judicial review.

The OCA avers that the prohibition against retroactive ratemaking is well established. *Cheltenham & Abington Sewerage Co. v. Pa. P.U.C., (Cheltenham), 344 Pa. 366, 25 A.2d 334 (1942); Barasch v. Pa. P.U.C., 507 Pa. 496, 491 A.2d 94 (1985).* OCA M.B., pp. 143-144.

The OCA submits that this claim does not represent an unusual, extraordinary or non-recurring expense. It did not result from a change in tax law, and **[*256]** IRS audits are not an unusual, extraordinary or non-recurring, one-time event. Therefore, the OCA disagrees with the Company's assessment that this claim constitutes an exception to the prohibition against retroactive ratemaking. *Philadelphia Electric Co. v. Pa. P.U.C., 93 Pa. Commonwealth Ct. 410, 422, 502 A.2d 722, 727-728 (1985); Columbia Gas of Pennsylvania v. Pa. P.U.C., 149 Pa. Commonwealth Ct. 247, 613 A.2d 74 (1992),* aff'd, *Pa. , 636 A.2d 627 (1994).* OCA M.B., pp. 144-145; OCA R.B., pp. 69-70.

In Philadelphia Electric, the Commonwealth Court found that the Commission had correctly applied basic regulatory tenets when it denied recovery of prior period expenses related to a pollution control facility. Regarding the ratemaking principle prohibiting retroactive recovery of costs in setting prospective rates, the Commonwealth Court held:

The general rule is that there may be no line examination of the relative success or failure of the utility to have accurately projected its particular items of expense or revenue and an excess over the projection of an isolated item of revenue or expense may not be, without more, the subject of the Commission's order of refund **[*257]** or recovery, respectively, on the occasion of the utility's subsequent rate increase requests.

An exception to this rule in the case of retroactive recovery of unanticipated expenses has been recognized where the expenses are extraordinary and nonrecurring. . . . We agree with the Commission that the pollution control facilities' expenses here at issue are clearly neither extraordinary nor nonrecurring.

Philadelphia Electric, 93 Pa. Commonwealth Ct. at 422, 502 A.2d at 777-728 (citations omitted).

Commonwealth Court, in Columbia, found that ratepayers should bear the cost to recapture prior tax benefits which were lost as a result of changes in federal tax law under the Tax Reform Act of 1986. *Columbia, 149 Pa. Commonwealth Ct. at 262, 613 A.2d at 82.* In the instant proceeding, OCA argues, there was no formal change in tax law that caused NFGD to incur the tax deficiency assessment. OCA R.B., pp. 71-72.

The OCA also contends that NFGD's reliance on *Pike County, supra,* is inapplicable to the instant case. In Pike County, the utility sought review of a Commission Order that reduced its federal income tax expense for ratemaking purposes to account for loss carryovers **[*258]** available as a result to its participation in a consolidated income tax filing. This case does not shed any light on NFGD's claim for interest on an IRS audit assessment that was due to its actions. Id. pp. 72-73.

Furthermore, the OCA notes that none of the cases cited by the Company deal with interest on a tax deficiency. See West Penn Power, supra; Pennsylvania Gas and Water, supra; Philadelphia Electric Co., 46 Pa. P.U.C., supra; National Fuel Gas Distribution Corp., supra.

Finally, the OCA submits that the IRS has not made a final determination on this issue. Therefore, this issue should be disallowed as speculative and not known and measurable, consistent with the OTS' position. OCA M.B., p. 146.

The ALJ made the following resolution of this issue:

NFGD has attempted to distinguish its claim for recovery of interest expense and related state income tax expense from an attempt to recover inaccuracies in prior rate allowances, which would be prohibited under the general prohibition against retroactive ratemaking. However, the interest expense and related state taxes are a direct result of tax returns for the years 1977-1986 having been found deficient by the IRS. **[*259]**

As stated by the OTS and OCA, tax calculations in rate proceedings are "hypothetical calculations" which may be substantially different from taxes due on actual tax returns (OTS Statement No. 2, pp. 15-16), and rates are not set on a "true-up methodology" (OCA Statement 3, p. 67).

Therefore, in keeping with the general prohibition against retroactive ratemaking, it is recommended that the Commission reject NFGD's $ 443,000 annual expense claim to amortize $ 1,200,000 of interest expense resulting from IRS audits for the years 1977 to 1986 and $ 130,000 in related state income taxes.

(R.D. at 180)

The ALJ observed that NFGD has also requested a concomitant adjustment to decrease deferred taxes (thereby increasing rate base) by $ 204,000, representing the remaining deferred tax consequence of the audit adjustment requiring it to pay taxes on contributions-in-aid-of-construction. The ALJ observed further that this audit adjustment represents a tax timing issue because the resulting taxes paid will be capitalized and recovered by NFGD through additional depreciation expense over the life of the associated assets. NFGD Statement No. 16, p. 11.

Because this adjustment represents **[*260]** a timing difference in the form of taxes paid by NFGD but not recovered from ratepayers, it results in a reduction in deferred taxes, which normally reflect funds supplied by ratepayers in advance of actual tax payments. The ALJ recommended the adoption of that adjustment.

In its Exceptions, the Company argued that the ALJ did not explain why he found the claim to be retroactive ratemaking. Further, the Company stated that the ALJ did not explain how the claim fails to meet the exceptions to the rule which permits after the fact recovery of unusual expenses. The Company repeated its cites of cases that support its position on the issue. Additionally, the Company further discussed West Penn in the context of the discussion that the Commission held that it was good public policy to encourage the Company to be aggressive in taking all tax deductions. (NFGD Exceptions at 33-34).

In its Reply Exceptions, the OCA and the OTS point out that the claim associated with the IRS Tax Audit is from the years 1977-1986 and is clearly retroactive. (OCA Reply Exceptions at 21). (OTS Reply Exceptions at 18).

In our disposition of the issue of taxes associated with contributions wherein NFG claimed **[*261]** in rate base a portion of the contributions that have not been recouped through increased depreciation, we found that since NFG had appealed these findings to the IRS, and the result is pending, the claim for the associated expenses was speculative and thus we disallowed the claim without prejudice to the Company to seek future recovery of the expense if the claim is not successful. We view this issue to be related to the rate base issue decided previously herein. Therefore, we take the same action here and deny without prejudice, the Company's claim.

Sales and Use Tax Audit Expense

NFGD originally filed a future test year claim of $ 92,000, relating to a proposed deficiency from a sales and use tax audit assessment for the period April 1, 1989 through August 31, 1992. NFGD Statement No. 16, pp. 12-14. NFGD witness Wagner testified that the assessment had been revised, and the Company had paid a reduced assessment of $ 49,759.97 ($ 39,494 principal and $ 10,265.97 interest) on May 27, 1994. N.T. 443. The Company's final claim reflects the reduced payment of $ 49,759.97. Nfgd M.B., Tables, P. 3 of 14.

Both the OTS and the OCA dispute the Company's claim relating to the Sales **[*262]** and Use Tax audit. OTS witness Maher recommends a five year amortization period to be consistent with the flow back of deferred state income taxes to ratepayers. This recommendation results an annual allowance of $ 9,952, or a $ 39,808 reduction to the Company's revised claim (OTS Statement No. 2, p. 14). In rebuttal, NFGD witness Wagner did not take issue with the recommendation to amortized the audit assessment but, instead, recommended a three year amortization period to coincide with the frequency of audits. NFGD Statement No. 216, p. 9.

The OCA, however, argues for a compete disallowance of the claim for the same reasons set forth in the section regarding the IRS audit interest claim, i.e., that it is both retroactive ratemaking and speculative in nature. OCA M.B., p. 148.

The ALJ found the OCA's argument persuasive. The ALJ recommended disallowance of NFGD's $ 49,760 revised claim in keeping with the prohibition against retroactive ratemaking, as discussed supra. (R.D. at 182).

In its Exceptions, NFGD disagrees with the ALJ's reasoning that allowance of the claim would result in retroactive recovery of past costs. The Company cites Pa. P.U.C. v. York Water Company, 75 Pa. P.U.C. 134, 155 (1991), ("York"), for the proposition that the Commission has allowed amortization for costs that do not recur annually and that are unusual. The Company cites its 1988 rate case docketed at No. R-870719, (Order entered May 27, 1988) for the proposition that, in other instances a normalized amount is allowed for costs that do not occur annually. (NFGD Exceptions at 34-35).

In its Reply Exceptions the OCA argued that, as in the IRS Audit issue, the claim is clearly retroactive and should be disallowed. The OCA adds that the expense item claimed is not unusual, extraordinary, or non-recurring, and the ALJ was correct in recommending disallowance. (OCA Reply Exceptions at 21).

In its Reply Exceptions, the OTS disagrees with the Company's argument that either normalization or amortization of this expense should be permitted. The OTS argues that *Butler Twp., supra,* should be controlling and that if the expense is allowed, it must be amortized rather than normalized. As a minimum, the OTS suggests that if amortization is allowed, the amortization period should be 5 years and not 3 years as requested by NFGD. (OTS Reply Exceptions at 20-21).

Upon our consideration **[*264]** of the positions of the parties, we find that NFGD did not bear the burden of proving that allowance of the expense amortization would not in retroactive ratemaking. Therefore, we will adopt the reasoning and recommendation of the ALJ on this issue. Accordingly, we deny the Company's Exception.

VII. RATE OF RETURN

A. Introduction

A public utility is entitled to an opportunity to earn a fair rate of return on the fair value of its property. *Pennsylvania Public Utility Commission v. Pennsylvania Gas & Water Co., 19 Pa.Cmwlth. 214, 11 PUR 4th 38, 341 A.2d 239 (1975); Keystone Water Co. v. Pennsylvania Public Utility Commission, 19 Pa.Cmwlth. 293, 302, 330 A.2d 873, 877 (1975); Riverton Consol. Water Co. v. Pennsylvania Pub. Utility Commission, 186 Pa.Super.Ct. 1, 24 PUR 3d 9, 140 A.2d 114 (1958).* Rate of return can be defined as:

. . . 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" are interest on long-term debt, dividends on preferred stock, and earnings on common equity. In other **[*265]** words, the return is the money earned from operations which is available for distribution among the various classes of contributors of money capital.

Public Utility Economics, Paul J. Garfield and Wallace F. Lovejoy (1964), at 116. The return authorized must not be confiscatory, and must be based upon the evidence presented. *City of Pittsburgh v. Pennsylvania Pub. Utility Commission, 165 Pa.Super.Ct. 519, 82 PUR NS 572, 69 A.2d 844 (1949).*

Although it is acknowledged that the fair rate of return and cost of capital are not always synonymous, we consider the "cost of capital" approach to be one of the important bases upon which a fair rate of return in determined. *Township of Lower Paxton v. Pennsylvania Pub. Utility Commission, 13 Pa.Cmwlth. 135, 317 A.2d 917 (1974); Pennsylvania Pub. Utility Commission v. Duquesne Light Co., 54 Pa PUC 695, 43 PUR 4th 27 (1981).* In availing ourselves of this generally accepted method of arriving at a fair rate of return, we, the ratemaking authority, first examine the utility's capital structure to identify the sources of the utility's capital and accompanying ratios. We then ascertain the cost of each component; namely, the cost **[*266]** of debt, determined essentially by the annual interest requirement of the utility's bonds, the cost of preferred stock, and the cost of common stock (common equity), determined by the return required to sell such stock upon reasonable terms in the market. *Pennsylvania Pub. Utility Commission v. Bell Teleph. Co. of Pennsylvania, 57 Pa PUC 639, 52 PUR 4th 85 (1983); Pennsylvania Pub. Utility Commission v. Pennsylvania Power Co., 55 Pa PUC 552 (1982).*

Regardless of the procedure employed in determining fair rate of return, we must exercise "informed judgement". As we stated in Pennsylvania Power:

The return finding should consider the financial costs being incurred, so that the utility has the opportunity to recover its present cost of capital or to attract needed capital at reasonable cost. A fair rate of return for a public utility, however, is not a matter which is to be determined by the application of a mathematical formula. It requires the exercise of informed judgement based upon an evaluation of the particular facts presented in each proceeding. There is no one precise answer to the question as to what constitutes a proper rate of return. The interests of the **[*267]** company and its investors are to be considered along with those of the customers, all to the end of assuring adequate service to the public at the least cost, while at the same time maintaining the financial integrity of the utility involved. (Emphasis supplied).

Id., 55 Pa PUC at 578.

Moreover, we must adhere to the legal constraints which guide our decision.

In the landmark case of *Bluefield Water Works & Improv. Co. v. West Virginia Pub. Service Commission, 262 U.S. 679, 43 S.Ct. 675 (1923),* the United States Supreme Court addressed the issue of fair rate of return for a public utility. In Bluefield, the Court stated:

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgement, having regard to all relevant facts. 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 in investments in other business undertakings which are attended by corresponding risk and uncertainties; **[*268]** but it has no constitutional rights 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 reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business generally.

Id. 262 U.S. at 692, 693, 67 L.Ed. at 1182, 1183.

In establishing the standards to be applied in implementing the Federal Natural Gas Act, the United States Supreme Court, in *Federal Power Commission v. Hope Nat. Gas Co., 320 U.S. 591, 603, 51 PUR NS 193, 200, 201, 88 L.Ed. 333, 345, 64 S.Ct. 281 (1944),* said:

The rate-making process, under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. . . ." [R]egulation does not insure that the business shall produce net revenues." (Citations omitted) But such **[*269]** considerations aside, the investor interest has legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

As noted in these cases, we are required to approve as just and reasonable, rates which will produce revenue sufficient to enable the utility to recover all reasonable operating and maintenance expenses, depreciation and taxes. Additionally, the utility is entitled to have an opportunity to earn a fair rate of return on the capital invested in the enterprise. *Pennsylvania Pub. Utility Commission v. North Penn Gas Co., 55 Pa PUC 425 (1981).* We stated in *Pennsylvania Pub. Utility Commission v. Philadelphia Electric Co., 52 Pa PUC 772, 808, 31 PUR 4th 15, 50 (1978):*

Among the factors to be considered in determining a fair return are (1) the earnings which are necessary to assure confidence in the financial integrity of the utility and to maintain its credit standing; (2) the payment of dividends and interest; and (3) the amount of the investment, the size and nature of the utility, its business and financial risks, and the circumstances attending its origin, development and operation.

Finally, we must engage in an appropriate balancing of the rates charged to the customers, for the services provided, with the return to which investors in the enterprise are entitled to have an opportunity to earn.

The calculation of the appropriate rate of return, particularly the determination of the common equity element, was a major issue in this proceeding. Although its quantification is subject to various methodologies and interpretations of financial data, the term's definition is not disputed. As explained in Garfield and Lovejoy's Public Utility Economics at 116 (1964):

The rate of return is the amount of money a utility earns, over and above operating expenses, depreciation expense, **[*271]** and taxes, expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the "return" are 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 various classes of contributors of money 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.

(Emphasis in original)

A public utility, whose facilities and assets have been dedicated to public service, is entitled to an opportunity to earn a fair rate of return on its investment. The standards to be used by the Commission in determining what is a fair rate of return are well-established, having been set forth more than six decades ago by the United States Supreme Curt in *Bluefield Waterworks and Imp. Co. v. P.S.C. of West Virginia, 262 U.S. 679 (1923):*

Rates which are not sufficient to yield a reasonable **[*272]** return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility of its property in violation of the *Fourteenth Amendment. (262 U.S. at 690)*

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. *(262 U.S. at 693)*

These principles have been adopted and applied by the Appellate Courts of Pennsylvania in numerous circumstances. See, e.g., Riverton Consolidated Water Co. v. Pa. P.U.C., 186 Pa. Super. 1, 140 A.2d 114 (1958), Pittsburgh v. Pa. P.U.C., 182 Pa. Super. 376, 126 A.2d 777 (1956); Lower Paxton Twp. v. Pa. P.U.C., 13 Pa. Cmwlth., 135, 317 A.2d 917 (174).

The return allowed to investors must be commensurate with the risk assumed, as the Supreme Court has stated in three landmark opinions. Bluefield, supra, requires that the rate of return reflect:

[A] return on the value of the [utility's] property **[*273]** which it employs for the convenience of the public equal to that generally being made at the same time on investments in other business undertakings which are attended by corresponding risk and uncertainties. (262 U.S. at 692)

Twenty-one years later, the Supreme Court reiterated that standard in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944), as follows:

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. (320 U.S. at 603)

More recently, in reaffirming the Hope decision, the Supreme Court, in Duquesne Light Co v. Barasch, 488 U.S. 299, 109 S.Ct. 609, 619, 102 L.Ed.2d 646, 661 (1989), observed that "[o]ne of the elements always relevant to setting the rate under **[*274]** Hope is the return investors expect given the risk of the enterprise."

The determination of a fair rate of return thus requires the review of many factors, including: (1) the earnings which are necessary to assure confidence in the financial integrity of the company and to maintain its credit standing; (2) the need to pay dividends and interest; and (3) the amount of the investment, the size and nature of the utility, its business and financial risks, and the circumstances attending its origin, development and operation. Pa. P.U.C. v. Pennsylvania Gas and Water Co. - Water Division, 19 Pa. Cmwlth, 214, 233, 341 A.2d 239 (1975); Lower Paxton Twp., supra. Moreover, the Commission's findings must be based upon substantial and competent evidence on the record before it, not upon speculation or hypothesis. Ohio Bell Telephone Co. v. Pub. Util. Comm. of Ohio, 301 U.S. 292 (1937); United Sates Steel Corp. of Pa. P.U.C., 37 Pa. Cmwlth, 195, 390 A.2d 849 (1978); Octoraro Water Co. v. Pa. P.U.C., 38 Pa. Cmwlth, 83, 391 A.2d 1129 (1978).

NFGD, the OCA and the OTS actively contested the rate of return question. This R.D. does not detail each party's position but contains **[*275]** data sufficient to support each parties' rate of return proposal and to promote our resolution of the question.

B. Capital Structure

The following table summarizes the capital structure position proposals of NFGD:

Capital Structure	**NFGD [1]**	**OCA [2]**	**OTS [3]**
	%	**%**	**%**
Long-Term Debt	36.1	35.34	36.0
Short-Term Debt	10.7	16.09	10.8
Common Equity	53.2	48.57	53.2
Total	100.0	100.0	100.0

NFGD's proposed test year end November 30, 1994 capital structure reflects updated retained earnings, the issuance of $ 100 million of medium term notes on July 14, 1994, redemption of the remaining outstanding 9 1/2 percent debentures on July 1, 1994 and the average balance of short term debt for the twelve months ending November 30, 1994. NFGD St. No. 211, pp. 1-4.

NFGD used a consolidated capital structure because National is the sole source of its debt and common equity. NFGD **[*276]** does not issue securities to the public.

NFGD contends that unless its proposed capital structure is unreasonable for a local distribution company (LDC) there is no reason to depart from the Commission's practice of using the capital structure of its parent, National. See *Lower Paxton Township v. Pa. P.U.C., 13 Pa. Commonwealth Ct. 135, 142, 317 A.2d 917 (1974).* See e.g., *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 54 Pa. P.U.C. 401, 409-410 (1980)* and *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 55 Pa. P.U.C. 665, 673-674 (1982)* for a demonstration that the Commission has consistently used National's capital structure ratios. NFGD contends its capital structure is reasonable and similar to the capital structure ratios employed by other local distribution companies. To demonstrate the reasonableness of its capital structure proposal NFGD witness Grabowski compared NFGD's claimed test year end capital structure ratios with the range of common equity ratios for Moody's eight and a barometer group of thirteen gas companies. That compilation is reprinted, below:

Excluding Preferred Stock

			Thirteen	
	Moody's Eight	**Gas Dist. Cos.**		
	High	**Low**	**High**	**Low**
1994	63.0%	46.5%	63.0%	43.0%
1995	61.0%	47.5%	61.0%	43.5%
1997-1999	65.0%	47.5%	65.0%	46.5%

[*277]

Including Preferred Stock

			Thirteen	
	Moody's Eight	**Gas Dist. Cos.**		
	High	**Low**	**High**	**Low**
1994	63.0%	51.0%	63.0%	46.0%
1995	61.0%	51.0%	61.0%	46.5%
1997-1999	65.0%	51.5%	65.0%	49.0%

St. No. 211, p. 15.

The above table is based on permanent capital because projections of short-term debt are not available. At November 30, 1994, National's equity ratio on a permanent capital basis is 58.8%. NFGD St. No. 211, p. 16. The

58.8 percent common equity ratio of National is within the range of equity ratios expected to be employed by both the Moody's 8 group and the Thirteen Gas Distribution Companies group.

Witness Grabowski explained that National has employed, in the past, and expects in the future to employ, significantly more short term debt than the barometer groups. NFGD states that when this difference in short term debt is considered, Distribution's proposed equity ratio is about average as compared to the Moody's 8 group:

Q. Does a comparison of projected common equity ratios on a permanent capital basis for the Moody's Eight and National Fuel Gas Company provide a complete analysis of relative capital structure ratios?

A. **[*278]** No, it does not. Historically, National Fuel Gas Company has used a higher percentage of short-term debt than has been used by the Moody's group on average. A direct comparison of projected capital structure ratios on a total basis, including short-term debt, is not possible since there are no projections of short-term debt for the Moody's Eight.

In order to make a comparison of capital structure ratios on a projected basis, we have assumed that the relationship between amounts of short-term debt employed by National Fuel Gas Company and the Moody's Eight barometer group on average will be the same in the future as was experienced at the end of 1993. As shown in Exhibit 211-I, page 1, approximately 5.8% of total capital employed by the Moody's Eight companies was short-term debt at the end of fiscal years of the companies. By comparison, as shown on Exhibit No. 403, page 2, 13.9% of National Fuel Gas Company's total capital at September 30, 1993 was short-term debt.

In order to place projected data on a comparable basis, we have recalculated the projected permanent capital structure ratios of National Fuel Gas Company to include as additional long-term debt the difference between **[*279]** short-term debt employed by National Fuel Gas Company and the barometer group historically. By making this adjustment, projected data can be placed on a comparable basis in that short-term debt used by National Fuel Gas Company as a substitute for permanent capital is included in the analysis. As shown in Exhibit No. 211-K, page 1, this produces a projected common equity ratio for National Fuel Gas Company of 53.8%. This common equity ratio is well within the range of projected common equity ratios for both barometer groups shown on Exhibit No. 211-J and, in fact, is reasonably close to the projected average common equity ratios for the groups.

NFGD St. No. 211, pp. 16-18.

The average projected common equity ratios for Moody's 8 barometer group is 52.3 percent to 53.8 percent excluding preferred stock. NFGD Exh. No. 211-J.

Further, witness Grabowski stated that a 53.2% equity ratio is below the level of 54% that is recommended by Standard & Poor's as necessary to achieve an "A" bond rating for a local distribution company with an "average" business position. NFGD St. No. 211, p. 19. National has retained earnings and issued equity to attempt to achieve an A bond rating. National **[*280]** has raised its bond rating from BBB+ to A-. NFGD St. No. 211, p. 12. Grabowski explains this change is in response to a stronger equity ratio and produces lower debt costs for customers. There is a trend toward increasing common equity ratios in response to increased risk created by the requirement that LDCs purchase all gas supplies and arrange for transportation under restructured pipeline services. It is undisputed that there is greater risk for LDCs in the Post FERC Order No. 636 environment and the appropriate reaction is an increased equity ratio (N.T. 499).

NFGD contends that National's capital structure ratios are within the range of those employed by Moody's 8 and, in fact, National's equity ratio is close to the average employed by Moody's 8.

Although OCA employed Moody's 8 as a barometer group, it does not rely upon Moody's 8 data to judge the reasonableness of National's capital structure. Instead, OCA relies on data reported by Value Line for all gas distribution companies. OCA St. No. 1, p. 37 and Sch. JRW-1, p. 3; N.T. 481. If a barometer group is to be used to establish a cost rate for common equity, consistency requires that the same barometer group be used to determine **[*281]** the reasonableness of capital structure ratios. The Value Line data contain companies which are not comparable in size or in other characteristics to NFGD.

The OCA contends that National "must" have more equity because of its exploration activities. As demonstrated by OCA Statement No. 1, Schedule JRW-10, National has greater earnings predictability/stability than any of the Moody's 8 or Thirteen Gas Distribution Companies. The earnings stability results because National is primarily a utility. N.T. 938-39. NFGD contends there is no evidence that National employs greater equity to offset earnings variability of exploration activities.

NFGD states there is a defect in OCA's capital structure analysis concerning the manner in which the capital structure ratios are derived.

The OCA averaged the capital structure ratios of National and Distribution at November 30, 1994. When asked why, the OCA witness Woolridge indicated only that it produced a reasonable result. N.T. 487-88. NFGD viewed defects in this approach. The alleged flaws are summarized as follows:

1. Averaging the capital structure of National and Distribution is meaningless because NFGD's capital structure is not managed **[*282]** for the purpose of raising capital and may be set at any level by National. NFGD St. No. 211, pp. 20-21;

2. Dr. Woolridge, OCA witness, has averaged point in time capital structures even though he recognizes that short term balances vary significantly through the year (N.T. 487) and the Commission has recognized (<u>Peoples,</u> supra) that a thirteen month average should be used. Use of thirteen month average data for National and NFGD in a simple average would produce a common equity ratio of 53.0%. NFGD St. No. 211, pp. 21-23; Ex. No. 211-L; and

3. OCA witness Woolridge provided no explanation of how or why he concluded that his calculation produces a reasonable hypothetical capital structure.

The OCA's final criticism of the proposed capital structure ratio, according to NFGD, is that NFGD has overstated its projected equity ratio in prior cases. NFGD contends that Exhibit No. 211-M shows that its projections in its last two cases were very accurate. Over-projections of the equity ratio in prior cases were substantially the result of lower retained earnings as a result of significantly warmer than normal weather. Ex. No. 211-M.

NFGD receives the benefit of reduced short and long **[*283]** term debt costs which are generated by the raising of capital by National and by National's equity ratio. Therefore, states NFGD, it is inconsistent to provide NFGD with such benefits without paying the costs of achieving the benefits. One of those costs is a reasonable equity ratio. St. No. 211, pp. 23-25.

The OCA's position is that a parent's capital structure is inappropriate and that an average of the projected capital structures of NFGD and National are appropriate. OCA St. 1, pp. 5 and 6 and Sch. JRW-1. The OCA's capital structure proposal has a lower common equity ratio and a higher debt level. OCA witness Woolridge explained why this results in a more reasonable and appropriate capital structure:

As compared to the capitalization which is recommended for NFGDC by Mr. Grabowski, the capital structure which we am [sic] using is more reflective of gas distribution companies. The <u>Value Line</u> gas distribution industry survey is provided on page 3 of Schedule JRW-1, and it shows a projected industry common equity ratio of 48% for 1993, 1994 and the 1997-1999 period. In addition, my capital structure ratios are more indicated [sic] of the actual and historic capital structure **[*284]** of both NFGDC and NFG.

OCA St. 1, p. 6.

The OCA contends that a capital structure based on the market data is more appropriate for NFGD "an equity ratio more in the area of 48 to 49 percent is more what the typical gas distribution company has as a capital structure, as opposed to National, the parent company, which is involved in other activities" which "presumably are riskier and therefore they have more common equity to support the greater degree of risk." N.T. 478-88. OCA states that approximately one-third of NFG's capital structure supports unregulated activities, including oil and gas exploration. N.T. 926-27.

According to the OCA, NFGD's proposed 53.2 percent common equity ratio is not reflective of industry averages shown in Value Line's gas distribution industry survey. Based solely on total permanent capital (not including short-term debt), [2]4 that survey indicates an actual common equity ratio for the gas distribution industry of 47.5% for 1993, and a projected common equity ratio of 48.0%. OCA St. 1, Sch. JRW-1, p. 3; N.T. 481-82. Similarly, on the basis of total permanent capital, the Moody's Eight barometer group, which is employed by both NFGD and OCA in developing **[*285]** the cost of equity capital, indicates a much lower average common equity ratio than that employed by National Fuel Gas Company -- 52% versus the 61% employed by NFGD. OCA St. 1, Sch. JRW-2, p. 1.

The OCA responded to NFGD's criticism that its capital structure, based on its inclusion of short-term debt at a point in time, should be rejected. On cross-examination OCA witness Dr. Woolridge explained why his use of spot balances of short-term debt is appropriate:

. . . we think it is appropriate when you look at the overall picture and look at the capital structures of other gas distribution companies. We was [sic] just trying to arrive at a capital structure which we feel reflects the industry standard, and in doing so we have used this procedure, which we used last year as well in this hearing, and come up with a common equity ratio which we think is much more reflective of industry standards. It appears to me, from looking at market data, that an equity ratio more in the area of 48 to 49 percent is more what the typical gas distribution company has as a capital **[*286]** structure, as opposed to NFG, the parent company, which is involved in other activities and therefore has -- these activities presumably are riskier and therefore they have more common equity to support the greater degree of risk.

N.T. 487-88.

The OCA witness Dr. Woolridge further discussed spot short-term data on surrebuttal.

Q. Dr. Woolridge, the company pointed out in their rebuttal testimony, and again during your cross examination, they made the same point that you used point-in-time short-term debt balances rather than average short-term debt balances in computing your capital structure. Do you have any comment about that?

A. My comment is that the figures would be the figures that at that point in time investors would see, and they would have those figures in terms of assessing the company's capitalization.

I think in conjunction with, again, proxy or hypothetical capital structures, which we're both using, we think it also provides a capitalization which reflects the industry as a whole.

N.T. 943-44.

In his Surrebuttal Testimony, Dr. Woolridge explained why the NFGD's comparisons, based on the inclusion of preferred stock, are inappropriate:

. . . in his -- Mr. **[*287]** Grabowski's rebuttal testimony, a number of comparisons were made which focused on total long-term capital between the Moody's 8 and NFG. And these comparisons included preferred stock as part of common equity for Moody's 8.

I believe that's inappropriate. Mainly because, as Mr. Grabowski stated, from the standpoint of an equity investor, preferred stock is viewed as more like a debt type instrument. And the concern here is how much common equity is invested in Moody's 8 versus NFG. And those are the comparisons I made.

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[2] OCA's capital structure claim can be found at OCA Main Brief, p. 155.

N.T. 927-28. NFGD witness Grabowski agreed that from the vantage point of an equity investor, preferred stock is a fixed obligation because the Company has a commitment to pay before it makes any payment of dividends to common equity investors. N.T. 913.

As OCA witness Woolridge testified on Surrebuttal, both he and the Company have utilized hypothetical capital structures for NFGD. N.T. 926; N.T. 913-15. The ultimate question in this case is which is appropriate. NFGD witness Grabowski admitted that his use of National Fuel Gas Company's capital structure -- which he uses as a "proxy" -- supports investment in unregulated activities which may be riskier. N.T. **[*288]** 912, 910. OCA witness Woolridge submitted that this made use of the parent company capital structure inappropriate. He reiterated this point on Surrebuttal:

Issue two relates to why we feel that NFG's capital structure is inappropriate for NFG Distribution, and relates primarily to the fact that NFG, the parent, is listed as a diversified gas distribution company by Value Line. . . . And obviously it takes and makes, it's investing -- currently in 1993 it invested one third of its capital budget in unregulated activities, especially through Seneca Resources and Empire Exploration in oil and gas exploration.

So it's my opinion that in these riskier ventures where the company would be committed to invest greater amounts of equity because of the underlying business risk of the oil and gas exploration; so it's my opinion that when you have NFG's capital structure and NFG Distribution's capital structure, it's inappropriate, on the other hand, to take and apply that overall capital structure which supports riskier activities, unregulated activities, for NFG Distribution.

N.T. 926-27.

Consequently, the OCA submits that the Company's proposed use of NFG's capital structure as a proxy **[*289]** for the Company should be rejected since its equity-rich composition tends to support riskier activities and, is, therefore inappropriate for setting rates for a regulated enterprise. In its place, OCA witness Woolridge's proposed capital structure, which more closely reflects the level of equity employed by gas distribution companies, should be adopted.

The ALJ recommended that the capital structure proposed by NFGD best reflects the manner in which NFGD will be financed during the life of the proposed rate increase. He reasoned that the proposed capital structure of 36.1 percent long-term debt, 10.7 percent short-term debt and 53.2 percent common equity equal reflects security issuances, 9 1/2 percent debenture redemption and an increase in retained earnings.

ALJ Kashi concluded that the use of the parent capital structure ratio is reasonable where the capital structure is representative of the industry. He noted that we have used the parent's capital structure in the past and, he saw no reason to depart from the Commission's practice in this case. See R.D., p. 202 wherein *Lower Paxton Township v. Pa. P.U.C., 13 Pa. Commonwealth Ct. 135, 142, 317 A.2d 917 (1974).* See e.g., **[*290]** *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 54 Pa. P.U.C. 401, 409-410 (1980)* and *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 55 Pa. P.U.C. 665, 673-674 (1982)* are cited for a demonstration that the Commission has consistently used National's capital structure ratios.

Further, ALJ Kashi opined that the short-term debt varies throughout the year as a company goes about its daily activities. NFGD used an average to produce its short-term debt which he found a more equitable method than using a spot in time short-term debt which may be unreliable because of aberrations of financing, gas purchase, timing or other seasonal fluctuations. Id.

The OCA excepted to the ALJ's recommendation concerning capital structure. It objected to the use of a hypothetical capital structure based on that of NFG's parent corporation. The OCA argues that the recommended capital structure is erroneous because it "is inflated relative to that of a regulated utility, . . . [therefore] it supports substantial unregulated activities and is inconsistent with the capital structures of those utilities upon whose economic performance the Company's cost of equity is estimated." (OCA Exceptions, **[*291]** at 10).

The OCA contends that there is no sound evidence showing that NFG's parent capital structure is representative of the local gas distribution industry. It submits that there are good reasons to depart from the Commission's historic practice of accepting parent company capital structures for establishing the rates of the regulated subsidiary.

Finally, the OCA stresses that the recommended capital structure has an equity-rich composition which tends to support riskier activities and therefore, inappropriate for setting rates for a regulated enterprise.

On consideration of the Exceptions of the OCA concerning the recommended capital structure, we observe that the OCA's contention that the recommended capital structure is not representative of distribution companies mischaracterizes the evidence and the ALJ's determinations.

We find the Rely Exceptions of NFGD to be illuminating on this issue. NFGD points out that the OCA, incorrectly, states that NFGD's proposed capital structure as 46.8% long-term debt and 53.2% equity (OCA Exceptions, at 10). In fact, the Company's proposal is 36.1% long-term debt, 10.7% short-term debt and 53.2% (R.D. at 211). NFGD's use of a significant **[*292]** level of short-term debt is important since it is the lowest cost of capital -- 5.48% (R.D. at 211).

By ignoring short-term debt, the OCA also mischaracterizes the evidence concerning the comparability of NFGD's capital structure with the capital structure of distribution companies. NFGD demonstrated that when projected data for Moody's 8 and NFGD are adjusted to include historic levels of short-term debt, the projected average equity ratio of Moody's 8 ranges from 52.3% to 53.8%. Therefore, NFGD argues that its equity ratio of 53.2% is reasonable and appropriate. We would agree.

We note that use of parent capital structure and 13-month average of parent short-term debt was approved by this Commission in *Pa. P.U.C. v. Peoples Natural Gas Co., 63 Pa. P.U.C. 6, 28-31 (1986),* where we adopted a common equity ratio of 61.2%. When we consider the increased risks to the local distribution companies after FERC Order No. 636, NFGD's proposed common equity ratio of 53.2% is reasonable.

The OCA's proposal to average the point in time total capital structures of NFGD and its parent was also rejected by the ALJ. We affirm the ALJ's recommendation. The OCA's justification for its approach **[*293]** is not persuasive and is rejected for the following reasons: (1) it does not reflect prospective conditions of increased equity ratios in response to risks; (2) it is not based on the Moody's 8 group which was used to develop the cost of equity; and (3) its position is based on the Value Line Group which reflects only permanent capital.

After a review of the record evidence, we find the ALJ's recommendation reasonable. Therefore, we deny the Exceptions of the OCA.

C. Cost of Debt

The OCA and the OTS both accept NFGD's Long-Term Debt and Short-Term Debt cost rate claims. OCA M.B. p. 153; OTS M.B. p. 101-102. NFGD's pro forma November 30, 1994 Long-Term Debt cost rate is 8.16 percent and the Short-Term Debt cost rate is 5.48 percent. NFGD St. No. 211, pp. 1-5; Exh. No. 211-B. The cost of debt proposed by the Company will, therefore, be used in our Opinion and Order.

D. Common Equity

The following table, reprinted from page 203 of the R.D. summarizes the common equity methodologies and claims of the parties:

Methodology	**NFGD** [1]	**OCA** [2]	**OTS** [3]
	%	**%**	**%**
Discounted Cash Flow (DCF)	11.56	10.50	10-10.75
Risk Premium (RP)	13.50	12.00	

Methodology	NFGD [1]	OCA [2]	OTS [3]
	%	%	%
Capital Asset Pricing Model (CAPM)	13.08		
Comparable Earnings	14.10		
Recommendation	12.75	10.75	10.25

[*294]

ALJ Kashi appropriately noted that this Commission has, in numerous recent decisions, determined the cost of common equity primarily upon the Discounted Cash Flow ("DCF") method and informed judgment. See *Pa. Public Utility Commission v. Philadelphia Suburban Water Co., 71 Pa. P.U.C. 593, 623-632 (1989); Pa. Public Utility Commission v. Western Pennsylvania Water Co., 67 Pa. P.U.C. 529, 559-570 (1988).*

The Risk Premium ("RP") and Capital Asset Pricing Model ("CAPM") methodologies have been criticized by the Commission in recent years. In *Pa. Public Utility Commission v. Pa. American Water Co., 68 Pa. P.U.C. 343, 377-378 (1988)* we did not give any weight to the RP analysis. See also *Pa. Public Utility Commission v. Peoples Natural Gas Co., 69 Pa. P.U.C. 138, 165-168 (1989); Pa. Public Utility Commission v. National Fuel Gas Distribution Corp., 67 Pa. P.U.C. 264, 331-332 (1988); Pa. Public Utility Commission v. York Water Co., 62 Pa. P.U.C. 459, 79 PUR 4th 332 (1986).* In *Pa. Public Utility Commission v. Duquesne Light Company, 66 Pa. P.U.C. 518, 91 P.U.R. 4th 546 (1988),* we stated as follows:

We continue to believe that the economic environment over lengthy time frames is not representative of current economic conditions and therefore does not produce realistic risk premium results.

66 Pa. P.U.C. at 696.

In rejecting Risk Premium and CAPM analyses in *Pa. Public Utility Commission v. Pennsylvania Power Company, 67 Pa. P.U.C. 91 (1988),* the Commission ruled as follows:

[F]irst, we cannot accept that historic experienced earnings reflect the cost of capital. We know of no reputable analyst who would seriously argue that experienced earnings represent the cost of capital, except by pure happenstance. But, such is the inherent assumption of each methodology **[*296]** [Risk Premium and CAPM]. Second, we cannot accept, even assuming that historic experience earnings represented the cost of capital that the average premium of an equity investment over a fixed income investment over a period as long as 50 years, represents the investor required premium in today's and tomorrow's market.

Accordingly, we conclude that we can place little credence in the results of these methodologies.

Pennsylvania Power, 67 Pa. P.U.C. at 164.

Because of our consistent preference for the DCF methodology, ALJ Kashi concluded that the record before him did not lead to a different conclusion. R.D., p. 205.

NFGD employed comparable earnings as a check on the common equity cost rates produced by its other methodology. NFGD M.B. p. 170. NFGD did not use comparable earnings as a cost rate methodology so the presiding ALJ did not consider it as a common equity cost rate determinant. Additionally, it was noted that comparable earnings are not market related but accounting related ratios.

NFGD is a subsidiary of National Fuel Gas (National) and as such does not have publicly traded common stock. OCA St. 1 p. 15. The cost of common equity for National was reviewed, **[*297]** but primary consideration was given to the barometer groups. The ALJ recommendation recognized the need for similar risk barometer groups upon which to base a market related cost rate for NFGD.

No two utilities are ever complete replications of each other with the result that no barometer group of companies is ever universally comparable to the subject utility. Consequently, data for all proposed utility groups was considered. Since no one barometer group is totally comparable to NFGD, the ALJ did not give primary weight to any one barometer group. Each of the barometer groups consists of gas distribution companies which the sponsoring party argues are as similar to NFGD in terms of risks as it is possible to be. NFGD is not faced by business risks that are not faced by the barometer group companies and as such the risks are reflected in the market price of their stock. In the world of corporate finance and utility regulation, the existence of risk rate imperfections between a specific utility and a barometer group is inevitable.

The following table taken from pages 206-207 of the R.D. summarizes the dividend yield and growth rate recommendations of the parties:

DCF	**NFGD [1]**	**OCA [2]**	**OTS [3]**	
	%	**%**	**%**	
Dividend Yield	5.4	4.85-5.6	5.12-5.72	4.68-5.13
Growth Rate	6.0	5.5-4.75	4.75 5.5	

[*298]

The DCF methodologies were not detailed in the body of the R.D. References to the DCF methodology were found at NFGD Statement 13 pages 30-41 and Appendix B pages B-1 to B-15, OCA Statement 1 pages 12-30 and OTS at OTS Statement 1 pages 22-30.

NFGD considered the OTS' common equity to be inadequate for four reasons. NFGD Reply Brief pages 79-86. Those reasons were:

1. OTS' exclusive reliance on the DCF method;

2. OTS' use of a twelve month dividend yield in its dividend yield recommendation;

3. OTS' adoption of unrealistically low growth rates; and

4. OTS' financial risk adjustment is unsupported by the record evidence.

NFGD considered the OCA's common equity cost rate to be inadequate for three **[*299]** reasons. NFGD Reply Brief pages 80-84. They were:

1. OCA's use of a twelve month dividend yield in its dividend yield recommendation;

2. OCA did not update its dividend yield recommendation; and

3. OCA's adoption of unrealistically low growth rates.

The OCA contended that NFGD's cost of common equity is flawed for three reasons. OCA Main Brief pages 170-176; OCA Reply Brief pages 90-91. Those reasons, summarized, were:

1. NFGD's problem is application of the DCF methodology rather than the dividend yield component;

2. NFGD's adoption of unrealistically high growth rates; and

3. NFGD's contention that there is no financial risk difference between Distribution and the barometer group.

The OTS states that NFGD's cost of common equity analysis failed for five reasons, listed below. OTS Reply Brief pages 42-45.

1. NFGD's DCF analysis is biased by its growth rate analysis;

2. NFGD misinterpretation of Professor Gordon's growth rate conclusions;

3. NFGD contention that there is no financial risk difference between Distribution and the barometer group;

4. NFGD's use of RP, CAPM and Comparable Earnings in determining a cost of common equity; and

5. NFGD's use of dividend yield **[*300]** based on less than twelve month dividend yields.

ALJ Kashi stated that no cost of common equity is without flaws. He observed that the DCF method generally accepted by this Commission contains certain flaws. Nevertheless, of all the methods available to determine the cost of common equity, the DCF methodology may be the most accepted. He continued his discussion of the positions concerning return on equity by noting that the assumptions of a predictive model do not have to be in perfect harmony with the known world as long as the model predicts the future in a reasonable and accepted manner. An example of this are the assumptions of a perfect economic market place model, which is unrealistic in the real world, but is still predictive of the real market activity. Therefore, he employed the DCF method analysis in his recommendation with full knowledge of its various flaws but adjusted to mitigate the effects of those flaws.

The ALJ made the following recommendations: (1) an unadjusted dividend yield of 5.4 percent; [2]5 (2) the use of the midpoint of the growth rate ranges of 4.75 percent to 5.5 percent, or 5.13%; [2]6 and (3) a DCF common equity cost rate based upon an adjusted dividend **[*301]** yield of 5.54 percent and a growth rate of 5.13 percent or 10.67 percent. R.D., p. 210.

NFGD excepted to the ALJ's recommendation that 10.67% be set as the cost of common equity. NFGD asserts that the cost of common equity, "placing sole reliance on the DCF analysis, is not less than 11.56% (12-month adjusted dividend yield of 5.56% and a growth rate of 6.0%)." (NFG Exceptions, at 35).

The Company, at page 35, note 18, states that the 6 percent growth rate is within the range of 5.29% to 6.96% for projected earnings growth reported by IBES, S&P and Value Line. NFGD asserts that the ALJ improperly ignored analysts' projections of growth in earnings by averaging only the OCA and the OTS' proposed growth rates. In this regard, the Company states that projections of earnings **[*302]** have been demonstrated to be the best indicator of growth by independent study.

NFGD further argues that "[d]uring this proceeding, interest rates have risen substantially." (NFG Exceptions, at 35). It cites the rise in interest rates of long term treasury rates and A-rated bond yields. In additional support of its position, NFGD cites two recent cases in which it is argued that the Commission recognized that rising interest rates increase the cost of equity and, consequently, raised the allowed return on common equity: Pa. P.U.C. v. Pa-American, Docket No. R-932670 (July 21, 1994) -- 10.84% and Pa. P.U.C. v. Roaring Creek Water Co., Docket No. R-932665 (February 3, 1994) -- 10.48%. NFG asserts that the record in Pa-American closed on March 9, 1994 and that interest rates continued to rise between that date and the date of the record closing in the present proceeding, July 28, 1994.

With specific reference to Exhibit No. 213, Schedule 3, NFGD notes that the yield on long-term Treasury bonds increased by .77% from 6.85% on March 9, 1994, to 7.62% on July 1, 1994. On this basis, alone, states the Company, it must be concluded that the cost of common equity is in excess **[*303]** of the 10.84% which was adopted in Pennsylvania-American Water Co., supra.

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[2] The OCA's common equity rates are found at OCA Statement 1 pages 26 and 31. The common equity recommendation is found at OCA Statement 1 page 32. The OCA's DCF common equity includes an adjusted dividend yield. OCA St. 1 p. 26.

Finally, NFGD contends that "sole or partial weighting of the 12-month dividend yield during a period when interest rates are rising from a 20-year low understates the cost of equity." (NFGD Exceptions, at 36). The Company urges us to use either a three-month or one-month dividend yield given this fundamental reversal of interest rates. NFGD argues that even if the ALJ recommended growth rate of 5.13% were employed with a three-month dividend yield of 6.05%, the DCF cost rate would not be below 11.0% (11.18%). NFGD stresses that the record supports a cost of equity which is not below 11.0%.

In determining the cost of common equity for NFG, we are guided by the United States Supreme Court's ruling in *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of West Virginia et al, 262 US 679, 67 L Ed 1157, 43 SC 679 (1923)* wherein the Court stated:

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to **[*304]** 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 money necessary for the proper discharge of its public duties.

The record before us contains evidence which supports a range for the cost of equity from a high side of 12.75% and a low side of 10.25%. We acknowledge that determining the cost of common equity is not an exact science. There is no perfect calculation to ascertain the cost of equity since the record evidence attempts to "forecast" events in the future based on historical data. It is our responsibility to balance the interest of the **[*305]** ratepayers and the utility. On consideration of the position of the Company, we generally agree with NFGD's assertion that there is some correlation between changes in interest rates and upward pressure in the cost of equity. [2]7 On the basis of the foregoing, we conclude that more weight should, in fact, be given to the recent dividend yields. Consequently, the use of the 12-month dividend yield of 5.4% is not, in our view, reflective of the equity market the Company will operate within during the test year. We will, therefore, use a dividend yield which approximates the recent dividend yields set forth by the Company.

After a review of all the evidence **[*306]** presented by the parties and in the exercise of our judgement, we find that the appropriate cost of equity for this company in this proceeding is should not be set below 11.0%. Therefore, we shall establish a cost of common equity at 11.0% for use.

The following summarizes the risk adjustments to the cost of common equity proposed by the parties.

	NFGD [1]	**OCA [2]**	**OTS [3]**
	%	**%**	**%**
Financial Risk			- .25
Weather Normal- ization Clause			+ .125

The ALJ reasoned that the existence of differences between NFGD and the recommended capital structure and the barometer group indicates that there are business risks and financial risk differentials. The exact measurement of that risk is not possible based upon the record before us.

Further, the ALJ stated that the weather normalization clause adjustment should be rejected because it is not proven that a .125 **[*307]** percent adjustment is supportable other than judgmentally by the OTS witness.

Therefore, the ALJ's recommendation did not adjust its DCF cost rate to reflect either of OTS' proposed adjustments.

The OTS, in its Exceptions, clarifies that it would not except to this recommendation if a WNC is disallowed. However, to address the contingent approval of a WNC, the OTS would clarify its position concerning the ALJ reasoning. As discussed supra, a WNC was rejected. Consequently, we need not address the OTS Exception on this issue. After a review of the record, we find that the ALJ's recommendation not to adjust the DCF cost rate is supported by the record and shall be adopted. A summary of the findings herein appears below:

Summary of Findings

Capital Structure	**Ratio**	**Cost Rate**	**Weighted Cost**
	%	**%**	**%**
Long-Term Debt	36.1	8.16	2.95
Short-Term Debt	10.7	5.48	.59
Common Equity	53.2	11.0	5.85
Total	100.0		9.39

VIII. RATE STRUCTURE

A. Cost Of Service Study

NFG has presented two separate cost of service studies in this proceeding. Its preferred study, found at NFG Exhibit Nos. 111-1 (present rates) and 111-2 (proposed rates), separates **[*308]** distribution mains into large and small categories for cost allocation purposes, and uses a peak and average allocation methodology. The alternate study, found at NFG Exhibit Nos. 111-3 (present rates) and 111-4 (proposed rates) also uses the peak and average methodology, but makes no distinction among mains, treating all main sizes equally for allocation purposes. A number of issues were raised concerning the Company's cost of service studies. These will now be addressed in the following sections.

1. Allocation of Distribution Mains By Size

a. NFGD Position

The cost of service study preferred and utilized by NFG in this proceeding separates distribution mains into two size categories for cost allocation purposes. This separation was described by NFG witness Perry D. Figliotti as follows:

For the cost of service studies summarized in Exhibit Nos. 111-1 and 111-2, an analysis was performed which identified the diameter of distribution main directly serving the LVIS and LIS classes of customers. A review of each LVIS and LIS customer's service line(s) and the size, in diameter, of the distribution main connected to that service line was made. An estimate was then made, as **[*309]** to the amount of the LVIS and LIS customer's annual throughput and peak day requirements which are met from each diameter of distribution main serving that customer.

Based on this analysis, for the LVIS and LIS customer classes approximately 6% of their total annual throughput and peak delivery needs were served through distribution mains less than 4" in diameter. For the LIS class alone, 99% of its annual throughput was determined to be served by mains 4" in diameter or larger. Therefore, the peak and average allocation factor used to allocate the costs of distribution mains less than 4", excluded approximately 94% of the total LVIS and LIS annual throughput and peak requirements.

The basis for the mains allocation procedure followed by Distribution flows from the observation of the general design of a natural gas distribution system. Generally speaking, a natural gas distribution system is analogous to a local highway or road system. Just as a local highway system is configured with larger, multiple lane thoroughfares, which feed narrower residential side streets, a natural gas distribution system is constructed of larger diameter, higher pressure, distribution mains (feeder mains) **[*310]** serving smaller, lower pressure, distribution mains. Just as vehicular traffic to large industrial plants is likely to be served from the multiple lane thoroughfares which also service residential side-streets, so too, are industrial natural gas customers predominantly serviced from larger feeder mains which also service the gas requirements of distribution mains located in residential subdivisions. Also, similar to the traffic system where the traffic flows into a large industrial plant (with its hundreds and perhaps thousands of employees) would be inadequately served by a road with the configurations of a residential side-street, the natural gas demands of large volume customers would not be adequately met by the smaller diameter, low pressure, distribution mains used to serve residential subdivisions.

The large industrial customer mains study, utilized by the Company to allocate distribution mains plant, largely confirmed this common sense understanding of the basic design of a natural gas distribution system. The study of the diameter of main connected to large industrial customers provided information which confirmed that the majority of large industrial throughput (approximately **[*311]** 94%) was served through distribution mains with a diameter of 4 inches or greater. This basic design characteristic of natural gas distribution companies was recognized by the American Gas Association in its, General Engineering and Operating Practices (GEOP), A series by the Operating Section, The American Gas Association, Volume III, Distribution, Book D-1, System Design, (1990, American Gas Association, Arlington, Virginia), were (sic) it stated at page 192, "Very large future loads such as those produced by large industrial complexes, generally can be served from a transmission line spur or the high-pressure feeder system, so they do not burden the base distribution system."

NFG St. No. 102, pp. 37-40, footnote omitted.

b. OTS Position

The OTS objects to NFGD's use of the separated mains study. OTS contends that in such a study, the residential, commercial, public authority and small industrial classes are allocated most of the small mains cost, and hence, most of the total mains cost. OTS M.B., pp. 126-127. Moreover, OTS asserts that such a study ignores that fact that NFGD's system is an integrated distribution network providing benefits to all customers. In this **[*312]** regard, OTS argues that transportation customers can be served by gas displacement, and large customers benefit by having multiple delivery pathways available to them. Id., p. 128. Also, OTS contends that the decision to build a new high pressure main is based on the combined needs of both large and small customers. Id., p. 129. Finally, OTS notes that the Commission has previously denied a separation of mains cost of service study in Pa. P.U.C. v. Pennsylvania American Water Company, Docket No. R-901652, arguing that such a proposal ignored the integrated nature of the water transmission and distribution system. Id., pp. 129-130. For these reasons, OTS recommends that the separated mains study be rejected, and that the study allocating mains equally to all customers be utilized for rate design purposes in this proceeding. Id., p. 130.

c. OCA Position

The OCA opposes NFG's separated mains cost of service study for essentially the same reasons as does OTS. OCA contends that NFG's preferred study is based on present engineering design with regard to the physical movement of gas, and thus, ignores the fact that distribution systems are created over time to serve **[*313]** present and future loads. OCA M.B., pp. 196-198, 202-203. Specifically, the OCA states as follows:

NFGD's small mains adjustment should be rejected because it fails to recognize that Distribution's system is integrated both for operating and planning purposes. As an integrated system, Distribution will continue to change over time based upon the needs and revenues of both large and small customers. Thus, allocating distribution mains on the basis of size is not reasonable because the system was developed over time to serve accumulated loads and not to serve particular customers and their needs. As Mr. Ruback testified:

Distribution systems were not built according to a master design adopted at the formation of a retail distribution company. Rather, distribution systems are a series of improvements built upon each other and projects that are not cost effective at one point in time can become cost effective if new facilities are built for loads that are cost justified.

OCA St. 2 at 13. This is how NFGD's distribution system was created. No parties have disputed this point. NFGD's current system embodies numerous past and on-going augmentations to meet these continually changing requirements. **[*314]** As Mr. Ruback further testified:

The effect of the small mains adjustment is to allocate fewer costs to large customers because their services are connected to larger mains when the larger mains would not exist but for previous improvements or facilities made possible because of the revenue from all classes. . . . It would be a complete irony for small customers to be allocated more costs when their combined load may have justified the large mains from which the large customers attach their services.

Id. at 13-14. OCA M.B., pp. 196-197.

The OCA contends that NFG's main extension policy exemplifies this concept that the development of mains depends on the costs and benefits with regard to all customers. Id., p. 197. OCA also contends that NFG's small mains adjustment is inconsistent with the testimony of its witness Robert Sprague with regard to the reliability benefits of NFG's integrated system. Id., pp. 203-204. Like OTS, OCA notes that the Commission rejected a proposed small mains adjustment in a past base rate case involving Pennsylvania American Water Company. Id., pp. 198-199, 205. In addition, OCA asserts that the Commission has previously rejected cost **[*315]** of service studies which utilized a minimum system methodology with a customer component in the allocation of mains. Id., pp. 206-208. According to OCA, "the small mains adjustment proposed by NFGD in this case is little more than another form of a minimum system approach for the allocation of distribution main costs." Id., p. 208.

Finally, the OCA contends that NFG's small mains adjustment results in an unfair allocation of costs to the Company's smaller, captive customers. OCA suggests that the small mains adjustment is result-oriented and self-serving because it attempts to accommodate the Company's competitive concerns by allocating a lesser portion of total costs to the large customers. OCA R.B., pp. 100-101.

For all the reasons discussed above, the OCA opposes the use of NFG's preferred separated mains cost of service study, and advocates the use of the study which allocates distribution mains equally to all customers. Id., p. 95.

d. OSBA Position

The OSBA also argues against the use of the small mains adjustment in NFG's cost of service study. OSBA's position is similar to that of OCA in that it contends that NFG's separate allocation of small and large mains **[*316]** is a way of assigning the same cost reductions to the LVIS class that would occur for all non-residential customers if a customer component of mains were recognized in the cost of service study. OSBA R.B., p. 32. OSBA argues that the small mains adjustment acts to shield the larger customers from the costs that ordinarily would be allocated to them under a peak demand or annual volumes methodology, and to reassign these costs to mid-sized customers. Id., pp. 32-33. Like OCA, OSBA contends that NFG's small mains adjustment is done specifically to support a preferred revenue allocation. OSBA St. No. 1, p. 59.

e. Hospital Council Position

The Hospital Council of Western Pennsylvania also objects to NFG's separate allocation of distribution mains according to size. Like OTS, the Hospital Council argues that this separation of mains fails to recognize the integrated nature of NFG's system. According to the Hospital Council, LVIS customers benefit from the integrated nature of the system through the fact that they receive gas through displacement. Hospital Council M.B., pp. 6-7.

f. NFG Response

In response to the objections and arguments of the other parties, NFG contends **[*317]** that its gas system is not integrated in the same sense as a water system. NFG argues that the larger distribution mains are generally high pressure mains used to serve large customers and to meet the cumulative needs of groups of smaller customers. NFG avers that gas does not flow from low pressure mains to high pressure mains. Therefore, the smaller, low pressure mains do not serve large customers. NFG M.B., pp. 176-178.

As for OCA's argument that NFG's system is integrated with regard to its planning and economics, NFG contends that regardless of whether or not that is true, small mains were still constructed to serve small customers, not large ones. Id., p. 179. Furthermore, NFG argues that the various cost items that relate to the common planning aspects of its system are already appropriately allocated elsewhere in its cost of service study, and do not need to be recognized in the allocation of mains. Id., pp. 179-180.

g. ALJ Recommendation

The ALJ recommended that NFG's small mains adjustment be utilized. He reasoned that the proposal was a logical and reasonable step in cost allocation. Because NFG's proposal treats small and large mains separately for cost **[*318]** allocation purposes, the small mains adjustment represents a refinement in cost allocation which he deemed preferable to the more general allocation procedures. (R.D. at 219)

h. Exceptions

The following parties argue that the ALJ erred in his recommendation: OTS, OCA, OSBA and the Hospital Council. Each party's respective position on exception is summarized as follows.

The OTS contends that all customers benefit from an integrated mains system. NFG's system was not built just for one customer.

The OCA argues that Commission practice is to allocate costs on the basis of each class' contribution to peak and annual requirements.

The OSBA states that it is erroneous to utilize a cost study which separates distribution mains into two cost categories as opposed to the "mains equal" approach.

The Hospital Council urges that the allocation of distribution mains on the basis of size allegedly required o service specific customer classes does not reflect the cost causative factor applicable to NFG's integrated system.

After a review of the record, we find that the arguments opined by OCA are most persuasive. We conclude that we should retain our historic practice of allocating total **[*319]** distribution main costs based on each class' contribution to peak and annual requirements. NFG's proposed small mains adjustment suffers from the same weaknesses that we have previously found required the rejection of other alternatives to a Peak and Average cost of service study.

Specifically, we have previously rejected proposals for a zero-intercept or minimum system method of cost of service. See, *Pennsylvania P.U.C. v. National Fuel gas Distribution Corp., 73 Pa. P.U.C. 552, 617 (1990); Pennsylvania P.U.C. v. Peoples Natural Gas Co., 63 Pa. PUC 6 (1986).* In those cases we rejected these methods, agreeing with the OCA's position that such methods are not consistent with cost causation.

There is little on this record to distinguish NFGD's proposed small main adjustment in the instant proceeding from the "minimum system" approach which we have previously rejected. Like the minimal system approach, the small mains adjustment would allocate the costs of smaller mains primarily to customers with smaller throughput. At the same time, NFGD did not propose an equally skewed allocation of larger distribution mains to customers with larger throughput based on any analysis of the **[*320]** use of such larger-size distribution mains by smaller customers. Instead, the focus of NFG's study was clearly to relieve large customers of the burden of paying for smaller distribution mains, without any consideration of whether small customers should be paying for larger distribution mains.

NFGD's current system embodies numerous past and on-going augmentations to meet the continually changing requirements of its customers, and it is simply improper to look at the distribution system at a particular point in time and attempts to identify particular sizes of mains to particular customer classes. The Company's analysis focuses only upon the use of small mains by large customers and does not consider small customers' use of large mains. The size of mains directly connected to a customer is only a small factor in determining the cost of system augmentation necessary to serve a particular customer or customer class. Main line extensions are made based upon the particular economics of each extension in terms of the load generated and the number of customers served.

For all the reasons discussed above, we find that NFGD's separate treatment of small and large mains for cost allocation **[*321]** purposes should be rejected. The Peak and Average method that allocates mains equally is a sound and reasonable method of cost allocation and should remain intact.

2. Direct Assignment of Mains to LIS Customers

a. NFG Position

In this proceeding, NFG has reduced the volumetric requirement for eligibility in the LIS customer class from 3 million Mcf annually to 200,000 Mcf annually. As a result, 15 customers have become eligible for service under Rate Schedule LIS. Previous to this change in eligibility requirements, there had been no customers served under this rate schedule since Sharon Steel Corporation ceased operations. NFG M.B., p. 180.

In its cost of service studies, NFG has chosen to allocate the cost of mains to the LIS customers through the use of a direct assignment. NFG witness Figliotti described this methodology as follows:

As explained previously, mains were directly assigned to the revised LIS class in determining the mains to be assigned. For each LIS customer, the entire length of mainline pipe (by size) from the customer's facility to a National Fuel Gas Supply line was identified and then priced out at the average cost per foot for each size pipe. In **[*322]** order to be conservative, the LIS customer was assigned the full responsibility for the length of mainline identified as needed to serve the LIS customer, even if as is usually the case, other customers are served from that mainline. The fact is that a single main from a source of supply to an LIS customer together with a meter, service and regulator, are all that are required to serve LIS customers. This point has been demonstrated time and time again by the successful use of bypass facilities which generally consist of only these simple facilities.

NFG St. No. 102, pp. 36-37.

b. OSBA Position

The OSBA criticizes NFGD's direct assignment of mains to the LIS class, stating that it "does nothing more than build a bypass scenario into the cost allocations." OSBA St. No. 1, p. 59. Specifically, OSBA argues as follows:

The LIS allocations are premised completely on the assumption that large users -- all large users -- need only effectuate a bypass by installing a single main to the nearest source of supply. Worse yet, NFG assumes that such customers can accomplish such a bypass at cost levels which match NFG's own historic embedded costs, which of course would be less than replacement **[*323]** costs. NFG Ex. No. 102, p. 36. The effect of this practice is to cap prices for the most "competitive" markets not just at embedded cost but at a stripped-down version of this cost. NFG Ex. No. 1, p. 60. This fact specifically contradicts the Company's remark that, "[i]f they are charged more than the cost of providing service they will be lost to bypass." NFG M.B., at 183.

NFG's allocation treatment is predestined to cause LIS customers to be charged less than the cost of providing service, much less the cost of effectuating a bypass. As such, the Company's proposed direct assignment of mains to the LIS class is entirely inappropriate.

OSBA R.B., p. 34.

The OSBA suggests that the cost to serve LIS customers is greater than simply the customers' cost to bypass the system. OSBA witness Edwards stated that "[t]here is real value in NFG's organizational integration; it is one of the extra things NFGDC has to sell which cannot be measured in a cost study." OSBA St. No. 1, p. 62. In this regard, Mr. Edwards referred to NFG's expertise in natural gas sales, marketing, supply acquisition and utilization. N.T. 44.

c. Hospital Council Position

The Hospital Council of Western **[*324]** Pennsylvania also objects to the Company's direct of assignment of the cost of distribution mains to the LIS class. The Hospital Council contends that in taking service from NFG, LIS customers use more than just the type of facilities they would use if they bypassed NFG's system. The Hospital Council argues that NFG's system is an integrated system, and that LIS customers utilize the whole system in receiving transportation service through displacement of gas. Hospital Council M.B., pp. 5-7.

d. NFGD Response

In response to the OSBA's position, NFGD contends that this position is improperly based on value of service considerations. NFGD argues that the expertise it provides its customers is either already accounted for in other cost allocations, or is not applicable to the LIS class. NFGD M.B., p. 183. As for the Hospital Council's contentions, NFGD asserts that these contentions are simply incorrect. NFGD R.B., p. 99. NFGD reiterates its position that its system is not integrated, and that small mains at low pressures physically cannot be used to serve large industrial customers. *Id., p. 100.*

e. ALJ Recommendation

ALJ Kashi recommended that NFGD's proposed direct assignment **[*325]** of mains costs to the LIS class be accepted. R.D., p. 225.

f. Conclusion

Based on the recommendation herein, we shall adopt the ALJ recommendation concerning the direct assignment of main costs to the LIS class.

3. Determination of Peak Day Load

a. OSBA Position

OSBA objects to the fact that NFG developed its peak day load figure for cost allocation purposes on the basis of a 70 degree-day (-5 degrees Fahrenheit) peak day. OSBA contends that a 70 degree-day peak is an extreme assumption, and has the probability of occurring only once every seven years. OSBA M.B., p. 21. OSBA asserts that the use of the 70 degree-day peak results in the overstatement of cost responsibilities for the weather sensitive customer classes. Id. According to OSBA, a more reasonable assumption is a 60 degree-day (+5 degrees Fahrenheit) peak day, which has a probability of occurrence of once every two years. Id.

b. NFG Response

NFG responds to OSBA's position by arguing that its system is designed and built to meet design day loads, not average peak day loads. NFG contends that it is the use of gas on the design day that causes the Company to incur construction costs. NFG M.B., **[*326]** p. 184. NFG notes that in its 1993 1307(f) proceeding at Docket No. R-922499, the Commission rejected the Company's proposal to allocate capacity costs between sales and transportation customers based on an average peak day, ruling that a design day should be used instead. Id. Thus, the Company asserts that OSBA's criticism of its use of a design day in this proceeding is without merit and should be rejected. Id.

c. ALJ Recommendation

ALJ Kashi concluded as follows:

We agree with NFG that a design day should be used to develop the peak day load for cost allocation purposes since the system was constructed to meet a design day peak and not an average peak. Therefore, we find nothing improper in the Company's use of the 70 degree-day peak, and recommend that it be accepted.

R.D., p. 226.

d. Conclusion

On consideration of the recommendation of ALJ Kashi, we shall so adopt it.

B. Revenue Allocation

1. NFG Position

NFG witness Figliotti provided a general description of the Company's proposed revenue allocation as follows:

. . . [T]he apportionment of revenues among rate classes consists of deriving a reasonable balance between various criteria or guidelines **[*327]** that relate to the design of utility rates. The criteria that were considered in the process included: (1) cost of service; (2) class contribution to present revenue levels; (3) recognition of market conditions; and (4) customer impact considerations. These criteria were evaluated for each of Distribution's rate classes. The resulting class revenue levels under proposed rates for the future test year were derived as detailed on pages 6 through 9 of Exhibit No. 111-C. Based on the evaluation of the above-mentioned criteria, adjustment of class revenue levels were made so that all class rates of return, as derived in Distribution's peak and average allocated cost-of-service study with distribution mains allocated by diameter of mains for the future test year at proposed rates, were approximately equal.

NFG St. No. 102, pp. 17-18.

The following tables set forth NFG's proposed allocation of its requested revenue increase among the various customer classes, as well as the class rates of return at present and proposed rates under both the separately allocated mains cost study, and the equally allocated mains cost study.

NFG PROPOSED INCREASE ALLOCATION

Percent Total	**Class**	**Increase**	**Percent of Increase**
79.17	Residential	$ 12,600,000	7.45
23.69	Comm & Pub Auth	3,771,000	7.57
5.58	SVIS	888,000	11.23
4.18	LVIS	(666,000)	-15.60
4.26	LIS	(678,000)	-19.28
100.00	Total Company	$ 15,915,000	6.78

[*328]

NFG Ex. No. 103-A-1, pp. 1-4.

CLASS RATES OF RETURN

(Mains Allocated by Small & Large Size)

Present Rates	**Proposed Rates**

Customer Class	ROR	Unitized ROR	ROR	Unitized ROR
Residential	5.20%	0.9	9.77%	1.0
Small Comm & Pub Auth	7.46%	1.2	9.89%	1.0
Large Comm & Pub Auth	4.46%	0.7	10.05%	1.0
Small SVIS	11.08%	1.8	10.66%	1.1
Intermediate SVIS	5.20%	0.9	9.97%	1.0
LVIS	15.11%	2.5	10.01%	1.0
LIS	18.31%	3.1	11.95%	1.2
Total Company	6.00%	1.0	9.90%	1.0

NFG Ex. No. 111 (Revised), p. 2.

CLASS RATES OF RETURN

(Mains Allocated Equally)

	Present Rates	Proposed Rates		
		Unitized		Unitized
Customer Class	**ROR**	**ROR**	**ROR**	**ROR**
Residential	5.37%	0.9	10.00%	1.0
Small Comm & Pub Auth	7.65%	1.3	10.12%	1.0
Large Comm & Pub Auth	4.68%	0.8	10.38%	1.0
Small SVIS	11.34%	1.9	10.92%	1.1
Intermediate SVIS	5.49%	0.9	10.39%	1.0
LVIS	8.68%	1.4	5.08%	0.5
LIS	18.31%	3.1	11.95%	1.2
Total Company	6.00%	1.0	9.90%	1.0

NFG Ex. No. 111 (Revised), p. 2.

Both the LVIS and the LIS classes would receive revenue decreases under NFG's proposal. However, with regard to the decrease for **[*329]** the LIS class, NFG explains as follows:

Presently, no customer is eligible for Rate Schedule LIS. Distribution proposed to expand the eligibility for Rate Schedule LIS so that its largest 15 customers would be served under it, instead of under Rate Schedule LVIS. Under Distribution's proposed rates, although there would be an increase in rates under Rate Schedule LIS, the 15 customers to be served under Rate Schedule LIS would receive a decrease in rates as a result of their transfer from Rate Schedule LVIS to Rate Schedule LIS, since rates under Rate Schedule [LVIS] are greater than rates under Rate Schedule LIS at both present and proposed rates. In Distribution's revenue exhibits, the change in rates under Rate Schedule LIS is shown as a decrease because less revenues would be produced under proposed rates for the customers to be served under Rate Schedule LIS. See Ex. No. 103-A-1, p. 4.

NFG R.B., p. 87.

2. OTS Position

OTS opposes NFG's proposed revenue allocation, asserting that it is not reasonable when evaluated from the standpoint of OTS' preferred cost of service study -- the study which allocates mains equally. Specifically, OTS objects to the fact that under this **[*330]** study, the unitized rate of return for the LVIS class moves from 1.4 at present rates to 0.5 at proposed rates. OTS asserts that customer classes with rates of return below the system average will be subsidized by other classes. OTS M.B., p. 131.

OTS proposes a revenue allocation in which the LVIS class would remain at present rates instead of receiving a decrease as it would under the Company's proposal. Under OTS' proposal, the LVIS class would show a unitized rate of return of .8547. OTS contends that while the LVIS class would still be subsidized under this proposal, its allocation would be more cost-based than the Company's. OTS states that the LVIS class should continue to move towards cost in future proceedings. Id., p. 132.

If the LVIS class is held at present rates as OTS proposes, the $ 666,000 decrease which the Company proposes for this class would have to be reallocated. OTS recommends that this decrease be allocated to the residential class and the commercial and public authority classes in proportion to the amounts of the increases proposed for these classes by NFG. The resulting decrease to the commercial and public authority classes would be further allocated **[*331]** 50% to the small commercial and public authority customers, and 50% to the large commercial and public authority customers. Id., pp. 132-133. OTS contends that this proposal is consistent with rate design principles of gradualism and class risk. Id., p. 133.

Should NFG be granted less than its full requested increase in this case, OTS recommends that the scale-back in revenue be allocated proportionately to the residential, commercial and public authority, and small volume industrial classes, with the LVIS class remaining at present rates. OTS further recommends that the Company's proposed revenue reduction for the LIS class be scaled back proportionately. Id., pp. 133-134. In addition, OTS recommends that the Company's proposed revenue reduction for the LVIS class be scaled back proportionately as well if the OTS proposal to have this class remain at present rates is rejected. Id., p. 135.

NFG objects to OTS' scale-back proposal as it relates to the LIS class. NFG contends that such a proposal would produce an illogical result because a scale-back of a revenue decrease would amount to a revenue increase over that proposed by the Company for this class. This would **[*332]** be unreasonable for a rate class that is already producing the highest rate of return of all classes, the Company argues. NFG R.B., pp. 88-89. However, OTS asserts that its proposed scale-back is not illogical, arguing as follows:

[OTS witness] Keim testified that if the Commission were to grant a lesser increase than the Company's originally requested $ 15.9 million, the company's proposed reductions to both the LVIS and LIS classes must be scaled back, even if the Commission would have agreed that rates to these classes should be reduced. This is because the Company actually had to design the rates of classes other than LVIS and LIS to recover $ 17,259,000, in order to provide a $ 666,000 and $ 678,000 reduction, respectively, to the LVIS class and LIS class. See, OTS Ex. No. 4B, Sched. 1. Thus, if the proposed reductions are not scaled back, the other classes will not receive the full benefit of any proposed revenue increase scaleback, because their rates would have to be designed to recover the amount not recovered in the LIS and LVIS rates to maintain revenue neutrality.

OTS M.B., pp. 134-135.

The following tables set forth OTS' proposed revenue allocation and resulting **[*333]** class rates of return under the OTS preferred cost of service study.

OTS PROPOSED INCREASE ALLOCATION

Percent Total	**Class**	**Increase**	**Percent of Increase**
75.95	Residential	$ 12,087,000	7.15

OTS PROPOSED INCREASE ALLOCATION

Percent Total	Class	Increase	Percent of Increase
22.73	Comm & Pub Auth	3,618,000	7.26
05.58	SVIS	[2]8 888,000	11.23
0	LVIS	0	0
4.26	LIS	(678,000)	-19.28
100.00	Total Company	$ 15,915,000	6.78

OTS Ex. No. 4B, Sch. 1; NFG Ex. No. 103-A-1, pp. 1-4.

CLASS RATES OF RETURN

(Mains Allocated Equally)

	Present Rates		Proposed Rates	
		Unitized		Unitized
Customer Class	ROR	ROR	ROR	ROR
Residential	5.37%	0.9	9.82%	0.9915
Small Comm & Pub Auth	7.65%	1.3	9.90%	1.0002
Large Comm & Pub Auth	4.68%	0.8	10.24%	1.0341
Small SVIS	11.34%	1.9	10.78%	1.0890
Intermediate SVIS	5.49%	0.9	10.40%	1.0501
LVIS	8.68%	1.4	8.46%	0.8547
LIS	18.31%	3.1	11.95%	1.2072
Total Company	6.00%	1.0	9.90%	1.0000

OTS **[*334]** Ex. No. 4A, Sch. 3; NFG Ex. No. 111 (Revised), p. 2.

3. <u>OCA Position</u>

The OCA also objects to NFG's proposed revenue allocation, contending that it cannot be justified based upon the equal mains allocation cost of service study, which is OCA's preferred study. Like OTS, OCA specifically criticizes NFG's proposed revenue reduction to the LVIS class. OCA M.B., pp. 208-210. OCA contends that NFG's proposals are meant to address competitive concerns. However, OCA argues that competitive conditions in NFG's service territory do not justify the low class rate of return for the LVIS class produced under the equal mains allocation cost of service study. <u>Id.,</u> pp. 211-212. OCA asserts that the Company's proposal with regard to other customer classes also cannot be justified. <u>Id.,</u> p. 210.

The OCA recommends that NFG's proposed decrease to the LVIS class be eliminated, and that an additional $ 675,000 be allocated to this class. OCA further recommends that the revenue levels for the other classes be reduced by the amount of OCA's total LVIS increase over the Company's proposed amount, and that this reduction be made in proportion to these classes' contribution to the revenue increase. **[*335]** Id., p. 216. Should NFG receive less than its total requested increase in this case, OCA recommends that its proposed allocations be scaled back proportionately except for the LVIS class, which should receive no reduction. Id., pp. 216-217.

Should the Commission reject OCA's LVIS allocation, OCA recommends that other classes not be required to absorb the shortfall between the Company's LVIS rate of return at proposed rates and the system average rate of return (as determined using the equally allocated mains cost of service study). OCA witness Steven W. Ruback calculated this amount to be $ 951,000. Id., p. 213. OCA argues that this amount represents the consequences of the risk associated with the loss of customers and associated throughput. It is OCA's position that the Commission should change its policy of allowing fixed costs to be redistributed to remaining customers when throughput is reduced due to reduced demand or competition. Thus, OCA contends that either its proposed allocation be adopted, or the Company's shareholders be made to bear the risk associated with lost throughput, which is represented by the $ 951,000 amount. Id., pp. 213-216.

In response **[*336]** to this point, NFG contends that its proposed reduction to the LVIS class is based on its cost of service study, not competitive concerns. NFG R.B., pp. 94-95. NFG asserts that it is not seeking to have small customers bear the burden of cost shifting from discounted rates. Id., pp. 95-96. NFG argues that OCA's proposal in this regard is unreasonable and not supported by Commission or appellate court precedent. Id., pp. 96-97.

The following tables present OCA's proposed revenue increase allocation and the resulting class rates of return under OCA's preferred cost of service study.

OCA PROPOSED INCREASE ALLOCATION

Percent Total	**Class**	**Increase**	**Percent of Increase**
74.97	Residential	$ 11,965,300	7.05
6.77	Small Comm & P/A	1,080,600	4.67
13.60	Large Comm & P/A	2,170,300	7.80
0.12	Small SVIS	19,000	4.59
4.56	Intermediate SVIS	727,700	9.70
4.23	LVIS	675,100	15.78
4.25	LIS	(678,000)	-19.27
100.00	Total Company	$ 15,960,000	6.77

OCA St. No. 2, SWR Ex. 2.

CLASS RATES OF RETURN

(Mains Allocated Equally)

	Present Rates	Proposed Rates		
		Unitized		Unitized
Customer Class	**ROR**	**ROR**	**ROR**	**ROR**
Residential	5.37%	0.9	9.76%	0.986
Small Comm & Pub Auth	7.65%	1.3	10.89%	1.100
Large Comm & Pub Auth	4.68%	0.8	8.90%	0.900
Small SVIS	11.34%	1.9	14.94%	1.509
Intermediate SVIS	5.49%	0.9	9.50%	0.960
LVIS	8.68%	1.4	11.89%	1.201
LIS	18.31%	3.1	11.95%	1.207
Total Company	6.00%	1.0	9.90%	1.000

[*337]

OCA St. No. 2, SWR Ex. 2; NFG Ex. No. 111 (Revised), p. 2.

4. OSBA Position

OSBA objects to NFG's proposed revenue decrease to the LVIS and LIS classes, and the proposed increase to the small commercial and public authority class. OSBA contends that the only support for the revenue decreases for LVIS and LIS is NFG's cost of service study, which OSBA opposes. OSBA M.B., p. 33. With regard to the small commercial and public authority class, OSBA argues that NFG's proposed $ 817,000 increase to this class is unreasonable, and ignores the fact that small business customers are a critical part of the economic base of the Company's service territory. Id., pp. 33-35. OSBA states that "[n]ot only is such an increase not justified, but the record evidence is clear that the economic impact of such an increase to this vital sector of the community would be too much to bear." Id., p. 35. OSBA also objects to any increase to the small SVIS class. Id., p. 36.

The following table sets forth OSBA's revenue allocation proposal in this proceeding. This proposal incorporates OSBA's position that the LVIS and LIS customers should receive no decrease. It also incorporates the position **[*338]** that the small commercial and public authority customers and small SVIS customers should receive no increase. In addition, OSBA's proposal reflects its recommended $ 2.4 million adjustment to the Company's total requested increase based on its position with respect to the degree-day issue as discussed earlier.

OSBA PROPOSED INCREASE ALLOCATION

Percent			Percent of
Total	**Class**	**Increase**	**Increase**
82.75	Residential	$ 11,160,678	6.34
0	Small Comm & P/A	0	0
13.62	Large Comm & P/A	1,837,649	6.34
0	Small SVIS	0	0
3.63	Intermediate SVIS	489,478	6.34
0	LVIS	0	0

OSBA PROPOSED INCREASE ALLOCATION

Percent Total	Class	Increase	Percent of Increase
0	LIS	0	0
100.00	Total Company	$ 13,487,805	5.52

OSBA Ex. 1, Sch. 3, p. 3.

The OSBA contends that if NFG's cost of service study were adjusted to reflect OSBA's position with regard to peak day degree-days, the small mains adjustment, and the direct assignment of mains to LIS customers, a revenue decrease for the small commercial and public authority class would be indicated. OSBA M.B., pp. 36-38. OSBA further argues that if NFG is granted less than the $ 13.5 million recommended by OSBA, the final amount of the overall increase should still be apportioned equally among the residential, **[*339]** large commercial and public authority, and small SVIS classes. OSBA R.B., p. 36. If the ultimate residential increase is less than 5%, OSBA asserts that the small commercial and public authority class and the small SVIS class should receive decreases, determined by subtracting 5 percentage points from the ultimate residential increase. Id.

5. ALJ Recommendation

The ALJ found that NFG's proposed revenue allocation was the most reasonable since he concluded that the more appropriate cost of service study to use in this proceeding was the separated main study. The ALJ reasoned that NFG's allocation moves all classes of service toward cost, resulting in unitized rates of return that are at, or near unity, for almost all classes.

The ALJ did recommend that the OTS recommendation to scale back the revenue increase proportionally including the proposed decreases to LVIS and LIS classes should be adopted.

6. Exceptions

The OTS and OCA except to the ALJ's recommendation to adopt NFG's proposed revenue allocation, particularly to the decrease to the LVIS class.

The OTS proposes that the LVIS rate should remain at its present level. The OTS states that the LVIS class should **[*340]** continue to move towards cost in future proceedings.

The OCA also alleges that adoption of NFG's revenue allocation is erroneous. OCA submits that the $ 1.35 million should be allocated to the LVIS class with $ 675,000 utilized to reduce the revenue requirement of the remaining classes.

As previously discussed, the cost of service study which separated mains by size was rejected as unreasonable. Therefore, NFG's proposed revenue allocation, based on that cost of service study, to the various rate classes must also be rejected. We have found that the cost of service study which allocates mains equally should be utilized. Therefore, the revenue allocation using the peak and average study with distribution mains allocated equally should be adopted.

We have reviewed the cost allocation of the OTS and OCA and finds that the OTS's revenue allocation is more appropriate in this proceeding.

NFG did not except to the ALJ's proposed scale-back for all other rate classes, but argues that the scale-back should not be applied to the proposed reduction in the LVIS and LIS classes. NFG argues that such a proposal would produce an illogical result because a scale-back of a revenue decrease would **[*341]** amount to a revenue increase over that proposed by NFG for those classes.

We agree with OTS witness Keim who testified that if the proposed reductions in the LVIS and LIS classes are not scaled back, the other classes will not receive the full benefit of any proposed revenue increase scaleback, because their rates would have to be designed to recover the amount not recovered in the LIS and LVIS rates to maintain revenue neutrality.

Therefore, we deny the Exceptions of NFGD and find that the LVIS and LIS classes are to be scaled-back to maintain revenue neutrality.

C. Residential Customer Charge

1. NFG Position

NFG is proposing an increase in its residential customer charge in this proceeding. The Company describes its proposal as follows:

In this proceeding, Distribution has proposed an increase to its residential customer charge from $ 11.68 per month to $ 13.50 per month. This increase was based upon a study, that is provided at Exhibit No. 111-E, which provides an analysis of customer cost of service. As shown on page 2 of Exhibit No. 111-E, a cost-based residential customer charge would be $ 17.57. Therefore, Distribution's proposed increase to the customer charge **[*342]** would simply move the customer charge toward (but not to) a cost-based rate. Distribution is proposing to move its residential customer charge toward a cost-based rate with increases limited by principles of gradualism.

NFG M.B., p. 185.

NFG asserts that its proposed customer charge is consistent with Commission orders regarding cost-based customer charges and gradualism in prior rate cases involving both NFG and other utilities. Id., pp. 185-187. NFG argues that a cost-based customer charge is necessary to minimize the subsidization of small customers by large ones within the residential class as a result of customer costs being included in the commodity charge. NFG M.B., pp. 187, 188; R.B., pp. 93-94. The Company notes that it has not increased its residential customer charge in almost five years. NFG M.B., p. 185. It argues that if its proposed increase is approved, it would still have one of the smallest percentage increases in customer charges over that period. Id., p. 187.

2. OTS Position

The OTS is opposed to NFG's proposed residential customer charge. OTS notes that the Company's proposed increase to this charge is 15.58%, which is more than twice the overall **[*343]** requested increase percentage of 6.8%. OTS further notes that under the Company's proposal, it would recover about 34% of its proposed additional residential revenues through the customer charge, in contrast to the 16% of residential revenues currently recovered through the customer charge. OTS M.B., p. 122.

The OTS also contends that NFGD improperly included customer allocated administrative and general expenses in calculating residential customer costs at $ 17.57/month. The OTS claims that the exclusion of such indirect costs would produce a customer cost figure of $ 13.51/month. Thus, the OTS argues that NFGD's proposed increase in the customer charge to $ 13.50/month is an increase to 100% of customer costs, which violates the principle of gradualism. Id., p. 123. OTS notes that the Commission, in Pa. P.U.C. v. Pennsylvania-American Water Company, Docket No. R-00932670, ruled that a true customer charge should only include direct customer costs relating to metering, billing, meters and services. Id., pp. 123-124.

Instead of NFGD's proposed increase in the residential customer charge to $ 13.50/month, the OTS recommends a more moderate increase to $ 12.75/month at **[*344]** the Company's full requested revenue increase of $ 15.9 million. At the OTS' recommended revenue increase of $ 3.4 million, OTS would propose no increase to the customer charge. Id., p. 122. In order for NFGD to recover the amount of the difference in the revenue level between that produced by its proposal and that produced by OTS' proposal, OTS recommends the following:

[OTS witness] Keim proposed to recover the $ 1.75 million revenue shortfall, produced by the $ 12.75/month customer charge, through the two residential volumetric blocks. This results in an increase of 7.16 cents in each block over the rate proposed by the Company. The first rate block is increased to $ 6.6267 from $ 6.5551 or by 7.43% vs. the Company's 6.27%. The tailblock is increased to $ 6.2382 from $ 6.1667 or 6.59%, as compared to the Company's proposal of 5.37%. OTS Stmt. No. 4, pp. 5-6. As indicated on OTS Ex. 4A, Schedule 1, this proposal is revenue neutral.

Id., p. 125.

3. OCA Position

The OCA also objects to NFG's proposed increase to the residential customer charge. OCA states that if the Company's proposed customer charge is accepted, it will be the highest of any major natural gas company **[*345]** in the Pennsylvania. OCA M.B., p. 186. The OCA contends, as does the OTS, that NFGD improperly included indirect costs such as administrative and general expenses, some mains costs, and return and income taxes in its calculation of residential customer costs. OCA M.B., pp. 186-187. Citing a number of past rate cases, the OCA argues that the only costs that are properly included in a customer charge are carrying charges on the meter and service drop, their associated operations and maintenance expenses, and customer service expenses associated with meter reading and billing. Id., pp. 187-189. OCA determined that the proper level of residential customer costs to be considered in this case, based only on direct costs, is $ 12.02. Id., p. 187.

The OCA also contends that the Company is attempting to avoid the risk of non-recovery of revenues by recovering an inordinate amount of residential revenues through a high customer charge. Id., pp. 191-192. Furthermore, OCA argues that a large customer charge would be a disincentive for customers to conserve, and would cause customers to experience inappropriately high gas bills during the non-heating season. Id., p. 192. Finally, **[*346]** the OCA asserts that the Company's proposed increase to the residential customer charge violates the principle of gradualism. Id., pp. 192-193. For these reasons, OCA recommends that NFG's proposed increase to its residential customer charge be rejected, and that the customer charge remain at its current level in this proceeding. Id., p. 186.

4. NFG Response

In response to the arguments of OTS and OCA that only direct customer costs should be included in the residential customer charge, NFG contends that the cases cited by these parties do not support such arguments. NFG argues that these cases either do not truly address the issue of direct versus indirect customer costs, or they involve situations wherein the utility attempted to include costs that were not customer-related at all. NFG R.B., pp. 89-93. Moreover, NFG asserts that even if only direct customer costs as defined by OTS and OCA should be included in the customer charge, an increase would still be justified because the current residential customer charge is still below the level of direct customer costs as determined by OTS and OCA. NFG M.B., pp. 188-189.

5. ALJ Recommendation

The ALJ agreed with the **[*347]** OTS and the OCA on this issue. Despite NFGD's arguments to the contrary, he believed the Commission has clearly defined the costs to be included in a residential customer charge as being limited to those costs which directly relate to the meter and service drop, and customer service expenses associated with meter reading and billing. See, e.g., *Pa. P.U.C. v. Metropolitan Edison, 60 Pa. PUC 349 (1985); Pa. P.U.C. v. West Penn Power Company, 59 Pa. PUC 552, 69 PUR 4th 470 (1985).* The evidence in this case reveals that NFG developed its customer cost figure on the basis of costs that fall outside of this definition of applicable customer costs. Moreover, he agreed with OTS and OCA that NFG's proposed increase to the residential customer charge violates the principle of gradualism, given the fact that it amounts to a 15.58%

increase as compared to the overall requested revenue increase of 6.78%. Therefore, the ALJ recommend that NFG's proposed residential customer charge be rejected.

In light of the fact that OTS and OCA determined the applicable residential customer cost to be $ 13.51/month and $ 12.02/month, respectively, the ALJ did not believe an increase to the current **[*348]** customer charge of $ 11.68/month can be justified at this time. Therefore, he recommended that the current level of the customer charge be maintained in this proceeding. He further recommended that the difference in revenue between that produced under the Company's proposal and that produced under the present charge be assigned proportionally to the residential commodity rate blocks to assure revenue neutrality. (R.D., at 245-246)

6. Exceptions

NFGD contends that the ALJ's recommendation is wrong for several reasons. First, even the "direct" customer costs would justify an increase in the customer charge to $ 12.02. Second, the ALJ's reliance on the cited cases is misplaced because of a difference in circumstances since the Commission previously removed costs which were demand-related, not customer-related, and that the Company's customer charge analysis includes only customer costs. NFGD contends that in the instant proceeding, all costs which NFGD proposes to recover through its customer charge are only customer costs.

We affirm the ALJ's recommendation and reject NFG's Exception on this issue. The evidence in this proceeding reveals that NFG developed its customer cost figure **[*349]** on the basis of costs that fall outside of the definition of applicable customer costs. NFG's proposed increase to the residential customer charge violates the principle of gradualism, given the fact that it amounts to a 15.58% increase as compared to the overall requested revenue increase of 6.78%.

Commission precedent is clear that indirect customer costs are not properly included in the customer charge. Only those costs which represents items that the utility must have in place each month for each customer are "basic customer costs" which are properly recovered in the customer charge. *Pa. P.U.C. v. Metropolitan Edison, 60 Pa. PUC 349 (1985)*' *Pa. P.u.C. v. West Penn Power Company, 59 Pa. PUC 552, 69 PUR4th 470 (1985).*

Based on the above discussion, we find that the current level of the customer charge be maintained in this proceeding. The difference in revenue between that produced under NFG's proposal and that produced under the present charge is to be assigned proportionally to the residential rate blocks to assure revenue neutrality.

D. Small Commercial/Public Authority and Small SVIS Customer Charges

1. NFG Position

NFG proposes to increase the monthly customer **[*350]** charge for the small commercial and public authority class from $ 26.00 to $ 30.00 in this proceeding. NFG also proposes to increase the monthly customer charge for the small SVIS class from $ 68.50 to $ 80.00. NFG M.B., p. 189.

2. OSBA Position

The OSBA objects to NFG's proposed increases to the small commercial and public authority class, and the small SVIS class. It is OSBA's contention that NFG's cost analysis on which these increases are based is flawed. OSBA asserts that the various costs assigned to small commercial customers are two to six times those assigned to residential customers. OSBA M.B., pp. 24-25. It argues that NFG's cost of service allocation methodology does not recognize the similarities between small commercial customers and residential customers, thus resulting in an over-allocation of costs to the small commercial customers. OSBA St. No. 1, pp. 67-70. OSBA provides the following example of this alleged flaw:

In [NFG's response to OSBA Interrogatory No. 9], the Company acknowledged that the number of small commercial services that are the same size and type as residential service is estimated to be 9,210. N.T. 266. This represents more than 70% of the **[*351]** total amount of small commercial customers. N.T. 267. Yet, under NFG's costing methodology, all of the service drops assigned to the Small Commercial/PA class are of diameter 1-7/8" and 2". OSBA Stmt. 1, p. 69. The smaller and less costly service drops are all assigned to the Residential class, despite the actual similarity between the two classes. This is a significant error since the cost of service drops amounts to 73% of the total allocated customer cost for Small Commercial/PA customers. N.T. 267.

OSBA M.B., pp. 25-26. OSBA contends that a small commercial and public authority customer has an annual average usage less than twice that of a residential customer, and most resembles a residential customer as compared to all other customer classes. Id., pp. 27-28.

The OSBA asserts that 73% of NFG's overall proposed increase to the small commercial and public authority class is due to the proposed increase in the customer charge. OSBA argues that this is detrimental to small businesses, which are a critical part of the economic base in NFG's service territory. Id., p. 28. OSBA contends that NFG's present customer charge for small commercial and public authority customers **[*352]** is already the highest in Pennsylvania. Id., pp. 29-30. According to OSBA, the customer charge for this class has experienced an average annual increase of almost twice that of the residential class over the past ten years. Id., pp. 30-31.

Based on its arguments as presented above, it is OSBA's position that the customer charge for the small commercial and public authority class should not be increased, but rather, should be decreased in this proceeding. Id., pp. 31-32. OSBA asserts that the customer charge for this class should be set at 1.5 times that of the residential class, or $ 20.25/month. OSBA further asserts that the customer charge for the small SVIS class should be set at fifty percent of its current level, or $ 34.25/month. OSBA St. No. 1, pp. 78-79.

3. NFG Response

In response to OSBA, NFG argues as follows:

The real difficulty with OSBA's recommendation is that there is essentially no analytical basis for it. OSBA's recommendations are admittedly, judgmental. there are no calculations to support such proposals (N.T. 856). Further, the fact that the results of the customer cost study do not meet OSBA's expectations does not justify the conclusion that **[*353]** the customer cost study is incorrect. The problem may be with OSBA's expectations.

NFG M.B., pp. 189-190. NFG contends that there are differences between small commercial and public authority customers and small SVIS customers on the one hand, and residential customers on the other, which justify different customer charges. These include differences in the size of applicable service lines, the need for protective devices such as poles filled with concrete for commercial and industrial facilities, and more frequent leak detection patrolling in business areas. Id., pp. 190-191. Furthermore, NFG argues that although many small commercial and public authority customers may have usage characteristics similar to those of residential customers, the small commercial and public authority class as a whole includes customers with annual usage up to 1,000 Mcf. Id. For these reasons, NFG asserts that OSBA's recommendations with regard to customer charges should be rejected, and that the Company's proposals should be approved. Id., p. 191.

4. ALJ Recommendation

ALJ Kashi disposed of this issue reasoning as follows:

OSBA's position is based upon its perception that the cost **[*354]** of serving small commercial and industrial customers is much closer to the cost of serving residential customers than is reflected in NFG's proposed customer charges. OSBA provides general examples in an attempt to show that this is so. However, because OSBA did not provide a more rigorous cost of service analysis as an alternative to that of the Company, it is not truly possible to evaluate its claim in this regard. Thus, there is no valid basis on which to accept OSBA's position that the customer charge for the small commercial and public authority class should be 1.5 times that of the residential class, or that the charge for the small SVIS class should be set at fifty percent of its current level. Therefore, we recommend that OSBA's proposals be rejected.

However, with respect to the Company's proposed customer charges for these classes, we note that the cost of service analysis performed by NFG on which these charges are based appears to suffer from the same flaw as NFG's analysis of residential customer costs. That is, the customer cost figures which NFG developed for these small commercial and industrial classes appear to include more than the direct customer costs relating **[*355]** to these classes as defined earlier. See, NFG Ex. 111-E. Furthermore, we note that the percentage increase proposed for the small commercial and public authority customer charge is 15.38%, while that proposed for the small SVIS customer charge is 16.79%. These are in contrast to the Company's overall requested increase of 6.78%. Therefore, we cannot accept NFG's proposed customer charges for these classes.

For the reasons discussed above, we recommend that the customer charges for the small commercial and public authority class and the small SVIS class be held at their present levels of $ 26.00/month and $ 68.50/month, respectively in this proceeding. We further recommend that the difference in the amount of revenue recovery between that produced by the current charges and that which would be produced by NFG's proposed charges be made up in the commodity charges of these respective classes to maintain revenue neutrality.

R.D., pp. 249-250.

5. Conclusion

On consideration of the positions of the parties, we shall adopt the recommendation of the ALJ concerning this issue.

IX. Impact on Customers

At the public input hearings in this case, there was extensive testimony **[*356]** about the impact of NFGD's proposed rate increase upon the communities, businesses, governments and individual customers to which NFGD provides service. OCA sets forth a fair, balanced and comprehensive review of this matter in its Main Brief at pp. 10-27 which we adopt without further attribution. Specifically, the customers of NFGD testified about their inability to afford current or proposed gas rates and the poor economic conditions of their communities. Customers repeatedly testified about their difficulty in affording current gas bills, their inability to pay more and the economic and social problems plaguing their communities. [3]3 Representatives from social service agencies also urged the Commission to reject NFGD's latest rate increase request because their clients simply cannot afford the routine costs of living. [3]4 In addition, governmental representatives and other elected officials appeared at the public input hearings held in Sharon and Erie to indicate their concern for their constituents' economic inability to afford gas bills. [3]5

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Customer testimony from the Sharon and Erie public input hearings indicated that there are social and economic problems in many of the areas served by NFGD, such as Erie, Venango and Mercer Counties and the local communities of Sharon, Farrell, Wheatland, Oil City, Erie, Hermitage, Franklin, and Greenville.

Robert T. Price, Mayor of Sharon, testified about the shutdowns of large industrial businesses in Sharon since the 1980s which has resulted in a massive loss of jobs for many of the people of his community. Sharon P.I. N.T. 15. He testified that 33% of the City's approximately 18,000 people are senior citizens, 65 years of age and older and on fixed incomes. Sharon P.I. N.T. 16. Due to these dire economic circumstances, the City of Sharon has had to

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[3] OTS' capital structure claim can be found at OTS Main Brief, p. 101. OTS accepts NFGD's capital structure claim. OTS M.B. p. 101.

[3] The OTS' common equity rates are found at OTS Main Brief pages 102 and 109. OTS' DCF dividend yield is adjusted as is OTS common equity recommendation. OTS M.B. p. 100 and pp. 109-110.

[3] OTS unadjusted dividend yield for the Moody's barometer group and NFG are found at OTS Statement 1 pages 25-29 and OTS Exhibit 1-A Schedule 6, pages 1 and 2.

find "innovative" ways to run the city to reduce the need to raise taxes and to cut costs. Sharon P.I. N.T. 17. Mayor Price testified that people of all walks of life, not only those on fixed incomes, have had to change their lifestyles to meet the difficult social and economic times. Sharon P.I. N.T. 22. Mayor Price testified:

Is it your testimony that a typical Sharon resident, or at least a resident that you're talking about today, **[*358]** will not be able to afford NFG's rate if the Commission has an increase, or is it that they can't afford them now before the increase?

THE WITNESS: They're telling me they can't afford them now. They don't know what they're going to do when they go up. What sacrifice will they make then? See, they have no rabbits left in their hat either, Ms. Davis. They don't have anything. I have none left in my hat.

Sharon P.I. N.T. 26.

James DeCapua, Executive Director of the Mercer County Regional Council of Governments, testified that a rate increase would be "unconscionable" in a community that is attempting to recover from "devastating losses of employment." Sharon P.I. N.T. 64. Mr. DeCapua testified that affordability must be a consideration in setting rates. Sharon P.I. N.T. 68-69. He testified:

THE WITNESS: Certainly, it has to be. It's one of the primary things. If you're dealing with a public utility and the public can't afford to pay the utility, it's got to be entered into the rate structure, the affordability of the product. It's very important that it be.

Sharon P.I. N.T. 68.

Eugene Pasci, Mayor of Farrell, testified that the City of Farrell and its citizens are a distressed **[*359]** community and that Farrell was the first community to be so designated in Pennsylvania. Sharon P.I. N.T. 73. Mayor Pasci testified that the City of Farrell has responded to these economic conditions by downsizing the scope of its government and sharing services with neighboring governments and communities. He testified that, "The people of this community and this district and their customers cannot afford to have the prices go up by over 50 percent over the last two years." Sharon P.I. N.T. 73-74. He said, "If governments can do it and these senior citizens can hold the line and make do, I think National Fuel Gas and other utility companies can also do the same thing and keep their increases at a level that is affordable and reasonable." Sharon P.I. N.T. 74.

There was testimony that customers who are disabled, on fixed incomes, poor and unemployed are having difficulty affording the basic costs of living. Irene Churlik and Maxine Perry testified that they are on fixed incomes and have seen their gas bills constantly increase over the years, even though they have not increased their consumption and have insulated their homes. Sharon P.I. N.T. 44, 124. Marie Davis testified that she **[*360]** sets her thermometer at 65 degrees and "wears many heavy sweaters in the winter." Erie P.I. N.T. 40. She testified that she conserves as much as possible to keep her gas bills as low as possible. She testified that while NFGD is granted regular rate increases by the Commission, this "exemplary standard of fairness is not granted to the consumer." Id. at 41. She adamantly opposed the rate increase, stating, "The consumer cannot afford to go through another round of rate hikes." Id. at 41.

Public input testimony indicated that even a typical customer, who is not on a fixed income or unemployed, is experiencing hardship at this time and can barely afford gas bills. Ms. Davis testified that she can hardly afford her gas bill now, under current rates, and is struggling to live under very tight budgets. Sharon P.I. N.T. 33. Bill Plyler testified as follows:

We never get a break. The only break we get is to pay, pay more all the time, and I don't think it's right because they're a company making millions of dollars.

They ought to stop and think a little bit at times like this. People are out of work, starving, freezing, and still they want to raise the price of their gas. I'm **[*361]** asking that the PUC deny every cent of it. . . .

Erie P.I. N.T. 80. David Stafford echoed these sentiments:

I think it's outrageous, and I think the working people as well as the senior citizens better start doing something right now, and the people better start getting together and organizing otherwise we're going to let the National Fuel Gas monopoly gouge us.

I don't know what to do. I'm appealing to you, sir, because all of us as citizens deserve the right to be heard and to be understood, and I'm hoping that you will understand that we are hurting. Just as well as the senior citizens, we're hurting, and it just seems like there is no end to it.

Erie P.I. N.T. 97.

Kenneth Springirth, an Erie consumer leader, provided extensive and impressive testimony opposing the specific components of NFGD's rate increase request and addressed the impact of this rate increase on NFGD's customers. Mr. Springirth implored the Commission to consider affordability in this case:

There are many hundreds of families out there that are having a hard time making ends meet. There will be thousands of pages of testimony in this case with statisticians and all kinds of experts crunching all kinds **[*362]** of numbers, but the bottom line, Your Honor, is that people are hurting.

We have a right to expect our utility to act in the public interest at all times. We also have a right to expect that the PUC will look very closely at the affordability side of the equation.

I realize that legislatively the rule book, The Public Utility Code, doesn't talk about the affordability as such, but I don't think you can render any kind of a decision in this case unless and until that affordability issue is considered.

I am appealing to you tonight, on behalf of our people, to look very closely at the human toll that has been taken on our people as a result of increase after increase after increase.

Erie P.I. N.T. 31-32.

There was public input testimony that an increase in NFGD's rates would exacerbate the plight of the poor. The constant increases in the cost of living, including increased gas bills, is an impediment to the poor who are trying to become self-sufficient. Sister Clare Marie Beechner of the Prince of Peace Center, an agency that provides emergency services, testified:

I would just like to, in the name of all those that we see day in and day out, oppose the increases that are suggested. **[*363]** Our main goal is to help the low-income become more sufficient, but the people that come through our doors, they're concerned about their rent, their utilities. They are often not able to even minimally pay their utilities or rent.

Often they come in when they are doing just anything to avoid termination, and they either have to choose between basic necessities or paying their rent or utilities, and often they fall behind because whatever their source of income is, it's just not sufficient.

Sharon P.I. N.T. 89.

Ron Errett, Executive Director of Mercer County Community Action Agency, urged the Commission to consider the impact of a gas rate increase in the context of a variety of things that have happened in his community. Sharon P.I. N.T. 112. Mr. Errett testified that affordability must at least be acknowledged because it is a critical issue. Sharon P.I. N.T. 111. He testified that over the last two years, Community Action has had a two-thirds turnaway rate for energy and housing assistance. N.T. 111-112. Mr. Errett stated that the various increases that are occurring now affect the ability of his clients to buy homes and afford bills. N.T. 112. Mr. Errett testified:

The final **[*364]** thing I guess I would leave you with is an idea. There is a question of balance. I guess that's what you have to resolve here; what is the question of balance of their request versus the consumers' needs.

Sharon P.I. N.T. 115.

Darlene Sherman testified that she is disabled and still has not paid off very high arrearage owed to NFGD. Sharon P.I. N.T. 107. She testified:

I still to this day do not have them paid off because of how much they were, and I do not look forward to ever paying it off because I feel that I will always go from one place to the next that's going to be a place where it is included in the rent.

Unless they can lower it to where I am able to afford it, to where I can go and I can pay the bill . . . I would like to live a nice decent place where I could afford to pay for my gas, but I cannot afford it.

Sharon P.I. N.T. 108.

Representative Michael C. Gruitza, through a staff member, made a statement at the Sharon public input hearing that requested "the strictest of scrutiny" of the proposed rate increase because his constituents "simply cannot afford what is being asked of them." Sharon P.I. N.T. 36. Rep. Gruitza requested the Commission "do everything **[*365]** possible to limit future rate hike requests, including this one." Id.

Rep. Gruitza's office also submitted into the record resolutions from most of the local governments in NFGD's service territory demanding a rate freeze on natural gas costs. See Gruitza Exh. 1. The resolutions included in Rep. Gruitza's exhibit were from Mercer County, City of Hermitage, Borough of Mercer, Borough of Clark, City of Farrell, Lackawannock Township, Hempfield Township and Township of Shenango. In sum, these resolutions objected to the "uncontrolled escalation" of NFGD's rates (and that of other utilities in Pennsylvania); noted the financial burden and hardship upon their communities; urged the legislature to institute changes in the current public utility laws and regulations; and supported the regulatory price control of public utilities to protect the welfare of "captive customers" since competitive price control is nonexistent in a monopoly industry. Id.

From the public input testimony summarized above, it is apparent that the impact of NFGD's rates on consumers must be considered in this proceeding. Clearly, it is a relevant factor to be considered in determining what rate relief **[*366]** should be afforded NFGD.

The Company has considered non-cost factors such as customer impact in making its rate filing. In particular, NFGD provided testimony that addressed the effect of rate levels upon customers. [3]6 NFGD witness Sprague testified that Distribution's sales levels are dependent upon the success of its customers. Therefore, customer impact is an important consideration. He testified:

To the extent that customers are successful, jobs may be created or retained which affects the overall economic viability of the marketplace. Therefore, Distribution's objective has been, and continues to be, to provide its product at a price or rate which enables its customers to compete. Distribution works closely with its customers to assist them in achieving their competitive goals.

[*367]

NFGD St. 12 at 2.

NFGD witness Wright testified that, while the Company is "concerned" about the impact of rates upon residential customers, this consideration is made primarily for NFGD's competitively situated industrial customers. N.T. 1034. The same consideration is "not necessarily" made for residential customers. N.T. 1034-1035.

NFGD witness Figliotti testified about "customer considerations" that are factored into Distribution's rate design process. NFGD St. 102 at 14. Mr. Figliotti mentioned market conditions, the general economic environment and competition as examples of factors relevant to rate design. Id. However, it is clear that in this proceeding, NFGD only applied these customer considerations when designing rates and determining revenue requirement for its competitive load.

The OCA submits that the Commission has frequently relied on non-cost factors in determining the appropriate design of rates and revenue requirement and the appropriateness of reliance on such factors is well-established. For example, objectives such as conservation, value of service, and gradualism with respect to the residential customer charge have been and should be considered by **[*368]** the Commission, as OCA witness Ruback testified. OCA St. 2 at 32. The OCA submits that the objective of affordability is equally important and should be carefully considered by the Commission in this proceeding.

The OCA has not proposed a specific "affordability" adjustment in this case. The OCA, however, urged that this Commission consider impact on consumers -- as demonstrated by the powerful public input testimony -- as decide each and all of the issues in this case. We believe that the instant Opinion and Order will effect a balancing of the interests of all the parties, mindful of the impact on NFGD consumers.

X. MISCELLANEOUS

A. Introduction

On July 16, 1994, an evening public input hearing was held in Erie, Pennsylvania. There, certain individuals, including Mr. Kenneth C. Springirth, criticized Distribution and presented certain proposals. Distribution presented evidence, at pages 47 to 54 of Mr. Higley's rebuttal testimony, Statement No. 205, explaining that Mr. Springirth's proposals are incorrect, speculative and/or not relevant. Further, similar proposals made by Mr. Springirth have been rejected previously by the Commission in Distribution's last five base-rate **[*369]** proceedings at Docket Nos. R-850287, R-870719, R-891218, R-901670 and R-932548. See, e.g., *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 73 Pa. P.U.C. 552, 623-624 (1990);* *Pa. P.U.C. v. National Fuel Gas Distribution Corp., 72 Pa. P.U.C. 1, 85-86 (1989);* and Pa. P.U.C. v. National Fuel Gas Distribution Corp., Docket No. R-911912 (July 30, 1992), where Mr. Springirth's proposals were rejected without comment. Similar proposals were also rejected by the Commission in Distribution's most recent base-rate case. Pa. P.U.C. v. National Fuel Gas Distribution Corp., Docket No. R-932548 (December 1, 1993), at p. 13. The material presented at the public input hearing provides no basis for adjusting Distribution's rates or revenue requirement or for granting any of the proposals.

At pages 261-269 of the R.D., AKJ Kashi disposes of various contentions of Kenneth C. Springirth, a consumer advocate and ratepayer of NFGD. On consideration of the R.D., we adopt the ALJ's conclusion therein, without fully endorsing his reasoning.

B. IOGA's Exceptions

IOGA seeks Commission review of the requirement that transportation customers purchase firm upstream transportation and **[*370]** excepts to the fact that the ALJ did not address this issue. IOGA argues that the Monthly Metered Transportation ("MMT") tariff rate [3]7 is requiring that transportation customers purchase firm or enhanced firm transportation services from NFG's interstate pipeline affiliate. IOGA urges that the MMT tariff became an issue in this proceeding as a result of the tariff being approved on July 29, 1994. NFG, OCA and OTS do not support IOGA's position.

The issue raised by IOGA is not part of the record in this proceeding but rather was disposed of by the Commission in the 1994 1307(f) docket. It should be noted that IOGA was denied intervention in that proceeding since the intervention was untimely. A subsequent Petition for Reconsideration in that docket was also denied.

The record in the instant proceeding was closed on July 28, 1994. The MMT Tariff rate was approved on July 29, 1994. No Petition to Reopen the record was filed by any party. The issue of the MMT tariff was first raised in IOGA's Exceptions. IOGA participation in this rate **[*371]** proceeding was perfunctory at best. Once IOGA's intervention was granted its participation in the instant proceeding ceased. IOGA did not present evidence, cross-exam witnesses, file a brief or in any way develop the record on the MMT Tariff rate. .

IOGA seeks to challenge an Opinion and Order of the Commission and as such bears the burden of proof under Section 332 (a) regarding the factual allegations raised. IOGA has failed to carry this burden of proof. Rather, IOGA is merely attempting to collaterally attack the valid Opinion and Order in the 1994 1307(f) proceeding.

Based on the above discussion, we find that IOGA's Exception is without merit and denied.

XI. ORDER

In light of the above, we, hereby find that the Company should be allowed an annual operating revenue increase of no more than $ 4.754 million. Additionally, its proposed allocation of that increase should be made consistent with our proposed revenue allocation discussed above. Finally, the Company's proposed Weather Normalization Clause is, hereby, rejected;

THEREFORE IT IS ORDERED:

1. That National Fuel Gas Distribution Corp. shall not place into effect the rates in Supplement No. 39 to Tariff Gas-Pa.No. **[*372]** 8, the same having been found to be unjust and unreasonable, and therefore, unlawful.

2. That Distribution is granted special permission to file a tariff or tariff supplement containing rates that are designed to increase Distribution's annual operating revenues by $ 4.754 million over the level of operations for the twelve months ending Nov. 30, 1994, as adjusted for ratemaking purposes, to become effective for service rendered on, and after December 7, 1994.

3. That the rates contained in the tariff to be filed shall allocate the increase in a manner consistent with this Order.

4. That Distribution's Weather Normalization Cause be and is hereby rejected.

5. That the formal Complaints against the proposed increase filed at dockets: R-00942991C001 through R-00942991C020 be and are hereby sustained or denied to the extent consistent with the decision.

6. That the Commission investigation at Docket No. R-00942991 be and is hereby terminated and the Secretary is directed to mark the docket closed.

TABLE I

National Fuel Gas Distribution Corporation

Income Summary

$ 000

	Pro-Forma Present Rates		**Pro-Forma Present Rates (Revised)**
	1	1	1
Operating Revenue	$ 235,612	($ 411)	$ 235,201
Expenses			
Operating & Maintenance Expense	193,842	(2,121)	191,721
Depreciation and Amortization	10,204	54	10,258

[1] NFGD's capital structure claim can be found at NFGD's Main Brief, p. 151.

	Pro-Forma Present Rates		Pro-Forma Present Rates (Revised)
	1	1	1
Taxes			
Other Than Income Taxes	13,936	(91)	13,845
State Income Tax	749	155	904
Federal Income Tax	1,837	444	2,281
Deferred Tax & ITC Amort.	2,029	(2)	2,027
Total Expenses	$ 222,597	($ 1,561)	$ 221,036
Net Income Available for Return	$ 13,015	$ 1 150	$ 14,165
Rate Base	$ 216,907	($ 196)	$ 216,711
Rate of Return	6.00%		6.54%

[*373]

	Commission Adjustments	Adjusted Present Rates	Commission Revenue Adjustments
Operating Revenue	$ 1,255	$ 236,456	$ 4,754
Expenses			
Operating & Maintenance Expense	(3,882)	187,839	90
Depreciation and Amortization	(216)	10,042	0
Taxes			
Other Than Income Taxes	13	13,858	238
State Income Tax	669	1,573	531
Federal Income Tax	1,711	3,992	1,363
Deferred Tax & ITC Amort.	(45)	1,982	0
Total Expenses	($ 1,750)	$ 219,286	$ 2,222
Net Income Available for Return	$ 3 005	$ 17,170	$ 2,532
Rate Base	($ 6,892)	$ 209,819	$ 0

	Commission Adjustments	Adjusted Present Rates	Commission Revenue Adjustments
Rate of Return		8.18%	

	Total Allowable Revenue
Operating Revenue	$ 241,210
Expenses	
Operating & Maintenance Expense	187,929
Depreciation and Amortization	10,042
Taxes	
Other Than Income Taxes	14 096
State Income Tax	2,104
Federal Income Tax	5,355
Deferred Tax & ITC Amort.	1,982
Total Expenses	$ 221,508
Net Income Available for Return	$ 19 702
Rate Base	$ 209,819
Rate of Return	9.39%

TABLE II

National Fuel Gas Distribution Corporation

Summary of Adjustments

$ 000

Adjustments	Rate Base	Revenue	Expense
RATE BASE			
Cash Working Capital	($ 1,654)		
CWC O & M and Taxes	($ 303)		
CWC Interest & Dividends	$ 12		

Adjustments	Rate Base	Revenue	Expense
Post FTY Plant in Service	($ 3,521)		
Depr Post FTY Retirements	($ 877)		
Def FIT on Post FTY Adj	$ 45		
Depr on Payroll Adjust	$ 10		
Def. FIT on Cont			
REVENUES			
Degree Days		$ 1,255	
LIRA Related Revenue		$ 0	
EXPENSES			
Payroll	($ 604)		($ 1,094)
Inflation Adjustment			($ 442)
Advertising			($ 549)
Rate Case Expense			($ 122)
Def Post-Retirement Benefits	$ 0		$ 0
R & D Expenses			($ 80)
Take-or-Pay			($ 337)
Satellite Dispatch			($ 196)
AM/FM/GIS Program			($ 185)
Deferred Order 636 Costs			($ 100)
Corporate Charges			($ 213)
Injuries and Damages			($ 21)
Management Audit			($ 100)
IRS Audit Interest Expense			($ 443)
TAX EXPENSE			
Sales and Use Tax			
Interest Synchronization			
TOTALS	($ 6 892)	$ 1,255	($ 3 882)

[*374]

Adjustments	Depreciation	Taxes - Other	State Income Tax
RATE BASE			
Cash Working Capital			
CWC O & M and Taxes			
CWC Interest & Dividends			
Post FTY Plant in Service	($ 196)		$ 24
Depr Post FTY Retirements			
Def FIT on Post FTY Adj			

Adjustments	Depreciation	Taxes - Other	State Income Tax
Depr on Payroll Adjust	($ 20)		$ 2
Def. FIT on Cont			
REVENUES			
Degree Days		$ 63	$ 143
LIRA Related Revenue		$ 0	$ 0
EXPENSES			
Payroll			$ 131
Inflation Adjustment			$ 53
Advertising			$ 66
Rate Case Expense			$ 15
Def Post-Retirement Benefits			$ 0
R & D Expenses			$ 10
Take-or-Pay			$ 40
Satellite Dispatch			$ 24
AM/FM/GIS Program			$ 22
Deferred Order 636 Costs			$ 12
Corporate Charges			$ 26
Injuries and Damages			$ 3
Management Audit			$ 12
IRS Audit Interest Expense			$ 53
TAX EXPENSE			
Sales and Use Tax		($ 50)	$ 6
Interest Synchronization			$ 27
TOTALS	($ 216)	$ 13	$ 669

Adjustments	Federal Income Tax	Deferred Income Taxes
RATE BASE		
Cash Working Capital		
CWC O & M and Taxes		
CWC Interest & Dividends		
Post FTY Plant in Service	$ 60	
Depr Post FTY Retirements		
Def FIT on Post FTY Adj		($ 45)
Depr on Payroll Adjust	$ 6	
Def. FIT on Cont		

Adjustments	Federal Income Tax	Deferred Income Taxes
REVENUES		
Degree Days	$ 367	
LIRA Related Revenue	$ 0	
EXPENSES		
Payroll	$ 337	
Inflation Adjustment	$ 136	
Advertising	$ 169	
Rate Case Expense	$ 37	
Def Post-Retirement Benefits	$ 0	
R & D Expenses	$ 25	
Take-or-Pay	$ 104	
Satellite Dispatch	$ 60	
AM/FM/GIS Program	$ 57	
Deferred Order 636 Costs	$ 31	
Corporate Charges	$ 65	
Injuries and Damages	$ 6	
Management Audit	$ 31	
IRS Audit Interest Expense	$ 137	
TAX EXPENSE		
Sales and Use Tax	$ 15	
Interest Synchronization	$ 68	
TOTALS	$ 1,711	($ 45)

[*375]

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